

The African Development Bank

**Guidelines for Financial
Management and Financial
Analysis of Projects**

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This operational policy document is a revised version of *The African Development Bank Group Guidelines for Financial Management and Financial Analysis of Projects* that were approved by the Boards of Directors of the African Development Bank Group on 27 November 2000. It is intended primarily to guide Bank staff and other personnel of the Bank Group in their identification, preparation, implementation, monitoring and evaluation of Bank Group programs and projects in the Regional Member Countries.

It was prepared by the Operations Policies and Review Department, C.K. Muthuthi (Task Manager), O. Fajana (Manager of POPR.3 until July 2005) and G. Negatu (Acting Manager of POPR.3 after July 2005), under the overall guidance of P. Afrika (Director of the Department). As per Bank procedures, it was first reviewed internally by a Bank-wide taskforce, followed by an Inter-Departmental Working Group and subsequently by a Senior Management Committee, whose observations were incorporated into the guidelines submitted to the Board of Directors of the Bank Group.

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Foreword

As the premier financial development institution in Africa, the African Development Bank (the Bank) has, since its establishment in 1964, dedicated to financing the highest quality projects and programmes that maximize its development impact. To enable it to achieve this objective the Bank has mainstreamed good governance into its operations, in a manner consistent with its charter, mandate, and development priorities. To this regards, the Bank Group issued in 1999 its Policy on Good Governance that reflects the growing consensus that good governance is an essential element of sound and sustainable development.

As part of the implementation process for its good governance practices, the Bank's Board approved in 2000, *The African Development Bank Group Guidelines for Financial Management and Financial Analysis of Projects*. As a requirement, borrowers are asked to confirm that sound financial management will be a primary objective of investment operations by the efficient employment of appropriate modern financial management systems and techniques in the design, implementation and operation of investments to be supported by Bank loans. The support by borrowers for efficient financial management is to be further evidenced by the provision and regular use of effective financial and performance measurement and reporting systems acceptable to the Bank.

In 2004, the Bank launched a Bank-wide program to promote project quality from inception to completion. Within this context the Bank has undertaken a major review of the 2000 *Guidelines* to ensure that they mainstream operations excellence and reflect current developments in financial management and analysis practices. In December 2004, a Bank-wide taskforce was appointed, under the leadership of the Governance Division, of the Operations Policies & Review Department (POPR) to guide the revision process. The review process, lasting over nine months, was carried out in consultation with all concerned divisions, units and departments. The taskforce was supported by a consultant. The revision process was significantly informed by the Showcase Project Initiative (SPI) that was launched by the Bank under the stewardship of CHRM, and the coordination of FFMA.

These revised *Guidelines* are an outcome of the review process. They reflect changes in Bank mandate on governance and its policies and procedures since 2000. They outline the Bank's policy, approach and philosophy to financial management of Executing Agencies (EAs) and financial analysis of projects and programmes financed through the Bank's public sector lending window.

These Guidelines have been prepared for the benefit of Bank staff and others including consultants who evaluate financial management practices of EAs and conduct financial analysis of projects and programmes. They are available on the web and in a CD-ROM. This hardcopy version omits a significant portion of the information available in the Knowledge Management Chapter of the CD-ROM version.

The advice, directions and recommendations in the *Guidelines* should not be regarded as a substitute for initiative. This recognizes that the Bank deals with countries and sectors that are at different stages of development and that have different resource and staff constraints. Because of these constraints, the *Guidelines should be* applied in a realistic, practical, and flexible manner. Importantly, Bank staff should at all times exercise resourcefulness and imagination in reaching sound professional judgments.

African Development Bank.

Acronyms & Table of Contents

ACRONYMS

The following acronyms are used in these Guidelines:

ACCA	Association of Chartered Certified Accountants		(issued by IASB)
ACFD	Anti-corruption and Fraud Investigation Division	IMF	International Monetary Fund
AfDB	African Development Bank	INTOSAI	International Organization of Supreme Audit Institutions
ADF	African Development Fund	IOSCO	International Organization of Securities Commissions
AMINA	ADF Microfinance Initiative for Africa	IPSAS	International Public Sector Accounting Standard (issued by IPSASB)
APRM	African Peer Review Mechanism	IPSASB	International Public Sector Accounting Standards Board
AR	Appraisal Report	ISA	International Standard on Auditing (issued by IAPC)
AsDB	Asian Development Bank	MDB	Multilateral Development Bank
AUDT	Internal Audit Department	MFI	Microfinance Institution
BASAL II	New Basel Capital Accord	MIGA	Multilateral Investment Guarantee Agency
BCBS	Basle Committee for Banking Supervision (BIS)	MOF	Ministry of Finance
BIS	Bank for International Settlements	NEPAD	New Economic Program for Africa's Development
BOO	Build-Own-Operate	NGO	Non-government Organization
BOT	Build-Own-Transfer	NPV	Net Present Value
BWIs	Bretton Woods Institutions	OAG	Office of the Auditor General
CAMELS	Capital adequacy, Assets, Management quality, Earnings, Liquidity, and Sensitivity	OCCF	Oversight Committee on Corruption and Fraud
CAR	Capital Adequacy Ratio	OCR	Ordinary Capital Resources
CBOs	Community Based Organizations	OECD	Organization for Economic Cooperation and Development
CFAA	Country Financial Accountability Assessment	OM	Operations Manual
CGP	Country Governance Profile	PBL	Policy Based Lending
CHRM	Human Resources Department, AfDB	PCR	Project Completion Report
CGAP	Consultative Group to Assist the Poorest	PEARLS	Protection Effective financial structure, Asset quality, Rates of return and costs, Liquidity and Signs of growth
COSTAB	Standard Project Cost Table	PEFAR	Public Expenditure and Financial Review
CPAR	Country Procurement Assessment Review	PERs	Public Expenditure Reviews
CSOs	Civil Society Organizations	PFM	Public Financial Management
DAC	Development Assistance Committee	PFM-PR	PFM Performance Report
EA	Executing Agency	PIU	Project Implementing Unit
ED	Exposure Draft	POPR	Operations Policies & Review Department, AfDB
EIRR	Economic Internal Rate of Return	PPTA	Project Preparatory Technical Assistance
FCDD	Financial Charges During Development	PRSP	Poverty Reduction Strategy Papers
FFMA	Financial Management Department, AfDB	RBCSP	Results-Based Country Strategy Paper
FI	Financial Intermediary	RMC	Regional Member Country
FIL	Financial Intermediary Loan	ROR	Rate of Return
FMQ	Financial Management Questionnaire	SAI	Supreme Audit Institution
FNPV	Financial Net Present Value	SFR	Self-Financing Ratio
FIRR	Financial Internal Rate of Return	SI	Sensitivity Indicator
FOCC	Financial Opportunity Cost of Capital	SME	Small or Medium-scale Enterprise
GAAP	Generally Accepted Accounting Principles	SOE	Statement of Expenditure
GDP	Gross Domestic Product	SPI	Showcase Project Initiative
GECL	General Council and Legal Services, AfDB	SV	Switching Value
GNP	Gross National Product	SWAp	Sector Wide Approach
HLF	High Level Forum	TA	Technical Assistance
IA	Implementing Agency	TAF	Technical Assistance Fund
IAASB	International Auditing and Assurance Board (IFAC)	TOR	Terms of Reference
IAD	Internal Audit Division	VaR	Value at Risk
IAPC	International Auditing Practices Committee (IFAC)	VAT	Value Added Tax
IAPS	International Auditing Practice Statement (issued by IAPC)	WACC	Weighted Average Cost of Capital
IAS	International Accounting Standard (issued by IASB)	WCCU	World Council of Credit Unions
IASB	International Accounting Standards Board (formerly IASC)	WTO	World Trade Organization
IFAC	International Federation of Accountants		
IFI	International Financial Institution		
IFRS	International Financial Reporting Standard		

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Introduction

1. INTRODUCTION

1.1 OVERVIEW

Preamble

1.1.1 The African Development Bank is the premier financial development institution in Africa dedicated to combating poverty and improving the lives of the people of the continent and engaged in the task of mobilizing resources towards the economic and social progress of its regional member countries (Bank Group vision). The Bank Group comprises the African Development Bank (the Bank), the African Development Fund (ADF) and the Nigeria Trust Fund (NTF). The Bank recognizes that good governance is essential for sustained pro-poor growth and social and human development of the continent. This vision reflects the belief that unleashing the potential of the poor will substantially contribute to overall growth and enhance the quality of life for all.

1.1.2 The African Development Bank's Guidelines for Financial Management and Financial Analysis of Projects describe and explain the Banks' policies, procedures and approaches to the financial management and analysis of projects and programmes that the Bank finances. The Guidelines are intended to ensure the sustained operations of entities that implement projects and programmes within the Bank's public sector operations. They do not apply to the Bank's private sector lending window that has separate policies and guidelines, as well as approaches. The Guidelines replace the Bank's Guidelines on the Financial Management and Financial Analysis of Projects that were approved by the Board in 2000.

1.1.3 The Bank has launched a number of initiatives to improve quality of projects, from inception to completion. Examples include the Quality at Entry Assessment (QEA) and the Showcase Projects Initiative (SPI). These Guidelines are complementary to such initiatives and incorporate state-of-the-art financial management and financial analysis practices adopted by the Bank as a direct outcome of its quality of projects initiatives. In addition, they reflect the results of both the 2005 Paris Declaration on Aid Effectiveness and the 2003 Rome Declaration on Harmonization as well as financial management and financial analysis practices adopted by other Multilateral Development Banks (MDBs) where these are in harmony with the Bank's practices.

1.1.4 A separate *'Handbook for Borrowers on Financial Management and Financial Analysis of Projects Financed by the African Development Bank'* that will summarize the policies and procedures contained in these Guidelines will be developed. The Handbook will benefit borrowers, EAs, auditors, task managers, consultants, and others whose work requires them to be familiar with the Bank Group's policies and procedures.

1.1.5 For purposes of these Guidelines, unless otherwise indicated, "African Development Bank" (or Bank) means the African Development Bank, the African Development Fund, and the Nigerian Trust Fund. Also, unless stated otherwise, the requirements for executing agencies also apply to implementing agencies. "Loan" means a loan, credit or grant made available by the Bank.

Rationale

1.1.6 These Guidelines represent one of several initiatives that the Bank is taking to address poverty alleviation through improved financial management and financial analysis of projects it finances. The following key factors are driving this initiative:

- The Agreement Establishing the African Development Bank and the Agreement Establishing the African Development Fund require that the “*Bank shall make arrangements to ensure that the proceeds of any loan made or guaranteed by it are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency*”¹ The Agreement, also, requires that the Bank be guided by sound banking principles in its operations. Accordingly, the Bank has adopted specific requirements for financial reporting and management in relation to its loans and equity investments, including the borrower’s executing agencies.
- The international community, including the Bank, is supporting the development of guidelines, standards, and codes in relation to good financial management and governance. These guidelines, standards, and codes – to varying degrees – all involve improved accounting and auditing arrangements. They include *Principles of Corporate Governance* (OECD); *Harmonizing Donor Practices for Aid Effectiveness* (OECD); *Code of Good Practices on Fiscal Transparency* (IMF); *Code of Good Practices on Transparency of Monetary and Financial Policies* (IMF); *Implementation of the Objectives and Principles for Securities Regulation Assessment Surveys* (IOSCO); *International Accounting Standards* (IASB); *International Standards on Auditing* (IAASB); International Public Sector Accounting Standards (IPSASB) and *Banking Supervision Guidelines* (BCBS).
- The Bank issued its *Bank Group Policy on Good Governance* in December 1999. Over the last few years, the Bank has given due recognition to the issue of good governance for two main reasons. First, from a broader perspective, good governance, which promotes accountability, transparency, rule of law and participation and combats corruption, is central to creating and sustaining an enabling environment for development. Second, from the Bank’s perspective, good governance is inextricably related to the efficacy of the investment that the Bank helps to finance, and is in line with the Bank’s vision for sustained development for the continent into the 21st Century.

1.1.7 This is the second release of the African Development Bank’s Guidelines for Financial Management and Financial Analysis of Projects. The new Guidelines incorporate lessons learned by the Bank since it issued the first set of guidelines in 2000, and reflects the ongoing activities associated with the Harmonization Agenda².

¹ Agreement Establishing the African Development Bank, Article 17 (h) and the Agreement Establishing the African Development Fund, January 1981, Article 15, paragraph 5.

² In February 2003, a Harmonization Forum was jointly sponsored by five MDBs (African Development Bank, Asian Development Bank, European Bank for Reconstruction and Development, Inter-American Development Bank, and World Bank) and the Development Assistance Committee of the Organization for Economic Co-operation and Development (OECD-DAC). All MDB presidents attended the meeting. The closing statement, the Rome Declaration on Harmonization, Rome, Italy February 25, 2003, summarized progress and committed all participating institutions to specific activities to enhance harmonization. Subsequent to the Forum, the Islamic Development Bank joined the harmonization effort. In addition, an MDB Technical Working Group on Financial Management Harmonization was formed to foster increasing harmonization among the MDBs. On March 2, 2005, the Paris Declaration on Aid Effectiveness, Paris, France, was issued, to move forward the harmonization efforts.

1.1.8 The Harmonization Agenda has, at its core, the objective of improving aid effectiveness by reducing the transaction costs to the recipient country. Improved financial management systems, at the country level, and agreement from development partners to rely on these systems to the greatest extent possible are critical to the harmonization efforts. The Development Assistance Committee of the Organisation for Economic Co-operation and Development (OECD-DAC) has developed a number of good practice notes, including the Good Practice Paper on Financial Reporting and Auditing (December 2002) and the MDB Technical Working Group on Financial Management Harmonization have developed the *Framework for Collaboration Among Participating MDBs on Financial Reporting and Auditing* (February 2003).

1.1.9 These revised Guidelines serve two purposes. First, they provide guidance to Bank staff, consultants, and borrowers on the financial due diligence activities to be completed as part of the project appraisal process, namely financial analysis and financial management assessment. Second, they describe and explain Bank's policies, procedures, and approach to the financial management of the projects/programmes that it finances. In addition to providing guidance on Bank's financial due diligence activities, the Guidelines contain business processes and good practice examples of financial management and financial analysis practices adopted by the Bank and other Multilateral Development Banks (MDBs).

Objectives

1.1.10 The objective of these Guidelines is to provide Bank management and staff, borrowers, co-financiers and investors with a comprehensive and understandable directory of standards of financial management and financial analysis for the assessment, implementation and operation of Bank funded projects, including:

- Detailed guidance covering standards of financial management of EAs and/or individual projects,
- Fundamental parameters, designs and measurement techniques to apply to the financial analyses of EAs and/or individual projects, and
- An innovative knowledge management section that includes financial tools, checklists and reference documents for use during the financial analysis and financial management assessment of projects and programmes.

1.1.11 The Guidelines will ensure that persons charged with providing the analysis required by the Bank have immediate access to the most effective and up-to-date tools for undertaking and completing their assignments by:

- Defining financial management requirements for the assessment of projects and borrower entities, EAs, investees and other organizations seeking Bank funding,
- Establishing norms for financial analysis of revenue earning and non-revenue earning projects,
- Achieving consistency in the presentation of findings and recommendations by Bank staff and borrowers in studies, reports and documents for which these forms of assessment and analysis are required,
- Explaining to borrowers the Bank's project and institutional financial performance requirements to achieve successful implementation of projects and sustainability of ongoing operations, and
- Providing a knowledge management section for the guidance and training of Bank staff and borrowers.

1.1.12 The Bank’s financial analysts as well as borrowers’ and investees’ financial staff should at all times have access to these guidelines. The aim, in this regard, is to ensure that each project and entity is well maintained financially, and that borrowers, investees and Bank staff have access to identical information and guidance.

1.1.13 These Guidelines recognize that the analysis of projects should be carried out through an integrated approach including a thorough evaluation of the physical, economic, financial, stakeholder and risk aspects of each project in a single consistent framework or model. These guidelines holistically addresses project appraisal from a financial perspective and integrates the financial analysis of projects within the overall financial framework and financial management of the Executing Agency (EA). The financial implications of the physical solution chosen are addressed in the financial evaluation of the project, while the net financial benefits of the project are subjected to sensitivity analysis and discussed in the appraisal report. The evaluation of the economic and stakeholder aspects of projects are, however, outside the scope of these Guidelines and are addressed in the “Guidelines for Economic Analysis and Design of Bank Group Projects”. It is, however, imperative that during project appraisal, the teams conducting the economic and financial analysis of projects work closely together to ensure that economic analysis is built directly upon the financial cash flows of the project that has undergone a rigorous assessment in line with the requirements of these Guidelines.

1.1.14 The Guidelines are prepared from the point of view that at each stage of the Bank’s project cycle – from the identification of a project, followed consecutively by its preparation, appraisal, negotiation, supervision and issuance of a completion report, and, where appropriate, by a post-evaluation report – appropriate financial analysis and management techniques are adapted to suite each sector in which the Bank operates and to generate management information for timely decision making. This includes, where necessary, the identification by Bank staff of the need for design and installation of suitable financial management systems by borrowers to assure all interested parties that the project will have reasonable and continuing prospects of financial viability. Financial viability needs to be confirmed by timely, accurate financial reporting by borrowers and investees and by timely and rigorous project supervision by financial analysts.

1.1.15 The Bank’s public sector project portfolio contains a wide array of projects ranging from revenue-earning operations to non-revenue-earning operations; financial intermediaries (FIs); utilities and transportation entities, as well as many specialized entities associated with agriculture. It is impossible for any set of guidelines, such as these ones, to provide guidance for all situations that a financial analyst is likely to face. These Guidelines will, therefore, require adaptation of financial management and financial analysis techniques to meet specialized needs. These adaptations include sector and project-specific financial analysis, financial performance measurement, design and operation of financial management systems, including accounting, financial reporting and auditing systems.

1.1.16 The advice, directions, and recommendations in these Guidelines should not be regarded as a substitute for initiative on the part of Bank staff, which should always be exercised when situations arise that require resourcefulness, imagination and sound professionalism.

1.2 USER INFORMATION

Preamble

1.2.1 This section of the Guidelines begins by describing the Bank’s operational lending approaches (lending modalities). It then proceeds to describe how these Guidelines apply. The

resulting classification provides a basis for identifying step-by-step financial management requirements throughout the project cycle. In doing so readers can quickly, by first referring to this section, identify what needs to be done, by whom, and by when. The section concludes by introducing the structure of the Guidelines.

Bank Lending and Technical Assistance

1.2.2 The Bank makes loans from its Ordinary Capital Resources (OCR), from the African Development Fund (ADF) and from the Nigeria Trust Fund (NTF). The ADF and NTF are designed to provide loans on concessional terms to Regional Member Countries (RMCs) with low per capita gross national product (GNP) and limited debt repayment capacity. The ADF is maintained by regular member contributions. The Bank also provides technical assistance from its own resources and from special funds.

1.2.3 The Agreement Establishing the Bank permits it to make, participate in, or guarantee loans to its RMCs, or their governments, to any of their agencies or political subdivisions, and to public or private enterprises operating within such countries, as well as to international or regional entities concerned with economic development in the region. Loans are made only for projects or programs of high developmental priority.

1.2.4 The Bank has three primary public sector types of lending:

- **Project Loans:** Among other things, project lending is aimed at developing energy, agriculture, transport and communications, and other basic infrastructure as well as health, education, and finance.
- **Sector-Wide Approach (SWAp):** The purpose of a SWAp is to assist in the development of a specific sector (or sub-sector) by financing part of an investment program in that sector. A SWAp is expected to improve sector policies and strengthen institutional capabilities. Technical assistance may be given for project preparation, sector studies, and/or institution building, prior to, or together with, the provision of the SWAp.
- **Program Loans:** Program loans are given by the Bank to assist an RMC in supporting its budget as a whole while focusing policy dialogue on improving a sector's performance through appropriate policy and institutional improvements over the medium to long term. Advisory technical assistance may be attached to a program loan to further study unresolved policy issues or to strengthen the capacity of key sector institutions. Although program lending differs from project lending in objectives, the procedural and administrative steps in processing a program loan are generally the same as those for projects.

1.2.5 The Bank's Technical Assistance (TA) is classified into four development activities:

- **Project preparatory technical assistance (PPTA)** for assisting in the preparation of one or more projects including a program loan or a SWAp, for financing by the Bank and cofinancing by other external sources,
- **Project implementation technical assistance** for assisting in the implementation, operation, and management of a Bank-financed project,
- **Advisory technical assistance** for financing institution-building; plan-formulation; and sector, policy, or issues-oriented studies, and
- **Regional technical assistance**, covering more than one RMC.

1.2.6 The Bank encourages cofinancing. The cofinancing strategy comprises: (i) maximizing the amount of cofinancing from other official funding agencies, and (ii) increasing the flow of

private capital through cofinancing to RMCs. The purpose of this strategy is to maximize the impact of the Bank's assistance in the development of its RMCs and to mobilize additional resources for such development. Cofinancing funds come from (i) official funding agencies; (ii) export credit agencies; and (iii) commercial finance institutions.

Applying these Guidelines

1.2.7 The provisions of these Guidelines apply to investment projects and project executing and implementing agencies within the public sector³. Consequently, they relate mainly to identifiable investment activities that have been undertaken with support from project, and sector loans. However, the provisions of these Guidelines will also apply where program loans include discrete, identifiable investment components.

1.2.8 These Guidelines are also relevant to PPTAs. PPTAs are designed and implemented prior to the beginning of a program or project. PPTA resources should be used to include appraisal of the financial aspects of projects and the financial management of project executing agencies and, where necessary, to develop sufficient financial management capacity to implement and manage projects.

1.2.9 The Bank's activities are guided by policies and guidelines that have been approved by its Board and operationalized through the Operations Manual (OM). In the event of any differences between these Guidelines and the OMs, the OMs take precedence.

Project Types and General Treatments

1.2.10 These Guidelines effectively classify projects, executing agencies, and implementing agencies into two distinct groups: (i) non-revenue earning; and (ii) revenue-earning (including public sector, and financial intermediaries). The Bank, together with other international financial institutions (IFIs), is actively encouraging borrowers and EAs to adopt uniform standards of accounting and financial reporting. However, some time will be required to achieve a high level of uniformity.

1.2.11 In the case of non-revenue-earning EAs, the Bank expects sound financial policies, adequate accounting records, proper internal control systems, timely reporting to management, and sound and timely auditing.

1.2.12 The Bank requires revenue-earning EAs to follow International Financial Reporting Standards (IFRS)/International Accounting Standards (IASs). The Bank, however, recognizes that certain RMCs follow national accounting standards and practices, with the eventual objective of moving towards IFRS/IAS compliant accounting policies, as capacity allows and the situation warrants. Given the varying levels of RMC development, it will take time to improve financial reporting practices to international standards and best practices. Financial analysts should determine during project processing the extent to which international standards are used by the executing agency and/or the project as the basis for accounting and reporting, taking into account

³ Several provisions of these Guidelines apply to identifiable investment activities that have been financed through the Bank's private sector loans. There are, however, many aspects of the Bank's private sector operations that the financial management concepts introduced in these Guidelines do not apply, for example, as regards investment projects that involve equity participation and venture capital. It is hoped that in future updates, these Guidelines will be strengthened to take account of developments in the private sector lending window of the Bank.

the country's capacity and capability. In exercising this discretion, financial analysts are responsible for ensuring that the Bank's funds are utilized for the purpose intended and in an effective and efficient manner.

An Overview of Project Processing Steps

1.2.13 Once a project is identified by agreement between a government and the Bank, it is processed and implemented. The various steps from project identification to completion comprise what is known as the project cycle. The steps in a typical Bank financed project include project identification; preparation to establish project feasibility; appraisal to assess project soundness and viability; consideration and approval by the Bank's Board of Directors; and finally, project implementation. Many Bank-financed projects are also subject to operations evaluation when completed.

1.2.14 The first step of project identification is generally undertaken during preparation of the Results-Based Country Strategy Paper (RBCSP). RBCSPs are usually prepared every three years for each RMC and are updated annually, in consultation with member governments.

1.2.15 In appraising a project, its technical, financial, economic, social, environmental, production, marketing, management, and loan conditionalities are closely examined. This helps to pinpoint specific steps necessary to ensure its smooth and efficient implementation and operation.

1.2.16 Loan approval by the Bank does not mean that the amount of the loan is immediately transferred to the borrower in a lump sum. The loan is disbursed to meet expenditures under the loan agreement, as and when they are incurred. Specific procedures for disbursement are laid down in the loan documents.

1.2.17 Normally, the loan documents allow 180 days for the loan to become effective. The preparatory work for construction (including recruitment of consultants, preparation of tender documents, detailed designs, procurement of equipment, and selection of contractors may take several months or longer. Usually, these activities cannot begin until the loan becomes effective. However, certain preliminary steps in the procurement of goods and selection of consultants can begin at an earlier stage to speed up project implementation. Implementation time generally ranges from two to five years and depends on the type and nature of the project. The progress of project implementation is assessed by Bank review missions, which visit the project up to twice a year throughout the implementation period.

Step 1: Identification and Early Preparation

1.2.18 When compared with the needs of its borrowing members, Bank resources are limited. Consequently, projects are selected carefully. Before any project is identified for Bank financing, Bank staff reviews a country's economy, particularly its national and sector development programs, and determine the prospects for its economic success. Country programming missions visit RMCs regularly to discuss topics of mutual interest with government officials and select suitable projects for Bank assistance.

1.2.19 The levels of economic growth and the priorities for development vary from one RMC to another. The Bank selects those projects which will most effectively contribute to the economic and social development of the country concerned. The Bank's approach is consistent with the 2005 Paris Declaration in that programs and projects selected for Bank support are part of the RMC's national development strategy.

1.2.20 Once a project has been identified and included in the Bank's program for that RMC, the Bank evaluates the project. In some cases, especially in the smaller and less-developed RMCs, project identification may require the help of outside experts. If so, the Bank can provide technical assistance to a country to help it identify and prepare a project for possible Bank financing.

Step 2: Loan Preparation

1.2.21 Loan preparation involves assessing the technical feasibility, economic viability, environmental impact and financial soundness of a project. This preparation phase can be undertaken by the government or any other agency. The Bank may also assist by providing technical assistance grants to fund the project preparation studies. The Bank uses PPTAs to hire consultants to undertake a project feasibility study. The consultants' work is closely monitored by Bank staff and the draft final report is reviewed at a meeting attended by representatives of the government, the Bank and the consultants.

Step 3: Project Examination

1.2.22 Project feasibility is examined by the Bank, first through a preparation mission and then through an appraisal mission. The mission team, in consultation with the government, examines the project's technical, financial, economic, environmental and management aspects and potential social impact. Loan terms and conditions are discussed. Following the examination in the field, the appraisal mission team prepares a report and draws up a draft loan agreement for detailed negotiation.

Step 4: Loan Negotiations

1.2.23 After detailed loan negotiations with the government, the loan proposal is submitted to the Bank's Board of Directors for approval. The loan agreement is then signed by the Bank's President and representatives of the government and the executing agency. The loan takes effect once specified loan conditions are met.

Step 5: Project Implementation

1.2.24 The project is implemented by the EA according to the agreed implementation schedule and procedures. Project supervision consultants may be recruited, the detailed engineering design and bidding documents are prepared, machinery and equipment are procured, and civil works are constructed and installed. Bank staff reviews the implementation in close coordination with the borrower and the EA. The Bank disburses the loan for approved expenditures, as provided in the loan agreement.

Step 6: Project Completion

1.2.25 After the project facilities are completed and commissioned, the Bank prepares a project completion report (PCR) to document the implementation experience. The Bank undertakes separate post-evaluations of projects on a selective basis. In these cases, it prepares post-evaluation project performance audit reports that assess project formulation and implementation; economic, financial, and social benefits; and environmental impacts as well as identifies lessons learned from the project experience.

Project File

1.2.26 Financial Analysts should maintain a permanent project file for each project/programme. The project file must contain all relevant financial information gathered during fact-finding, appraisal, and project supervision (either originals or copies). This information should include details of original and amended financial policy decisions affecting the project and the EA. Also included in the file are the assumptions and basic calculations underlying financial analysis, financial performance indicators, and the design of financial covenants. The file must also include copies of all computer files that have been used to develop project-specific financial projections and analyses. The financial management assessment report and the related supporting documentation should also be included in the file.

Structure

1.2.27 In addition to this introduction the Guidelines comprise of six chapters as follows:

- **Chapter 2 – Financial Management** – advises on institutional and systems requirements and relevant financial management/governance considerations. Individual sections address key topics such as governance, money laundering and terrorist financing, anticorruption, forms of implementing agency, scope of the financial analysts work, use of country financial management systems and assessing Executing Agencies.
- **Chapter 3 – Financial Analysis and Appraisal of Projects** – advises on the key features that a borrower and a financial analyst need to know to participate in the preparation and appraisal of an investment project. It describes the preparation of project cost tables. In addition, it discusses loan covenants in the context of the 2005 Paris Declaration and provides some guidance on the types of loan covenants that may be applied.
- **Chapter 4 – Monitoring and Evaluation** – advises on the requirement to monitor the implementation and operation of Bank financed projects' resources as well as subsequent performance measurement and evaluation. It discusses the preparation of financial forecasts and the various tools available to monitor the performance of an EA.
- **Chapter 5 – Reporting and Auditing** – focuses on the Bank's requirements for financial reporting and auditing of projects, EAs and Implementing Agencies (IAs).
- **Chapter 6 – Financial Intermediaries** – describes the particular applicability of these Guidelines to Financial Intermediaries.
- **Chapter 7 – Knowledge Management** – This section includes a wide variety of guidance materials including selected websites, checklists and descriptions of accounting and auditing standards. It also includes examples of auditors' opinions, and a questionnaire to check the adequacy of financial statements from an audit perspective. Additionally, the section contains best-practice guidance and sector-specific case studies. Space and presentation constraints limit the Knowledge Management section of the hardcopy version of these Guidelines.

Financial Management

2. FINANCIAL MANAGEMENT

2.1 INTRODUCTION

2.1.1 *Financial Management* is a process having as its primary objective the optimization of financial and economic benefits from an investment. Although viewed and managed as a process, it comprises multiple processes, including financial accounting, management (and cost) accounting, assets accounting, cash and money markets accounting, financial reporting, internal controls and internal audit, with external audit providing a report and opinion on the reported financial status and performance. Each of these processes, including financial management itself, should incorporate sub-processes and techniques, including management, forecasting, strategic planning, planning and budgeting, organizing, procurement, disbursements, control and communications.

2.1.2 This rest of this section outlines some initiatives in the area of good governance that the Bank is involved in and that have direct bearing on financial management of Bank operations.

Combating Corruption

2.1.3 Since it issued its Policy on Good Governance in 1999 (see Knowledge Management, section 7.5) the Bank has given due recognition to the issue of good governance because it is central to creating and sustaining an enabling environment for development. The absence of good governance has proved to be particularly damaging to the role of government. Programs for poverty alleviation, for example, have been undermined by pervasive corruption. Corruption weakens the ability of governments to carry out their functions efficiently and leads to inequitable distribution of government services. It squanders government revenues and distorts and deters investment flows, thus undermining growth. To this regard, the Bank in February 2004, approved the Guidelines for Preventing & Combating Corruption and Fraud in Bank Group Operations (see Knowledge Management Section 7.6).

2.1.4 The Boards noting the importance of an Anti-Corruption and Fraud Investigation Function, and the positive effects of institutionalizing the investigation of corruption and fraud decided, with effect from 1 November 2005, to rename the existing Internal Audit Department (AUDT) as the Office of the Auditor General (OAG), and reorganized the Department to comprise a Directorate, and two Divisions, namely the Anti-corruption and Fraud Investigation Division (ACFD), and the Internal Audit Division (IAD) and approved their respective Terms of Reference as well as the mandate of the Oversight Committee on Corruption and Fraud (OCCF).

2.1.5 ACFD shall undertake investigations in response to specific allegations of fraud or misconduct against individuals who are staff members or third parties who engage in business with the Bank. The role of the investigator therefore shall be to determine the truth or falsehood of the allegation and to recommend appropriate sanctions against the offender. The OAG, in conjunction with OCCF will discuss and put in necessary controls around the following processes: receiving allegations; screening allegations of fraud and corruption; conducting investigations; etc

2.1.6 The OCCF will ensure a fair system so that no individual wrongly accused shall be punished for an offence s/he did not commit and that no offender shall be allowed to go unpunished. The Committee's responsibilities include amongst: Overseeing compliance with all

due process requirements of both the Bank and the RMCs in which activities are being investigated; Approving debarment and imposition of sanctions against individuals, firms and companies found to have engaged in corrupt practices; and recommending cancellation of loans where necessary; Reviewing and approving cases that should be forwarded to the national authorities for further action, including prosecution; and accordingly making recommendations to the President.

Money Laundering and Terrorist Financing

2.1.7 The Bank is concerned with growing global problems of money laundering and terrorist financing. The Bank is fully aware of the impact money laundering and terrorist financing can have on the financial systems of RMCs and their hampering of efforts to reduce poverty. In this context, the Bank is developing a Strategy and Plan of Action to assist RMCs combat money laundering and terrorist financing. The Bank plans to incorporate money laundering and terrorist financing issues in its policy dialogue with RMCs and to strengthen the Bank's internal controls to safeguard Bank funds and prevent their use in money laundering or terrorist activities. The Bank recognizes that its efforts to reduce poverty contribute to addressing some of the root causes of these activities and that its efforts to assist RMCs to improve their financial management systems help to address these concerns. The Bank also recognizes that greater efforts need to be undertaken to ensure that money laundering and terrorist activities do not interfere with the Bank's main goal of poverty reduction.

Country Governance Profile

2.1.8 The Bank's instrument for review of the governance framework in a nation is the Country Governance Profile (see Knowledge Management, section 7.4). The Country Governance Profile (CGP) identifies the strengths and weaknesses of governance arrangements in a country and helps in assessing the risks that these may pose to the use of Bank funds. The Financial Analyst should read the CGP report carefully noting the financial management environment that the proposed program or project will operate within.

African Peer Review Mechanism

2.1.9 The African Peer Review Mechanism (APRM) is an instrument voluntarily acceded to by Member States of the African Union as an African self-monitoring mechanism. Its mandate is to ensure that the policies and practices of participating states conform to the agreed political, economic and corporate governance values, codes and standards contained in the Declaration on Democracy, Political, Economic and Corporate Governance¹. Like the CGP, the APRM enables the identification of Member States governance related deficiencies and assesses the needs for capacity building.

2.1.10 The Bank can lead the policy dialogue with RMCs over the implementation of the corrective undertakings identified in the APRM Program of Action. It can draw lessons from experience, and distil a collection of good governance related best practices as well as support monitoring and reporting progress in area of governance in RMCs to interested stakeholders. To this regard, the Bank and the New Partnership for Africa's Development (NEPAD) should dialogue on ways to harmonize the CGP, and the APRM processes.

¹ See www.au2002.gov.za/docs/summit_council/aprm.htm

2.1.11 Based on the Bank's Operations Manual and other related guidance documents, this Chapter of these Guidelines is aimed at providing the financial analyst with a comprehensive view of financial management. In addition to this introduction, this Chapter has the following two sections:

- **2.2 – Country Financial Management Systems** – Approaches for examining the various institutions and agencies of borrowers, particularly as they impact on the financial management of programs and projects are reviewed in this section.
- **2.3 – Executing Agencies** - This section is applicable to the executing agencies of all projects. It describes the analysis of the EA's systems and procedures that will be utilized to implement and manage the project. Importantly it introduces an innovative tool to assist the Financial Analysts to make an assessment of the adequacy of the financial management systems. It contains advice on how to design and cost institution development initiatives in the area of financial management as well as the implementation strategies and major risks that should be taken into account when planning institutional strengthening measures.

2.2 COUNTRY FINANCIAL MANAGEMENT SYSTEMS

Financial Management Systems

2.2.1 Financial management systems² include budget planning and implementation systems, procurement systems, financial statement preparation systems and audit systems. These systems are utilized across government and apply equally to ministries and other government agencies that may be implementing a budget support or sector loan, an investment project loan, a line of credit or a grant.

Harmonization

2.2.2 Donors recognize that country ownership is enhanced and harmonization efforts facilitated through the use of country financial management systems. In response to the efforts of both donors and developing countries to increase the effectiveness of development assistance an increased focus has been placed on holistic approaches to addressing development issues. Two High Level Forums on development issues have been held to discuss the role of the development community in achieving the Millennium Goals established in the United Nations Monterey Declaration. These forums focused on Aid Effectiveness and Harmonization³ and issued declarations calling for greater reliance on developing country systems, minimizing independent project financial management systems and on recognizing the need for and providing institutional assistance to national governments to improve their country systems.

2.2.3 While the Rome Declaration expressed support for greater use of RMC country systems the Paris Declaration seeks to set specific measurable goals for achieving greater ownership and alignment of aid with country priorities and use of country systems. The Paris Declaration has set

² Financial management in government requires accountability of financial and program managers for financial results of actions taken, control over the government's financial resources and protection of governments' assets. To enable these requirements to be met, financial management systems must be in place to process and record financial events effectively and efficiently, and to provide complete, timely, reliable and consistent information for decision makers and the public.

³ Paris Declaration on Aid Effectiveness, Paris, France March 2, 2005 and Rome Declaration on Harmonization, Rome, Italy February 25, 2003, respectively (see Knowledge Management, section 7.3).

five goals on a tentative basis with seven additional goals and the five tentative goals to be confirmed by September 2005 (Knowledge Management, section 7.3).

2.2.4 The Bank encourages collaboration with development partners in the preparation of the CGP. Collaboration may take the form of joint preparation of a CGP with one or more development partners or it may take the form of reflecting in the scope of coverage of the CGP the work undertaken by a development partner or by a partner country. The World Bank and/or the International Monetary Fund often collaborate with the Bank to undertake the following studies which should be reviewed and considered during the preparation of a CGP and/or during preparation of a project or a programme:

- Country Procurement Assessment Report (CPAR), which reviews public procurement institutions and practices in borrower countries,
- The Public Expenditure and Financial Accountability Review (PEFAR) that reviews the Public Financial Management (PFM) arrangements in client countries. PEFAR has two main components – the Financial Accountability Assessment and the Public Expenditure Review (see Knowledge Management, section 7.10).
- The Public Expenditure and Financial Accountability (PEFA) PFM Performance Measurement Framework, included in section 7.11 of the Knowledge Management, provides a common pool of information for measurement and monitoring of PFM performance progress.
- HIPC Expenditure Tracking Assessment, which assesses the ability of highly indebted poor country's public financial management systems to track poverty reducing expenditures.

2.2.5 To remain effective and relevant to RMCs, the CGP will need to evolve into a more flexible and adaptive instrument, adequately differentiated among RMCs, and harmonized with APRM. On the one hand, in non-APRM RMCs, the CGP will remain a key governance assessment diagnostic tool. And on the other hand, in RMCs participating in the APRM, the CGP preparation will need to be sequenced to precede APRM assessments. This way the CGP findings will inform those undertaking country self-assessments within the APRM framework. In RMCs where APRM is already completed, the Bank's CGP can be adapted to address coverage gaps and emerging areas not sufficiently covered in the APRM as well as moving forward the APRM findings and recommendations to broaden and deepen governance analysis in such areas.

Budget Support Loans/Policy Based Loans

2.2.6 Budget support loans provide funding intended to support agreed policy objectives, including reforms that result from policy changes. As a result most budget support loans do not have a specific investment program with a detailed cost schedule. However, in many cases the achievement of development goals envisaged under budget support loans depend entirely on the government making investments in a particular targeted sector. As a result the program is dependent on the government's financial management system for the investment of funds to achieve the program goals.

2.2.7 The Agreement Establishing the Bank requires it to ensure that loan proceeds are used only for the intended purposes for which the loan was granted, with due attention to considerations of economy and efficiency. Normally, the Bank's loan proceeds would be paid into a central bank account that is part of a country's foreign reserves and an equivalent amount in local currency is credited to the government to finance its budgetary expenditure. For the

foreign exchange component the Bank relies on IMF's findings of safeguard assessments of central banks.

2.2.8 For the Bank's resources that are channelled through the government budget and, therefore, the country financial management system, the Bank conducts ex-ante assessments of the fiduciary risk inherent in the borrower government's accounting and procurement system. This is done through diagnostic work as well as reviewing country and other donor fiduciary assessments reports, including audits.

2.2.9 The fiduciary assessment informs the Bank's decision as to whether the level of risk is acceptable. Where weaknesses exist, the Bank will take appropriate measures to mitigate and monitor the risks. The diagnostic tools that the Bank uses to assess fiduciary risks in the government financial management system are identified elsewhere in these guidelines.

2.2.10 By reference to the diagnostic assessments conducted by the Bank or by other donors, the financial analyst needs to determine the effectiveness of the government's financial management system and describe in the appraisal report the system in general and in particular how it applies to any ministry or other unit of government responsible for implementing/achieving the program goals. The financial analyst should, also, assess the adequacy of available financial statements or budget utilization reports that would provide a summary of the operations of the ministry or agency and that would reflect the anticipated budget expenditures of the program.

Sector Wide Approach (SWAps)

2.2.11 The Bank's guidelines covering SWAps (Knowledge Management Section 7.8), notes that a SWAp is neither a lending instrument nor an end product. It constitutes a process through which national policies and strategies are translated into sector investment and expenditure programs based on a country's long-term development plan. The guidelines note that the intention of a SWAp is to pool funds and reporting for funds and to use common procurement procedures. However, noting that the Agreement Establishing the African Development Bank and the Agreement Establishing the African Development Fund require that "*the proceeds of any loan granted, investment or other financing made in respect of the ordinary operations of the Bank shall be used only for procurement in member countries of goods and services produced in member countries,....*"⁴ and differences between donor financial management requirements, a pooling of funds involving the Bank's resources may be difficult to achieve. The guidelines note that it is very likely that specific components of the Public Investment Programme supporting the sector may be financed by Bank project loans, that Bank provided grants may be utilized to support technical assistance for needed capacity building and that the Bank may channel resources in support of a SWAp using a budget support loan.

2.2.12 At the outset, sector staff should be aware that for fiduciary issues, it is not a "SWAp" that matters but the nature of financing and implementation arrangements that are proposed. There are three financing modalities options to support programs under SWAps. One option is a parallel financing arrangement whereby the Bank becomes fully engaged in intensive coordination around a common program/strategy through strong harmonization and coordination frameworks such as joint reviews, monitoring and evaluations, policy dialogue and use of common reporting formats. Pooled financing is a second option, whereby, all pooling partners would pool their funds, support the same scope of activities and use the same financing

⁴ Agreement Establishing the African Development Bank, Article 17 (d) and the Agreement Establishing the African Development Fund, January 1981, Article 15, paragraph 4.

mechanisms and planning cycles. Lastly, SWApS may take the form of a general budget support that is directed to a specific sector.

2.2.13 The decision on whether to or not to enter into a SWAp will depend on three factors. First, in social sectors, where significant expenditures are largely recurrent, small and local, there is less need for fiduciary safeguards. Second, where difficult and contentious policy issues exist, it would be more difficult to agree on a common program. Lastly, in general, pooled financing is more challenging if large procurement, major environmental/social safeguard issues, and a large number of donors are present.

2.2.14 As in the case of budget support loans, a clear understanding of the country's financial management system, including its budget approval, appropriation and expenditure reporting system, is necessary before the Bank embarks in a SWAp. Therefore, the Bank can embark on a SWAp only after it conducts a comprehensive and detailed review of the particular sector-wide as well as microeconomic issues.

2.2.15 The financial management system in a SWAp should produce timely, understandable, relevant, and reliable financial information that would allow the Bank, other donors, and the government to plan and implement the program, monitor compliance with agreed procedures, and appraise progress toward its objectives. To ensure that these financial management requirements are met a financial analyst should participate in a fiduciary assessment for the SWAp that should be conducted by the Bank in collaboration with other participating donor agencies. The Bank has not developed its own methodology of assessing fiduciary risks in a SWAp. This is an area that the Bank would need to work on as SWApS gain prominence in the Bank's operations. In the meantime, staff would need to utilize methodologies developed by other donors to perform the financial management assessment of a SWAp.

Project Loans

2.2.16 Project loans provide funding for specific investments designed to achieve clearly defined goals including specified financial and/or economic goals. Where the EA is a unit of government it would be expected to follow the financial management policies and practices of the government. The purpose of the financial management assessment of the executing agency is to ascertain whether the EA's systems are consistent with the government's systems and to evaluate the EA's accounting systems and internal control systems to verify that the EA's standards are adequate and to ensure that an effective framework for accounting and financial reporting is developed during appraisal (Knowledge Management section 7.9, OM 600). Issues or defects in the government financial management system may be identified as a result of an analysis undertaken as part of the processing for an individual investment project. The issues or defects identified may be addressed through the investment project or separately.

2.2.17 Financial management systems of EAs serve two equally important goals, both of which are expressed in the requirement to ensure that funds are used for the purpose intended. One goal is to use the financial management system as a tool to assist the project manager in ensuring the development objects of the project are achieved, which is the purpose intended. To achieve this, the project manager needs to know the total funds available to complete the task, the source(s) of the funds, any prerequisites to accessing the funds, restrictions on utilizing the funds and the currency or currencies the funds are available in, etc. The financial system needs to track the utilization of each pool of funds, the balance of funds available to complete the project and the expenditures incurred to date for each cost category of the project.

2.2.18 Another goal is to give to each of the providers of funds (including the government) an accounting of the use of all funds provided, informing them that their funds were utilized for the purpose intended. The financial management system needs to incorporate internal controls that ensure any prerequisites to utilizing the funds are first met, any restrictions on the use of the funds are observed and that there is a timely accounting to the providers of the funds.

2.2.19 Financial reports that meet the needs of the project manager should be sufficient to meet the needs of the funding agencies. A single financial report covering all sources of funds, accounted for in the national currency, and reporting all direct and indirect disbursements related to the project and with additional information in the Notes to the Financial Statements would be appropriate. Indirect disbursements are payments made by a funding agency to a supplier on behalf of the borrower/EA. The Notes to the Financial Statements should indicate at least the accounting standards applicable to preparation of the financial reports, any deviations in the application of those standards, and sufficient information about the funding arrangements to understand the main financial terms and conditions.⁵

2.2.20 While financial aspects of these matters should attract a financial analyst's principal attention, they must be aware of, and capable of responding to other factors. These may be related economic and technical objectives, techniques of design and implementation, and the operation of the project, together with the impact of any related, ongoing facilities and activities with which the project will be linked. These may include parallel investments in the same or other sectors that should appropriately be linked to achieve common economic objectives. For example, the construction of water supply and sewerage facilities by different EAs, or by the same agency drawing on differing sources of funding, should have common economic, financial and environmental objectives. These should be related to achieving appropriate standards of public health, including recognition of the financial impact which good health has upon the earning capacity of the population concerned.

Local Government Financial Management

2.2.21 Effective and efficient local government budgeting and financial management is the cornerstone of any effective decentralization strategy. The task of improving local government financial management systems is enormous. The legal framework varies across countries. Local governments vary in size, financial and economic resources. As a result, there is no singular financial management system that can be applied across the board to all local governments and countries. What is similar across countries and local governments is the conceptual framework of modern budgeting and financial management. The application of these budgeting and financial management practices may however vary across countries.

2.2.22 The Knowledge Management Chapter of these Guidelines (see section 7.12) reviews the core elements that underpin effective frameworks relating to local government budgeting and financial management practices. Financial Analysts charged with the task of assessing financial management systems at sub-national levels of governments are advised to be familiar with the materials presented therein.

⁵ Harmonizing Donor practices for Effective Aid Delivery, Chapter 5, OECD-DAC Guidelines and Reference Series 2003 (Knowledge Management, section 7.7)

Partnership Arrangements

2.2.23 The Bank will take the opportunity to engage in policy dialogue related to use of country financial management systems with RMCs as well as strengthen collaboration to build country systems between the Bank and other donors. An effective strategy to strengthen country systems must build on gains in this area and be grounded in a vibrant partnership setting between the donors and the RMCs and amongst the donors themselves. It is expected that much of the Bank's role on this initiative will involve sensitizing RMCs to improve fiduciary arrangements on the one hand, and coordinating and harmonizing with other donors on the other.

Other Issues

2.2.24 Every Appraisal Report prepared (including those for budget support loans and SWAs) should include a focused description of the main features of the country's financial management system. The strengths and the weaknesses of the system should be described. Where weaknesses are identified the appraisal report should describe how those weaknesses would be addressed in the implementation and supervision of the proposed program or project. Comparisons of the country financial management system with international best practice provide the reader with a basis to view the financial reports and financial data included in the appraisal report in context. The Bank's past experience in relying on the RMC's financial management systems should also be described. A key challenge is, therefore, for the financial analyst to review the various financial governance-related assessments that have been conducted by the Bank and/or by other developmental partners/partners countries, and summarise the key conclusions that will be documented in the Bank's Appraisal Report.

2.2.25 Circumstances may exist at the time of the preparation of a program or project where the prescribed financial policies, strategies and systems of the government in part, or as a whole, contain defects not acceptable to the Bank and which may affect the design and execution of the program or project. In such conditions, the design of the program or project should include means of eliminating or where necessary counteracting these defects thereby enabling the financial analyst to confirm at appraisal that the EA's financial management systems will be sustainable. This means that the financial policies, strategies and systems of the government must be adequate to underpin the EA's financial management systems and support the program or project and the EA from start-up, through implementation, and where appropriate, during the operation of a project.

2.2.26 International best practice requires donors to rely on partner country financial reporting systems when the financial reports meet the information needs of government and donors. The Paris Declaration seeks to harmonize donor practices on the basis of the partner country financial management systems and accounting standards rather than introducing accounting standards developed in a donor country or continuing the practice of utilizing donor specific systems on each donor funded project. The appraisal report should clearly state the decision made regarding whether or not the partner country financial management system will be relied upon, relied upon with assistance or support from a PIU, or whether an independent PIU is necessary. Where the partner country financial management system requires assistance or support from the PIU or a separate PIU is deemed necessary capacity building should be a priority of external assistance. The Bank will increasingly need to be able to demonstrate why it relied on or why it did not rely on the financial management system of the partner country.

2.2.27 The financial analyst is required during preparation or at the latest by appraisal to obtain sufficient information to advise the Bank whether a program or project has been developed to

operate within the existing framework of governmental financial policies, strategies and systems. Where the existing framework of governmental financial policies, strategies and systems contains defects that are not acceptable to the Bank the financial analyst is required to advise the Bank whether steps will be taken under the program or project to correct the defects or whether acceptable countermeasures have been designed into the implementation of the program or project. The financial analyst should also determine whether the program or project is fully aligned with the Bank's policies. The Bank typically uses various covenants in loan agreements to reinforce this determination.

2.2.28 When designing covenants for inclusion in the loan's legal documents consideration should be given to the steps that needs to be undertaken by the government in applying policies, strategies, and systems acceptable to the Bank. These steps should support the program or project from the start of its implementation throughout its life. Also, policy dialogue should be conducted to remove concerns or unacceptable policies and practices. Consideration should be given to addressing the institutional strengthening needed as part of the current project or by providing standalone technical assistance.

2.2.29 Following program or project inception, the financial analyst is required to continually assure the Bank's management that the above framework will facilitate the accomplishment of the program's or project's goals. The financial analyst should also draw management's attention to any change, which has occurred, or is under consideration or planned, in financial policies or strategies or systems, (including failure to comply with financial covenants) which could reduce project effectiveness.

2.3 EXECUTING AGENCIES

Introduction

2.3.1 The Bank requires that to the maximum extent possible a program or project be designed, developed, and operated (among other factors) within the framework of the financial policies, strategies and systems prescribed by those institutions of the government which are responsible for national and sector economic and financial planning. Where use of country systems is not feasible, additional safeguards and measures are to be established in ways that strengthen rather than undermine country systems and procedures.

2.3.2 The Paris Declaration on Aid Effectiveness adopted at the High-Level Forum in March 2005 reaffirmed the donor community's commitment to align their programs to national development strategies, institutions, and procedures. It identified a reduction in the number of parallel project implementation units (PIUs) as one of the key actions the aid community could take to promote greater capacity development within borrower countries, and thus increase aid effectiveness.

2.3.3 Greater integration of project management in a country's existing institutions and systems is important to the Bank's objective of developing institutional capacity in its RMCs. Equally, it promotes, the Bank's objective of making concrete steps towards greater use of country financial management systems. Importantly, developing country institutional capacity is an integral part of the Bank's mission to reduce poverty and promote sustainable development, in Africa.

2.3.4 On the one hand, formation of PIUs to execute project implementation reflect the need to mitigate risk that Bank's loan proceeds might be used for purposes rather than that intended when the loan was approved. This is especially the case where project implementation capacity is weak. But on the other hand, created PIUs reflect sector staff incentives to ensure that projects are implemented speedily so as to reflect high implementation performance ratings.

2.3.5 The outcome is often PIUs that vary in size, function, physical location, legal status, and degree of integration into existing country structures⁶. First, "**Stand-alone**" or "**enclave**" PIUs are typically formed outside the structure of an EA and are responsible for a "turnkey" solution to the final outcome. At project closure, the completed project is then handed over to the parent ministry for operation. These PIUs duplicate functions and capabilities of the ministry that oversees the sector and are generally considered to be most damaging to long-term country institutional development efforts. Second, "**Semi-integrated**" PIUs partially augment the existing structures within the EA with some capacity, for example, long-term technical assistance and/or specialists to address some functions or capabilities. Third, "**Super**" PIUs take a sectoral approach to implementation of projects and are financed by different donors. Another variant of "**Super**" PIUs is found where a single donor forms an implementation unit covering multiple projects in a sector or for related projects in a region. Fourth, "**Semi-autonomous Agencies**" are either newly created or already existing institutions outside mainstream government. They implement programs (e.g., social funds) and thus eliminate the need for further project implementation units. Lastly, in the case of "**Fully Integrated**" PIUs the EA/government ministry takes full responsibility for project implementation and uses its own structure and staff. Although donors may support "Fully Integrated" PIUs with limited technical assistance for specific areas, they significantly promote institutional capacity development.

2.3.6 The recent shift toward greater use of country's procedures and institutions, with proper fiduciary safeguards, means that Bank staff should have detailed knowledge about a country's rules and practices, especially in sectors where the Bank expects to be engaged in over a long period. Then, during project preparation, Bank staff should agree with the borrower the appropriate measures to align procedures, and design safeguard measures that are as closely integrated with government systems as feasible. Country Departments will need to develop country-level strategies on project implementation arrangements including PIU staff remuneration and other incentives to minimize distortions, while pursuing broader civil service pay reforms.

2.3.7 These Guidelines while encouraging Operations Complex staff to continue giving priority to efficiency of project implementation performance they should also ensure that Bank's mandate to strengthen country institutional capacity development is not overlooked. To this regard, use of existing country institutions for project implementation should be the "rule" rather than the exception and PIUs, especially parallel "stand-alone" PIUs, should be phased out.

⁶ This discussion is summarized from the following World Bank document: Guidance Note for Project Management: *Strengthening Institutional Capacity during Project Implementation*, October 2005 (Knowledge Management, section 7.3.7).

2.3.8 It is important for Financial Analysts⁷ to view financial management assessment in the context of the country financial management system and to relate the program or project being processed such systems. Such a review is undertaken to understand the setting within which the program or project will operate. The review starts at the national level. Financial Management at the national level sets the tone for financial management in lower levels or units of government. Financial management is an integral component of the governance framework of a nation. Usually laws are passed by the national legislative body or bodies that establish the means by which revenue is raised, debt is incurred and funds are budgeted and appropriated. Laws or regulations provide authority to various Ministries/Departments and units of government to spend money and the means by which resources spent are accounted for and reported to the legislative body and to the public. Detailed regulations will establish the rules for procurement, internal control, accounting standards followed by the government and the content and timeliness of financial reporting.

2.3.9 The project should respond to clearly defined objectives, including among others, sustainable economic goals; execution based on the least cost technical solution; time-bound delivery of benefits; and in the case of project loans - financial viability. The Bank has a broad interpretation of financial viability in relation to project loans. It implies at an optimum, the ability of a project to replicate itself, to finance day-to-day operations and maintenance, and to service its debt. As a minimum, financial viability should represent the provision of adequate funds to finance day-to-day operations and maintenance. The funding may come from either service fees or product sales associated with the operation of the project itself and/or from sufficient government budgetary support to assure the Bank that a partial revenue earning or a non-revenue earning investment will generate the intended levels of economic benefits through its working life.

2.3.10 Investment projects selected for Bank support may be the responsibility of borrowers, EAs and/or Implementing Agencies (IAs)⁸ that have already implemented or are in the process of implementing an investment project for the Bank or for another International Financial Institution. In support of the harmonization agenda the Bank is willing to share, with other Developmental Partners, its governance assessments as well as utilize the assessments of other MDBs. Accordingly where the borrower, EA or IA has been assessed recently the Bank will only undertake the minimum work necessary to update such as assessment to meet its current requirements.

2.3.11 The rest of this Chapter equips financial analysts with tools to evaluate EAs and project specific institutional capacity in the area of financial management.

Scope Of Financial Analyst's Work

2.3.12 Operations Manual 600 set out the Bank's policy with respect to the need for the examination of the EA's financial management systems during project preparation and appraisal.

⁷ A financial analyst should have adequate financial management skills to enable him/her to conduct an effective financial management assessment. Where such capacity does not exist within the concerned Operations Department, a short-term consultant with adequate financial management skills should be recruited to conduct the assessment. To this regard, a sample Terms of Reference for recruitment of such a consultant is included in section 7.13.11 of the Knowledge Management chapter of these Guidelines.

⁸ The project financial management system depends on the nature of the project and of its implementing entity, which could be a self-standing Project Implementing Unit (PIU), Project Co-ordination Unit (PCU), Project Management Unit (PMU), Project Liaison Unit (PLU), a government ministry, department, or agency, or a commercial entity. These guidelines use 'IAs' to refer to all of the above.

This is to form an assessment of the financial policies and the capacity of the financial management systems in place or proposed by the borrower or EA to support project implementation and operation.

2.3.13 The identification, preparation and appraisal activities to be undertaken by a financial analyst prior to loan negotiations should be adequate to comply with the requirements of OM 600 (Knowledge Management, section 7.9). Identification and preparation of an investment project requires a financial analyst to obtain a detailed knowledge of the institutions and systems that are, or will be used during implementation and where appropriate, future operations. This task includes, among other things, acquiring the knowledge and ability to determine at or before appraisal and preparation of the Appraisal Report, whether or not the financial management system(s) proposed by the borrower and the EA will be sustainable from project start-up, through implementation, and where appropriate, for the continued operation of the project.

2.3.14 The financial analyst should advise the Bank in all cases where, in his/her judgment, the level of financial management arrangements proposed by the EA would be adequate to sustain the proposed project or the financial viability of the EA – especially if no defined modifications are to be set in place. This advice should be stated in the Back to Office Report of the Appraisal Mission and take the form of a clear statement included in the Appraisal Report.

2.3.15 Where appropriate, the financial analyst should make recommendations to the borrower and the Bank regarding minimum changes to be made in financial management, considered necessary to assure efficient and effective delivery of the proposed project from start-up. The financial analyst should advise the EA and the Bank regarding those elements of a financial management system that either should be put in place before start-up or within a defined time after start-up to enable the financial management system to operate at full efficiency. The elements identified may constitute components that are to be financed as part of the project, and completed in accordance with a timetable acceptable to the Bank or may be incorporated into a separate technical assistance project.

2.3.16 The extent of a financial appraisal will depend upon the extent and type of experience the Bank has had with the concerned EA, the EA's experience in implementing programs or projects, and the extent and nature of previous institutional strengthening. Broadly, the Bank conducts financial appraisals of EAs and IAs to determine whether such institutions are technically, managerially and financially capable of efficiently and effectively implementing proposed projects. The specific objectives are to:

- Decide whether institutional financial management capacity is sufficient to support loan approval;
- Identify any institutional financial management needs – both project related and long term – that should be addressed either as a project component or by technical assistance; and
- Confirm that the financial management system is sustainable.

2.3.17 The appraisal scope, pertaining to financial management activities, should include:

- Analysing the EAs' structure and management framework with regard to financial management;
- Assessing the agency's compliance with national accounting, reporting and auditing standards and relating those standards to International Standards;

- Assessing the agency's resources, including the number, quality and technical capabilities of its staff, the extent of financial and budgetary support it receives, the nature of technology, equipment, software in use; and
- A diagnosis of performance shortfalls to identify specific institutional deficiencies and related institutional strengthening interventions. The institutional deficiencies should be classified into those pertaining to the management framework and those due to resource constraints.

Categorizing EAs

2.3.18 EAs are critical to the success of the design and implementation and, in many cases, operation a project. Within the public sector operations of the Bank, EAs are broadly classified into the following three types:

- Agencies, which include government line agencies and state/provincial arms of such agencies, and local governments; and
- Statutory bodies, public sector enterprises, or government-owned bodies such as agricultural and industrial credit banks and the like.

2.3.19 EAs are further classified as revenue-earning and non-revenue-earning. The term revenue-earning encompasses EAs and projects which are commercially oriented. Revenue-earning would also cover public sector institutions which generate substantial revenues either by consumer charges or forms of sector-specific local taxation (property tax levies for water supplies, drainage, etc.), or both. Examples are public sector commercial and industrial enterprises, public utilities, telecommunications companies, industrial and agricultural credit banks and municipal government utility operations. Non-revenue-earning projects are usually implemented and operated by public sector EAs whose financial support derives predominantly from central, provincial, state and/or local government budget allocations, and for whom there may be no service fee or only partial cost recovery, often accomplished indirectly. Non-revenue-earning EAs include government ministries and departments, and project EAs under their control in sectors such as education and health.

2.3.20 An EA may have a tiered management in the form of a Project Management Unit (PMU), with the PMU having one or more Project Implementing Units (PIUs). In such cases, the EA is responsible to the borrower and the Bank for the successful implementation of the project, including delivery of all financial reports and auditors' reports and opinions in accordance with agreed timetables.

Determining the Status and Role of EAs

2.3.21 An EA is likely to be subject to laws, regulations and rules that are administered by superior authorities, typically ministries or departments. Departments that have control over EAs, may themselves be agencies of state or provincial governments that also are the subjects of superior central administrations. Therefore, the extent of an EA's autonomy and/or control by superior authorities at all levels of a national government's hierarchy should be established. This is in order to determine its authority and ability to formulate and implement financial policy, and to design and install financial management systems.

2.3.22 To resolve these concerns, answers should be sought to the following questions:

- Is the EA fully autonomous (for example, can it legally exist in its own right by the laws of the country without government control)?

- Can it contract, and sue and be sued in its own name?
- Can it determine its own financial policies?
- Is it government-controlled? If so, what is the extent of that controls and influence on financial policies and accounting and auditing requirements?
- Is there a specified national code or chart of accounts?
- Is it a government agency? If so, does the EA's management have any powers to decide financial policy, determine its own accounting systems and financial management rules, or does government prescribe these? For example, there could be separate accounting rules for public sector enterprises.
- Is the project to be executed by only a part of an EA?
- Is it necessary or desirable to require a separation of accounts and/or funds for only that part of the EA, and would such a step be feasible?

2.3.23 It is possible that an EA may not have a definitive view of its related governance, particularly the actual superior levels of control. In such circumstances, it may be prudent to seek the advice of the government auditor. Government auditors are often well informed on national legislation and of the powers and duties of the agencies for which they have audit responsibility.

Assessment of Financial Management

2.3.24 Financial management assessment field work comprises the following four steps:

- Planning the assessment;
- Conducting the assessment;
- Recording the assessment; and
- Assuring the quality of the assessment.

2.3.25 To assess risks that the project may face, the Financial Analyst should evaluate factors at three different levels--country specific, entity specific, and project specific. For country specific risks, the Financial Analyst is expected to draw upon the existing analytic work (such as CGP, PEFAR, PEFA-PFM, CPAR, etc). However, entity and project specific risks are assessed every time the financial management systems are assessed for an individual project. Risks assessment in relation to the project implementing entity is primarily conducted in three areas: (a) institutional and organizational aspects, (b) funds flow, and (c) audit arrangements. In some projects the distinction between the entity and project may be nonexistent as the project implementing unit (PIU) is created exclusively to implement the Bank Group-financed project. In such a case one assessment for both entity and project risks would suffice.

Planning the Assessment

2.3.26 The financial management assessment should commence as early as possible in the project preparation process to allow for early detection and resolution of issues. The financial management assessment starts with a contribution to the following sections of the Project Briefs: technical assistance requirements; issues and proposed actions; and sector assumptions/risks. Participation by Financial Analysts, with financial management expertise, at this stage helps plan the scope of the assessment, and allows the impact of any known financial management issues to be taken into account in early project design decisions. The assessment will need to be updated as project preparation progresses to reflect the most recent status of the financial management system, including whether previously agreed actions have been taken.

2.3.27 Planning the assessment should be performed in close coordination with the project's Task Manager who can assist the Financial Analyst to understand the project's overall context, including specific demands that will be placed on the financial management system. This discussion would be the foundation for continued interaction, as required, during the assessment and project preparation/appraisal processes. When planning the assessment, the Financial Analyst should focus on the following issues that will impact its quality:

- Obtaining sufficient knowledge of the country, the implementing entity and the project before commencing the assessment work in the field;
- Planning and communicating the work the Financial Analyst will perform during the assessment; and
- Determining the minimum financial management requirements appropriate to the project.

2.3.28 During the planning phase, the Financial Analyst should estimate the resources required to complete the assessment. The resource requirements (for instance, budget, time, technical skills) and how they will be met should be discussed and agreed with the Task Manager and the Financial Analyst's supervisor before starting the assessment. Resource requirements will be affected by the amount of analysis of the financial management systems of the implementing agency carried out as part of the technical assistance for project design.

2.3.29 In accordance with Bank policy stated above, the focus should be on using the government's financial management system to the extent possible rather than creating a new system for the project. An understanding of the country's financial accountability framework (essentially the rules, regulations and institutions which provide assurances that public resources are used economically and efficiently) will assist the Financial Analyst to highlight the financial management and fiduciary risks to which the proposed project may be exposed. The Bank's CGP and the World Bank's PEFAR are useful sources of this information. Other sources may include other Bank diagnostic economic and sector work, similar reviews conducted by other donors, and reports from borrower country institutions. This information should be used as reference documents so that analysis of the country issues is not replicated in full in the assessment. Project specific information gathered during the planning phase should be included in the supporting documents.

2.3.30 Financial management issues such as the following should be considered during the project planning phase:

- What the country financial analytic assessments, such as the CGP, PEFAR, PEFA-PFM, CPAR and experience with the existing country portfolio tell us about accountability issues, corruption, financial management capacity, etc;
- Do aspects of the proposed project design have significant financial management implications or risks? If so, how should such issues be identified and approached?

2.3.31 Where a financial management assessment has previously been conducted on a proposed EA in the context of a previous Bank Group project, it would not be necessary to conduct a full assessment for a new project. In deciding on the extent of work, if any, to be carried out on the new project, the Financial Analyst should take into account the date of the previous assessment and experience with implementation of the financial management aspects of the previous project. In countries where there is a high degree of homogeneity between implementing agencies, experience with previous projects, as well as knowledge gained from available country assessments, will often mean that less detailed work will need to be carried out in the assessment of a new project. Where the Bank Group is planning to co-finance with another donor and there

is alignment of project preparation/appraisal schedules, opportunities should be sought for sharing the work in support of, and conclusions from, the financial management assessment work.

Conducting the Assessment

2.3.32 This sub-section covers the following areas:

- Assessment Methodology
- Designing the Institution Development Proposal
- Types of Institution Development Interventions
- Costing of the Institutional Strengthening
- Implementation Strategies
- Risks

Assessment Methodology

2.3.33 An agency's capacity to achieve results mainly depends on: (i) its structural and managerial ability to effectively and efficiently employ its resources; and (ii) the extent of resources mobilized in the form of financial budgets, the number and quality of staff, and the extent and type of materials and equipment. The Bank Group's principal concerns are to ensure that the project's development goals are delivered in a timely manner and that project funds are used economically and efficiently. In support of this, it seeks to ensure that the financial management system can report on the source(s) and payments from the project funds. The primary responsibility of the Financial Analyst is to assess the adequacy of the financial management system to meet the Bank's concerns. The responsibility for maintaining an adequate financial management system rests with the borrower. In assisting the borrower to evaluate, and if necessary strengthen, financial management capacity self-assessment techniques are likely to be useful, particularly at an early stage of the assessment process. To build ownership of the diagnosis and the resulting action plan, the Financial Management Questionnaire (Knowledge Management, section 7.13) should be completed by the borrower before the assessment begins. The borrower may supplement its capacity to carry out the self-assessment with consultants or the external auditors. If the Financial Management Questionnaire (FMQ) is completed as a self-assessment, then the Financial Analyst will review the checklist as part of the financial management assessment. When a self-assessment approach is not used, the Financial Analyst should complete the FMQ.

2.3.34 The FMQ provides an indicative list of issues and questions to be considered in the assessment. It is clearly difficult for a single questionnaire to adequately cover the diversity of the Bank Group's operating environment and projects. The FMQ may therefore be customized to better address specific project circumstances by adapting the questions (adding, deleting, or modifying, as appropriate) to better suit the objective of the assessment. The weighting to be given to individual questions or control areas varies from project to project.

2.3.35 A central aspect of the FMQ is an evaluation of the risks associated with the project financial management arrangements. Assessing the risks involved in the project and their materiality helps in choosing the appropriate course of action to ensure robust project financial management arrangements. Assessment of risk is an important part of the financial management assessment work. Annex D of the FMQ sets out an approach to assessing risk by applying the

model of inherent risk and control risk to the assessment.⁹ For each topic in the FMQ, there is space to indicate the level of risk—high, substantial, moderate, or negligible/low. The summary risk analysis is used to bring together the component risks into an overall risk analysis.

2.3.36 The next step is for the Financial Analyst to make an assessment of the adequacy of the project financial management system following four basic steps:

2.3.37 **Step 1:** Analyze the EA’s Structural and Management Framework:

- Examine the organization’s structure with regards financial management. This will include an analysis of how functions are distributed and distinguished, how roles, responsibilities, and authorities are delineated and apportioned both vertically and Financial Management of Executing Agencies horizontally, what are the key lines of command etc. Also included should be an analysis of links with collaborating agencies also operating in the sector concerned.
- Examine the agency’s main administrative and management systems and procedures, in relation to financial management. These should include operational planning and programming systems, financial management and budgetary processes, and management information and monitoring systems.

2.3.38 **Step 2:** Assess Institutional Resources (Inputs)

- Assess the number, qualifications, and experience of financial management staff at all key levels.
- Assess for all relevant periods, the extent of financial support available in terms of investment budgets and operating budgets. These should be described by major items, as well as by allocations made to various operational units, both functional as well as geographical.
- Assess the adequacy of agency accounting information systems.

2.3.39 **Step 3:** Assess Institutional Results (Outputs)

- Develop agency consolidated financial statements (against budgets) for each functional area, for relevant operating periods, and for geographical agency units (if these exist).
- Also develop consolidated financial statements for past operating periods (including growth trends, if possible) and compare these against similar agencies (comparator agencies may be similar agencies in other countries where the socio-political environment, the cultural context, and the geographical dimensions of operation are similar).
- Identify financial performance shortfalls or variances by comparing current performance with targeted performance, past performance-growth trends and, if feasible, with the performance of comparator organizations.

2.3.40 **Step 4:** Analyze Performance Shortfalls

- Develop a diagnostic analysis of linkages between identified financial performance shortfalls/variances and deficiencies in the agency’s resource availability and management framework. This should be done in collaboration with the agency’s top management. These analytical findings should be agreed with the agency’s management.

⁹ This approach is largely based on IFAC Standard 400 “Risk Assessment and Internal Control.”

- Together with the agency's management, develop alternative institution-building interventions, with regards financial management arrangements. These should be prioritized and based on an alternatives-analysis, using criteria such as cost, envisioned scope of impact, degree of risk, ease of implementation, etc.

Design the Institution Development Proposal

2.3.41 Types of Institution Development Interventions, with regards financial management:

- When planning and designing institution development proposals (based upon project preparation), staff should keep in mind that institutional strengthening can be targeted at resource enhancement or management upgrading or both, depending on the needs identified. As a general rule, resource enhancement should be resorted to first, if this option is available, since this can be achieved more easily and quickly.
- The caveat, however, is that resource enhancement is normally only a short-term solution to institutional deficiencies and should preferably be supported by more basic institutional changes or upgrading. Changes in or upgrading of policies, strategies, structures, administrative and management systems, etc. are far more difficult to achieve, require strong institutional support and commitment, and consequently a more extended time frame. On the other hand, they have a more lasting and permanent impact on institutional efficiency and effectiveness.

2.3.42 A general checklist of the types of institutional strengthening that may be focused upon in an institution-building proposal is given below.

- Resource Enhancement
 - Staffing: enhance staff availability, reallocate staff resources, upgrade staff skills (training);
 - Budgets: enhance operating budgets, reallocate funds by item; and
 - Technology: enhance availability of equipment and materials, improve quality of equipment, introduce new types of software.
- Management Upgrading
 - Policies and Strategies: review, revise, change priorities, adjust funding allocations, adjust strategic emphasis, build research and analytic capability, enhance "market" or "sector" information system, etc.;
 - Organization Structure: change and reassign roles and responsibilities change lines of authority, revise position descriptions and position hierarchies, establish task groups, create coordination mechanisms, strengthen linkages with collaborating agencies, etc.;
 - Administrative and Management Systems and Procedures: revise, upgrade, simplify, reorient basic systems and procedures such as: planning and programming, financial management, operations monitoring, information feedback, personnel management and compensation, incentive systems, etc.; and
 - Leadership Style: revise methods of communication, methods of involving staff at all levels, build openness and willingness to innovate, etc.

Costing Institutional Strengthening

2.3.43 If part of a project, the institution strengthening measures should preferably be consolidated into a discrete component to facilitate project administration. The costs relating to such a component would usually include (i) consultant services; (ii) civil works (e.g., training

centre), equipment; (iii) training expenses; and (iv) administration overheads (e.g., for the training centre). Some of these costs could be recurrent costs that will continue to be incurred even after project/TA completion.

2.3.44 In such a case careful consideration should be given to whether the Bank should fund such costs during project/TA implementation: if so, to what extent; and does the government have the capacity to meet such recurrent costs after project/TA completion. Given that TA resources are limited, the availability of co-financing or funding from other donors should be examined.

Implementation Strategies

2.3.45 Implementation strategies will necessarily depend on the type of institution development interventions planned. However, staff should bear in mind the following when planning and scheduling the implementation of institution development interventions with the agency concerned.

- Institutional strengthening measures, especially those which relate to the upgrading of the management framework, have to be implemented in a gradual and phased manner. Like a person, an institution takes time to learn, adopt, and adjust to new and revised forms of behaviour.
- Experience has indicated that it is very useful to make use of implementation workshops. These are carefully structured discussion sessions of small groups of concerned institutional staff held periodically. Their primary objectives would be as follows: (i) creating awareness and recognition of the need to change, revise, and upgrade; and developing the commitment to do something about it; (ii) action planning to ensure the active involvement of all concerned and to facilitate briefing of what is required; and (iii) reviewing implementation to assess progress and impact, and to accordingly adjust the direction, focus, schedule, etc. of the institutional strengthening program.

Risks

2.3.46 Some of the major risks that should be taken into account when planning institutional strengthening measures (in relation to financial management arrangements) are as follows:

- In the case of resource enhancement, do not create dependency.
- In the case of management upgrading, do not create disorientation by introducing too many changes too quickly.
- Do not overlap or conflict with already ongoing institutional strengthening initiatives.

2.3.47 Institutional strengthening programs should also always be proposed and undertaken by the Bank with caution, care, and a great deal of responsibility. This is because the longer-term risk potential with institution-building programs is usually greater than those related to the transfer of capital and investments. Furthermore, these types of program can create dependency or result in the transfer of inappropriate technology.

2.3.48 If not done in a circumspect and phased manner, attempts to revise or upgrade the management framework can create serious institutional disorientation, especially if prior commitment at all levels has not been ensured for the changes being implemented.

2.3.49 External financing agencies tend to view “their” project as the most critical. Consequently, institution-building activities can be implemented in a parallel rather than a

complementary manner. This usually confuses, rather than assists, the institution concerned. In the longer term, the results of a misguided institution-building program can consequently be quite the opposite than what was originally envisaged. It is, therefore, always necessary and essential to proceed cautiously and with an action learning format that is structured to include phasing, review, and consequent program readjustments in an ongoing cyclical process.

Recording the Results of the Assessment

2.3.50 The results of the assessment are documented in the Financial Management Assessment Report, with a separate file for relevant supporting documentation. The overall assessment is stated in the executive summary of the assessment report. If the system is considered inadequate, the report should identify the actions considered necessary to rectify the weaknesses.

2.3.51 The title, date and author of any project financial management report should be clearly stated and the report placed in the project's permanent files. Supporting documentation comprises the material, documents, and working papers prepared or collected by the Financial Analyst during the assessment. Supporting documents (a) assist in the planning and performance of the assessment; (b) facilitate the supervision and review of the assessment work; and (c) record evidence resulting from the assessment performed to support the Financial Analyst's conclusion.

2.3.52 Since the assessment relies on application of professional judgment, it is neither necessary nor practical to document every matter the Financial Analyst considers. In determining the extent of the supporting documentation to be prepared and retained, the Financial Analyst should consider what would be necessary to provide another Financial Analyst, who has had no previous experience with the assessment, with an understanding of the work performed and the principal decisions taken but not necessarily every detailed aspect of the assessment.

2.3.53 The Financial Management Assessment report will:

- Include an executive summary, with a statement of the assessment's overall conclusion;
- Provide a brief summary of the project design;
- Describe and assess the adequacy of the financial management arrangements including disbursement arrangements;
- Identify the significant risks;
- Summarize the primary strengths and weaknesses of the financial management system, including actions required to address weaknesses;
- Identify the relevant issues to be included in the legal documents; and
- Describe the plans for supervision of the financial management aspects of the project.

2.3.54 Annex C of the FMQ (Knowledge Management, section 7.13) provides a sample format and a description of the contents of each section of the financial management assessment report. The assessment report will be written so that it can be read as a stand-alone document. It should facilitate appropriate inputs to both the financial management sections of the Appraisal Report and the project legal documents. The Report should be the minimum required to adequately describe and assess the project financial management system. The draft report should be discussed with the implementing entity and any action plans agreed with them.

2.3.55 The table below provides an outline of the assessment report with an indication of which items would typically be (a) included in the FMQ, (b) described in the assessment report, and (c) copied into the indicated section of the Appraisal Report.

Topic	FMQ	Financial Management Assessment Report	Appraisal Report	Annex to Appraisal Report
Executive Summary and Conclusion		√	Conclusions (Section 8)	
Summary Project Description		√		
Country Issues		√		√
Risk Analysis	√	√	Critical Risks (Section 6), if significant to project	
Strengths and Weaknesses		√		√
Implementing Entity	√	√	Executing Agency (Section 5)	√
Funds Flow	√	√	Disbursement (Section 5)	√
Staffing	√	√		√
Accounting Policies and Procedures	√	√		√
Internal Audit	√	√		√
External Audit	√	√		√
Audit Reports	√	√		√
Reporting and Monitoring	√	√		√
Format of Financial Statements		√		
Information Systems	√	√		√
Impact of procurement arrangements		√		
Disbursement Arrangements		√		√
Method (i.e., periodic or traditional)		√		√
Periodic disbursement arrangements, if applicable		√		√
Limits and review arrangements, if applicable		√		√
Special Account Allocation and Procedures		√		√
Disbursement Mechanisms (e.g., Direct payment)		√		√
Any unique circumstances or requirements		√		√
Action Plan, if required (agreed with borrower)		√		√
Conditions		√	Conditions (Section 8)	
Financial Covenants		√	Conditions (Section 8)	
Supervision plan		√		√

Assuring the Quality of the Assessment

2.3.56 The Financial Analyst's supervisor is responsible for developing, documenting and implementing arrangements to assure that the quality of all financial management assessments performed is acceptable. Country Teams, Interdepartmental Working Groups and the Senior Management Committee will review the quality of financial management assessments as part of the Bank Group review process.

Special Purpose Entities

2.3.57 Borrowers may create new, dedicated organizational units specifically to implement Bank Group-financed projects. These units are sometimes not established, and are frequently not operational, until project preparation is well advanced. In some cases, they do not become operational before funding for the project has been approved. In these circumstances, the actual project financial management systems¹⁰ will not exist in the initial stages of project preparation. Nevertheless, the Financial Analyst should be engaged from an early stage of the project process, focusing initially on the proposed financial management arrangements. The Financial Analyst reviews whether the action plan prepared by the Borrower to implement the proposed arrangements is reasonable and whether sufficient capacity and resources are available to implement it. The assessment will need to be updated during project appraisal, especially before negotiations, to assess implementation progress and to determine which steps will need to be included in the legal documents (for instance, as conditions of effectiveness) to ensure that the project has adequate financial management arrangements.

Relationship with Procurement Assessments

2.3.58 All investment projects are required to have an assessment carried out of the entity's capacity to implement procurement as part of project preparation and appraisal. Procurement forms part of the entity's overall internal control framework. The Financial Analyst should therefore work closely with the Procurement Specialist throughout the project preparation/appraisal processes. The procurement and financial management assessments should be exchanged and discussed. The objective is to ensure that the aggregate of the two assessments provides a coherent picture of the overall control arrangements. While each assessment focuses on a different functional area, care should be taken to ensure that they are not inconsistent, and that measures proposed to mitigate risk should be mutually supportive as far as practicable.

¹⁰ The project financial management system is the series of tasks and records of the project entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyse, calculate, classify, record, and report transactions and other events periodically presented in the financial statements.

Financial Analysis and Appraisal of Projects

3. FINANCIAL ANALYSIS AND APPRAISAL OF PROJECTS

3.1 INTRODUCTION

3.1.1 OM 500 and OM 600 (Knowledge Network Section 7.9) address project preparation and project appraisal respectively. While project preparation is the process that converts a project idea into a formal plan, the overall objective of appraising a project is for the Bank to satisfy itself as to (i) the project's technical, financial and economic viability against the background of national, sectoral and local needs for the investment; (ii) the economic and financial justification for the proposed output(s); (iii) project and/or entity sustainability; (iv) the extent of its contribution to human and technological advancement; and (v) governance aspects of the project. Financial analysis is important for understanding whether a project is financially viable and that the EA is financially sustainable and capable of bring the project to fruition.

3.1.2 Project investment is a series of processes aimed at foregoing short-term economic benefits from financial resources by investing them in land, buildings, equipment, and other capital assets to produce products, goods, and services directly or through investments in securities or direct loans to financial intermediaries with the objective of maximizing economic benefits over the life of the investment. Projects are managed by and implemented by Executing Agencies (EAs) and Implementing Agencies (IAs).

3.1.3 These Guidelines recognize that the analysis of projects should be carried out through an integrated approach including a through evaluation of the physical, economic, financial, stakeholder and risk aspects of each project in a single consistent framework or model. The assessment of the physical aspects of the project focuses on a determination of or identification of the least cost technical solution to the issue addressed by the project. The issue that the economic analysis is mainly focused on is the contribution of the project to the economy of the country concerned and the economic cost of producing the project goods or services. Within the integrated appraisal framework, the economic analysis is built directly upon the financial cash flows of the project. The economic treatment of project benefits is initially based by either the revenue generated by the project and/or its cost savings, consistent with the methodology for the financial evaluation of revenue or cost savings. Similarly, direct project costs form the basis of the input values for the economic evaluation of the project. Upon this base any externalities are measured and included in the economic analysis. In the stakeholder analysis the quest is to identify the primary stakeholders affected by the project. The decision-makers need to know the present value of net economic benefits created by the project, and the economic gain/loss realized by each stakeholder as a result of the project. Decisions regarding any differences between the distribution of net economic benefits and net financial benefits must be explained. Finally, the objective of the sensitivity and risk analysis is to identify the risks the project faces and address those mitigating measures, if any, which need to be instituted. Project managers can, to a certain extent, control some risk factors while others can only be addressed at the level of the EA and the government of the country concerned. There are also some factors that are totally exogenous forces that none of the country institutions can address.

3.1.4 These Guidelines holistically addresses project appraisal from a financial perspective. They integrate the financial analysis of the project within the overall financial framework and financial management of the Executing Agency (EA). The financial implications of the physical

solution chosen are addressed in the financial evaluation of the project, while the net financial benefits of the project are subjected to sensitivity analysis and discussed in the appraisal report. Although the evaluation of the economic and stakeholder aspects of projects are included in the appraisal report, they are outside the scope of these Guidelines. These matters are addressed in the “Guidelines for Economic Analysis and Design of Bank Group Projects”.

3.1.5 Under the stewardship of Human Resources Department (CHRM), and the coordination of the Financial Management Department (FFMA), the Bank initiated the Showcase Project Initiative (SPI) as part of its ongoing efforts to improve project quality at entry by providing staff with the necessary tools to perform state-of-the art project appraisal. A team of consultants from Queen’s University assisted Bank staff in conducting enhanced project appraisals on four projects covering Power, Agriculture, Water, and Telecom sectors. These have become benchmark case studies for the Bank Group (Knowledge Management, section 7.14).

3.1.6 This section of the Guidelines is aimed at providing a financial analyst with a comprehensive view of the financial analysis and appraisal of investment projects, based on the Bank’s Operational Manual and related guidance documents. The rest of this Chapter is organized in the following eight sections:

- **3.2 – Investment Projects:** This section discusses potential revenue-earning and non-revenue-earning projects.
- **3.3 – Appraisal Checklists:** Generic appraisal checklists are discussed in this section. The checklists provide sequential activities in financial analysis of projects.
- **3.4 – Estimated Project Cost:** This section discusses the preparation of Project Cost Estimates.
- **3.5 – Financing Plan:** This section discusses the identification of the financing plan for the project.
- **3.6 – Project Financial Viability:** This section discusses the methods for determining the project’s financial viability. The need for financial analysts to identify and bring for discussion high-value financial policy issues related to financial viability and that require harmonization across donors are discussed here.
- **3.7 – Economic and Financial Objectives:** This section discusses economic and financial objectives and policy goals associated with a project.
- **3.8 – Preparing Financial Forecasts:** This section discusses the major decisions and assumptions, as well as presentation issues the financial analyst must consider in preparing financial forecasts.
- **3.9 – Financial Covenants:** This section discusses the selection and applicability of financial performance indicators as covenants in the loan documents.

3.2 INVESTMENT PROJECTS

3.2.1 Through active participation in the Paris High level Forum, the Bank committed itself to base its overall support – country strategies, policy dialogue and development cooperation programmes – on RMC’s national development strategies and periodic reviews of progress in implementing these strategies (Knowledge Management, section 7.3). The Bank’s preparation of the Results-Based Country Strategy Paper (RBCSP) allows it to clearly define its strategy in relation the applicable RMC’s national development strategy. The Bank’s RBCSP evolve from and build country systems, providing a framework for designing the strategy and implementation plans around specific measurable outcomes, building synergies between lending and non-lending activities and selectively leveraging opportunities to ensure the greatest impact of Bank Group interventions. Individual project proposals are considered by the Bank if they: (i) address key

RMC developmental needs; (ii) meet the Bank's basic development and investment criteria; and (iii) are 'owned' by the borrower and stakeholders. Once project proposals received by the Bank go through a rigorous vetting procedure in line with the requirements of OM 340 they are included in a 3-year Rolling Lending Programme that is subject to Board approval.

3.2.2 The following two sections provide indicative lists of revenue-earning and non-revenue sectors, sub-sectors and projects covered in a typical 3-year Rolling Lending Programme. The lists exclude Technical Assistance and needs to be updated on an ongoing basis.

Revenue-Earning Projects

3.2.3 The following is a possible list of potential revenue-earning projects. Operations Complex Departments should ensure that financial expertise is made available for these projects, during project identification, preparation, appraisal and supervision: Electric Power, Flood Management, Grain Productivity, Irrigation, Micro-finance, Road Transport, Rural Electrification, Rural Finance, SME Development, Urban Development (e.g., water supply), Urban SME Business Development, Water Resources.

Non-Revenue-Earning Projects

3.2.4 The following is a possible list of potentially non-revenue-earning projects. Financial analysts' advice may be sought in relation to the cost-recovery and efficiency improvement aspects of projects in these categories. Importantly, financial management expertise is required during project supervision: Agriculture Extension, Basic Education, Civil Service Reform, Coastal Resources Management, Eco-tourism, Health Services, Inter-regional System Improvements, Natural Resources Management, Non-formal Education, Post-Secondary Education, Rural Infrastructure, Rural Poverty Reduction, Rural Productivity Enhancement, Social Sector Development, Urban Development (e.g., drainage), Urban Environment.

3.3 APPRAISAL CHECKLISTS

3.3.1 The Knowledge Management section 7.16 provides a generic checklists for the financial appraisal of: a non-revenue earning project; revenue-earning project; and financial intermediary institution. It, also, includes a checklist to review financial aspects of Appraisal Reports.

3.3.2 Bank financed non-revenue projects would be in the public sector. Revenue-earning projects may be in the public sector or in the private sector¹. Financial intermediaries range from large-scale apex institutions that support multiple FIs to specialised industrial and agricultural FIs and micro-finance organizations. Because of the unique financial characteristics of FIs a separate checklist is proposed. Projects are different in their objectives, their sectoral and institutional structure and management as well as their design and implementation. Consequently, care should be taken in the application of the checklists.

¹ These Guidelines are restricted to public sector operations. The private sector lending window of the Bank is governed by separate policies and guidelines.

3.4 ESTIMATED PROJECT COST

Introduction

3.4.1 A key element of the Bank's due diligence is to require its staff to work with their counterparts in borrowers' agencies, particularly EAs, throughout the processes of project identification, preparation and appraisal. This is to ensure the Bank that all reasonable efforts have been made by the borrower to prepare meaningful forecasts of cash receipts and payments to support effective and timely project delivery. After the start of project implementation of non-revenue earning projects, the Bank continues to require updated forecasts to project completion to provide early warning of project problems so that corrective action may be taken. In the case of revenue-earning projects the financial analyst will agree with the EAs the period during which updated forecasts should be provided. The exact period will be at the discretion of the financial analyst and will normally not exceed a total of ten years ranging from three to five years following project completion. This period will be specified in the loan agreement.

3.4.2 During project preparation and appraisal, staff should carefully scrutinize the estimated cash receipts and cash payments for the project, but it remains the responsibility of the Bank's Task Manager to ensure that the project base costs are realistic. The word "staff" is emphasized to stress the fact that a financial analyst and the project engineer each have a responsibility, to not only scrutinize the cost estimates generally, but more particularly to ensure that the items which are included in the base cost are realistic. In addition, the financial analyst and the project engineer should ensure that related components and investments that are not included in the project cost estimate but may be of a potentially beneficial nature are omitted only for sound technical, financial and economic reasons.

3.4.3 The rest of this section discusses: the use of the Standard Project Cost Table (COSTAB²) computer model; the principal elements of cost estimates and how these are developed, including physical, price and risk contingencies and the disbursement profiles. In addition, outlines of a typical Project Cost Estimates Table and a Financing Plan are reviewed.

The Use of the COSTAB

3.4.4 Financial analysts may use the COSTAB computer model. COSTAB calculates physical and price contingencies, taxes and foreign exchange. It displays data in detailed costs tables, summary project cost tables, financing plans, procurement tables and loan allocation tables. It also converts financial costs to economic costs for economic analysis.

3.4.5 The COSTAB software program can be downloaded from the following website: <http://www.worldbank.org/html/opr/costab/costab.html>.³

² COSTAB is a software developed to improve the efficiency and effectiveness of project work done by the World Bank and its borrowers. It helps project analysts organize and analyze data in the course of project preparation and appraisal (<http://www.worldbank.org/html/opr/costab/contents.html>).

³ The Information Methods and Management (CIMM) Department of the Bank is responsible for providing copies of the software, a user manual and user support services for the software.

Project Cost Estimate

3.4.6 The Project Cost Estimate Table shows the total cost of a project and incorporates all elements in a manner that is both explicit and meaningful. It provides an understanding of the costs of the principal components as at the date of appraisal. Equally it provides information for project cost control during implementation by the borrower, the EA and the Bank.

3.4.7 The model of the Project Cost Estimates Table provided below is suitable for the main body of an Appraisal Report (AR). Each line item can be broken down to provide additional sub-line items. The COSTAB software provides a high degree of detail that can be tailored for the AR main text and for an annex thereto.

PROJECT COST ESTIMATE TABLE

COUNTRY: XXX					
PROJECT: Name of Project					
In (thousands)/(millions) of UA/Bank Lending Currency					
	Local Costs	% of Total	Foreign Costs	% of Total	Total
COMPONENTS ***					
Land	0.00	0	0.00	0	0.00
Capital Goods	0.00	0	0.00	0	0.00
Civil Works and Construction	0.00	0	0.00	0	0.00
Consulting Services	0.00	0	0.00	0	0.00
Training	0.00	0	0.00	0	0.00
Incremental Administrative Costs	0.00	0	0.00	0	0.00
Initial Working Capital	0.00	0	0.00	0	0.00
Base Cost as at (date)	0.00	0	0.00	0	0.00
Contingencies ***					
Physical	0.00	0	0.00	0	0.00
Price	0.00	0	0.00	0	0.00
Other (Identify)	0.00	0	0.00	0	0.00
SUB-TOTAL					
	0.00	0	0.00	0	0.00
Financing charges ***					
Interest during construction	0.00	0	0.00	0	0.00
Other	0.00	0	0.00	0	0.00
TOTAL PROJECT COST AND FINANCING REQUIRED					
	0.00	0	0.00	0	0.00
*** Footnotes to be used as necessary, particularly for contingency explanations					

Base Cost Estimate

Principle Components

3.4.8 The principal components that should be included in the base cost typically consist of local and foreign costs of (i) land and rights of way needed for implementation and incurred after the loan request was made, (ii) capital goods (including initial requirements of operational inputs, e.g. fertilizers), (iii) civil works and construction, (iv) consulting services, (v) training, (vi)

incremental administrative costs (including cost of staffing and auditing to satisfy the Bank's requirements) incurred during implementation, (vii) initial working capital, and (viii) taxes and duties incurred on any of the above components. The cost of land, rights of way and taxes and duties are properly included in the base cost of a project even though the Bank does not finance these costs.

3.4.9 Normally an EA will have project designers (engineers, architects, agriculturalists, economists, etc.) who undertake a feasibility study to design the physical operational features of a project and ascertain the cost and the economic benefits of the project. These project designers may be staff of the EA or foreign and local consultants or a combination of the three. The cost of the feasibility study may be met from a technical assistance loan, or from the borrowers own resources. Normally the design cost will be incurred prior to project implementation, but there will be circumstances where the final design work is ongoing during implementation and may form part of the project cost.

3.4.10 Typically, base costs are estimated as part of the feasibility study and are refined to take into account any further engineering and other detailed preparation work that has taken place by the time of appraisal. With large, complex projects, or in cases where there is little record of recent procurement involving Bank projects in the country, the services of specialized cost estimating firms, or quantity surveyors, or the advice of contractors or manufacturers may be employed to confirm or modify base cost estimates. During appraisal, the estimates should be adjusted and updated to take account of any price changes in the period between their preparation and the base cost date specified in the AR.

3.4.11 The role of the appraisal mission's financial analyst may range from (i) satisfying him/herself that the methods, data and assumptions used in the determination of the project base cost are credible and justifiable, to (ii) assisting in the assembly of data provided by the designers in order to compile the cost estimate (OM 500). The base cost estimate assumes that the quality and quantity of works, goods and services as well as the prices of inputs and outputs relevant to the project have been developed as accurately as possible using, wherever feasible, known factors which will not change during implementation and that the project will be implemented precisely as planned. Contingency provisions provide for the possibility that the base cost estimate may not have accurately estimated the quantity or quality of goods and services needed or that the prices of those goods and services may change subsequent to the date of the cost estimate.

3.4.12 The Base Cost Estimate is the appraisal mission's best judgment of the estimated project cost as of a specified date. The Date of Base Cost Estimate should be specified in the AR and should not be earlier than six months prior to presentation of the loan proposal to the Board for approval. If the elapsed period prior to Board presentation is more than six months, the base costs should be revised by indexation for the time period elapsed up to a maximum of 12 months from the date of the Base Cost Estimate. A reappraisal of costs should be made if the presentation of the loan to the Board is more than 12 months after the Date of Base Cost Estimate.

Retroactive Financing

3.4.13 As a general rule the Bank does not disburse funds for expenditures incurred and paid for by a borrower or recipient during or after appraisal but before a Bank loan agreement or a technical assistance agreement becomes effective. However, based on a prior agreement between the Bank and the borrower, a clause authorizing the financing of agreed expenditures incurred before the loan effectiveness date may be included in the loan agreement. This clause should indicate the amount of the retroactive financing, the category of expenditures concerned and the

date from which the expenditures may be incurred. The financial analyst should ensure that any request specifying justification(s) by a borrower for retroactive financing is recorded in the Aide Memoire prepared during project identification, project preparation, and/or project appraisal, as well as in the related reports issued on return to Headquarters.

Contingencies

Introduction

3.4.14 The reliability of base cost estimates reflect the amount of detailed preparation work which has been undertaken before appraisal. For example, for a large reservoir, or a major roll-on/roll-off harbour facility, the detailed engineering may be completed before appraisal and the base cost estimate will have a correspondingly high degree of reliability. This, also, applies to projects involving purchases of equipment that is of standard design, in quantities that are precisely specified, for example, telecommunications expansion.

3.4.15 Some projects may be appraised when there is much less detailed information available about designs or quantities. In health care projects, for example, the exact locations and the designs of clinics may not be known at the time of appraisal. The base cost estimates in such cases may have been made by setting a target population to be served, allocating the building space per 1,000 residents according to local norms and estimating costs on a price per square meter basis obtained from actual costs of similar local clinics. Similarly in some sector loans and agricultural projects, slum upgrading projects, minor water and sanitation systems projects or highway improvement projects base costs may be estimated by extrapolation using unit prices derived from detailed designs and specifications for sample areas and facilities which are representative of the various project components. Such bases for estimating are acceptable to the Bank, provided the appraisal team is assured of the relevancy and currency of the data, and that, where necessary, appropriate contingencies are recognized.

3.4.16 Contingencies address the possibility that unanticipated costs may need to be incurred or that quantities required and/or prices may change between the specific date of the base cost estimate and the actual expenditures for those items when implementing the project. Contingency allowances should reflect the costs of probable physical and price changes arising from special risks that can reasonably be expected to increase the base cost estimate. However, contingencies cannot provide assurance against the effects of all possible adverse events or conditions.

3.4.17 Contingencies are an integral part of the expected total cost of a project as well as the financing plan and are normally necessary for all project items involving significant expenditures. Separate estimates should be made of physical contingencies and of price contingencies. Contingency allowances should be identified in the project cost tables and shown as individual line items in the project cost table separately from base cost estimates. For projects with several major components, it is generally desirable to present contingency estimates separately for each component as well as for the project as a whole. The text accompanying the cost tables should discuss the physical factors, price changes and risk factors expected to affect the project costs from the date of the base cost estimates to the completion of the project. Any special features relating to contingencies should be explained in the AR. Appraisal missions should confirm that: (i) the estimates produced for ARs specifically designate all physical and price contingencies as such; (ii) the amounts are reasonable; and (iii) no contingencies are included in the base cost estimates.

3.4.18 In the case of sector/sub-sector loans where physical targets have been broadly defined but the exact scope is not essential to the success of the project (e.g., installation of 500 serviced sites as part of a rolling program, or maintenance of rolling stock in railway workshops) only price contingencies should be included. The impact on such projects of any shortfall in the expected amounts of works, goods or services should be tested by sensitivity analysis.

3.4.19 In the case of technical assistance projects with well defined Terms of Reference and relatively short time duration and industrial development finance and agricultural credit projects – where the project is essentially a line of credit to help finance a program defined in financial terms and without specific physical content – contingency allowances should not be included.

Disbursement Profiles

3.4.20 The Bank has gained considerable experience with the capacity and capability of borrowers and their EAs in various sectors to adhere to construction schedules. Patterns of disbursements for loans to the same sector or borrower show that EAs rarely meet these schedules, and time and cost overruns are a consistent feature of many lending operations. Therefore the estimated project construction period should be influenced by past experience and should not vary greatly from the average for similar projects executed in the same sector in the same country.

3.4.21 To develop a realistic disbursement profile, the financial analyst should work with the Loan Disbursement department to obtain disbursement data for the country and sector in which the project under development is located. The most appropriate period would be about 12 years prior to the current fiscal year of the Bank. If shorter periods are used, both for the profile period and for the proposed disbursement period in the AR, a specific explanation of the factors that would enable achievement of shorter periods should be provided.

3.4.22 The adoption of realistic implementation and disbursement periods based on sector and country disbursement profiles should be reflected in the calculation of contingencies and the economic rate of return and financial internal rate of return calculations.

Physical Contingencies

3.4.23 Allowances for physical contingencies reflect expected increases in the base cost estimates of a project due to changes in quantities, methods and/or the period of implementation. Physical contingencies should be calculated on both foreign and local cost items, and expressed as percentages of the foreign and local base costs in the Project Cost Table. OM 600, Annex 3 provides extensive advice on the determination, calculation and application of physical contingencies to base prices. The Annex, also, advises on the methods of including price contingencies which should also be applied to physical contingencies, as well as the base costs.

3.4.24 The principal factors from which uncertainties arise in civil works and for which provisions for physical contingencies should be made are (i) the type of terrain where the project is to be constructed, particularly, (a) geologically difficult areas where slips and slides that are difficult to predict are frequent, (b) areas of thick marine clay deposits where the flooding potential is high and (c) areas subject to frequent earthquakes, (ii) the climatic conditions in the project area e.g. the likelihood of unusual rain that may cause flooding or strong windy conditions, (iii) difficult access to the site of the work because of long and poorly maintained roads or railroads which may be subject to destruction due to flooding, landslides, etc., (iv) the amount of field work which has been completed, particularly the degree of thoroughness of

borings and sub-surface exploration as well as the location and testing of construction material sources (gravel, rock quarries, etc.). Some projects covering a large area or involving very long and deep excavations, such as tunnels, are so expensive or even impossible to explore thoroughly in advance that it may be prudent to assume some risks of encountering poor conditions, (v) the consultant's knowledge of local conditions of materials and labour costs, (vi) the degree of precision with which the quantity estimates have been prepared (vii) the possibility of design changes during construction and the addition of unforeseen items and (viii) the quality of contract supervision.

3.4.25 Some of the main factors that cause uncertainties with regard to material and equipment components are (i) the degree of precision with which quantity estimates of needed material and equipment, including necessary spare parts, have been prepared; (ii) the extent to which detailed specifications for material and equipment have been set; and (iii) the extent to which equipment is to be purchased *off-the-shelf* or on special order.

3.4.26 The extent to which the services can be accurately and fully defined in advance is a major factor causing uncertainties with respect to the provision of services. If the extent of service requirements can only be fully defined during the course of project implementation then a relatively large contingency allowance might be reasonable. An example is the case of site investigations for the design of a large command area irrigation scheme.

3.4.27 The Bank expects that physical contingencies would normally be between 5 to 10 per cent of base costs. Acceptable ranges of physical contingencies will vary from sector to sector as well as for the various components of a project. As an example, the contingency allowances for civil engineering works for power stations probably would be higher than those for the supply of materials or equipment for schools. When physical contingencies are relatively large, for example more than 10 to 15 per cent overall, consideration should be given to further refining basic designs and additional site investigations in order to reduce uncertainties before appraisal. Higher physical contingency provisions are, however, often necessary to reflect an extraordinary uncertainty inherent in works where it is too costly, or impractical to further refine the quantity and cost estimates. Examples include: structural foundations in difficult soils; marine work; tunnelling; dam construction; construction of roads involving difficult soil conditions; pile driving; and rehabilitation of existing facilities. Inclusion of these higher physical contingencies must be fully justified in the AR.

3.4.28 In any event, if the physical contingencies exceed 5 per cent of the base cost estimates, justification should be made in the Aide Memoire and BTOR during project identification (OM 500) and in the AR (OM 600).

Price Contingencies

3.4.29 Price contingency allowances reflect forecast increases in project base costs and physical contingencies due to changes in unit costs/prices for the various project components/elements subsequent to the date of the base cost estimates. Price contingencies should be expressed as percentages of the base costs plus physical contingencies calculated separately for the local and foreign expenditures of the project. OM 600, Annex 3 provides extensive advice on the development and application of price contingencies and charges. The Country Economist is mandated with advising on inflation rates and foreign exchange factors that may have an impact on price contingencies.

3.4.30 Periodically, the Country Economist will provide suggested price escalation factors for internationally procured goods and services. Such price escalation factors should not be applied mechanically. If they are deemed to be inadequate or excessive more appropriate factors may be applied with the approval of the Director concerned. For local cost components, the expected price increases should be calculated in accordance with the inflation rate in the borrowing country. The Country Economist will periodically update suggested escalation factors to be applied for local cost estimates.

3.4.31 In determining the appropriate amount to be provided for price contingencies the following key factors should be considered (i) the commencement date for project expenditures and the total project implementation period (ii) in the absence of some rationale for modifying a Country Economist's suggested local price escalation factors (which should be explained in the BTOR at project identification and in the AR) the suggested escalation factors should be consistently applied to all projects in that country; (iii) the extent to which local or foreign prices for particular types of works, goods and services will follow general inflationary trends. For example, when a construction industry is overextended or depressed, price trends may exceed or be lower than the general movement of prices. Similarly, technological improvements in the production of some types of equipment have resulted in a much lower rate of price increase than general price trends and (iv) the extent to which a large project may have the effect of increasing the cost of local resources such as land, labour and raw materials more rapidly than the general price escalation.

3.4.32 Governmental procurement procedures that award only fixed price contracts even when construction will be ongoing for a number of years, or that set a ceiling on the allowable price adjustment should be ignored when preparing project costs for Bank financing. Bidders typically adjust for such practices by increasing their base cost bids and bidders total cost including their price contingencies is often not significantly different to the unadjusted base project cost plus price escalation forecast by the Bank. Accordingly, in using estimates prepared by bidders in establishing the true base cost estimates, care should be taken to deduct any price contingencies implicitly included by the bidder as part of their base cost.

3.4.33 If, in the opinion of the financial analyst (and/or the mission) distortions may occur due to significant differences between domestic and foreign inflation rates and potential exchange rate adjustments the issues, where necessary, should be referred after discussion with the Country Economist to the concerned Director. This would apply in those countries that may be subject to frequent currency devaluations.

3.4.34 The allowance for price contingencies is to be calculated on total expenditures per year of implementation. The cumulative rate of price increase for a particular year is calculated by compounding the estimated rate of price rise in prior years and one half of the rate of price increase in the year of procurement⁴. This rate is applied to the base cost estimate for the applicable expenditures. In the following example: (i) procurement is assumed to commence one year after date of Base Cost Estimate, (ii) years two to six are implementation years and (iii) compound interest tables are used to calculate the increase for the years prior to procurement before adding 50 per cent of the escalation factor in the year of expenditure. Where special circumstances support a different rate of price escalation for specific items the price contingency for those item must be calculated separately.

⁴ An assumption is made that expenditures in the year of expenditure will be spread evenly over the year therefore an average of one half year's price escalation is applied.

Example: Calculation of Price Contingencies for Project Appraisal and Financial Projections

Year	Base Cost + Physical Contingencies in Project Cost Table	Rate of Inflation from Date of Base Cost Estimate	Calculation	Inflation adjusted Base Cost + Physical Contingencies	Increase due to Inflation
1	0.00	7%	Year for negotiations, Board approval signing, etc	0.00	0.00
2	50	7%	$50 \times (1 + 0.07) \times (1 + 0.035)$	55.37	5.37
3	100	7.5%	$100 \times (1 + 0.07) \times (1 + 0.07) \times (1 + 0.0375)$	118.78	18.78
4	200	8%	$200 \times (1 + 0.07) \times (1 + 0.07) \times (1 + 0.075) \times (1 + 0.04)$	256.00	56.00
5	75	7%	$75 \times (1 + 0.07) \times (1 + 0.07) \times (1 + 0.075) \times (1 + 0.08) \times (1 + 0.035)$	103.18	28.18
Total	425			533.33	108.33

Other Contingencies

3.4.35 The standard approach to the costing of a project requires that the cost of land, equipment, goods and services should be based on current prices. In addition, allowances should be made for unforeseen physical conditions that may increase costs and for inflation. But where current prices cannot be determined until the borrower takes certain steps or decisions, or certain events have occurred it may be necessary to include an additional risk contingency. An alternative is to encourage the borrower to insure against risk, possibly by using the Multilateral Investment Guarantee Agency (MIGA).

3.4.36 Risk contingencies are infrequently used because, wherever possible, the financial impact of future events should be reflected either in base costs or in physical or price contingencies. Therefore a strong justification is required for risk contingencies as a separate line item in a Project Cost Estimate Table. Such justifications must explain to Bank management that current circumstances pertaining to the base cost estimate of the project make normal estimation techniques unreliable. This draws Bank management's attention to the risk and its potential cost impact on the project. The special contingency provision may not be used for any purpose other than the specific risk(s) identified.

3.4.37 When Bank staff consider that certain conditions may be present to a degree which makes the estimation of costs of future events/activities particularly uncertain a special "risk allowance" should be calculated and shown separately from the physical and price contingencies. As an example, because of uncertain political and economic conditions foreign contractors may only offer bids for work in a country at prices that include a premium for the unusual risks they would face. Any part of the "risk allowance" not needed, say after bids are received, should be cancelled and not reallocated to the general contingencies. A "risk allowance" contingency, if applied, should be included as a separate contingency item in the Project Cost Estimate Table and the reasons for it, the amount and its possible cancellation should be explained in the AR and noted in the loan agreement. This contingency should be included in the financial and economic sensitivity analysis. In lieu of including a separate risk allowance, it may be preferable to require the prospective borrower to complete the bidding process to the stage of bid evaluation before the

loan is made. In the event that a borrower insures this risk with MIGA, the costs of the premium should be shown as a line item in the Project Cost Estimate Table.

Financial Charges during Construction (FCDC)

3.4.38 Financial charges incurred during the construction period are a legitimate implementation cost and should be shown in the Project Cost Estimate Table. FCDC includes commitment fees, interest, and other front-end charges. The method of calculating FCDC should follow that normally applied in computing interest charges for the Income Statements and Cash Flow Statements in the financial analysis of an EA's financial performance. An annex to the AR should summarize the rationale for the inclusion of the FCDC in the project costs, the criteria used and the method of calculation. A clear cut-off point for the cessation of capitalizing finance charges and the commencement of charging financing charges to the Income Statement should be established.

3.4.39 Bank loan agreements normally fix the interest rates applicable on loans that may be used to finance FCDC. There is, however, need to provide for contingencies where a project is expected to incur increased costs of funds over and above those covered by the Bank loan agreement. Such anticipated increases in financing costs should be regarded as price contingencies but included in the financing charges and disclosed, with justification, in the AR.

3.5 FINANCING PLAN

Introduction

3.5.1 The purpose of the financing plan is to demonstrate that the funding to support all required aspects of the total estimated cost of the project including contingencies and items ineligible for Bank financing are identified and committed. It is essential that the Bank receive assurances that sources other than the Bank are committed and there will not be any delay in achieving the projects intended economic goals as a result of any unavailable financing for any part of the project cost.

Items Ineligible for Bank Financing

3.5.2 The Bank does not finance the cost of land, rights of way, goods or services procured from countries that are not members of the Bank, FCDC on non-Bank sources of financing and taxes and duties paid by a borrower/EA on either local or foreign costs. The cost of land, rights of way, goods and services from ineligible countries and the amount of FCDC on financing from sources other than the bank are easily identified. In addition, the Borrower is expected to cover local project costs since the Bank normally finances only the foreign exchange component. In special circumstances the Bank may finance a portion of local costs. For ADF-funded projects, the lending policies of the respective ADF replenishment provide a list of conditions which need to be met for projects to qualify for local cost financing. The Country Economist will assist the appraisal team in drafting appropriate justifications to be included in the AR (OM 600)

3.5.3 Calculation of the amount of eligible financing must reflect the requirement that the Bank does not finance taxes and duties that will be incurred for the acquisition of goods and services during project implementation. The financial analyst should advise the borrower and the EA about this limitation on funding, and that the borrower/EA must meet the funding requirement for such obligations. In some cases taxes and duties are clearly stated on invoices in other cases they are not always so clearly identifiable.

3.5.4 Taxes and duties on direct foreign cost are relatively easy to identify on quotations/bids and invoices. However, in some cases taxes and duties are applied at a wholesale level or are otherwise not apparent in the retail invoice. Where heavily taxed commodities are acquired indirectly, such as petroleum products included in manufacturing and various other processes, it may be necessary to determine an appropriate percentage that should be deducted from the total invoice for the cost of goods or services acquired by the borrower/EA. The adjustment for taxes and duties should be reflected in the percentage of goods eligible/ineligible for Bank financing by particular categories of disbursements specified in the legal documents. It should, however, be noted that the Bank does not seek to exclude small amounts of indirect taxation or duties levied at secondary or tertiary stages of the manufacture of goods or provision of services. As an example, taxes on petroleum products used in the manufacture of plastic containers would not be quantified and excluded. However, taxes and duties on petroleum products purchased directly by the EA for use during project construction should be adjusted or deducted from the invoices for petroleum products submitted to the Bank for financing through reimbursement.

3.5.5 In some cases, local taxes on goods and services are very clear, as in the case of Value Added Taxes (VAT). It should be relatively simple to determine this percentage for goods and services. For example, if VAT is levied at 15%, this percentage should be excluded from the estimated cost of the goods or services. In other cases, the amount of local taxes imposed on goods and services will vary within components, and when determining the estimated amounts of taxes, the financial analyst should also have regard for the need to provide a practical means of identifying costs eligible for Bank financing. A practical solution to the difficulty and time required to identify varying amounts on a large number of invoices is for the financial analyst to agree with the borrower and the appraisal team the estimated or weighted average amount of tax expressed as a percentage of total cost and included in a local cost component that is otherwise eligible for reimbursement. Similarly, where invoices for goods and services include taxes and duties (including custom duties) that are not well-defined the amount to be financed by the Bank in that category of goods and services should be reduced by a percentage amount estimated to equal the amount of taxes and duties. The costs of excluding taxes and duties should be kept to a minimum. Any formulae that are to be used should be agreed between the EA and the Bank and notified to the external auditor through the auditor's Terms of Reference, in order that the latter may apply suitable tests during audits to verify amounts eligible for Bank financing.

3.5.6 In some sectors, the Bank may be invited to finance incremental salaries and wages of the EA or of other involved departments and agencies of government or local organizations. In these cases it is frequently found that these incremental costs include taxes in the form of employer's contributions to national insurance, social security contributions and similar statutory employee benefits. These are not eligible for Bank financing and should be eliminated from calculations of Bank financing of incremental (or any other form) of salaries and wages. In this regard, it is also important for the financial analyst to work with the EA to establish a mechanism for claiming reimbursements from the Bank of expenses net of employer contributions for statutory deductions.

3.5.7 These percentage deductions should be reflected in the categories for disbursements in the legal documents once agreement is reached between the Bank and the borrower. This will enable the appropriate percentage adjustments to be made on claims for disbursements by the borrower/EA, where necessary. It is, however, preferable that borrowers/EAs be encouraged to make claims net of taxes, based on the agreed percentages, as this will expedite disbursements by the Bank. It is also necessary for the financial analyst to identify the source of financing within the financing plan that will finance the items ineligible for Bank financing to ensure the project

has the required financing to complete the investment and generate the intended economic benefits.

Financing Table

3.5.8 The Project Cost Estimates Table identifies the total financing required for a project. The AR requires a discussion of the means of financing this total expenditure. In a non-revenue-earning entity, where there are rarely any internally generated sources of funds, project financing is usually not related to the future financial performance of the entity. In such cases, the illustration and discussion of the financing plan in ARs would be confined to the project only and would normally be an extension of the discussion of the cost estimates. In the case of a revenue-earning project, a summary financing plan should be included after the Project Cost Estimate Table. As required by OM 600, Annex 1, this would indicate the sources of financing (Bank Group, Government, other Co-financiers and Beneficiaries if applicable).

3.5.9 The illustration and discussion of the financing plan for a project to be implemented by a revenue-earning enterprise usually consists of a summary - all in current terms - of (i) the project financing requirements and the external sources of finance from the funds flow statement, (ii) other capital and incremental working capital expenditures occurring during the project construction period, (iii) incremental and initial operating costs to be incurred during the implementation period, to be financed out of either project capital funding, or from other sources, (iv) net income from any ongoing operations, and (v) debt service. Funds from all principal sources should be identified as line items in the financing plan. Funds sources should be set out in terms of foreign and local currencies, using Bank Lending Currencies as the foreign currency, and grouped in the table under local and foreign sources, including Bank loans, ADF, and TA, funds from other foreign lenders and donors; local loans, local equity including grants and subsidies from government, and internally generated funds

3.5.10 In cases where the EA is conducting ongoing operations, as in the case of a public sector enterprises, it may, or may not, be generating sufficient funds from ongoing operations to support these activities. It is, therefore, advisable to include in the financing plan either the net funding through the period of the financing plan that the agency will generate, or the additional funding needs which it will require, to operate and maintain its existing and new facilities. The sources of additional funding should be identified, for example, subsidies from government, etc. The financing plan should contain an explicit reference to any contributions to investment to be made by the agency during implementation, with specific reference to the acceptability to the Bank of a policy of deficit funding by government, particularly any policy which, in effect, contributes to the capital investment of the EA.

3.5.11 An annex to the AR should cover the following items, with detailed explanations where necessary (i) any cofinancing arrangements, (ii) availability of internal funds, referenced as necessary to the cash flow statements, (iii) the self-financing ratio, (iv) equity contributions, (v) terms of loans, including interest rates (or on-lending rates where applicable), grace periods, repayment periods, incidence of foreign exchange risk, guarantee fees and interest during construction, and (vi) the dependability of a financing plan in terms of firm commitments that have been received, the progress of negotiations where loans or equity contributions have not been finalized, the availability of additional sources of funds in the event of cost overruns or lower than expected generation of internal funds, and a sensitivity analysis relating to the latter items.

3.5.12 The summary Financing Plan should be included in the AR and the detailed one in an annex to the AR. For a non-revenue-earning project, the project cost table (in summary or in detail) can be readily converted to a financing plan by adding after the "Project Cost" line item the sources of funds that have been identified as available to meet the cost. An exception for a non-revenue-earning project can occur when the project is directly concerned with operation after completion of implementation. In this case, the operating costs would be displayed for the first two/three years, with the related sources of funding (usually budgetary provisions with perhaps minor direct receipts).

3.5.13 The following is an example of a typical summary Financing Plan for a revenue-earning project. A detailed Financing Plan is included in the Knowledge Management, section 7.18 of these Guidelines.

FINANCING PLAN
(xx through xx)

COUNTRY: XXX

PROJECT: Project Name

In (thousands)/(millions) of UA/Bank Lending Currency

	Local		Foreign		Total	
	Currency	%	Exchange	%		%
FUNDS REQUIRED						
Proposed Project						
Capital expenditures	0.00	0	0.00	0	0.00	0
Operating expenditures	0.00	0	0.00	0	0.00	0
Interest during construction	0.00	0	0.00	0	0.00	0
Other financing charges	0.00	0	0.00	0	0.00	0
TOTAL PROJECT REQUIREMENTS	0.00	100%	0.00	100%	0.00	100%
SOURCES OF FUNDS						
Proposed Bank loan	0.00	0	0.00	0	0.00	0
Other loans	0.00	0	0.00	0	0.00	0
Equity or capital contributions	0.00	0	0.00	0	0.00	0
Government	0.00	0	0.00	0	0.00	0
Other sources	0.00	0	0.00	0	0.00	0
Subsidies for operations	0.00	0	0.00	0	0.00	0
Internal cash generation (if any)	0.00	0	0.00	0	0.00	0
TOTAL SOURCES	0.00	100%	0.00	100%	0.00	100%

3.6 PROJECT FINANCIAL VIABILITY

Introduction

3.6.1 The Bank requires that financial analysis and economic analyses are undertaken for projects (OM 600). Although both types of analysis have the same objective – to assess whether the proposed investment is viable - the concept of financial viability differs from that of economic viability. While financial analysis examines the adequacy of the returns of a project to the EA, and other project participants, economic analysis of a project measures its effects on the national economy. Financial analysis and economic analysis are complementary. If a project is not financially sustainable, economic benefits will not be realized.

Non-revenue Earning Projects

3.6.2 Non-revenue earning projects are not subjected to a financial viability test because by definition they do not have a positive cash flow stream. It is difficult to quantify monetary benefits of projects in sectors like health, education, water supply and sanitation, etc. To this regards two evaluation approaches are popular, namely, cost-effectiveness analysis and cost-utility analysis. Where attaching monetary values to any outcome is untenable a cost-minimization approach is commonly used, whereby the option with the least cost is selected, given the identical outcome of all alternative options. This is the cost-effectiveness analysis. The cost-utility analysis also measures costs per unit of an outcome, but the outcome effectiveness is further measured in terms of the quality of the benefits and therefore the outcome effectiveness reflects both quantity and quality.

3.6.3 For both approaches, relevant costs should include both direct and indirect costs. Direct costs include capital and operating costs. Indirect costs refer to those costs that are incurred as a result of participating in the event, for example, home care costs that are associated with a particular treatment. Indirect costs may be more difficult to obtain. Moreover, all costs or expenditures should be measured in economic prices of goods and services to reflect their resource costs from the economy as presented in the cost benefit analysis. When a series of expenditures are spread over a number of years, the present value of the expenditures should be discounted by the economic opportunity cost of capital. Consequently, the appraisal techniques for non-revenue earning projects are underpinned on the basis of economic viability, which is covered in the *Guidelines for Economic Analysis and Design of Bank Group Projects* and, not in these Guidelines.

Revenue Earning Projects

3.6.4 The financial viability of revenue earning projects is determined on the basis of the project itself, not on the basis of the operations of the entity that owns or operates the project. The principal comparison is between the Financial Internal Rate of Return (FIRR) which represents the rate of return earned on the project and the Weighted Average Cost of Capital (WACC) for the project. If the rate of return exceeds the cost of capital to finance the project it meets the test of financial viability. Both comparators are measured in real terms to remove the effect of price changes on the comparison. Care needs to be taken to identify whether all cash receipts and payments have been identified and that all cash transactions are based on arms length prices in real terms. If the project is determined to be viable the FIRR is tested for sensitivity to the reliability of the assumptions and/or possible errors in estimating the FIRR. A clear statement of all the assumptions used should support the calculations of FIRR and WACC.

Project Incremental Cash Flows

3.6.5 A project's annual net cash flow should be forecast over the life of the project. Annual net cash flow is the difference between annual cash receipts and annual cash payments. In cases where the project represents incremental development – for instance, the extension of an existing power plant – cash flows should be computed on an incremental basis (e.g. “with project scenario” and “without project scenario”). Annual cash receipts should include all service fees or sales revenue plus any subsidy received from the government to support the project and the estimated salvage or market value of project assets at the end of the project's physical life. Annual cash payments should include all payments incurred to construct operate and maintain the project's facilities over its useful life. All taxes such as customs and excise duties, value added taxes, similar levies and income taxes should be included. The estimated income taxes on earnings should be based on operating income (before financial expenses but after depreciation) generated from the project and at the effective tax rate.

3.6.6 Cash payments for construction costs used in the FIRR should be reconcilable with the project cost estimates that is with the base cost and physical contingencies, but excluding price contingencies and FCDC. Price contingencies are excluded because the FIRR is calculated in real terms (i.e., without the effects of price escalation and/or foreign currency rate fluctuations). Exchange rates for converting currencies must be fixed at a particular date and consistently applied throughout the forecast period. FCDC is excluded to segregate the investment decision from the financing decision and because it is represented in the WACC.

3.6.7 Because project cost streams are calculated in real terms, the relevance of contingencies to the project's financial viability depends upon whether or not the contingencies reflect the use of additional real resources. Physical contingencies represent the estimated cost of the expected additional real resources required and, therefore, should be included in this analysis for all projects. Price contingencies should be excluded from a financial benefit-cost analysis. Risk contingencies should be included where they represent the likely cost of a physical risk, but excluded where they relate to a cover for the risk of changes in prices. It should be noted, however, that since risk contingencies that relate to pricing of goods and services are often withdrawn following receipt of bids the results of these bids may require revisiting the financial benefit-cost analysis.

3.6.8 A typical enterprise-wide forecasting period for financial statement presentations will not exceed five years beyond the completion of project construction, even though normal operating levels may not have been reached by that time. This will not provide enough information to determine financial viability of the project investment over its full lifetime. This shortcoming may be overcome by preparing an income statement forecast for the project, in isolation, up to the achievement of capacity operational levels and assuming that the net cash flow is held constant thereafter. If the project is one of several projects being executed by an EA separate projections must be prepared.

3.6.9 In the following example of a net cash flow calculation, years 2009-20012 are not shown.

NET CASH FLOWS, 2004 (US \$'000)

	2004	2005	2006	2007	2008	2013-2034
Operating Cash Flows						
<u>Receipts</u>						
Water sales:						
Domestic consumers	0	668	1,613	2,922	4,740	14,077
Government establishments	0	21	50	80	124	726
Private establishments	0	32	76	117	170	997
Subtotal	0	722	1,739	3,119	5,034	15,800
Connection fees	0	2,552	3,067	3,689	4,436	0
Total operating receipts	0	3,273	4,806	6,807	9,470	15,800
<u>Payments:</u>						
Operation and maintenance	0	(410)	(918)	(1,534)	(2,303)	(4,281)
Sales taxes	0	(84)	(109)	(142)	(183)	(139)
Business tax	0	(100)	(100)	(100)	(100)	(100)
Connection payments	0	(2,424)	(2,914)	(3,504)	(4,214)	0
Total operating payments	0	(3,018)	(4,041)	(5,280)	(6,800)	(4,520)
Net Cash Flows from Operations	0	255	765	1,527	2,670	11,280
Investing Cash Flows:						
Investments	(7,184)	(43,107)	(64,660)	(28,738)	0	0
Net Cash Flows to Investments	(7,184)	(43,107)	(64,660)	(28,738)	0	0
Net Cash Flows	(7,184)	(42,852)	(63,895)	(27,211)	2,670	11,280

Financial Opportunity Cost of Capital (FOCC)

3.6.10 If the net cash flow from operations during the lifetime of the project is discounted at the Financial Opportunity Cost of Capital (FOCC) the result will show the maximum capital that may be invested for the project to be the most attractive alternative available to the borrower. Determination of the FOCC is problematic because it necessitates a ranking of the alternative investment opportunities available to the borrower to determine the most financially attractive alternative opportunity forgone to make the project investment. Since the Bank's process of selecting projects for Bank financing is based on a vigorous screening of projects to be included in the Bank's three year rolling lending program the financial analyst can rely on that process to ensure that the project meets the requirement of being a priority investment needed to achieve the government's national development goals.

Financial Internal Rate of Return

3.6.11 The rate of return of a project to the entity is indicated by the project's FIRR. Therefore, the FIRR is also the discount rate at which the net present value (NPV) of the net cash flows becomes zero. The following table provides an example of an FIRR calculation. The table presents project receipts, payments, and net cash flows for the full project period of 30 years. For the purpose of the illustration, it is assumed, that receipts and payments will remain constant from year 2013 onwards.

FIRR ESTIMATION AT 2004 PRICES (US \$'000)

Year	Payments	Receipts	Net Cash Flows	Year	Payments	Receipts	Net Cash Flows
2004	7,184	0	(7,184)	2,020	4,520	15,800	11,280
2005	46,125	3,273	(42,852)	2,021	4,520	15,800	11,280
2006	68,702	4,807	(63,895)	2,022	4,520	15,800	11,280
2007	34,018	6,807	(27,211)	2,023	4,520	15,800	11,280
2008	6,800	9,470	2,670	2,024	4,520	15,800	11,280
2009	2,810	6,306	3,496	2,025	4,520	15,800	11,280
2010	3,193	7,795	4,602	2,026	4,520	15,800	11,280
2011	3,604	9,535	5,931	2,027	4,520	15,800	11,280
2012	4,045	11,568	7,523	2,028	4,520	15,800	11,280
2013	4,520	15,800	11,280	2,029	4,520	15,800	11,280
2014	4,520	15,800	11,280	2,030	4,520	15,800	11,280
2015	4,520	15,800	11,280	2,031	4,520	15,800	11,280
2016	4,520	15,800	11,280	2,032	4,520	15,800	11,280
2017	4,520	15,800	11,280	2,033	4,520	15,800	11,280
2018	4,520	15,800	11,280	2,034	4,520	15,800	11,280
2019	4,520	15,800	11,280				
					FNPV	@4.33%	0

Weighted Average Cost of Capital (WACC)

3.6.12 The WACC represents the cost incurred by the entity to raise the capital necessary to implement the project. As most projects raise capital from several sources and each of these sources may seek a different return it is necessary to use a weighted average of the different returns paid to these sources. The AR should include a calculation of the project's WACC expressed in real terms. Both FIRR and WACC should be measured on an after-income tax bases.

3.6.13 The following is an illustration of the approach that should be taken to calculate the WACC:

- Step 1: **Categorize** financing components as shown in the table below. These components should be taken from the Project Financing Plan as the WACC is calculated only for the project and not for the organization as a whole.
- Step 2: **Estimate the Cost of Funds.** Ascertain the actual lending (or on-lending) rates, even where these may not be the current market rates, together with the cost of equity contributed as a result of the project. Note (i) loans from government may or may not specify a rate of interest (ii) government budgetary allocation of funds is not costless – they might be applied to purposes other than the project, such as debt repayment or to alternative investments. For simplicity, the average cost of government funds can be calculated by dividing total government financing costs by total public debt, (iii) in estimating the cost of equity capital, the degree of business (industry) and financial (bankruptcy) risks should be considered and an appropriate risk premium over market borrowing rate should be added. In most cases, only a small amount, if any, of project financing will be provided by the

organization. As such, the estimate of the cost of equity capital is unlikely to unduly affect the WACC. However, the means by which the estimate is developed should be documented.

- Step 3: **Adjust for Corporate Tax.** Ascertain whether or not the interest payments relating to each component are deductible for corporate tax purposes and, if so, the level of the applicable tax rate. Adjust each component as appropriate.
- Step 4: **Adjust for Domestic Inflation.** The estimated costs of borrowing and equity capital should be adjusted for inflation to obtain the WACC in real terms. Note: (i) For foreign-sourced loans, the Bank requires that a premium for foreign exchange risk is included in the WACC. On the other hand, foreign-sourced funds are required to be adjusted for foreign inflation. To simplify the WACC calculation, it should be assumed that the foreign exchange risk premium exactly offsets the prevailing foreign inflation rate. As such, neither of these factors needs to be estimated and applied. (ii) The Bank's projected domestic inflation rate should be used for domestically-sourced loans and equity.
- Step 5: **Apply the minimum Rate of Test.** The real cost of capital for each component should be at least 4 percent. If not, replace the derived value with 4 percent.
- Step 6: **Determine the WACC.** Apply the weighting percentage to each component to derive the WACC.

Methodology for Calculating Weighted Average Cost of Capital (WACC)

	Financing Component					
	AfDB Loan	Foreign Loans	Domestic Loans	Government Funds	Equity Participation	Total
A. Amount (US \$'000)	50,000	5,000	5,000	30,000	10,000	100,000
B. Weighting	50.00%	5.00%	5.00%	30.00%	10.00%	100%
C. Nominal cost	6.70%	6.70%	12.00%	7.00%	10.00%	
D. Tax rate	40.00%	40.00%	40.00%	0.00%	0.00%	
E. Tax-adjusted nominal cost [Cx(1-D)]	4.02%	4.02%	7.20%	7.00%	10.00%	
F. Inflation rate	...	...	4.00%	4.00%	4.00%	
G. Real cost [(1+E)/(1+F)-1]	4.02%	4.02%	3.08%	2.88%	5.77%	
H. Minimum rate test [H=4%]	4.02%	4.02%	4.00%	4.00%	5.77%	
I. Weighted component of WACC	2.01%	0.20%	0.20%	1.20%	0.58%	4.19%
Weighted Average Cost of Capital (Real):			4.19%			

3.6.14 In this example: (i) the sources of capital for the project are the Bank, 50%; other foreign bank loans 5%; local banks loans 5%; government grant 30%; and the project EA's own equity capital 10%. Differing nominal returns on each source of capital are assumed, including the expected return of 10 percent on equity to project shareholders; (ii) interest payments on Bank

loan, on other foreign bank loans and on the local bank loans are deductible from pre-tax income. The after tax cost of capital to the project is, therefore, 60 percent. Dividends paid to shareholders (if any) are not subject to corporate tax (although they might be subject to personal income tax, which does not impose a cost to the entity); and (iii) the WACC in real terms amounts to 4.19%. This is the discount rate to be used in the financial cost-benefit analysis of this project as a proxy for the FOCC.

Comparison of FIRR and WACC

3.6.15 If the Project's FIRR exceeds the Project's WACC, the project is considered to be financially viable. If the FIRR were below the WACC, the project would only be financially viable if it increases its net cash flow by increased revenue or reduced costs or receives a sufficient subsidy from the government to bring the FIRR up enough to exceed the WACC. If the project is restricted in its ability to raise revenue, for poverty reduction or other social reasons etc, it is already receiving a subsidy and the FIRR does not exceed the WACC then it either has to cut its costs or the subsidy needs to be increased sufficiently to result in the FIRR exceeding the WACC. In the example, the FIRR of 4.33 percent is above the WACC of 4.19 percent, and hence the project is financially viable. The AR should describe how the project's FIRR compares with its WACC. The supporting analyses should be included in the annexes to the AR

Alternative Test of Project Viability

3.6.16 An alternative test of financial viability is to determine whether the Net Present Value (NPV) of the projects lifetime net cash flow stream discounted using the WACC is positive. Technically if the NPV in this case is positive then the FIRR exceeds the WACC. A negative NPV points to a project that does not generate sufficient returns to recover its costs and as above it needs to increase its revenue, cut its costs or it requires a subsidy from the government

3.6.17 In the above example the net cash flow discounted at the WACC of 4.19 percent is +\$2,560,000. The project is thus financially profitable. If a discount rate of 4.33 percent is used (equal to the FIRR), the NPV (by definition) equals zero. The example shows that if the discount rate used (4.19 percent) is below the FIRR (4.33 percent), the NPV is positive.

Sensitivity Analysis

3.6.18 Financial cost-benefit analysis is based on forecasts of quantifiable variables such as demand, revenue and costs. The values of these variables are estimated based on the most probable forecasts, which cover a long period of time. The values of these variables for the most probable outcome scenario may be influenced by many factors and the actual values may differ considerably from the forecast values depending on future events. It is therefore necessary to consider the sensitivity of project viability to potential changes in key variables

3.6.19 The viability of projects is evaluated based on a comparison of its FIRR to the WACC. Alternatively, the project is considered to be viable when the NPV is positive, using the WACC as the discount rate. The WACC is usually considered to be constant because loan funds and government capital contributions are fixed and made at the beginning of the cash flow stream. However some funding may result from variable rate instruments in which case it would be appropriate to test project viability for its sensitivity to changes in interest rates. In the example below WACC is assumed to be constant. Sensitivity analyses, will therefore focus on analysing the effects of changes in key variables on the project's FIRR or NPV, the two most widely used measures of project viability.

3.6.20 Sensitivity analysis tests the impact of changes in project variables on the base-case (most probable outcome scenario). Typically, only adverse changes are considered in sensitivity analysis. The purpose of sensitivity analysis is to: (i) to identify the key variables that influence the project cost and benefit streams; (ii) investigate the consequences of possible adverse changes in these key variables; (iii) assess whether project decisions are likely to be affected by such changes; and (iv) identify actions that could mitigate possible adverse effects on the project. Sensitivity analysis needs to be carried out in a systematic manner. To meet the above purposes, the following four steps are suggested.

Step 1: **Identify** key variables to which the project viability may be sensitive.

Step 2: **Calculate** the effect of possible changes in these variables on the base-case FIRR or NPV, and calculate a sensitivity indicator and/or switching value.

Step 3: **Consider** possible combinations of variables that may change simultaneously in an adverse direction.

Step 4: **Analyse** the direction and scale of likely changes for the key variables identified, involving identification of the sources of change.

3.6.21 The Knowledge Management, section 7.19 of these Guidelines provides further information on each of these steps in the context of a numerical example. The information generated can be presented in a tabular form with an accompanying commentary and set of recommendations, such as the example shown below.

Simple Sensitivity Analysis: Numerical Presentation

Item	Change	NPV	FIRR %	SI (NPV)	SV (NPV)
Base Case		126	13.7		
Investment	+10%	70	9.6	13.3	7.5%
Benefits	-10%	57	7.8	16.6	6.0%
Operating and maintenance costs	+10%	68	12.9	2.3	43.4%
Currency rate movements	-20%	70	9.6	13.3	7.5%
Construction delays	One year	79	10.8		NPV 37% lower

SI = Sensitivity Indicator; SV = Switching Value

3.6.22 Sensitivity tests are not without problems. Correlations among the variables often pose serious difficulties. The usual technique of varying one variable at a time, keeping the others constant at their expected values, is justified only if the variables concerned are not significantly correlated, otherwise, the related variables must be varied jointly. In such cases the sensitivity of the outcome to changes in several combinations of variables that are expected to vary together must be explored, for example revenues rather than price and quantity separately. But it should be noted that the greater the degree of aggregation, the less useful is the information provided by the tests.

Policy Issues

3.6.23 Financial management related policy issues raised elsewhere in these Guidelines for which “high-value policy harmonization and alignment” would be appropriate include the issue of deficit financing or contributions to the capital of the EA as part of the project financing plan and the issue of the government providing annual operating subsidies. These are the types of issues that have a direct implication on project financial viability and are envisioned in the Paris Declaration for discussion and agreement with all donors active in the country and specifically with donors in the sector concerned. This is because a policy to subsidize either the capital cost or the operations of the EA represents a policy that applies to all development investments in the country. The Paris Declaration envisages a coordinated discussion with the government regarding the strategy to subsidize (i) as to whether the policy is appropriate in general, and if so (ii) should it be applied selectively to specific sectors, and do the policy and the selected sectors relate to the government’s poverty reduction strategy. Affordability of subsidies to the government and the willingness and appropriateness of donor funding of the subsidies through development assistance is an issue upon which harmonization among donors is needed. The two examples discussed are commonly seen in development projects, particularly infrastructure and other revenue generating projects. They should not be seen as exclusive of the types of policy oriented financial management issues that may be encountered. Financial Analysts need to focus their attention on the financial management policy issues evident in all development projects.

3.6.24 The Financial Analyst’s analysis may identify a need for technical assistance to analyse the targeting of subsidies and/or assist in implementing a subsidy targeting program for the EA. The financial analyst, also, should identify financial management issues and determine whether the EA’s treatment of the identified issue is consistent with the National Development Strategy, the National Poverty Reduction Strategy and with any Sector Specific Strategy Papers. A related issue is the effectiveness of the subsidy policy which may be reflected in the targeting of the subsidy. Using the example of the subsidy for capital costs of the project or for operational subsidies the financial analyst should determine (i) whether the capital cost subsidy is intended to support the extension of services into physical areas known to be inhabited by low income residents (ii) whether the quantity and quality of delivery of those services reflects the needs of the residents, and (iii) whether it is cost effective, for example using stand posts to deliver potable water to densely populated areas. Financial Analysts should review subsidies for operations to determine whether they (i) offset the provision of lifeline support levels or minimum levels of energy or potable water through minimal or nil tariff for these levels of service (usually seen in step tariff systems), (ii) offset high levels of non-revenue water or energy particularly if bulk meters can identify the high losses to areas inhabited by low income residents, (iii) pay overdue and unpaid invoices for poor families, and (iv) how the EA attempts to measure the use of the subsidy or to ensure the targeting intended in the subsidy is in fact being achieved. Broad general subsidies usually benefit the largest users of the EA’s services the most and the large users are generally not the poor.

3.6.25 The Bank has a broad interpretation of financial viability in relation to project loans. This includes the use of government subsidies to ensure the financial viability of the EA. The Financial Analyst’s review of the financial viability of the project and any policy issues such as subsidies and their targeting should lead to appropriate financial covenants that compliment the government’s poverty reduction strategy. Assurances need to be given that any subsidy needed to ensure the financial viability of the project and the EA is paid in a timely manner.

3.7 ECONOMIC AND FINANCIAL OBJECTIVES

Introduction

3.7.1 Economic and financial analyses of projects are closely related, and in practice both involve, among others things, the calculation of internal rates of return. Both types of analysis are conducted in monetary terms the major differences lie in the definition of costs and benefits. It is very important that both economic and financial analyses are undertaken. It is equally important that the financial analyst understands the reasons for divergences between economic and financial analysis results.

3.7.2 The objective of economic analysis is to evaluate a project on the basis of all its impacts upon the economy⁵. For example an addition to port facilities may permit significant increases in the export of commodities, agricultural products and manufactured goods which will encourage increased production in these sectors as well as other sectors of the economy, the creation of many new jobs in those sectors and related sectors such as land transport. All these economic benefits would be measured in the economic analysis of the project. The objective of financial analysis is to evaluate the commercial viability of a project from the viewpoint of the project entity; that is, only expenditures incurred under the project and revenues resulting from it are taken into account. In the case of the port project the only financial benefits measured would be the marginal increase in port fees resulting from the new facilities.

Economic Objectives

3.7.3 The efficient allocation of resources is a primary goal of economic planning. Economic policy decisions are made to implement economic plans. These policy decisions may result in direct financial impact on national residents such as pricing policies for the supply of goods or services by State Owned Enterprises (SOEs) or may have indirect impact such as tariffs on imports or land use decisions. In other cases, the policy decision may be that some goods or services provided by a SOE should be provided at no cost to the user. The Bank refers to a project in this situation as a non-revenue project. There is both an economic cost and a financial cost to providing the goods or services “free”.

3.7.4 Economic theory suggests that efficient allocation of resources is achieved when the benefit or price of the goods or services equals the marginal cost of supplying them, that is, the increment to the total system cost of producing and delivering an additional unit of output under specified circumstances. Economic theory also suggests that important divergences between social costs and benefits on the one hand, and market price on the other (due, for example, to external factors) should be taken into account, and that public investments should be evaluated in terms of opportunities for investment or consumption foregone elsewhere in the economy. An example of this situation might be a vaccination program where charging consumers for the cost of the vaccine might discourage people from being vaccinated, particularly poor people who may be at the greatest risk due to their living conditions, while the economic cost of lost productivity from a disease outbreak might be very high. This is the basis of justification for many non-revenue projects, but it does not mean that financial analysis has no role in the assessment of the project.

⁵ Further guidance on Bank practice regarding the economic analysis is found in the ‘*Guidelines for Economic Analysis and Design of Bank Group Projects*’ that are found at: <http://intranet/GPA/index.htm>

3.7.5 The unit of government that will provide the goods or services “free” will incur financial costs, which need to be identified by the financial analyst. This brings into consideration the information accumulated through the review of budgeting and financial management systems of government. The financial analyst needs to identify all project costs. The financial analyst will need to work with the EA to identify the year in which expenditures will be incurred and determine that adequate additional budget will be provided, by the government, each year. This may be an issue for covenant consideration.

3.7.6 The balancing of added benefits with added costs may also be achieved by establishing prices equal to the marginal costs of supply and relying on consumers to equalize benefits and costs at the margin. In other words, the cost-benefit analysis is decentralized and each consumer is left to decide what quantity they would like to consume and when. Some outputs of a revenue-earning EA are valued highly by a majority of consumers and exceed the cost of supplying it. Other uses are less valuable, and the quantity consumed for these uses will depend on the price charged by the revenue-earning EA. For an efficient allocation of scarce resources, consumption should be facilitated when its valuation by consumers exceeds the added cost of supply, and discouraged whenever this is not the case. An example of this type of project might be the supply of potable water in which all consumers highly value a minimum lifeline quantity of potable water. Poor people may be willing to sacrifice large portions of their available resources through labour to carry water long distances or dig wells, etc or pay cash, if available, to meet basic human needs and to avoid lost productivity and other costs of water borne disease. Wealthier people may not value large quantities of consumption as highly and may respond by conserving the use of potable water for lawns and swimming pools if high consumption is charged at tariffs much higher than the financial cost of supply. This is the basis of step tariffs for potable water supply (usually involving lifeline supplies at no tariff with steeply rising tariffs for larger blocks of consumption) and is also an example of an income/resource transfer between high consumption users and low consumption users.

3.7.7 The efficient allocation of resources is an important economic consideration in pricing policies, particularly for revenue-earning EA services. Financial analysis is used to describe, project and monitor the impact of such a policy.

Financial Objectives

3.7.8 The primary objective of financial analysis is to forecast and/or determine the actual financial impact, status and performance of a project and, where appropriate, of the EAs. This enables the Bank to combine that information with all other pertinent data (technical, economic, social, etc.) in order to assess the feasibility, viability, and potential economic benefits, of a proposed or continuing lending operation. A secondary objective is the provision of technical assistance to a borrower and/or an EA to enable them to make similar assessments and to apply the techniques to other non-Bank investments. A tertiary objective is to encourage borrowers and/or EAs to make any necessary changes to their institutional and financial management systems to facilitate the generation of appropriate data to support good financial analysis. These objectives are intended to measure the achievement of financial objectives of the borrower, the EA, and the project and vary by the nature of the project/EA in terms of revenue-earning and non-revenue-earning categorization.

Revenue-earning Projects

3.7.9 There is a presumption that if a government establishes a revenue-earning EA that all the goods and services that it supplies to the public will be for a price or a fee, otherwise the government would provide those goods or services through a department of government. The determination of the price of the goods or services provided is a policy decision and need not necessarily mean that the entity is designed to earn a profit, at least not necessarily at all times or for all goods or services. For public sector entities, there is no absolute rule as to a sector/sub-sector where less-than-full-cost recovery may be acceptable. The Bank has no policy or guidelines on subsidies.

3.7.10 In addition, there is a presumption that public sector revenue-earning EAs will cover at least a majority of their cost of providing the goods or services from sales or fee revenue. Agencies of government that charge a small or nominal fee for services are not usually considered revenue-earning EAs. Examples include fees charged for obtaining copies of government documents (birth or marriage certificates, driver's licences, etc.) or fees to enter government buildings/facilities such as museums or parks which are attempts at limited cost recovery but these entities are not usually regarded as revenue-earning entities. The size of the individual or unit charge for goods or services is not the guiding principle because in some jurisdictions the post office is considered a revenue-earning entity because of the significance of the total revenue received. The deciding factor is whether the government's policy intention for the entity is that it should be a revenue-earning entity.

3.7.11 One of the initial tasks of the financial analyst is to determine and document the government's policy goals for any proposed EA. Successful financial management of an EA should be determined on the basis of its ability to achieve the policy goals established for it rather than on any preconceived idea of what an entity in a particular economic sector is capable of earning. The Bank may agree with the policy goals established for the EA or the Bank may not agree with them. If the Bank disagrees with the policy goals established for the EA by the government the mission will be charged by Bank management with the responsibility of undertaking policy dialogue with the government as part of project processing. Similarly, the Bank may agree with or accept pricing policies for a revenue-earning EA in one country but not accept them for a similar revenue-earning EA in another country, for example subsidized pricing of a consumable product (for example rice) in a low income country may be accepted but similar pricing policies in a middle income country may be considered inappropriate.

3.7.12 Generally speaking, a revenue-earning project should enable an EA to achieve financial viability. Financial viability generally implies an ability to generate sufficient revenues to cover operating and maintenance costs, renew assets, service debt, pay dividends on equity capital, where appropriate, and finance a reasonable proportion of the EA's capital expenditures from internally generated funds. This definition would enable the EA to firstly, become self-sustaining and to achieve a degree of autonomy in its day-to-day operations which encourages better management, and secondly to relieve the government from the financial burden of subsidizing from scarce public funds the provision of the goods or services supplied by the EA. The pursuit of certain financial goals by a revenue-earning EA can be seen as a means of stimulating managerial efficiency. Also, if financial viability were to be ignored, the incentive to hold down costs may be weakened, if not removed.

3.7.13 Revenue-earning EAs are sometimes required to generate additional revenue in order to supplement national resources for investment. Experience in some RMCs, however, suggests that the continuing financial losses made by many revenue-earning EAs may not make them

satisfactory tools for resource mobilization, unless government is willing to enforce the use of effective tariff and revenue collection. Tariffs should permit a level of financial performance that would enable a revenue-earning EA to operate efficiently and on a continuous basis, provided that the collection of revenues continues to be efficient.

Non-Revenue-Earning Projects

3.7.14 A principal objective of a non-revenue-earning project is the achievement of the financial and economic goals set for it by government. This usually involves three broad goals. One is to enable the project to deliver the forecast benefits at the least cost as estimated at the time of the financial and economic evaluation. A second goal is to achieve a degree of efficiency in the EA's operations to encourage better management of the development and operation of the project. A third goal is to minimize the government's financial cost to reduce as much as possible the financial burden associated with the continuous provision of scarce public funds. As with revenue-earning projects, financial analysis is a key tool in defining and measuring the achievement of financial goals and objectives.

3.7.15 Again one of the initial tasks for the financial analyst is to determine and document the financial goals of the EA. The financial analyst needs to determine what financial records are maintained by the EA that will facilitate or demonstrate the achievement of the defined goals. In many non-revenue-earning projects it is necessary to identify non financial data to support a determination of the effective achievement of the project's goals. An example may be the number of individuals inoculated in a vaccination campaign. A measure of efficiency in this case may be the average cost per individual of providing the service.

Tariffs and Cost Recovery

Preamble

3.7.16 Policies affecting tariff and cost recovery result from economic plans approved by government. Long-run marginal cost may be used to set tariff when there is recognition that the cost of adding an additional unit of output to the system is high. Pricing at long-run marginal cost will send a signal to consumers about the expected rise in the cost of production and will encourage conservation. Those who continue to consume large amounts of output at these higher prices are indicating that the marginal benefits continue to exceed the tariff. By definition, long-run marginal cost must exceed the cost of the current project and therefore using this pricing model may be problematic for pricing public goods. It has been used for pricing more commercial products such as power where the cost of adding output capacity is high and long lead times are needed for construction. A more practical approach may be to increase tariff over time toward long-run marginal cost as existing capacity is becoming fully utilized. This will both signal the market of the higher costs of expansion and build up funds to contribute to the cost of building the next capacity. Another concern with long-run marginal cost pricing is that if the resulting tariff is considered too high by consumers they may build their own independent systems, e.g. drill water supply wells on their property or install power generators.

3.7.17 The Bank has no policy or guidelines on subsidies and no absolute rule as to sectors or sub-sectors where less-than-full-cost recovery may be acceptable. The Bank has, however, an implicit goal of achieving efficiency. The financial analyst must ensure that cost recovery is the lowest economic and financial cost commensurate with the highest levels of efficiency of performance. Endorsing cost recovery policies that require the EA to recover all costs incurred for the project may result in unnecessary or unreasonable charges, especially if the EA is in a

monopoly position. There must be an assurance that all costs incurred result from efficient operations and that recovery of unreasonable costs must be avoided.

3.7.18 These issues typically give rise to valid concerns where the technical problems and costs of installing and operating charging mechanisms could exceed benefits. OECD has a useful publication on Best Practice Guidelines for User Charging for Government Services (Knowledge Management, section 7.23).

Bank Policy on Tariffs

3.7.19 In 1985, the Bank published its policy on tariffs and cost recovery. While many years have passed since its publication, much of the advice and guidance relating to tariffs and cost recovery continues to be relevant. The emphasis is primarily on the sufficiency of revenues to finance operations and debt service, and perhaps there may be insufficient reference to the need to develop means of cost reduction to avoid increasing tariffs and rates. In addition, the Bank relies on the skill and experience of the Bank staff and experienced consultants to develop appropriate tariffs for revenue-earning EAs, and to report their findings and recommendations in ARs.

Cost Recovery Systems

3.7.20 Generally there are two options available for full-cost recovery, namely the pricing by user charges of products and services produced (typically using tariff-structured charges), and benefit taxes that are levied directly (wherever possible), or indirectly, on beneficiaries. Vehicle or gasoline tax, and land taxes, are typical benefit taxes.

3.7.21 The selection and use of the appropriate mechanisms should be a matter of practical convenience, e.g. using a system that is already in place and which either works or can be made to work with minimum investment; rather than enforcing a principle. In water supply utilities, it is frequently a principle that domestic water consumers should pay for water by measured consumption. However, where by local practice a property-value based water tax can yield the necessary revenues; this may be an acceptable mechanism. A property tax based water charge will not inhibit consumption. Therefore in conditions of constrained supply and high long-run marginal cost, the recovery mechanism adopted should contribute materially to the attainment of conservation objectives; in this case by charging on a consumption basis and restraining consumption future investments may be deferred. This particular approach requires that (i) metering systems are efficient; (ii) illegal connections are prevented; and (iii) the tariff structure effectively constrains high consumption levels by incremental pricing.

3.7.22 Where an activity, such as sewerage operations, has difficulty in achieving full-cost recovery, it should be linked whenever possible with an allied activity or service. In the case of sewerage, its principal activity is wastewater removal, which can be directly related to water consumption. An integrated tariff policy to recover water supply and sewerage costs should be developed which would achieve full cost recovery for both systems. Similar activities include rural electrification for irrigation systems which can be recovered through the overall tariff structure by cross subsidies; rural roads which can be recovered through adjustments to vehicle import or operating taxes.

3.7.23 In some cases pricing below full cost recovery can have undesirable effects. Pricing fertilizer below cost in some countries has resulted in excessive use of fertilizer which has polluted water supply sources. This has been problematic in that it adds additional costs to water treatment to remove the chemicals which may be harmful to humans or livestock and because

rural water supply systems had been built with minimal treatment systems because they generally were away from industrial pollution and costs were kept within the means of the rural consumers.

3.7.24 Public utilities sometimes favour providing services to the more affluent sections of a population, partly on the grounds that cost recovery is likely to be more effective, and that delivery to, and servicing of these domestic consumers is generally more simple and cost-effective. However, research into these situations often shows that the poor, ill-served population are paying, and will continue to pay, considerably more per litre for their limited supplies of water, either by bottles, or through tankers or vendors, than the more affluent sections who are already served (albeit insufficiently) or will be provided with water supplies by the proposed project. The equity principle must, therefore, be observed.

3.7.25 Social benefit must not be sacrificed for financial expediency. Sound project design should call for an equitable distribution of benefits, including the use of cross-subsidies, where necessary, to provide the largest volume of benefits to the most deprived sectors of the population concerned.

Social Sectors and Services

3.7.26 In sectors that deliver social services, including poverty relief, health services, education, agriculture extension, etc., cost recovery is not normally sought because these services have been regarded as public services to be financed from general taxation. While this practice is likely to continue for many years, particularly for the poorest sections of a population, increasing pressures on national budgets may force the development of some form of user charges. While some cost recovery may be introduced to reduce budget deficits, others fees may be used to cut back demand for frivolous or unnecessary services or to re-direct demand for services for which a section of the population could pay. But because user charges applied in such sectors will probably have the effect of demand reduction, their introduction needs to be designed with much care. In this regard, income and social studies may be needed to identify and to target the elements of services and population groups to be addressed.

3.7.27 User charging assessment and collection methods should be examined for feasibility and costs, as part of cost/benefit studies to determine viability of such schemes. Comparing the demand, supply, and costs of ongoing, parallel private sector schemes that provide similar service can develop validity tests of such studies. As an example, private sector fee-paying education facilities sometimes rival state systems, which may be of lower quality due to lack of funding. Measurement of likely demand for equivalent-level state schemes may reveal the feasibility of charging for partial, or all, services in a particular stream of training without undue hardship, especially if the constraint is lack of facilities instead of consumer resources.

3.8 PREPARING FINANCIAL FORECASTS

Introduction

3.8.1 Forecasting financial performance is frequently a difficult task for the financial analyst. The records of past performances may not be up to date, may not be reliable or may not be available at all making designing a model for forecasting based on past experience difficult. Despite these difficulties, the financial analyst is required to develop financial information relating to a project, and where appropriate the EA, for a period of time that will allow the Bank's management and the borrower to form a judgment regarding the financial viability of the proposed project. As part of that decision it may be necessary to define the minimum financial

performance that must be achieved to ensure the project will be viable. Steps necessary to achieve the minimum levels of performance will need to be agreed with the borrower and may be included in the loan covenants. It will not help the borrower or the Bank for a financial analyst to forecast financial success in order to bring a project to the Bank's Board, if there are indications are that such success is unlikely. Overly optimistic financial projections have too often been associated with unsuccessful projects.

3.8.2 Recognizing that it is impossible to know precisely what will happen in the future it is still the responsibility of the financial analyst to anticipate financial, economic and political issues that have the potential to affect the performance of the project. Where the probability of the anticipated events occurring is high they need to be reflected in the financial projections and stated in the assumptions. Where the probability is below the threshold needed to be reflected in the financial statements the potential impact needs to be subject to sensitivity testing. In addition, any mitigating steps needed to be taken to avoid or minimize the potential negative effects need to be identified and implemented, and if future action is needed, included in the loan covenants.

Financial Accounting Standards

3.8.3 Financial statements for revenue-earning projects and EAs presented in Bank ARs should be compiled in accordance with International Financial Reporting Standards (IFRS)/International Accounting Standards (IASs). However, where tables are prepared on the basis of the local accounting standards, the text or footnotes to the tables must disclose the deviations from IFRS/IAS and their impact on the financial statements. Financial covenants in loan documents would normally be based on IFRS/IAS as well.

3.8.4 For an EA whose accounting practices do not conform to IFRS/IAS; or to the country's generally accepted accounting practices (GAAP), which are acceptable to the Bank; or where the country's GAAP are inappropriate for presentation of financial analysis, actual and forecast data should be presented on the basis of the staff's judgment of reasonable practice. Where the presentation departs from the EA's existing procedures, the report should explain the changes made. Where restatement is extensive, comparison of actual financial statements with forecasts may be impossible during project supervision without preparing an additional set of forecasts reflecting the entity's accounting practices. Such forecasts should be included in the Project File.

3.8.5 Accounting standards followed by non-revenue earning projects should be compared with International Public Sector Accounting Standards (IPSASs). In most cases the comparison will be with the Cash Basis IPSAS. EAs for non-revenue projects should be encouraged to disclose differences between national accounting standards and IPSASs, if any, in the Notes to the Financial Statements.

Determining Fiscal Period Coverage

Revenue-Earning Projects

3.8.6 For revenue-earning projects and their EAs, financial analysis needs to be based on a reasonable period of confirmed past financial status and operating performance of the EA. The current financial status and performance will also be a useful guide to the capability and capacity of the EA to deliver the project. With the information gained from the past and current performances, forecasts should be prepared of the financial status and performance likely to be achieved during implementation, and for a meaningful period of operations following commissioning of the project. This applies particularly in cases where the EA will implement and

operate the project as part of its ongoing operations, such as an existing electric power generating utility or a water supply and sewerage utility.

3.8.7 There can be no definitive time periods for performance measurement. The time frame chosen for each project and EA must be selected on the basis of the financial analyst's judgment of the period(s) that are likely to be the most informative for an accurate and reliable justification for the project. Forecasts should normally be made until a "steady state" has been reached, reflecting normal utilization of the project facilities. As a general rule, it is unlikely that a period of less than two years of actual (audited) performance immediately prior to implementation, together with the implementation period and not less than three years of full operation following final commissioning would provide a satisfactory reliable sample. If a substantial financial change is forecast within the life of the loan that would seriously affect the "steady state", the text should specifically discuss the impact of such a change on the financial condition of the EA. If possible, the projections should be extended to cover such an event.

3.8.8 Some projects have high risk factors, such as drilling for ground water or for oil or gas. Usually these types of projects provide for significant testing (seismic tests or drilling test wells, etc), which are preferably undertaken prior to Bank financing. However, even with testing, the volume of water available or the size of the oil or gas field may not be known until the planned drilling program is at least partially complete. These types of projects have high risk levels and require careful sensitivity testing for various outcomes for capital expenditures as well as sensitivity testing for output yields. Conversely, other types of projects may be commissioned within one or two years of the commencement of implementation. Usually it is necessary to provide a financial forecast of the completed project including at least three years of full operation, therefore the period of detailed analysis may cover 10-12 years or more (two years past performance, the current year, five or six years for implementation and three years after project completion) until reaching the "steady state" stage.

3.8.9 Some projects include components that have protracted implementation periods, for example, hydro-electric dams and forestry projects. In these cases of projects which take many years to reach normal capacity operating rates (e.g., 15-20 years for forestry projects), it is acceptable to limit the time horizon of the forecasts for the enterprise as a whole to between two and five years beyond the completion of project construction, even though normal operating levels may not have been reached.

Non-Revenue-Earning Projects

3.8.10 Normally for non-revenue-earning projects, the financial analysis should address only the financial requirements of the project itself, in the form of the Financing Plan, and the operating costs for up to five years following completion. Unless the EA is also the subject of some form of financial performance reform as part of the project, there is no requirement to provide past performance data, unless this is material to support project justification. Similarly future performance should normally focus on project execution and include only those costs of the EA for which financing must be assured to ensure the successful implementation of the project. There are no standard presentations for the wide range of non-revenue-earning projects and agencies.

Current, Real and Constant Prices

Current Prices

3.8.11 Forecasts, in the form of annual financial projections over the period of implementation, and for the period necessary to achieve a steady state, should be made in nominal (current) prices. Tables should clearly so indicate. The year of appraisal is the base year of projection. Forecasts in current terms are usually based on the same price assumptions as in the project cost estimates, at least through the construction period, as long as such assumptions are relevant for the labour, goods and services concerned. Appropriate price assumptions should be made for items which are not involved in the project cost estimate or which need to be priced on differing bases. Such forecasts should be made on the basis of alternative scenarios to illustrate a range of possible futures and uncertainties, and the forces that are likely to shape them. This is particularly true for revenue projections because in some industries: (i) the output is subject to market competition and an assumption that revenue will increase in a manner consistent with general price increases needs to be carefully examined for validity; (ii) the output price is regulated by the government or by a government agency such as power, water or port authority; and (iii) the price increases may be subject to political approvals in a legislative body or be otherwise subject to political influence. Several tests of the sensitivity of revenue projections should be undertaken with a full discussion of assumptions made, conclusions reached and mitigating actions taken to minimize the risks, possibly including introduction of a covenant specifically relevant to the assurance of an adequate revenue stream.

Real Prices

3.8.12 Where the analysis is made in real terms, its use must be fully justified. Relative price changes resulting from the differential effects of changing prices and inflation on particular expenditure items and on the revenue stream may be overlooked when real terms are used. This can lead to distortions in the cash flow statements. By contrast, forecasts in current terms require the analyst to make specific judgments about these effects. Therefore forecasts in current price terms are preferred.

Constant Prices

3.8.13 Where an EA operates within an established national system for adjusting costs and/or revenues for inflation or in countries where price and foreign exchange rate movements are highly erratic, constant price forecasts may be used, provided that the impact of the conversion to current prices, particularly on cash flows, is demonstrated. Whenever constant prices are used sensitivity analysis needs to be applied to both revenue and cost streams for the impact of significant price changes particularly where the project has incurred debt denominated in foreign currencies.

Using a Stable Foreign Currency

3.8.14 Forecasts normally should be made in the local currency. An exception may be made when the local currency is unstable, for example due to high and erratic levels of inflation, in which case an alternative to the use of constant prices may be to denominate the forecasts in a stable currency with which the borrowing country has a consistent money-market/foreign exchange relationship. This alternative method prepares forecasts in current price terms using the stable currency, for example, the US Dollar. Justification for the use of the foreign currency, the

foreign country's inflation rates and the exchange rates used to convert local costs to the foreign currency basis should be stated in the AR. Sensitivity analysis on the exchange rate used and on inflation differentials should be applied and explained.

Summary Financial Statements

3.8.15 In the AR projected balance sheets, income statements and cash flow statements of the project entity should be shown in summary tables, so as to permit comparisons between past and forecast data and to allow for ready identification of trends. The data should be consistent with demand and disbursement forecasts elsewhere in the report. Because the presentation and interpretation of figures in periods of changing prices and inflation is both difficult and risky, staff should assist readers whenever possible by (i) highlighting underlying trends in data, particularly where these may be obscured by substantial rates of inflation and (ii) describing the results of sensitivity analysis of the underlying trends.

3.8.16 Summary tables should be inserted adjacent to the textual material in the AR. Past, present and future performance, and status data may be combined in one summary. The use of summary tables should not be substituted for detailed tables in an appendix to an AR where the latter are necessary to disclose significant information to support a project and loan. Conversely, the presentation of lengthy summary tables in the financial chapter of an AR covering many years of past and future performance may be confusing to readers. The optimum presentation is the one that conveys the maximum information in the minimum of space, without sacrificing accuracy and intelligence.

3.8.17 The Knowledge Management, section 7.26 of these Guidelines provides examples of formats for financial projections and year-end reporting for the following: Income Statement, Balance Sheet, and Cash Flow Statement. The examples are for a service-type organization and for a manufacturing organization and should be modified appropriately to reflect the nature of each project or EA.

Income Statements

3.8.18 The following matters should be considered when preparing detailed income statements: (i) Data for each year are to be defined as actual or forecast, (ii) Presentations normally should follow the accounting and financial reporting format adopted by the EA, and (iii) Operating revenues and operating costs presentations will vary widely by sectors, and should detail the specific forms of revenue and costs typically found in the sector.

3.8.19 At least the following information and analyses should be provided with the income statement:

- *Unit volume*: the basis for volume forecast should be described and related to the EA's output capacity and market demand,
- *Operating revenues*: describe significant past and expected changes in selling prices, tariffs and composition of sales mix,
- *Operating costs*: analyse past trends, and give assumptions for projections in each operating cost category (for example: examination of numbers and skills of staff and unit costs; expected cost trends for goods and services; or percentages of revenues or assets where these are the appropriate bases for the forecasts),
- *Depreciation rates*: these may be addressed as balance sheet information,

- *Non-operating section*: describe any significant past experience and give assumptions for the forecasts of other income and expenses; relate forecast interest expenses to loans outstanding,
- *Taxes on income*: give the basis for income tax charges; in public utilities or other sectors where taxes on income are normally presented as part of operating costs, the presentation shown in the table need not be adhered to; and
- *Appropriations from net income*: state basis for past appropriations and any assumptions on future dividends, etc.

3.8.20 Useful ratios for analysing income statement information: growth rates; gross profit as a percentage of revenues; operating ratio; operating income or net income as a percentage of revenues; net income as a percentage of revenues; and return on average invested capital (see Knowledge Management, section 7.20 of these Guidelines).

Balance Sheets

3.8.21 The following should be considered when preparing the detailed balance sheet:

- *Data for each year*: should be defined as Actual or Forecast.
- *Surplus cash*: where it is assumed that material amounts of funds may be accumulated and available for other capital projects or paid as dividends, the forecast balance sheet should show such cash separately.
- *Long-term debt*: should be shown in detail, if necessary, distinguishing between local and foreign debt. Current maturities of long-term debt should be deducted and shown under Current Liabilities.
- *Current assets and liabilities*: working capital requirements should be based on the entity's practices, together with any changes due to the project; operational cash requirements should be illustrated; and projected cash surpluses or shortfalls should be explained.
- *Intangible assets and long-term investments*: the basis of forecasts should be stated – particularly any valuation of goodwill on acquisition of other executing enterprises, or justification for the realization and use of long-term investments.
- *Fixed assets*: the basis for estimating additions to fixed assets in relation to the construction program, revaluation of assets, and any anticipated property retirements should be in accordance with IFRS/IASs or otherwise explained. Transfers of capital expenditures to the “plant under construction” and “plant in service” accounts may be based on the assumption that a certain percentage of capital expenditures is “booked” to plant in service each year. In other instances, the transfers may be based on a detailed asset construction completion schedule. It is often useful to provide a subsidiary schedule to the balance sheet, showing the transfers from capital expenditures to plant under construction and plant in service, together with the basis for such transfers.
- *Accumulated depreciation*: rates and bases for depreciation should be stated. Alternatively, they may be shown with the income statement or as part of assumptions in an appendix. Any substantial changes in accumulated amounts (e.g., due to revaluation of assets) should be explained.

3.8.22 Ratios relating to balance sheets include: asset turnover; growth rates; quick ratio; current ratio; debt as percentage of total capitalization; rate of return on net fixed assets in operation; accounts receivable outstanding on a daily basis; inventory outstanding on a daily basis; and, net tangible assets as percentage of long-term debt (see Knowledge Management, section 7.20 of these Guidelines).

Cash Flow Statements

3.8.23 Cash flow statements classify cash flows during the period from operating, investing, and financing activities. The Bank prefers that cash flows are prepared using the direct method⁶. Where this method is used, a note that reconciles net surplus to net operating cash flows should be provided.

3.8.24 Matters that may need to be considered when preparing cash flow statements include:

- *Data for each year:* should be defined as “Actual” or “Forecast”.
- *Total column:* To reconcile the statement with the financing plan, a total column should be inserted to show the aggregate cash flows during project implementation.
- *Capital expenditures:* The following items should be shown separately: (i) the total expenditures on assets; (ii) financial charges during construction (FCDC); and (iii) working capital, particularly for start-up industrial and manufacturing projects. The separation of item (i) and item (iii) should facilitate reconciliation with amounts in the project cost table and the financing plan in the AR.
- *Borrowings:* Bank loan data should be disclosed in the disbursements table(s) of the AR. Estimates of funds available from other sources should be consistent with the information contained in the discussion of the financing plan. In more complicated financing, the funds statement should be supported by a supplementary schedule showing the forecast disbursement of other loans and equity investments.
- *Short-term loans to finance working capital:* working capital requirements may be shown net of short-term loans, in which case a footnote indicating the amount of short-term financing should be added. On the other hand, such short-term financing may be shown separately as a source of funds with a corresponding increase in working capital needs.
- *Debt service:* the actual payments estimates of interest and debt repayment should be consistent with the terms of debt explained by notes to the balance sheet. Where several loans are involved, an interest expense and debt repayment schedule could be used. Interest payments should be net of financial charges during development (FCDC);
- *Equity contributions:* these should, where appropriate, be classified as amounts contributed by shareholders, the government and consumers, where appropriate. Sources of resource mobilization for the project include funds from retained earnings.
- *Cash:* should contain an amount estimated to reflect operational needs. If cash surpluses are planned, for example, as a result of advance long-term borrowing, the balances may be added to a “short-term investments” account, to distinguish the operational cash needs from the more financially related, tactical funds needs. The use of a short-term investment account is advisable when the surplus cash balances are large and the interest income significant. Short-term borrowings - “balancing liabilities account” - may be used where funding needs temporarily exceed fund sources.

3.8.25 The following are typical ratios relating to cash flow statements: (i) debt service coverage; (ii) growth rates; and (iii) percentage of capital expenditure financed by internal sources (see Knowledge Management, section 7.20 of these Guidelines).

⁶ Direct method: cash flow components are shown directly, such as cash receipts and payments to employees and suppliers, rather than being derived from the income statement and balance sheet.

Other Assumptions

3.8.26 Financial forecasting requires analysts to make assumptions, although as many factors as possible in an analysis should be based on researched and actual empirical performance data. When a project consists of additional new investment such as additional power generation capacity for an established power utility, a history of management and levels of efficiency already achieved exists. This provides a sound base for forecasting assumptions. A new project, however, will require a lot of assumptions to be made by its designers and by the analyst regarding input costs, quality and quantities for both investment purposes and for operations and maintenance. Therefore it is essential that the financial analyst disclose all assumptions made together with the date of the base data. Where an assumption is crucial to the analysis, and possibly contentious in nature, the basis of reasoning for that assumption should be indicated, and the grounds or basis for its adoption must be stated in the AR. All assumptions and data sources should be summarized in an appendix to the AR and detailed in the Project File.

3.9 LOAN COVENANTS

Introduction

3.9.1 The entry into force of loan agreements is subject to the fulfillment by borrowers of the provisions of the General Conditions Applicable to Loans and Guarantee Agreements of the Bank. The general conditions are the subject of a separate publication issued by the Office of the General Counsel & Legal Services (GECL) and are not discussed in these Guidelines. In addition to the general conditions, GECL translates agreed policies, goals or objectives into covenants as either Conditions Precedent to First Disbursement of the Loan or Other Conditions. The financial covenants discussed in these Guidelines fall under the later two categories.

3.9.2 To assist EAs to achieve their financial objectives, as well as governmental economic objectives including contributing to the National Development Strategy to the government's Poverty Reduction Strategy, the Bank seeks assurance, for projects it is supporting through loans that the operational objectives of an EA as agreed with the borrower, would be met, at least through the life of the project. These covenants are designed to: (i) enhance the financial performance of the entity; and (ii) ensure that the investment, including Bank loan proceeds, is used effectively. Such covenants, as described in the loan agreement, are to be complied with in a manner that is consistent with the Bank's policies and may be varied in nature, often addressing technical or social and economic performance, in addition to financial performance.

3.9.3 In the Paris Declaration on Aid Effectiveness (Knowledge Management, section 7.3) donors committed themselves to: "(i) Draw conditions, whenever possible, from a partner's national development strategy or its annual review of progress in implementing this strategy. Other conditions would be included only when a sound justification exists and would be undertaken transparently and in close consultation with other donors and stakeholders; and (ii) Link funding to a single framework of conditions and/or a manageable set of indicators derived from the national development strategy. This does not mean that all donors have identical conditions, but that each donor's conditions should be derived from a common streamlined framework aimed at achieving lasting results'.

3.9.4 The process of choosing covenants to apply to loans processed after the issuance of the Paris Declaration focuses more clearly on achievement of National Development Strategy or Poverty Reduction Goals and less on the financial viability of individual EAs and projects as a goal in itself. While not precluding financial management covenants that apply to an individual

EA there is an implication that policy issues, such as the appropriateness of a subsidy, will be resolved at a sectoral level or a national level and would not be an EA specific issue. Financial covenants might seek assurance that a subsidy is paid promptly and included in measuring cash receipts for the purpose of achieving other financial covenanted goals. In addition, there is a need to coordinate and communicate with other donors in the same sector to ensure that there is agreement on policy issues applicable to the EA in question and that there is agreement on the type of covenants and the definitions applicable to those covenants. Recognizing that all donor covenants need not be identical does not mean that covenants applied by different donors may contradict each other.

3.9.5 To further the Paris High Level Forum harmonization agenda, the Bank Group, has developed an Action Plan on *Harmonization, Alignment, and Managing for Results* (revised, October 2005) where it commits itself to work with other MDBs, and bilateral donors to simplify and harmonize policies, procedures, and requirements; and to reduce their associated costs by aligning support with country-owned poverty reduction strategies or other country frameworks.

3.9.6 Financial performance covenants can be broadly classified into two categories, namely financial and management systems and financial performance. *Financial and management system covenants* usually address such specific problems as selling and marketing practices, inventory control, installation and operation of accounting and costing systems, control of labour and material costs, strategic and financial planning, budgeting systems, etc. Financial performance covenants are designed to:

- Support socio-economic development,
- Promote financial viability, satisfactory financial performance and prudent financial management of an enterprise,
- Development of local capability to manage the project without external assistance not only under normal business conditions, but also in adverse operating or trading circumstances,
- Provide a basis for monitoring by regulatory agencies of government, and the Bank, of the financial performance of the enterprise,
- Assist the enterprise to achieve a creditworthy status to facilitate acceptance in capital markets, and
- Protect the borrower's and the Bank's financial interests.

3.9.7 Frequently public sector enterprises provide services to lower income groups at or below the financial or economic cost as part of a National Poverty Reduction Strategy. This raises issues of whether: (i) an enterprise and a sector should be responsible for cross-subsidization; (ii) the government should finance the costs through subsidies either to the enterprise or directly to the beneficiaries; and (iii) the enterprise should be allowed to set lower financial targets which recognize the inability of certain users to meet actual and/or marginal costs. In the latter case, the setting of lower financial targets should not normally be acceptable. If the financial targets are set according to this design their lowering can only risk the future ability of the enterprise to provide a quality of service or product to all consumers. For a public utility to achieve all its goals under the National Development Strategy or the Poverty Reduction Strategy it must have a cash flow that maintains its financial health. The amount of subsidy a government wishes to provide directly or indirectly (e.g., through public enterprises) to low income citizens to enable them to receive goods or services from public enterprises should be recognized in the government's budget and the government should get credit for the true amount of assistance they are providing though implementation of their Poverty Reduction Strategy. A transparent manner to achieve the above goals would be for the government to pay the public enterprise the full amount of the

goods or services provided under normal tariff conditions. Such issues must be resolved as part of project preparation and discussed in the AR. Because financial performance indicators are used as the basis for measuring the foregoing, it is essential that the most appropriate indicator(s) be selected for each covenant for each project and enterprise.

3.9.8 The appraisal mission should ensure that, to the extent possible, financial systems covenants and financial performance covenants are complementary. They should be viewed as a comprehensive package designed for the enterprise's management to achieve an integrated financial performance. The proposed financial performance covenants duly subjected to sensitivity analyses should be included in the AR. Before the final formulation of financial performance requirements and related covenants the appraisal mission must carefully weight their effects on appropriate cost recovery, efficiency improvements, fiscal impact and distributional effects. This will help ensure that financial performance requirements are consistent with a government's socio-economic objectives. In addition, when choosing covenants financial analysts should ensure that they include the requirement for a review to be conducted no later than the end of the first quarter of each fiscal year. Such a review should be in respect of the fiscal year in which it is conducted and should cover a review of budgets or forecasts for the succeeding year.

3.9.9 A full discussion of the financial covenants is included in section 7.27 of the Knowledge Management Chapter of these Guidelines.

Operating Covenants

3.9.10 To assist RMC governments achieve efficient management of scarce resources, including the mobilization of revenues and savings, the Bank recommends to borrowers that their public sector revenue-earning enterprises meet a "reasonable portion" of their investment requirements from internally-generated funds. Definitions of "reasonable portion" will vary between countries and sectors, frequently based on a government's policies for public sector EAs. It will also be dependent on the latest performance of the EA, particularly if its current financial performance is inadequate to support its operations, when the "reasonable portion" may need to be substantially increased above current performance.

3.9.11 The principal covenant which the Bank uses to assure the financial performance of a revenue-earning enterprise is one of several possible "operating covenants". The two principal forms of operating covenant used most frequently are the Rate of Return and the Self-Financing Ratios. Each specifies the minimum annual financial performance to be achieved by a public sector enterprise in terms of either the rate of return on invested capital, or the contribution to investment requirements to be generated from the enterprise's operations.

3.9.12 Competition is usually limited in the market(s) in which public enterprises operate. Levels of output prices may be adjusted by the enterprise's management board (for example, Public Boards of Management for Electric Power) or the government may control or regulate tariffs and charges through the concerned sector ministry, the Ministry of Finance or the Cabinet. In such cases, operating covenants serve to require a management board or a government to authorize tariffs and prices that provide for the satisfactory financial performance by the EA or enterprise. Where an independent regulator regulates the sector, the enterprise and/or the government may not have the same degree of discretion to adjust output prices or tariffs and charges. In such cases, operating covenants serve the same purpose, but the enterprise may need to take alternative measures (such as tighter controls on operating expenditures) in order to meet

such covenant, in addition to making applications to the regulatory authority to increase tariffs and charges.

3.9.13 When the financial performance of the EA has been very poor, forms of operating covenants used include the operating ratio covenant, or the break-even covenant. Depending on the ratio specified, the operating ratio covenant may serve a variety of financial objectives, but it is usually limited in its application, for example, ensuring that earnings would at a minimum cover operating expenses including depreciation and, to the extent possible, debt service requirements in excess of depreciation. The break-even covenant has similarly limited objectives intended to ensure the continued operating capability, solvency and financial viability of the public sector enterprise. It is used where internally generated funds are not expected to contribute significantly to investment. These covenants should be seen as steps to an improved financial performance to ensure that the public enterprise may achieve its other goals as part of the National Development Strategy or the Poverty Reduction Strategy.

3.9.14 Operating covenants should contain provisions for periodic reviews by the enterprise of the actions required to achieve compliance and for furnishing the results of such reviews to the Bank. Such reviews should be made at least annually before the beginning of a fiscal year to permit the enterprise to take timely action. In some cases where financial information is late in delivery, such reviews would need to be made on the basis of firm estimates and the specific forecasts noted for revision when final data is available. In highly inflationary economies, more frequent reviews (e.g., quarterly) may be needed.

Capital Structure Covenants

3.9.15 The Bank uses four capital structure covenants; (i) debt service-coverage ratio; (ii) debt-equity ratio; (iii) absolute debt limitation; and (iv) capital-adequacy ratio. These covenants shape the capital structure by limiting the debt that may be incurred in relation to annual cash flows, the amount of equity capital, or absolute annual amount.

3.9.16 The capital-adequacy ratio covenant seeks to ensure that the equity of a financial institution will at least be adequate to meet its losses. Some form of debt limitation covenant, usually either the debt service coverage or debt-equity ratio, should be used for projects involving revenue-earning entities. The debt limitation covenant complements an operating covenant to provide assurance that fixed debt service obligations will not increase significantly when the broader financial objectives of the operating covenant are not being met. Where an operating covenant is not appropriate, the debt limitation covenant serves as the main covenant promoting financial viability. Exceptions to the use of both types of covenant would be where an entity is financed predominantly through borrowing, and earnings may reasonably be expected always to be sufficient to meet debt service obligations; for example, where a public utility project, usually in the water supply or sewerage sector, funds virtually all of its capital requirements through borrowings and its financial performance is regulated by a breakeven covenant. When dealing with entities that are likely to pay dividends, it may be advisable to use a dividend limitation covenant to complement a debt limitation covenant.

3.9.17 Capital structure covenants serve to assure the continued solvency and financial viability of revenue-earning enterprises by imposing prudent limits on their long-term borrowing. If an EA does not incur debt after entering into such a covenant, or refrains from further borrowing after a period of compliance with the covenant, even though the performance criteria agreed to in the covenant subsequently may not be complied with, (for example if the debt service-coverage ratio falls below 1), the EA is not in default of this covenant until it again commences to incur debt.

The limits of a covenant should be set so as to enable debt service obligations to be met under adverse as well as normal business conditions, taking into account business and financial risks.

3.9.18 The distinction between debt and equity is not always clear. For instance, preference shares have many characteristics of debt while convertible notes might be treated as equity. Furthermore, derivatives and other financial instruments add layers of complexity. Therefore, for the purposes of formulating covenants, a cautious approach should be taken by including any difficult-to-classify instruments in the definition of debt.

Treatment of Short Term Debt

3.9.19 The Bank's standard definition of the term "debt", as applied in the design of capital structure covenants, is any indebtedness of the borrower maturing by its terms more than one year after the date on which it is originally incurred. This limits the application of the covenant to what is usually referred to on a balance sheet as long-term debt, and it excludes short-term debt usually shown on a balance sheet as part of current liabilities. This exclusion is appropriate when short-term debt is incurred as a source of working capital, since any limitation on such uses that is considered necessary can be covered by a liquidity covenant. However, although the current portion of long-term debt (shown as a current liability) is included in the definition of long-term debt for purposes of a capital structure covenant, it should still be retained as a current liability for purposes of a liquidity covenant.

3.9.20 Consideration should be given to the need to refine the definition of "debt" or to use a supplementary covenant to cover some short-term loans that are: (i) being continuously rolled over, or (ii) used as "bridging funds" pending receipt of the proceeds of sale of equity or long-term debt. In the former case, if the amounts involved are likely to be significant, they should be included within the definition of debt covered by the covenant or be covered by a complementary limitation on short-term debt. In the latter case, the need will depend on the judgment as to the likelihood and timing of the replacement by long-term debt or equity. When in doubt, the overall objective should be used as a guide; viz., if the borrower's recourse to long-term debt needs to be restrained, no alternative facility in the form of short-term debt should be admissible, unless suitably defined, categorized and counted in part, or in total, as long-term debt for purposes of the covenant.

Treatment of Financing Leases

3.9.21 Some institutions use finance leases to acquire the use of assets; the final ownership of the asset being dependant upon the terms of the lease. A finance lease effectively places all the risks upon the lessee, and therefore it is reasonable to interpret the existence of such a lease and its associated lease payments as debt and debt service respectively, for purposes of the capital structure of EAs. Therefore where an EA has entered into, or proposes to enter into finance leasing agreements, the value of the lease and the annual lease payments should be included in the capital structure and the debt servicing requirements of the agency for purposes of covenants in loan agreements.

Restricting the Use of Loan Funds

3.9.22 Capital structure covenants have the inherent limitations that although they are primarily intended to constrain the amounts of borrowing, they do not regulate the use to which any permissible borrowing can be put, (nor do they ensure that existing debt will

be serviced, if further borrowing is not incurred). Also, planning and implementation of new projects having substantial debt requirements sometimes delays the completion of ongoing projects, by pre-empting the use of scarce loan resources. If there is substantial concern that a revenue-earning entity is likely to embark on additional projects of questionable merit, a supporting covenant may be needed to restrict the enterprise to investments, which are economically justified and financially appropriate. Such limitations, however, are generally not needed or advisable, and should be employed only exceptionally and usually limited to the implementation period of the project.

Liquidity Covenants

3.9.23 Most operating and capital adequacy indicators are formulated on the basis of accrual information. This means that they may not adequately disclose an EA's liquidity (actual cash) position. Liquidity covenants are intended to assure that an enterprise maintains sufficient working capital (i.e., an excess of current assets over current liabilities) to meet its current obligations in a timely manner and conduct its operations effectively, without financial constraints. The Bank's experience shows that lack of, or insufficient, cash is a major cause of non-performance by EAs. Therefore, a liquidity indicator, preferably the Quick Ratio or "acid test", should be provided for each project. Their limitations are that the data used for the ratio is a "snapshot" figure, usually as at the end of a fiscal period – and, as such, are capable of manipulation. This "snapshot" defect can be substantially overcome by calling for a periodic report to provide a table of month-end quick ratio results for the preceding 12 months (or such other appropriate period).

3.9.24 These covenants are generally used only when working capital requirements are significant, as in the case of most industrial and agro-industrial projects, where the enterprise's management may use limited resources to fund capital expenditures to the detriment of operating expenses. By contrast, these covenants are not normally needed in projects where working capital needs may be relatively small, such as utilities and railways. The cash needs of such projects are adequately covered through operating covenants, supplemented, as necessary, by other covenants dealing with working capital issues, such as timely collection of accounts receivable.

3.9.25 The Current ratio and Quick ratio covenants require the borrower to maintain a specified minimum liquidity ratio and to undertake corrective actions if the actual ratio falls below the prescribed level. The quick ratio covenant excludes the cost of inventories at the date of the balance sheet.

Monitoring and Evaluation

4. MONITORING AND EVALUATION

4.1 INTRODUCTION

4.1.1 OM 600 addresses the need for a sound system of financial monitoring and evaluation of a project and its EA to assist the Borrower in managing the implementation of the project and its continuing financial well being and the Bank's Task Manager in monitoring the progress of project implementation and operation.

4.1.2 At the design and appraisal stage of a project, financial analysis is used to anticipate the impact of the project on the financial operations of the EA during the project's implementation and operation. Throughout the actual implementation and commissioning, it is used to monitor, by use of financial indicators, the EA's operational performance in delivering the intended outputs or benefits, according to design estimates. Monitoring should examine; (i) the implementation of the project and the ongoing operations of the EA during project implementation (where EA operations are present); and (ii) the combined performance of ongoing operations and the new project following commissioning throughout the life of the Bank loan.

4.1.3 Following this introduction, this part of these Guidelines is organized in two sections:

- **4.2 - Objective of Performance Monitoring:** This section views monitoring and evaluation as a process by which the Bank reviews the activities of the Executing Agencies and projects/programmes in relation to the stated goals of the Bank's intervention that are derived from RMC's national development strategies.
- **4.3 Performance Indicators:** This section provides advice and guidance on the identification of performance indicators that are likely to advance and secure efficient and effective financial viability and financial integrity of EAs and projects/programmes.

4.2 OBJECTIVE OF PERFORMANCE MONITORING

4.2.1 The objective in using performance monitoring techniques as a key element in the management of projects is to:

- Provide the management of the EA, the borrower and the Bank with an effective means of measuring the progress of a project, of its components, and the adequacy and timeliness of the provision and use of funds;
- Regularly assess the achievement of or the potential for achieving the technical, financial, and economic goals of the project;
- Determine the form and nature of corrective actions necessary to achieve goals monitored by performance indicators, and
- Assist in defining new or modified performance measures that may be more effective, and to replace any that may be ineffective.

Compliance with National Development Strategies

4.2.2 Monitoring and evaluation is the process by which the Bank reviews the activities of the EA and the project in relation to the stated goals of the Bank's intervention. The Bank bases its intervention on the RMC's national development strategy including its poverty reduction strategy. Since each project is selected on the basis of its ability to contribute to achieving the national development strategy any program of monitoring and evaluation of the project needs to ensure that it includes the project's contribution to achieving the national development strategy. This involves the systemic collection of data on indicators specified in the Bank's Results-based Country Strategy Paper (RSCSP) to provide management and the main stakeholders of an ongoing development initiative with feedback on the extent of progress, the achievement of objectives and effectiveness in the use of allocated resources. The financial analyst, therefore, needs to coordinate with other members of the project team in designing the monitoring program for the project. Evaluation involves a systemic and objective assessment of an ongoing program or policy, its design, implementation and results.

4.2.3 The project may have been designed to contribute to a national poverty reduction strategy in a number of different ways. For example a project may have been designed to expand power generating capacity and to extend power supply to rural areas inhabited by poor farmers or to support a private sector company building a new factory resulting in both job creation and technology transfer to the RMC. The project's progress towards achieving its objectives, therefore, needs to be monitored and evaluated.

4.2.4 Equally important is the financial impact on the EA of the government policy decision to have the EA participate in implementing activities that support national poverty reduction goals. For example, rural electrification projects generally involve high capital costs and relatively low revenue per connection. The financial analyst needs to be aware of the manner in which the EA will be compensated. This may involve a direct subsidy of the capital cost of the project possibly on a percentage of the total project cost basis or possibly on a per connection basis. Such a subsidy should have been included in the FIRR calculation to determine whether the project was financially viable. Receipts by the EA, of the agreed compensation, need to be reported and monitored against set targets. Promised but unpaid subsidies can become problematic during project implementation.

4.2.5 In view of the Bank's participation in and agreement to harmonize its monitoring, evaluation and covenants with other donors there needs to be an understanding between the EA and all donors to the sector concerned regarding content and distribution of monitoring and evaluation reports. This also means that financial analysts should discuss with the EA monitoring systems and reports that reflect the government's development strategy and that meet the needs of all donors to the sector and/or the EA rather than that only respond to Bank's requirements.

4.2.6 Monitoring and evaluation is a process that should be owned by the EA and not by the Bank or other donors. Where the financial analyst determines that the EA's information systems are not capable of producing the necessary information to properly assist EA management monitor its achievement of policy or operational goals, the necessary system capacity

development initiatives should be incorporated in the project cost estimates. At all times financial analysts should avoid creating unnecessary financial information demands on EAs.

4.2.7 In regards to this determination, financial analysts need to be aware that management of aid funds diverts capacity away from managing the national systems. This is compounded when different donors have different requirements. Capacity development initiatives should support a comprehensive and sustainable capacity-building program that is driven by government. To this end, OECD-DAC has published a paper that describes good practices donors can apply to support capacity development in the area of public financial management (see Knowledge Management, section 7.7). Financial analysts are required to review assessments on Public Financial Management¹ by donors and governments and related actions plans to ensure that the Bank's capacity building recommendations are consistent with national plans. In particular, this is important for projects or programs that supporting sectoral developmental goals.

Policy Decisions

4.2.8 Project implementation goals usually revolve around completing the project on time and within budget. Clear reporting and monitoring of the costs incurred and the progress made should be achieved through the Bank's normal requirement for quarterly reporting. This should include information on expenditures to date, bid documents issued and contracts entered into, and physical progress. Other financial goals may include ensuring that the EA is able to achieve the development goals set for it and to provide its intended level of service to the public within the cost estimates agreed upon.

4.2.9 The results of policy decisions need to be monitored. As mentioned earlier subsidies of capital costs of projects may be necessary to relieve the EA of the cost of a social program. Equally important in this case would be monitoring of the rural connections, for example for electricity, to determine whether they provide expected revenue. To this regards, the financial analyst will need be aware of whether the government's policy is to seek cross subsidy of connection costs through the tariff structure of the utility or to pay some or all of the cost of supplying the rural consumers from the national budget. Continued government commitment to deliver on its policy is important to the long-term survival of the EA and its ability to generate adequate funds to either properly maintain the existing facilities or to contribute to the continuing expansion of the utility.

Project Assumptions

4.2.10 The assumptions made during project preparation become an essential part of project monitoring. To this end, EA, as part of the project financial reporting requirements, should provide an annual review of critical assumptions used, for example, inflation rate, forecast costs of principal imports-like petroleum products, cement, etc. This would enable the financial analyst to maintain a continued review of the factors on which the financial projections were based, and

¹ Important PFM assessment reports include: the '*Public Expenditure and Financial Accountability Review (PEFAR)*' and the '*PFM Performance Report (PFM-PR)*' within the 'Public Expenditure and Financial Accountability (PEFA) PFM Performance Measurement Framework' (Knowledge Management, sections 7.10 and 7.11, respectively).

to be aware of any early warning signals of potential deviations from the forecasts. Management of an efficient EA should be continuously monitoring actual costs and prices as well as physical inputs and outputs and comparing them to the forecasts and should regard the annual review of assumptions by the financial analyst as a support exercise. In the event that the borrower or EA does send to the Bank the necessary data for updating the assumptions, the financial analyst, during project supervision missions, is responsible for obtaining the requisite data and preparing an annual revision to the assumptions.

Operational Goals

Non-revenue-earning Projects

4.2.11 There are good reasons for applying performance indicators to the operations of a non-revenue earning project particularly to measure the efficiency of its use of a project's resources, including human resources. Indicators for non-revenue-earning projects are more difficult to establish. Usually non-financial information needs to be incorporated to indicate performance. Indicators such as "mortality per million of population under age 45" or "percentage reduction in traffic accidents in urban areas", are examples that might apply to a rural health project and a road improvement project, respectively.

Revenue-earning Projects

4.2.12 The Bank encourages the application of financial performance monitoring techniques to revenue-earning EAs that implement and operate projects financed using Bank loans, and which typically apply these factors in the designs of their primary cost recovery mechanisms.

4.2.13 In some cases, revenue-earning EAs have benchmarks set for them by governing, regulatory, and advisory bodies. While regulators of utilities for some countries have tried to set national indicators, they have rarely proved to be practical and in some developed countries, government regulators for telecommunications, water, electricity and gas have chosen to determine benchmarks for individual companies or regional groupings of companies. Where regulators have set performance indicators or conversely laws or rules limiting revenue generation the financial analyst should assist the mission in forming an opinion regarding the degree to which the law or rule is consistent with current national development strategy goals and the Bank's or other interested donors' policies.

4.2.14 Each sector contains sub-sectors which may not be mutually compatible, either in their fiscal and social objectives, or in detailed aspects of their accounting treatment and financial reporting. Projects in the same sector may have substantially different financial issues that affect the design of an effective monitoring and evaluation program. Financial analysts need to ensure that the monitoring and evaluation program utilized by the EA or required by the Bank responds to the specific issues and policy objectives established by the government. Examples from different sectors that explain financial performance measurement techniques are provided below.

4.3 PERFORMANCE INDICATORS

Introduction

4.3.1 Financial Analysts in the private sector have developed various performance measuring techniques to enable management and other stakeholders understand the performance of the enterprises. The use of these techniques is appropriate for public sector enterprises bearing in mind the varying objectives and ownership considerations. The use of ratios and other performance indicators are an effective means of measuring performance, particularly when used to compare time-bound performance goals. An inherent danger in the use of performance ratios and indicators lies in the brevity of the descriptions used, and sometimes of the quality or accuracy of the data used.

4.3.2 Performance indicators are intended to convey information quickly and succinctly, but users may be misinformed unless they are provided with a clear understanding of the technical components of the indicator and the bases of the data used to compile the indicators as well as the nature of any changes that may occur in the data to cause sudden fluctuations. As an example, the term “debt” can mean all debt both long and short term, or only long-term debt; or it can mean the local currency equivalent of foreign debt converted at either historical or current exchange rates. Performance indicators should be displayed on a financial report or in related tables in such a manner that readers can quickly appreciate the significance of the information and are left in no doubt as to the basis of the information used to generate a ratio or an indicator. This means that financial analysts must include in their documents, particularly the financial projections, the assumptions used in compiling financial ratios and indicators.

4.3.3 Financial analysts should encourage EAs to recognize that it is very useful for their management, the borrower and the Bank to develop a set of performance indicators to monitor the performance of the EA and where applicable of the project. Their regular review by EA management, the borrower and the Bank may provide critical information on an entity’s operational progress and financial performance. The most informative of the performance indicators should be used in periodic and annual reports.

Time Frame

4.3.4 Achieving financial viability of project may extend beyond the period of project implementation. Meaningful performance and financial forecasting over extended periods of time is not reliable. Projected financial performance information can only be indicative, rather than precise because of many factors. The designed project content and performance may change. Equally, the prevailing financial and economic conditions in which the project is to be implemented and operated may change. Recognition of the inherent risk means that the Bank and the borrower’s agreed definition of the type of performance indicators and any related financial covenants with their specific measurement criteria at loan negotiations must change as physical, financial and economic conditions change in the future.

Checklist For Selecting Indicators and Covenants

4.3.5 The following checklist should be consulted when selecting performance indicators and covenants:

- What is the basis for the available financial management and financial analysis data?
- Is it transparent, accurate, reliable, and the subject of an auditor's report and opinion, or prepared by a consultant with a reliable financial management track record?
- What are the current, or in the case of a "greenfield project", the most likely, financial performance weaknesses that should be given priority for correction (or prevention)?
- What changes are necessary to ensure an adequate capital structure (debt/ equity including reserves) for the EA?
- How can they be affected?
- Which indicators and covenants could be the most appropriate to achieve correction?
- Do the levels of revenue generation and collection need upgrading, prioritise the steps to achieve: (i) short-term improvements; and (ii) long-term improvements?
- Which performance indicators should be included in periodic performance reports (i.e., not subject to covenants)?
- Will the Bank's sector operational experts or consultants confirm that each level of operating costs are, or will be, operating at optimum efficiency and effectiveness?
- What should be the time scale to achieve correction?
- Which indicators and covenants could be the most appropriate to achieve correction (or prevention)?
- For ongoing operations of an EA, what are the deficiencies in cash management performance for at least the past two years (using audited annual financial statements)?
- How should they be corrected?
- Which indicators and covenants could be the most appropriate to achieve correction?
- If not, what performance levels are they proposing, and which financial performance indicators should be used to support their proposed operational performance upgrading?
- Does (or will) the EA have a financial management system from the date of project start-up capable of accurately reporting the financial performance data required in a timely manner?
- Does the EA have a track record of submitting interim financial reports and audited annual financial statements?
- Should this track record be improved? If so, how?
- Does (or will) the EA have a management system capable of developing and efficiently responding to the results of each proposed financial indicator and financial covenant?
- Does the EA have qualified and experienced personnel who can interpret and monitor performance against the indicators or covenants?

Selecting Performance Indicators

4.3.6 Performance indicators are usually characterized by ratios expressed as relationships (e.g., percentages; relating absolute numbers) between two items of information (e.g., debt-equity). The Bank, focuses its monitoring of an EA's performance on indicators drawn from the

three categories, namely: operating indicators; capital adequacy indicators; and liquidity indicators.

4.3.7 Where the Bank is processing a project with an EA for which another donor may have either established performance indicators, or may be seeking to do so, the financial analyst, in the interest of advancing the harmonization agenda should agree with the other donor and the EA on the most appropriate indicators to apply. Leadership for this harmonization effort, as well as in linking the indicators to financial goals and objectives of the EA, however, remains the responsibility of the EA's management.

4.3.8 Among other things, the Paris Declaration emphasised the reliance on borrower systems and a manageable set of indicators derived from the national development strategy. However, it does not expect all donors to use identical sets of indicators but strongly encourages a focus on macro-level development strategy issues rather than micro-level EA issues. The Paris declaration does not preclude agreeing with an EA a program of monitoring and evaluation which will assist the EA in achieving its goals, but the focus is moving away from establishing a set of indicators that responds primarily to the donor's individual concerns.

4.3.9 The financial performance of an EA should normally be monitored by the use of several indicators. However, the Bank seeks to agree with a borrower on the covenanted use of one or more key indicators. In addition, the borrower/EA should be asked to agree to the use of non-covenanted indicators in periodic financial reporting. This means that if only one indicator from the three categories identified above would be the subject of a loan covenant, the remaining indicators should be the subject of periodic reporting.

4.3.10 Additional indicators should be developed whenever necessary to measure specific performance. To this regards, the financial analyst should:

- Identify all factors that could prevent, or limit the effectiveness of financial sustainability of the project. Use identified factors to determine the most efficient financial and non-financial performance indicators that would reflect increases in exposure to financial failure.
- Recommend financial performance indicators that would give early warning of actual or approaching financial management failures by selecting at least one financial performance indicator from each of the revenue, capital adequacy and liquidity financial indicators referred plus any necessary additional financial performance indicators.
- Establish recommended dates of performance achievement and review where the EA will be required to adjust financial performance during project implementation and operation.
- Recommend those financial performance loan covenants that should cause the borrower and the EA to take action to limit or remove the exposures.
- Insist that all forms of financial management weaknesses be either eliminated or that the financial commitments of the proposed project be scaled down to levels that the EA would be able to sustain beyond project implementation.
- Develop a rationale for the use of each indicator selected.

4.3.11 Recommending a specific monitoring indicator and/or a financial covenant for use in each sector or sub-sector is not feasible due to the wide range of sectors, sub-sectors and country conditions. The section that follow only provides advice and guidance on the identification of performance indicators that are likely to advance and secure efficient and effective financial viability and financial integrity for an EAs that seek funding for revenue-earning projects. The

section, however, does not apply to Financial Intermediaries (FIs), a topic covered in chapter 6 of these Guidelines.

Operating Indicators

4.3.12 The Bank recommends to borrowers that they establish a policy of requiring their public sector revenue-earning enterprises to meet a “reasonable portion” of their investment requirements from internally generated funds, after providing for costs of operation and maintenance, taxes, incremental working capital, debt service and any dividend requirements. The generation of this “reasonable proportion” is heavily dependant on the relationship between operating costs and operating revenues. The smaller the share of revenues consumed by operating expenses, the larger the amount available for meeting taxes, incremental working capital, debt service and any dividend requirements with the residual to provide the “reasonable portion” of investment requirements.

4.3.13 Using the reasonableness of the contribution of investment requirements will be subject to the “lumpiness” of the investment program. In many developing countries there is a continuing need to expand public utilities to meet expanding demand and therefore there is usually a continuously high investment requirement. In a more mature utility annual investment may vary considerably in which case an indicator based on the return on investment generated by operating income may be a more appropriate indicator of the appropriateness of revenue generation and cost control.

4.3.14 It is critical that there should be an effective indicator of performance for the level of operating revenues consumed by operating costs. This indicator is the Operating Ratio; an alternative indicator which should only be used to monitor stability of a financially troubled EA is the breakeven ratio. In addition to seeking an overall reduction in costs, it may be necessary to monitor one or more categories of costs to seek specific reductions. Levels of salaries and wages frequently require specific indicators. There can be other costs, such as fuel, transportation, management and administration, etc., that should be the focus of the EA’s attention through the use of indicators.

4.3.15 Where there is a need for an EA to improve its revenue generation, either in parallel with operating cost improvements, or with respect to improving operating revenues only, the EA should still use the Operating Ratio together with appropriately designed revenue indicators. Revenue indicators should be used to show the performance of each revenue category (e.g. domestic, commercial, industrial, etc. or passenger traffic, freight traffic, etc.). Such indicators include “Percentage Growth in Revenues” and “Gross Profit Margin” together with billing performances (number of consumers billed by billing periods or annually).

4.3.16 Where an EA wished to monitor the level of operating revenues in real terms over a defined period, the indicator may break down revenue on the basis of a price/volume variance. Similarly, a specific or unique indicator may be needed when the determination of and payment of government subsidies are critical to achieving the EA’s contribution to the National Development Strategy.

4.3.17 With regards to the calculation of Rate of Return, this indicator should be based upon the value of assets at depreciated historical cost, unless the economy is hyperinflationary. This issue brings forward the question of what the Bank policy is regarding asset revaluations. The MDBs have, in the past, accepted the use of both historical cost accounting, and modified historical cost accounting (where assets are revalued on a regular basis). Both these accounting methods are

consistent with International Accounting Standards. The MDBs will seek to agree a consistent policy position on the revaluation of assets, or otherwise, as part of the harmonization exercise. In the meantime, and in keeping with general Bank practice, asset revaluations should be undertaken where that is the standard practice of the particular country. However, if asset revaluations are undertaken:

- The whole class of assets should be revalued at the same time (e.g., land);
- A robust methodology should be applied that accords with generally acceptable practices (e.g., as applied by the International Valuers' Association) – the use of price indices and other less robust revaluation methods should not be used; and
- The assets must be revalued on a regular basis (e.g., every three years).

4.3.18 Examples of the commonly used ratios and the applicability of the following performance indicators is provided in section 7.20 of the Knowledge Management Chapter of these Guidelines: Operating Indicators - Operating Ratio; Break-Even Ratio; The Self-Financing Ratio (SFR); and Rate of Return (ROR).

Capital Adequacy Indicators

4.3.19 Public sector and private enterprises need an appropriately balanced and adequate capital structure, even though for the former, the objective of return on capital may be tempered by socioeconomic policy considerations. It would be possible to provide all the capital of revenue-earning public sector enterprises as equity and thus avoid all borrowing risks. This is generally considered undesirable because the additional equity thus provided represents capital the government may have used to fund other high priority projects. Borrowing from others increases the total capital devoted to implementing the government's National Development Strategy. In addition, borrowing by a public sector enterprise imposes on the enterprise the financial discipline associated with the obligation to service debt. It is also an oversimplification to view the equity capital in a public sector enterprise as having no recognizable financial cost because the funds used have an opportunity cost regardless of where they are invested. Also the cost of capital is a legitimate cost that should be covered by tariffs, regardless of whether there is debt in the structure of the enterprise. Moreover, in a public sector enterprise, earnings must be in excess of debt service obligations (and/or dividend payments on equity) to provide a safety margin, and to provide additional funds for investment.

4.3.20 The public sector enterprise can use internally generated funds for its investment requirements or to pay dividends that the government can apply for other developmental or fiscal needs. Capital structure indicators serve to indicate an assurance (or otherwise) of the continued solvency and financial viability of revenue-earning enterprises by imposing prudent limits on their long-term borrowing. However, these indicators are not designed as revenue-generating indicators and thus cannot be used as operating indicators. Limits on the liability of public sector enterprises to contract additional debt also prevent the use of borrowings to pay for excessive expenses thus postponing cost reductions or an increase in charges/tariff to maintain earnings at an adequate level.

Capital Structure and Risk Management

4.3.21 Business risk refers to the inherent uncertainties, or variability of expected returns, related to the nature and type of business activity of a particular enterprise. The financial risk is the additional risk inherent in the obligations associated with borrowings (interest and debt repayment) which must be met irrespective of the results of operations. Equity investors because they are subject to the prior claims of lenders and have no fixed promises of returns, will usually

expect a higher return on their capital than lenders. Like lenders, equity investors will accept lower or higher returns when they judge the risks to be low or high. They will consider their risk to be lower when equity is high in relation to debt, and vice versa.

4.3.22 A well-managed entity with a low business risk will have a fairly dependable cash flow and can assume higher financial risks in the form of a large proportion of debt to equity in its capital structure. This would apply, for example, to a public utility with a relatively steady and increasing demand for its services, little competition from other sources of supply, and fairly dependable production facilities. On the other hand, an entity which may be subject to wide variations in demand and prices, such as a steel company or a coffee estate, is likely to have substantial swings in its cash flow from year to year. It should therefore have a relatively conservative financial structure with low fixed financial obligations.

4.3.23 Thus, when an enterprise is being established, or is raising funds for expansion, the capital invested ideally should be structured to balance the lower financial costs of loan funds against the higher costs of equity capital and provide for long-term financial stability at minimum cost. Differences in the capital structure of enterprises in the same industry or in industries with similar business risks may reflect varying management judgments on the trade-off between security and risk, or an unwillingness to adequately fund replacements or expansion, all subject to limitations imposed by protective covenants agreed with lenders.

Foreign Exchange Risk

4.3.24 The foreign exchange risk is an extension of the financial risk when the obligations associated with borrowings (interest and debt repayment) that must be met irrespective of the results of operations are expressed in a currency other than the local currency. Foreign exchange risk is realized when the local currency declines in value against the foreign currencies in which the obligations must be paid, resulting in the cost (or value) of the obligation being increased in local currency terms by reason of the additional local currency required to purchase the requisite amount of foreign exchange to meet the obligation. If the local currency increases in value against the foreign currency obligation, the borrower requires less local currency to purchase the foreign exchange needed to meet the obligation and a foreign exchange gain occurs.

Inflation and Capital Structure

4.3.25 The risk of inflation is another factor that affects the cost of capital and decisions on capital structure. Although inflation may lower the burden on servicing outstanding debt at fixed terms, it may increase the financial risk associated with loan capital, since the earnings of an enterprise may not keep pace with inflation. The interest payable on long-term loans at fixed terms may include a substantial inflation premium over the returns lenders would otherwise accept for the business and financial risks they are assuming. Alternatively, long-term loans may be available only if loan amounts and repayments are indexed for changes in the value of money, or if the interest rate varies with the current cost of borrowings.

4.3.26 The impact of inflation on financial risk is greatest when only short- or medium-term funds are available, and the enterprise is exposed to the risk of being unable to refinance at maturity or of having to pay higher interest rates for renewal. The risks associated with borrowings under inflationary conditions, therefore, must be carefully appraised in determining a prudent capital structure. Inflation also increases the working capital requirement of enterprises. The negative effects of inflation often outweigh the positive effects of lower debt service, and after a few years, the impact may be one of under-capitalization.

4.3.27 Examples of the commonly used ratios and the applicability of the following performance indicators is provided in section 7.20 of the Knowledge Management Chapter of these Guidelines: Capital Adequacy Indicators - Debt Service Coverage; and Debt-Equity Ratio.

Liquidity Indicators

4.3.28 Liquidity indicators are intended to measure the adequacy of an enterprise's working capital, i.e., an excess of current assets over current liabilities, to meet its current obligations in a timely manner and conduct its operations effectively without financial constraints. These indicators are generally used only when working capital requirements are significant, as in the case of most industrial and agro-industrial projects. However, the inability of many EAs to collect and manage their cash resources has brought these indicators into increased attention and popularity.

4.3.29 While these indicators were not normally used for projects where working capital needs were considered to be relatively small, they are increasingly being deployed. The Current Ratio and Quick Ratio define a specified minimum liquidity ratio and corrective actions will be necessary when the actual ratio falls below the prescribed level. The Quick ratio (or acid test) is the preferred indicator because it ignores inventories that are frequently not readily realizable in public utilities (e.g., uninstalled large water main pipes or electrical transformers that are stored for emergency use).

4.3.30 Examples of the commonly used ratios and the applicability of the following performance indicators is provided in section 7.20 of the Knowledge Management Chapter of these Guidelines: Liquidity Indicators - Current Ratio; and Quick Ratio.

Reporting and Auditing

5. REPORTING AND AUDITING

5.1 INTRODUCTION

5.1.1 This Chapter of these Guidelines addresses the financial reporting and auditing of EAs, IAs and projects. It also advises on the selection and terms of reference of auditors, particularly in relation to their qualifications and competence. Arrangements for monitoring and reviewing financial reports and auditors' reports are explained in detail. A checklist is provided for reviewing auditors' reports.

5.1.2 This chapter aims to: (i) provide financial analysts with detailed guidelines to enable them to advise governments, EAs, and IAs on the Bank's financial reporting and auditing requirements; and (ii) facilitate the identification of inadequate financial reporting and auditing performance by EAs, IAs and auditors. In addition to this introduction this part has four sections:

- **5.2 – Accounting Standards and Policies:** This section describes accounting standards and their applicability to financial reports on Bank financed projects.
- **5.3 – Financial Reporting:** This section describes the Bank's financial reporting requirements.
- **5.4 – Auditing:** This section describes auditing standards and their use in the audit of the financial reports of Bank financed projects.
- **5.5 – Reviewing Financial Statements:** This section discusses the process of reviewing financial statements, including audit reports, and outlines actions that should be taken where financial reports are overdue or are inadequate.

5.2 ACCOUNTING STANDARDS AND POLICIES

Introduction

5.2.1 The preparation and reporting of accounting information varies widely among countries and contributes to a substantial lack of transparency and consistency in financial reporting. This means that precise interpretation of financial statements can be a daunting process. At best, they may be misleading; at worst, they may be fraudulent. A serious Bank concern is the accurate interpretation of the financial position and performance of its borrowers and EAs. It is even more important for investors and those charged with the safeguarding of stock exchanges, brokerage houses and banks to have confidence in reported financial performance and position.

5.2.2 In recent years, there has been significant progress in the availability and usage of internationally-consistent accounting standards. First, the International Financial Reporting Standards/International Accounting Standards (IFRS/IASs) issued by the International Accounting Standards Board (IASB) were developed to the point where they presented a viable, and arguably preferable alternative to nationally-developed accounting standards for revenue earning or commercial entities. Second, most developed and developing countries are in the process of either harmonizing their accounting standards with IFRS/IASs or adopting IFRS/IASs directly. Third, International Public Sector Accounting Standards (IPSAS) issued by the International Public Sector Accounting Standards Board (IPSASB) have been gaining acceptance as a source for generally accepted accounting standards for the public sector.

5.2.3 This section discusses the Bank's approach to the application and use of accounting standards and policies by borrowers.

International Financial Reporting Standards (IFRS) / International Accounting Standards (IAS)

5.2.4 Differences in financial reporting practices and accounting standards can be significant between countries. The factors that influence the development of accounting practices and the differences between countries in terms of these practices include the nature of a country's legal system, the prevalent providers of finance, the influence of taxation, and the strength of the accountancy profession.

5.2.5 The International Accounting Standards Board (IASB), which superseded the International Accounting Standards Committee (IASC) on 1 April 2001, promulgates IFRS/IASs. IFRS/IASs are appropriate for private sector reporting and for reporting by government business enterprises, including public utilities (e.g., electricity, gas, water and sanitation, and telecommunications). The Knowledge Management, section 7.24 of these Guidelines provides a list of IFRS/IASs with further information regarding these standards available at: www.iasb.org and at www.iasplus.com.

5.2.6 Surveys of national accounting standards show that many countries are aligning their private sector accounting standards with IFRS/IASs. Some countries have adopted IFRS/IASs completely. In particular, the G7 Group of nations has pledged to align their accounting standards with IFRS/IAS and the European Union has decreed that all member countries should adopt IFRS/IASs for listed company reporting by 2005. The status of country-adoption of IFRS/IASs can be examined at the IASB's website (www.iasb.org).

5.2.7 In 1998, the IMF was charged with monitoring the country adoption and usage of IFRS/IASs. Consequently, countries will be under pressure to adopt some form of accounting standards in close harmony with IFRS/IAS, if not the complete IFRS/IAS package of standards. The G7 expects the IFIs, including the Bank, to contribute to advancing the use of IFRS/IAS in their member countries. These contributions may be by requiring the use of IFRS/IASs in financial reporting to the Bank by revenue earning entities, and by providing assistance in appropriate cases to modify systems and build capacity to enable RMCs to achieve this goal.

International Public Sector Accounting Standards (IPSASs)

5.2.8 The IPSASB which superseded the Public Sector Committee in 2004 publishes IPSASs. IPSASB focuses on the accounting and financial reporting needs of national, regional and local governments, related governmental agencies, and the constituencies they serve. It addresses these needs by issuing and promoting benchmark guidance, conducting educational and research programs, and facilitating the exchange of information among accountants and those that work in the public sector or rely on its work.

5.2.9 Accounting practices in the public sector vary considerably between countries. A limited number of countries have adopted the accrual basis of accounting for government reporting but most use the cash basis of accounting or a modified cash basis of accounting. The modified cash basis of accounting includes a broad spectrum of deviations from the cash basis of accounting, such as the accrual of accounts payable at fiscal year end and the adoption of most but not all accrual based IPSASs.

IPSASB has issued 21 IPSASs addressing issues under the accrual basis of accounting plus an omnibus Cash Basis of Accounting IPSAS. The Rome Declaration called upon the International

Federation of Accountants, through IPSASB, to issue a public sector accounting standard for development assistance. As a result, the IPSASB issued, in February 2005, the following Exposure Draft No. 24: *Financial Reporting under the Cash Basis of Accounting – Disclosure Requirements for Recipients of External Assistance*. Financial analysts should be conversant with the status of these developments by reviewing information in section 7.24 of the Knowledge Management Chapter of these Guidelines and at: www.ifac.org.

The Bank's Requirements

International Standards

5.2.10 Financial analysts need to fully understand IFRS/IASs and IPSASs. They also need to be familiar with the accounting standards in use in the countries in which they operate. More particularly, financial analysts should become familiar with the accounting policies used by the EAs and IAs that manage Bank-financed projects. This will enable analysts to recommend approaches that will: (i) provide the Bank with adequate information to understand the efficiency of the management of borrowers' investments; and (ii) contribute to narrowing differences between IFRS/IASs, and IPSASs and national accounting standards.

5.2.11 It is important that a clear understanding is reached with the EA during appraisal so that forecasts used in the approval process will be comparable with the financial statements submitted for reporting purposes. Therefore, the Bank will seek to agree with the borrower, and EA, not later than at loan negotiations, the acceptable accounting standards and policies governing the preparation of financial statements of the proposed project.

5.2.12 The Bank recommends that all public sector revenue-earning EAs/IAs and projects, should account and report on financial transactions on the basis of accounting policies consistent with IFRS/IASs. As for public sector non-revenue earning EAs/IAs and projects, the Bank recommends accounting standards that are consistent with IPSASs.

5.2.13 Alternatively, the Bank may accept audited annual financial statements of projects, EAs and IAs that are based on national or other defined standards, provided that the Notes to the Financial Statements include realignments and adjustments of the financial information in the audited annual financial statements to provide a report in accordance with IFRS/IASs or IPSASs. In this case, borrowers, EAs or IAs should adopt IFRS/IAS or IPSAS-compliant accounting policies by an agreed date. Until that time, financial statements should be prepared in accordance with a set of accounting policies acceptable to the Bank and noted in the Minutes of Loan Negotiations.

Timetable to Introduce Acceptable Accounting Policies

5.2.14 The Bank recognizes that some time will be required for borrowers, EAs and IAs to adopt IFRS/IAS-compliant accounting policies and will negotiate with new borrowers on a project-by-project basis for the timing of their introduction. In these instances, financial analysts should coordinate with the Supreme Audit Institution (SAI) of the borrowing country, the EA and the IA, to determine required modifications of accounting policies and the required date for their introduction. The introduction date of the revised policies and practices may be included as a loan covenant.

5.2.15 Bank reports relating to project identification, preparation, appraisal and supervision should describe the current status of application and use of IFRS/IASs and IPSASs in the country

concerned, and by the EA/IA. The reports should include recommendations or commentaries on, timetables and associated steps by the Bank to encourage borrowers, EAs and IAs to adopt IFRS/IAS and IPSASs-compliant accounting policies.

5.3 FINANCIAL REPORTING

Introduction

5.3.1 Subject to the obligations agreed upon by the Bank and the borrower and its EAs and IAs on the progress of a project, the Bank typically requires the submission of periodic progress reports, covering: (i) the interim, annual, and final costs of a project; (ii) where appropriate, the financial performance and financial position of an EA or IA; (iii) accountability for all funds, including the Bank's loan(s), provided for project implementation; (iv) the bases for disbursements of the proceeds of the Bank's loan(s); (v) the extent of compliance with financial and related covenants, and (vi) the effectiveness of project-related financial management and accounting systems as specified by the Bank and agreed to by the borrower. In cases where a TAF grant is provided by the Bank, either in parallel with a Bank loan to a borrower, or independently, the provisions for financial reporting and auditing set out in this part of the Guidelines will apply.

5.3.2 Early in the project processing cycle, preferably at project identification, the financial analyst should inform borrowers, EAs and IAs of the Bank project accounting and auditing requirements. In addition, borrowers and EAs should be reminded of the need to inform other concerned entities or persons regarding those reporting requirements, including: (i) the government agency responsible for the performance of an EA, and for assigning or appointing the auditor; (ii) the government auditor mandated by law to audit the accounts of the EAs or IAs; (iii) private or commercial auditors acting on behalf of the government auditor; and (iv) a principal or holding company having financial responsibility for the EAs or IAs. Early notification of the Bank's requirements to the above responsible authorities is essential to enable Bank staff to assess the likely prospects for compliance prior to, and during, appraisal. This will also allow Bank staff to comment on the expected performance and quality of financial reporting and auditing in the Appraisal Report and, if necessary, in the project identification and preparation back-to-office-reports.

5.3.3 Reports on project identification, preparation, appraisal and supervision should include a reference to the accounting standards and policies adopted by the borrower's EA and IA, and their acceptability to the Bank. Any modifications that will be, or have been, made to financial reporting requirements should be communicated to the Bank.

Content and Timing of Financial Reporting

5.3.4 The Bank recognizes that many project financial statements, particularly those prepared for non-revenue-earning projects, are of a "special purpose nature". Consequently, the Bank requires that financial information submitted by non-revenue-earning entities adhere to an appropriately designed format acceptable to the Bank. The following fundamental principles should apply to all interim and annual financial statements on projects issued by a borrower, EA or IA: (i) disclosure of full accountability for all funds of the borrower, other donors and lenders, and the Bank; (ii) compliance with loan covenants and Bank requirements for project management; (iii) adequate disclosure of all material information; and (iv) a true and fair view, or a fair presentation in all material respects, of the financial performance and status of the project (and where applicable, of the EA/IA). In addition, the following fundamental principles apply to

annual financial statements only: (i) a clear statement of the accounting policies and accounting principles adopted; and (ii) the results of an independent review of the financial accounts and financial management systems by an auditor acceptable to the Bank.

5.3.5 Audited annual financial statements of EAs/IAs or projects are required in either of the Bank's official languages for each fiscal year of project development and implementation, including the year of final commissioning of the project.

5.3.6 Interim and annual financial statements may combine financial transactions of a project with those of the EA/IA, where the agency is established solely for purposes of developing the project. Interim and annual financial statements, also, should show sufficient information to identify separately the transactions relating to the reporting year and the cumulative transactions from the date of start-up. This applies particularly to those expense and revenue categories contained in the loan agreement and/or Appraisal Report and revisions thereto. The reporting year includes a part-year from the start-up date to the end of that fiscal year, and a part-year from the start of the fiscal year in which a project is closed, to the date of closure. "Date of start-up" means the date of the first financial transaction that is the subject of the Project Cost Table and/or the project operating costs and revenue forecasts referred to in the Appraisal Report. Therefore the date of start-up could include the date when costs that were approved for retroactive financing were incurred (e.g., design costs or mobilization expenses). There are cases where there are no expenditures incurred in the first fiscal year (or part thereof), but an Imprest Account has been established with Bank funds. Such a transaction must be reported in the annual financial statements, even though there have been no withdrawals there from. In the event that a IA or EA was established and local counterpart funds were expended (e.g., on salaries and wages) but no project implementation occurred, the first year's annual financial statements should be provided to the Bank showing the operating costs of the EA/IA even if such costs were fully met by the borrower.

5.3.7 Where an EA is responsible for implementing defined subprojects (with or without engaging PIUs for subproject implementation) separate financial statements should be provided for each defined component together with a consolidated financial statement for the complete project. Where an EA is responsible for developing more than one project, common or joint project financial transactions of the agency may be apportioned and allocated to each project on a basis defined in the Notes to the Financial Statements. For projects where multiple EAs/IAs are required to submit separate statements, compliance details will be recorded separately indicating separate status of compliance and ratings, which will be the basis for calculating the overall rating/compliance of the project.

5.3.8 The reports on a revenue-earning project may be incorporated within EA financial statements provided that the statements explicitly describe the financial status and performance of the project for the fiscal year, the previous fiscal year and from start-up. Interim financial reporting should follow the format of the annual financial statements, but should cease on completion of Bank disbursements.

5.3.9 Borrowers are asked to provide interim and audited annual financial statements in accordance with a timetable agreed with the Bank. Interim financial reports are normally required at intervals of three, four or six months of each fiscal year. Audited annual financial statements should be provided normally within six months (or such other period as the Bank may agree) following the end of each fiscal year. Interim and annual financial statements should normally be presented in the local currency, with the basis for translation of any foreign exchange transactions or commitments explicitly stated. Where audited financial statements first submitted to a

government legislature, (with the risk thereby of substantially delaying the transmission of the audited financial statements to the Bank), a draft thereof, certified by the chief financial officer and the auditor, should be submitted to the Bank within the required reporting timetable, with subsequent confirmation after they have been ratified by the legislature.

Project Financial Statements

Non-Revenue Earning Projects

5.3.10 For non-revenue earning projects, annual financial statements should be prepared by an EA in respect of a project only particularly where the project is implemented by organizations of national, provincial, state or regional and/or local governments. The statements may take the following forms and may be produced in the local budgetary and accounting formats for the project and, where applicable, for the EA concerned:

- Statement of Income and Expenses (or Cash Receipts and Payments)
- Imprest Fund Account
- Statements of Expenditure; and
- Notes to the Financial Statements

Revenue-Earning Projects

Projects and IAs/EAs

5.3.11 Borrowers are asked to provide the Bank with annual financial statements in respect of each autonomous or semi-autonomous EA that plays a substantive role in implementing and/or operating a project having revenue-earning characteristics. These financial statements should contain details sufficient to identify the financial performance and status of the project/EA. Normally these should comprise:

- A Balance Sheet showing the financial position of the entity, including the project, as at the close of each fiscal year.
- An Income (or Operating, or Income and Expenditure, or Profit and Loss) Statement.
- A Cash Flow Statement that should disclose the cash flows during each Fiscal year.
- An Imprest Account Statement.
- Record of Statements of Expenditures.
- Notes to the Financial Statements.

5.3.12 Financial statements should include comparative figures for the preceding fiscal year; with appropriate supporting schedules and explanatory notes (e.g., methods of revaluation of assets; unusual conditions that affected performance). Supplementary financial statements should be provided containing information requested by the Bank with respect to items requiring additional disclosure or explanation. Unaudited interim Cash Flow Statements and Balance Sheets may be required for specified periods of each fiscal year – for example, at the end of each quarter or semester – in addition to audited annual financial statements.

5.3.13 An Income Statement should report the results of operations for the period covered under major categories of financial information. These may embrace, but are not limited to the following: (i) operating revenue by categories of sales or service charges; (ii) operating expenses by category (e.g., labour, supplies, and administration; cost of sales, or transmission and distribution, etc.); (iii) depreciation; (iv) income from sources other than operations; (v) taxes on income; (vi) interest and financing costs charged to operations; and (vii) net income.

5.3.14 The Cash Flow Statement should show, during the period covered by the Income Statement, the origins of all cash flows and their use in financing the project, any expansion of the entity, debt service, working capital, and, where appropriate, payment of dividends on equity or other forms of surplus funds distribution. The Bank prefers that this Cash Flow Statement be designed and presented in a manner which illustrates the cash flow of the entity during the period, with separately identified information on non-cash and working capital transactions.

5.3.15 The Balance Sheet should be drawn up at the close of a reporting period and should display fixed, current and other assets, with liabilities, particularly long-term and short-term debt, paid-up equity, and accumulated earnings and surpluses. To best illustrate the nature and business of the entity, the Balance Sheet should be compiled in a manner that highlights such important characteristics as the capital structure, the liquidity position, or the reserves.

Supplementary Financial Statements

5.3.16 The Bank will normally specify the form and content of supplementary financial statements to be attached to the standard annual financial statements, but borrowers should include all information that is considered informative and appropriate to illustrate the performance of project implementation and operation. The following are examples of information that may be requested by the Bank:

- A detailed summary of the fixed assets of an entity distinguishing between assets in service and construction work in progress, and accounting for changes during the year, the basis for their valuation (and revaluation, where applied), and related accumulated depreciation, including an explanation of the methods and rates of depreciation (frequently required for public utilities).
- A summary of long-term debts, including lenders, terms, amounts outstanding showing sub-borrowers repayment history, amounts still to be disbursed showing currencies of repayment, and noting the extent to which any of the entity's assets have been pledged (frequently required for financial intermediaries).
- A summary of accounts receivable and accounts payable in terms of their age, showing differences in accounts outstanding for government and nongovernmental parties (frequently required where agencies of governments do not meet their commitments to public utilities).
- A summary showing major categories of inventory and the basis of their valuation.
- For financial intermediaries, a summary of sub-borrowers' accounts showing the short-term and long-term positions, with an explicit statement on provisions for losses (bad and doubtful debts), their methods of computation, and the adequacy of securities.
- Information on costs of sales, labour costs, and other important items in the Income Statement.
- Comparators and performance indicators showing the methods of calculation and tracking record from start-up of the project or such other date as shall be agreed with the Bank.
- An analysis of any asset and debt revaluation, method used, and the effect on the entity's financial position.
- A statement of budget allocations and actual expenses to date.

Examples of Model Financial Statements

5.3.17 The Knowledge Management section 7.26 of these Guidelines provides examples of model financial statements for revenue-earning and non-revenue-earning projects. Furthermore, a

set of model financial statements, which are cross-referenced to IFRS/IAS requirements, together with a disclosure checklist is provided at: www.iasplus.com.

5.4 AUDITING

Introduction

5.4.1 An audit's overall objective is for the auditor to express an opinion as to whether the financial statements present a true and fair view of the project and, where applicable, of the EA and IA are presented fairly in all material respects in conformity with IFRS/IAS or IPSASs or other accounting standards acceptable to the Bank, and are applied on a basis consistent with that of the preceding year. Where an audit opinion is being issued on a project or EA when other MDBs or donor agencies are cofinancing the same project a single audit that satisfies the needs of all agencies financing the project should be undertaken.

5.4.2 The auditor's opinion is necessary to establish the credibility, or otherwise, of the financial statements of an EA. The examination should be of such scope and depth to allow the auditor to give an opinion and make a report on the veracity, accuracy and fairness as regards the presentation of the financial statements of an EA or a defined part thereof (such as a project, a project unit, or a department or division). However, financial analysts should not assume that the auditor's opinion is an assurance of the future viability of an entity or of the efficiency or effectiveness with which management has conducted the affairs of the entity.

5.4.3 During project identification and preparation, financial analysts should become familiar with the existing laws, regulations, rules and national standards of the country and the EA that govern financial reporting and auditing requirements. It is essential to identify incompatibilities between the Bank's requirements and local legal requirements for financial reporting and auditing and to resolve gaps before appraisal.

Auditing Standards

5.4.4 The Bank recognizes International Standards of Auditing (ISAs), promulgated by IFAC, and the auditing standards of the International Organization of Supreme Audit Institutions (INTOSAI). ISAs are widely adopted by the international accounting/auditing profession and many national professions. They form the benchmark for standards on auditing acceptable to the Bank for audits.

5.4.5 Majority of RMCs Auditor-Generals and their equivalents use INTOSAI auditing standards. The Bank prefers that auditors conform to ISAs, but recognizes that in some countries auditors are expected to apply "generally accepted auditing standards", which may not conform to ISAs. Such other standards may have been prescribed by a country's law or may have been adopted by public accountants or associations of public accountants in the country concerned. These standards differ from country to country, but are intended by the accounting profession to imply the highest standards of auditing practice. Although ISAs are widely recognized, it should not be assumed that these have been adopted by national accounting professions or governments, and are therefore automatically applicable to audits and auditors of project entities. Local standards may not conform partially or completely with international guidelines.

5.4.6 Therefore at project identification, or during project preparation, financial analysts are required to accurately determine the auditing standards that will be applied by an auditor of annual financial statements of a borrower. If these do not correspond to ISAs, the analyst must

determine the extent and impact of variances in application of the local standards. In the event that the impact of variances is sufficient to give rise to concerns for the adequacy and veracity of an audit, the analyst must request the EA to have the auditor adopt ISAs for the audit of the Bank-financed project and the project entity.

5.4.7 Failure by an EA to meet such requests must be reported in the Aide Memoire and the fact-finding BTOR. If agreement is not obtained by project appraisal, an Issues Paper should be prepared so that management can give guidance. The BTOR and the Appraisal Report should include confirmations of the acceptable auditing standards that will be used.

5.4.8 Supplementary auditing and reporting procedures may be requested by the Bank, if necessary, to confirm accountability and financial performance in cases where the Bank considers local standards need to be supplemented. In addition, the Bank would expect auditors to indicate in their report the extent of differences, and the impact on the audit, of use of local auditing standards compared to the application of ISAs.

Audit Scope

5.4.9 The audit is intended to provide an ex post review of the EA's financial statements, financial systems, records, transactions, and operations, performed by professional accountants. It is intended to provide assurances of accountability, give creditability to the financial statements and other management reports, identify weaknesses in internal controls and financial systems, and make recommendations for improvements. The auditor should obtain an understanding of the project and the entity being audited, including the contents of the Appraisal Report, legal agreements, and these Guidelines.

5.4.10 The extent of an auditor's review of the accounting records depends on the systems of accounts and of internal checks and controls used by the entity being examined. An auditor will need to examine, and where necessary, test:

- the organizational procedures for making financial decisions, budgeting and authorizing expenditures;
- the design, management, and operation of the accounting system;
- the effectiveness of related systems and procedures such as inventory control and data processing;
- the efficiency of the systems of internal control and of internal audit;
- all financial transactions, and verify year end balances, including an appropriate degree of physical verification;
- compliance with IFRS/IASs or IPSASs or any other applicable accounting standards, including the adequacy of disclosures;
- subsequent events and their possible effect on the financial statements;
- overall comparators of actual costs and achievements against budgets and planned indicators, obtaining and reporting adequate explanations for significant variations;
- test compliance with loan covenants and the Bank's requirements;
- a determination as to whether the borrower and project implementing entities have maintained adequate documentation on all relevant transactions;
- a confirmation that expenditures submitted to the Bank are eligible for financing and identification of any ineligible expenditures.
- test compliance with country legal requirements on financial reporting, including auditing; and
- the adequacy and competence of accounting staff.

5.4.11 In the light of their findings, auditors should normally test the financial transactions of the organization against such documentary or other evidence as maybe necessary to enable them to be satisfied as to the authenticity and correctness of the transactions, their complete and proper entry in the books of account, and their effect on financial performance and status.

5.4.12 The timeliness and accuracy of the recording of assets and liabilities and of the methods of their valuation should be reviewed by the auditors, particularly for projects executed by government departments, for which asset recording typically is not a routine requirement. In addition they should be satisfied as to the methods of regularly determining their existence, ownership and appropriate valuation, including, where necessary, physical inspection by the auditor. Examples of items to be addressed include: (i) land, buildings, machinery, and equipment, including methods of provision for depreciation, if such provision is applicable to the accounting procedures for the project or EA under audit; (ii) inventories, including appropriate accounting for obsolescence, spoilage, or losses; (iii) receivables, including provisions for bad and doubtful debts; (iv) cash and bank balances; (v) investments; (vi) amounts due to third parties (long-term and short-term loans and suppliers' accounts payable); and (vii) insurance coverage, particularly of project components. Where appropriate, an auditor should examine such items as capital commitments and treatment of contingent liabilities, the effects of currency devaluation or revaluation on foreign currency transactions, and events occurring after the date of preparation of the balance sheet.

5.4.13 Circumstances beyond the control of an auditor and the EA may sometimes make it impossible to carry out all preferred auditing procedures, fully. In such cases, auditors should satisfy themselves by alternative procedures that are practicable and reasonable in the circumstances. There are two important auditing procedures which should be carried out: (i) direct correspondence with debtors and creditors on a substantial test basis by an auditor, to confirm sums due to, and payable by the EA/IA being audited; and (ii) observation by the auditor of physical inventory taken by the client. Specific disclosure should be made of the reasons for non-compliance in cases where these procedures are not carried out, and whether satisfactory alternative procedures were employed.

5.4.14 Any significant effects on the financial performance or status of the project, as a result of not conforming to IFRS/IASs, should be disclosed. Examples of such variations and their effects on reported financial results that should be disclosed are any overstatements of assets and understatements of liabilities that may be sanctioned by local laws; accounting on a cash basis or on a basis other than historical costs; recognition and equalization of income over several accounting periods; omission of certain gains or losses in determination of net income; the use of "reserve" accounting when full details of movements in, and realized profits on, reserves may not be revealed; and the treatment of foreign exchange profits or losses in a manner that does not disclose their impact. The auditor should review the interim financial statements for each year and compare them with the annual financial statements.

5.4.15 The Bank requires the auditor to report any differences, particularly any ineligible expenditure against which the Bank may have disbursed, recommending actions necessary to avoid recurrences. The audit of the statement of expenditures should be included as a part of the overall audit of the project. However, the Bank requires that particular attention be paid to the internal control systems and the verification of documents relating to expenditures, not only to ascertain proper financial accountability, but also that expenditures are eligible for inclusion in the project.

5.4.16 The Bank requires the audit of the Imprest Accounts to be included as a part of the overall audit of the project. This audit is limited to the transactions of the Imprest Accounts, as the audit of the expenditures reimbursed or paid directly from the Imprest Accounts are to be audited as a part of the project audit, with appropriate review of the in-transit items. Where the audits of the Imprest Accounts are stand alone, a special purpose audit opinion is required. Where the audit forms a part of that of the project, a separate reference to the Imprest Account audit should be included in the auditor's opinion.

5.4.17 Legal and professional requirements will normally determine the scope and depth of an audit examination, but these may also be supplemented by client instructions in the form of a Terms of Reference. These instructions would usually extend an audit's scope and detail, but they may restrict an auditor's activities rendering them unacceptable. Care should be taken when framing a request for additional work from an auditor. Borrowers should be asked to remove unacceptable restrictions on auditor's scope of work.

Auditor Appointment

5.4.18 A borrower is responsible for the selection, appointment and performance of an auditor. The Bank wishes to be informed by a borrower of an ongoing or proposed appointment of an auditor, who should meet the Bank's required standards in terms of independence, experience and competence. More specifically, the Bank should indicate the acceptability of an auditor in the form of a "no objection" provided that the actual or proposed auditor satisfies the following criteria:

- They must be impartial and independent of the management of the entity to be audited, and of the person appointing them. In particular, the auditors should not otherwise be employed by, serve as directors for, or have any financial or close business relationship with the entity during the period covered by the audit.
- They must be well-established and reputable using procedures and methods that conform to ISAs or INTOSAI auditing standards, and employ adequate staff with the skills and competence required for their responsibilities.
- They must be able to demonstrate experience in auditing the accounts of projects or entities comparable in nature, size, and complexity to the assignments they are to undertake. However, specialized auditing experience, obtainable only from external sources, may be necessary for some projects.
- The audit work should be assigned to personnel who have the professional and technical training and proficiency required in the circumstances.

5.4.19 The Bank requires that the borrower, the EA, and the project implementing entity select and appoint an auditor acceptable to the Bank within sufficient time to carry out its responsibilities, including a review of the financial management systems at the beginning of project implementation, and periodically thereafter. The Bank does not normally advise on the selection of auditors, but prefers to review a list of several auditors submitted from whom an appointment will be made by the borrower. The Bank will advise on any auditor who may not meet the Bank's criteria. The Bank will indicate its agreement to a proposal to engage an auditor when it is satisfied that an existing auditor, or the auditor under consideration for engagement, would be acceptable to the Bank in terms of independence and competence to carry out the audit.

5.4.20 Many prospective borrowers and EAs have ongoing audit arrangements. In other cases, borrowers initiate audit engagements at the start of a project. Whenever an auditor is to be appointed by a borrower, or the auditor is a statutory appointee, the Bank will seek information in

order to be satisfied regarding the independence and experience of the proposed auditor. The required information includes: (i) the name of the auditor; (ii) the names, qualifications, and experience of the auditors' principals and managers; (iii) the approximate number of professional staff employed; (iv) a listing of some of the main audits currently and previously carried out by the auditor; and (v) a statement of the independence of the firm of auditors vis-à-vis the entity it is proposed to audit.

Auditor Independence

5.4.21 The scope and detail of an audit may also depend upon laws or regulations that may constrain a government auditor from providing the independence and the depth of examination required by the Bank. The following are examples of situation that would be unacceptable to the Bank: (i) a government auditor whose staff may be required by laws or regulations to participate in the processing of financial transactions; (ii) an auditor who acts for an EA in the preparation of annual financial statements; (iii) an auditor who designs and constructs components of the EA's financial management system. In each case, the financial analyst must thoroughly review the circumstances and have adequate support, if necessary, by seeking an independent opinion, for the exclusion of the proposed auditor from doing the auditing assignment.

5.4.22 In certain instances, staff constraints may cause the borrower and EA/IA to request an auditor to compile part or all of the annual or supplementary financial statements. Where this is necessary, to be eligible to carry out the audit, the auditor should play no part in any aspect of the decision making and/or management of the entity concerned, including maintaining and finalizing accounting and financial reporting preparation services for the current year of audit and at least the most recent preceding fiscal year of the project. The extent of the auditor's involvement in accounting should be discussed in the Management Letter.

Timeliness of Auditor Appointment

5.4.23 It is essential that auditors are able to commence work at project start-up, and thereafter sufficiently early in each fiscal year to complete the audit expeditiously after the year-end; for example, the checking of stocks and balances at critical times in a year may require the presence of an auditor if a qualified report is to be avoided. It is important, therefore, for the borrower, before the beginning of each fiscal year, to appoint an auditor. The borrower will be expected to provide the Bank with an assurance that the initial auditor has been notified of the Bank's requirements, including the timing of the audit and issuance of the auditor's report. In all cases, this will not be later than the starting date of the project or the date of the Bank's Board approval of the loan, whichever is the earlier. Financial analysts are also encouraged to meet with the auditor at the earliest opportunity following their appointment.

5.4.24 Where a government auditor is to serve during execution and operation of a revenue-earning project until the loan period expires, the borrower will be expected to provide the Bank with an assurance that the government auditor will begin and complete the audit operations within the timetable required. This timely appointment allows the auditor to carry out interim audits, therefore reducing their work at the year-end to facilitate timely reporting. Also, it allows the earlier identification of possible errors and frauds and enables quicker corrective actions where required.

Auditor Qualification

5.4.25 Auditors for public sector projects and EAs may be drawn from commercial or state audit practitioners. Government auditors will not be acceptable for revenue-earning projects and EAs within the public sector, unless confirmed by the Bank after a review of their capacity, capability, and ongoing performance has been conducted and such a review confirms that they are capable of conducting such an audit. The EA, or its controlling authority, is normally responsible for this selection and appointment of auditors, except in cases where a government auditor is required by law to provide the service. Therefore, where no auditor is currently engaged, steps should be taken during project preparation to ensure that the borrower will engage an auditor acceptable to the Bank by the date of loan signing or start up of the project.

5.4.26 Where an auditor is currently engaged, staff should ensure that they carefully review the past performance of the auditor with respect to the quality of reports and opinions, and management letters. If the appraisal mission questions the capabilities and capacity of the auditor to perform to Bank-required standards, the borrower/EA should be advised as to the possible deficiencies, and asked to convey these concerns to the auditor. In cases where the auditor fails to respond to the concerns raised or the auditor is clearly unacceptable to the Bank, the borrower/EA should be requested to select another auditor prior to loan signing.

5.4.27 When private or commercial auditors are to be used, Bank staff may, if requested, assist borrowers to review the qualifications and experience of an auditor. For this purpose, in order to form a judgment on their competence, it may be necessary to visit the local offices of the auditors and request samples of their previous or ongoing work, including typical audit reports prepared by them. Examination of data on auditors submitted to the Bank prior to their engagement by a borrower should include the ability and track record of an auditor to meet Bank requirements. In addition the MDBs have an understanding to share information and to undertake joint evaluations of private sector auditors and maintain a list of acceptable auditors in all borrowing countries.

5.4.28 An auditor's engagement should be kept under review to ensure consistent quality of performance, including ability to adapt to changes in an entity's accounting and general operations, and to adopt improved audit techniques. For example, development of computerized accounting would require complex and expensive auditing techniques. Auditors inexperienced in this field may not be able to provide these services, or may be constrained from appropriate expansion of services by an inadequate audit fee. In such cases, inclusion of audit costs in the project costs estimates would be appropriate. Borrowers should therefore be encouraged to restrict audit engagements to relatively short-term assignments. It is common practice in some countries to appoint the auditor each year. However, engagements should normally be long enough to enable an auditor to become familiar with the project or EA under audit and to permit efficient operation, but short enough to facilitate a change of auditor, if necessary. Engagements of three to five years are in the optimum range.

Terms of Reference for an Auditor

5.4.29 The Bank requires that a Terms of Reference (TOR) acceptable to the Bank be prepared for each audit. For different types of audits, the scope of the audit will vary according to the nature of the implementing organization and type of operation being audited. For example, the TOR for the audit of a Financial Institution will require the auditor to pay particular attention to the loan portfolio, while the area of greatest emphasis for auditing of a public utility may be the accounting of its fixed assets and its accounts receivable.

5.4.30 ISAs suggest that the auditor determine the scope of the audit of financial statements in accordance with the requirements of legislation, regulations, and generally accepted auditing standards. The TOR must not restrict the auditor's obligations with respect to the above. However, the TOR provides the opportunity for drawing special attention to areas of concern that may not be covered or emphasized under a normal audit, such as compliance with loan covenants; or a special review of procurement documents. The TOR should always include in the scope of the audit the requirement to give an opinion on any specific items such as compliance with loan covenants. In addition, a Management Letter will always be another requirement.

5.4.31 The OECD publication on '*Harmonising Donor Practices for Effective Aid Delivery: Good Practice Papers*' provides a '*Specimen Terms of Reference for External Auditors of Donor-supported Projects and Sector Programme*' (see Knowledge Management, section 7.17, of these Guidelines). Bank staff should give advice to borrowers and EA on the minimum requirements of the TOR for auditors based on this model TOR. However, although the Bank wishes to approve the TOR for auditors, it is preferable that borrowers and EAs/IAs prepares the TOR themselves and Bank staff remain independent of the drafting process.

5.4.32 The model TOR should not be regarded as universally applicable to audits of Bank projects or project entities. Staff should select those components they consider appropriate for a particular audit engagement, omit inappropriate items and add relevant matters that are not in the model to develop a working draft. This model relates only to the appointment of auditors to carry out an audit, as defined in these Guidelines. The model is not intended for the appointment of accountants for other forms of investigation, assessment, design or installation of accounting or internal auditing systems.

5.4.33 The drafting of the TOR should not restrict an auditor's obligations with respect to legislation, regulations, and generally accepted auditing standards, nor give reasons for an auditor to claim that adherence to the TOR prevent adequate statutory, regulatory or professional performance.

Auditors Contract or Engagement Letter

5.4.34 The use of a Contract or Audit Engagement Letter is recommended. Where a formal contract is used, it is normally prepared by the EA or IA. A simple engagement letter is frequently used, often prepared by the auditor. The contract or letter sets out the responsibilities of the auditor and should include, but not be limited to:

- Confirmation of acceptance of the appointment including specific reference to the TOR,
- The borrowers' responsibilities, particularly the preparation of financial statements,
- The provision of access to whatever premises, records, documentation (including legal agreements, etc.) and any other information the auditor may request in connection with the audit,
- The form of the audit report(s),
- Arrangements regarding the involvement of internal auditors and of any other external auditors (such as the government auditor),
- The expected date of issuance of the audited financial statements, and
- The basis on which fees are computed and any billing arrangements

Government Auditors

5.4.35 In some countries where projects are to be executed by government controlled/sponsored entities, statutory requirements may specify the use of the government auditor. Under such circumstances, the Bank will continue to require that the auditor is independent and competent; that the auditor has the capacity and professional capability to provide audit reports and opinions of the quality required by the Bank, and is generally acceptable to the Bank. Normally, the independence of a government auditor would not be questioned if the auditor's position is established under constitutional or legal provisions designed to assure independence (e.g., by reporting directly to a legislature). In circumstances where the government auditor is acceptable, but the auditor's report will be placed before the national assembly for approval, the borrower should provide the Bank with a draft of the report, certified by the Chief Financial Officer and the auditor, immediately on completion of the audit. As specified in the loan agreement, the approved version of the auditor's report should be submitted to the Bank as soon as this becomes available.

5.4.36 Circumstances may exist where government auditors are involved directly or indirectly in pre-expenditure and revenue collection decision-making – a status that compromises their independence. The Bank then may seek to agree with a borrower that the Bank, will be provided with opinions and reports prepared by an independent private or commercial auditor in addition to the report of a government auditor. A government auditor who does not control, and is not under the control of the department or agency of government to be audited, and who is not involved in any aspects of its management, may in some instances be considered as independent.

5.4.37 Where the Bank has doubts with respect to the auditor's independence and/or competence, the Bank will seek an agreement with the borrower to have the government auditor subcontract the audit to an independent and competent private auditor to carry out the audit on their behalf. In appropriate circumstance, the Bank could include this expenditure in the loan. In general, the Bank requires that private auditors, using their experience in the use of ISAs, carry out the audit of a commercial or revenue-earning entity.

5.5 REVIEWING FINANCIAL STATEMENTS

Introduction

5.5.1 The Loan Agreement sets out the Bank's requirements for the delivery of audited annual financial statements of projects and EAs. The Loan Agreement also contains the remedial actions that the Bank will undertake in the event of non-compliance with loan covenants relating to financial reporting and auditing.

5.5.2 The examination of the annual financial statements of EAs is an important feature of project supervision and should be conducted in the same way as financial appraisal. Additional attention, however, should be given to actual performance against appraisal forecasts, compliance with financial covenants and review mission financial reports. Interim reports and unaudited annual financial statements may be the only up-to-date monitoring documents available on project progress. Consequently, their accuracy should be tested both during supervision missions and against audited annual financial statements.

The Review Process: Late or Unacceptable Financial Reports

5.5.3 The Task Manager responsible should ensure that all requirements for progress reporting are prepared in a timely manner acceptable to the Bank. The Task Manager is responsible for maintaining records on the scheduled date of submission of progress reports (and annual financial reports, auditor's reports and completion reports), the actual date of receipt by the Bank, and date of completion of review.

5.5.4 Communications by the Bank requesting submission of audited financial statements should be addressed to the EA/IA and/or the borrower. However, in some cases, compliance with the submission of audited accounts is delayed by difficulties encountered in the government audit office. When delays are attributable thereto, it is likely that similar problems are being experienced by other divisions/departments. In such a case the issue may be better handled at country dialogue level.

5.5.5 The Financial Analyst should in all cases review the interim and annual financial reports of the project, with or without auditors' reports. Where loan documents require submission of unaudited and audited financial statements beyond the closing date of the loan, the monitoring of submission of financial statements and compliance with financial performance covenants should continue.

5.5.6 Within four weeks of the receipt from the Project Manager of the unaudited and audited annual financial statements relating to a project and, where applicable, of an EA, the Financial Analyst should review the financial statements in consultation with the relevant task manager and other Bank staff. After the review, the Financial Analysts will have a memo sent by the Bank to the Project Manager, copied to the borrower/EAs on (i) the financial status of the project and, where applicable, the EA and (ii) compliance with all of the Bank's financial and audit covenants. The memo should report declining compliance trends regarding financial or audit covenants.

5.5.7 On the basis of this review, notice should be sent to the borrower and EA acknowledging receipt of the financial statements (and, where applicable, the Audit Report) and pointing out any violation of the loan's financial or audit covenants. A time-bound remedial plan of action will be required from the EA/IA. Receipt of a response to a request for a time-bound action plan should be closely monitored and if the response is not received within the specified time, the lack of a response must be noted as an issue to be addressed under the loan.

5.5.8 The Financial Controllers Department is informed of the review results if: (i) the audited annual financial statements are unacceptable; (ii) the auditor's report contains significant findings that would affect loan proceeds and implementation of the overall project (or other accountability issues); or (iii) the auditor's report highlights exceptions regarding the imprest accounts and statements of expenditures.

Compliance with Financial Covenants

5.5.9 The Bank prefers that the auditors' report provides details on the Bank's requirements, including among other requirements, the auditor's view on compliance with loan covenants and on the Bank's requirements. Borrowers and EAs enter into agreement with the Bank to provide all appropriate financial management, accounting and financial reporting information necessary to support effective management of the project. Borrowers and EAs, also, enter into financial performance covenants with the Bank. The auditor's Terms of Reference will require an opinion on compliance with each financial covenant as well as other requirements contained in the

project's legal documents. The auditor should also indicate the extent of any non-compliance with the loan agreement, by reference to the specified (required by the loan documents) and actual performance of the borrower in respect of these requirements of the Bank for the fiscal year concerned.

5.5.10 The majority, if not all, financial performance covenants for projects include the clause "except as the Bank shall otherwise agree." The exercise of the prerogative to "otherwise agree" rests exclusively with management. In cases where non-compliance exists with a financial performance covenant, the responsible department should analyse the adequacy of the proposed actions to be taken by the borrower and EA while assessing the probability of their being successfully implemented within the period specified. The task manager should write a memo through the responsible department head outlining the review and the conclusions reached. The memo should also specify whether the current auditor is acceptable to the Bank or whether the Bank should ask for a replacement. Recommendations on whether management should agree to a deviation from the covenant (including minor technical deviations), retention of the auditor or such other actions as the responsible department may propose, are put forward. Once management approves the recommendations, the department should communicate its decision to the borrower and EA/IA.

Reviewing Auditors' Reports

5.5.11 An examination of the annual financial statements should begin with a review of the auditor's opinion. An audit report must include: (i) name and title of the auditor; (ii) date of the report; (iii) addressee (EA and/or borrower); (iv) identification of the financial information audited; (v) a reference to auditing standards or practices followed; (vi) an expression of an opinion, including a qualification; disclaimer or declination of an opinion, on the financial information; (vii) the auditor's signature; (viii) auditor's address; and (ix) date of signing of the report.

5.5.12 The auditor's opinion for a project should refer to the reporting format agreed between the borrower and the Bank, noting the basis of accounting followed (e.g., cash basis or accrual basis). The auditor's opinion for a revenue-earning entity, should refer to the accounting standards adopted. Significant departures from IFRS/IASs (if any), with a reference to the quantified impact of such departures on the Balance Sheet, the Income Statement or the Cash Flow Statement should be detailed in the Notes to the Financial Statements or the Auditor should disclose their impact in the Audit Report.

5.5.13 Attention should, also, be given to auditors' comments on the accounting standards and policies used. It is common for financial statement preparers (i.e., EAs) and external auditors to use vague phrases, such as "approved standards", "official local standards", and "international standards". Financial Analysts should insist on the accurate description of both accounting standards and policies used to compile the financial statements and the definition of the auditing standards applied by the auditor.

5.5.14 Three principal features should be addressed when examining an auditor's report: (i) authenticity, form and timeliness of the report; (ii) quality or tenor of the opinion; and (iii) scope, significant accounting policies, audit practices, qualifications, and other matters addressed by the auditor. The audit report should also indicate whether any attached supplementary financial statements and Notes to the Financial Statements have been subjected to the same auditing procedures as in the case of the basic financial statements.

5.5.15 If a qualified opinion and report by an auditor is received, the materiality and extent of the qualification should be determined, particularly as regards accountability for project funds and the agency's financial position. In the case of substantial qualifications, the financial analyst should ascertain as soon as possible what remedial measures the borrower proposes to take. If the borrower is unable or unwilling to take corrective action, staff should, after investigating the reasons, follow the course of action normally followed in cases of non-compliance with covenants.

5.5.16 Qualifications which appear not to be of a material nature (limited inadequacies in accounting sub-systems, failure by accounting staff to respond to inquiries, etc.) should be followed up with the borrower by correspondence or during review missions, to ensure that appropriate corrective action is taken. In the same way that accounting systems need to be designed and installed over a period of time, auditing capability often also needs gradual development. In such cases, loan agreements should have referred to the form and timing of this process.

5.5.17 The analyst should participate in review work in a manner that fosters improvement of the auditor's work. Early audit reports that lack quality and depth of performance should not be rejected at the outset. Instead, the EA and the auditor should be informed in writing of possible deficiencies and encouraged to produce either an improved audit report, or to improve presentation on the next year's financial statements. Under such circumstances, it is important that the financial management and accounting functions of the entities involved be carefully supervised, so as to compensate as far as possible for inferior auditing ability. The foregoing does not, however, preclude the Bank from requesting the replacement of an auditor, particularly if training or other support is unlikely to achieve short-run improvements.

5.5.18 For general guidance, a checklist of matters that a reviewer of an auditor's report should consider is provided in the Knowledge Management Section 7.17 of these Guidelines. While extensive, the checklist is not exhaustive and reviewers must exercise their own skills and common sense in deciding the adequacy of the completed audit. Similarly, reviewers should decide whether the auditor, in the manner of framing the opinion, is trying to convey a message of concern, which may be difficult to express explicitly.

5.5.19 If there are any "no" answers on the checklist, especially in areas of key concern to the project, then clarifications of the auditor's report should be sought from the borrower and/or the EA. If the omissions are serious and/or the quality of the report is unacceptable, the matter should be discussed with the responsible department and the Office of the General Counsel. The borrower and/or the EA/IA should be advised that the audit does not conform to standards and practices acceptable to the Bank. The monitoring records should be annotated accordingly.

Types of Auditors' Opinion

5.5.20 ISA 700 advises auditors in detail on the form and content of an auditor's report. In particular, paragraph 39 - 41 of ISA 700 (Revised) addresses the Opinion Paragraph of an auditor's report as follows¹: "The auditor's report should clearly state the auditor's opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects,) in accordance with the financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements". Examples of typical auditor's

¹ ISA 700 has been amended with effect 31 December 2006. Financial Analysts should become familiar with the revisions and prepare borrowers in advance for the changes to come.

reports and opinions for (i) an unqualified opinion for a non-revenue-earning project; and (ii) an unqualified opinion for a revenue-earning project are provided in the Knowledge Management, section 7.17 of these Guidelines.

5.5.21 An unqualified opinion indicates the auditor's satisfaction in all material respects with the following matters: (i) The financial information has been prepared in accordance with (a) for a project, the reporting format agreed; and (b) for a revenue-earning entity, consistently applied accounting standards and practices acceptable to the Bank; (ii) The financial information complies with relevant regulations and statutory requirements; (iii) The view presented by the financial information as a whole is consistent with the auditor's knowledge of the project/entity; (iv) There is adequate disclosure of all material matters relevant to the proper presentation of the financial information; and (v) Additional requirements that may have been requested in the TOR have been met.

5.5.22 When a qualified opinion, adverse opinion, or a disclaimer of opinion is given, the audit report should state in a clear and informative manner all of the reasons for such opinion. Explanations of these opinions follow:

- A **qualified opinion** is issued when the auditor concludes that an unqualified opinion cannot be issued, but that the effect of any disagreement, uncertainty or limitation of scope of the audit is not so material as to require an adverse opinion or a disclaimer of opinion. The subject of the qualification and its financial effect must be clearly stated in the auditor's report.
- An **adverse opinion** is issued when the effect of a disagreement is so pervasive and material to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. The reason for the adverse opinion and its financial effect must be clearly stated in the auditor's report.
- A **disclaimer of opinion** is issued when the effect of a limitation on the scope of the audit or of an uncertainty is so significant that the auditor is unable to express an opinion on the financial statements. The nature of the limitation or the uncertainty must be clearly stated in the auditor's report.

5.5.23 If an audit report is received with an opinion that is qualified, is adverse or a disclaimer of opinion has been issued, the financial analyst should review the issues carefully and write a memo to Bank management to explain the matter fully and to seek further action to be taken, as appropriate.

Materiality

5.5.24 ISA 320 states among other things: "Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item of error judged in the particular circumstances of its omission or misstatement. Thus materiality provides a threshold or cut-off point, rather than being primarily a qualitative characteristic which information must have if it is to be useful"

5.5.25 Certain auditors (particularly government auditors) provide reports listing all mistakes, irrespective of their materiality. The Bank requires a clear opinion. Thus irregularities and instances of noncompliance with government or institutional rules and regulations that do not give rise to a qualified or disclaimed opinion should not be subjects of the report of the auditor.

Where an auditor has comments that are not material to the opinion, these should be set out in the Management Letter.

Use of Technical Experts

5.5.26 For certain types of expenditures financed from Bank loans, the auditor may need to rely on an independent technical expert who normally would be engaged by the EA. An example would be civil works executed by the regular labour force of an entity (e.g., “force account” carried out by the Ministry of Works); or fixed-price reimbursements for measured units of work to be supervised by independent experts such as an engineering or architectural firm. In addition to the normal responsibility of such experts to check that the work is performed in accordance with the plans and specifications, an appropriate certification by the expert of the value of the work executed may be acceptable to the Bank.

5.5.27 The acceptability of the certification would depend on the independence and competence of the firm and its staff engaged in the verification. Such a certification, where used, should normally be attached to the related documentation supporting the expenditure. Any dissatisfaction with the work of the expert that concerns the auditor should be stated in the auditor’s report.

5.5.28 The content of the certificate might cover matters such as whether the goods and services were procured, received, paid for and used in the project in conformity with the loan agreement. In the above instances, the auditor should include a note under the scope paragraph of the opinion, stating the extent and amount involved with respect to their reliance on the technical expert (who should be identified and his/her expertise noted in the Notes to the Financial Statements prepared by the EA).

Audit Management Letters

5.5.29 The scope of the engagement as set out in the TOR should require the auditor to provide a Management Letter. This is a report on the internal controls and operating procedures of the entity, covering all aspects included during the normal course of the audit. Because an auditor is unlikely to cover all activities of a client during an annual audit, the Management Letter may address only those specific matters that came to the attention of the auditor during the review.

5.5.30 The borrower and the auditor may agree at the commencement of the audit on particular subjects (including those at the request of the Bank) to be included in the TOR and addressed in the Management Letter. These may include: (i) the review of compliance with financial covenants, and actual versus planned performance indicators; (ii) implementation of the auditor’s recommendations made in prior year’s audit reports; (iii) efficacy of and improvements required in budgetary control; (iv) reliability of field and financial controls; and (v) payroll, procurement, or inventory problems. However, it should be the prerogative of the auditor to address any matter not agreed upon, but which, in the auditor’s opinion, should be drawn to the borrower’s attention. In addition, the auditor should comment on all significant variations between the interim financial statements and the annual audited financial statements.

5.5.31 The Bank wishes to review all Management Letters. The task manager should ensure that copies are forwarded to the Bank at the same time as the audited annual financial statements are sent. The project task manager should ensure that a financial analyst reviews each Management Letter. The Financial Analyst should advise the task manager of any matters to which the auditor has drawn attention that may adversely affect the operation of the EA and the implementation of project activities.

Financial Intermediaries

6. FINANCIAL INTERMEDIARIES

6.1 INTRODUCTION

6.1.1 The Bank's involvement in a country's financial sector is set out in the Results-Based Country Strategy Paper (RBCSP) and driven by the Bank's overarching poverty reduction objective. Where applicable, the RBCSP will show how the financial sector affects the country's development prospects; it high-lights reforms to be supported by Bank financial sector operations, including their sequencing; and it states why the proposed operation is an appropriate vehicle for Bank support for reforms. As appropriate, the Bank consults with the IMF, the World Bank, and selected donors on its proposed financial intermediary lending, and it coordinates its financial sector strategies and operations with theirs.

6.1.2 One form of Bank's intervention in the financial sector is a Financial Intermediary loan (FIL). Under FILs or a FIL component of an investment loan, the Bank provides funds to eligible participating Financial Intermediaries (FIs) for onlending to final borrowers at the FIs' risk. The objective of such lending includes: (i) supporting reform programs in the financial sector or related real sectors; (ii) financing real sector investment needs; (iii) promoting private sector development, including helping to stabilize, broaden, and increase the efficiency of private financial markets and their allocation of resources and services; (iv) promoting the development of the participating FIs; and (v) supporting the country's poverty reduction objectives.

6.1.3 FILs are provided in the context of sound analytical work on sector issues, appropriate technical assistance, and, as relevant, adjustment operations to address policy issues. The Bank's intervention in the financial sector may also be in the form of other lending instruments (e.g., structural and sector adjustment loans and technical assistance loans), guarantees, and non-lending activities (e.g., country economic and sector work, training, and financial advisory services).

6.1.4 RMCs use Financial Intermediaries (FIs) to manage funds received from government, multilateral development banks (including the Bank), other donors, and the financial markets. The FIs provides loans and equity contributions to organizations in sectors, or sub-sectors, such as agriculture, industry, and small or medium-scale enterprises. FIs include commercial banks and other financial institutions. They are also known by sectoral titles, such as agricultural banks, industrial banks and housing development banks, or as development financial intermediaries, microfinance institutions (MFIs) and microfinance intermediaries.

6.1.5 FIs are expected to generate an interest rate spread (the difference between lending and borrowing interest rates) that covers all operating costs, including provisions for bad and doubtful debts, and provide a profit.

6.1.6 In addition to this introduction, this part of these Guidelines has six sections:

- **6.2 – Reviewing Financial Management:** This section describes specific issues to be considered when reviewing the financial management practices of FIs. These issues include the treatment of interest rate distortions, directed credit and subsidies.
- **6.3 – Investments:** This section describes the Bank's approach to FI investments. It discusses selection of participating institutions and appraisal approaches.
- **6.4 – Assessing Performance:** This section describes considerations regarding and approaches to, measuring the performance of FIs. In particular, it advises on applying the

- CAMELS¹ framework and assessing FI risks. The section stresses that the performance measures recommended throughout other parts of these guidelines are not necessarily applicable to FIs.
- **6.5 – Appraisal Checklist:** A generic checklist is provided for appraising FIs.
 - **6.6 – Reporting and Auditing Issues:** This section provides specific guidance on the reporting and auditing requirements of FIs.
 - **6.7 – Microfinance Institutions:** This section discusses the special case of Microfinance institutions.

6.2 REVIEWING FINANCIAL MANAGEMENT

General Operational Issues

6.2.1 State-owned FIs resemble their commercial cousins in that frequently they have been formed to address the needs of a particular community, or category of commerce or industry, or branch of human activities, such as lending very small sums to urban and rural poor through microfinance. Some state-owned FIs are very large while others can be very small. There is no generic model for preparing, and appraising the capabilities and capacities to deliver a proposed project by FIs.

6.2.2 The objective of reviewing FI operational performance is to assess its ability to: (i) deliver subloans to achieve defined country/sector economic objectives; (ii) efficiently recover subloans; and (iii) cover all operating costs and make a reasonable profit on the invested capital. FIs have numerous forms of performance indicators that can provide analysts with an understanding of past and ongoing performance. Where an existing FI is the subject of a proposed project, or of a continuing Bank lending operation, the financial analyst (or investment officer) should begin by closely studying the FI's most recent annual financial statements and associated auditors' reports and opinions.

6.2.3 For an ongoing project, this review should be conducted against the objectives and recommended operational performance set out in the most recent AR. After drawing conclusions as to past and current performance, the financial analyst (or investment officer) should discuss their findings in detail with the project task manager and the FI management and, if appropriate with the proposed or actual borrower, and an apex institution, (where participating). Every effort should be made to reach agreement on these initial findings; particularly on management deficiencies, system defects, and performance shortcomings or failures. This first step is essential to ensure that the FI management understands and will fully support the objectives of a proposed project, or revision of objectives (where necessary) for an ongoing project. Full collaboration by FI management and their complete endorsement of a mission's proposals is critical for the investment's success. Any reservations by FI management or the borrower should be confirmed in the Aide Memoire and reported to Bank management.

6.2.4 It is particularly important to monitor the implementation and fulfilment of the stakeholders responsibilities, and the impact of their obligations on: (i) their respective national economies; (ii) performance of the institution as a borrower; (iii) national influences on regional operations (where present), and (iv) selected enterprises in representative regions of countries as sub-borrowers.

¹ Capital adequacy, Assets, Management quality, Earnings, Liquidity and Sensitivity.

Policy Framework for FIs and FI Loans

6.2.5 The design and timing of FILs should take account of the prevailing and expected macroeconomic environment, including the exchange rate regime and international capital mobility, as well as conditions in real sectors. Given the critical importance of the macroeconomic and sectoral framework for financial sector sustainability and efficiency, the Bank considers FILs in the context of a satisfactory macroeconomic framework. Within this framework, the Bank uses its lending and non-lending services to focus on improving the incentive environment for FIs.

6.2.6 The Bank involvement in the financial sector of countries through FILs: (i) supports improvements in the incentives structure for market participants, including elimination of impediments to efficient resource mobilization and allocation; (ii) supports development of infrastructure, including creation and strengthening of sound and competitive financial intermediaries and markets, and improvements in financial and prudential regulations, banking supervision, and accounting and auditing standards; and (iii) aims to remove or substantially reduce subsidies, whether provided through interest rates, directed credit, institution-building grants, or otherwise. (Institution-building TAF grants and other non-interest rate subsidies may be provided in a variety of ways, for example, as preferential income-corporate tax treatment, free use of facilities, consultancies, guarantees, training, and subsidized staff costs and overheads).

Treatment of Interest Rate Distortions

6.2.7 The level and structure of interest rates are critical determinants of: (i) the economic efficiency with which resources are allocated in an economy, and (ii) financial sector viability. By definition, interest rates reflect the opportunity cost of capital in undistorted markets. Interest rate distortions may lead to a misallocation of resources, resulting in forgone national income. Therefore, the removal of interest rate distortions in a country is an important objective of financial sector reform programs supported by Bank-funded FILs. Interest rate reforms should be appropriately phased to minimize adverse impacts on the solvency and liquidity of FIs and enterprises.

6.2.8 When there are major interest rate distortions in a country (e.g., large interest rate subsidies, pervasive interest rate controls, or policies that cause extremely high interest rates), the Bank does not support a program until the country establishes agreed programs to remove or substantially reduce the distortions during implementation of the FIL. In determining whether there are major interest rate distortions, the following factors should be considered: (i) whether domestic interest rates are administered, are determined non-competitively, or are affected by the government's fiscal tax/subsidy and regulatory policies; and (ii) when capital markets are open, whether there are significant differences between domestic interest rates and interest rates payable on borrowings of foreign capital (that cannot be explained by prevailing economic conditions).

Treatment of Directed-Credit Programs

6.2.9 Bank-supported FILs also aim to remove or substantially reduce the use of directed credits that are similar to interest rate subsidies, as these lead to resource allocation outside market mechanisms. However, under certain circumstances, Bank may support programs that include directed credit or subsidies. Directed credit programs supported by Bank may be channelled through specialized FIs, particularly those that concentrate their lending in certain sub-sector market niches for business strategy reasons.

6.2.10 In many countries, increasing access to credit by specific sectors (e.g., micro-finance institutions or the rural sector) is a major government policy objective, and some use directed credit to pursue this objective. A Bank FIL may support directed-credit programs to promote sustainable financing for such sectors, provided that the programs are accompanied by reforms to address the underlying institutional infrastructure problems and any market imperfections that inhibit the market-based flow of funds to those sectors. Such reforms include measures to: (i) address obstacles that impede the flow of funds to the credit recipients, or (ii) enhance the creditworthiness of the intended beneficiaries through appropriate approaches such as mutual group guarantees. When such targeted lending is commercially oriented, it is not considered to be directed credit.

6.2.11 It is good practice to routinely monitor the contribution of directed credits and their associated concessional terms to the growth of the targeted sector(s) and poverty reduction, taking into account any adverse impact on other parts of the economy.

Bank Policy on Subsidies

6.2.12 The Bank does not have a specific policy on subsidies. In some cases, however, subsidies may be an appropriate use of public funds e.g., for poverty-reduction programs. The Bank supports programs involving subsidies only if they: (i) are transparent, targeted, and capped; (ii) are funded explicitly through the government budget or other sources subject to effective control and regular review; (iii) are fiscally sustainable; (iv) do not give an unfair advantage to some FIs over other qualified and directly competing institutions; and (v) are economically justified, or can be shown to be the least-cost way of achieving poverty reduction objectives. Subsidies that do not meet these tests should be phased out, or are substantially reduced, during the course of a FIL.

Eligibility Criteria for FIs

6.2.13 Bank requires assurances that FIs, acting as lenders using FILs and other investment operations, are financially efficient and viable institutions. In particular, they must be financially sustainable – as represented by adequate profitability, capital, and portfolio quality, as confirmed by financial statements prepared and audited in accordance with accounting and auditing standards acceptable to Bank – and have: (i) acceptable levels of loan collections; (ii) appropriate capacity, including staffing, for carrying out subproject appraisal (including environmental assessment) and for supervising subproject implementation; (iii) the capacity to mobilize domestic resources; (iv) adequate managerial autonomy and commercially oriented governance (particularly relevant when state-owned or state-controlled FIs are involved); and (v) appropriate prudential policies, administrative structure, and business procedures. Using these criteria, Bank determines the eligibility of a proposed FI, or it may require an apex institution or other appropriate entity to do so.

6.2.14 New and existing FIs that do not meet all the eligibility criteria for being intermediaries may participate in a Bank-funded FIL if they agree to an institutional development plan that includes a set of time-bound monitorable performance indicators and provides for a midterm review of progress. When an FIL includes such FIs, the size and complexity of the FIL should be commensurate with the FIs' implementation capacity; and the FIL may include an institution-building component that the borrower may pass on in the form of grants. Such FIs' continued participation in the FIL is subject to their satisfactory implementation of their institutional

development plans; when progress is not satisfactory, Bank considers appropriate remedial action, including suspension.

6.2.15 FIs whose performance in relation to eligibility criteria has been unsatisfactory for an extended period of time are required to take substantial corrective measures and to demonstrate improvement before they are permitted to participate in a FIL under an institutional development plan as described above.

6.3 INVESTMENTS

Appraising an FI Investment

6.3.1 The Bank's appraisal of an FIL should establish financial and economic justifications for the intervention and confirm: (i) whether it will achieve the desired objectives with due regard to the sustainability of the financial sector; (ii) for an FIL established for its poverty-reduction goals, that it is a practical, cost-effective way of achieving such goals; (iii) the eligibility of FIs proposed for inclusion; and (iv) that implementing the FIL is not likely to undermine the financial condition of participating FIs.

6.3.2 The economic analysis of an FIL should take into account the prevailing and expected macroeconomic environment and substantiate that the proposed operation will lead to net economic benefits arising from policy and institutional changes and increased availability of investment funds. If the justification for an FIL depends critically on addressing perceived market failures (i.e., non-market effects or externalities), the analysis should explain the assumptions and their empirical basis. If there is evidence of a subsidy involved in an FIL such that resources through interest rates subsidies or other means are provided below their economic opportunity cost, the extent of subsidy dependence must be calculated and assessed.

6.3.3 Risk analysis should be used to demonstrate how robust the projected economic benefits of the project are to possible changes in assumptions about the macro economy, borrower commitment to the reforms supported by the FIL, and institutional performance. Note that this reference to risk analysis should not be confused with market risk and associated indicators.

Sub-Projects

6.3.4 FILs are used to finance investments in subprojects for increased production of goods and services which should be established at the subproject level. It must be derived from expanding existing productive capacity, increasing the efficiency of capacity utilization, or creating new types of productive capacity. The subprojects must meet eligibility and development criteria agreed with the Bank. The Bank will also agree appropriate arrangements to monitor subproject compliance with these criteria. In addition to the above criteria, the appraisal should ensure that subprojects are financially viable and technically, commercially, managerially, and environmentally sound. Working capital financing to maintain existing levels of production is not eligible for Bank financing.

Use of Bank Funds

6.3.5 The borrower may pass on Bank funds to a FI either as a loan or as borrower's equity; similarly, FIs may pass on Bank funds to sub-borrowers as subloans or equity investments. In all cases, Bank funds are disbursed against eligible expenditures for goods, works, and services.

6.3.6 FILs are normally amortized by Bank's borrowers on country specific terms as established by the Bank and not on a back-to-back basis, by earmarking sub-borrowers' repayments for amortizing the Bank loan. The borrower may pass the funds on to FIs either on a back-to-back basis or on the basis of another amortization schedule acceptable to the Bank. When FI loan repayments to the borrower are not on a back-to-back basis, the FIs may, within their overall loan amortization schedules, use repayments for purposes that are consistent with their business strategies, or for prepayments to the borrower. Under an apex or two-tier lending arrangement, Bank funds are passed initially to an apex (first-tier) institution, which on-lends them to the participating retail financial institutions. Two-tier lending arrangements are common, but a three-tier arrangement may be feasible, particularly to address micro-credit operations. A FI with actual or potential conflict-of-interest cannot serve as an apex institution.

On-lending Terms

6.3.7 FIL on-lending terms are set in the context of a borrowing country's interest rate structure and any agreed program for interest rate reforms. Bank funds are priced to be competitive with what the participating FIs and their sub-borrowers would pay in the market for similar money, taking into account relevant maturities, risks, and scarcity of capital. When interest rates are not market-determined and there is an agreed program of interest rate reforms, FIL funds are on-lent to participating FIs at interest rates agreed with the Bank that: (i) are not negative in real terms; (ii) provide adequate margins to FIs to cover all costs, including credit and other risks, and an adequate profit margin; and (iii) do not discourage resource mobilization from the market by providing a price advantage to using FIL funds.

6.3.8 Bank funds may be on-lent to participating FIs and their sub-borrowers in either foreign exchange or domestic currency on the basis of prudent credit decisions, including prospective sub-borrowers' ability to bear the foreign exchange risk and to avoid later credit risk. Where interest rates are market-determined and there is relatively easy capital movement, local currency interest rates include an implicit premium that reflects market expectations in regard to exchange rate changes. In such situations: (i) Bank FIL funds are on-lent to FIs in either local or foreign currency, provided the on-lending interest rates are consistent with prevailing interest rates in the borrowing country for comparable credit; and (ii) FIs normally on lend to sub-borrowers in the same currency or currencies that the FIs borrowed.

6.3.9 If interest rates are not market-determined but are set administratively, it is not possible to determine market expectations of exchange rate changes, as foreign exchange risks may be under priced in local currency interest rates. Therefore, the foreign exchange risk of FIL funds is borne either by: (i) Sub-borrowers through borrowing and repayment in foreign currency, or (ii) the government if on-lending and repayment are in domestic currency at prevailing administered interest rates. In the latter case, the government charges a fee that is passed on to FIs and sub-borrowers to offset the anticipated foreign exchange risk.

Monitoring FI Investments

6.3.10 During project appraisal and negotiations, provision is made for effective monitoring and evaluation of the FIL's progress toward its objectives and development impact throughout the life of the project. The performance indicators agreed on at loan negotiations cover sectoral, financial, and institutional variables. The variables for FIs include among other things, adequacy of capital, quantity and quality of earnings, quality of assets, sufficiency of liquidity, extent of subsidy

dependence, effectiveness of FI loan administration (appraisal, supervision, and collection performance), and adequacy and timeliness of preparation of audited financial statements. During implementation, the Bank, the borrower, and the FIs in each tier must use the agreed performance indicators, implementation progress reports, and a review of a sample of subprojects to monitor the FIL's progress.

6.3.11 At least once each year during implementation, the Bank conducts a formal review of the condition and performance of participating FIs, including a review of their audited financial statements, to determine their continued compliance with eligibility criteria. The findings of this review are to be recorded in supervision reports.

6.4 ASSESSING PERFORMANCE

Introduction

6.4.1 A wide range of indicators are available for reporting by FIs. The most important are described in this section. Macroprudential indicators—defined broadly as indicators of the health and stability of the financial system—that can help countries assess their banking systems' vulnerability to crisis are discussed in section 7.20.32 of the Knowledge Management Chapter of these Guidelines. Section 6.7 of this Chapter examines the case of Microfinance Institutions (MFIs). The ratios and indicators that are described in other parts of these Guidelines are generally not appropriate for assessing FI performance.

6.4.2 It is important that financial analysts (investment officer) recommend indicators that the FI fully understands and is willing to use in their day-to-day management processes. If an FI is reluctant to prepare and use indicators effectively, or does not have a financial management system capable of preparing the indicators that Bank staff recommends it should be recorded in an Aide Memoire and reported to senior management.

6.4.3 The most important criteria for determining the appropriateness of an FI to act as a financial intermediary are its solvency, profitability, and liquidity. In this respect, since 1988, the Basel Committee on Banking Supervision (BCBS) of the Bank of International Settlements (BIS) has recommended using the CAMELS framework, which looks at six major aspects of a financial institution: **c**apital adequacy, **a**sset quality, **m**anagement soundness, **e**arnings, **l**iquidity, and **s**ensitivity to market risk.

Applying the CAMELS Framework

6.4.4 This section describes the application of the CAMELS framework and the benchmarks² for each of its components. It is important to note that the CAMELS rating system is subjective and, therefore, should not eliminate consideration of other pertinent factors. Its benchmarks, however, present essential foundations upon which its composite rating is based.

² The benchmarks have been extracted from the 'Basel Committee on Banking Supervision Working Papers, No. 4 – December 2000, *Supervisory Risk Assessment and Early Warning Systems*, by Ranjana Sahajwala Paul Van den Bergh, Bank for International Settlements Basel, Switzerland, pages 45-46, (http://www.bis.org/publ/bcbs_wp04.pdf).

Capital Adequacy Ratio

6.4.5 Capital Adequacy (CAR) is a measure of an FI's financial strength, in particular its ability to cushion operational and abnormal losses. A FI should have adequate capital to support its risk assets in accordance with the risk-weighted capital ratio framework. It has become recognized that capital adequacy more appropriately relates to asset structure than to the volume of liabilities. This is exemplified by central banks' efforts internationally to unify the capital requirements of commercial banks and to generate worldwide classification formulae such as the one proposed here. This indicator requires that assets be classified by reference to their demands on the equity (or capital) structure of the FI.

6.4.6 Capital adequacy comprise of the following components:

- Size of the bank
- Volume of inferior quality assets
- Bank's growth experience, plans and prospects
- Quality of capital
- Retained earnings
- Access to capital markets
- Non-ledger assets and sound values not shown on books (real property at nominal values, charge-offs with firm recovery values, tax adjustments)

6.4.7 The CAR indicator is derived by comparing the ratio of an entity's equity to its assets-at-risk. The covenant specifies that the borrower/EA/FI should not make an advance to a sub-borrower if after making the advance; the ratio (the performance indicator) of its equity to its assets-at-risk would be greater than that specified in the covenant.

6.4.8 The BCBS of the BIS recommends a mandatory minimum Capital Adequacy Ratio (CAR) of 8 percent for banks in OECD countries. However, the emerging banking regulatory and supervision system in most of the Bank's RMCs, combined with an emphasis on directed lending, results in poor portfolio quality. It is, therefore, common for RMCs banking regulatory authorities to mandate higher minimum CAR than the 8 percent that BIS recommends for banks in OECD countries.

Assessing Asset Quality

6.4.9 Asset Quality has a direct impact on the financial performance of an FI. The quality of assets particularly, loan assets and investments, would depend largely on the risk management system of the institution. The value of loan assets would depend on the realizable value of the collateral while investment assets would depend on their market value.

6.4.10 The components of asset quality are:

- Volume of classifications
- Special mention loans – ratios and trends
- Level, trend and comparison of non-accrual and renegotiated loans
- Volume of concentrations
- Volume and character of insider transactions

Assessing Management Quality

6.4.11 The performance of the other CAMELS components will depend on the vision, capability, agility, professionalism, integrity and competence of the FI's management. As sound management is crucial for the success of any institution, management quality is generally accorded greater weighting in the assessment of the overall CAMELS composite rating. Components of the management factors are:

- Technical competence, leadership etc of middle and senior management
- Compliance with banking laws and regulations
- Adequacy and compliance with internal policies
- Tendencies towards self-dealing
- Ability to plan and respond to changing circumstances
- Demonstrated willingness to serve the legitimate credit needs of the community
- Adequacy of directors
- Existence and adequacy of qualified staff and programmes

Assessing Earning Performance

6.4.12 The quality and trend of earnings of an institution depend largely on how well the management manages the assets and liabilities of the institution. A FI must earn reasonable profit to support asset growth, build up adequate reserves and enhance shareholders' value. Good earnings performance would inspire the confidence of depositors, investors, creditors, and the public at large. The components of earnings performance include:

- Return on assets compared to peer group averages and bank's own trends
- Material components and income and expenses – compare to peers and bank's own trends
- Adequacy of provisions for loan losses
- Quality of earnings
- Dividend payout ratio in relation to the adequacy of bank capital

Assessing Liquidity

6.4.13 A FI must always be sufficiently liquid to meet depositors' and creditors' demands in order to maintain public confidence. There needs to be an effective asset and liability management system to minimize maturity mismatches between assets and liabilities and to optimise returns. As liquidity has an inverse relationship with profitability, a FI must strike a balance between liquidity and profitability.

6.4.14 Current and quick ratios are inappropriate for measuring FI liquidity. A loan-to-deposit ratio is more relevant. However, an FI's liquidity and solvency are directly affected by portfolio quality. Consequently, Financial Analysts (investment officers) should carefully analyse the FI's portfolio quality on the basis of collectability and loan-loss provisioning. Key liquidity components include:

- Adequacy of liquidity sources compared to present and future needs
- Availability of assets readily convertible to cash without undue loss
- Access to money markets
- Level of diversification of funding sources (on- and off-balance sheet)
- Degree of reliance on short-term volatile sources of funds
- Trend and stability of deposits

- Ability to securitise and sell certain pools of assets
- Management competence to identify, measure, monitor and control liquidity position

Sensitivity to Market Risk

6.4.15 Sensitivity to market risk relates the degree to which changes in foreign exchange rates, commodity prices, interest rates, or equity prices can negatively impact the earning power or economic capital of a financial institution. When analysing this factor, particular emphasis should be given to: management's ability to identify, measure, monitor and control market risk; the institution's size; the nature and complexity of its activities and the adequacy of its capital in relation to its level of market risk exposure. The components of the sensitivity to market risk are:

- Sensitivity of the financial institution's net earnings or the economic value of its capital to changes in interest rates under various scenarios and stress environments
- Volume, composition and volatility of any foreign exchange or other trading positions taken by the financial institution
- Actual or potential volatility of earnings or capital because of any changes in market valuation of trading portfolios or financial instruments
- Ability of management to identify, measure, monitor and control interest rate risk as well as price and foreign exchange risk where applicable and material to an institution

Assessing FI Risks

Introduction to FI Risk Management

6.4.16 The main concern for FIs is risk management. World capital markets are dynamic, their activities can generate rapid and dangerous movements that need to be anticipated and managed. The ability of traditional performance measurement criteria to indicate declining or poor FI performance is limited. Therefore the capital markets and their regulators and advisers [e.g., the Basle Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO)] have developed additional means of measuring performance and, more importantly, to identify problems in a timely manner.

6.4.17 In many cases, the FIs that the Bank deals with are attached to the public sector and have multiple objectives (e.g., sectoral development objectives in addition to profitability objectives). The risk factors associated with these FIs are likely to be more significant than for single-objective commercial banks. Consequently, it is essential that the financial analyst (investment officer) seeks to: (i) identify the principal potential risks that an FI is exposed to; and (ii) develop an appropriate set of indicators that will provide FI management and the Bank with an early warning of problems.

6.4.18 The major risks to be examined include: (i) market risk; (ii) exchange risk; (iii) maturity risk; and (iv) contagion risk.

Market Risk and Value-at-Risk (VaR)

6.4.19 Market risk arises from the potential that a borrower or counter-party will fail to perform on an obligation. The assessment of market risk involves evaluating both the probability of default by the counter-party, obligor or issuer and the exposure or financial impact in the event of

default. The BCBS of the BIS www.bis.org makes recommendations on means to sustain the credit-worthiness of FIs

6.4.20 The concept of Value-at-Risk (VaR) is very important in risk management. VaR is a measure of the maximum potential change in an FI's portfolio's value with a given probability over a pre-specified horizon. In simple terms, the Value-at-Risk is meant to answer the question: "Over a 10-day period, what is the dollar amount of V such that there is only a 1% chance our portfolio will lose more than V?" The main advantages of VaR-based management are that: (i) it incorporates the mark-to-market approach uniformly; and (ii) it relies on a short forecast horizon of market variables. Where FI lending is government guaranteed, financial analysts should treat such government-guaranteed bank lending as risk free when estimating VaR.

Foreign Exchange Risk

6.4.21 The Bank of International Settlements (BIS) document on Managing Settlement Risk is included in the Knowledge Management Section 7.21 of these Guidelines. The document provides advice and guidance on managing foreign exchange settlement risks. It also defines foreign exchange settlement risk, advises on management practices, and includes guidance on internal auditing.

Maturity Risk

6.4.22 Maturity risk relates to mismatching of investments and borrowing operations. To the extent possible, to avoid losses, an FI should seek to match the maturities of subloans and borrowing operations to minimize the risk of having to meet large outgoing interest payments on borrowings and deposits with lower levels of interest receipts from subloans.

6.4.23 Mismatching can be expensive during times of increasing market rates, particularly when the FI may have subloans extended over four to six years with no break or adjustment clauses to address rising interest costs. A FI should maintain a running risk analysis of forecast forward transactions with alternative scenarios of market (borrowing rates) to identify the date(s) when it is most at risk, based on its current portfolio. Forecasts of future portfolios can be similarly risk assessed.

Contagion Risk

6.4.24 Contagion can arise in regions, in countries, in regions within countries, or within a class or category of financial intermediaries (such as agricultural FIs). Contagion risk can arise where declining economic conditions for depositors and sub-borrowers simultaneously cause a shortage of funds and a rapid increase in defaults on subloans. This condition can automatically trigger a substantial rise in the risk premium of major lenders that prevents an FI from covering shortfalls.

6.4.25 Anticipating and avoiding contagion risk is best addressed by financial sector supervisors and regulators because they should maintain a consistent, regular overarching view of the financial sectors and of the local/national/international economies with the objective of providing early warnings, not only to the financial intermediary, but to the appropriate ministries that are charged with economic management.

The Role of Regulators in Risk Management

6.4.26 The financial analyst (investment officer) should interview regulators and receive assurances that the following matters are addressed:

- Market surveillance for large positions
- Cross-market supervision
- Setting of capital reserves
- Disclosure of data on market value of financial instruments and risk policies to achieve least-cost uniformity in the sector
- Examination of FIs' records and internal controls
- Optimum collaboration with FIs' auditors
- International, regional, and national linkages and exchanges of information
- There is a set of rules and requirements that, at the lowest possible cost, effectively contributes to prevent an isolated failure or crisis of small proportions threatening the market as a whole
- To the extent possible obtaining voluntary convergence and agreement on the role of the regulator
- A complete set of emergency plans
- That the emergency plans are constantly updated
- That the emergency plans are agreed between the central bank and FIs)

Other Key Risk Management Steps

6.4.27 The following steps should be considered as means of supporting the generation of useful and accurate performance indicators in an FI: (i) the use of a consistent set of accounting standards (IOSCO supports the use of IASs); (ii) efficient netting agreements; (iii) segregation of customers' accounts and protection of customers' funds in event of bankruptcy; and (iv) ensuring regulators are kept fully informed, and are efficient in their reporting.

Determining FI Credit Ratings

6.4.28 The BCBS of the BIS released, in April 2003, an overview paper to accompany its Third Consultative Paper (CP3) on the New Basel Capital Accord (also known as Basel II). The CP3 that can be accessed at: <www.bis.org/bcbs/cp3ov.pdf> represented an important step in putting the new capital adequacy framework in place. The BCBS finalized the New Accord - Basel II: International Convergence of Capital Measurement and Capital Standards: a Revised Framework - in June 2004 with implementation to take effect in G-10 countries³ by year-end 2006. This statement by the BCBS, agreed by all its members, details the agreed Framework for measuring capital adequacy and the minimum standard to be achieved. The Revised framework can be accessed at: <www.bis.org/publ/bcbs107.pdf>. The BIS does not envisage implementation of the new accord in non-G-10 countries by the end of 2006. Staff processing loans, including FILs or Technical Assistance involving the banking sector should be aware of the views of the national banking supervision authorities in the applicable country regarding the implementation of the New Accord and/or changes contemplated in their supervision framework that currently do or plan to incorporate some or all of the recommendations contained in the New Accord. The views of the national banking supervision authorities should be disclosed in the Appraisal Report.

³ G-10 is comprised of eleven countries with the largest banking institutions including Belgium, Canada, France, Germany, Italy, Japan, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

6.4.29 Financial analysts (investment officers) are required to determine the credit rating of the FI being appraised. In some cases, these credit ratings will be readily available from published sources (for instance, the Standard & Poor's Global Ratings Handbook). In other cases, the financial analyst (investment officer) can determine the FI's credit rating by questioning other FI's in the country or region.

Specialized FI Internal Controls

6.4.30 Internal controls for FIs are employed by banks and securities institutions and should: (i) comprise a set of rules and procedures designed to provide qualitative standards that are complimentary to the quantitative analysis of risk; (ii) be used to internally manage operational risk, agency risk, and legal risk; and (iii) be exercised by an independent control unit reporting to the Board, and having no operating linkage with trading activities that create risk. Their objective is to enhance the risk management culture in the organization, including by:

- Requiring transparency of reports and documentation of the risk control process
- Monitoring the content and the efficiency of the vertical and horizontal information flows
- Monitoring and reporting on accountability
- Ensuring remuneration policy rewards efficient risk management through high returns and minimum risk
- Monitoring observance of trading limits and market procedures
- Establishing rules for dealing with changes in volatilities
- Testing the soundness of models
- Examining the quality and uniformity of data input
- Validating and back-testing procedures

6.5 APPRAISAL CHECKLIST

6.5.1 A checklist for appraising an FI project is provided in the Knowledge Management section (see section 7.16). However, the generic appraisal checklist should be used with caution and appropriately modified to address the nature and form of the FI being appraised because FIs: comprise a wide range of institutions, including Apex institutions that service one or more FIs in a country; may provide services to one or more sectors in a country (agriculture, various categories of industry, etc.), including support to microfinance organizations.

6.6 REPORTING AND AUDITING ISSUES

Introduction

6.6.1 Financial reporting by, and audits of, FIs require individual specifications for each institution so that financial reporting and auditing requirements will be appropriate to the type, nature, and form of the institution. For example, an industrial FI and a microfinance FI have few common characteristics and the reporting requirements and the auditing specifications will differ sharply.

6.6.2 Unless the financial analyst concerned is well-experienced in the financial management of FIs, it is recommended that a consultant be employed, who is experienced with the type of FI that is to be the subject of financial reporting, and later, auditing. Specific guidance on MFI reporting and auditing issues is given below.

FI Financial Reporting

6.6.3 FIs should be required to report in accordance with IAS No. 30 (Disclosures in the Financial Statements of Banks and Similar Financial Institutions). In addition to the standard statements (Balance Sheet, Income Statement and Cash Flow Statement), an FI should be required to provide the additional statements listed below. This listing is not all-inclusive and should be amended to address the objectives and operations of the FI to be audited:

- The income statement and balance sheet adjusted for subsidies
- Portfolio Report for current and two past years
- Portfolio Report showing aging of receivables (arrears)
- Portfolio Report showing aging of portfolio at risk
- Capital Adequacy Analysis
- Assets Structure by Income
- Table of Contingencies, Guarantees, Commitments showing corresponding securities and collateral

FI Auditing

6.6.4 Selection of an auditor for a FI should include the provision of a TOR that is specifically geared to the FI concerned. In addition to the standard requirements (see Chapter 5) for auditor selection and appointment, including providing a report and an opinion on the annual financial statements, the auditor should be required to include in the report confirmation, or otherwise, that the additional financial statements and the performance indicators listed above can be relied upon.

6.6.5 The FIs Terms of Reference should also address the following:

- The auditor's impression of the efficiency and effectiveness of the overall operations and condition of the institution
- The adequacy of the intermediary's risk management systems and internal control procedures, including whether or not the bank uses VaR, and if so whether its use is professionally managed under a separate non-lending manager; results achieved during the fiscal year; and the operation of VaR as at the date of completion of the audit
- The quality of the loan portfolio and adequacy of loan loss provisions, illustrated as necessary by use of performance indicators above
- The competence and effectiveness of management, including development of strategic plans and their implementation
- The adequacy of accounting, financial reporting and management information systems
- The adequacy of public information systems
- The resolution, or otherwise, of issues identified off-site or during previous on-site supervisory processes
- Adherence to laws and regulations and terms of licenses and agreements, including loan covenants with the Bank
- A commentary on central bank or other forms of regulatory supervision during the fiscal year
- Quality of human resources employed by the FI and their potential to efficiently sustain all areas of the FI's operations

6.7 MICROFINANCE INSTITUTIONS

Bank Experience

6.7.1 In 1999, the Bank established the ADF Microfinance Initiative for Africa (AMINA), to bring microfinance to its operations. Through AMINA, the Bank Group was able to contribute to building the capacity of microfinance institutions (MFIs), expanding the outreach of 70 MFIs in ten countries to hundreds of thousands of additional clients. By the time of its closure in 2002, the implementation of the AMINA initiative had generated a number of lessons, the most important of which led to the current microfinance mainstreaming within the Bank.

6.7.2 In 2004, the Bank adopted the Eleven Principles of Microfinance which were sanctioned by the G8 Summit. To this regard, a “*Microfinance: Policy and Strategy for the Bank Group, January 2006*” has been issued and work has commenced to prepare detailed guidelines to operationalize the Policy and Strategy. Importantly, the document outlines the policy and strategy of the Bank in microfinance, which is to support the RMCs to build sustainable systems of financial intermediation and mainstream them into their formal financial sectors. It, also, outlines four specific strategic areas of orientation and intervention for the Bank’s work in microfinance:

- enhancing key stakeholder capacity in microfinance, including financing the expansion of microfinance institutions (MFIs);
- creating an enabling environment that promotes the building of inclusive financial systems that serve the poor;
- enhancing strategic partnerships; and
- facilitating knowledge management to ensure effective research, information collection, and dissemination.

6.7.3 Another useful Bank document is the “*Operational Guidelines for the Rural Financial Sub-sector, October 2002*”. This guideline aims to provide a detailed tool to the Bank microfinance designers on how to formulate microfinance projects, design financial products, establish management information systems, set up accounting systems, identify risks and measure performance of microfinance interventions.

International Bodies

6.7.4 The Consultative Group to Assist the Poorest (CGAP) publishes specific guidance on Microfinance Institutions (MFI) reporting and auditing issues. This guidance includes Handbooks for MFI auditors, Guidelines for MFI financial statements, and a handbook on appraising an MFI. These materials can be accessed online at www.cgap.org.

6.7.5 The World Council of Credit Unions (WOCCU) recommends a set of financial ratios covering Protection, Effective financial structure, Asset quality, Rates of return and costs, and Liquidity and Signs of growth (PEARLS) to monitor the financial stability of Credit Unions, including MFIs. The PEARLS methodology is specifically designed for evaluating credit unions and addresses shortcomings of the CAMELS system in this respect. Further information on the PEARLS methodology can be found in the Knowledge Management section 7.22 of these Guidelines and at www.woccu.org.

Knowledge Management

7. KNOWLEDGE MANAGEMENT

7.1 INTRODUCTION

7.1.1 This, Knowledge Management, section of the African Development Bank Group's Guidelines for Financial Management and Financial Analysis of Projects is intended to provide Financial Analysts and other readers with background information supporting the positions presented in the Guidelines. In addition, this section provides references to pronouncements, websites and learning materials that, is hoped, will form a collection of learning tools and knowledge enhancement for users of the Guidelines. It is anticipated that this part of these guidelines will be updated, on an ongoing basis, with new and emerging best practices.

7.1.2 These Guidelines are available on the web and in a CD-ROM. This hardcopy version omits a significant portion of the information available in this Chapter of the CD-ROM version. Importantly, new and emerging best practices in financial management and financial analysis of projects will first be updated in the web-based version. Users are, therefore, advised to consult regularly, the web-based version of these Guidelines to keep abreast of current updates.

7.2 USEFUL WEBSITES

Regulatory and Standard-Setting Bodies

Bank for International Settlements (BIS)	http://www.bis.org
Financial Accounting Standards Board (FASB – United States)	http://www.fasb.org
International Accounting Standards Board (IASB)	http://www.iasc.org.uk
International Federation of Accountants (IFAC)	http://www.ifac.org

Professional Bodies

Association of Chartered Certified Accountants	http://www.accaglobal.com
International Auditing and Assurance Standards Board (IAASB)	http://www.ifac.org/iaasb/index.php
International Federation of Accountants (IFAC)	http://www.ifac.org

The Regional Federation of Accountants and Auditors

AFROSAI - African Organization of Supreme Audit Institutions	Email: afrosai@ids.tg
ARABOSAI - Arab Organization of Supreme Audit Institutions	http://www.arabosai.org
Eastern Central and Southern African Federation of Accountants	http://www.ecsafa.org
INTOSAI - International Organization of Supreme Audit Institutions.	http://www.intosai.org

International Organizations

International Federation of Accountants (IFAC)	http://www.ifac.org
International Organization of Securities Commissions (IOSCO)	http://www.iosco.org
Organisation for Economic Co-operation and Development (OECD)	http://www.oecd.org
World Trade Organization (WTO)	http://www.wto.org

Donor Organizations

Asian Development Bank (AsDB)	http://www.adb.org
European Bank for Reconstruction and Development (EBRD)	http://www.ebrd.org
European Union – Technical Assistance to the Commonwealth of Independent States (EU-TACIS)	http://europa.eu.int/comm/dg1a/tacis/index.htm
Food and Agriculture Organization of the United Nations	http://www.fao.org
International Fund for Agricultural Development	http://www.ifad.org
International Monetary Fund (IMF)	http://www.imf.org
Islamic Development Bank (ISDB)	http://www.isdb.org
United Nations Development Program (UNDP)	http://www.undp.org
World Bank	http://www.worldbank.org

Selected Bilateral Organizations

Canadian International Development Agency (CIDA)	http://www.acdi-cida.gc.ca
Danish International Development Agency (DANIDA)	http://www.um.dk/danida
Department for International Development (DFID) (United Kingdom)	http://www.dfid.gov.uk
Gesellschaft für Technische Zusammenarbeit (GTZ) (German Technical Cooperation)	http://www.gtz.de
Japan Bank for International Cooperation (JBIC)	http://www.jbic.go.jp
Japan International Cooperation Agency (JICA)	http://www.jica.go.jp
Swedish International Development Agency (SIDA)	http://www.sida.se
United States Agency for International Development (USAID)	http://www.usaid.gov

Sectoral References

Consultative Group to Assist the Poorest (CGAP)	www.cgap.org
The Microfinance Gateway	http://www.microfinancegateway.org
World Council of Credit Unions (WCCU)	www.woccu.org

Other

Africa Governance Institute, UNDP	http://www.undp.org/dpa/pressrelease/releases/2005/june/pr9jun05a.html
Aid Harmonization and Alignment Council for the Development of Social Science Research in Africa (CODESRIA)	http://www.aidharmonization.org/ http://www.codesria.org/Links/Training_and_Grants/governance_institute.htm
COSTAB	http://www.worldbank.org/html/opr/costab/costab.html
Decentralization, UNDP	http://www.undp.org/governance/decentralization.htm
E-governance	http://www.eldis.org/ict/egovernance.htm
Governance Research Indicator Country Snapshot (GRICS), World Bank	http://info.worldbank.org/governance/kkz2002/index.htm
Governance Resource Centre (GRC) of the UK Department for International Development (DFID) Institute of Development Studies	http://www.grc-exchange.org http://www.ids.ac.uk/ids/govern/index.html
International Corporate Governance Network	http://www.icgn.org
PEFA - Public Expenditure & Financial Accountability	http://www.pefa.org
Promoting Good Governance, GTZ	http://www.gtz.de/en/themen/politische-reformen/882.htm
Public Sector Governance	http://www1.worldbank.org/publicsector/index.cfm
The Civil Society and Governance Programme	http://www.ids.ac.uk/ids/civsoc
The Encyclopedia about Corporate Governance	http://www.encycogov.com/
Transparency International	http://www.transparency.org/
Working Group on Internet Governance (WGIG)	http://www.wgig.org

7.3 ROME & PARIS DECLARATIONS**Rome Declaration**

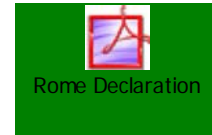
In February 2003, leaders of the major multilateral development banks and international and bilateral organizations, and donor and recipient country representatives gathered in Rome for the High-Level Forum on Harmonization (HLF-Rome). They committed to take action to improve the management and effectiveness of aid and to take stock of concrete progress. Information regarding the HLF and follow up to the Forum is found at: www.aidharmonization.org.

7.3.1 The HLF concluding statement, The Rome Declaration on Harmonization, sets out an ambitious program of activities:

- Ensure that harmonization efforts are adapted to the country context, and that donor assistance is aligned with the development recipient's priorities.
- Expand country-led efforts to streamline donor procedures and practices.
- Review and identify ways to adapt institutions' and countries' policies, procedures, and practices to facilitate harmonization.

- Implement the good practices principles and standards formulated by the development community as the foundation for harmonization.

7.3.2 The attached is the Rome Declaration on Harmonization:



Paris Declaration

7.3.3 The Paris Declaration represents the culmination of the High Level Forum on Aid Effectiveness (HLF) held in Paris 28 February to 2 March 2005. The HLF was hosted by the French Government and attended by development officials and ministers from ninety one countries, twenty six donor organizations and partner countries, representatives of civil society organizations and the private sector. The participants took stock of progress in the wide range of activities that have taken place since the Rome High-Level Forum (2003). They also identified the areas in which further, or more intense, work is needed. The Bank participated in and contributed to the funding of the HLF. For further details regarding the HLF and follow up to the Forum please refer to www.aidharmonization.org

7.3.4 The Paris Declaration is as follows:



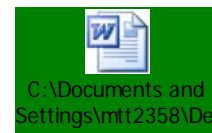
7.3.5 The Paris Declaration on Aid Effectiveness (see above) reflects the commitment of external funding agencies to “avoid, to the maximum extent possible, creating dedicated structures for day-to-day management and implementation of aid-financed projects and programmes.” The Bank has committed in the Paris Declaration to harmonize project implementation arrangements, minimize the use of parallel structures for project implementation, and to use joint PIUs with other development partners where possible.

7.3.6 As a follow up to the Paris Declaration, OECD-DAC has prepared the attached document: ‘Paris Declaration on Aid Effectiveness - Indicators of Progress: (i) List of Indicators; (ii) Letter from the DAC Chair; and (iii) Methodology for Quantitative Indicators’



7.3.7 The following World Bank paper: ‘*Guidance Note for Project Management - Strengthening Institutional Capacity during Project Implementation, October 2005*’ aims to encourage operations managers and staff not only to give priority to project implementation performance but also to balance it with sustainable institutional capacity development beyond the project. To that end, existing country institutions should be the “default” mode, and PIUs—especially parallel “stand-alone” PIUs—should be phased out.

7.3.8 The World Bank ‘*Guidance Note for Project Management - Strengthening Institutional Capacity during Project Implementation, October 2005*’ is attached:



7.4 COUNTRY GOVERNANCE PROFILE

7.4.1 The Bank issued a Staff Guideline covering Country Governance Profile Assessments (CGP) in October 2003. It documents the Bank's approach to the review of Governance processes in a country. It includes a check list of matters to be covered and indicates how issues are to be disclosed and reported. It also relates Governance issues to the Project Lending and Technical Assistance operations of the Bank.

7.4.2 The CGP Guidelines are attached:



7.5 POLICY ON GOOD GOVERNANCE

7.5.1 The Bank issued its Group Policy on Good Governance in November 1999. The policy mandates that in operationalizing its agenda in the area of good governance the Bank will focus on accountability, transparency, combating corruption, participatory governance and legal and judicial reforms.

7.5.2 Attached is the Bank Group Policy on Good Governance:



7.6 PREVENTING & COMBATING CORRUPTION & FRAUD

7.6.1 In February 2004 the Bank approved the Guidelines for Preventing & Combating Corruption and Fraud in Bank Group Operations. The paper contains the following Chapters:

- Introduction & Objective
- Taxonomy of Corruption
- Rationale for Combating Corruption
- Basic Principles, Bank Rules & Procedures for Preventing & Combating Corruption
- The Experience of Other MDBs
- Policy Framework for Preventing & Combating Corruption
- Where and How Corruption may occur in Bank Operations
- Procedures for Addressing Corruption & Fraud in Bank Operations
- The way forward and Implications for the Bank
- Conclusions

7.6.2 The Guidelines for Preventing & Combating Corruption and Fraud in Bank Group Operations are as follows:



7.7 HARMONIZING DONOR PRACTICES

7.7.1 To promote good practices for enhanced aid effectiveness, OECD-DAC published, in 2003, the following booklet: 'Harmonising Donor Practices for Effective Aid Delivery, Good

Practice Papers, *A DAC Reference Document*'. The Booklet covers the following six specific papers that have been agreed as setting out good practices:

- Framework for Donor Co-operation.
- Country Analytic Work and Preparation of Projects and Programmes.
- Measuring Performance in Public Financial Management.
- Reporting and Monitoring.
- Financial Reporting and Auditing.
- Delegated Co-operation (i.e. when one donor acts on behalf of another).

7.7.2 The booklet 'Harmonising Donor Practices for Effective Aid Delivery, Good Practice Papers, *A DAC Reference Document*'.



7.7.3 Additionally, OECD-DAC has published a paper that describes good practices donors can apply to support capacity development in the area of public financial management. Case studies illustrate how effective support of capacity development is beginning to take shape in a few countries and it provides guidance to donor organisations looking to improve the effectiveness of aid delivery aimed at capacity development in public financial management.

7.7.4 The paper '*Capacity Development in Public Financial Management*' is attached



7.7.5 OECD papers 'DAC Guidelines and Reference Series: Harmonising Donor Practices for Effective Aid Delivery' can be accessed from the following website: www.oecd.org/dac/harmonisingpractices

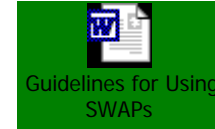
7.8 SECTOR-WIDE APPROACHES

7.8.1 Sector-Wide Approaches (SWAs), emerged in the 1990s out of a growing dissatisfaction with the traditional project approach which has often been viewed as "fragmented, donor-driven" and entailing high transaction costs for aid recipient countries. SWAs emphasize greater reliance on government institutions, common implementation procedures and stronger and closer country partnership with its development partners.

7.8.2 In this regard, the Bank issued its Guidelines for Using Sector-Wide Approaches in April 2004. The paper defines the key imperatives for an effective SWAp process as: the existence of a government-led and coordinated comprehensive sector development programme; the existence of a conducive policy environment or policy reform agenda leading to it; and, the commitment and availability of donor resources in the form of sector investment loans and grants for institutional capacity building and studies to underpin sector development issues. SWAs also require the existence of a strong and coordinated donors approach to the relevant sector's problems as well as the presence of an effective consultation mechanism between the aid recipient member country and its development partners. The approach generally envisages the pooling of donor financial resources in support of government budget, the use of a common government-led implementation and coordination mechanism and a streamlined/harmonized disbursement and procurement procedures.

7.8.3 The paper notes that SWAPs have emerged as important instruments for operationalizing country-led development frameworks. Several recent reviews of aid effectiveness have underlined the importance of wide stakeholder ownership of the development process, country-led coordination of donor interventions, greater country accountability, fewer donor conditionalities on the use of aid resources, and streamlined donor procedures that place fewer strains on the limited national capacities. An increasing number of donors are adopting SWAPs as a process for facilitating sustainable development and enhancing the development impact of aid resources.

7.8.4 The Guidelines for Bank Group Operations Using Sector-Wide Approaches are as follows:



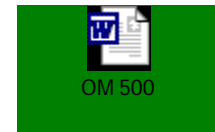
7.9 OPERATIONS MANUALS 500 & 600

Operations Manual 500

7.9.1 Operations Manual 500 covers the topic of Project Preparation and includes the following main topics:

- Introduction
- Borrower Has Done Own Preparation Without Bank Involvement
- Bank Assists in Project Preparation
- Bank Carries Out Project Preparation

7.9.2 The Operations Manual 500 is attached:



Operations Manual 600

7.9.3 Operations Manual 600 with its various Annexes, covers the topic of Project Appraisal and includes the following main topics:

- Definitions and Objectives
- Conducting the Field Appraisal
- Preparing the Project Appraisal Report

7.9.4 The Operations Manual 600 is as follows:



7.9.5 Operations Manual 600 has the following Annexes:

- Annex 1 – Format and Content of an Appraisal Report:



- Annex 1A – Content of an Executive Summary:
- Annex 1B – Provisional List of Goods and Services:
- Annex 2 – The Project Logical Framework:
- Annex 3 – Financial and Economic Analysis in Appraisal Reports:
- Annex 4 – Project Implementation Document:
- Annex 4A – Supervision Plan:
- Annex 5 – Content of the Procurement Section in Appraisal Reports:
- Annex 6 – Appraisal Quality Assessment Check List:



OM 600 Annex 1A



OM 600 Annex 1B



OM 600 Annex 2



OM 600 Annex 3



OM 600 Annex 4



OM 600 Annex 4A



OM 600 Annex 5



OM 600 Annex 6

7.10 PUBLIC EXPENDITURE AND FINANCIAL ACCOUNTABILITY REVIEW

7.10.1 The Public Expenditure and Financial Accountability Review (PEFAR) is a World Bank led assessment of the Public Financial Management (PFM) arrangements in client countries. It has two main components – the Financial Accountability Assessment and the Public Expenditure Review (PER). The Bank participates, within its RMCs, in the preparation of the PEFAR.

7.10.2 The PEFAR is designed to enhance the Bank's, the World Bank's, and other Development Partners' and the borrowers' knowledge of Public Financial Management (PFM) and financial accountability arrangements in client countries.

Financial Accountability Assessment

7.10.3 The main focus of the Financial Accountability Assessment is to assess the following key functions and systems of central government: (i) *Financial Management System*: Revenue Management, Debt Management, External Resource Management and Aid Coordination, Cash Management, Public Procurement Management, and Payroll and Pension Management; (ii) *Accounting, Reporting, Monitoring and Control*: Internal Controls, Data Integrity, Security and

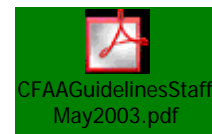
IT Contingency Plans, Management and Annual Financial Reporting, Internal Audit; and (iii) *External Accountability and Oversight*: External Audit, Legislative Scrutiny, Ethics and Integrity Bodies, Public Access and Demand for Information. In addition, the assessment also focuses on cross-cutting issues, namely: (a) human resource, (b) legislative and institutional framework, and (c) the use of Information Technology (IT) that are assessed as components of the main focus areas. Furthermore, the assessment reviews *areas of high-level concern* that may be identified separately to ensure that they form part of the annual review of Budget Performance and Accountability Issues.

7.10.4 Financial Accountability is the obligation to demonstrate and take responsibility for the results of financial decisions against agreed expectations. Financial accountability is meaningful only if actual practice is in accordance with the framework as designed. Therefore, an exercise to assess the strength of a country's financial accountability framework needs to include empirical evidence on actual practice (compliance with established rules and regulations in the country).

7.10.5 The Financial Accountability component of the PEFAR does not constitute an audit of country systems, nor does it provide a "pass/fail" assessment of a country's PFM system in terms of its adequacy for managing government, Bank or other donor-provided resources. This component supports the Bank's development objectives by identifying strengths and weaknesses in country PFM systems. It facilitates a common understanding among the government, the Bank, and development partners on the performance of the institutions responsible for managing the country's public finances. This common understanding helps to identify priorities for action and informs the design and implementation of capacity-building programs. Information also helps the Bank and Development Partners to meet its fiduciary objectives by identifying risks to the use of loan and grant proceeds posed by weaknesses in borrower PFM arrangements. The Financial Accountability component provides a well-informed and objective assessment, a diagnosis of problems, advice on their resolution and an indication of the level of fiduciary risk. However, it is not intended to, and does not, provide assurance on the specific uses to which funds have been or may be applied.

7.10.6 The Financial Accountability assessment component of the PEFAR replaces the World Bank led Country Financial Accountability Assessment (CFAA). The scope of the CFAA comprised a review of public finance including budgeting, accounting and financial reporting, internal control systems and records management, auditing, legislative scrutiny, private sector financial accounting and auditing practices and corporate financial accountability.

7.10.7 The World Bank's CFAA guidelines are attached:



Public Expenditure Review

7.10.8 The Public Expenditure Review (PER) analyses whether the government's strategic priorities as outlined in the Poverty Reduction Strategy Papers (PRSP) are in line with the country's overall macroeconomic and fiscal situation. Importantly, PERs focus on the efficiency and efficacy of public sector resource allocation.

7.10.9 PERs normally make an independent and objective assessment of country's fiscal performance and review progress and lessons learnt from recent government efforts to improve upon the budget strategy that translates the national strategy for growth and poverty reduction in

budget terms. The exercise also reviews progress in implementation of previous PER recommendations and takes stock of ongoing budgetary reforms aimed at improving public expenditure management at local government level.

7.10.10 Apart from the standard independent (to government) assessment of government operations and public expenditure policies, the other main objectives of the PER reviews are to support the government's effort to improve the link between the national strategy for growth and poverty reduction and the budget framework, and review progress in implementation of the previous PER recommendations. Mostly, the results from the PER's work are aimed at feeding into the preparation of government budget for subsequent years, inform the annual PER consultations with stakeholders, and provide advice towards further improvement in public expenditure management in the country concerned. PERs analyse and estimates government revenues, evaluates government spending, inter- and intra-sectoral spending, and the efficacy of public enterprises.

7.11 PERFORMANCE MEASUREMENT

7.11.1 There is wide agreement that effective institutions and systems of public financial management (PFM) have a critical role to play in supporting implementation of policies of national development and poverty reduction. The Public Expenditure and Financial Accountability (PEFA) PFM Performance Measurement Framework, included as an attachment, below, has been developed as a contribution to the collective efforts of many stakeholders to assess and develop essential PFM systems, by providing a common pool of information for measurement and monitoring of PFM performance progress, and a common platform for dialogue. The development of the Framework has been undertaken by the Public Expenditure Working Group, which involves World Bank, IMF and PEFA staff, with direction provided by the PEFA Steering Committee.

7.11.2 The PEFA PFM Performance Measurement Framework incorporates a PFM performance report, and a set of high level indicators which draw on the HIPC expenditure tracking benchmarks, the IMF Fiscal Transparency Code and other international standards. It forms part of the Strengthened Approach to supporting PFM reform, which emphasizes country-led reform, donor harmonization and alignment around the country strategy, and a focus on monitoring and results. This approach seeks to mainstream the better practices that are already being applied in some countries.

7.11.3 Further information on the Framework and the Strengthened Approach can be found at the PEFA website – www.pefa.org.

7.11.4 The PFM Performance Measurement Framework (English & French versions) are attached:



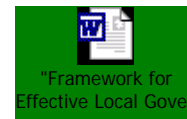
7.12 LOCAL GOVERNMENT FINANCIAL MANAGEMENT

7.12.1 Enhancing local government management capacity is a key to the success of any decentralization strategy. Effective and efficient local government budgeting and financial management is the cornerstone of any effective decentralization strategy. The task of improving local government financial management systems is enormous. The legal framework varies across countries. Local governments vary in size, financial and economic resources. As a result, there is

no singular financial management system that can be applied across the board to all local governments and countries. What is similar across countries and local governments is the conceptual framework of modern budgeting and financial management. The application of these budgeting and financial management practices may however vary across countries.

7.12.2 These issues are discussed in the following paper - Framework for Effective Local Government Finance - that provides a framework for central elements of local government budgeting and financial management practices. The paper covers five primary sections including: i.) Essential Components of Effective Local Government Finance; ii.) A Shift in the Nature of Local Government Budgeting; iii.) The Capital Budget; iv.) The Role of Financial Reporting and Accounting; and, v.) The Treasury System. Additionally, the presentation that is provided below summarizes the broad issues discussed in the paper. Further information in this area is found at: <http://www1.worldbank.org/publicsector/coursedetails.cfm?ID=69>.

7.12.3 Framework for Effective Local Government Finance:



7.13 ASSESSMENT OF FINANCIAL MANAGEMENT

7.13.1 This section provides the Annexes (A to E) that support the **Assessment of Financial Management** topic that is discussed in Section 2.3 (Executing Agencies), of these Guidelines.

7.13.2 **Annex A-2** provides details of the FMQ, which is a series of questions, organized by topics. The topics duplicate the headings in the outline of the Financial Management Assessment Report (**Annex C-2**). It is designed as a single form so that it can be used for both self-assessment by borrower, executing agency or implementation agency and by the Bank's review team. If the financial management system is not yet in place, the FMQ can be used as a checklist of issues that will need to be considered in the development of the system.

7.13.3 **Annex A-1** summarises the risk ratings at two levels. Macro fiduciary risks inherent in the borrower country, entity, and project environment are summarized in the 'Inherent Risks' section. The risks identified through the FMQ are then summarised, per topic, in the 'Control Risk' section.

7.13.4 Annex B provides examples of documentation required to support the assessment. In Annex C highlights the key contents of the Financial Management Assessment Report as well as an outline of the report.

7.13.5 A structured framework to assist Financial Analysts in carrying out the review of the financial management systems is given in Annex D. The approach used is largely based on IFAC Standard 400 "Risk Assessment and Internal Control" framework.

7.13.6 Management recognises that financial governance of projects is posing new challenges for the Bank in terms of its capacity by way of staff strengths and skills-mix of specialists with financial management skills. Where capacity to operationalize the financial management assessments required by these Guidelines is inadequate, Task Managers should ensure consultants with adequate financial management skills are recruited to assist in the assessment process. To this end, a sample Terms of Reference for use when recruiting consultants is provided as Annex E.

7.13.7 Annex A: Financial Management Questionnaire

Annex A-1: Summary Risk Assessment

Project: _____

Date: _____

	<i>Risk Assessment</i>				<i>Comments</i>
	1	2	3	4	
Inherent Risk					
[list specific country, entity, and project inherent risks]					
Overall Inherent Risk					
Control Risk					
1. Implementing Entity					
2. Funds Flow					
3. Staffing					
4. Accounting Policies and Procedures					
5. Internal Audit					
6. External Audit					
7. Reporting and Monitoring					
8. Information Systems					
Overall Control Risk					

Risk Assessment Legend:

- 1 - High** (no accountability mechanisms for resources. Bank and Borrower to take urgent action)
- 2 - Substantial** (limited accountability mechanisms for resources. Bank and Borrower should be on guard)
- 3 - Moderate** (good accountability systems in place that require improvement. Bank and Borrower should monitor progress)
- 4 - Negligible or Low** (solid accountability systems in place. Bank and Borrower can rely on systems)

Annex A: Financial Management Questionnaire *(continued)*

Annex A-2: Questionnaire and Detailed Risk Assessments

Project: _____

Self-Assessment completed by: _____ Date: _____

Bank Review/Assessment completed by: _____ Date: _____

Note: If there is more than one implementing entity, a Questionnaire should be completed for each entity

Topic	Remarks/Comments				
<i>1. IMPLEMENTING ENTITY</i>					
1.1 What is the legal status/registration of the entity?					
1.2 Has the entity implemented a Bank-financed project in the past?					
1.3 What are the statutory reporting requirements for the entity?					
1.4 Is the governing body for the project independent?					
1.5 Is the organizational structure appropriate for the needs of the project?					
<u>CONCLUSIONS AND RECOMMENDATIONS</u>					
(a) <i>Please outline, principal areas where controls regarding ‘Implementing Entity’ assessment area might be improved.</i>					
(b) <i>Please outline, any other aspects of ‘Implementing Entity’ financial management system that merit specific mentioning.</i>					
(c) <i>Risk Assessment (Implementing Entity):</i>	<table border="1"> <tr> <td>1</td> <td>2</td> <td>3</td> <td>4</td> </tr> </table>	1	2	3	4
1	2	3	4		

2. FUNDS FLOW	Remarks/Comments
2.1 Describe the funds flow arrangements, including a chart and explanation of the flow of funds from the African Development Bank Group, government and other financiers.	
2.2 Are the arrangements to transfer the proceeds of the loan/grant (from the government / ministry of finance) to the entity satisfactory?	
2.3 Were there any major problems in the past in receipt of funds by the entity?	
2.4 In which Bank will the Special Account be opened? Is it acceptable?	
2.5 Does the PIU ¹ have experience in the management of disbursements from the African Development Bank Group?	
2.6 Does the entity have/need a capacity to manage exposure to foreign exchange risks?	
2.7 How are the counterpart funds accessed?	
2.8 Are controls over payments made from the counterpart funds adequate?	
2.9 If part of the project is implemented by communities or by NGOs, does PIU have necessary reporting and monitoring features built into its systems to track the use of project proceeds by such agencies.	

¹ The project financial management system depends on the nature of the project and of its implementing entity, which could be a self-standing Project Implementing Unit (PIU), Project Co-ordination Unit (PCU), Project Management Unit (PMU), Project Liaison Unit (PLU), a government ministry, department, or agency, or a commercial entity. These guidelines use ‘PIU’ to refer to all of the above.

2.10 Are the beneficiaries required to contribute to the project costs? If beneficiaries have an option to contribute in kind (in the form of labour) are proper guidelines formulated to record and value the labour contribution?	
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<u>CONCLUSIONS AND RECOMMENDATIONS</u>				
<i>(a) Please outline, principal areas where controls regarding 'Funds Flow' assessment area might be improved.</i>				
<i>(b) Please outline, any other aspects of 'Funds Flow' financial management system that merit specific mentioning.</i>				
<i>(c) Risk Assessment (Funds Flow):</i>	1	2	3	4

3. STAFFING	Remarks/Comments
3.1 What is the organizational structure of the accounting ² department? Attach an organization chart.	
3.2 Identify the account staff, including job title, responsibilities, educational background and professional experience. Attach job descriptions and CVs of key accounting staff.	
3.3 Is the project finance and accounts function staffed adequately?	
3.4 Is the finance and accounts staff adequately qualified and experienced?	
3.5 Is the project accounts and finance staff trained in the Bank procedures?	
3.6 What is the duration of the contract with the finance and accounts staff?	
3.7 Indicate key positions not contracted yet, and the estimated date of appointment	
3.8 Does the project have written position description for all of the officers, managers and staff that clearly define duties, responsibilities, lines of supervision, and limits of authority?	
3.9 At what frequency is the staff transferred?	
3.10 What is training policy for the finance and accounting staff?	

<u>CONCLUSIONS AND RECOMMENDATIONS</u>				
<i>(a) Please outline, principal areas where controls regarding 'Staffing' assessment area might be improved.</i>				
<i>(b) Please outline, any other aspects of 'Staffing' financial management system that merit specific mentioning.</i>				
<i>(c) Risk Assessment (Staffing):</i>	1	2	3	4

4.1 ACCOUNTING POLICIES AND PROCEDURES	Remarks/Comments
4.1.1 Does the entity have an accounting system that allows for the proper recording of project financial transactions, including the allocation of expenditures in accordance with the respective components, disbursement categories and sources of funds? Will the project use the entity accounting system?	
4.1.2 Are controls in place concerning the preparation and approval of journal entries, ensuring that journal entries are correctly made and adequately explained?	
4.1.3 Is the chart of accounts adequate to properly account for and report on project	

² The role of the accountant in the public sector is far wider than the production of the annual financial statements. Financial management is usually a more important task. This may include: development of a Medium-Term Expenditure Framework; annual budget planning development, monitoring and reporting; reviewing, maintaining and enhancing internal financial control; efficient procurement of goods and services; cash-flow planning and treasury management; planning, developing, managing and auditing financial management information systems (computerised financial systems); and activity based costing (ACCA: <http://www.accaglobal.com/transparency/publicsector/financialmanagement/>).

activities?	
4.1.4 Are cost allocations to the various funding sources made accurately and in accordance with established agreements	
4.1.5 Are the General Ledger and subsidiary ledgers reconciled and in balance?	
4.1.6 Are all accounting and supporting documents retained on a permanent basis in a defined system that allows authorized users easy access?	

4.2 Segregation of Duties	Remarks/Comments
4.2.1 Are the following functioning responsibilities performed by different units or persons: (i) authorization to execute a transaction; (ii) recording of the transaction; and (iii) custody of assets involved in the transaction?	
4.2.2 Are the functions of ordering, receiving, accounting for and paying for goods and services appropriately segregated?	
4.2.3 Are bank reconciliations prepared by someone other than those who make or approve payments?	
4.3 Budgeting System	Remarks/Comments
4.3.1 Do the budgets lay down physical and financial targets?	
4.3.2 Are budgets prepared for all significant activities in sufficient detail to provide a meaningful tool with which to monitor subsequent performance?	
4.3.3 Are actual expenditures compared to budget with reasonable frequency and explanations required for significant variations from the budget?	
4.3.4 Are approvals required in advance or post-facto for variations from the budget?	
4.3.5 Who is responsible for preparation and approval of budgets?	
4.3.6 Are procedures in place to plan project activities, collect information from the units in charge of the different components, and prepare the budgets?	
4.3.7 Are the project plans and budgets of the project activities realistic, based on valid assumptions and developed by knowledgeable individuals?	

4.4 Payments	Remarks/Comments
4.4.1 Do invoice processing procedures provide for: <ul style="list-style-type: none"> • Copies of purchase orders and receiving reports to be obtained directly from issuing departments? • Comparison of invoice quantities, prices and terms, with those indicated on the purchase order and with records of goods actually received? • Comparison of invoice quantities with those indicated on the receiving reports? • Checking the accuracy of calculations? 	
4.4.2 Are all invoices stamped <i>PAID</i> , dated, reviewed and approved, and clearly marked for account code assignment?	
4.4.3 Do controls exist for the preparation of the payroll and are changes to the payroll properly authorized?	
4.5 Policies And Procedures	Remarks/Comments
4.5.1 What is the basis of accounting (e.g., cash, accrual)	
4.5.2 What accounting standards are followed?	
4.5.3 Does the project have an adequate policies and procedures manual used to control activities and to ensure staff accountability?	
4.5.4 Are the accounting policies and procedure manuals updated for the project activities?	
4.5.5 Do procedures exist to ensure that only authorized persons can alter or establish a new accounting principle, policy, or procedure to be used by the entity?	
4.5.6 Are there written policies and procedures covering all routine financial management	

and related administrative activities?	
4.5.7 Do policies and procedures clearly define <i>conflict of interest</i> and <i>related party transactions</i> (real and apparent) and provide safeguards to protect the organization from them?	
4.5.8 Are manuals distributed to appropriate personnel?	

4.6 Cash and Bank	Remarks/Comments				
4.6.1 Are there any project bank accounts opened yet?					
4.6.2 Indicate names and positions of authorized signatories in the bank accounts.					
4.6.3 Does the project maintain an adequate, up to date cashbook, recording receipts and payments?					
4.6.4 Do controls exist for the collection, timely deposit, and recording of receipts at each collection location					
4.6.5 Are bank and cash reconciled on a monthly basis?					
4.6.6 Are all unusual items on the bank reconciliation reviewed and approved by a responsible official?					
4.6.7 Are all receipts deposited on a timely basis?					
4.7 Safeguard over Assets	Remarks/Comments				
4.7.1 Is there a system of adequate safeguards to protect assets from fraud, waste, and abuse?					
4.7.2 Are subsidiary records of fixed assets and stocks kept up to date?					
4.7.3 Are there periodic physical inventories of fixed assets and stocks?					
4.7.4 Are assets sufficiently covered by insurance policies?					
4.8 Other offices and implementing entities	Remarks/Comments				
4.8.1 Are there any other regional offices or executing entities participating in implementation?					
4.8.2 Has the project established controls and procedures for flow of funds, financial information, accountability and audits in relation to the other offices or entities?					
4.8.3 Does information among the different offices/implementing agencies flow in an accurate and timely fashion?					
4.8.4 Are periodic reconciliations performed among the different offices/implementing agencies?					
4.9 Other	Remarks/Comments				
4.9.1 Has the project advised employees, beneficiaries and other recipients whom to report to if they suspect fraud, waste or misuse of project resources or property?					
CONCLUSIONS AND RECOMMENDATIONS					
(a) Please outline, principal areas where controls regarding 'Accounting Policies and Procedures' assessment area might be improved.					
(b) Please outline, any other aspects of 'Accounting Policies and Procedures' financial management system that merit specific mentioning.					
(c) Risk Assessment (accounting Policies and Procedures):	<table border="1"> <tr> <td>1</td> <td>2</td> <td>3</td> <td>4</td> </tr> </table>	1	2	3	4
1	2	3	4		

5. INTERNAL AUDIT	Remarks/Comments
5.1 Is there an internal audit department in the entity?	
5.2 What are the qualifications and experience of the persons working in the department?	

5.3	To whom does the internal auditor report?	
5.4	Will the internal audit department include the project in its work program?	

<u>CONCLUSIONS AND RECOMMENDATIONS</u>				
<i>(a) Please outline, principal areas where controls regarding 'Internal Audit' assessment area might be improved.</i>				
 <i>(b) Please outline, any other aspects of 'Internal Audit' financial management system that merit specific mentioning.</i>				
<i>(c) Risk Assessment (Internal Audit):</i>				
	1	2	3	4

6. EXTERNAL AUDIT	Remarks/Comments
6.1 Is the entity's financial statement audited regularly by an independent auditor? Who is the auditor?	
6.2 Are there any delays in audit of the entity? When are the audit reports issued?	
6.3 Is the audit of the entity and/or the project conducted according to the International Standards of Auditing?	
6.4 Were there any major accountability issues brought out in the audit report of past three years?	
6.5 Will the entity auditor audit the project accounts or will a separate auditor be appointed to audit the project financial statements?	
6.6 Are there any recommendations made by the auditors in prior audit reports or management letters, which have not yet been implemented?	
6.7 Is the project subject to any kind of audit from an independent governmental entity (e.g., the Supreme Audit Institution) in addition to the external audit?	
6.8 Has the project prepared acceptable Terms of Reference for an annual Project audit?	

<u>CONCLUSIONS AND RECOMMENDATIONS</u>				
<i>(a) Please outline, principal areas where controls regarding 'External Audit' assessment area might be improved.</i>				
 <i>(b) Please outline, any other aspects of 'External Audit' financial management system that merit specific mentioning.</i>				
<i>(c) Risk Assessment (External Audit):</i>				
	1	2	3	4

7. REPORTING AND MONITORING	Remarks/Comments
7.1 Are financial statements prepared for the entity? In accordance with which accounting standards?	
7.2 Are financial statements prepared for the implementing unit?	
7.3 What is the frequency of preparation of financial statements? Are the reports prepared timely to be useful to management for decision-making?	
7.4 Does the reporting system need to be adapted to report on the project components?	
7.5 Does the reporting system have the capacity to link the financial information with the project physical progress? If separate systems are used to gather and compile physical data, what controls are in place to reduce the risk that the physical data may not synchronize with the financial data.	
7.6 Does the Project have established financial management reporting responsibilities that specify what reports are to be prepared, what they are to contain and how they are to be used?	
7.7 Are financial management reports used by management?	

7.8	Do the financial reports compare actual expenditures with budgeted and programmed allocations?					
7.9	Are financial reports prepared directly by the automated accounting system or are they prepared by spreadsheets or some other means?					
<u>CONCLUSIONS AND RECOMMENDATIONS</u>						
(a) Please outline, principal areas where controls regarding 'Monitoring and Reporting' assessment area might be improved.						
(b) Please outline, any other aspects of 'Monitoring and Reporting' financial management system that merit specific mentioning.						
(c) Risk Assessment (Monitoring and Reporting):						
		<table border="1"> <tr> <td>1</td> <td>2</td> <td>3</td> <td>4</td> </tr> </table>	1	2	3	4
1	2	3	4			

8. INFORMATION SYSTEMS		Remarks/Comments				
8.1	Is the financial management system computerized?					
8.2	Can the system produce the necessary project financial reports?					
8.3	Is the staff adequately trained to maintain the system?					
8.4	Does the management organization and processing system safeguard the confidentiality, integrity and availability of the data?					
<u>CONCLUSIONS AND RECOMMENDATIONS</u>						
(a) Please outline, principal areas where controls regarding 'Information System' assessment area might be improved.						
(b) Please outline, any other aspects of 'Information Systems' financial management system that merit specific mentioning.						
(c) Risk Assessment (Information Systems):						
		<table border="1"> <tr> <td>1</td> <td>2</td> <td>3</td> <td>4</td> </tr> </table>	1	2	3	4
1	2	3	4			

7.13.8 Annex B: Supporting Documents

The supporting documents will normally include the following items, if applicable to the project financial management system and necessary for the assessment. General country information need only be included if it is not otherwise available.

- Assessment Report
- Financial Management Questionnaire
- Financial regulations, standards or pronouncements used by the project/entity
- Information concerning the legal and organizational structure of the entity
- Extracts or copies of important legal documents, agreements, or minutes
- Information concerning the sector, economic environment, and legislative environment within which the entity operates
- Evidence of the assessment planning process
- Evidence of the Financial Analyst's consideration of the work of the Internal Auditor (if applicable) and conclusions reached
- Analyses of significant ratios and trends (revenue generating projects)
- Draft format of the financial statements produced by the project/entity
- Evidence that work performed by consultants was supervised and reviewed

- Copies of communications with other experts, or third parties involved in the assessment
- Chart of Accounts
- Project or entity Financial Management Manual
- Terms of reference for the audit
- Terms of reference and *curriculum vitae* for key financial and accounting personnel
- Operational manual
- Copy of most recent audit report (if applicable)

7.13.9 Annex C: Financial Management Assessment Report

Annex C-1: Content of the Financial Management Assessment Report

Executive Summary: The executive summary fulfils two purposes: (a) to summarize the findings of the assessment and (b) to be the input to the project Appraisal Report, including an overall assessment as to the adequacy of the financial management system. The executive summary should be brief and cover the following points:

- (a) record an assessment of the adequacy of the financial management system and of the financial performance of any revenue-earning entities, and describe and give a timetable for any measures proposed to improve capabilities;
- (b) describe the status of the borrower's and the project implementing entities' compliance with audit covenants in existing Bank Group-financed projects, and explain any actions being taken to address noncompliance; and
- (c) record agreements with the borrower on standards and formats for audited financial statements and the timetable for their submission.

In addition, country level issues arising from the Country Governance Profile (CGP) and other country analytic work (e.g. the World Bank led Financial Accountability assessment component of PEFAR) should be identified, including the impact on the project financial management system.

In addition, the following issues should be covered, if significant:

- The flow of funds between donors, the project, and its beneficiaries.
- If project implementation capacity in financial management is assessed as weak, the supervision and other actions to mitigate the possible unfavorable results.
- The adequacy of banking arrangements.

Summary Project Description: Provide a brief summary of the project, focusing on the issues that impact the Assessment.

Country Issues: Identify any country issues that are relevant to the project. The source of the issues should be current analytical work (e.g., CGP, PEFAR, PEFA-PFM, CPAR, etc.). Insofar as possible, analysis of the country issues should not be repeated as part of the assessment. The bulk of the content for this section could be common to all assessments in the country.

Risk Analysis: The risk analysis from the Financial Management Questionnaire should be copied into this section. In addition, the appropriate contribution to project's Appraisal Report should be presented in the same format as is required in the Appraisal Reports:

<i>Risk</i>	<i>Risk Rating</i>	<i>Risk Mitigation Measures</i>

Strengths and Weaknesses: Identify the significant strengths that provide a basis for reliance on the project financial management system.

In the following chart, identify the significant weakness of the project financial management system and the way in which each weakness will be addressed. Methods of addressing the weakness include an agreed action to rectify the weakness (the resolution will link to the action plan) or to accept it as a risk that will be mitigated (the resolution will link to the risk table, above).

<i>Significant Weaknesses</i>	<i>Resolution</i>

Implementing Entity: Provide a description of the implementing entity and any unique features that impact the financial management issues.

Funds Flow: Describe the funds flow, preferably in the format of flow chart.

Staffing: Identify the key staff positions and the capability of this staff to fulfil the accounting and reporting needs of the project.

Accounting Policies and Procedures: Describe key policies and procedures that demonstrate the adequacy of the project financial management system.

Internal Audit: Describe the internal audit function and its oversight responsibilities over the project financial management system.

External Audit:

- Describe issues that have arisen in the audit of previous Bank Group-financed projects implemented by the project and/or entity, including the status of overdue audit reports or outstanding issues; if the issues are significant, they should be included in the action plan and conditions.
- Describe audit arrangements for the current project, including appointment of auditor and the audit terms of reference.
- Complete the following chart to clearly identify the audit reports that will be required to be submitted by each project implementation agency and the due date for submission.

<i>Audit Report</i>	<i>Due Date</i>
Entity	
Project	
Other (specify)	

Reporting and Monitoring: Describe the financial reporting systems and the ability to report on the project expenditures.

Attach a draft of the format of the financial statements that will be prepared by the project. This financial statements format will be used as the annual audited financial statements.

Information Systems: Describe information systems that will be used for the financial management of the project.

Impact of Procurement Arrangements: Describe the impact of the procurement assessment on the assessment of the financial management system.

Disbursement Arrangements: The assessment should document the following details of the disbursement arrangements:

- Method;
- Special Account allocation and procedures;
- Disbursement Mechanisms (e.g., direct payment);
- Any unique circumstances or requirements.

Action Plan, If Required (Agreed with Borrower): If weaknesses have been identified that need to be rectified before the project has acceptable financial management, an action plan should be documented in the assessment. Actions that are conditions should be noted as such; all action plans must be agreed with the borrower.

<i>Action</i>	<i>Responsible Person</i>	<i>Completion Date</i>

Conditions: List all conditions (e.g., negotiation, Board presentation, effectiveness, disbursement), fully describing actions that must be taken to meet the condition.

Financial Covenants: List all financial covenants that will be in the project Loan/Grant Agreement.

Supervision Plan: Identify the supervision strategy and required resources for the financial management aspects of the project.

Annex C: Financial Management Assessment Report (*continued*)

Annex C-2: Financial Management Assessment Report (*Template Format*)

[Name of Country]

[Name of Project (Project Ref. Number)]

[Date of Review Completion]

I. Background

1. Scope/Objective of Review of Financial Management System. This report is the result of a financial management review and analysis as conducted by [Name and Title of Consultant

and/or Bank staff conducting Review]. The scope of the work has been set out in the Terms of Reference for “Conducting and Preparing a African Development Bank Group Financial Management Assessment” dated X/X/XX. The objective of the review is to determine whether the project has in place a financial management system as required by the Bank Group under Operations Manual 600, Paragraphs 15 & 16.

2. Project Objective. The proposed Project’s main development objectives are:...
3. Project Status/Schedule. The Project is currently at [... stage]. Dates for the project cycle are: (a) Decision Meeting: [date]; (b) Appraisal: [date]; (c) Negotiations: [date]; (d) Board [date]; (e) Signing: [date]; (f) Effectiveness: [date]; (g) Completion: [date]; and (h) Closing: [date]. (Please separate ‘actual dates’ from ‘estimated dates for the remaining project cycle’)

II. Organizational Structure/Institutional Arrangements

4. Organization Chart (Annex 4). Identify ministries, committees, Project Implementation Units involved, how they relate to one another, responsibilities, staffing and status of set up.
5. Institutional Experience with Bank Group-Financed Projects. Identify prior Bank Group financed programs that have had experience with PIUs and entities involved.

III. Project Structure and Costing

6. Financing and Cost Sharing. Identify project financing sources, amounts and details on funding for each loan/grant category and/or project component.
7. Loan/Grant Agreement Categories. Identify loan/grant agreement categories and amounts and percentages of Bank financing for each.
8. Project Component and Sub-Components. Identify project components, sub-components and amounts of financing for each funding source.
9. Procurement Budget. Identify procurement categories and projected volume to determine risk areas (e.g. breakdown by amounts).

IV. Internal and Other Controls

10. Project Financial Management Systems Manual. Describe components, develop and attach outline of topics (Annex 9), identify group responsible for preparation and maintaining the manual.
11. Laws/Regulations. Identify local laws and regulations affecting the project on financial management related issues.
12. Cash Management and Documentation Flow.

V. Accounting Standards, Financial and Management Reporting

13. Accounting Standards. Identify the accounting standards applied by the project in preparing and presenting Project Management Reports.

14. Project Reports. Identify which project reports (examples: Quarterly Progress Report, Annual Progress Report, Audit Report, Audit Management Letter, etc.) are used, attach agreed formats (Annex 5); identify parties responsible for preparing and submitting; identify project Chart of Accounts (COA) (Annex 8). Check actual project reports against reporting timetable and identify shortfalls. Reconcile project report's figures to COA. Ensure project reports are fairly presented.

15. Automation Assessment. Assess automation capacity and needs (both hardware and software) in preparing and presenting project reports.

VI. Special Accounts, Disbursements and Supporting Documentation

16. Special Accounts. Identify how many accounts are utilized, the entities and individuals who are responsible for processing and reconciling transactions, where bank accounts are held and in what currency and how transactions are authorized. Assess appropriateness of segregation of duties. Prepare a flowchart of project receipt procedures and entities/individuals involved (Annex 6). Assess adequacy of the bank reconciliation procedures.

17. Disbursement Processing and Supporting Documentation. Prepare a flowchart of project disbursement procedures and entities/individuals involved (Annex 7).

VII. Staffing and Training

18. Project Financial Management Staffing, Qualifications and Job Descriptions. Assessment and evaluation of financial management staff backgrounds, experience, qualifications and job descriptions.

19. Training. Identify training needed, for whom and who would conduct training programs.

VIII. Audit Arrangements

20. Project Audits. Describe audit TOR details (when prepared, by whom, content), accounting and auditing standards applied, types of audits submitted or to be submitted (Project, Special Account, etc.) timing of audit submission, selection process and timing for auditor and identify auditor used. Assess independent and objectivity of auditor.

21. Entity Audits. Same as above.

22. Compliance with Audit Covenants. Describe PIUs and country overall's audit compliance with existing Bank financed programs, quality of past audit submissions, auditors used, outstanding follow-up issues.

IX. Budgeting and Monitoring

23. Describe and evaluate project budgeting process, cycle. Identify issues in obtaining and monitoring local funding.

X. Risks

24. Country Risks. Describe relevant: (a) Country Governance Profiles; and (b) World Bank led PEFAR details analyzing the general financial management environment and risks in the country. Identify Country Corruption Index (Transparency International statistic).

25. Project Risks. Identify, discuss and evaluate project risks. Complete and attach: (a) Financial Management Questionnaire (Annex 1) and Summary of Risk Assessment (Annex 2) identifying elements of material risk, strategies used to evaluate and recommendations.

XI. Issues/Next Steps

26. (a) Other Findings. Summarize other internal control finding and recommendations not covered elsewhere in this report; and

(b) Action Plan. Discuss time-based Action Plan items. The Action Plan is included in report as Annex 3.

XII. Conclusion

27. Based on assessment, specify whether project does or does not satisfy minimum Bank financial requirements as stipulated in OP 600 Paragraphs 15 & 16.

Attachments:

- Annex 1: Financial Management Questionnaire
- Annex 2: Summary of Risk Assessment
- Annex 3: Action Plan
- Annex 4: Project Organization Chart
- Annex 5: Project Reports Project Management Reports (Quarterly Progress Report, Annual Progress Report, Audit Report, Audit Management Letter, etc.)
- Annex 6: Flow chart of receipts, including funds from external donors
- Annex 7: Flow chart of disbursements
- Annex 8: Chart of accounts
- Annex 9: Project Financial Management Systems Manual - Outline
- Annex 10: Meeting Schedule of Project Contacts

7.13.10 Annex D: Assessing Risk

This annex provides a structured framework to assist the Financial Analyst in carrying out the review of the financial management systems. The approach is largely based on IFAC Statement 400 "Risk Assessment and Internal Control." Consistent with the fact that the assessment is not an audit, the Financial Analyst is not required to carry out compliance or substantive testing of the system reviewed.

Definitions

Inherent risk -- Inherent risk is the susceptibility of the project financial management system to factors arising from the environment in which it operates, such as country rules and regulations and entity working environment (assuming absence of any counter checks or internal controls).

Control risk -- Control risk is the risk that the project's accounting and internal control framework are inadequate to ensure project funds are used economically and efficiently and for the purpose intended, and that the use of funds is properly reported.

Financial management system -- The project financial management system is the series of tasks and records of the project entity by which transactions are processed as a means of maintaining financial records. Such systems identify, assemble, analyze, calculate, classify, record, and report transactions and other events periodically presented in the financial statements.

Internal control framework -- The internal control framework is defined as all the policies and procedures adopted by the management of the project entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of the project, including adherence to management policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information. The internal control framework extends beyond those matters that relate directly to the functions of the financial management system, and comprises:

The **control environment**, which means the overall attitude, awareness and actions of the project management and staff regarding the internal control framework and its importance in the entity. The control environment has a bearing on the effectiveness of the specific control procedures. A strong control environment--for example, one with tight budgetary controls--can significantly complement specific control procedures. However, a strong environment does not, by itself, ensure the effectiveness of the internal control framework. Factors affecting the control environment include:

- Composition of the Project Management Unit,
- Philosophy and operating style of the project management,
- Project entity's methods of assigning authority and responsibility,
- Arrangements for external audit of the project, and
- Management's personnel and incentive policies.

The **control procedures** are those policies and procedures, in addition to the control environment, which management has established to achieve the specific project objectives. Specific control procedures include:

- Reporting, reviewing and approving reconciliation,
- Controlling applications and environment of computer information systems,
- Maintaining and reviewing control accounts and trial balances,
- Reviewing and reconciling disbursement summaries with the project accounting records,
- Limiting physical access to assets and records, and
- Comparing and analyzing the financial results with budgeted amounts.

Assessing Inherent Risks

To assess inherent risks that the project may face, the Financial Analyst should evaluate factors at three different levels--country specific, entity specific, and project.

(a) Country specific

In assessing the country specific inherent risks, the Financial Analyst is expected to draw upon the existing work (such as CGP, PEFAR, PEFA-PFM, CPAR, etc) and is not expected to carry out the risk assessment every time financial management systems are assessed for an individual project. Areas to be reviewed include:

- Significant weaknesses in the budgetary process (transparency, basis of preparing the budget, budget monitoring process, sanctity of budget approvals, medium/short term expenditure framework);
- Significant weaknesses in the public sector accounting and reporting (standards, timeliness, capacity of the public sector accounting professionals);
- Significant weaknesses in the public and private sector auditing (standards, capacity, independence, timeliness);
- Significant weaknesses in the legislative scrutiny process particularly in respect of review and follow up over the audit findings (composition of the Public Accounts Committee, frequency of Public Accounts Committee PAC meetings, independence, effectiveness);
- Significant weaknesses in the funds flow mechanism (bureaucratic delays, cumbersome procedures, weak banking system);
- Salary structure within the public sector as compared to the private sector;
- Degree of management independence from the politics; and
- Status of the accounting profession in the country.

(b) Entity specific

The inherent risks in relation to the project implementing entity are primarily in three areas: (a) institutional and organizational aspects, (b) funds flow, and (c) audit arrangements. In some projects the distinction between the entity and project may be nonexistent as the project implementing unit (PIU) is created exclusively to implement the Bank Group-financed project, and the PIU is independent of any existing agency.

(i) Institutional and Organizational Aspects. The Financial Analyst should review the institutional and organizational structure, considering the following:

- Capacity to handle the budgeting, accounting, internal controls, and reporting functions;
- Complexity of the project, volume of transactions, number of implementing agencies, and geographical spread of the project activities (for a complex project that is implemented by a large number of agencies, the project will require a strong project financial management team to monitor the release of funds, their use, and reporting of expenditures);
- Number of accounting staff required to manage the financial management function, staff qualifications, staff training requirements, the level of the accounting staff vis-à-vis other departments, and reporting relationships;
- Staff retention and turnover rate, and the adequacy of the performance review process (frequent staff changes may have an adverse impact on the project implementation); and
- Risks that the project will not have appropriate staff who are sufficiently qualified and trained, or that the staff will be transferred frequently leading to disruptions or that the reporting relationships are conducive to efficient functioning.

(ii) Fund Flow Arrangements. The Financial Analyst should review the funds flow arrangements from the Bank to the special account, the implementing agency, contractors and suppliers, and in some cases, to the ultimate beneficiary to assess the risks that the proceeds of the loan/grant will

be used for their intended purposes. The same issues need to be examined for flow of counterpart funds.

(iii) Audit Arrangements. The Financial Analyst should assess the risks that audited project financial statements will not be furnished to the Bank on time or that the quality of audit will not be acceptable to the Bank.

(c) Project specific

The Financial Analyst should pay particular attention to the following factors when assessing the project-specific inherent risks:

- Complexity of the project,
- Number of project implementing agencies involved and their prior experience,
- Involvement of NGOs and community groups in project implementation,
- Ability of the PIU to attract and retain qualified staff,
- The integrity of project management, and
- Susceptibility of assets to loss or misappropriation.

Assessing Control Risk

To assess the weaknesses of the internal control system, the Financial Analyst will need to understand its objectives, framework, environment, and control procedures.

(a) Objectives of internal control framework

Internal controls relating to the financial management system are concerned, among other things, with ensuring that:

- Transactions are executed in accordance with management's authorization.
- All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts, and in the proper accounting period to permit the preparation of financial statements in accordance with an identified financial reporting framework.
- Access to assets is permitted only in accordance with management's authorization.
- Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken regarding any differences.

(b) Understanding the internal control framework

To understand the internal control framework, the Financial Analyst should obtain knowledge of its design and operation through completion of the Financial Management Questionnaire. Where the system is already in place, it may be appropriate to perform a "walk-through" test (i.e., trace a few transactions through the financial management system). When the transactions selected typify those that pass through the system, this procedure may also form part of the assessment of the degree of control risk.

The nature, timing, and extent of the review of the internal control framework will vary with, among other things, the

- Size and complexity of the entity and its computer systems,

- Type of internal controls involved,
- Nature of the project entity's documentation of specific internal controls, and
- Extent to which the financial management system and internal control framework are in place and functioning at the time of the assessment.

An understanding of the main elements of the financial management system and internal control framework is obtained through previous experience with the PIU (where applicable), and is supplemented by:

- Inquiries with management and personnel at various levels within the PIU, together with reference to documentation such as procedure manuals, job descriptions, and flow charts;
- Inspection of documents and records produced by the financial management system and internal control framework; and
- Observation of the project entity's activities and operations, including computer operations
-

Observation of the project entity's activities and operations, including computer operations

(c) Understanding the financial management system

The Financial Analyst should obtain an understanding of the financial management system that the project has established by completing the Financial Management Questionnaire.

(d) Understanding the control environment

The Financial Analyst should obtain an understanding of the control environment sufficient to assess project management's attitude, awareness, and actions regarding internal controls and their importance to the entity. The control environment will include the budgeting, costing, management reporting, and auditing systems. The Financial Analyst will have to gain an understanding of various aspects of these systems; the Financial Management Questionnaire provides a format for gathering this understanding.

(e) Understanding the control procedures

Because control procedures are integrated with the control environment and the financial management system, some knowledge about control procedures is likely to be gained while obtaining an understanding of the financial management system. For example, in assessing the control procedures pertaining to cash and bank balances, it would be usual to ascertain whether bank accounts are reconciled.

(f) Tests of control

When reviewing the effective operation of internal controls, the Financial Analyst should consider how and by whom they are applied. The concept of effective operation recognizes that some deviations may occur. Deviations from prescribed controls may be caused by such factors as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error. When deviations are observed, specific inquiries should be made regarding these matters, particularly the timing of staff changes in key internal control functions. However, the Financial Analyst will not normally carry out tests of the internal controls system.

(g) Assessing the control risk

After obtaining an understanding of the financial management system and internal control framework, an assessment of control risk should be made and documented in the Financial Management Questionnaire. The assessment of control risk is the process of evaluating the effectiveness of the project entity's financial management system and internal control framework in ensuring that project funds are used economically and efficiently and for the purpose intended and are properly reported.

Many internal controls which would be relevant to large project entities are not practical for small entities. For example, in small projects, accounting procedures may be performed by a few persons, who may have both operating and custodial responsibilities, and therefore segregation of duties may be missing or severely limited. Inadequate segregation of duties may, in some cases, be offset by a strong management control system in which managerial supervisory controls exist because of direct personal knowledge of the entity and involvement in transactions. In circumstances where segregation of duties is limited and evidence of supervisory controls lacking, the evidence necessary to support the assessment may have to be obtained entirely through the performance of substantive procedures.

7.13.11 Annex E: Terms of Reference³**Conducting and Preparing an African Development Bank Group
Project Financial Management Assessment**

[Name of Country, Name of Project and Project Reference Number]

I. Objective and Background

(Cut and paste a brief description of the project's objectives, size and what appraisal activity has already been performed. Reference any documents you would like the consultant to review about the project. It is usually also important to include any country risks noted in our country's analyses concerning corruption or lack of financial management capacity in the environment the project will operate in. Mention all funding sources and whether you would like the consultant to review project procedures designed to meet the requirements imposed by other donors, in addition to the Bank Group's.)

(Add information concerning the implementing entities, including where they are located, the Bank Group's experience with them on previous projects and other activities.)

- The objective of the proposed Financial Management Assessment for the proposed XXX Project is to assess the extent to which the Project has in place an adequate financial management system, as required by the African Development Bank Group's Operations Manual 600, Paragraphs 15 & 16.

³ This TOR is for use when recruiting consultants to assess the financial management arrangements in Bank Group-financed projects.

- (Add other objectives as appropriate.)

II. Scope of Testing

The Financial Management Assessment of the financial management system should be carried out in accordance with the *'Assessment of Financial Management Arrangements In African Development Bank Group-financed Projects: Guidelines To Staff'* and *'The African Development Bank Group Guidelines for Financial Management and Financial Analysis of projects'* and should address the following important aspects:

1. Understanding the Project

The reviewer should pay particular attention to:

- reports issued by the African Development Bank and other donors that provide insights on general financial management environment prevailing in the country;
- project appraisal reports to become familiar with the project's objectives, components and sub components;
- cost sharing arrangements including categories of expenditures, location, and sources of financing;
- the experience, lessons learned and recommendations noted from prior projects, or from the previous activities of the implementing agencies;
- the structure and experience of the implementing agencies used in implementing the project, including the relationships between any lead agencies and participating agencies;
- the paths for project funds flow and the timing of those flows and the implications where decentralization is involved (e.g. whether direct to the project or through government ministries; direct financing or reimbursements); laws, rules, regulations and agreements that govern or may affect any aspect of the project;
- reports issued by project auditors (if any audit has been conducted) or by the Bank Group in respect of the projects' operations;
- the scope and purposes of the local decentralized levels' formats and procedures; and
- identifying the key risk areas of the specific project.

2. Review of Records Management System

The reviewer should assess whether the following aspects of the Records Management System are in place:

- there are clearly defined procedures for creating, maintaining and safeguarding records;
- the records management procedures address the location and maintenance of records relating to project participating agencies;
- there are clearly defined procedures for safeguarding the records from fire, water, other environmental risks, and from unauthorized access;
- there are adequate back-up procedures, particularly with respect to computerized records; and
- there is adequate access to records by authorized persons including auditors and external donor supervision staff.

3. Review of Internal Controls

The reviewer of internal controls should pay specific attention to:

- assessment of both country and project risks to include, inter alia, the overall environment for internal controls (e.g. support for an accountability culture at a high level of government) and organizational risks - presence of honest and capable employees (usually influenced by compensation, education and experience levels);
- ascertaining the strength and identifying weaknesses in the management structure or function;
- determining whether there is accountability to an outside implementation agency or committee;
- ascertaining if there are adequate (a) administrative, accounting and operational procedures for various levels of authority, (b) segregations of duties, (c) controls over assets, and (d) cash management procedures and they are clearly defined; and
- evaluating the general and procedural controls surrounding (a) budget preparation and execution; (b) the operation of the accounting and reporting system; (c) the receipt and disbursement of cash; (d) the maintenance and recording of capital and other assets; (e) procurement and payables; and (f) employee compensation and payroll processing, when applicable to the project.

4. Project Accounting

The reviewer should assess the adequacy of the design of the project accounting system. The system should be capable of providing financial information as required by all donors and relevant parties and of fulfilling all the legal and regulatory requirements of the Borrower country. The accounting standards to be used should be clearly identified and reported to the Bank. Special attention should be given to:

- describing the basis of accounting and ascertaining its appropriateness for the controls and reporting requirements of the project;
- identifying or assisting in the preparation of a chart of accounts that is tailored to the specifics of the project and make it possible to aggregate sources of financing and expenditures under project components, sub components and locations, taking into consideration the requirements of the Borrower, co-financiers, the Bank, and other interested parties;
- reviewing the cost components and sub components to see if they are adequate to measure physical and other monitorable achievements; and
- ensuring that there are arrangements to record contract commitments, expenditures and other information required to track the procurement process.

5. Staffing

The reviewer should assess if an adequate number of staff and management have been identified or hired for the project. The Financial Management Assessment should include an assessment of credentials and experience in accounting to make good judgments on the maintenance of the books of accounts and on the production of financial information. The reviewer should also:

- assess management and staff proposed for the project for having appropriate professional skills and performance, and strong accountability over operations; and
- review policies and experience of the implementing agencies in staff retention, turnover rates and the recruitment process with respect to appropriate qualifications, training opportunities and examine the adequacy of performance review process.

6. Accounting Software

The reviewer should assess the proposed financial software's capabilities to ensure that it:

- can provide data for periodic reporting (monthly, quarterly, annual etc.); by unit or activity; by funding source and expenditure categories; by actual and budget for the period and accumulated to date; to show variance between actual and for the period, accumulated for year, and to date;
- has the ability to work in the currency of the Bank (UA), the Borrower and that of the Special Account;
- has good internal controls, is auditable and will provide transparency; and
- has a good track record for reliability, will be installed on time, will be within budget, and is well supported technically.

7. Audit Arrangements

The reviewer should assess whether the auditor has been identified and plans have been made to appoint the auditor before the commencement of project activities, and to re-appoint the auditor well before the beginning of each fiscal year. The auditing standards to be used should be clearly identified and reported to the Bank. Special attention should be given to:

- reviewing whether the proposed auditor is independent of the entity/project to be audited;
- reviewing whether that the proposed auditor is capable and experienced with respect to this type of project;
- reviewing whether the proposed auditor is appropriately qualified, competent and follows acceptable standards on auditing; and
- reviewing whether an appropriate terms of reference has been drafted, drawing special attention to areas of concern that may not be emphasized under a normal audit (compliance with donor financial covenants and procurement guidelines), and that the auditor is provided with appropriate information on the project (Appraisal Report, Loan/Grant Agreements, etc.).

8. Financial Management Reporting

The review should be comprehensive enough to ascertain whether the project would satisfy African Development Bank requirements for disbursements (e.g. Inadequate Financial and/or Procurement Management). Special attention should be given to:

- documenting the agreed upon formats for project reporting, as well as their frequency and distribution, and for the financial statements as tailored to the specifics of the project); and
- determining whether the project is capable of producing reliable [quarterly] project management reports.

9. Procedures Related to Funding Sources

The reviewer should ascertain and document the mechanisms envisioned for the project to obtain periodic funding from the host government and external donors, including the method planned to draw down funds pledged in legal agreements, as well as arrangements proposed to establish and maintain Special Accounts. Limits and approval procedures should be clearly established, along with procedures to conduct periodic reconciliations.

III. Financial Management Documentation

In conducting the assignment, the reviewer should become familiar with the following project documentation: Project Appraisal Report; Loan/Grant Agreement; Project Financial Management Systems Manual; and Other Bank policies and procedures regarding disbursement, procurement (e.g. Disbursement Manual, etc.)

IV. Deliverables

The reviewer shall prepare a report from their Financial Management Assessment fully documenting and evaluating the project financial management results noted from the work performed in Section II: above. The report (a template format is attached), should include the following information:

- a general report, in accordance with the attached template, which should include a detailed summary of each topic in II, above, as well as an opinion on the financial management system in place and its adequacy to meet Borrower's, external donor's and project management's needs; and
- a listing of findings and recommendations proposed, as well as a realistic time-bound action plan detailing specific steps considered necessary to address inadequacies noted in the project's financial management capacity.

7.14 SHOWCASE PROJECT INITIATIVE

Introduction

7.14.1 Under the stewardship of CHRM, and the coordination of FFMA, the Bank initiated the Showcase Project Initiative (SPI) as part of its ongoing efforts to improve project quality at entry by providing staff with the necessary tools to perform state-of-the art project appraisal through both pedagogical and hands-on training. Specifically, a team of consultants from Queen's University was retained to assist staff conduct enhanced project appraisal on live projects that will be turned into benchmark case studies for the Bank Group.

Integrated Project Appraisal

7.14.2 The analysis of the selected projects is carried out through an integrated approach, covering the evaluation of the financial, economic, stakeholder and risk aspects of each project in a single consistent model. This model also integrates the financial results from the analysis of the project within the overall financial position of the parent Executing Agency (EA).

7.14.3 The central tool of the integrated project appraisal approach is the pro forma cash flow and net economic benefit statement. From these annual inflows and outflows, over the life of the project, are estimated. There are several goals of the appraisal. First, the appraisal seeks to determine if the project will be financially sustainable. The EA, as owner of the proposed project, should expect to recover the initial outlays on the project and to earn a fair rate of return. The debt service coverage ratios are very important indicators of financial sustainability. Secondly, the lenders to the project should feel comfortable with the ability of the project to generate the cash to the EA in order to meet the scheduled debt obligation, as well as, with the ability of the borrower to make timely payments not only on the project in question but also on its overall debt service. Other measures of financial performance such as the unit cost of products produced also provide useful benchmarks for comparing the proposed investment with alternative options.

7.14.4 The pro forma net economic benefit statement constructed from financial appraisal serves as the basis for determining the project's economic feasibility. Within the integrated appraisal framework, the economic analysis is built directly on the financial cashflows of the project and the economic treatment of project benefits is measured by the cost savings expressed in economic terms, consistent with the financial valuation of system cost savings by the EA. The issues that analysis aims to address in the economic analysis are mainly focused on the contribution of the project to the economy of country concerned and economic cost of producing the public goods or services.

7.14.5 In the stakeholder module of the integrated appraisal, the quest is to identify the primary stakeholders affected by the project. What the decision-makers should know is the present value of economic externalities created by this project, and what is the amount of the gain/loss realized by each stakeholder because of the project.


7.14.6 The objective of the sensitivity and risk analysis is to identify the risks the project faces. Project managers, to a certain extent, can control some risk factors while others can only be addressed at the level of the EA and the government of country concerned. There are also some factors that are totally exogenous forces that none of the country institutions can address.


SPI Benchmark Projects

7.14.7 Four Showcase Projects were selected by the SPI working group in cooperation with the consultants from Queen's University and approved by the SPI steering committee. Project selection was based on objective criteria, including: (i) suitability to highlight key project appraisal issues; (ii) geographic and sector mix; (iii) borrower diversity (AfDB/ADF, sovereign/non-sovereign); and (iv) project timing (to fit the six-month SPI window). The four selected projects are: (1) El Kureimat Power Plant (Egypt); (2) Rural Water and Sanitation Initiative (Senegal); (3) Rascom Satellite Telecommunications (Multinational); and (4) Smallholder Agriculture Development (Zambia).

7.14.8 In accordance with the objectives of the SPI, the consultants assisted the Bank's operations departments and other support departments to perform the following three primary tasks: (i) the preparation of full-fledged financial, economic and risk analysis models for four Bank Group Showcase Projects; (ii) the transformation of the four Showcase Projects into AfDB-specific case studies to serve as examples of 'best practices' and provide reference material for future Bank Group appraisal work; and (iii) the development of the AfDB case studies into well-documented teaching materials for use in future training courses both inside the Bank and at external development training centers.

7.14.9 Below, the Appraisal Reports that are an outcome of the SPI can be accessed through the link provided. However, the related case study and teaching materials and the appraisal models are available separately in the Bank as they are too voluminous to link them to these Guidelines.

El Kureimat Power Plant	
Sector	Power
Country	Egypt
Widow	AfDB
Appraisal Report is as follows:	 El-Kureimat.pdf

Rural Water and Sanitation Initiative	
Sector	Water
Country	Senegal
Widow	ADF
Appraisal Report is as follows:	 "Rural Water and Sanitation Initiative.p

Smallholder Production Project	
Sector	Agriculture
Country	Zambia
Widow	ADF
Appraisal Report is as follows:	Not Yet Finalized

Rascom Satellite Telecommunications	
Sector	Telecom
Country	Multinational
Widow	AfDB
Appraisal Report is as follows:	Not Yet Finalized

7.15 RESULTS-BASED COUNTRY STRATEGY PAPER

7.15.1 In June 2005 the Board considered the Results-Based Country Strategy Paper (RBCSP) that among other important innovations requires countries and the Bank country teams to be more explicit about the outcomes that the Bank supported assistance interventions will influence. It also entails better monitoring and evaluation of performances in terms of outcome and allows for a better harmonization and alignment of donors procedures with country monitoring and evaluation system. **The main features of the RBCSP are:**

- **Results Framework:** a planning and management tool that defines the links between strategic development goals and outcomes that are directly influenced by the Bank's programs; thus emphasis is on measurement and management.

- **Monitoring and Evaluation System:** This is part of results framework, which aims at minimizing the burden on country capacity by trying to reduce multiplicity of donors systems. Monitoring is a continuing function that uses systematic collection of data on specified indicators to provide management and the main stakeholders of an ongoing development intervention with indications of the extent of progress and achievement of objectives and progress in the use of allocated funds. Evaluation involves a systematic and objective assessment of an on-going or completed project, program or policy, its design, implementation and results.
- **The RBCSP should be analytic** in its content and orientation: The document should analyze issues and derives logical conclusions.
- **A more systematic stocktaking** self-evaluation using mid-term reviews and CSP completion report.

7.15.2 The RBCSP paper is attached:



7.16 APPRAISAL CHECKLISTS

7.16.1 This section provides generic checklist for the financial appraisal of: a non-revenue earning project; revenue-earning project; and financial intermediary institution. It also provides a checklist to review financial aspects of Appraisal Reports.

Appraisal Checklist for a Non-Revenue-Earning Project

	Activity	Remarks/comments
A.	Preparation at Headquarters	
A.1	Meet with Division Manager and Task Manager to receive briefing on the Bank's approach to defining a non-revenue-earning project with respect to the country, borrower, co-financier(s), project and appraisal mission (OM 600).	
A.2	Study the Country Strategy Paper (OM 330) to understand the role that the project to be designed will fulfil.	
A.3	Study relevant reports on the country profile, institutions to be involved and responsible for the project, and where available, the proposed EA.	
A.4	Study all reports on project identification and preparation including the Country Economist's forecast of local and foreign inflation for the country concerned (OMS 600 Annex 3, paragraph 17).	
A.5	Study relevant reports on country project performance.	
A.6	Study all recent reports on ongoing projects in the sector in the country.	
A.7	Based on steps A.1 to A.6, above, summarize all positive and negative attributes ascribed to country, sector and similar projects.	
B.	Initial Steps	
B.1	Participate in, or where necessary, arrange initial meetings with government counterparts in all organizations likely to be concerned with the project, including counterparts in the EA.	
B.2	Ensure all managers and staff to be involved in project planning and implementation have copies of the Bank's Handbook for Borrowers on Financial Management and Financial Analysis of Projects, the Bank's	

	handbooks on Disbursement and Procurement.	
B.3	Advise on the availability of the Bank's Web site on Governance and the web-based Financial Management and Financial Analysis of Projects guidelines.	
C.	The Institutional Environment	
C.1	Confirm/modify information obtained through readings in section A, above.	
C.2	Determine current organizational and management linkages of central government, state government (where applicable) and sector institutions to be involved in financial aspects of project design, development, implementation and operation.	
C.3	Determine current and/or proposed organizational and financial aspects of the management structure of the existing or proposed EA to be involved in project design, development, implementation and operation	
C.4	Understand the country's financial sector, the role of the central bank and the banking system, and their potential application to/impact on, the project.	
C.5	Determine the capability, capacity and current performance of the accounting and auditing profession in the country, particularly as they will impact on the project.	
C.6	Determine the capability, capacity and current performance of the government audit service, particularly as they will impact on the project.	
C.7	Determine the quality of accounting and book-keeping capability and training in the existing or proposed executing agency.	
C.8	Determine the capability of the financial manager(s) designated to be responsible for the project.	
C.9	Make recommendations for modifications to organizational structures, managements, staffs and training necessary to support the project and, where necessary, prepare an institutional appraisal of the EA to support upgrading of institutional performance. Share recommendations with the Task Manager.	
D	Financial Management Systems	
D.1	<p>Taking into account the conclusions arrived at under C.5 to C.9 above, where there exists an ongoing financial management system, accounting and book-keeping systems, computer/data processing systems, and an internal control environment and systems to support the project, form a judgment on the acceptability, or otherwise, of these systems. Examine the following systems to the extent that they are likely to be necessary to support the project:</p> <ol style="list-style-type: none"> a). Planning and budgeting records b). Payroll including HR records c). Accounts payable d). Accounts receivable e). Taxes and duties f). Inventories g). Project accounting records h). Ledgers and journal systems i). Bank accounts and reconciliations j). Equity records k). Subsidies received l). Grants/Donations records m). Loans received and repayments n). Loans advanced o). Cash management 	

	<p>p). Asset records q). Internal controls and internal audit r). Periodic and annual financial statements s). External auditors' reports and opinions</p>	
D.2	On the basis of examination in D.1, determine the nature and form of the accounting standards in use and their likely acceptability to the Bank. In the event that they would not be acceptable, define the Bank's requirements to counterparts of the EA and the borrower.	
D.3	On the basis of examination in D.1, determine the nature and form of the auditing standards in use and their likely acceptability to the Bank. In the event that they would not be acceptable, define the Bank's requirements to counterparts of the EA and the borrower.	
D.4	In the absence of any of the system elements set out in D.1 above, define new or additional system requirements necessary to support the project and advise a timetable to counterparts for their introduction and full operation, including necessary staff additions and training.	
E.	Definition of Project Cost Requirements	
E.1	Review with counterparts and consultants responsible for project design/preparation the project description and specifications documents in order to understand the likely project components and their related cost elements.	
E.2	Although this project is proposed as non-revenue-earning, review with the Task Manager the possibility of introducing a tariff and charges as part of project design, for meeting all or any critical part of the costs of producing products/outputs/sales, etc., ensuring that such a tariff and charges would encourage cost savings that could be proposed as part of the project and meet forecast inflationary factors.	
E.3	Use appropriate MS Excel models or where available, "COSTAB" software to compile all project costs and procurement documentation.	
E.4	Review with counterparts and consultants responsible for project design/preparation the Project Cost Estimates Table for comprehensiveness, adequacy of structure/descriptions of base cost line items, including annual foreign and local costs, and annual/periodic expenditures including interest during construction, where applicable. Ensure that taxes and duties are clearly defined and capable of being measured for exclusion from Bank financing.	
E.5	Prepare or obtain a country/sector disbursement profile to judge the likely accuracy of the forecasts of proposed expenditures and Bank disbursements.	
E.6	Examine the price contingencies for accuracy with respect to local and foreign costs, including application of appropriate rates of local and foreign inflation in accordance with Country Economist's advice (OM 600, Annex 3 paragraph 17).	
E.7	Examine the physical contingencies for accuracy with respect to appropriate allowances (OM 600 Annex 3 paragraph 9 et seq).	
E.8	Discuss with Task Manager and, where appropriate, with counterparts, the Financing Plan and disbursement profile to determine the total financing requirements, the amount and timing of receipt of each input of funds requirements, the amount of the Bank's proposed total loan/credit proceeds, of receipts from co-financier(s), and from counterpart funds.	
F.	Preparation of Financial Projections and Draft Appraisal Report	
F.1	Determine forecast annual operating costs of the EA that relate to the implementation of the project only, and incorporate inflation as forecast in A.4 above	

F.2	Using information gathered in E.3 to E.9, above prepare a projected combined annual income statement /funds flow /balance sheet for the project period.	
F.3	On the basis of the data gathered in E.3 to E.9 above, compile the FIRR, with appropriate financial performance indicators for the project and, where appropriate, the EA. Discuss proposed indicators with Task Manager and counterparts, explaining logic of selection and methods of calculation	
F.4	With Task Manager, explain in detail to counterparts the method of compilation and the forecast results of all financial statements at all appropriate levels of concerned institutions and managements with the objective of reaching agreement on the Project Cost Estimates Table, the Financing Plan, the financial projections, the financial performance indicators and any tariffs and charges proposed.	
F.5	With the Task Manager, meet with co-financiers at mutually agreed locations (whenever possible, in the presence of counterparts) to explain the method of compilation and the forecast results of all financial statements at all appropriate levels of concerned institutions and managements with the objective of reaching agreement on the Project Cost Estimates Table, the financing plan, the financial projections, performance indicators and any tariffs and charges proposed.	
F.6	Draft the section of the Aide Memoire (OM 600, paragraph 39) relating to all financial aspects of the project and discuss with Task Manager. Make any agreed amendments for presentation of complete Aide Memoire to counterparts at appropriate levels.	
F.7	Draft paragraphs for inclusion in the financial section of the Appraisal Report, and prepare financial annexes to attach to the Appraisal Report. Review with the Task Manager.	

Appraisal Checklist for a Revenue-Earning Project

	Activity	Remarks/comments
A.	Preparation At Headquarters	
A.1	Meet with Division Manager and Task Manager to receive briefing on the Bank's approach to defining a revenue-earning project with respect to the country, the sector, the project and objectives of the appraisal mission (OM600).	
A.2	Study the Country Strategy Paper (OM 330) to understand the role that the project to be designed will fulfil.	
A.3	Study relevant reports on the country profile, institutions to be involved in design, authorization, implementation, and operation of the project, particularly where available, the proposed EA.	
A.4	Study all reports on project identification and preparation. Obtain forecasts of inflation for the country concerned from the Country Economist (OMS 600 Annex 3 paragraph 17).	
A.5	Study all reports on country and sector project performance.	
A.6	Study all reports issued within the past five years on similar projects in the sector in the country.	
A.7	Based on steps A.1 to A.6, above, summarize all positive and negative attributes ascribed to country, sector and similar projects.	
B.	Initial Steps	
B.1	Participate in, or where necessary, arrange meetings with key managers and any counterparts representing managers in the EA to confirm	

	appraisal arrangements/requirements. Make a judgment on the likely efficiency of the managers and the counterpart(s).	
B.2	Participate in, or where necessary, arrange initial meetings with government counterparts in all organizations likely to be concerned with the project, to confirm appraisal arrangements/requirements.	
B.3	Ensure all managers and staff to be involved in project planning and implementation have copies of the Bank’s Handbook for Borrowers on Financial Management and Financial Analysis of Projects, the Bank’s Disbursement Handbook and the Bank’s Procurement Handbook.	
B.4	Advise on the availability of the Bank’s Governance Web Site and the Guidelines on Financial Management and Financial Analysis of Projects	
C.	The Institutional Environment	
C.1	Confirm evidence provided through readings in section A. above	
C.2	Determine current organizational structure and responsibilities with respect to the project of central government, state government(s) and sector agencies that will be involved in project design, development, implementation and operation, for example, Ministries of Finance and Economy, Industrial Production, Planning and Development, Agriculture, Export Guarantee Agency, etc.	
C.3	Determine the likely acceptability to the Bank of current and/or proposed organizational and management structure of the EA and/or consultants involved in preparing the project’s planning, programming, design, development, implementation and operation.	
C.4	Understand the country’s financial sector, the role of the central bank and the banking system, and their probable application to/impact on the project.	
C.5	Explore current status of positive and negative attributes in paragraph A.7, above	
C.6	Determine the capability, capacity and current performance of the country’s accounting and auditing profession as it impacts, or will impact, on the EA and on the project	
C.7	Determine the capability, capacity and current performance of the government auditing profession, particularly the Auditor-General’s Office or equivalent, as it impacts, or will impact, on the EA and on the project.	
C.8	Determine the actual, or forecast anticipated, quality of accounting and book-keeping capability and training in the EA to service the project and EA.	
C.9	Determine the capability of the financial manager(s) designated to be responsible for the project, against the background of paragraphs C.6 to C.8, above.	
C.10	Make recommendations for modifications to organizational structures, financial management(s), accounting /bookkeeping /inventory management staffs and training necessary to support the project and where necessary, prepare an institutional appraisal of the EA to support upgrading of institutional performance. Share findings with the Task Manager.	
D.	Financial Management Systems	
D.1	Taking into account the outcome of paragraphs C.7 – C.10 above, where there exists an ongoing financial management system, accounting and book-keeping systems, computer/data processing systems, and an internal control environment and systems to support the project, form a judgment on the acceptability, or otherwise, of these systems and documentation. Examine the following systems and documentation to the extent that they are likely to be necessary to support the project:	

	<ul style="list-style-type: none"> a). Planning and budgeting records b). Payroll including HR records c). Accounts payable d). Accounts receivable e). Taxes and duties f). Inventories g). Cost of Manufactured goods h). Project accounting records i). Management and Overhead j). Ledgers and journal systems k). Bank accounts and reconciliations l). Records of stock issues and re-purchase m). Investors/Shareholders Records n). Equity records o). Grants/Donations records p). Subsidies received q). Loans received and repayments r). Loans advanced s). Cash management t). Dividends records u). Asset and depreciation records v). Internal controls and internal audit w). Periodic and annual financial statements x). Recent external auditors' reports and opinions <p>In cases where the EA is a public company owned wholly or in part, by the government, the following two additional matters should be reviewed: i) financial clauses of the Articles of Incorporation (or Association) of the Company; and (ii) minutes of company meetings for the past three years (or such other period as may be reasonable) in which financial policy, strategy, decisions and issues were recorded.</p>	
D.2	On the basis of examination in paragraphs C.6, C.8 and D.1, determine the nature and form of the accounting standards in use and their likely acceptability to the Bank. In the event that they would not be acceptable, define the Bank's requirements to counterparts of the EA and the borrower (where applicable).	
D.3	On the basis of examination in paragraphs C.6, C.7, and D.1, determine the nature and form of the auditing standards in use and their likely acceptability to the Bank. In the event that they would not be acceptable, define the Bank's requirements to counterparts of the EA, the existing auditing firm (if it is to be retained for the project) and the borrower (where applicable).	
D.4	In the absence of any, or all, of the system elements set out in D.1 above, define new or additional system requirements and documentation necessary to support the project and advise a timetable to counterparts for their introduction and full operation, including necessary staff additions and training.	
E.	Definition of Project Cost Requirements	
31. E.1	Review with counterparts and consultants responsible for project design/preparation the project description and specifications documents in order to understand the cost of each project component (new assets) and their likely foreign and local costs for each year of implementation, the total cost of each asset for depreciation purposes (including interest during construction) and the forecast date(s) of their commissioning.	
E.2	Review with the Task Manager the likely adequacy and suitability of the	

	existing tariff and charges, or any new tariff and charges developed as part of project design, for products /outputs /sales, etc. ensuring, where necessary, that the tariffs and charges reflect cost savings proposed as part of the project and take account of forecast inflationary factors.	
E.3	Use appropriate MS Excel models or where available, "COSTAB" software to compile all project costs and procurement documentation.	
E.4	Review with counterparts and consultants responsible for project design/preparation the Project Cost Estimates Table for comprehensiveness, adequacy of structure/descriptions of base cost line items, and annual/periodic expenditures including interest during construction, where applicable. Ensure that taxes and duties are clearly defined and capable of being easily defined for exclusion from Bank financing.	
E.5	Use a country/sector disbursement profile to judge the likely accuracy of the forecasts of proposed expenditures and Bank disbursements.	
E.6	Examine the physical contingencies and their legitimacy (OM 600 Annex 3).	
E.7	Examine the price contingencies for accuracy with respect to local and foreign costs, including application of appropriate rates of local and foreign inflation in accordance with Country Economist's advice.	
E.8	Discuss with Task Manager and, where appropriate, with counterparts, the Financing Plan and disbursement profile to determine the total financing requirements, the amount and timing of receipt of each input of funds requirements, the proposed amount of the Bank's total loan proceeds, of receipts from co-financier(s), from internal funds, and from government counterpart funds (where applicable).	
F.	Preparation of Financial Projections for an Ongoing Production Operation	
F.1	Determine actual and forecast physical output statistics and losses (industrial /agricultural products /electricity /water/ telecom, etc.) for at least two completed fiscal years prior to the start of project implementation, for the period of project implementation, and for at least three years of operation.	
F.2	In consultation with the Task Manager and counterparts, as appropriate, apply the tariff and charges gathered in paragraph E.2, above to provide a revenue stream during implementation and thereafter.	
F.3	In consultation with the Task Manager and counterparts, as appropriate, determine a commissioning schedule for the components of the project with related costs, and prepare a depreciation schedule for the assets to be provided by the project.	
F.4	In consultation with the Task Manager and counterparts, as appropriate, if it will be necessary to revalue assets periodically through the implementation period and thereafter to reflect the impact of severe inflation, prepare a forecast depreciation schedule with and without the assets referred to in paragraph F.3, above	
F.5	In consultation with the Task Manager and counterparts, as appropriate, prepare the EA's operating costs with and without the project for at least two completed fiscal years prior to the start of project implementation, for the period of project implementation, and for at least three years of operation and incorporate inflation as forecast in paragraph E.7, above	
F.6	Prepare schedules of interest payments due to lenders.	
F.7	Prepare schedules of loan repayments to lenders.	

F.8	Using the results of paragraphs F.1 – F.6, above compile an Income Statement for at least two completed fiscal years prior to the start of project implementation, for the period of project implementation, and for at least three years of operation.	
F.9	For an ongoing operation - using the following information determined in paragraphs, above: projected annual investments (paragraph E.1), disbursements (paragraph E.8), interest payments (paragraph F.6), loan repayments (paragraph F.7), and the results from the Income Statements (paragraph F.8, - prepare a Cash Flow Statement for at least two completed fiscal years prior to the start of project implementation, for the period of project implementation, and for at least three years of operation.	
F.10	For an ongoing operation - on the basis of audited annual financial statements for two fiscal years prior to implementation and the results of the Income Statement (paragraph F.8, above) and the Cash Flow Statements (paragraph F.9, above), - prepare Balance Sheets for the period of implementation and three years of operation.	
G.	Preparation of Financial Projections for a New Production Operation	
G.1	Determine forecast physical output statistics and losses (industrial /agricultural products /electricity /water /telecom, etc.) for the period of project implementation (if any), and for at least five years of operation	
G.2	In consultation with the Task Manager and counterparts, as appropriate, apply the tariff and charges determined in paragraph E.2, above to provide a revenue stream during implementation and thereafter.	
G.3	In consultation with the Task Manager and counterparts, as appropriate, determine a commissioning schedule for the components of the project with related costs, and prepare a depreciation schedule for the assets to be provided by the project.	
G.4	In consultation with the Task Manager and counterparts, as appropriate, if it will be necessary to revalue assets periodically through the implementation period and thereafter to reflect the impact of severe inflation, prepare a forecast depreciation schedule.	
G.5	In consultation with the Task Manager and counterparts, as appropriate, prepare the EA’s operating costs for the period of project implementation, and for at least five years of operation and incorporate inflation as forecast in paragraph E.7, above.	
G.6	Prepare schedules of interest payments due to lenders.	
G.7	Prepare schedules of loan repayments to lenders.	
G.8	Using the results of G.1 – G.6, above compile an Income Statement for the period of project implementation, and for at least five years of operation.	
G.9	Using the following information determined in paragraphs, above: projected annual investments (paragraph E.1), disbursements (paragraph E.8), interest payments (paragraph G.6), loan repayments (paragraph G.7), and the results from the Income Statements (paragraph G.8), prepare a Cash Flow Statement for the period of project implementation, and for at least five years of operation.	
G.10	On the basis of the results of the Income Statements (paragraph G.8), and the Cash Flow Statements (paragraph 59), prepare Balance Sheets for the period of implementation and five years of operation.	
H.	For All Projects	
H.1	On the basis of data generated in paragraphs F.1 to G.10, above compile appropriate financial performance indicators including the FIRR for the project and, where appropriate, the EA. Discuss proposed indicators with Task Manager and counterparts, explaining logic of selection and	

	methods of calculation.	
H.2	With the Task Manager, explain to counterparts, in detail, the method of compilation and the forecast results of all financial statements at all appropriate levels of concerned institutions and managements with the objective of reaching agreement on the Project Cost Estimates Table, the financing plan, the financial projections and tariffs and charges proposed.	
H.3	With the Task Manager, meet with co-financiers at mutually agreed locations (if possible in the presence of counterparts) to explain the method of compilation and the forecast results of all financial statements at all appropriate levels of concerned institutions and managements with the objective of reaching agreement on the project cost table, the financing plan, the financial projections and tariffs and charges proposed.	
H.4	Draft the section of the Aide Memoire (OM 600 paragraph 39) relating to all financial aspects of the project and discuss with the Task Manager. Make any agreed amendments for presentation of complete Aide Memoire to counterparts at appropriate levels.	
H.5	Draft paragraphs for inclusion in the financial section of the Appraisal Report, and prepare financial annexes to attach to the Appraisal Report. Review with the Task Manager.	

Appraisal Checklist for a Financial Intermediary Institution

7.16.2 Financial Intermediaries (FIs) comprise a wide range of institutions, including Apex institutions that service one or more FIs in a country. FIs may provide services to one or more sectors in a country (agriculture, various categories of industry, etc.), including support to microfinance organizations. The latter may also receive support from the banking sector in a country, with or without FI support. The generic checklist that follows, therefore, should be used with caution and appropriately modified to address the nature and form of the FI that is under appraisal.

	Activity	Remarks/comments
	Preparation at Headquarters	
A.1	Meet with Division Manager and Task Manager to receive briefing on the Bank's approach to funding FIs in the country, the sector (e.g. agriculture, industry, etc), the objectives of the project and of the appraisal mission.	
A.2	Study the Country Strategy Paper (OM 330) to understand the role that the project to be designed will fulfil.	
A.3	Study relevant reports on the country profile, institutions to be involved in design, authorization, implementation, and operation of the project, particularly where available, the proposed FI.	
A.4	Study all reports on project identification and preparation.	
A.5	Study all relevant reports on country and sector project performance.	
A.6	Study all reports issued within the past five years on similar FI projects in the country.	
A.7	Based on steps A.1 to A.6, above, summarize all positive and negative attributes ascribed to country, sector and similar projects	
B.	Initial Steps	
B.1	Participate in, or where necessary, arrange meetings with key managers and any counterparts representing managers in the FI to confirm appraisal arrangements/requirements. Make a judgment on the likely efficiency of the managers and the counterpart(s).	

B.2	Participate in, or where necessary, arrange initial meetings with government counterparts in all organizations likely to be concerned with project development, to confirm appraisal arrangements/requirements. Organizations may include the Central Bank, Ministry of Economy, Ministry of Finance, sector ministries (Agriculture, Industry), Ministry of Trade and Industries, etc.	
B.3	Ensure all managers and staff to be involved in project planning and implementation have copies of the Bank’s Handbook for Borrowers on Financial Management and Financial Analysis of Projects, the Bank’s Disbursement Handbook and the Bank’s Procurement Handbook.	
B.4	Advise on the availability of the Bank’s Governance Web site and the web-based Guidelines on Financial Management and Financial Analysis of Projects	
C.	The Institutional Environment	
C.1	Confirm evidence provided through information gathered from paragraphs A.1 to A.6, above.	
C.2	Determine current organizational structure and management position responsibilities, with respect to the FI and the project, of central government, state government(s) and sector agencies that will be involved in project design, development, implementation and operation, for example, Central Bank, Ministries of Finance and Economy, Industrial Production, Planning and Development, Agriculture, Export Guarantee Agency, etc.	
C.3	Determine the likely acceptability to the Bank of current and/or proposed organizational and management structure of the FI and/or consultants involved in preparing the project’s planning, programming, design, development, implementation and operation.	
C.4	Understand the country’s financial sector, the role of the central bank and the banking system, and their probable application to/impact on the FI and the project.	
C.5	Understand the role that the FI plays within the financial sector, for example, is it an apex institution serving one or more FIs? Is it a microfinance institution serving a specific small sectoral or regional/local group of clients? Is it a narrowly focused operation for a sub-sector such as textiles?	
C.6	Determine the capability, capacity and current performance of the country’s accounting and auditing profession as it impacts, or will impact, on the FI and on the project.	
C.7	In countries where the government audit service is required to audit the activities and financial statements of a FI, determine the capability, capacity and current performance of the government auditing profession, particularly the Auditor-General’s Office or equivalent, as it impacts, or will impact, on the FI and on the project.	
C.8	Determine the actual, or forecast anticipated, quality of accounting and book-keeping capability and training in the FI to service the FI and the project.	
C.9	Determine the capability of the financial manager(s) designated to be responsible for the project, against the background of paragraphs C.6 through C.8 above.	
C.10	Make judgments as to required modifications to the FI’s organizational structures, lending operations, cash management, risk management, financial accounting /bookkeeping /management and staffs, and training necessary to support the project and where appropriate recommend for inclusion as a component in the project for appraisal.	

	Share findings with the Task Manager.	
D.	Management Policies and Systems	
D.1	<p>Examine the following policies, systems and documentation to the extent that they are likely to be necessary to support the FI and the project:</p> <p>1. Soundness and Clarity of Management Policy</p> <p>a). Soundness, rationality, and integrity of management policy: <i>Has management established a sound and rational policy (short- and long-term strategies) with full consideration given to current and future management conditions?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • When drawing up management policy, does the management take into consideration soundness, rationality, and feasibility? • Is the management policy integrated? <p>b). Clarity and permeability of management policy: <i>Is management policy clear and well understood, and does it function well?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Is the management policy clear with respect to criteria for action by each department? • Is the policy well understood throughout the entire organization, and does it function well? • Does the FI compile a medium- and long-term business plan (e.g., every 3-5 years)? • Does the FI compile a business plan (annually or semi-annually)? • Does the department in charge of management planning regularly monitor the level of accomplishment and make necessary adjustments? <p>2. Permeability of Risk Management Policy</p> <p>a). Understanding of risk management: <i>Does the management accurately recognize the types of risk and risk exposure inherent in the bank's portfolio and understand the method of risk management, and has it encouraged the FI to establish full awareness of the importance of risk control throughout the FI?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Does the management have high professional moral standards and make efforts to establish awareness of the importance of internal controls among employees? • Does the management recognize internal and external factors constituting potential risks to the FI, and is the management aware of the different types and degrees of risk and risk exposure inherent in these factors? • Does the management recognize different risk management methods according to the types of risk and risk exposure? • Does the management set limits to the acceptable amount or degree of risks inherent in the FI and adequately instruct relevant sections? 	

<p>b). Basic strategy for risk management: <i>Is the management actively involved in drawing up strategies and establishing the framework for risk management giving due consideration to the balance between various risks to FI's capital and also the strategic importance of its risk-taking?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Is the management clearly aware of its responsibility for drawing up appropriate and adequate risk management policy? • Does the board of directors decide basic policy vis-à-vis risk-taking and risk control giving due consideration to the balance between various risks to the FI's capital as well as each business operation? • Does the management regularly check the effectiveness of its risk management system? • Does the management possess the necessary framework, system, and procedures for identifying, monitoring, and controlling various risks? • Does the management aim to build a comprehensive risk management system on an institution-wide basis? <p>c). Diversification of risks: <i>Does the FI diversify risks in the operation of its various businesses?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Is the FI aware of the necessity of diversifying fund-raising sources and investment vehicles? • Does the FI have in place an organization and operational framework that further emphasizes the importance of risk management rules and regulations such as limit on exposure to a single borrower? • Does the FI avoid excessive dependency on a specific counter-party in its business operation? • Is it possible to monitor risks so as to detect any mal-distribution? <p>d). Countermeasures against payment failure of other FIs: <i>Does the management understand the effects of payment failure by other FIs and resulting instability of the financial system, and have in place appropriate countermeasures?</i></p> <p>Sample supporting question:</p> <ul style="list-style-type: none"> ▪ Does the FI have in place countermeasures against payment failure by other FIs or resulting financial system instability? <p>3. Internal Controls: Organization, Delegation of Authority, and Reporting System</p> <p>a). Organization: <i>Is the FI adapting its organization so as to strengthen the risk management system and to implement flexible countermeasures to meet changes in the financial environment?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Is the FI adapting its organization and staff allocation so as to strengthen the risk management system? • Is the burden of responsibility regarding business operations 	
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	<p>and risk management clearly defined?</p> <ul style="list-style-type: none"> • Does the FI have in place a system that can control risk exposure while responding to economic change by utilizing research department data? • Does the FI have in place an internal control system capable of swiftly and adequately dealing with newly recognized risks arising from changes in the environment, etc.? • Is the FI aware of the necessity for organizational reform in line with changes in the environment, etc., and is there a department responsible for planning and implementing measures in response to such changes? • Does the institution-wide risk management section regularly assess the effectiveness of the FI's overall risk control system? <p>b). Separation of responsibilities: <i>Are the framework and procedures for decision-making clarified? Are delegation of authority and allocation of responsibilities conducted appropriately from the standpoint of securing a double-checking system and avoiding conflict of interest? Are these procedures clearly stipulated in the internal rules for delegation of authority?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Are internal rules for the delegation of authority rational from the standpoint of securing double-checking of operations and risk control in line with business expansion? • Has the FI confirmed that there is no excessive concentration of authority nor extreme delegation of authority to subordinates? • Does the FI have in place a framework where monitoring and evaluation of major risks are conducted by a specializing section independent from the business promotion department? • Are risk management responsibilities clearly defined among the board of directors, ALM committee, directors in charge, and department heads? • Does the department head keep to the unavoidable minimum the range of duties where a sufficient double-checking system cannot be applied, and does the FI have in place a system for close monitoring? <p>c). Reporting of business information: <i>Does the FI have in place an appropriate reporting by which the management can receive valuable information on business operations and risk management? Are decisions made by the management clearly understood by the entire organization?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Does the FI have in place an appropriate reporting system by which directors in charge and the board of directors receive information on business operations and risk management without undue delay? • Does the FI have a consistent reporting format, giving due consideration to easy comprehension and coherency of contents? • Are decisions made by directors in charge and the board of 	
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	<p>directors adequately communicated to, and understood by, concerned sections (including domestic and overseas branches)?</p> <ul style="list-style-type: none"> • Does the FI have in place a regular reporting system to senior officers and management regarding risk management? <p>4. Staff Recruitment and Training</p> <p>a). Staff recruitment: <i>Does the FI recruit staff with appropriate experience, skill levels, and degree of expertise to undertake, specialized business operations?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Does the FI recruit staff with appropriate experience, skill levels, and degree of expertise to undertake specialized business operations, in particular, those risk management? • Do staff members actively take part in business operations in line with their position and responsibilities? • Does the FI recruit staff based on an employment plan? <p>Sample supporting questions:</p> <p>b). Training: <i>Does management have a clear staff-training policy?</i></p> <ul style="list-style-type: none"> • Does the on-the-job training (OJT) program function adequately? • Does the FI have training programs according to qualifications and job description? • Does the FI revise training programs in accordance with changes in business operation and sophistication of risk management? <p>5. Internal Audit</p> <p>a). Audit system: Does the FI conduct effective internal audits (headquarters audit and in-house audit) to enhance its risk management system and check the thoroughness of internal rules?</p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Are the frequency, checkpoints, and scope of internal audits adequate? • Does the internal audit section/department have auditors with expertise in each business area, and are they able to effectively audit the FI's overall operation? • Does the internal audit section/department have access to all relevant documents and vouchers? • Does the FI conduct regular internal audits of all departments including headquarters and of all operations excluding those that are considered customarily exempted from auditing? • Is the internal audit section/department completely independent from other sections/departments, and does it directly report to the management? <p>b). Follow-up of audit: <i>Does the management give prompt and adequate attention to audit results, and take appropriate measures if problems are detected?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Are internal audit results reported to the management 	
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	<p>promptly and accurately?</p> <ul style="list-style-type: none"> • Is information useful for improvement of operations regularly passed on to concerned departments such as the operations planning department? • Does the internal audit section/department take the initiative in directing improvement measures such as the revision of internal rules in order to prevent the reoccurrence of problems? • Does the management appropriately monitor whether improvement measures directed to sections/departments are carried out? <p>6. Profit and Loss Management</p> <p>a). Monitoring of profit/loss: Do the management and individual departments within the organization monitor profit/loss while considering the balance between risk and return? Sample supporting questions:</p> <ul style="list-style-type: none"> • Does a specialized department (e.g., the financial department) monitor profit/loss from various viewpoints such as profit by customer and branch, and on a consolidated basis? • Does each department manage profit/loss bearing in mind the allocation of indirect costs? • Is due consideration given to risk profiles when assessing and determining profit/loss conditions? • Is there a computerized support system for profit/loss management (e.g., cost accounting of deposits and lending)? <p>b). Distribution of management resources taking into account risk and return: <i>Is due consideration given to the balance between risk and return, and between risk and the FI's capital when distributing management resources to each department?</i> Sample supporting questions:</p> <ul style="list-style-type: none"> • Does the FI thoroughly assess capital and other resources before embarking on a new business? • Does the management appropriately decide the resources distribution policy based on regular profit/loss reports? • Are limits on risk exposure set for each department taking into consideration the FI's capital? <p>c). Rational pricing: <i>Is pricing of deposit and lending rates rational in view of operational/profit planning, market conditions, and risks?</i> Sample supporting questions:</p> <ul style="list-style-type: none"> • Is the differential between actual market rates and pricing of deposit, lending, and derivatives rates within a rational range? • Is delegation of authority relating to pricing clearly defined? • In pricing, is consideration given not only to operations, profit, and market conditions, but also operating cost, credit spread, and embedded option premium for premature cancellation? <p>7. Risk Management of Affiliated Companies</p>	
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a). Monitoring of profit/loss on a consolidated basis including affiliated companies: *Is financial performance monitored appropriately on a consolidated basis or on the basis of including affiliated companies (but not consolidating)?*

Sample supporting questions:

- Is financial performance monitored on a consolidated basis with full understanding of the business performance of companies subject to consolidated accounting?
- Is financial performance monitored appropriately on the basis of including affiliated companies not subject to consolidated accounting taking into consideration degree of business affiliation?
- Is there a section responsible for monitoring the business operations of affiliated companies (including non-bank financial institutions)?
- Is the FI capable of checking unusual activities such as large fund transfers among affiliated companies?
- Does the head office fully recognize the risk profiles inherent in overseas affiliated companies?
- Does the FI regularly monitor risks to which domestic and overseas affiliated companies are exposed to ensure that they are within a rational range in relation to their financial strength such as capital?

8. Establishment of Compliance Framework

a). Management understanding of legal compliance and action to achieve it: *Does the management fully recognize the importance of complying with laws and regulations, market rules, and internal rules? Are they taking the initiative in raising compliance awareness?*

Sample supporting questions:

- Does the management fully understand that insufficient compliance can impair the management base?
- Is the top management making efforts to ensure that recognition of the importance of compliance penetrates throughout the FI?
- Is the management fully aware which FI operations are most likely to cause problems in terms of compliance?
- When starting a new operation, does the management take into consideration of newly arising risks in the area of compliance?

b). Establishment and implementation of a framework for compliance: *Has the FI established a framework and concrete procedures (a compliance program) to ensure consistent compliance? Are they appropriately implemented?*

Sample supporting questions:

- Are responsibilities with respect to compliance clarified by appointing an executive director and setting up a responsible coordination department?
- Are matters regarding compliance such as planning and monitoring under centralized control?
- Does the FI have in place concrete procedures (i.e., planning

	<p>of education and training programs, compiling codes of conduct and compliance manuals, drawing up internal rules, etc.) that effectively initiate compliance?</p> <ul style="list-style-type: none"> • Do FIs with overseas branches have a compliance officer for each country who regularly monitors local legal changes? • Has the FI appropriately placed a person in charge of compliance in relevant departments and clearly stipulated their job descriptions in the allocation of duties? • Have these positions been effectively put into practice (i.e., implementation of training programs and educational activities, consultation, and inspection in the event of any doubtful contradictions to rules, swift reporting to the coordinating department)? • In the development and sales of new products, does the coordinating department confirm the legal compliance of its content and policy of customer explanation in advance? • Does the FI maintain close contact with its lawyers with a view to forestalling trouble and dealing with any incident appropriately and swiftly? <p>c). Monitoring and reporting to management: <i>In addition to monitoring, does a department independent of operations sections conduct checks on compliance? Are lawsuits and problems that could harm the FI's reputation appropriately reported to the management?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Is the compliance consistency in each type of FI business monitored by compliance officers and in-house audits on a daily basis? • Does the compliance officer promptly and appropriately report the compliance consistency and problems in each operation section to the coordinating department? • Does a department (i.e., internal audit department) independent from operation sections and a coordinating department regularly examine the compliance consistency? • Does the coordinating or internal audit department promptly and appropriately report the compliance consistency and problems to the management and auditors (or auditors committee)? • Are incidents and accidents swiftly reported to the supervisory authorities? • Is the credibility of the content of reports sent to other authorities assured? • Are summaries of customer complaints or lawsuits sent to branches in order to forestall problems? <p>9. Disclosure and Accounting Process</p> <p>a). Active disclosure of financial information and restraints on management: <i>From the standpoint of fulfilling accountability to customers and shareholders, does the management actively and fairly disclose financial information? Is the management sufficiently monitored internally and externally in order to secure business operations?</i></p>	
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	<p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Are the FI’s management policy and strategies made widely known through disclosure magazines and other management means? • Are major indicators of the FI’s performance accurately disclosed? • Do the board of directors and auditors (or auditors committee) function appropriately to secure proper execution of business by the management? When required, does the FI appoint external board members and set up a compliance committee? • Does the management take due notice of the opinions of external auditors (letters of advice on improvement of internal control, i.e., management letters)? Does the management examine and implement appropriate improvement measures? • Does the FI actively initiate relations with investors, by for example, conducting briefings about its business performance for investors? <p>b). Appropriate accounting procedures: <i>Is the FI’s processing of daily accounts and annual financial statements sound?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Is the processing of daily accounts carried out properly? • Are annual financial statements produced in accordance with International Accounting Standards (IAS)? • Is there any unsound accounting manipulation of statements (i.e., figures subject to financial statements and disclosure) such as carrying over of losses that should be realized? • Are the required amounts of write-offs and provisioning determined by self-assessment appropriated in the financial statements? • Are soundness of accounting principles and reliability of financial statements secured through adequate auditing? <p>10. Compilation and Understanding of Contingency Plan</p> <p>a). Compilation of a contingency plan: <i>Has the FI drawn up a counter-measure (contingency plan) against disasters and accidents?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Has the FI drawn up a comprehensive plan for the head office and all branches, and is there a manual for it? • Is there a section responsible for drawing up and coordinating the plan? <p>b). Understanding of the plan: <i>Are the management and the staff fully aware of the contingency plan, and do they fully understand it?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Is the management aware of the plan, and do they fully understand it? • Are staff aware of the plan, and do they fully understand it? • Is the plan approved by the board of directors? <p>c). Content of the plan: <i>Does the contingency plan enable the FI to continue its operations in case of an emergency?</i></p>
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	<p>Sample supporting questions:</p> <p>(i) <i>Managerial factors:</i></p> <ul style="list-style-type: none"> • Does the plan give due consideration to the safety of customers and employees in case of an emergency? • Does the plan clearly designate an emergency headquarters to be in charge of dealing with a crisis? • Does the plan assess the degree of impact an emergency will have on operations? • Does the plan clearly designate the priority level of each operation, delegation of authority, and arrangements for obtaining the necessary staff in case of an emergency? • Does the plan clearly state the order and method of contacting management and staff in case of an emergency? • Does the FI have a means of communication with entities operating payment systems and supervisory authorities, etc., in case of an emergency? • Does the FI have in place a public relations network (including the use of mass communications) directed at customers in case of an emergency? <p>(ii) <i>Material factors:</i></p> <ul style="list-style-type: none"> • Does the plan take into consideration electricity, water, and food supply? • Does the plan clearly designate the necessary action to protect assets such as securing a warehouse to store things and deciding the evaluation procedure for damaged property? • Has the FI secured backup data in a vault and/or distant location? • Does the FI have in place a backup center or a backup contract with trustworthy subcontractors or other FIs? • Has the FI secured multiple communications methods using private lines between the head office and branches, and between the computer center and branches? • Has the FI secured countermeasures (i.e., alternative office space, etc.) in the event of an emergency (in particular, for overseas branches)? <p>d). Review and on-site drilling of the plan: <i>Does the FI have a system for reviewing the contingency plan when appropriate, and are on-site drills conducted regularly?</i></p> <p>Sample supporting questions:</p> <ul style="list-style-type: none"> • Does the FI have a system to review the plan when necessary? • Are on-site drills conducted regularly at the head office against possible shutdown of the system? • Are on-site drills conducted regularly at both the head office and branches? • Are results of on-site drills reported to management after appropriate assessment, and utilized in reviewing the plan? 	
D.2	<p>On the basis of examination in paragraphs C.6, C.8, and D.1 above, determine the nature and form of the accounting standards in use and their likely acceptability to the Bank. In the event that they would not be acceptable, define the Bank’s requirements to counterparts of the FI and the borrower (where applicable).</p>	

D.3	On the basis of examination in paragraphs C.6, C.7, and D.1, determine the nature and form of the auditing standards in use and their likely acceptability to the Bank. In the event that they would not be acceptable, define the Bank’s requirements to counterparts of the FI, the existing auditing firm (if it is to be retained for the project) and the borrower (where applicable).	
D.4	In the absence of any, or all, of the management policies and systems set out in D.1 above, define new or additional management policies and systems requirements and documentation necessary to support the FI and the project and advise a timetable to counterparts for their introduction and full operation, including necessary staff additions and training.	
E.	Definition of Project Cost Requirements	
E.1	Review with counterparts and consultants responsible for project design/preparation the project description and specifications documents in order to understand the cost of proposed sub-projects and similar components (new sub-loans) and the likely foreign and local costs for each year of new advances.	
E.2	Review with the Task Manager the likely adequacy and suitability of the existing interest rate spread, or any new spread that needs to be instituted as part of project design, for on-lending of Bank loan proceeds, etc. ensuring, where necessary, that the charges reflect any operating cost savings proposed as part of the project and take account of forecast inflationary factors.	
E.3	Review with counterparts and consultants responsible for project design/preparation the Project Cost Estimates Table for comprehensiveness, adequacy of structure/descriptions of base cost line items, and annual/periodic funds flows. Ensure that any taxes and duties to be funded by sub-loans are clearly defined and capable of being easily defined for exclusion from Bank financing.	
E.4	Examine any proposed physical contingencies and their legitimacy.	
E.5	Discuss with Task Manager and, where appropriate, with counterparts, the Financing Plan to determine the total financing requirements, the amount and timing of receipt of each input of funds requirements, the proposed amount of the Bank’s proposed total loan proceeds, of receipts from co-financier(s), from internal funds, and from government’s counterpart funds (where applicable).	
F.	Preparation of Financial Projections for an Ongoing FI Operation	
F.1	Determine the FI’s operating objectives for at least two completed fiscal years prior to the start of project implementation and the extent of their fulfilment, and reasons for any shortcomings.	
F.2	Examine and determine the feasibility of, and acceptability to the Bank of, the FI’s operating objectives for the period of project implementation and its forecast for the next two following years.	
F.3	Review the portfolio of performing and non-performing loans, paying specific attention to adverse commentaries (if any) by the external auditor.	
F.4	Review the actual ongoing performance and past statistics relating to recoveries, bad debts, and provisions, particularly the adequacy of the latter.	
F.5	Review the status and performance of equity participations and the realism (realisability, earning capacity) of the related entries in the FI’s financial statements.	
F.6	Review the adequacy of the FI’s interest rate spreads to meet all	

	obligations.	
F.7	Examine for reasonableness and profitability the FI's proposed term lending program using the Bank loan proceeds and other resources	
F.8	Examine the FI's proposed equity participation program using the Bank loan proceeds and other resources.	
F.9	Measure the resilience, earning capacity, and security of the FI's past, ongoing and proposed short-term lending program and its actual and proposed sources of funding.	
F.10	Examine the continuing feasibility /profitability of the FI's current and proposed leasing program and its actual and proposed sources of funds.	
F.11	In consultation with the Task Manager and counterparts, as appropriate, if it will be necessary to revalue assets periodically through the Bank loan period and thereafter to reflect the impact of severe inflation, prepare a forecast of the impact on lending operations.	
F.12	In consultation with the Task Manager and counterparts, as appropriate, prepare the FI's operating costs with and without the project for at least two completed fiscal years prior to the start of project implementation, for the period of Bank loan disbursement, and for at least two years of operation and incorporate impacts of inflation forecasts.	
F.13	Review the FI's status and performance of schedules of interest payments due to lenders.	
F.14	Review the FI's status and performance of loan repayments to lenders.	
F.15	Examine the reliability of the system of liquidity (cash) management and determine the number of occasions when cash reserves were depleted to dangerous levels in the most recent two years without available recourse.	
F.16	<p>Compile the following financial statements for at least two completed fiscal years prior to the start of loan signing, forecasts for the period of loan disbursement, and forecasts for at least three years thereafter.</p> <ul style="list-style-type: none"> a). Income Statement b). Cash Flow Statement(or Sources and Uses of Funds) c). Balance Sheet d). Capital Adequacy Analysis e). Portfolio of Investments at year-end f). Schedule of non-performing assets showing: (i) non-performing not rescheduled; (ii) non-performing rescheduled but not performing; (iii) non-performing equity investments; and (iv) non-performing leases. g). Analysis of Income and Earnings showing % of average assets by categories h). Losses experience by sector/activities i). Credit Risk Management j). Liquidity and Interest Rate Sensitivity Management k). Statement of Changes in Shareholders' Equity l). Provisions for Losses, Write-offs and Recoveries m). Schedule of Collateral and Securities 	
F.17	Review the records of VaR and prepare a chart showing significant at-risk dates and amounts at risk in the two years prior to appraisal.	
F.18	On the basis of generated data in paragraphs F.1 through F.16 above, compile appropriate financial performance indicators for the FI. Discuss proposed indicators with the Task Manager and counterparts, explaining logic of selection and methods of calculation.	
F.19	With Task Manager, explain in detail to counterparts the method of	

	compilation and the forecast results of all financial statements at all appropriate levels of concerned institutions and managements with the objective of reaching agreement on the Project Cost Estimates Table, the financing plan, the financial projections, interest spreads, and lending conditions proposed.	
F.20	With the Task Manager, meet with co-financiers at mutually agreed locations (if possible in the presence of counterparts) to explain the method of compilation and the forecast results of all financial statements at all appropriate levels of concerned institutions and managements with the objective of reaching agreement on the Project Cost Estimates Table, financing plan, the financial projections and interest spreads, and lending conditions proposed.	
F.21	Draft the section of the Aide Memoire (OM600 para 39) relating to all financial aspects of the project and discuss with the Task Manager. Make any agreed amendments for presentation of complete Aide Memoire to counterparts at appropriate levels of authority.	
F.22	Draft paragraphs for inclusion in the financial section of the Appraisal Report, and prepare financial annexes to attach to the Appraisal Report. Review draft with the Task Manager.	

Financial Review Checklist for Appraisal Report (AR)

7.16.3 The following checklist is for reviewing ARs. Items resulting in ‘NO’ answers should be resolved to the financial analyst’s satisfaction. When reviewing projects, it is important to review the lessons learned from the past. In this respect, the first section of the checklist (lessons from past projects) provides guidance on the issues that should be examined. The remaining sections apply to the project under appraisal.

	Yes	No
A. Lessons from Past Projects		
1. Were finance-related covenants met (for instance, revenue-generating targets, following up on agreed financial restructuring, adhering to expected financial ratios etc)?	<input type="checkbox"/>	<input type="checkbox"/>
2. Were counterpart funds made available on a timely basis?	<input type="checkbox"/>	<input type="checkbox"/>
3. Were adequate funds made available for operations and maintenance (O&M)?	<input type="checkbox"/>	<input type="checkbox"/>
4. Were Financial Statements and Auditor reports submitted in a timely manner?	<input type="checkbox"/>	<input type="checkbox"/>
5. Were auditors’ reports unqualified?	<input type="checkbox"/>	<input type="checkbox"/>
6. Was there an absence of weaknesses in handling finances or in procurement?	<input type="checkbox"/>	<input type="checkbox"/>
7. Were onlending and relending activities free of problems?	<input type="checkbox"/>	<input type="checkbox"/>
8. Were capacity-building programs effective in relation to financial management?	<input type="checkbox"/>	<input type="checkbox"/>
B. Project Cost Estimates		
1. Has the Project Cost Estimates Table summary been prepared in accordance with these Guidelines?	<input type="checkbox"/>	<input type="checkbox"/>
2. Are detailed project cost estimates available and have they been prepared in accordance with these Guidelines?	<input type="checkbox"/>	<input type="checkbox"/>
3. Are the assumptions that support the estimates available and do they appear reasonable?	<input type="checkbox"/>	<input type="checkbox"/>
4. Have Local and Foreign costs been properly identified?	<input type="checkbox"/>	<input type="checkbox"/>
5. Are the physical and price contingency provisions adequate?	<input type="checkbox"/>	<input type="checkbox"/>
C. Financing Plan (FP)		
1. Has the FP summary table been prepared in accordance with these Guidelines?	<input type="checkbox"/>	<input type="checkbox"/>

2. Do relending and onlending arrangements appear to be reasonable?	<input type="checkbox"/>	<input type="checkbox"/>
3. Does the FP indicate that adequate counterpart funds will be available in a timely manner?	<input type="checkbox"/>	<input type="checkbox"/>
4. Are local cost financing arrangements in line with Bank policy?	<input type="checkbox"/>	<input type="checkbox"/>
D. Executing Agencies (EA) and Implementing Agencies (IA)	Yes	No
1. Has the past financial performance of the EA/IA been analyzed?	<input type="checkbox"/>	<input type="checkbox"/>
2. Has a ratio analysis of the EA/IA financial statements been conducted?	<input type="checkbox"/>	<input type="checkbox"/>
3. Are the financial management capabilities of EA and IA adequate?	<input type="checkbox"/>	<input type="checkbox"/>
4. Are properly trained and qualified staff in place to manage finances?	<input type="checkbox"/>	<input type="checkbox"/>
5. If there are other ongoing operations, have financial details been provided and are these reasonable?	<input type="checkbox"/>	<input type="checkbox"/>
6. Have EA/IA budgets and forecasts (excluding the project) been provided?	<input type="checkbox"/>	<input type="checkbox"/>
7. Does the EA/IA have processes in place to prepare or update budgets and forecasts on a regular basis?	<input type="checkbox"/>	<input type="checkbox"/>
8. Where the EA/IA is not a government department, state government body or local government body; is its capital adequate to support operations and to execute or implement the project?	<input type="checkbox"/>	<input type="checkbox"/>
E. Financial Projections	Yes	No
1. Have the assumptions and bases that underlie the financial projections (e.g., cash flows, income, expenses and other financial projections) been provided?	<input type="checkbox"/>	<input type="checkbox"/>
2. Are the assumptions that underlie the financial projects reasonable?	<input type="checkbox"/>	<input type="checkbox"/>
3. Are provisions adequate (for instance, bad debts, non-revenue water and power supplies, and technical losses)?	<input type="checkbox"/>	<input type="checkbox"/>
4. If the projections were prepared by the financial analyst or by consultants, does the borrower “own” the projections?	<input type="checkbox"/>	<input type="checkbox"/>
F. Financial Analysis	Yes	No
1. Have the detailed FIRR calculations been undertaken in accordance with these Guidelines?	<input type="checkbox"/>	<input type="checkbox"/>
2. Are the detailed FIRR calculations reasonable?	<input type="checkbox"/>	<input type="checkbox"/>
3. Have the detailed WACC calculations been undertaken in accordance with these Guidelines?	<input type="checkbox"/>	<input type="checkbox"/>
4. Are the detailed WACC calculations and assumptions reasonable?	<input type="checkbox"/>	<input type="checkbox"/>
5. Does FIRR exceed WACC and, if not, are there reasonable justifications for proceeding with the project?	<input type="checkbox"/>	<input type="checkbox"/>
6. Have sensitivity analyses been conducted in accordance with these Guidelines?	<input type="checkbox"/>	<input type="checkbox"/>
G. Project Justifications	Yes	No
1. Is the project financially sustainable?	<input type="checkbox"/>	<input type="checkbox"/>
2. Have cost-recovery mechanisms and pricing issues been adequately considered?	<input type="checkbox"/>	<input type="checkbox"/>
3. Has an affordability study been conducted on proposed prices (tariffs)?	<input type="checkbox"/>	<input type="checkbox"/>
H. Accounting and Auditing	Yes	No
1. Have arrangements been made to ensure the timely submission of quarterly reports?	<input type="checkbox"/>	<input type="checkbox"/>
2. Have actions been taken to select and engage auditors in accordance with these Guidelines?	<input type="checkbox"/>	<input type="checkbox"/>
3. Have arrangements been made to support the timely submission of audited annual reports (within six to nine months) including audit reports on special agreements?	<input type="checkbox"/>	<input type="checkbox"/>

4. If in the past government audits were either not satisfactory or not available, has the appointment of private auditors and funding to cover cost of such appointments been considered?	<input type="checkbox"/>	<input type="checkbox"/>
I. Procurements and Disbursement Arrangements	Yes	No
1. Has adequate attention been given to anticorruption measures?	<input type="checkbox"/>	<input type="checkbox"/>
2. Are adequate fund reimbursement procedures in place (in accordance with Bank requirements)?	<input type="checkbox"/>	<input type="checkbox"/>
J. Finance-Related Risks	Yes	No
1. Have risks regarding the timely availability of adequate counterpart funds been minimized?	<input type="checkbox"/>	<input type="checkbox"/>
2. Have risks regarding the timely availability of adequate funds for operations and maintenance been minimized?	<input type="checkbox"/>	<input type="checkbox"/>
3. Have risks regarding the availability of staff to manage financial management activities been minimized?	<input type="checkbox"/>	<input type="checkbox"/>
K. Assurances	Yes	No
1. Have adequate assurances been obtained in relation to measures to counter finance-related risks (see above)?	<input type="checkbox"/>	<input type="checkbox"/>
2. Have adequate assurances been obtained that proposed pricing formulas will be implemented?	<input type="checkbox"/>	<input type="checkbox"/>
3. Have adequate assurances been obtained that efficiency improvements and capacity building in relation to financial management will be undertaken?	<input type="checkbox"/>	<input type="checkbox"/>
4. Have adequate assurances been obtained that financial covenants will be implemented and monitored as agreed?	<input type="checkbox"/>	<input type="checkbox"/>

7.17 AUDIT

The Terms of Reference for Auditors

7.17.1 The following sample Terms of Reference for Auditors (TOR) is an extract from Chapter 5: Financial Reporting and Auditing (pages 81 – 84) of the following OECD publication: **Harmonising Donor Practices for Effective Aid Delivery**, Good Practice Papers, A DAC Reference Document, OECD 2003 (see section 7.7, of this Chapter of these Guidelines).

Specimen Terms of Reference for External Auditors of Donor-supported Projects and Sector Programmes

Audit responsibilities

This “Specimen Terms of Reference (TOR) for Donor-Supported Projects and Sector Programmes” is intended to provide guidance to the staff of governments and donors in agreeing terms of reference for donor-supported activities. It should not be seen as universally applicable to all donor-supported projects. Those components that are considered appropriate for a particular project should be selected, inappropriate items omitted, and additional matters included, where considered necessary.

Background

The background section of the TOR should include a brief summary of government accounting and financial management practices. It should include a general description of the supervising agency (often a Ministry of the Government or Department within a Ministry) and the executing agency (often a department or division within a Ministry) and should include a statement of their economic goals. There should be a broad description of the project in the context of its contribution to achieving the goals of the executing agency. The auditor should understand the “purpose for which the funds are intended” in the context of project objectives as well as in terms of the specific budget for the project.

Financial statements of the executing agency that provide sufficient disclosure of the receipts and disbursements of the project and of relevant information in the notes to the financial statements should normally meet the needs of donors. Where financial statements do not provide this information, a separate special purpose financial statement with a special purpose audit report would be expected. This would normally take the form of a Cash Flow Statement, prepared on the cash basis of accounting. This TOR is directed to the audit of special purpose financial statements.

The executing agency

This section should contain a description of the executing agency including the physical address, phone numbers, fax numbers, web sites and general e-mail addresses. A summary of the financial management assessment of the project executing agency should be included, together with a reference that the full financial management assessment would be available to the auditor. Other details would include:

- An organisation chart.
- A list of senior officers together with their contact details.
- A list of the contact persons responsible for accounting, financial management and internal audit together with phone numbers and email addresses.
- A description of the project including the project budget by major expenditure categories and the sources of all funding for the project.
- A statement that the project appraisal report (if applicable) would be available to the auditor should be included.

Accounting standards

This section should include a description of the accounting standards followed for the project and whether they are consistent with the government’s accounting standards. Any deviations from standard government accounting practices should be specified. Any deviations between the actual accounting standards applied and international practice as embodied in either International Accounting Standards (IAS) published by the International Accounting Standards Board or the draft International Public Sector Accounting Standards (IPSAS) on Cash Accounting published by the Public Sector Committee (PSC) of the International Federation of Accountants may also be described.

Reporting standards

The usual format of reporting for a non-revenue project is a Cash Flow Statement. The format of the accounting report should be provided. The format should include a list of funding sources to be reported separately as well as a list, agreed during the funding agreement negotiations, of the expenditure categories for reporting purposes.

The Cash Flow Statement format should normally include the current reporting period compared with the annual budget and accumulative figures from the commencement of the project compared with the total project budget.

The date by which the project accountants will prepare a draft Cash Flow Statement together with the agreed supporting schedules should be specified. Audited special purpose financial statements should be issued within about four to six months after the end of the fiscal period.

Available facilities

There should be a description of the nature and the location of all records belonging to the project. This list should specify those records kept at the executing agency's headquarters and those that are located at other offices. If computers are used to record transactions relating to the project a description of the computer specifications needs to be provided together with a description of the operating software.

The TOR should state that the auditor would have full and complete access at any time to all records and documents (including books of account, legal agreements, minutes of committee meetings, bank records, invoices and contracts etc.) and all employees of the entity. The auditor should be advised that he/she has a right of access to banks and depositories, consultants, contractors and other persons or firms engaged by the programme/project management. If an auditor may not have unrestricted access to any records, person or location during the course of the audit, this restriction should be clearly defined, with reasons, in the TOR.

Audit scope

Scope of work

The scope of the audit should be sufficiently clear to properly define what is expected of the auditor but not in any way restrict the audit procedures or techniques the auditor may wish to use to form an opinion. It should specify at least the following:

- A definition of the entity or the portion of an entity that is subject to audit.
- The audit will be carried out in accordance with either ISA⁴ or INTOSAI⁵ auditing standards.
- The audit period covered will include the current reporting period. Issues relevant for the accumulative reporting period (from inception of the project) will rely upon the audit work of previous auditors, if necessary through communication with them.
- Sufficient audit evidence will be gathered to substantiate in all material respects the accuracy of the information contained in supporting schedules attached to the Cash Flow Statement.
- If Statements of Expenditures (SOEs) were used to fund disbursements, the scope of the audit will include a sufficient sample of such disbursements to determine whether funds disbursed through SOEs were used for the purposes defined by the funding agreement.
- If a special/imprest bank account is used in conjunction with the SOEs, the scope of the audit will include gathering sufficient evidence to determine that the balance indicated as being on hand in the records is represented by unencumbered cash in a bank account.

⁴ International Standards of Auditing (ISA) published by the International Auditing Practices Committee of the International Federation of Accountants.

⁵ International Organization of Supreme Audit Institutions.

The TOR should require the auditor to state in the audit report if the audit was not in conformity with any of the above and indicate the alternative standards or procedures followed.

The audit report

The TOR should clearly indicate expected content of the auditor's opinion. This would include at least the following:

- That it is a special purpose report and its intended use.
- Accounting standards that have been applied and indicate the effect of any deviations from those standards.
- The audit standards that were applied (either INTOSAI standards, ISAs, or national standards that comply with one of these in all material respects).
- The period covered by the opinion.
- Whether the specified Cash Flow Statement and supporting schedules present fairly the cash receipts and disbursements for the project and that the funds were used for the purposes defined by the funding agreement(s).

This section should also indicate the due date for submission of a draft audit report and the signed audit report to the management of the project, as well as the due date for the submission of the signed audit report to the donors for compliance with the funding agreement.

Compliance with funding agreement covenants

Traditionally compliance with covenants referred to meeting technically defined financial targets, such as debt service coverage in revenue producing projects. Increasingly funding agreements of programme/projects which are not revenue earning contain specific performance targets. These are sometimes specified by a time bound action plan such as the date of the introduction of a double entry accounting system or implementation of a system of internal controls. In other cases there may be a broader action plan with specific dates to achieve a specific set of actions. In some cases funds releases are tied to meeting these targets. In other cases specific quantifiable targets such as the construction of specified numbers of rural health clinics or the provision of specific or "at least" numbers of inoculations against infectious diseases are covenanted. Some grant and loan covenants are too nebulous to be subject to audit.

The scope section of the TOR should clearly indicate whether the auditor is expected to issue an opinion on the implementing agency's compliance with any specific covenants. This section should specifically state:

- The auditor is not an arbitrator in any disagreements between the borrower and lender(s).
- The covenant(s) for which an opinion will be issued, by a very specific reference to the funding agreement section(s) and paragraph number(s).
- A copy of the funding agreement will be provided to the auditor.
- Copies of all correspondence between the government and the funding agency/agencies relating to compliance, calculation of compliance or interpretation of definitions used in the covenants will be provided.

Management letter

The TOR should specify that the auditor will submit a management letter at the completion of the audit. Guidance should be provided regarding the topics/issues to be covered in the management letter. At least the following topics/issues should be included:

- A general review of programme/project progress and timeliness in relation to progress milestones and the planned completion date, both of which should be stated in the programme/project document. This is not intended to address whether there has been compliance with specific covenants relating to specific performance criteria or outputs. However general compliance with broad covenants such as implementing the programme/project with economy and efficiency might be commented upon but not with the legal force of an audit opinion.
- An assessment of the programme/project's internal control system with equal emphasis on *i*) the effectiveness of the system in providing the programme/project management with useful and timely information for the proper management of the programme/project and *ii*) the general effectiveness of the internal control system in protecting the assets and resources of the programme/project.
- A description of any specific internal control weaknesses noted in the financial management of the programme/project and the audit procedures followed to address or compensate for the weaknesses. Recommendations to resolve/eliminate the internal control weaknesses noted should be included.

Model Audit Opinions*Model Audit Opinion for a Non-Revenue-Earning Project*⁶

To: Borrower (or designated agency)

We have audited the accompanying financial statements (pages ___ to ___) of the _____ Project financed under the African Development Bank Loan # _____ as of December 31, 20___, and for the year then ended.

These financial statements are the responsibility of the management of the _____ EA.

Our responsibility is to express an opinion on the accompanying statements based on our audit.

We conducted our examination in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of misstatement. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our audit also includes assessing the accounting principles and significant estimates made by management, as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The ___ (EA's) policy is to prepare the accompanying statements in the format agreed between the African Development Bank and the Government of _____ as noted in the Minutes of Negotiations for the Loan, [on a cash receipts and disbursements basis in which cash is recognized when received and expenses are recognized when paid, rather than when incurred] /

⁶ ISA700 has been amended with effect from 31 December 2006. Financial Analysts should become familiar with the revisions and prepare borrowers of changes.

[on an accruals basis in which expenses are recognized when incurred and revenue is reported when income is due.]

In our opinion, (A) the aforementioned financial statements and appended notes that were also the subject of the audit, fairly present in all material respects the financial position of the _____ project as at _____ 20__ and the results of its operations for the year ended _____ 20__, in conformity with _____ accounting standards, applied on a basis consistent in all material respects with that of the previous year; (B) the [Borrower] [EA] has utilized all proceeds of the loan withdrawn from the African Development Bank only for purposes of the Project as agreed between the African Development Bank and [the Borrower] in accordance with the Loan Agreement; and no proceeds of the loan have been utilized for other purposes; and (C) the [Borrower] [EA] was in compliance as at the date of the balance sheet of the year of audit with all financial covenants of the Loan Agreement.

In addition:

(a) (1) With respect to Statements of Expenditures, adequate supporting documentation has been maintained to support claims to the African Development Bank for reimbursements of expenditures incurred; and (2) which expenditures are eligible for financing under Loan Agreement No. ____.

(b) (1) The Imprest Accounts (page __) give a true and fair view of the receipts collected and payments made during the year ending ____; and (2) these receipts and payments support Imprest Account liquidations/replenishments during the year.

[(a) and (b), above, are to be provided where the Loan Agreement requires separate Imprest Account and Statement of Expenditures audits and audit opinions.]

Model Audit Opinion for a Revenue Earning Project

To: Borrower (or designated agency)

“We have examined the Balance Sheet of _____ as of _____ 20__ , and the Income Statement, Cash Flow Statement and related statements and Notes (see pages ____ to ____ of our Report) of the _____ Project financed under the African Development Bank Loan # _____ as of December 31, 20__, and for the year then ended.

We conducted our examination in accordance with International Standards on Auditing [auditing standards of the country of ____]. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of misstatement. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our audit also includes assessing the accounting principles and significant estimates made by management, as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, (A) the aforementioned financial statements and appended notes that were also the subject of the audit, fairly present separately (i) the financial position of the _____ project and (ii) the overall operations of the _____ [name of EA] as at _____ 20__ and the separate results of the project operations and the EA’s operations for the year ended _____ 20__, in conformity with international accounting standards [accounting standards of the country of ____], applied on a basis consistent in all material respects with that of the previous

year; (B) the [Borrower] [EA] has utilized all proceeds of the loan withdrawn from the Bank only for purposes of the Project as agreed between the African Development Bank and [the Borrower] in accordance with the Loan Agreement; and no proceeds of the loan have been utilized for other purposes; and (C) the [Borrower] [EA] was in compliance as at the date of the balance sheet of the year of audit with all financial covenants of the Loan Agreement.

In addition:

(a) (1) With respect to Statements of Expenditures (SOE), adequate supporting documentation has been maintained to support claims to the African Development Bank for reimbursements of expenditures incurred; and (2) which expenditures are eligible for financing under Loan Agreement No. _____. (Required where an SOE audit is required under the Loan Agreement.)

(b) The Imprest Accounts (page____) gives a true and fair view of the receipts collected and payments made during the year ending _____.

[(a) and (b) above to be provided where a separate Imprest Account audit is required under the Loan Agreement.]

Audit Report Questionnaire

7.17.2 This questionnaire is provided only as an example of the nature and type of questions that should be considered when reviewing the report of an auditor. Financial analysts should have regard to the nature of the organization under audit and frame their questions accordingly. Agencies operate in a wide range of sectors and activities, and therefore the form and nature of their financial statements will vary equally widely.

7.17.3 Further, approaches to, and the quality of auditing is variable. Therefore, the questions set out below should be regarded with some caution, because these may not have sufficient breath or depth for some institutional statements and audits. Conversely, these may also be considered too extensive for some EAs, their activities and the audit services available.

7.17.4 Nevertheless, by using this checklist, or a suitably modified version thereof to reflect the nature and form of the EA concerned, a financial analyst should be able to obtain a reasonable view of the acceptability of the financial statements concerned and the audit thereof. To the extent possible each question should be answered by either “YES”, or “NO”, or N/A (Not applicable).

Authenticity, Form, and Timeliness					
	Yes	No	N/A	Ref	Remarks
(1) Are the audited annual project financial statements and, where applicable, the EA’s audited annual financial statements signed by the entity’s management?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(2) Is the audit report signed by the auditor?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(3) Is the opinion on the auditor’s letterhead?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(4) Is the report bound and pages consecutively numbered?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(5) Was the report received within a reasonable time after signing?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(6) Was the report received within period covenanted (refer to the loan agreement)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(7) Is there a copy of a Management Letter?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(8) Where appropriate, do the annual financial statements include					

<p>reported data for the previous accounting period to enable comparisons to be made, particularly closing balances which should represent opening balances for the fiscal year under audit, and illustrate increases and decreases where applicable?</p>	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
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Audit Opinion	Yes	No	N/A	Ref	Remarks
(1) Was the examination asserted to be made in accordance with generally accepted auditing standards?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(2) Were generally accepted accounting principles applied on a basis consistent with that of the preceding year?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(3) Is a precise and "clear" opinion provided on: (i) Financial position, (ii) Results of operation, and (iii) Cash flows?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(4) Does the paragraph on the scope of the audit cover examination of the: (i) Balance Sheet (ii) Income Statement, and (iii) Cash Flow Statement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(5) Are supplementary data stated fairly in all material respects, when considered in conjunction with the financial statements taken as a whole?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(6) Does the report address the auditor's objectives under the loan agreement (i.e., utilization of loan funds, compliance with specific covenants, use of imprest funds, statement of expenditure procedures, conformity with the Bank's Procurement Guidelines)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(7) Does it appear that the supplementary statements form part of the accounts? Are they covered by the auditor's certificate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(8) Is the auditor's opinion unqualified?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

Matters Addressed	Yes	No	N/A	Ref	Remarks
(1) Balance Sheet - Fixed Assets					
(a) Is the categorization and analysis of assets representative of the entity's interests and activities (e.g., land, buildings, equipment, machinery, vehicles)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(b) Are fixed assets under construction shown separately (Does the line item include the project)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(c) Is there a schedule attached of gross fixed assets, accumulated depreciation provision and net fixed assets: (i) in operation; (ii) not in operation; (iii) with data on changes in asset holdings in year, including (a) sales, (b) revaluations, and basis for it, and (c) changes in depreciation provision?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(d) Is accumulated depreciation shown with depreciation rates and bases of calculation in supporting schedules?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(e) Are disclosures made of assets: (i) leased out, and (ii) pledged?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(f) In cases of revaluation of fixed assets and/or restatements of foreign long-term debt, is sufficient information provided to reconstruct both sides of the revaluation entries?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(2) Balance Sheet. Current Assets					
(a) Is the total of current assets revealed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(b) Is there an adequate analysis of current assets (e.g., prepaid expenses, deposits on contracts, receivables, inventories, marketable securities, short-term bank deposits, cash at bank, and cash on hand)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

(c) Are receivables adequately analyzed, aged and classified between key classes of debtors?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(d) Do marketable securities exclude medium-/long-term investments?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(e) Is a bad and doubtful debt allowance indicated (Have actual bad debts been written off)? For financial intermediaries, is the provisioning policy in compliance with prudential guidelines)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(f) Is there a suitable inventory analysis including: (i) manufacturers' products for sale, (ii) materials and goods for incorporation, (iii) materials in manufacturing progress, (iii) materials and goods for maintenance, and (iv) work-in-process? Are the valuation bases described for each? Are the inventory policies and practices consistent from year to year?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(3) Balance Sheet - Investments and other Assets			
(a) Are investments detailed in supporting schedules, with bases of valuation, revaluation, losses and yields?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Are deferred charges and pre-operating expenses shown with amortization rates and accumulated amortization, where appropriate?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) For Other Assets, are goodwill or intangibles shown, with valuation bases? (Are "Other assets" substantial, and if so, is there an analysis in the Notes to the Financial Statements)	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(4) Balance Sheet - Investments and other Assets			
(a) Is there an adequate analysis of equity (e.g., authorized capital; paid-in capital; share premiums; shares outstanding; government or other public authority contributions; surpluses from appropriated earnings, unappropriated earnings, and revaluations)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Is there a statement of shareholders equity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(5) Balance Sheet - Long-term Debt			
(a) Are current maturities excluded and shown under current liabilities?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Are all amounts due and payable but not repaid to lenders disclosed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) Is there a comprehensive schedule of long-term debt, showing, among other things, for each outstanding loan: (i) original amount borrowed; (ii) interest rate, grace and repayment period and other relevant terms, (e.g., secured debt); (iii) currency in which debt is repayable and conversion rates, if applicable, at date of borrowing and current; (iv) gross amount outstanding and effective currency conversion, if applicable; (v) long-term debt transactions during year; (vi) current maturities; and (vii) maturities due and payable, but not paid?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(6) Balance Sheet - Current Liabilities			
(a) Is total of current liabilities shown and suitably analysed (e.g., current maturities of long-term debt, short-term borrowings, consumer deposits, taxes due, dividends due, accounts payable, accrued and other liabilities)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(7) Balance Sheet - Other Liabilities			
(a) Are relevant other liabilities adequately described and analysed,			

including such matters as: pensions and other employee benefits, and deferred Taxation?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Are the analysis of the foregoing and the format of the balance sheet items in accordance with sound accounting practices?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) Are contingent liabilities and pledges disclosed?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(d) Are reserve funds (e.g., pension funds) adequately classified, explained and legally utilized and provided for?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(e) Are suspense accounts fully explained?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(f) Is there an adequate description of verification procedures for fixed and movable assets and inventories?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(g) Is a statement of adequacy of insurance required?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(h) Is there an analysis in Notes to the Financial Statements of "Other Liabilities" where the amount is substantial?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(8) Income Statement			
(a) Does the construction of the revenue, expenditure and other key items of this statement and supporting data provide satisfactory financial evidence of the results of activities conducted by the entity?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Does the statement provide statistical data on (i) sales or other performance; (ii) manufacturing costs; (iii) sales costs; (iv) operating costs; (v) maintenance costs; (vi) administration costs; (vii) depreciation; (viii) non-operating income (analyzed); (ix) amortization of deferred charges?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) Are unusual items clearly shown (e.g., exchange gains or losses; profit or losses on sale of assets; and profits or losses from adjustments made to reflect changing prices and/or inflation)?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(d) Does the statement include any items relating to other fiscal years (e.g., prior-year adjustments), and are these separated from the current year?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(e) Is the net income relating to the fiscal year's operations clearly demonstrated before inclusion of other items, as in (c) and (d) above?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(f) Is the allocation of Net Income clearly demonstrated?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(g) Does the opinion cover this statement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(9) Cash Flow Statement			
(a) Does the statement provide a clear description of operating, investing and financing cash flows?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(b) Do the transactions shown tie back to the Balance Sheet and Income Statement with the appropriate reconciliations?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(c) Does the opinion cover this statement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Auditor's Opinion and Report					
	Yes	No	N/A	Ref	Remarks
(1) Where the audit opinion is qualified, is there sufficient information to quantify the effects of qualification on the: Balance Sheet Income Statement and Cash Flow Statement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		
(2) Does the audit report contain an opinion on whether the entity/borrower is complying with/ breaching any covenants or other legal agreements? For instance: <ul style="list-style-type: none"> Utilization of loan proceeds (e.g., diversion of funds, utilization for aspects where counterpart funds should have been used, etc). 	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>		

<ul style="list-style-type: none"> • Project implementation (delays, bottlenecks, procedural procurement lapses). • Statement of Expenditures (splitting of payments to avoid SOE ceiling, amount inadmissible). • Imprest Fund (used for aspects meant for counterpart funds). • Agreed upon matters between the Bank and Borrower that require special attention. • For revenue-earning EAs/Borrower (significant changes in financial statement balances between financial years, significant bad debts, unrecorded liabilities, etc). 			
(3) Did the audit examine the efficiency of systems of Internal Control? If so, does the audit report disclose any material deficiencies or weaknesses in the accounting system or overall system of internal control?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>
(4) Does the audit report confirm, or otherwise, that financial management systems employed by the EA conformity with Bank requirements in the loan agreement?	<input type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>

Conclusion and Further Action (if any)	Remarks
(1) Have the audit findings/recommendations of previous years been resolved satisfactorily by the EA (Please list separately all outstanding audit findings and recommendations as of the end of the previous year, and indicate on each finding whether or not it has been resolved by the EA during the current review period).	
(2) Have you reviewed the questions marked as “No” in the checklist filled out by the external auditors? If so, are there any material aspects that need to be pursued further?	
(3) Indicate conclusion reached by reviewer	
(4) Indicate any follow-up action needed immediately or during the next mission.	

Notes: In the case of revenue-earning EAs, the task manager will continue to make use of the financial statement in the manner currently used, which may include computations of ratios. The above questionnaire is meant to serve as a guide only and may be modified to suit specific needs.

7.18 DETAILED FINANCING PLAN

7.18.1 The following is an example of a typical Detailed Financing Plan for a revenue-earning project the purpose of which is to demonstrate that the funding to support all required aspects of the total estimated cost of the project including contingencies and items ineligible for Bank financing are identified and committed.

DETAILED FINANCING PLAN
(xx through xx)

COUNTRY						
PROJECT						
In (thousands)(millions) of UA/Bank Lending Currency	Local	%	Foreign	%	Total	%

	Currency		Currency			
FUNDS REQUIRED						
Proposed Project						
Interest during construction	0.00	0	0.00	0	0.00	0
Other capital investments	0.00	0	0.00	0	0.00	0
Required increase in working capital	0.00	0	0.00	0	0.00	0
- Project-related	0.00	0	0.00	0	0.00	0
- Non-project-related	0.00	0	0.00	0	0.00	0
Increase (Decrease) in cash	0.00	0	0.00	0	0.00	0
TOTAL REQUIREMENTS	0.00	0	0.00	0	0.00	0
SOURCE OF FUNDS						
Net income after taxes before interest and depreciation						
	0.00	0	0.00	0	0.00	0
Less:						
Dividends	(0.00)	(0)	(0.00)	(0)	(0.00)	(0)
Debt service	(0.00)	(0)	(0.00)	(0)	(0.00)	(0)
Taxes/other	(0.00)	(0)	(0.00)	(0)	(0.00)	(0)
Net internal cash generation	0.00	0	0.00	0	0.00	0
Proposed Bank loan						
	0.00	0	0.00	0	0.00	0
Cofinancier loan(s)						
	0.00	0	0.00	0	0.00	0
Other loans						
	0.00	0	0.00	0	0.00	0
- Project-related	0.00	0	0.00	0	0.00	0
- Non-project-related	0.00	0	0.00	0	0.00	0
Total Borrowings	0.00	0	0.00	0	0.00	0
Equity investments						
	0.00	0	0.00	0	0.00	0
Consumer Contributions						
	0.00	0	0.00	0	0.00	0
Subsides for operations						
	0.00	0	0.00	0	0.00	0
TOTAL SOURCES	0.00	0	0.00	0	0.00	0

7.19 SENSITIVITY AND RISK ANALYSES

Step 1: Identify the Key Variables

7.19.1 The selection of variables which should be tested and the detail in which they are specified apply primarily to (i) critical cost and benefit items, (ii) critical items likely to cause non-performance of financial covenants, (iii) the effect of delays; and (iv) aggregate costs and benefits, which are the four principal areas of a project for which sensitivity analysis normally is considered.

7.19.2 *Critical Cost and Benefit Items:* The most effective tests are achieved by detailed disaggregation of costs and benefits and therefore these items should be subjected to specific analysis for each project. Analysis is more beneficial if individual items that are most critical to the project are subjected to individual review. These include on the costs side, prices of major inputs, productivity coefficients, currency risks and inflation rates, and on the benefits side, output prices (with the substitution of possible tariff structure variations), rate of growth in demand for output, and unit cost savings. While “revenues” can be regarded as a critical benefit, it is likely to be more useful to identify the element or elements of revenues that are most at risk, such as “revenues from installing new sewer connections”, along with the extent/scope of their contribution to benefits and the timing thereof.

7.19.3 *Non-performance of Financial Covenants:* The sensitivity of the principal elements of operations (critical operating costs e.g., wages, power and fuel, etc.), operating revenues, working capital requirements, etc., that will impact on the EA’s ability to achieve (i) rate of return ratio – a rate of return on net fixed assets in operation; (ii) self-financing ratio; (iii) debt service coverage, etc., should be measured.

7.19.4 *Effect of Delays:* Start-up delays, implementation delays, capacity utilization and full development delays, and parallel investment delays should be subjected to analysis. Delays come in different shapes and sizes and on different occasions (at start-up; at critical commissioning stages, e.g., river crossings; weather delays, e.g., regular “wet season”; resource shortages – shipping delays, personnel strikes and slow-downs; in commissioning; in completion; and in commencement of operation. It is important to identify the delay(s) most likely to be considered in terms of the maximum permissible delay(s) for inclusion as a Switching Value (SV). Delays may also be analysed in terms of the periodic effects on FNPV (annual, forecast percentage of completion).

7.19.5 *Aggregate Costs and Benefits:* Sensitivity analysis of the effects of variations in total costs and benefits of a project is useful to indicate the collective influence of underlying variables, and should be applied in all cases.

7.19.6 In addition to the foregoing, other critical areas which merit subsection to sensitivity analysis are potential cost overruns in project implementation and non-achievement of capacity utilization. In simple cases the variability in the project’s rate of return on net fixed assets in operation will largely reflect the influence of two or three variables. In such cases probability assessments regarding those variables might provide an adequate basis for judging the risk of the project’s failure, thus avoiding the need for more detailed quantitative risk analysis. Even in more complex cases sensitivity analysis may some times facilitate risk analysis by identifying the variables for which probability distributions should be specified.

Steps 2 and 3: Calculate Effects of Changing Variables

7.19.7 The values of the basic indicators of project viability (FIRR and FNPV) should be recalculated for different values of key variables. This is preferably done by calculating sensitivity indicators (SIs) and switching values (SVs).

7.19.8 Switching Values (SVs) are sometimes used for conducting sensitivity analysis, but their application is not mandatory. It is the financial analyst’s responsibility to determine whether a demonstration of the impacts of switching values would support any decisions used in their selections. The SV of a variable is that value at which a project’s FNPV becomes zero (or the FIRR equals the discount rate). The SVs are normally given in terms of the percentage change in the value of the variable needed to turn a project’s FNPV equal to zero. SVs are useful to determine those variables that are most likely to affect project outcomes. SVs of the more important (or potent) variables should be presented in order of declining sensitivity.

7.19.9 The meaning of these concepts is presented below and a sample calculation immediately follows. Sensitivity indicators and switching values can be calculated for the FIRR and FNPV as shown below

Using Sensitivity Indicators and Switching Values

	Sensitivity Indicator	Switching Value
Definition:	<p>1. Towards the Net Present Value Compares percentage change in FNPV with percentage change in a variable or combination of variables.</p> <p>2. Towards the Internal Rate of Return Compares percentage change in FIRR above the cut-off rate with percentage change in a variable or combination of variables.</p>	<p>1. Towards the Net Present Value The percentage change in a variable or combination of variables to reduce the FNPV to zero (0).</p> <p>2. Towards the Internal Rate of Return The percentage change in a variable or combination of variables to reduce the FIRR to the cut-off rate (=discount rate).</p>
Expression:	<p>1. Towards the Net Present Value</p> $SI = \frac{(FNPV_b - FNPV_1) / FNPV_b}{(X_b - X_1) / X_b}$ <p>where:</p> <ul style="list-style-type: none"> X_b – value of variable in the base case X_1 – value of the variable in the sensitivity test $FNPV_b$ – value of FNPV in the base case $FNPV_1$ – value of the variable in the sensitivity test 	<p>1. Towards the Net Present Value</p> $SV = \frac{(100 \times FNPV_b)}{(FNPV_b - NPV_1)} \times \frac{(X_b - X_1)}{X_b}$ <p>where:</p> <ul style="list-style-type: none"> X_b – value of variable in the base case X_1 – value of the variable in the sensitivity test $FNPV_b$ – value of FNPV in the base case $FNPV_1$ – value of the variable in the sensitivity test

2. Towards the Internal Rate of Return

$$SI = \frac{(FIRR_b - FIRR_1) / (FIRR_b - d)}{(X_b - X_1) / X_b}$$

where:

- X_b – value of variable in the base case
- X_1 – value of the variable in the sensitivity test
- $FIRR_b$ – value of FIRR in the base case
- $FIRR_1$ – value of the variable in the sensitivity test
- d – discount rate

Calculation example

1. Towards the Net Present Value

Base Case:

Price = $P_b = 300$

$FNPV_b = 20,912$

Scenario 1:

$P_1 = 270$ (10% change)

$FNPV_1 = 6,895$

$$SI = \frac{(20,912 - 6,895) / 20,912}{(300 - 270) / 300} = 6.70$$

2. Towards the Internal Rate of Return

$$SV = \frac{(100 \times (FIRR_b - d))}{(FIRR_b \cdot FIRR_1)} \times \frac{(X_b - X_1)}{X_b}$$

where:

- X_b – value of variable in the base case
- X_1 – value of the variable in the sensitivity test
- $FIRR_b$ – value of FIRR in the base case
- $FIRR_1$ – value of the variable in the sensitivity test
- d – discount rate

1. Towards the Net Present Value

Base Case:

Price = $P_b = 300$

$FNPV_b = 20,912$

Scenario 1:

$P_1 = 270$ (10% change)

$FNPV_1 = 6,895$

$$SV = \frac{(100 \times 20,912)}{(20,912 - 6,895)} \times \frac{(300 - 270)}{300} = 14.9\%$$

Sensitivity Indicator	Switching Value
<p>2. Towards the Internal Rate of Return</p> <p>Base Case: Price = $P_b = 300$ $FIRR_b = 15.87\%$</p> <p>Scenario 1: $P_1 = 270$ (10% change) $FIRR_1 = 13.31\%$ $d = 12\%$</p> $SI = \frac{(0.1587 - 0.1331) / (0.1587 - 0.12)}{(300 - 270) / 300} = 6.61$	<p>2. Towards the Internal Rate of Return</p> <p>Base Case: Price = $P_b = 300$ $FIRR_b = 15.87\%$</p> <p>Scenario 1: $P_1 = 270$ (10% change) $FIRR_1 = 13.31\%$ $d = 12\%$</p> $SV = \frac{(100 \times (0.1587 - 0.12))}{(0.1587 - 0.1331)} \times \frac{(300 - 270)}{300} = 15.1\%$
<p>Interpretation</p> <p>Percentage change in FIRR above the cut-off rate (12%) is larger than percentage change in variable: price is a key variable for the project</p>	<p>A change of approximately 15 % in the price variable is necessary before the FNPV becomes zero or before the FIRR equals the cut-off rate.</p>
<p>Characteristic</p> <p>Indicates to which variables the project result is or is not sensitive. Suggests further examination of change in variable.</p>	<p>Measures extent of change for a variable that will leave the project decision unchanged.</p>

7.19.10 The switching value is, by definition, the reciprocal of the sensitivity indicator. Sensitivity indicators and switching values calculated towards the FIRR yield slightly different results if compared to SIs and SVs calculated towards the FNPV. This is because the FIRR approach discounts all future net benefits at the FIRR value and the FNPV approach at the discount rate, d .

Example of the Base Case for a Project

PV @12%		2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Benefits	2,104	0	283	339	396	453	509	566	566	566	566
Costs:											
Investment	1,687	1,889	0	0	0	0	0	0	0	0	0
Operations & maintenance	291	0	61	61	61	61	61	61	61	61	61
Total Costs	1,978	1,889	61	61	61	61	61	61	61	61	61
Net Cash Flow	126	-1,889	222	278	335	391	448	505	505	505	505

7.19.11 In the base case, the FNPV is 126 and the FIRR is 13.7 percent. The sensitivity of the base case FNPV has been analysed for (adverse) changes in several key variables, as follows:

- An increase in investment cost by 10 percent
- A decrease in economic benefits by 10 percent
- An increase in costs of operation and maintenance by 10 percent;
- An adverse foreign-exchange movement of 20 percent, and
- A delay in the period of construction, causing a delay in revenue generation by one year.

7.19.12 Proposed changes in key variables should be well explained. The sensitivity analysis should be based on the most likely changes. The effects of the above changes are summarized in the following table.

Sensitivity Analysis: A Numerical Example

Item	Change	FNPV	FIRR %	SI (FNPV)	SV (FNPV)
Base Case		126	13.7		
Investment	+ 10%	- 211	9.6	13.3	7.5%
Benefits	- 10%	- 294	7.8	16.6	6.0%
Operating and Maintenance Costs	+ 10%	68	12.9	2.3	43.4%
Foreign Exchange Movements	- 20%	- 294	7.8	16.6	6.0%
Construction delays	One (1) year	- 9 9	10.8	FNPV: 178% lower	

SI = Sensitivity Indicator, SV = Switching Value

7.19.13 Combinations of variables can also be considered. For example, the effect on the FNPV or FIRR of a simultaneous decline in economic benefits and an increase in investment cost can be computed. In specifying the combinations to be included, the project analyst should state the rationale for any particular combination to ensure it is plausible.

Analyse Key Variable Changes

7.19.14 In the case of an increase in investment costs the sensitivity indicator is 13.33. This means that a change of 20% in the variable (investment cost) results in a change of 266% (13.3 x 20%) in the FNPV. It follows that the higher the SI, the more sensitive the FNPV is to the change in the concerned variable.

7.19.15 In the same example, the switching value is 7.5%, which is the reciprocal value of the SI x 100. This means that a change (increase) of 7.5% in the key variable (investment cost) will cause the FNPV to become zero. The lower the SV, the more sensitive the FNPV is to the change in the variable concerned and the higher the risk with the project.

7.19.16 At this point the results of the sensitivity analysis should be reviewed. It should be asked: (i) which are the variables with high sensitivity indicators; and (ii) how likely are the (adverse) changes (as indicated by the switching value) in the values of the variables that would alter the project decision?

Undertaking Risk Analysis

7.19.17 In cases where project results are expected to be particularly sensitive to certain variables, it has to be assessed how likely it is that such changes would occur. This likelihood can be assessed by studying experiences in earlier, comparable projects and by investigating the situation in the sector as a whole.

7.19.18 Steps should be taken to reduce the extent of uncertainty surrounding those variables where possible. The following remedial actions might be taken at the project level:

- The development of specific agreements to ensure that contractor performance and project quality during construction works reduces the likelihood of delays
- The development of agreements for long-term supply contracts at specified quality and prices to reduce the uncertainty of operating costs
- The formulation of capacity-building activities to ensure appropriate technical and financial management
- The implementation of pilot phases to test technical assumptions and to observe user's reactions, in case there is considerable uncertainty in a large project or program, and
- The setting of certain criteria that have to be met by subprojects before approval. This is especially important in sector loans where most (small) subprojects will be prepared after loan approval.

7.19.19 The results of the sensitivity analysis should be stated along with the associated mitigating actions being recommended, and the remaining areas of uncertainty that they do not address. Sensitivity analysis is useful at all stages of project processing: at the design stage to incorporate appropriate changes; at the appraisal stage to establish a basis for monitoring; and, during project implementation to take corrective measures. The uncertainty surrounding the results of the economic and financial analysis is expected to decrease as the project moves into the operational phase.

7.19.20 For the key variables and combinations of such variables, a statement can be presented including: the source of variation for the key variables; the likelihood that variation will occur; the measures that could be taken to mitigate or reduce the likelihood of an adverse change; and the switching values and/or sensitivity indicators.

7.19.21 The purpose of quantitative risk analysis is to estimate the probability that the project FIRR will fall below the opportunity cost of capital; or that the FNPV, using the FIRR as the discount rate, will fall below zero. A statement of such an estimate means that decisions can be based not just on the single base-case FIRR but also on the probability that the project will prove unacceptable. Projects with smaller base-case FIRRs may involve less uncertainty and have a higher probability of being acceptable in implementation. Projects with higher base-case FIRRs may be less certain and involve greater risk. Risk analysis can be applied also to projects without measurable benefits, for example to assess the probability that unit costs will be greater than a standard figure.

7.19.22 Undertaking a risk analysis requires more information than for sensitivity analysis. It should be applied to selected projects that are large or marginal, or where a key variable is subject to a considerable range of uncertainty. A large project is one that takes a high proportion of government or the country's investment resources, for example a project using more than 5 percent of the government's investment budget in the peak project investment years. A marginal project is one where the base-case FIRR is only marginally higher than the opportunity cost of capital. A decision should be taken at an early stage of analysis whether to include a risk analysis in the appraisal or not.

7.20 PERFORMANCE INDICATORS

7.20.1 Few of the following ratios are appropriate for Financial Intermediaries (FIs). Appropriate indicators for assessing FI performance are described in Chapter 6 of these Guidelines and in section 7.20.32.

Ratios or Other Measures	Computation Method	Significance and Notes
1. Rate of Return on Net Fixed Assets in Service (%)	$\frac{\text{Net Operating Income (a)} \times 100}{\text{Average of Net Fixed Assets in Service (b)}}$	Measures the productivity (yield) of Net (Depreciated) Fixed Assets in use: (a) excluding government grants and subsidies (b) these fixed assets may, or may not, be subject to revaluations.
2. Self-Financing Ratio (%)	$\frac{\text{Cash from internal sources Ratio}}{\text{Average Annual Capital Expenditure }^{(*)}}$	Also called Cash Generation Capability and Contribution to Expansion. Measures the percentage of annual capital investments financed from available cash resources. (*) Average Annual capital expenditures may be derived from an average of multiple years (e.g. one past, the present year and one future year).
3. Operating Ratio (%)	$\frac{\text{Total Operating Expenses (including Depreciation and Taxes} \times 100)}{\text{Total Operating Revenues}}$	Measures the coverage of operating expenses by operating revenues.
4. Number of times interest earned (before income taxes)	$\frac{\text{Operating Income (before interest on long-term debt)}}{\text{Annual Interest Expense on Long-term Debt}}$	Measures the coverage of interest charges particularly on long-term debt before taxes.
5. Total Fixed Charge Coverage	$\frac{\text{Operating income, Interest, Lease Charge Payments (before taxes and charges)}}{\text{Annual Interest Expense on Long-term Debt}}$	Similar to interest coverage ratio except that it is expanded to cover leases and other fixed

	$\frac{\text{Annual Interest, Lease Charges and Other Fixed Charges}}{\text{Net Income + Interest Expense}}$	charges.
6. Return on Total Assets	$\frac{\text{Net Income + Interest Expense}}{\text{Average Investment in Assets}}$	Measures the productivity of assets.
7. Return on Common Stockholder Equity	$\frac{\text{Net Income - Preference Dividends}}{\text{Average Common Stockholders' Equity}}$	Indicates the earning power on common stockholder equity.
8. Return on Capital Employed	$\frac{\text{Net Income after Taxes + Tax-adjusted Interest}}{\text{Equity + Long-term Debt}}$	A measure of the efficient deployment of capital by the company.
9. Percentage Growth in Revenues	$\frac{\text{Current Period Revenues - Previous Period Revenues} \times 100}{\text{Previous Period Revenues}}$	Measures the increase in revenues between two periods.
10. Percentage of Revenues used to meet Operating (manufacturing) Expenses	$\frac{\text{Cost of Goods Sold} \times 100}{\text{Revenues}}$	Measures the gross margin for any period.
11. Gross Profit Margin	$\frac{\text{Revenues} - \text{Cost of Goods Sold}}{\text{Revenues}}$	Measures gross profit before inclusion of selling, warehousing, management and administration costs.
12. Non-operating (manufacturing) Cost compared to Sales	$\frac{\text{Selling, Warehousing, Management and Administration costs} \times 100}{\text{Revenues}}$	Overhead expense element of Revenues.
13. Profit element of Revenues	$\frac{\text{Net Profit}}{\text{Total Revenues}}$	Measures the profit element of sales.
14. Fixed Assets Turnover Ratio	$\frac{\text{Revenues}}{\text{Net Fixed Assets}}$	Measures the number of times fixed assets are turned over.
15. Inventory Turnover	$\frac{\text{Cost of Goods Sold in period}}{\text{Average Inventory for Period}}$	Measures the rate of movement in total inventory, that is, the number of times the inventory is turned over.
16. Revenues to Total Assets	$\frac{\text{Revenues}}{\text{Total Assets}}$	Measures efficiency of use of assets in generating sales.
17. Return on Equity	$\frac{\text{Net Profit}}{\text{Equity}}$	Measures the rate of return on the investment in business.

Capital Adequacy Indicators

The indicators in the table below are suitable for assessing capital adequacy.

Ratios or Other Measures	Computation Method	Significance and Notes
18. Debt Service Coverage Ratio (Version A)	$\frac{\text{Net Revenue [revenues – expenses (excluding non-cash and interest charges)]}}{\text{Annual Debt Service}^7 \text{ (b)}}$	Measures the number of times that debt service requirements are covered by available revenues. Note: (a) revenues may be adjusted to take into account any change in tariffs/charges in the year of measurement; (b) aggregate debt repayments including principal and interest.
19. Debt Service Coverage Ratio (Version B: Forecast Cash Flows)	$\frac{\text{Estimated Net Revenues [estimated revenues - estimated expenses (excluding non-cash and interest charges)]}}{\text{Estimated Debt Service Requirements (Principal + Interest Payments)}}$	Measures the extent to which forecast cash flows are able to cover forecast debt service requirements.
20. Debt: Equity Ratio	$\frac{\text{Total Debt}}{\text{Equity}}$	Measures the relationship between all borrowed funds and shareholders' invested capital.
21. Long-Term Debt to Total Equity Ratio	$\frac{\text{Total Long-term Debt}}{\text{Equity}}$	A capital adequacy measure. Measures the relationship of long-term debt to equity.
22. Long-Term Debt to Total Capitalization.	$\frac{\text{Long-term Debt}}{\text{Long-term Debt + Equity}}$	A capital structure measure. Measures the relationship of long-term debt to total capitalization.
23. Equity Ratio	$\frac{\text{Total Stockholders' Equity}}{\text{Total Shareholders' Equity + Total Liabilities}}$	Shows the protection to creditors and the extent of trading on the equity (leverage)

Liquidity Indicators

The indicators in the table below are suitable for assessing liquidity

Ratios or Other Measures	Computation Method	Significance and Notes
24. Current Ratio	$\frac{\text{Current Assets}}{\text{Current Liabilities}}$	Measures the short-run debt paying ability. Is highly dependant on the quality and content of Current Assets..
25. Quick Ratio (Acid Test)	$\frac{\text{Cash + Marketable Securities + Accounts Receivable+ other Liquid Assets (excluding inventories)}}{\text{Current Liabilities}}$	Measures short-term liquidity but does not depend on the realizing of inventories.

⁷ Based on the total of loan principal repayments and loan interest, including interest incurred on work in progress if this is to be financed from net income and not from capital receipts (loan/equity).

26. Days in Receivable	$\frac{\text{Average Accounts Receivable} \times 360 \text{ days}}{\text{Revenues}}$	Measures the average number of days required to recover accounts receivable.
27. Accounts Receivable Turnover	$\frac{\text{Net Revenues}}{\text{Average Accounts Receivable}}$	Measures the number of times that receivables turn over in a year. The higher the turnover, the shorter the time between sales and collection cash.
28. Days in Inventory	$\frac{\text{Average Inventory}}{\text{Cost of Goods Sold} / 360}$	Measures the average number of days it will take to sell an inventory.
29. Inventory Turnover	$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$	Number of times the inventory is turned over in a period.
30. Days in Accounts Payable	$\frac{\text{Average Accounts Payable}}{\text{Cost of Goods Sold} / 360 \text{ days}}$	Measures the average time span of unpaid payables.
31. Accounts Payable Turnover	$\frac{\text{Cost of Goods Sold}}{\text{Average Accounts Payable}}$	Measures the number of times Accounts Payable turnover during a period.

7.20.2 Further discussions on the applicability of performance indicators follow.

Operating Indicators

Operating Ratio

7.20.3 The objective of an operating ratio is to measure operating efficiency. It should be used to address the efficient use of manpower, materials, transport, and other factors of production. It should not be used to measure cash flow requirements. The operating ratio indicator expresses operating expenses, including adequate maintenance and depreciation, as a percentage of revenues. It is easily understood and calculated from income statement data. The lower the ratio, the better is the borrower’s financial performance; a ratio up to 100 means that revenues are sufficient to meet operating expenses (a ratio of 80 means that operating expenses consume 80 percent of revenues).

7.20.4 It does not provide for financial obligations for debt repayment or contributions for expansion, except indirectly to the extent that revenues fund depreciation. In the event that the operating ratio at project preparation is inadequate, or is already low (below 100), the financial analyst should discuss with the project engineer and the enterprise the efforts which should be made to improve the ratio without increasing revenues by increases in charges.

7.20.5 There may be a need for supplemental monitoring that addresses physical performance or is related to an action plan linked with improving the operating ratio (e.g., water and/or sanitation employees per 1,000 house connections).

Break-Even Ratio

7.20.6 The breakeven indicator, which is infrequently used, compares the total revenues of an enterprise to operating expenses plus the amount by which debt service requirements exceed the provision for depreciation. The objective is to measure an enterprise’s efforts to breakeven, without providing any surpluses for investment, dividends, etc. It is typically used by

transportation enterprises (buses, trams) which are frequently heavily subsidized, where the indicator can be used by these institutions to measure their efforts to obtain sufficient revenues, exclusive of subsidies, to match operating expenses and debt service.

7.20.7 This indicator should not be introduced without a detailed justification at preparation, and in the appraisal. The justification should include a detailed breakeven analysis, displaying the effects of changes in volume on the breakeven point(s), and on profitability and cash flows. The discussion should include a forecast of when a self-financing ratio should be introduced, and if debt service is not being met completely, or at all, the steps which the government and the enterprise propose to take to recover debt service from consumers through the charging system(s) of the enterprise.

The Self-Financing Ratio (SFR)

7.20.8 The self-financing indicator, sometimes referred to as contribution to expansion, or contribution to investment, or cash generation, measures the net internal cash generated by an enterprise which is available for investment (expansion) purposes, usually to contribute to its investment program, particularly the proposed project. It is typically defined as a percentage of specified capital expenditures that are to be financed after meeting operating expenses, debt service, taxes, dividends, increases in working capital, and other significant cash outflows excluding capital expenditures. As such, a self-financing ratio indicator directly measures the adequacy of internal cash generation to finance consistently an agreed proportion of investment requirements. However, a self-financing ratio, as for all performance ratios, should be determined on the basis of discussions of financial policy with the enterprise, the sector and center/state economic and financial ministries/departments' officials and other MDBs and Donors.

7.20.9 The target ratio should be carefully measured to directly support current and future policy objectives. The percentage of internal cash generation to be targeted is usually derived from the financing plan and financial projections for the period under consideration (which typically may be the project construction period plus three to five years beyond completion), after reflecting policy decisions on equity financing versus debt financing, and debt servicing principles. The principal method of determining this percentage is by comparing the net funds generated in a given year to the average capital expenditures for a representative period. This should consist of three years, including the year just past, the current year, and the next following year. The data for the current year and the next following year should be supported by a firm budget.

7.20.10 The often uncertain nature of future investment programs may make it necessary to provide for periodic reviews of the percentage(s) of internal cash generation. When a self-financing ratio indicator is used, the rate of return indicator for the enterprise should also be estimated and its adequacy should be judged on the basis of the considerations stated in that Section.

7.20.11 The financial analyst should encourage the policy-makers in an enterprise and the government concerned to address the issue of what should happen when investments decline, i.e., when the funds generated through the use of a self-financing ratio to drive or set the tariff level are greater than the yield targeted. For example, if a self-financing ratio target of 20 percent resulted in tariffs set in prior years that generated about \$20 million equivalent currently for an enterprise, and the investment program declined to about \$40 million annually, or even to less than the \$20 million yield of the ratio, what should the policy be vis-à-vis this "surplus" and further use of the self financing ratio itself.

7.20.12 Two matters should be actively pursued. First, the enterprise should be encouraged to meet as much of its capital development requirements (asset financing) as possible, and therefore even if the ratio reached 100 percent, the benefit would accrue to the enterprise, its consumers and to the government, particularly if foreign loans were no longer needed. Second, either the government has undoubtedly provided equity in the past for the development of the enterprise (and therefore the sector concerned) and is entitled to receive payment for the use of that capital in the form of dividends – or even in the form of repayment of capital contributions to re-employ the resources in other less fortunate sectors, or enterprises within the same sector. Or, in cases where the self-financing ratio is a sector-specific policy, this repayment of capital, or the payment of dividends on the government's equity, could commence once the balance of funds in excess of the yield of the specified self-financing ratio, even though the enterprise is still incurring debt, on the grounds that this “surplus” represented the funds available for distribution within the sector.

7.20.13 However, the self-financing ratio will continue to present the financial analyst with a paradox: (i) the higher the assessed risk, the higher the self-financing ratio required by prudent creditors; but (ii) weaker enterprises probably have higher risks and probably are unlikely to afford a high self-financing ratio - with the result that only limited investments are possible, thus contributing to (and not allaying) inherent weaknesses with the inevitable adverse impact on the community, the economy and government generally. This is a case where the indicator may be useful as an indicator only rather than as a driver of either tariff or a limiting factor on investment particularly if the national development plan depends on increased capacity from the EA. For example increased industrial development and resulting job creation may be important components of the national development strategy, which may depend on improved reliability in power supply.

Rate of Return (ROR)

7.20.14 The conventional concept of a rate of return is a measure of the efficiency of the use of operational assets, or alternatively, a measure of the return on invested capital compared to other opportunities to invest in the market place. This is particularly true at the margin (i.e., it is illogical to invest in assets if their yield is less than that obtainable for alternative uses of capital). The cost of capital is also proxy for when a utility should, or should not; put its money in the money market instead of buying an asset. The application and use of the rate of return concept has been broadened in its application to include being an indicator of performance of public sector enterprises.

7.20.15 The Rate of Return on Net Fixed Assets in Operation is a common financial performance indicator used in industry and commerce, and particularly by utility regulating agencies that seek to limit private sector profit maximization at the expense of unprotected consumers. Its application by MDBs in their performance monitoring has been the opposite of that adopted by regulatory agencies. The latter have always sought to keep rates and prices of utilities within fixed limits, whereas the MDBs have treated the indicator as a minimum (i.e., the borrower should either achieve or exceed the indicator specified in a covenant). This alternative use, particularly in cases where the indicator target is set too low, may result in the achievement of less than the effect desired (as a measure of the efficiency of the use of invested capital) or justified on economic grounds, by encouraging politicians and managements to believe that as long as they achieve the specific “target”, the financial health of an enterprise will be assured.

7.20.16 In practice the rigid adoption of the prescribed target under inflationary conditions, in particular, or in times of financial stringency, may result in an adverse impact on long-term performance by providing insufficient resources for investment and reserves, with resultant

damage to the quality of the service and/or product. The rate of return for the Bank's purposes is the relationship between the net operating income and the net fixed assets in operation, and expressed as a percentage.

7.20.17 Expressed in other words, it is the net yield or return after tax achieved by the net assets in operation in an operating period. A rate of return indicates the return which should be achieved on invested productive capital of an enterprise in the country concerned; or the reasonable rate of return to the enterprise which it could obtain from average interest rates or returns for the similar amounts of capital invested in the market place (long-term borrowings and equity) which are usually higher than interest rates payable on long-term borrowings available to public sector enterprises and institutions. The definition of "reasonable" in these circumstances is a judgment call, and reference should be made to similar returns on investment elsewhere in the economy of the country concerned, or at the current interest rate structure, after making allowances for differences in the business risks and terms of comparable investments.

7.20.18 Net operating income after taxes is represented by operating income less operating expenses. Operating expenses include adequate maintenance and provision for depreciation, usually on a straight-line basis at a specified rate or rates; but interest and other financial charges are not included as part of operating expenses. Capital invested in fixed assets normally is the average for the year of the net value of an enterprise's fixed assets. Invested capital may also include adequate working capital, particularly for enterprises that require a relatively high proportion of working capital to conduct operations.

7.20.19 With regards to the calculation of Rate of Return, this indicator should be based upon the value of assets at depreciated historical cost rather than the revalued amounts, unless the economy is hyperinflationary.

Capital Adequacy Indicators

Debt Service Coverage

7.20.20 The debt service coverage indicator measures the extent of the coverage of an enterprise's debt service by its internal cash generation over a defined period. A performance of one means that there is precise coverage, while a performance in excess of one (e.g., 1.3) indicates a margin of safety in covering debt. This indicator recognizes that the repayment terms of debt are more significant than the total amount of debt in measuring repayment capacity which in turn determines borrowing capacity. Except for Financial Intermediaries, the debt service coverage indicator is appropriate for revenue-earning enterprises in all sectors, particularly for public utilities, transportation, and industry, including agro- industry. There are two versions of this indicator: (i) based on historical earnings; and (ii) on estimated future earnings.

7.20.21 The version based on historical earnings is based on either the latest completed fiscal year or a more recent 12-month period. It is more objective and certain than the future earnings version which includes uncertainty regarding future earnings. In calculating internal cash generation, the historic earnings version permits an adjustment for changes in sales prices introduced during the year as though they were in effect throughout the year. Nevertheless, this version may be constraining because it gives no credit for the earning power of the investments to be financed by the proposed loan, or any other expected increases in earning power. Conversely if an EA fails to implement a project within the grace period of the related loan, debt service payments cannot be met by the unfinished investment and the ability to meet debt service payments out of existing earnings is conservatively desirable.

7.20.22 The version that is based on future earnings recognizes the importance of designing a project that is capable of servicing its debt to avoid the case where the EA does not meet its existing poverty reduction goals because it has to service the project's debt. It also recognizes the intention of the loan's grace period which is to defer debt service until the project is capable of servicing its debt. It is a normal business risk to invest with the expectation that the investment will pay for itself within a reasonable time.

Debt-Equity Ratio

7.20.23 The debt-equity ratio represents the relative proportions of these two sources of funds in the capital structure of an entity. If a capitalization of \$200 million is financed by long-term debt of \$120 million and by equity of \$80 million, the debt-equity ratio would be presented as 60:40. The debt-equity ratio indicator is normally used only for new enterprises, such as a "Greenfield" industrial plant, where for lack of an earnings record the debt service coverage indicator is not practicable. Except for FIs, the debt-equity ratio indicator helps to maintain a satisfactorily balanced financing plan in an enterprise's early years, but a debt service coverage indicator should be used also, because this is likely to become a more meaningful measure as output commences. It should then supersede the debt-equity ratio indicator after the first year or two of operations.

7.20.24 The considerations determining the magnitude of the debt-equity ratio are the same as those discussed for debt service coverage. It is generally inappropriate to have a debt-equity ratio higher than 60:40, but flexibility is permissible, depending on the sector or industry concerned, on the degree of capital intensity, and on the level of debt service commitments entered into. Where the latter are not severe, a higher ratio may be admissible. For example, where the loan principal is repayable at the end of the term and inflationary conditions prevail; or the interest rate is fixed at a low level; or the prospects for continued intensive borrowing are negligible, giving prospects of declining debt-equity ratios. Lower ratios than this are preferable for enterprises whose earnings are subject to wide fluctuations. Higher ratios, normally not greater than 70:30 may be acceptable for enterprises with very dependable earning power. However, there are a number of public sector enterprises, which are funded almost entirely by government debt, where the debt-equity ratio is 90:10 and sometimes 100:0.

7.20.25 In terms of sound commercial and financial management practice, such ratios are meaningless, but because the enterprises concerned are, in effect, government "departments", there may be no adverse performance effects, except that debt service could reach unmanageable proportions should the governments concerned ever seek to recover real interest rates. However, in many of these cases, the "debt" is often non-repayable, and interest rates are usually kept low. The indicator in these circumstances has no credibility. It should be noted, however, that one of the Bank's long-term objectives for enterprises of this type is, as a minimum to achieve self-financing status, and as an optimum, to achieve privatization. For either option, an unbalanced debt-equity structure of 90:10 or higher will mean that the enterprise will be regarded in the capital markets as not creditworthy, and until it can adopt a structure around 60:40, is unlikely to attract institutional lenders.

7.20.26 However, an important side issue arises from the highly leveraged enterprises referred to above. While it may be reasonable to accept their status in terms of an abnormally high debt-equity ratio, the financial analyst must recognize that these enterprises are operating on free or very "cheap" capital. The Bank considers, generally speaking, that enterprises should pay for the use of capital, and that a reasonable interest rate should be levied. If this capital is not transferred

in the form of loans and is injected instead as equity, this too has a price – probably a higher price than loan funds if it were sought in the money market. Therefore, the analyst should actively encourage the payment to government for this form of capital injection.

7.20.27 Any issues should be discussed at Project Preparation, and the RRP should contain a clear statement on the treatment proposed, and justification therefore, particularly if the market price of funds is not to be levied by government.

Liquidity Indicators

Current Ratio

7.20.28 The current ratio is the ratio of current assets to current liabilities as of the date of the balance sheet. It is an indicator of the adequacy of working capital and short-term liquidity, since it indicates the extent to which current liabilities are covered by current assets that are capable of being converted to cash in a period roughly corresponding to the maturity of the obligations. Current assets normally include cash, marketable securities, and other assets, such as accounts receivable, inventories, and prepaid expenses, which in the ordinary course of business are expected to be converted into cash within a year or business cycle. Current liabilities are those which would or could become due and payable in the next year, including accounts payable, short-term notes payable, customer advances and deposits accrued taxes and expenses, dividends payable and current maturities of long-term debt.

7.20.29 The appropriateness of a current ratio depends on the nature of the operations and the characteristics of the market for the entity's output. A ratio of less than 1.0 is generally inadequate and usually a ratio substantially above 1.0 is deemed appropriate. For example, an enterprise subject to seasonal or fluctuating demand for its output, or irregular timings of inventory acquisition/build-up, should have a current ratio high enough to carry the necessary inventories of goods in process and finished and saleable output pending actual sales – possibly as high as 4.0. An enterprise such as a public utility, with steady inflows of funds from monthly billings and a good record for prompt collection, may operate with a current ratio as low as 1.0, or even marginally lower. An enterprise which has to transport at its own time and expense large quantities of inputs and finished goods for long distances will likewise require a high ratio.

Quick Ratio

7.20.30 An alternative and better indicator of liquidity is the quick ratio. The basic difference between this and the current ratio lies in the treatment of inventories, which are the least liquid of current assets and are also those on which losses are most likely to occur if business conditions become adverse. The quick ratio is calculated by deducting inventories from current assets and dividing the remainder by current liabilities. In other respects this indicator possesses similar advantages and disadvantages as the current ratio. A quick ratio of at least 1.0 is usually considered appropriate.

7.20.31 The current and quick ratio indicators have a serious deficiency in that they present the status of an enterprise at a point in time, and not its regular performance. Distortions frequently occur, such as the case of enterprises relying on customers' advance payments for large delivery contracts, which if they do not take place, cause major shortfalls in cash, or if they occur as contracted, may make the ratio far higher than the actual consumption of inputs warrant. It is feasible to use this indicator to "window-dress" the enterprises' financial status for presentational purposes at the reporting date. Therefore the most useful application of this indicator is to request

an enterprise to provide a graphic presentation of a series of status indicators at, say, monthly, or weekly intervals for each year. In this way, the effective liquidity position can be better determined.

7.20.32 The International Monetary Fund (IMF) has been called upon to assess financial system soundness in its member countries as part of its surveillance work, including through the preparation of Financial System Stability Assessments. To this end, a joint World Bank-IMF Financial Sector Assessment Program (FSAP), was introduced in May 1999. The following article on ‘*New Tools for Assessing Financial System Soundness*’ that appeared in the ‘*Finance & Development: A quarterly magazine of the IMF*’, September 2000, Volume 37, Number 3⁸ explains how macroprudential indicators—defined broadly as indicators of the health and stability of the financial system—can help countries assess their banking systems' vulnerability to crisis.

7.20.33 The article, ‘*New Tools for Assessing Financial System Soundness*’ is attached:



7.21 FOREIGN EXCHANGE TRANSACTIONS

7.21.1 Foreign exchange (FX) settlement risk is the risk of loss when a bank in a foreign exchange transaction pays the currency it sold but does not receive the currency it bought. FX settlement failures can arise from counterparty default, operational problems, market liquidity constraints and other factors. The Bank of International Settlements (BIS) issued a statement: “*Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions*” whose purpose is to provide banking supervisors with information about FX settlement risk and its management that they should take into account when assessing a bank's policies and procedures.

7.21.2 The following is the BIS statement.

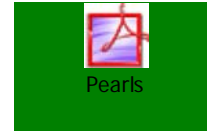


7.22 PEARLS MONITORING SYSTEM

7.22.1 Since 1990, the World Council of Credit Unions, Inc. has been using a set of financial ratios known as “PEARLS” to measure both the individual components and the system risks of Credit Unions (CU) operations. Each letter of the word PEARLS measures key areas of CU operations: **P**rotection, **E**ffective financial structure, **A**sset quality, **R**ates of return and cost, **L**iquidity and **S**igns of growth. PEARLS is a management tool that helps managers find meaningful solutions to serious credit union institutional deficiencies.

⁸ See: <http://www.imf.org/external/pubs/ft/fandd/2000/09/hilbers.htm>

7.22.2 The following is the World Council of Credit Unions paper on: *PEARLS Monitoring System* that was issued in October 2002.



7.23 FINANCING GOVERNMENT SERVICES THROUGH USER CHARGING

7.23.1 Countries are increasingly financing government services through user charging. The objective of user charging is not only to achieve cost recovery from users, but also to make government services more effective and efficient (Best Practice Guidelines for User Charging for Government Services, PUMA Policy Brief No. 3, Public Management Service, March 1998 by OECD: <http://www.oecd.org/dataoecd/19/38/1901769.pdf>).

7.23.2 The '*Best Practice Guidelines for User Charging for Government Services*, PUMA Policy Brief No. 3, Public Management Service, March 1998 by OECD' is attached:



7.24 INTERNATIONAL ACCOUNTING STANDARDS

Public Sector Accounting Standards

7.24.1 The following Public sector Accounting Standards have been issued by the International Public Sector Accounting Standards (IPSAS) board or by its predecessor the Public Sector Committee. As new standards continue to be issued and old ones amended on an ongoing basis, Financial Analysts are advised to consult the following website, regularly, for the current list of IPSAS: <http://www.ifac.org/PublicSector/>

IPSAS 1	Presentation of Financial Statements
IPSAS 2	Cash Flow Statements
IPSAS 3	Net Surplus or Deficit for the Period, Fundamental Errors and Changes in Accounting Policy
IPSAS 4	The Effects of Changes in Foreign Exchange rates
IPSAS 5	Borrowing Costs
IPSAS 6	Consolidated financial Statements and Accounting for Controlled Entities
IPSAS 7	Accounting for Investments in Associates
IPSAS 8	Financial Reporting of Interests in Joint Ventures
IPSAS 9	Revenue from Exchange Transactions
IPSAS 10	Financial Reporting in Hyperinflationary Economies
IPSAS 11	Construction Contracts
IPSAS 12	Inventories
IPSAS 13	Leases
IPSAS 14	Events after the Reporting Date
IPSAS 15	Financial Instruments: Disclosure and Presentation
IPSAS 16	Investment Property
IPSAS 17	Property, Plant and Equipment
IPSAS 18	Segment reporting
IPSAS 19	Provisions, Contingent Liabilities and Contingent Assets
IPSAS 20	Related Party Transactions
IPSAS 21	Impairment of Non-Cash Generating Assets

CASH BASIS IPSAS: Financial Reporting Under The Cash Basis of Accounting (Attached)



Exposure Draft

The IPSASB issued, in February 2005, the following Exposure Draft No. 24: *Financial Reporting under the Cash Basis of Accounting – Disclosure Requirements for Recipients of External Assistance*:



International Financial Reporting Standards and International Accounting Standards

7.24.2 The following is a list of International Financial Reporting Standards (IFRS) and International Accounting Standards (IAS) issued by the International Accounting Standards Board. Numbers missing in the sequence of IAS represent Standards that have been superseded. Again, Financial Analysts are advised to consult the following website, regularly, for the current list of IFRS and IAS: <http://www.iasplus.com/standard/standard.htm>

International Financial Reporting Standards

IFRS 1	First Time Adoption of International Financial reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-Current Assets held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Assets

International Accounting Standards

IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Cash Flow Statements
IAS 8	Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies
IAS 10	Events after the Balance Sheet Date
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 14	Segment Reporting
IAS 15	Information Reflecting the Effects of Changing Prices
IAS 16	Property, Plant, and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26	Accounting and Reporting by Retirement Benefit Plans

IAS 27	Consolidated Financial Statements and Accounting for Investments in Subsidiaries
IAS 28	Accounting for Investments in Associates
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 30	Disclosures in the Financial Statements of Banks and Similar Financial Institutions
IAS 31	Financial Reporting of Interests In Joint Ventures
IAS 32	Financial Instruments: Disclosures and Presentation
IAS 33	Earnings Per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities, and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

7.25 INTERNATIONAL AUDITING STANDARDS

International Standards on Auditing (ISAs)

100	Assurance Engagements (Withdrawn)
120	Framework of ISAs (Withdrawn)
200	Objective and General Principles Governing an Audit of Financial Statements
210	Terms of Audit Engagements
220	Quality Control for Audit Work
220R	Quality Control for Historical Financial Information
230	Documentation
240	Fraud and Error
250	Consideration of Laws and Regulations in an Audit of Financial Statements
260	Communication of Audit Matters to those Charged with Governance
300	Planning
310	Knowledge of the Business (Withdrawn)
315	Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement
320	Audit Materiality
330	The Auditor's Procedures in Response to Perceived Risk
400	Risk Assessments and Internal Control (Withdrawn)
401	Auditing in a Computer Information Systems Environment (Withdrawn)
402	Audit Considerations Relating to Entities Using Service Organizations
500	Audit Evidence
501	Audit Evidence-Additional Considerations for Specific Items
505	External Confirmations
510	Initial Engagements – Opening Balances
520	Analytical Procedures
530	Audit Sampling and other Selective Testing Procedures
540	Audit of Accounting Estimates
545	Auditing Fair Value Measurements and Disclosures
550	Related Parties

560	Subsequent Events
570	Going Concerns
580	Management Representations
600	Using the Work of Another Auditor
610	Considering the Work of Internal Auditing
620	Using the Work of an Expert
700	The Auditor's Report on Financial Statements
700R	The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements
701	Modifications to the Independent Auditor's Report
710	Comparatives
720	Other information in documents containing Audited Financial Statements
800	The Auditor's Report on Special Purpose Audit Engagement
	Glossary of Terms Preface to ISAs and RSs

International Auditing Practice Statements (IAPs)

1000	Inter-Bank Confirmation Procedures
1001	CIS Environments-Stand-Alone Microcomputer Systems (Withdrawn)
1002	CIS Environments-On-Line Computer Systems (Withdrawn)
1003	CIS Environments-Database Systems (Withdrawn)
1004	The Relationship Between Bank Supervisors and External Auditors
1005	The Special Consideration in the Audit of Small Entities
1006	The Audit of International Commercial Banks
1007	Communications with Management (Withdrawn)
1008	Risk Assessment and Internal Control (Withdrawn)
1009	Computer-Assisted Audit Techniques (Withdrawn)
1010	The Consideration of Environmental Matters in the Audit of Financial Statements
1011	Implications for Management And Auditors Of The Year 2000 Issue (Withdrawn)
1012	Auditing Derivative Financial Instruments
1013	Electronic Commerce – Effect on the Audit of Financial Statements
1014	Reporting by Auditors on Compliance with International Financial Reporting Standards

International Standards on Review Engagements

2400	Engagements to Review Financial Statements
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Assurance Engagements other than Audits or Reviews of Historical Financial Information

3000R	Assurance Engagements other than Audits or Reviews of Historical Financial Information
3400	The Examination of Prospective Financial Information

Related Services

4400	Engagements to Perform Agreed upon Procedures Regarding Financial Information
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4410 Engagements to Compile Financial Information

7.26 MODEL FINANCIAL STATEMENTS

Service Organization

7.26.1 The following model set of summary financial statements is appropriate for use by a service-type organization. The format used for this particular model is appropriate for forecasting (projecting) financial statements, for instance, during project preparation. The Financial Analyst should determine the forecast period.

7.26.2 When using these financial statements, it is essential that:

- An appropriate *Statement of Accounting Policies* be developed and agreed between the Bank and the borrower.
- Appropriate *Notes to the Financial Statements* supplement the financial statements.
- Where appropriate, the Financial Statements should be tailored so that they adequately reflect the performance and position of the organization.

Example Service Organization

Forecast Income Statements [Format for Financial Projections] For the years ended 31 December (US\$ 000s)

	Notes	20X1 Actual	20X2 Actual	20X3 Actual	20X4 Actual	20X5 Actual	20X6 Forecast	20X7 Forecast
Operating Revenues								
Revenues from services	1	35,052	36,748	39,288	41,202	41,202	41,202	41,202
Investment income		1,157	1,073	1,126	1,243	1,243	1,243	1,243
Other operating revenue		317	332	279	269	269	269	269
		<u>36,526</u>	<u>38,153</u>	<u>40,693</u>	<u>42,714</u>	<u>42,714</u>	<u>42,714</u>	<u>42,714</u>
Operating Expenses								
Wages, salaries and employee benefits		12,960	13,363	13,975	14,504	14,504	14,504	14,504
Supplies and consumables used		4,022	4,285	4,582	4,687	4,687	4,687	4,687
Repairs and maintenance		1,000	1,000	1,000	1,000	1,000	1,000	1,000
Depreciation and amortization expenses		791	872	918	926	926	926	926
Other operating expenses		18,677	20,395	20,601	21,280	21,280	21,280	21,280
		<u>37,450</u>	<u>39,915</u>	<u>41,076</u>	<u>42,397</u>	<u>42,397</u>	<u>42,397</u>	<u>42,397</u>
Surplus/(Deficit) from Operating Activities		-924	-1,762	-383	317	317	317	317
Project-related interest income / (costs)		2,373	2,527	2,588	2,512	2,512	2,512	2,512
Other interest costs		..	..	..	..	..	..	..
Gains on sale of fixed assets		..	..	..	..	..	..	..
Total non-operating revenue / (expenses)		<u>2,373</u>	<u>2,527</u>	<u>2,588</u>	<u>2,512</u>	<u>2,512</u>	<u>2,512</u>	<u>2,512</u>
Surplus/(Deficit) from Ordinary Activities		1,449	765	2,205	2,829	2,829	2,829	2,829
Minority interest share of surplus/(deficit)		..	..	..	..	..	..	..
Net surplus/(deficit) before extraordinary items		1,449	765	2,205	2,829	2,829	2,829	2,829
Extraordinary items		..	..	..	..	..	..	..
Income tax expense		..	..	..	..	..	..	..
Net Surplus/(Deficit) for the Year after Tax		1,449	765	2,205	2,829	2,829	2,829	2,829

Example Service Organization
Forecast Balance Sheets [Format for Financial Projections]
As at 31 December (US\$ 000s)

	Notes	20X1 Actual	20X2 Actual	20X3 Actual	20X4 Actual	20X5 Actual	20X6 Forecast	20X7 Forecast
Current Assets								
Cash and cash equivalents		210	93	97	100	100	100	100
Marketable securities		10,440	11,279	9,929	9,473	9,473	9,473	9,473
Receivables		5,520	5,490	5,559	5,593	5,593	5,593	5,593
Inventories		274	329	348	379	379	379	379
Work in progress		3,995	4,768	5,519	6,032	6,032	6,032	6,032
Investments		338	341	954	2,210	2,210	2,210	2,210
		20,777	22,300	22,406	23,787	23,787	23,787	23,787
Less: Current Liabilities								
Payables and provisions		4,716	4,588	4,428	4,401	4,401	4,401	4,401
Short-term borrowings		2,236	2,413	2,413	2,413	2,413	2,413	2,413
Current portion of borrowings		7,208	7,648	7,533	7,528	7,528	7,528	7,528
Employee benefits		832	857	857	856	856	856	856
		14,992	15,506	15,231	15,198	15,198	15,198	15,198
WORKING CAPITAL		5,785	6,794	7,175	8,589	8,589	8,589	8,589
Plus: Non-current Assets								
Investments		14,392	15,204	16,102	16,930	16,930	16,930	16,930
Property, plant and equipment		25,252	25,861	25,787	25,851	25,851	25,851	25,851
Intangible assets		2	302	830	1,322	1,322	1,322	1,322
		39,646	41,367	42,719	44,103	44,103	44,103	44,103
Less: Non-current Liabilities								
Payables		524	510	492	489	489	489	489
Borrowings		28,833	30,591	30,131	30,113	30,113	30,113	30,113
Employee benefits		7,491	7,710	7,716	7,706	7,706	7,706	7,706
		36,848	38,811	38,339	38,308	38,308	38,308	38,308
Net Assets		8,583	9,350	11,555	14,384	14,384	14,384	14,384
EQUITY								
Issued and paid-up capital		1,000	1,000	1,000	1,000	1,000	1,000	1,000
Reserves		7,201	7,190	7,190	7,190	7,190	7,190	7,190
Accumulated surpluses/(deficits)		382	1,160	3,365	6,194	6,194	6,194	6,194
Total Equity		8,583	9,350	11,555	14,384	14,384	14,384	14,384

Example Service Organization
Forecast Cash Flow Statements [Format for Financial Projections]
For the years ended 31 December (US\$ 000s)

	Notes	20X1 Actual	20X2 Actual	20X3 Actual	20X4 Actual	20X5 Actual	20X6 Forecast	20X7 Forecast
OPERATING CASH FLOWS								
Receipts								
Cash receipts from customers		34,793	36,603	39,177	41,118	41,118	41,118	41,118
Other Receipts		341	265	289	279	279	279	279
Payments								
Employees		-12,615	-13,043	-13,428	-13,917	-13,917	-13,917	-13,917
Suppliers		-19,750	-20,920	-20,848	-21,167	-21,167	-21,167	-21,167
Other payments		-369	-490	-1,088	-1,684	-1,684	-1,684	-1,684
Net Cash Flows from Operating Activities	2	2,400	2,415	4,102	4,629	4,629	4,629	4,629
INVESTING CASH FLOWS								
Receipts								
Interest received		1,070	835	834	901	901	901	901
Sales of fixed assets		250	125	68	59	59	59	59
Sales of investments		1,983	57	1,071	244	244	244	244
Payments								
Interest paid		-2,507	-2,516	-2,561	-2,502	-2,502	-2,502	-2,502
Purchases of fixed assets		-1,469	-2,459	-2,808	-3,181	-355	-355	-355
Purchases of investments		-130	-55	-102	-98	-98	-98	-98
Net Cash Flows from Investing Activities		-803	-4,013	-3,498	-4,577	-1,751	-1,751	-1,751
FINANCING CASH FLOWS								
Receipts								
Capital contributions from owners		..	..	..	..	..	..	..
Proceeds from new borrowings		275	1,477	353	56	56	56	56
Payments								
Capital withdrawals		..	..	..	..	..	..	..
Repayment of borrowings		-1,900	..	-953	-105	-105	-105	-105
Dividends paid		..	..	..	..	-2,829	-2,829	-2,829
Net Cash Flows from Financing Activities		-1,625	1,477	-600	-49	-2,878	-2,878	-2,878
Net increases/(decreases) for period		-28	-121	4	3	..	..	..
CASH AND CASH EQUIVALENTS								
Balances as at 1 January		230	210	93	97	100	100	100
Currency changes on opening balances		8	4	..	..	..	..	..
Net increases/(decreases) for period		-28	-121	4	3	..	..	..
Balances as at 31 December		210	93	97	100	100	100	100

Example Service Organization**Notes to the Financial Statements [Format for Financial Projections]****For the years ended 31 December (US\$ 000s)**

	20X1	20X2	20X3	20X4	20X5	20X6	20X7
Notes	Actual	Actual	Actual	Actual	Actual	Forecast	Forecast
Note 1: Revenues by Service Type							
Service Type A	376	353	379	387	387	387	387
Service Type B	34,035	35,748	38,274	40,195	40,195	40,195	40,195
Service Type C	641	647	635	620	620	620	620
	35,052	36,748	39,288	41,202	41,202	41,202	41,202

Note 2: Reconciliation of Income Statement to Operating Cash Flows

Net Surplus/(Deficit) per Income Statement	1,449	765	2,205	2,829	2,829	2,829	2,829
<i>Items included in net surpluses but not in net cash flows from operations:</i>							
Unrealised net foreign exchange gains	-66	-87	..	..	..	..	..
Interest received	-1,070	-835	-834	-901	-901	-901	-901
Interest paid	2,507	2,516	2,561	2,502	2,502	2,502	2,502
<i>Asset movements</i>							
Depreciation	791	872	918	926	926	926	926
Gains/(losses) on sales of assets	-7	3	..	..	..	..	..
<i>Other non-cash items</i>							
Movements in employee benefit liabilities	-918	110	864	1,134	1,134	1,134	1,134
<i>Movements in working capital</i>	-286	-929	-1,612	-1,861	-1,861	-1,861	-1,861
Net Cash Flows from Operations	2,400	2,415	4,102	4,629	4,629	4,629	4,629

Manufacturing Organization

7.26.3 The following model set of summary financial statements is appropriate for use by a manufacturing organization for year-end reporting. When using these financial statements, it is essential that:

- An appropriate *Statement of Accounting Policies* be developed and agreed between the Bank and the borrower.
- Appropriate *Notes to the Financial Statements* supplement the financial statements.
- Where appropriate, the Financial Statements should be tailored so that they adequately reflect the performance and position of the organization.

7.26.4 The format used for this particular model set of summary financial statements is appropriate for year-end reporting.

Example Manufacturing Organization
Income Statement [Format for Year-end Reporting]
For the year ended 31 December 20X2

	Notes	For the Year Ended 31 December 20x2				Cumulative Since Project Start-Date			
		Actual	Forecast	Variance		Actual	Forecast	Variance	
		US\$'000	US\$'000s	US\$'000	%	US\$'000s	US\$'000s	US\$'000	%
SALES	1	893,121	1,431,093	-537,972	-37.6%	1,976,522	2,173,098	-196,576	-9.0%
Less cost of goods sold	2	813,673	1,296,081	482,408	37.0%	1,760,823	1,932,016	171,193	8.9%
GROSS PROFIT		79,448	135,012	-55,564	-41.2%	215,699	241,082	-25,383	-10.5%
Operating Costs									
Administrative salaries		27,326	37,742	10,416	27.6%	39,950	41,506	1,556	3.7%
Depreciation		3,917	7,335	3,418	46.6%	8,554	7,953	-601	-7.6%
Amortization		12,357	12,357	..	0.0%	12,357	12,357	..	0.0%
Administration costs		56,037	88,259	32,222	36.5%	92,672	97,306	4,634	4.8%
Marketing expenses		3,109	4,985	1,876	37.6%	6,904	7,596	692	9.1%
		102,746	150,678	47,932	31.8%	160,437	166,718	6,281	3.8%
OPERATING PROFIT		-23,298	-15,666	-7,632	48.7%	55,262	74,364	-19,102	-25.7%
Other income		1,000	1,080	-80	-7.4%	1,166	1,260	-94	-7.5%
Foreign exchanges gains/(losses)		..	-1,570	1,570	-100.0%	-1,564	-1,845	281	-15.2%
Net income before interest and taxes		-22,298	-16,156	-6,142	38.0%	54,864	73,779	-18,915	-25.6%
Project-related interest expenses		-42,672	-63,657	20,985	-33.0%	-52,343	-39,604	-12,739	32.2%
Other interest expenses		..	..	..	0.0%	..	..	..	0.0%
Income tax expense		..	..	..	0.0%	..	-8,189	8,819	-100.0%
Net Income after Interest and Taxes		-64,970	-79,813	14,843	-18.6%	2,521	25,986	-23,465	-90.3%
Gross Margin (% of Sales)		8.9%	9.4%	-0.5%	...	10.9%	11.1%	-0.2%	...
Operating Margin (% of Sales)		-2.6%	-1.1%	-1.5%	...	2.8%	3.4%	-0.6%	...

Example Manufacturing Organization
Balance Sheet [Format for Year-end Reporting]
As at 31 December 20X2

Notes	For the year ended 31 December 20x2			Cumulative Since Project Start-date		
	Actual US\$'000s	Forecast US\$'000s	Variance US\$'000s %	Actual US\$'000s	Forecast US\$'000s	Variance US\$'000s %
Current Assets						
	25,308	10,373		34,085	-62,165	
	56,114	59,943		82,791	91,025	
3	18,705	19,981		27,597	30,342	
4	365,150	402,058		427,488	455,796	
	120,193	120,193		120,193	120,193	
	585,470	612,548		692,154	635,191	
Less: Current Liabilities						
	93,174	103,203		140,826	156,768	
	207,610	207,610		207,610	207,610	
	5,000	5,000		5,000	5,000	
	13,084	13,084		13,084	13,084	
	184,427	184,427		184,427	184,427	
	72,607	72,648		72,890	81,167	
	47,749	47,749		47,749	47,749	
	3,000	13,578		28,824	71,070	
	626,651	647,299		700,410	766,875	
	-41,181	-34,751		-8,256	-131,684	
WORKING CAPITAL						
Plus: Non-current Assets						
	800,263	1,222,024		1,136,482	1,056,928	
	445,108	169,390		520,880	913,740	
	49,426	37,069		24,712	12,355	
	30,572	15,572		..	..
	1,325,369	1,444,055		1,682,074	1,983,023	
Less: Non-current Liabilities						
	443,700	621,349		554,132	670,517	
	7,646	7,646		7,646	7,646	
	49,250	49,250		49,250	49,250	
	500,596	678,245		611,028	727,413	
	783,592	731,059		1,062,790	1,123,926	
NET ASSETS						
EQUITY						
	315,147	342,427		671,637	706,787	
	468,445	388,632		391,153	417,139	
	783,592	731,059		1,062,790	1,123,926	
	0.93	0.95		0.99	0.83	
	0.16	0.14		0.21	0.08	
	0.64	0.93		0.57	0.65	

Example Manufacturing Organization
Statement of Cash Flows [Format for Year-end Reporting]
For the year ended 31 December 20X2

	<u>For the Year Ended 31 December 20x2</u>				<u>Cumulative Since Project Start-Date</u>				
	Notes	Actual	Forecast	Variance		Actual	Forecast	Variance	
		US\$'000s	US\$'000s	US\$'000s	%	US\$'000s	US\$'000s	US\$'000s	%
Operating Cash Flows									
Receipts									
Cash receipts from costumers		915,146	1,448,537	-533,391	-36.8%	1,972,084	2,173,621	-201,537	-9.3%
Tax rebates		23,260	27,280	-4,020	-14.7%	30,990	35,150	-4,160	-11.8%
Other receipts		1,000	1,080	-80	-7.4%	1,166	1,260	-94	-7.5%
Payments									
Employees and suppliers		-896,292	-1,387,934	491,642	-35.4%	-1,811,168	-2,019,189	208,021	-10.3%
Taxes paid		-5,942	-7,508	1,566	-20.9%	-10,212	-11,414	1,202	-10.5%
Other payments				..	0.0%			..	0.0%
Net Cash Flows from Operations	5	37,172	81,455	-44,283	-54.4%	182,860	179,428	3,432	1.9%
INVESTING CASH FLOWS									
Receipts									
Interest received		..	..	..	0.0%	..	..	..	0.0%
Sales of fixed assets		..	..	..	0.0%	..	..	..	0.0%
Sales of investments		..	..	..	0.0%	..	..	..	0.0%
Payments									
Interest paid		-28,482	-42,370	13,888	-32.8%	-41,700	-39,604	-2,096	5.3%
Capital expenditures		..	-219,390	219,390	-100.0%	-351,490	-392,860	41,370	-10.5%
Purchases of investments				..	0.0%			..	0.0%
Net Cash Flows from Investing Activities		-28,482	-261,760	233,278	-89.1%	-393,190	-432,464	39,274	-9.1%
FINANCING CASH FLOWS									
Capital contributions from owners									
Proceeds from new borrowings		..	168,370	-168,370	-100.0%	247,620	185,610	62,010	33.4%
Payments									
Repayment of borrowings		-3,000	-3,000	..	0.0%	-13,578	-28,824	15,246	-52.9%
Dividends paid		..	..	..	0.0%	..	..	..	0.0%
Net Cash Flows from Financing Activities		-3,000	165,370	-168,370	-101.8%	234,042	156,786	77,256	49.3%
CASH AND CASH EQUIVALENTS									
Balances as at 1 st January		19,618	25,308			10,373	34,085		
Currency changes on opening balances		..	..				..	..
Net increases/(decreases) for period		5,690	-14,935	-20,625	-138.1%	23,712	-96,250	-119,962	-124.6%
Balances as at 31 December		25,308	10,373			34,085	-62,165		

Example Manufacturing Organization
Notes to the Financial Statements [Format for Year-end Reporting]
For the year ended 31 December 20X2

Notes	<u>For the Year Ended 31 December 20x2</u>				<u>Cumulative Since Project Start-Date</u>			
	Actual	Forecast	Variance		Actual	Forecast	Variance	
	US\$'000s	US\$'000s	US\$'000	%	US\$'000s	US\$'000s	US\$'000	%
			s				s	
Note 1: Gross Margin by Product								
Sales by Product:								
Product A	240,318	284,659	-44,341	-15.6%	394,096	433,618	-39,522	-9.1%
Product B	230,868	258,132	-27,264	-10.6%	357,413	393,240	-35,827	-9.1%
Product C	262,416	586,880	-324,464	-55.3%	812,700	894,080	-81,380	-9.1%
Product D	149,919	287,022	-137,103	-47.8%	397,913	437,760	-39,847	-9.1%
Product E	9,600	14,400	-4,800	-33.3%	14,400	14,400	..	0.0%
Total	893,121	1,431,093	-537,972	-37.6%	1,976,522	2,173,098	-196,576	-9.0%
Cost of Sales by Product:								
Product A	203,418	311,059	107,641	34.6%	352,165	405,723	53,558	13.2%
Product B	203,418	336,981	133,563	39.6%	316,948	367,083	50,135	13.7%
Product C	260,375	414,746	154,371	37.2%	739,546	734,166	-5,380	-0.7%
Product D	138,324	220,334	82,010	37.2%	334,556	405,723	71,167	17.5%
Product E	8,138	12,961	4,823	37.2%	17,608	19,321	1,713	8.9%
Total	813,673	1,296,081	482,408	37.2%	1,760,823	1,932,016	171,193	839%
Gross Profit by Product (\$'000s):								
Product A	36,900	-26,400	63,300	-239.8%	41,931	27,895	14,036	50.3%
Product B	27,450	-78,849	106,299	-134.8%	40,465	26,157	14,308	54.7%
Product C	2,041	172,134	-170,093	-98.8%	73,154	159,914	-86,760	-54.3%
Product D	11,595	66,688	-55,093	-82.6%	63,357	32,037	31,320	97.8%
Product E	1,462	1,439	23	1.6%	-3,208	-4,921	1,713	-34.8%
Total	79,448	135,012	-55,564	-41.2%	215,699	241,082	-25,383	-10.5%
Gross Margin by Product (%)								
Product A	15.4%	-9.3%	24.6%	...	10.6%	6.4%	4.2%	...
Product B	11.9%	-30.5%	42.4%	...	11.3%	6.7%	4.7%	...
Product C	0.8%	29.3%	-28.6%	...	9.0%	17.9%	-8.9%	...
Product D	7.7%	23.2%	-15.5%	...	15.9%	7.3%	8.6%	...
Product E	15.2%	10.0%	5.2%	...	-22.3%	-34.2%	11.9%	...
Total	8.9%	9.4%	28.2%	...	10.9%	11.1%	20.5%	...
Note 2: Cost of Goods Sold								
Raw Materials	424,751	690,624	265,873	38.5%	945,534	1,039,383	93,849	9.0%
Utilities	238,734	416,461	177,727	42.7%	592,612	679,561	86,949	12.8%
Direct Labor	79,639	121,775	42,136	34.6%	118,937	112,413	-6,524	-5.8%
Direct Depreciation	35,257	66,012	30,755	46.6%	76,988	71,601	-5,387	-7.5%
Other Variable Costs	22,750	38,117	15,367	40.3%	52,182	57,366	5,184	9.0%
	801,131	1,332,989	531,858	39.9%	1,786,253	1,960,324	174,071	839%
Plus opening finished goods	93,437	80,895	-12,542	-15.5%	117,803	143,233	25,430	17.8%
Less closing finished goods	-80,895	-117,803	-36,908	31.3%	-143,233	-171,541	-28,308	16.5%
Cost of Goods Sold	813,673	1,296,081	482,408	37.2%	1,760,823	1,932,016	171,193	839%

Example Manufacturing Organization
Notes to the Financial Statements [Format for Year-end Reporting]
For the year ended 31 December 20X2

	For the year ended 31 December 20x2			Cumulative since Project Start-Date		
	Actual US\$'000s	Forecast US\$'000s	Variance US\$'000s %	Actual US\$'000s	Forecast US\$'000s	Variance US\$'000s %
Note 3: Receivables						
By Organization Type:						
Related Parties	576	700		750	750	
State-owned organizations	10,256	12,500		17,200	19,000	
Other Organizations	9,744	9,000		12,500	14,000	
Gross Receivables	20,576	22,200		30,450	33,750	
By Age						
Less than 30 days old	10,000	11,000		15,000	19,000	
30 to 60 days old	5,000	5,500		7,000	9,000	
60 to 90 days old	2,500	2,500		5,000	4,000	
90 to 180 days old	2,000	2,000		2,000	1,000	
More than 180 days old	1,076	1,200		1,450	750	
Gross Receivables	20,576	22,200		30,450	33,750	
Less: Provision for Doubtful Debts	-1,871	-2,219		-2,853	-3,408	
Net Receivables per balance	18,705	19,981		27,597	30,342	
Note 4 Inventories						
By Age						
Less than 2 months old	100,000	120,000		125,000	160,000	
2 to 4 months old	80,000	90,000		95,000	150,000	
4 to 6 months old	100,000	95,000		95,000	90,000	
6 to 9 months old	60,000	60,000		70,000	40,000	
9 to 12 months old	20,000	30,000		35,000	20,000	
More than 12 months old	15,150	17,058		17,488	5,796	
Gross Inventories	375,150	412,058		437,488	465,796	
Less: Provisions for Obsolete Inventories	-10,000	-10,000		-10,000	-10,000	
Net Inventories per balance sheet	365,150	402,058		427,488	455,796	
Note 5: Reconciliation of Income Statement to Operating Cash Flows						
Net Surplus/(Deficit) per Income Statement	..	..		..	..
<i>Items included in net surpluses but not in net cash flows from operations:</i>						
Unrealised net foreign exchange gains	..	..		..	..
Interest revenues	..	..		..	..
Interest expenses	..	..		..	..
<i>Asset movements</i>						
Depreciation	..	..		..	..
Gains/(losses) on sales of assets	..	..		..	..
<i>Other non-cash items</i>						
Movements in employee benefit liabilities	..	..		..	..
<i>Movements in working capital</i>						
Decrease/(increase) in receivables	..	..		..	..
Decrease/(increase) in inventories	..	..		..	..
Decrease/(increase) in work in progress	..	..		..	..
Increase/(decrease) in payables	..	..		..	..
Net Cash Flows from Operations	..	..		..	..

7.27 FINANCIAL LOAN COVENANTS

Preamble

This section presents a full discussion of the financial covenants. The Bank, however, unlike other lenders will not apply all these covenants. Importantly, financial loan covenants tend to vary from one project to another and are an outcome of loan negotiations with the borrower. Therefore, the discussion below is intended to only ensure that financial analysts are well informed and NOT as a prescription of what must be found across all projects that are financed by the Bank.

Operating Covenants

Rate of Return Covenant

7.27.1 Under the rate of return covenant, an enterprise affirms that it will take all actions necessary, including changes in its tariffs, rates and charges, for its revenues each year to cover operating expenses and taxes, if any, and to earn an agreed return on its investment. The rate of return covenant is appropriate under low inflationary conditions. When inflation is forecast to exceed 7 percent per annum over the five years from the date of loan effectiveness, the practice has been to require a periodic revaluation of assets.

7.27.2 This covenant is most frequently applied to public sector enterprises constructing and operating projects in the sectors, which embrace agribusiness, electric power, ports, telecommunications, gas or fuel pipelines, water supply and sanitation. The rate of return covenant is generally less frequently used for sanitation and sewerage projects, because they have considerable difficulty in generating surpluses for investment or reserves and therefore these projects are normally combined with those of water supply as part of a water supply utility enterprise operation. A model covenant is provided in section 7.27.32, below.

7.27.3 Competitive factors bear significantly on the financial performance of industry (including oil and gas), therefore a specific rate of return covenant is used infrequently in this sector; instead, a less precisely defined form of the rate of return covenant, the general price covenant (see following paragraphs), is usually used. For railways, the rate of return on invested capital may be used but a commonly used covenant is the operating ratio.

Self-Financing Ratio Covenant

7.27.4 A self-financing ratio covenant, directly addresses the need for sufficient internal cash generation to consistently finance an agreed proportion of investment requirements. This covenant is often used when a more direct approach to addressing cash generation requirements is considered desirable. Borrowers often favour the covenant because it: (i) is more readily understood, particularly by politicians and administrators; (ii) is less costly to put in place and maintain; and (iii) avoids setting aside funds which may occur with the rate of return covenant.

7.27.5 However it can be manipulated. This may arise if a borrower deliberately decides to match its annual investment plans to whatever level of net revenues becomes available, in order to comply with the covenant. As an example, a borrower required to contribute 20 percent per annum to its investment program from internally generated revenues, can comply by financing \$100 million from \$20 million internally generated revenues, but in reality it may need to make

larger investments if it is to achieve its needed contribution to the National Development Strategy. More specifically, and even when using an extended review period (e.g. three years) as the base for determining investments, the objective of the covenant can be avoided by a borrower failing to implement acceptable levels of annual investments, with the result that the revenues required to be generated internally can be allowed to fall correspondingly. The significant and likely impact of this default is a failure by the borrower to expeditiously execute the project, directly due to the reduction of the level of investment agreed between the borrower and the Bank in the project implementation and financing plans. A model covenant is provided in section 7.27.32, below.

7.27.6 A further problem associated with using the self-financing ratio as a covenant is the reality of an often-uneven nature of investment programs (i.e., the pattern of investments can vary widely from year to year). A three-year investment pattern for a public sector enterprise could be \$10 million, \$77 million, and \$12 million. Such a program with a three-year moving average would show for that period an average of \$33 million. If the borrower was required to raise 30 percent from internally generated revenues annually, the result would be a surplus in year one of \$23 million, a shortfall of \$21 million in year two, with parity arriving only in year three.

7.27.7 This example makes the case for smoothing several years' performances, but does not address the issue of achieving a political realistic justification for tariff and charges increases for an as yet unaccomplished investment program. Under these circumstances it may be difficult for a borrower to justify politically the raising of charges to yield a very large surplus in year one. While it may forecast to complete \$77 million in year two, this may be a dubious estimate by a government that is hard-pressed for resources. Under these cases the Bank has to make its case convincingly in line with the macro-economic goals of the National Development Strategy.

General Price Level Covenant

7.27.8 The General Price Level Covenant should be carefully adapted to the circumstances of the particular project. The main purpose of the covenant is to set forth agreed criteria applicable in determining prices, and to provide for consultation with Bank. Because it is not feasible to be precise, the criteria should be expressed in general terms. A model covenant is provided in section 7.27.32, below.

Operating Ratio Covenant

7.27.9 An operating ratio covenant requires a public sector enterprise to set its tariffs and rates at levels that meet a specified operating ratio test. The covenant may also state a minimum reduction in the operating ratio to be achieved by a specified date, as part of an agreed effort to improve operating efficiency and, in some cases, eliminate uneconomic services. This covenant is normally used only where it is not feasible to use a rate of return or cash generation approach – for example, for an entity which has been incurring substantial operating losses and whose objective is to eliminate such losses. It may also be used for a revenue-earning entity that is likely to be restricted by government from generating appropriate amounts of capital for future expansion purposes. It is usually necessary to supplement an operating ratio covenant with agreements by the concerned government to provide necessary funds to offset operating deficits until they are eliminated, to cover any deficiencies in meeting debt service obligations, and to assist in financing capital needs. A model covenant is provided in section 7.27.32, below.

Breakeven Covenant

7.27.10 A Breakeven Ratio covenant is designed to achieve financial viability in its most limited sense. There are two breakeven variations: revenue (accrual) breakeven; and cash breakeven. This section, and the model covenant, refers to the former variation. The covenant requires the entity to take all measures necessary, including adjustments in its rates, for revenues to cover operating expenses, adequate maintenance, taxes if any, and the greater of depreciation or debt service requirements. The objective of this covenant is to support a revenue-earning enterprise's efforts to breakeven, without losses, but without providing any surpluses for investment, dividends, etc.

7.27.11 This approach is occasionally used for transportation and similar projects that follow the principle of funding their capital requirements predominantly through borrowings or grants, and also receive operating subsidies. It is infrequently used for the public sector, and is unlikely to be used for private sector projects. It compares the total revenues of an enterprise to the operating expenses plus the amount by which debt service requirements exceed the provision for depreciation.

7.27.12 The major risk in the use of this covenant is that the borrower/EA may become complacent if break-even is achieved, and will fail to pursue more aggressive revenue-earning policy to provide for the gradual removal of all subsidies. This covenant should not be introduced without a detailed justification at fact-finding, and in the AR. A detailed breakeven analysis, displaying the effects of changes in volume on the breakeven point and on profitability and cash flows should be developed.

Capital Structure Covenants

Debt Service Coverage Covenant

7.27.13 The two key issues to be decided in formulating the debt service ratio covenant are (i) whether to base it on historical or forecast earnings, and (ii) what particular ratio to require as the minimum acceptable coverage. A good rule to follow is to allow the enterprise reasonable flexibility in making financing arrangements without requiring the Bank's frequent approval for new borrowings. This factor must be balanced against the need to maintain prudent limits on the enterprise's debt service obligations. As a general rule, the covenant should be on the historical earnings basis if it is expected that the test could be met on this basis for the reasonably foreseeable future, or that the need to seek Bank approval for an exception would occur no more frequently than about once every several years.

7.27.14 The forecast basis should be used when it is likely that during a year there would be many occasions for incurring debt obligations, which would otherwise require prior Bank approval. This is particularly relevant for an enterprise that has a large investment program containing many projects, with long implementation periods and a need to arrange many borrowings to finance the program. It may also be advisable to use the forecast basis in highly inflationary conditions to ensure that tariffs and rates are moved in concert with interest rates. A model covenant is provided in section 7.27.32, below.

7.27.15 A ratio typically recommended for this covenant is 1.5, but it can vary from as low as 1.2 to as high as 2.0 or more depending on industry averages, or how stable or cyclical the earnings of the EA are judged to be. Where business risks are similar the appropriate ratio would be lower when using historical earnings than with forecast earnings. However, it is essential that the

financial analyst be prepared to justify the ratio recommended, particularly the excess requirement over 1.0. Any “mark-up” over 1.0 must be quantified in terms of the amount it is estimated to provide, and the proposed application of the funds, (working capital, reserves, investment purposes, dividends, etc). It is not sufficient to either select a “comfortable” or non-controversial figure, or to continue using a ratio already in a legal agreement for previous operations of the borrower.

7.27.16 Capital structure covenants have a limited use, in that they are not intended to perform as revenue-generating covenants. They serve only to restrict the borrowing capacity of EAs. The debt service coverage ratio covenant may be adapted to include a forecasting provision that would require an EA to institute mandatory adjustments to tariffs, or rates (if within its discretion, or to make the necessary applications for increases, if not). Bank staff should seek the advice of GECL before discussing with a borrower/EA the possible application of such a modified capital structure covenant.

Debt: Equity Ratio Covenant

7.27.17 The debt-equity ratio covenant is simple to understand and administer, and is consistent with the need to maintain a sound capital structure without unduly restricting the entity’s ability to make its own routine financing decisions. It is pertinent to note that for this form of covenant, debt need not be defined in the same way as for the debt service coverage covenant. For the latter, the definition applies to the entire amount of the long-term debt, and the applicable debt service obligations, as of the date of signing the contract for the debt. For the debt-equity ratio, the definition of debt may be framed in terms of debt outstanding. This provides the entity some flexibility in phasing additions to its equity capital to match the timing of expected drawdowns of debt. A model covenant is provided in section 7.27.32, below.

7.27.18 Defining debt in terms of the amount outstanding is appropriate for the debt-equity ratio covenant only when it is deemed feasible for an enterprise to apply the test each time it intends to draw down debt and, when necessary, call on its shareholders for additional equity capital before the increase in debt outstanding. This is most likely to be the case for financial intermediaries, which can generally limit their commitments to lend funds to the availability of resources in hand. Application of the drawdown concept is likely to be inappropriate in other sectors where use of borrowed funds cannot readily be interrupted if there is a failure to meet a debt limitation test for a particular drawdown of a loan. For similar reasons, application of the drawdown concept is generally not appropriate or feasible under the debt service coverage test.

7.27.19 The debt-equity ratio covenant is occasionally used for established entities when the borrower has overriding objections to the use of a debt service coverage covenant. Since the major shortcoming of the debt: equity ratio covenant is that it disregards the terms and conditions of the debt and their impact on the debt service burden, it may be advisable when using this form of covenant to add a limitation on medium-term debt; e.g., limiting the amount of debt incurred with a term of issuance of less than ten years to some ten or fifteen percent of total capitalization.

Debt Limitation Covenant

7.27.20 An absolute debt limitation covenant limits the amount of debt that may be incurred annually to a stated amount (expressed in absolute terms or as a proportion of the total capitalization) and requires Bank concurrence before exceeding this limit. This covenant is used infrequently and only where debt service coverage or debt-equity covenants cannot be applied. Consequently no example is provided, as each covenant should be uniquely drawn.

7.27.21 The typical case when this covenant is used involves a public authority whose capital structure consists entirely or predominantly of debt, because of statutory requirements that all externally provided investment funds be advanced in the form of borrowing from government. The limit for new debt is fixed at a relatively small amount which together with the internally generated funds which are likely to be available, allows the borrower to carry out minor plant replacements or improvements, but which requires the borrower to consult with the Bank whenever it plans a major expansion.

7.27.22 Although this form of covenant is simple to administer, it has substantial disadvantages. It is related to a stated amount of debt without consideration of its terms and without taking into account changes in an enterprise's financial requirements or debt servicing capacity; and it severely restricts an enterprise's freedom of action. A preferable approach would be to agree that a substantial part of any loan by the government to the public sector enterprise would be subordinated and treated as quasi-equity capital, thus permitting the use of either the debt service coverage or debt equity ratio covenants. The project team should ensure that it is legally possible to create a subordinated debt. There may be restrictions or regulations of the government, which affect its ability to have its debt treated as quasi-equity.

Capital Adequacy Ratio Covenant

7.27.23 This covenant is normally applied to financial intermediaries (FIs). It is used to compare the adequacy of an institution's available equity to meet losses that may be incurred by losses of financial assets. For this purpose, equity is defined in a similar manner as in the debt-equity ratio covenant, but with the addition of any provisions for bad and doubtful debts (loss provisions). However, the definition of assets will need to be defined on an institutional basis. A model covenant is provided in section 7.27.32, below.

7.27.24 Local market and lending conditions will materially affect the quality of assets and staff must reach agreement with the borrower on the risk factors applicable to each class of assets. This classification of risk by reference to groups of assets-at-risk may need to be varied over the life of a loan, and therefore it will be necessary to introduce regular reviews to determine any required revisions from time to time. In addition, judgment will be needed to determine a safe margin above the potential loss level of assets-at-risk prescribed in the covenant. Normally this is unlikely to be less than 1.00, when equity will at least absorb all potential losses, as calculated in accordance with methods specified in minutes to loan negotiations.

Liquidity Covenants

Current Ratio Covenant

7.27.25 The advantages of the current ratio covenant are that: (i) it is simple and easily understood by borrowers; (ii) it is based on an accurate and objective test; (iii) it can be based on readily defined accounting principles and calculated from standard financial statements; and (iv) in most cases it provides a fair representation of short-term solvency of the borrower. A model covenant is provided in section 7.27.32, below.

7.27.26 However, this covenant will only be an adequate test of liquidity if the covenant design provides for: (i) periods of falling sales and consequent declining internal cash generation, when the borrower may find it difficult to convert inventories to cash at reasonable prices; (ii) a suitable analysis of inventories, because some items may be non-saleable (for example, they may be spare

parts or obsolete products not written off) and because a minimum level of inventories must be retained to continue operations; and (iii) a suitable analysis of accounts receivable; and seasonal variations in working capital requirements and interim peaks for debt maturities during the year. These problems, although serious in some projects, can be overcome either by making appropriate allowances when determining the acceptable ratio, or by using the quick ratio test. The borrower should be asked to calculate and confirm compliance with the current ratio at intervals throughout the fiscal year (e.g., in quarterly or semi-annual reports; or whenever requested by the Bank).

7.27.27 This covenant requires consistent and close monitoring to ensure that unacceptable management and accounting practices are not being followed to give the appearance of compliance. For example, accounts receivable may be overstated because of inadequate provisions for bad debts. In some instances, it may be necessary to introduce supporting covenants that specifically address such key issues as the size of short-term debt, or levels of inventories and receivables.

Quick Ratio Covenant

7.27.28 The quick ratio covenant is similar to the current ratio covenant, except that inventories are excluded, to focus on the most liquid items in the financial statements. It gives a much clearer view of the “cash” position of the enterprise. After taking that benefit into account, this covenant still has the shortcomings associated with the current ratio. A model covenant is provided in section 7.27.32, below.

7.27.29 While any selected covenant must be framed to reflect the objectives of the borrower and the project, it is probably desirable when a decision has to be made between the current and quick ratios, to select the latter and to require at least a three-monthly submission of information; and introduce a performance covenant to address control of inventories. In this way the cash position can be examined closely and regularly.

Dividend Limitation Covenant

7.27.30 The dividend limitation covenant with a dividend limitation test prohibits the borrower from declaring a dividend the payment of which would cause the current ratio (or quick ratio) to fall below a specified minimum. The minimum level of current ratio specified in this covenant may be higher than the minimum required under the current ratio covenant discussed in section 4.5.47 because decisions on whether to pay dividends are often discretionary, and a stricter standard of prudent financial management can thus be applied to this context. Therefore, the borrower is asked not to make voluntary payouts of cash to its stockholders until it has taken further measures to establish and maintain the liquidity essential for operations. A model covenant is provided in section 7.27.32, below.

Model Financial Loan Covenants

7.27.31 In the sections that follow, outlines of model financial covenants are provided for use in loan agreements. They are intended as a guide only. It is the responsibility of the GECL to determine, in consultation with the Task Manager and the financial analyst, the precise wording of loan covenants for inclusion in the legal agreements and their legal enforceability. In cases of borrowers conducting multiple operations, the text of the covenant should define which operations are to be subject to performance measurement. As an example, in an electric power project to be carried out by a borrower that operates electric power, water supply and

telecommunications services, the covenant normally would be drafted to apply only to the electric power operations.

7.27.32 Model Operating Covenants

Rate of Return Covenant

Section _____.

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower's Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall earn, for each of its fiscal years after its fiscal year ending on [day/month/year], an annual return of not less than _____ percent of the average current net value of the Borrower's fixed assets in operation.
- (c) Before (date/month) in each of its fiscal years, the Borrower shall, on the basis of forecasts prepared by the Borrower and satisfactory to the Bank, review whether it would meet the requirements set forth in paragraph (a) in respect of such year and the next following fiscal year and shall furnish to the Bank the results of such review upon its completion.

Paragraph (d): Option 1: Where the borrower or government has discretion to adjust tariffs/rates:

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, adjustments of the structure or levels of its rates (prices)) in order to meet such requirements.

Paragraph (d): Option 2: Where there is an independent regulator in place (or where it is anticipated that an independent regulator may be established during the project implementation period):

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, filing applications with the [name of regulator] seeking a tariff/rate increase) in order to meet such requirements.
- (e) For the purposes of this Section:
 - (i) The annual return shall be calculated by dividing the Borrower's net operating income for the fiscal year in question by one half of the sum of the current net value of the Borrower's fixed assets in operation at the beginning and at the end of that fiscal year.
 - (ii) The term "net operating income" means total operating revenues less total operating expenses.

- (iii) The term “total operating revenues” means revenues from all sources related to operations, after making adequate provisions for uncollectible debts, but excludes government grants, subsidies and transfers.
- (iv) The term “total operating expenses” means all expenses related to operations, including administration, adequate maintenance, taxes and payments in lieu of taxes, and provision for depreciation on a straight-line basis at a rate of not less than ____ percent per annum of the average current gross value of the Borrower’s fixed assets in operation, or other basis acceptable to the Bank, but excluding interest and other charges on debt.
- (v) The average current gross value of the Borrower’s fixed assets in operation shall be calculated as one half of the sum of the gross value of the Borrower’s Fixed assets in operation at the beginning and at the end of the fiscal year [Where revalued: as valued from time to time in accordance with sound and consistently maintained methods of valuation satisfactory to the Bank].
- (vi) The term “current net value of the Borrower’s fixed assets in operation” means the gross value of the Borrower’s fixed assets in operation less the amount of accumulated depreciation [Where revalued: as valued from time to time in accordance with sound and consistently maintained methods of valuation satisfactory to Bank].
- (vii) The terms “operations” or “operating” refer to the [identify relevant part of the operations] operations of the Borrower.

Self-Financing Ratio Covenant

Section _____

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower’s Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall produce, for each of its fiscal years after its fiscal year ending on _____, cash from internal sources equivalent to not less than ____ percent of the annual average of the Borrower’s capital expenditures incurred, or expected to be incurred, for
Remainder of Paragraph (b), Option 1: that year, the previous fiscal year and the next _____ following fiscal years.
Remainder of Paragraph (b), Option 2: that year and the next _____ following fiscal years.
- (c) Before (date/month) in each of its fiscal years, the Borrower shall, on the basis of forecasts prepared by the Borrower and satisfactory to the Bank, review whether it would meet the requirements set forth in paragraph (a) in respect of such year and the next following fiscal year and shall furnish to the Bank a copy of such review, upon its completion.

Paragraph (d): Option 1: Where the borrower or government has discretion to adjust tariffs/rates:

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, adjustments of the structure or levels of its rates (prices)) in order to meet such requirements.

Paragraph (d): Option 2: Where there is an independent regulator in place (or where it is anticipated that an independent regulator may be established during the project implementation period):

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, filing applications with the [name of regulator] seeking a tariff/rate increase) in order to meet such requirements.
- (e) For the purposes of this Section:
 - (i) The term "cash from internal sources" means the difference between:
 - (A) the sum of cash flows from all sources related to operations, plus cash generated from consumer deposits and consumer advances of any kind, sale of assets, cash yield of interest on investments, and net non-operating income.; and
 - (B) the sum of all expenses related to operations, including administration, adequate maintenance and taxes and payments in lieu of taxes (excluding provision for depreciation and other non-cash operating charges), debt service requirements, all cash dividends paid and other cash distributions of surplus, increase in working capital other than cash and other cash outflows other than capital expenditures.
 - (ii) The term "net non-operating income" means the difference between:
 - (A) revenues from all sources other than those related to operations, after making adequate provisions for uncollectible debts; and
 - (B) expenses, including taxes and payments in lieu of taxes, incurred in the Generation of revenues in (a) above.
 - (iii) The term "working capital other than cash" means the difference between current assets excluding cash and current liabilities at the end of each fiscal year.
 - (iv) The term "current assets excluding cash" means all assets other than cash which could in the ordinary course of business be converted into cash within twelve months, including accounts receivable, marketable securities, inventories and prepaid expenses properly chargeable to operating expenses within the next fiscal year.
 - (v) The term "current liabilities" means all liabilities which will become due and payable or could under circumstances then existing be called for payment within

twelve months, including accounts payable, customer advances, debt service requirements taxes and payments in lieu of taxes, and dividends.

- (vi) The term “debt service requirements” means the aggregate amount of repayments (including sinking fund payments if any) of, and interest and other charges on, debt, excluding interest charged to construction and financed from loans.
- (vii) The term “capital expenditures” means all expenditures incurred on account of fixed assets, including interest charged to construction, related to operations.
- (viii) The terms “operations” or operating” refer to the [identify relevant part of the operations] operations of the Borrower.
- (ix) Whenever for the purposes of this Section it shall be necessary to value, in terms, of the currency of the (Borrower/Guarantor), debt payable in another currency, such valuation shall be made on the basis of the prevailing lawful rate of exchange at which such other currency is, at the time of such valuation, obtainable for the purposes of servicing such debt, or, in the absence of such rate, on the basis of a rate of exchange acceptable to the Bank.

General Price Level Covenant

Section _____

- (a) The (Borrower/Guarantor) and the Bank shall, from time to time, at the request of either party, exchange views with regard to the (Borrower’s/Guarantor’s) _____ pricing policies and its plans in respect of the overall development of the _____ sector.
- (b) The (Borrower/Guarantor) agrees, as long as it exercises control over the setting of prices of the _____ companies, to establish prices for _____ sold by such companies which would: (i) allow the _____ companies, under conditions of efficient operation at reasonable levels of capacity utilization, to cover their operating costs including taxes, earn an adequate return on funds invested in them, meet their financial obligations and make a reasonable contribution to future investment for expansion of capacity; (ii) be reasonably competitive with prices for _____ in other major producing countries; and (iii) subject to the achievement of objectives (i) and (ii) above, pass on the benefit of declines in the real cost of production to _____ through reduction in prices in real terms.

Operating Ratio Covenant

This covenant may be converted to a working ratio covenant by substituting a definition of working expenses for operating expenses. This will normally require that depreciation be omitted from the definition of operating expenses recommended herein.

Section _____

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower’s Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall maintain, for each of its

- fiscal years after its fiscal year ending on _____, a ratio of total operating expenses to total operating revenue not higher than _____ (percent).
- (c) Before (date/month) in each of its fiscal years, the Borrower shall, on the basis of forecasts prepared by the Borrower and satisfactory to the Bank, review whether it would meet the requirements set forth in Paragraph (a) in respect of such year and the next following fiscal year, and shall furnish to the Bank the results of such review upon its completion.

Paragraph (d): Option 1: Where the borrower or government has discretion to adjust tariffs/rates:

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, adjustments of the structure or levels of its rates (prices)) in order to meet such requirements.

Paragraph (d): Option 2: Where there is an independent regulator in place (or where it is anticipated that an independent regulator may be established during the project implementation period):

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, filing applications with the [name of regulator] seeking a tariff/rate increase) in order to meet such requirements.
- (e) For the purposes of this Section
- (i) The term "total operating expenses" means all expenses related to operations, including administration, adequate maintenance, taxes and payments in lieu of taxes, and provision for depreciation on a straight-line basis at a rate of not less than _____ percent per annum of the average current gross value of the Borrower's fixed assets in operation, or other basis acceptable to the Bank, but excluding interest and other charges on debt.
- (ii) The term "total operating revenues" means revenues from all sources related to operations, after making adequate provisions for uncollectible debts.
- (iii) The average current gross value of the Borrower's fixed assets in operation shall be calculated as one half of the sum of the gross value of the Borrower's fixed assets in operation at the beginning and at the end of the fiscal year, as valued from time to time in accordance with sound and consistently maintained methods of valuation satisfactory to the Bank.
- (iv) The terms "operations" or "operating" refer to the [identify relevant part of the operations] operations of the Borrower.

Breakeven Ratio Covenant

Section _____.

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower's Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall produce for each of its fiscal years after its fiscal year ending on _____, total revenues equivalent to /or not less that the sum of (i) its total operating expenses; and (ii) the amount by which debt service requirements exceed the provision for depreciation.⁹
- (c) Before (date/month) in each of its fiscal years, the Borrower shall, on the basis of forecast prepared by the Borrower and satisfactory to the Bank, review whether it would meet the requirements set forth in paragraph (a) in respect of such year and the next following fiscal year and shall furnish to the Bank the results of such review upon its completion.

Paragraph (d): Option 1: Where the borrower or government has discretion to adjust tariffs/rates:

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, adjustments of the structure or levels of its rates (prices)) in order to meet such requirements.

Paragraph (d): Option 2: Where there is an independent regulator in place (or where it is anticipated that an independent regulator may be established during the project implementation period):

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, filing applications with the [name of regulator] seeking a tariff/rate increase) in order to meet such requirements.
- (e) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, filing applications with the [name of regulator] seeking a tariff/rate increase) in order to meet such requirements.
- (f) For purposes of this Section:
 - (i) The term "total revenues" means the sum of total operating revenues and net non-operating income, but excludes all government grants, subsidies and transfers income.
 - (ii) The term "total operating revenues" means revenues from all sources related to operations, after making adequate provisions for uncollectible debts.

⁹ For some borrowers depreciation may not be applicable.

- (iii) The term “net non-operating income” means the difference between:
 - (A) revenues from all sources other than those related to operations; and
 - (B) expenses, including taxes and payments in lieu of taxes, incurred in the generation of revenues in (iii)(a) above.
- (iv) The term “total operating expenses” means all expenses related to operations, including administration, adequate maintenance, taxes and payments in lieu of taxes, and provision for depreciation on a straight-line basis at a rate of not less than _____ percent per annum of the average current gross value of the Borrower’s fixed assets in operation, or other basis acceptable to the Bank, but excluding interest and other charges on debt.
- (v) The average current gross value of the Borrower’s fixed assets in operation shall be calculated as one half of the sum of the gross value of the Borrower’s fixed assets in operation at the beginning and at the end of the fiscal year, as valued from time to time in accordance with sound and consistently maintained methods of valuation satisfactory to the Bank.
- (vi) The term “debt service requirements” means the aggregate amount of repayments (including sinking fund payments, if any) of, and interest and other charges on, debt.
- (vii) The term “debt” means any indebtedness of the Borrower maturing by its terms more than one year after the date on which it is originally incurred.
- (viii) Debt shall be deemed to be incurred: (a) under a loan contract or agreement or other instrument providing for such debt or for the modification of its terms of payment on the date of such contract, agreement or instrument; and (b) under a guarantee agreement, on the date the agreement providing for such guarantee has been entered into. Financial liabilities incurred by a borrower who is a lessee under finance leasing agreements may also be included as debt.
- (ix) Whenever for the purposes of the Section it shall be necessary to value, in terms of the currency of the Guarantor, debt payable in another currency, such valuation shall be made on the basis of the prevailing lawful rate of exchange at which such other currency is, at the time of such valuation, obtainable for the purposes of servicing such debt, or, in the absence of such rate, on the basis of a rate of exchange acceptable to the Bank.
- (x) The terms “operations” or “operating” refer to the [identify relevant part of the operations] operations of the Borrower.

7.27.33 Model Capital Structure Covenants

Debt Service Coverage Covenant (Version A: Historical orientation)

Section _____.

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower’s Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall not incur any debt, unless the net revenues of the Borrower for the twelve months prior to the date of such incurrence shall be at least ____ times the estimated maximum debt service requirements

- of the Borrower for any succeeding fiscal year on all debt of the Borrower, including the debt to be incurred.
- (c) For the purposes of this Section:
- (i) The term “debt” means any indebtedness of the Borrower maturing by its terms more than one year after the date on which it is originally incurred.
 - (ii) Debt shall be deemed to be incurred: (a) under a loan contract or agreement or other instrument providing for such debt or for the modification of its terms of payment on the date of such contract, agreement or instrument; and (b) under a guarantee agreement, on the date the agreement providing for such guarantee has been entered into. Financial liabilities incurred by a borrower who is a lessee under finance leasing agreements may also be included as debt. The alternative definition of incurrence of debt, as illustrated in the Debt-Equity Ratio Covenant should not be used for this form of debt limitation covenant.
 - (iii) The term “net revenues” means the difference between:
 - (A) the sum of revenues from all sources related to operations, after making adequate provisions for uncollectible debts, adjusted to take account of the Borrower’s (rates) (prices) in effect at the time of the incurrence of debt even though they were not in effect during the twelve-month period to which such revenues relate and net non-operating income; and
 - (B) the sum of all expenses related to operations including administration, adequate maintenance, taxes and payments in lieu of taxes, but excluding provision for depreciation, other non-cash operating charges and interest and other charges on debt.
 - (iv) The term “net non-operating income” means the difference between:
 - (A) revenues from all sources other than those related to operations; and
 - (B) expenses including taxes and payments in lieu of taxes, incurred in the generation of revenues in (iv)(A) above.
 - (v) The term “debt service requirements” means the aggregate amount of repayments (including sinking fund payments, if any) of, and interest and other charges on debt. Interest charges which are incurred in financing capital expenditures during development should be excluded, if such charges are capitalized. However, if the borrower’s policy is to meet the cost from operating income, such interest charges should be included in “debt service requirements”. Lease payments under finance leases should also be included
 - (vi) Whenever for the purposes of this Section it shall be necessary to value, in terms of the currency of the Guarantor, debt payable in another currency, such valuation shall be made on the basis of the prevailing lawful rate of exchange at which such other currency is, at the time of such valuation, obtainable for the purposes of servicing such debt, or, in the absence of such rate, on the basis of a rate of exchange acceptable to the Bank.
 - (vii) The terms “operations” or operating” refer to the [identify relevant part of the operations] operations of the Borrower.

Debt Service Coverage Covenant (Version B: Forecast orientation)

Section_____.

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower's Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall not incur any debt unless a reasonable forecast of the revenues and expenditures of the Borrower shows that the estimated net revenues of the Borrower for each fiscal year during the term of the debt to be incurred shall be at least _____times the estimated debt service requirements of the Borrower in such year on all debt of the Borrower including the debt to be incurred and no event has occurred since the date of the forecast which has, or may reasonably be expected in the future to have, a material adverse effect on the financial condition of future operating results of the Borrower.
- (c) For the purposes of this Section:
- (i) The term "debt" means any indebtedness of the Borrower maturing by its terms more than one year after the date on which it is originally incurred.
- (ii) Debt shall be deemed to be incurred: (a) under a loan contract or agreement or other instrument providing for such debt or for the modification of its terms of payment on the date of such contract, agreement or instrument; and (b) under a guarantee agreement, on the date the agreement providing for such guarantee has been entered into¹⁰.
- (iii) The term "net revenues" means the difference between:
- (A) the sum of revenues from all sources related to operations and net non-operating income, after making adequate provisions for uncollectible debts; and
- (B) the sum of all expenses related to operations including administration, adequate maintenance, taxes and payments in lieu of taxes, but excluding provision for depreciation, other non-cash operating charges and interest and other charges on debt. Lease payments under finance leases must also be included¹¹.
- (iv) The term "net non-operating income" means the difference between:
- (A) revenues from all sources other than those related to operations, and
- (B) expenses, including taxes and payments in lieu of taxes, incurred in the generation of revenues in (iv)(a) above.
- (v) The term "debt service requirements" means the aggregate amount of repayments

¹⁰ The alternative definition of incurrence of debt, as illustrated in the Debt-Equity Ratio Covenant should not be used for this form of debt limitation covenant.

¹¹ Interest charges that are incurred in financing capital expenditures during development should be excluded, if such charges are capitalized. However, if the Borrower's policy is to meet the cost from operating income, such interest charges should be included in "debt service requirements."

(including sinking fund payments, if any) of, and interest and other charges on debt.

- (vi) The term “reasonable forecast” means a forecast prepared by the Borrower not earlier than nine months prior to the incurrence of the debt in question, which both the Bank and the Borrower accept as reasonable and as to which the Bank has notified the Borrower of its acceptability.
- (vii) The terms “operations” or “operating” refer to the [identify relevant part of the operations] operations of the Borrower.
- (viii) Whenever for the purposes of this Section it shall be necessary to value, in terms of the currency of the Guarantor, debt payable in another currency, such valuation shall be made on the basis of the prevailing lawful rate of exchange at which such other currency is at the time of such valuation obtainable for the purposes of servicing such debt, or, in the absence of such rate, on the basis of a rate of exchange acceptable to the Bank.

Debt-Equity Ratio Covenant

Section _____.

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower’s Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall not incur any debt, if after the incurrence of such debt the ratio of debt to equity shall be greater than _____to_____.
- (c) For purposes of this Section:
 - (i) The term “debt” means any indebtedness of the Borrower maturing by its terms more than one year after the date on which it is originally incurred.

Subparagraph (ii): Option 1: General usage:

- (ii) Debt shall be deemed to be incurred: (a) under a loan contract or agreement, or conditional sale or transfer or financing lease agreement or other instrument providing for such debt or for the modification of its terms of payment on the date of such contract, agreement or instrument; and (b) under a guarantee agreement, on the date the agreement providing for such guarantee has been entered into. Financial liabilities incurred by a borrower who is a lessee under finance leasing agreements may also be included as debt.

Subparagraph (ii): Option 2: Primarily intended for use with financial intermediaries:

- (ii) Debt shall be deemed to be incurred: (a) under a loan contract or agreement or other instrument providing for such debt or for the modification of its terms of payment, on the date, and to the extent, the amount of such debt has become outstanding pursuant to such contract, agreement or instrument; and (b) under a guarantee agreement, on the date the agreement providing for such guarantee has been entered into but only to the extent that the guaranteed debt is outstanding. Lease payments under finance leases should also be included.

- (iii) The term “equity” means the sum of the total unimpaired paid-up capital, retained earnings and reserves of the Borrower not allocated to cover specific liabilities.
- (iv) Whenever for purposes of this Section it shall be necessary to value, in terms of the currency of the Guarantor, debt payable in another currency, such valuation shall be made on the basis of the prevailing lawful rate of exchange at which such currency is, at the time of valuation, obtainable for the purposes of servicing such debt, or, in the absence of such rate, on the basis of a rate of exchange acceptable to the Bank.

Capital Adequacy Ratio Covenant

Section _____

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower’s Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall not make an advance to a sub-borrower [including leasing of an asset], if after the making of any such advance [or lease], the ratio of its equity to its assets-at-risk shall be greater than ____to____.
- (c) For purposes of this Section,
 - (i) The term “equity” means the sum of the total of unimpaired paid-up capital, retained earnings, and reserves of the borrower available to meet any losses which may be incurred by non-recovery of assets, including provisions for bad and doubtful debts and loan [and lease] losses at the date of making such advance [lease] in (a) above;
 - (ii) The term “assets-at-risk” means the sum of the total impaired value of assets at the date of making such advance [lease] in (b) above;
 - (iii) The term “impaired value of assets” in (ii) above means the value of each asset of the borrower valued in accordance with sound and consistently maintained methods of valuation satisfactory to the Bank.

7.27.34 Model Liquidity Covenants

Current Ratio Covenant

Section _____.

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower’s Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall maintain a ratio of current assets to current liabilities of not less than_____.
- (c) Before (date/month) in each of its fiscal years, the Borrower shall, on the basis of forecasts prepared by the Borrower and satisfactory to the Bank, review whether it would meet the requirements set forth in paragraph (b) in respect of such year and the next following fiscal year and shall furnish to the Bank the results of such review upon its completion

Paragraph (c): Option 1: Where the borrower or government has discretion to adjust tariffs/rates:

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, adjustments of the structure or levels of its rates (prices)) in order to meet such requirements.

Paragraph (c): Option 2: Where there is an independent regulator in place (or where it is anticipated that an independent regulator may be established during the project implementation period):

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, filing applications with the [name of regulator] seeking a tariff/rate increase) in order to meet such requirements.
- (e) For the purposes of this Section:
 - (i) The term "current assets" means cash, all assets, which could in the ordinary course of business be converted into cash within twelve months, including accounts receivable, marketable securities, inventories and prepaid expenses properly chargeable to operating expenses within the next fiscal year.
 - (ii) The term "current liabilities" means all liabilities, which will become due and payable or could under circumstances then existing be called for payment within twelve months, including accounts payable, customer advances, debt service requirements, taxes and payments in lieu of taxes, and dividends.
 - (iii) The term "debt service requirements" means the aggregate amount of repayments (including sinking fund payments, if any) of, and interest and other charges on, debt.
 - (iv) Whenever for the purposes of this Section it shall be necessary to value, in terms of the currency of the Guarantor, debt payable in another currency, such valuation shall be made on the basis of the prevailing lawful rate of exchange at which such other currency is, at the time of such valuation, obtainable for the purposes of servicing such debt, or, in the absence of such rate on the basis of a rate of exchange acceptable to the Bank.
 - (v) The terms "operations" or "operating" refer to the [identify relevant part of the operations] operations of the Borrower.

Quick Ratio Covenant

Section _____.

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower's Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall maintain a ratio of liquid current assets to current liabilities of not less than _____

- (c) Before (date/month) in each of its fiscal years, the Borrower shall, on the basis of forecasts prepared by the Borrower and satisfactory to the Bank, review whether it would meet the requirements set forth in paragraph (b) in respect of such year and the next following fiscal year and shall furnish to the Bank the results of such review upon its completion.

Paragraph (d): Option 1: Where the borrower or government has discretion to adjust tariffs/rates:

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, adjustments of the structure or levels of its rates (prices)) in order to meet such requirements.

Paragraph (d): Option 2: Where there is an independent regulator in place (or where it is anticipated that an independent regulator may be established during the project implementation period):

- (d) If any such review shows that the Borrower would not meet the requirements set forth in paragraph (b) for the Borrower's fiscal years covered by such review, the Borrower shall promptly take all necessary measures (including without limitation, filing applications with the [name of regulator] seeking a tariff/rate increase) in order to meet such requirements.
- (e) For the purposes of this Section:
- (i) The term "liquid current assets" means cash, all assets, which could in the ordinary course of business be converted into cash within twelve months, including accounts receivable, marketable securities, and prepaid expenses properly chargeable to operating expenses within the next fiscal year, but excluding inventories.
 - (ii) The term "current liabilities" means all liabilities, which will become due and payable or could under circumstances then existing be called for payment within twelve months, including accounts payable, customer advances, debt service requirements, taxes and payments in lieu of taxes, and dividends.
 - (iii) The term "debt service requirements" means the aggregate amount of repayments (including sinking fund payments, if any) of, and interest and other charges on debt.
 - (iv) Whenever for the purposes of this Section it shall be necessary to value, in terms of the currency of the Guarantor, debt payable in another currency, such valuation shall be made on the basis of the prevailing lawful rate of exchange at which such other currency is, at the time of such valuation, obtainable for the purposes of servicing such debt, or, in the absence of such rate on the basis of a rate of exchange acceptable to the Bank.
 - (v) The terms "operations" or "operating" refer to the [identify relevant part of the operations] operations of the Borrower.

Dividend Limitation Covenant

Section _____.

- (a) For the purposes of this Loan Agreement, all financial calculations, ratios and financial covenants shall be applied in respect of the Borrower's Operations only.
- (b) Except as the Bank shall otherwise agree, the Borrower shall not declare any dividend or make any other distribution with respect to its share capital, unless after such dividend has been paid or other distribution has been made, the current assets of the Borrower would equal or exceed ___ times the current liabilities of the Borrower.
- (c) For the purposes of this Section:
- (i) The term "current assets" means cash, all assets, which could in the ordinary course of business be converted into cash within twelve months, including accounts receivable, marketable securities, inventories and prepaid expenses properly chargeable to operating expenses within the next fiscal year.
 - (ii) The term "current liabilities" means all liabilities, which will become due and payable or could under circumstances then existing be called for payment within twelve months, including accounts payable, customer advances, debt service requirements, taxes and payments in lieu of taxes and dividends.
 - (iii) The term "debt service requirements" means the aggregate amount of repayments (including sinking fund payments, if any) of, and interest and other charges on, debt.
 - (iv) Whenever for the purposes of this Section it shall be necessary to value, in terms of the currency of the Guarantor, debt payable in another currency, such valuation shall be made on the basis of the prevailing lawful rate of exchange at which such other currency is, at the time of such valuation, obtainable for the purposes of servicing such debt, or, in the absence of such rate, on the basis of a rate of exchange acceptable to the Bank.

Glossary

A

Account

- n.** The detailed record of a particular asset, liability, owners' equity, revenue or expense.
- v.** Method of classifying, recording, and accumulating transactions (from which a balance sheet and income statement can be derived). An account is usually expressed in money. A separate account exists for each category of asset and liability, shareholder equity, revenues, and expenses.

Accountability

Obligation to give answers and explanations concerning one's actions. Internal accountability exists within organizations; an example is management's responsibility to a board of directors. External accountability denotes an organization's responsibility to shareholders, lenders, and the public. The Bank monitors borrower accountability through project reviews and auditing to ensure that Bank funds are used with economy and efficiency, and in support of good governance.

Accounting

Process of recording, measuring, interpreting, and communicating financial data for the purpose of decision making.

Accounting period

Time period covered by financial statements, usually a year, a quarter, or a month. The annual accounting period for financial statements may be based on a calendar or a fiscal year.

Accounting policies

The specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements.

Accounting standards

Accounting principles after they have been established by an authoritative accounting rule-making body.

Accounts payable

Amounts due to others for goods and services purchased. They are usually payable within 12 months (from report date) and thus are classified as current liabilities on the balance sheet.

Accounts receivable

Amounts due from others for goods and services delivered in the normal course of business. Amounts due within one year of the report date conform to the definition of current assets. Any amounts known to be uncollectible within one year, but collectible after one year, should be listed as a separate line entry under non-current assets.

Accounts receivable turnover

Measurement arrived at by dividing annual net sales by the average accounts receivable. For an entity with a decreasing turnover rate, the longer receivables are held, the less likely they are to be collected.

Accretion

- (a) Growth in assets through mergers, acquisitions, or internal expansion.
- (b) Adjustment of the difference between the face value of a bond and the price of the bond bought at an original discount.

Accrual

The recognition of revenue when earned or expenses when incurred regardless of when cash is received or disbursed.

Accrual accounting

Accounting method that recognizes transactions and other events when they occur (and not as cash or its equivalent is issued or paid). The events are recorded in the accounting periods and reported in the financial statements of the periods to which they relate.

Accrued expense

Expenditure incurred in the current accounting period but not invoiced or paid by the end of the period. It is usually payable within 12 months.

Accrued liability

Liabilities which are incurred, but for which payment is not yet made, during a given accounting period. Some examples in a manufacturing environment would be: wages, taxes, suppliers/vendors, etc.

Accrued revenue

Revenue that has been earned and must be accounted for but is not received by the end of the reporting period.

Accumulated depreciation

The cumulative charges against the fixed assets of a company for wear and tear or obsolescence.

Acid test ratio

Stringent test of liquidity; also called quick ratio. The ratio is found by dividing the most liquid current assets (cash, marketable securities, and accounts receivable) by current liabilities.

Acquisition cost

Price paid to buy goods, services, or assets. It equals the list price plus normal incidental costs to acquire the item, such as taxes, preparation, transportation, and installation.

Additional paid-in capital

Excess received from stockholders over par value of the stock issued; also called contributed capital in excess of par. Additional paid in capital is shown in the shareholder equity section of the balance sheet.

Adverse Audit Opinion

The auditor's opinion accompanying a financial statement when the auditor concludes that qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Aging of receivables

Time analysis of accounts receivable in which they are classified as either current or past due. If past due, they are classed according to due date.

Amortization

Either (a) the retirement of debt on an instalment or serial payment basis, **or (b)** the process of systematically charging off the cost of an intangible asset (e.g., goodwill, systems development, copyright) over its estimated useful life. The second meaning is similar to the depreciation of tangible assets.

Annual report

Annual statement, on either a calendar or a fiscal year basis, containing an entity's financial statements. The statements, such as balance sheet, income statement, and cash flow statement, include footnotes, supplementary schedules, management discussion and analysis of earnings, President's letter, audit report, accounting policies, and other explanatory data (e.g., on research and marketing efforts) helpful in evaluating the entity's financial position and operating performance. The annual report is read by stockholders, potential investors, creditors, employees, regulatory bodies, and others. The Bank reviews annual reports as part of monitoring projects and ensuring accountability.

Annuity

Series of equal periodic payments or receipts--for example, an investment that upon maturing provides payments of a fixed amount over a regular recurring period.

Appraisal

The act of appraising the value of an item or real property, usually performed as a service by someone recognized as an expert or certified by an organization as such, and usually on property of high value that may need to be bought, sold or insured.

Arbitrage

The movements of funds to take advantage of differences in exchange or interest rates; such movements quickly eliminate any such differences.

Asset

A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.

Asset turnover

Ratio revealing the efficiency of an entity's assets in generating revenue. A high ratio is desirable. What is considered high for one industry, however, may be considered low for another.

Assurance

Independent Professional Services that improve information quality or its context". Such services are very broad and could include assessments of various industries, e.g., Internet security or quality of health facilities.

Audit

The inspection of the accounting records and procedures of a business, government unit, or other reporting entity by a trained accountant for the purpose of verifying the accuracy and completeness of the records. It could be conducted by a member of the organization (internal audit) or by an outsider (independent audit). A CPA audit determines the overall validity of

financial statements. A tax audit (IRS in the U.S.) determines whether the appropriate tax was paid. An internal audit generally determines whether the company's procedures are followed and whether embezzlement or other illegal activity occurred.

Audit opinion

See Audit Report

Audit report

Written report by an auditor in accordance with the terms of his appointment, in which he expresses his opinion as to the accuracy, fairness, consistency, and acceptability of the financial statements, in question, based upon generally accepted accounting principles. For the Bank's purposes, an audit report may extend beyond financial statements. There are four types of auditor's opinion: (a) unqualified, (b) qualified, (c) adverse, and (d) disclaimer or denial of opinion.

Auditing standards

Stated and regulated practices followed in the auditing of financial and other information. Such regulations may be either statutes, or statements issued by the regulatory or professional bodies in the countries concerned. International standards on auditing have been issued by the International Auditors Practices Committee of the International Federation of Accountants.

Auditor

Individual, partnership, company, or government agency that conducts an audit. The entity performs audits according to specified auditing standards.

B

Bad debt

Account or note receivable that proves to be entirely or partially uncollectible; also referred to as an uncollectible account receivable.

Balance of payments

Record of a country's measurable monetary transactions with the rest of the world during a particular period; composed of (a) the current account, (b) the capital account, and (c) gold and foreign exchange reserves.

Balance of trade

Record of a country's trade in goods with the rest of the world.

Balance sheet

Statement showing an entity's financial position at a certain date. It forms part of the financial statement. Measurements of financial position in the balance sheet are broadly classified under assets, liabilities, and equity.

Bankruptcy

A state of insolvency of an organization or individual, i.e. an inability to pay debts.

Base-cost estimate

Estimate of the expected cost of a project at the time specified (usually at the time of appraisal or negotiations). The estimate assumes no changes in project cost due to the estimated quantity or price of products.

Benchmark

A study to compare actual performance to a standard of typical competence; or, a standard for the basis of comparison as being above, below or comparable to.

Beneficiary

A person who benefits from the terms of a trust, pension or provident fund, or other deferred income plan, or an insurance policy. In banking, it is the person in whose favour a letter of credit is issued or a draft is drawn.

Benefit Monitoring and Evaluation (BME)

An instrument for assessing a project's socioeconomic impact on the target beneficiaries. BME comprises three sets of activities: (i) the preparation and analysis of benchmark (baseline) information on persons and population groups benefiting from the project as well as the affected population prior to the project's commencement, (ii) monitoring benefits delivered to intended beneficiaries during implementation, and (iii) evaluation of project impact a few years (usually three to five years) after completion when all project facilities and services have been fully developed.

Bid price

Price offered for a security or commodity by a prospective buyer.

Bookkeeping

Part of accounting that deals with the recording of actual transactions in monetary terms.

Breakeven analysis

Branch of cost-volume-profit (CVP) analysis that determines the break-even sales or cash point, or the level of sales at which total costs equal total revenue. A break-even chart plots sales revenue, variable costs, and fixed costs on the vertical axis and volume on the horizontal axis. The break-even point is the point at which the total sales revenue line intersects the total cost line.

Breakeven point

The volume point at which revenues and costs are equal; a combination of sales and costs that will yield a no profit/no loss operation.

Budget

An itemized listing of the amount of all estimated revenue which a given business anticipates receiving, along with a listing of the amount of all estimated costs and expenses that will be incurred in obtaining the above mentioned income during a given period of time. A budget is typically for one business cycle, such as a year, or for several cycles (such as a five year capital budget). Of the many kinds of budgets, a cash budget shows cash flow, an expense budget lists expected payments of money, and a capital budget shows the anticipated payments for capital assets.

Budgetary accounting

Contrary to financial accounting, looks forward: it measures the cost of planned acquisitions and the use of economic resources in the future.

Budgetary control

Actions carried out according to a budget plan. Through the use of a budget as a standard, an organization ensures that managers are implementing its plans and objectives. Their actual performance is measured against budgeted performance.

Budgeting

The documenting of intended expenditures over a specified time period (normally one year) along with proposals for how to meet them.

Capital

(a) In a business, the total amount of the owners' stake, represented by the difference between assets and liabilities. Also called equity or net worth. In a corporation, capital represents shareholder equity. Capital stock may consist of common and preferred stock. see paid-in capital.

(b) Goods purchased for use in production. **(c)** Net working capital, which is the difference between current assets and current liabilities. **(d)** Long-term assets that are not bought and sold in the ordinary course of business. The term usually refers to fixed assets, such as machinery, equipment, buildings, and land.

Capital Adequacy

Requirement for firms conducting investment business to have sufficient funds.

Capital adequacy ratio (CAR)

The Basel Capital Accord provides a definition of capital, which is the numerator in the capital adequacy ratio and divides a bank's assets into four risk categories, each of which is assigned a risk weight (i.e. risk weighted capital assets). The risk assets are then added to form the denominator of the ratio (off-balance-sheet items are also included). The Accord calls for a minimum capital adequacy ratio of 8%.

Capital asset

Asset purchased for use in production over a long period rather than for resale. Capital assets include land, buildings, plant and equipment, mineral deposits, and timber reserves.

Capital budget

The estimated amount planned to be expended for capital items in a given fiscal period. Capital items are fixed assets such as facilities and equipment, the cost of which is normally written off over a number of fiscal periods. The capital budget, however, is limited to the expenditures that will be made within the fiscal year comparable to the related operating budgets.

Capital expenditure

The amount used during a particular period to acquire or improve long-term assets such as property, plant or equipment.

Capital gain (or loss)

Extent by which the net realized value of a capital asset exceeds (or is less than) the cost of acquisition plus additional improvements less depreciation charges where applicable.

Capital issue

Issue of securities to finance purchase of capital assets.

Capital market

Trading center for long-term debt instruments and corporate stocks. Capital markets provide a facility for governments and other entities to mobilize resources through issuing debt and equity capital.

Capital structure

Makeup of the different categories of long-term financing employed by an entity; represented by long-term debt, paid-in capital (including capital surplus), retained earnings, inappropriate reserves, and revaluation surplus. Capital structure is an important indication of the ability of an enterprise to survive adversity or fluctuating fortunes; it is distinguished from financial structure, which includes short-term debt and all reserves.

Capital structure covenants

Binding agreement that aims to apply standards of financial prudence by constraining the amount of long-term borrowing. The covenants are designed to ensure that the borrowing entity will be able to operate satisfactorily and meet all its financial obligations. Typical covenants are (a) absolute debt limitation, (b) debt-equity ratio, (c) debt service coverage, and (d) dividend limitation.

Capitalization

The statement of capital within the firm - either in the form of money, common stock, long-term debt, or in some combination of all three. It is possible to have too much capital (in which case the firm is overcapitalized) or too little capital (in which case the firm is undercapitalized).

Capitalize

In general business, it is to supply with capital, as of a business by using a combination of capital used by investors and debt capital provided by lenders; or, to consider expenditures as capital assets rather than expenses. Specifically, it is to: a) convert a schedule of income into a principal amount, called capitalized value, by dividing by a rate of interest; b) record capital outlays as additions to asset accounts, not as expenses; c) convert a lease obligation to an asset/liability form of expression called a capital lease, i.e., to record a leased asset as an owned asset and the lease obligation as borrowed funds; or d) turn something to one's advantage economically.

Cash

Money, in the form of notes and coins, which constitutes payment for goods at the time of purchase.

Cash accounting

A form of accounting that records transactions only as cash is received or paid, rather than as money is earned or costs are incurred. In cash accounting, related financial statements are usually restricted to a summary of receipts and payments.

Cash flow

Net amount of money generated or used from a given operation or asset for a given period.

Cash flow statement

Statement showing where a firm's cash comes from and on what it is spent. The net result is reflected in the balance of the cash account as of a certain date. In its most refined form, the statement explains and accounts for the flows of cash, rather than of working capital.

Cash management

Type of bank account available to business clients, which offers services such as debt collection and cash flow services.

Central bank

The bank that provides financial and banking services to the government of a country and its commercial banking system and which implements the government's monetary policy.

Chart of accounts

A list of ledger account names and associated numbers arranged in the order in which they normally appear in the financial statements. The Chart of Accounts are customarily arranged in the following order: Assets, Liabilities, Owners' Equity (Stockholders' Equity for a corporation), Revenue, and Expenses.

Co-financing

Refers to a financing arrangement whereby one or more sources of official or commercial funds (other than contributions or loans from the borrowing or host regional member country and its government agencies and debt and equity from project sponsors) join the Bank in financing a project or program.

Commercial bank

A financial institution that provides commercial banking services. A commercial bank accepts deposits, gives business loans and provides other services to businesses.

Commitment Charge

A charge or fee levied by a lender on a borrower for the continuing availability of a line of credit (such as an Bank loan). The Bank levies a commitment charge on the unutilized portion of a loan from the Bank's ordinary capital resources (OCR) to a borrower for the continuing availability of the loan. It is designed to recover Bank's treasury costs. It closes when the entire line of credit is used, or when the loan is terminated.

Consolidated financial statement

Statement that presents the financial statements of a parent company and its subsidiaries as those of a single enterprise. In a consolidated financial statement, inter-company (subsidiary) items are netted out, but shareholdings in associated companies are shown as investments.

Constant price

See Real Price

Contingency

Condition or situation whose ultimate outcome (gain or loss) will be confirmed only upon the occurrence, or non-occurrence, of one or more uncertain future events. Provisional amounts are usually included in budgets or expenditure forecasts in income statements to allow for expenditures of unknown or indefinable nature in the future. Usually these amounts are expressed as a percentage of total base-cost expenditures.

Contingency allowance

An allowance included in the project cost estimates to allow for adverse conditions that will add to base costs. Physical contingencies representing the monetary value of additional resources that may be required beyond the base cost to complete the project are included in the economic cost of

a project. Price contingencies allow, for financing purposes, for general inflation during the implementation period but are not included in a constant price project statement.

Contingency plan

A plan that provides an outline of decisions and measures to be taken if defined circumstances, outside the control of the affected organization, should occur.

Contingent liability

(a) A possible obligation from past events that will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the enterprise; or (b) A present obligation from past events but is not recognized because (i) it is not probable that an outflow of resources will be required to settle the obligation; or (ii) the obligation cannot be measured reliably. Some examples: in corporate reports are pending lawsuits, judgments under appeal, disputed claims, and the like, representing potential financial liability.

Cost

The amount of money that must be paid to take ownership of something; expense or purchase price.

Cost accounting

System for recording and reporting, in aggregate and in detail, the cost of producing goods and performing services.

Cost-benefit analysis

The method of measuring the benefits anticipated from a decision by determining the cost of the decision, then deciding whether the benefit outweighs the cost of that decision.

Cost analysis

Examination of the cost of producing a particular product, normally undertaken before a project is begun.

Cost estimate

Forecast of probable cost to be incurred in the future.

Cost of capital

Calculated as a weighted average of the interest costs of debt and equity capital. Equity funds include both capital stock (common and preferred stock) and retained earnings. Costs of capital are usually expressed as annual percentage rates.

Cost of sales

Generally, the cost of goods sold during a given accounting period.

Cost overruns

The amount by which actual costs exceeds estimates.

Cost recovery

The extent to which user charges for goods and services recover the full costs of providing such services, including a return on capital employed. Can be defined in terms of financial cost recovery using financial costs or economic cost recovery using economic costs.

Covenant

Written pledge or promise. Typically a provision in a Bank loan agreement or contract whereby one or more parties undertake to do, or refrain from doing, a specific act.

Credit

In accounting, is an accounting entry system that either decreases assets or increases liabilities; in general, it is an arrangement for deferred payment for goods and services.

Credit enhancement

Increasing the creditworthiness of a loan, security issue, or other instrument by providing specific guarantees from third parties (including MIGA, African Development Bank), or by attachment of specified assets.

Credit risk

The risk that a counterparty to a financial transaction will fail to fulfil their obligation.

Credit union

A non-profit organization accepting deposits and making loans, operated as a cooperative.

Creditor

The entities to which a debt is owed by another entity.

Current assets

Asset that can easily be converted to cash; also, one that will convert to cash or equivalent benefit within one year.

Current cost (of an asset)

The cost which would be incurred for replacement of an asset.

Current expenditure

Primarily an income statement classification. Expenditure that results in benefits realized within a short period, generally a year. Sometimes referred to as recurrent or revenue expenditure.

Current liability

Primarily an income statement classification, encompassing a debt or other obligation coming due within a year of the balance sheet date.

Current price

Prices prevailing during the current accounting period. They are nominal prices (i.e., unadjusted) and should not be confused with present prices.

Current ratio

A comparison of current assets to current liabilities, is a commonly used measure of short-run solvency, i.e., the immediate ability of a firm to pay its current debts as they come due. Current Ratio is particularly important to a company thinking of borrowing money or getting credit from their suppliers. Potential creditors use this ratio to measure a company's liquidity or ability to pay off short-term debts. Though acceptable ratios may vary from industry to industry below 1.00 is not atypical for high quality companies with easy access to capital markets to finance unexpected cash requirements. Smaller companies, however, should have higher current ratios to meet unexpected cash requirements. The rule of thumb Current Ratio for small companies is 2:1,

indicating the need for a level of safety in the ability to cover unforeseen cash needs from current assets. Current Ratio is best compared to the industry.

D

Debenture

Long-term debt instrument that is a corporate security backed by the general credit of the issuer rather than by a lien on specific assets. The order of any prior claims is set forth in the debenture. Typically, in the event of liquidation, debentures have a low recovery ranking.

Debt

The amount due by a customer in respect of goods supplied or services rendered by you.

Debt financing

Raising money through selling bonds, notes, or mortgages or borrowing directly from financial institutions. You must repay borrowed money in full, usually in instalments, with interest. A lender incurs risk and charges a corresponding rate of interest based on that risk. The lender usually assesses a variety of factors such as the strength of your business plan, management capabilities, financing, and your past personal credit history, to evaluate your company's chances of success.

Debt limitation covenant

Form of capital structure covenant in a loan agreement designed to maintain a capital structure that ensures an entity's ability to service the debt. A debt limitation covenant can be used to regulate internally a borrower's future.

Debt restructuring

- (a) Adjustment or realignment of debt structure, reflecting concessions granted by creditors to assist the debtor to meet financial obligations. Restructuring is needed when a debtor has severe financial problems, including those resulting from disagreements, legal action, or bankruptcy.
- (b) Realignment of debt structure based on voluntary financial management decisions-- for example, replacing short-term debt with long-term debt, or substituting debt for equity.

Debt security

Security representing money borrowed that must be repaid, e.g., a bond, bill, or note.

Debt service

Aggregate amount (usually per annum) of amortization, interest, and other charges on debt. Amortization includes sinking fund payments, if any. In the case of Bank loans or credits where only a portion has been drawn down by the borrower, debt service also includes a commitment charge on the unutilized portion.

Debt service coverage covenant

Form of capital structure covenant related to debt and equity and designed to ensure that an entity can meet its debt obligation from operational cash flow.

Debt service ratio

The measurement of debt payments to gross income.

Debt-Equity ratio

Measure used in the analysis of financial statements to show the amount of protection available to creditors. The ratio equals long-term debt divided by total shareholder equity. Generally the higher the ratio, the higher the financial risk.

Debtor

Person or entity owing money to another person or entity; also refers to accounts receivable.

Deferred charge

Charge or form of asset whose benefits accrue in an accounting period subsequent to the one in which it was paid (incurred).

Deferred taxes

A liability recorded on the balance sheet that results from income already earned and recognized for accounting purposes, but not for tax purposes. In other words, the income has been realized but the tax on that income has yet to be paid.

Depreciation

The amount of expense charged against earnings by a company to write off the cost of a plant or machine over its useful life, giving consideration to wear and tear, obsolescence, and salvage value. If the expense is assumed to be incurred in equal amounts in each business period over the life of the asset, the depreciation method used is straight line (SL). If the expense is assumed to be incurred in decreasing amounts in each business period over the life of the asset, the method used is said to be accelerated. Commonly used variations of the accelerated method of depreciating an asset are the sum-of-years digits (SYD) and the double-declining balance (DDB) methods. Frequently, accelerated depreciation is chosen for a business' tax expense but straight line is chosen for its financial reporting purposes.

Derivative

A transaction or contract whose value depends on or, as the name implies, derives from the value of underlying assets such as stock, bonds, mortgages, market indices, or foreign currencies. One party with exposure to unwanted risk can pass some or all of the risk to a second party. The first party can assume a different risk from a second party, pay the second party to assume the risk, or, as is often the case, create a combination. Derivatives are normally used to control exposure or risk.

Disbursement

Payment of funds from the loan account of a borrower. Bank disbursements are made either directly to the borrower as reimbursement for expenditures already incurred on items provided for in the project, or as direct payments on behalf of the borrower to consultants, suppliers, or contractors.

Disclaimer of opinion

Statement by an auditor refusing to express an opinion on the financial statements of an entity.

Disclosure

An accounting principle that requires full (adequate) disclosure of all material (significant) matters affecting the financial statements that would be of interest to a concerned investor or creditor.

Discount rate

Interest rate used to convert future receipts or payments to their present value. The cost of capital may be used as the discount rate under the net present value method.

Dividend

Distribution of earnings paid to stockholders based on the number of shares they own. The most typical type is cash, but dividends may also be issued in such forms as stock and property.

Dividend limitation

Provision in a contract or agreement that limits the amount of dividend that an entity can pay to its owners. Usually the agreement is between the entity and its lenders. A form of debt service coverage covenant.

Dividend yield

Ratio providing an estimate of the return per share on a stock investment based on the market price at the end of the reporting period. The ratio equals dividends per share divided by market price per share. A disadvantage of this ratio is the timing mismatch between the numerator, which is based on the dividend declaration date, and the denominator, which is based on the yearend market price of the stock.

E

EBITDA (Earnings before Interest, Taxes, Depreciation, and Amortization)

In accounting, EBITDA stands for "Earnings before Interest, Taxes, Depreciation, and Amortization" (sometimes named OIBDA for operating income before depreciation and amortization). Which as the name suggests is earnings excluding expenses from depreciation, amortization, interest, and taxes (earnings + ITDA), in the order they usually appear on the income statement, up to down. It's the operating income with expenses for depreciation and amortization backed out.

Earning power

Earnings before interest and taxes (EBIT) divided by total assets.

Economic internal rate of return (EIRR).

The rate of return that would be achieved on all project resource costs, where all benefits and costs are measured in economic prices. The EIRR is calculated as the rate of discount for which the present value of the net benefit stream becomes zero, or at which the present value of the benefit stream is equal to the present value of the cost stream. For a project to be acceptable the EIRR should be greater than the economic opportunity cost of capital.

Economic viability

The assessment that increases in output produced by a project using the least cost method will recover costs, provide an additional required rate of return, and sustain effective production in the face of uncertainty and risk.

Enterprise

An organization created for business ventures.

Entity

In business, is a separate or self-contained existence that provides goods or services.

Equity

The residual interest in the assets of the entity after deducting all its liabilities.

Equity capital

Company's issued (or paid-up) share capital, without limitation or preference in how profits are distributed or how assets are ultimately distributed.

Equity financing

Investment that confers whole or partial ownership in an enterprise and entitles the investor to share in profits from its operation.

Exchange rate

The rate at which one currency can be traded for another.

Executing Agency (EA)

An organization charged by a borrower with the implementation of a Bank-funded project.

Expenditure

A cost incurred in the normal course of business to generate revenues.

Expenses

The daily costs incurred in running and maintaining a business.

External audit

An audit conducted by an individual of firm that is independent of the company being audited. These independent auditors audit the books of a company generally once per year after the completion of the company's fiscal year. Their role is to give an opinion of the financials statement's reflection of the status and operations of the company being audited. Based on what they witness during the audit they will also produce, for management and board utilization, a management letter. Although a financial statement audit is the most common type of external audit, external auditors may also conduct special purpose audits which might include; performing specific tests and procedures and reporting on the results, a less intensive review, and compilations.

External auditor

An auditor, usually working for an audit firm, that is completely independent of the company it is auditing. External auditors should always be certified by a professional association of accountants, and should be selected by, and report to, the corporation's board of directors.

F

Face value

Nominal amount of a debt obligation (e.g., note, bond, mortgage) or equity security as stated in the instrument. The same as par value. It excludes interest and dividends. The face value of an instrument is often different from its issuance price; for example, a bond may be issued at a bond discount or bond premium. Also, after issuance, the market price of an instrument will typically differ from its face value. At maturity, the debt instrument will be redeemed at its face value.

Fiduciary

A person or business (for example, a bank or stock brokerage) who has the power and obligation to act for another (often called the beneficiary) under circumstances which require total trust, good faith and honesty.

Finance lease

The lessor expects to recover the full cost (or almost the full cost) of the asset plus interest, over the period of the lease.

Financial accounting

Process of recording, classifying, and compiling financial transactions in a manner appropriate to determine (a) the financial performance of an entity, and (b) its status and financial relationship to other entities and persons. This process is performed in conformity with generally accepted accounting principles. Financial accounting relates to the preparation of financial statements for external users, such as creditors, investors, and suppliers. These statements, including the audit report and management's discussion of operations, appear in the annual report.

Financial analysis

Transformation of financial data into a form that can be used to monitor and evaluate an entity's financial position, plan future financing, and assess the entity's size and growth rate. Financial analysis includes the use of financial statement analysis and financial projections.

Financial forecast

Financial projection that assumes a most probable or realistic scenario.

Financial information system

System that accumulates and analyzes financial data to aid financial management decisions in running a business. The basic objective of the system is to meet the firm's financial obligations as they come due, using the minimum amount of financial resources consistent with an established margin of safety. System outputs include accounting reports, operating and capital budgets, working capital reports, cash flow forecasts, and various "what if" analyses. The evaluation of financial data may be performed through ratio analysis, trend evaluation, and financial planning modelling.

Financial Institution (FI)

An institution (public or private) that collects funds (from the public or other institutions) and invests them into financial assets.

Financial intermediary

Originally an intermediary between the U.S. Treasury (or equivalent) and the market. A variety of financial intermediaries now exist (e.g., commercial banks, development banks, savings and loans associations, microfinance organizations, pension funds). These organizations facilitate the transfer of funds from financial surplus units to those who need or that can better utilize financial resources.

Financial Internal Rate of Return (FIRR)

The rate of return that would be achieved on all project costs, where all costs are measured in financial prices and when benefits represent the financial revenues that would accrue to the main project participant. The FIRR is the rate of discount for which the present value of the net revenue stream becomes zero, or at which the present value of the revenue stream is equal to the present

value of the cost stream. It should be compared with the opportunity cost of capital, or the weighted average cost of capital, to assess the financial sustainability of a project.

Financial management

Process of financial decision making based on planning, forecasting, organizing, controlling, and communicating financial and physical data to achieve optimum financial and economic benefits from an investment. Financial management may incorporate one or more of the following: managerial accounting, financial accounting, and cost accounting.

Financial market

Market for the exchange of credit and capital in the economy. It is divided into the money market and the capital market.

Financial model

Mathematical model describing the relationships among financial variables of a firm. A functional branch of a general corporate planning model, it is used essentially to generate pro forma financial statements and financial ratios. The basic tool for budget planning, it is also used for risk analysis and "what if" experiments. Many financial models use special modelling languages and spreadsheet programs.

Financial position

The status of a firm's or individual's assets, liabilities, and equity positions as reflected on its financial statement. Also called Balance Sheet.

Financial projection

Essential element of planning; the basis for budgeting and estimating future financing needs of a firm. The steps in financial forecasting are (a) projecting the firm's income; (b) projecting variables, such as expenses, revenues, and assets; (c) estimating the level of investment in current and fixed assets required to support the projected income; and (d) calculating the firm's financing needs.

Financial ratio

Mathematical relationship between financial variables of business. There are many categories of ratios, including those that evaluate an entity's liquidity, solvency, return on investment, operating performance, asset utilization, and market measures. While computing a ratio is a basic arithmetical operation, its analytical interpretation is more complex. A financial ratio should be computed only if the relationship between accounts or categories has significance. To be meaningful, a given financial ratio of a company for a given year must be compared with (a) prior years (to examine the trend), (b) the industry norm, and (c) competing companies.

Financial report

Could contain financial statements, annual report, SEC Form 10-K, and/or prospectus among other documents, i.e. there is no set format.

Financial reporting

Presenting financial data on a company's position, operating performance, and funds flow for an accounting period. Financial statements and related information may be issued in various forms for external use, such as in the annual report.

Financial reporting period

See Fiscal Year

Financial risk

Portion of total corporate risk, over and above basic business risk, that results from using debt. Business risk is caused by fluctuations of earnings before interest and taxes (operating income). Business risk depends on variability in demand, sales price, and input prices, and amount of operating leverage. Financial risk includes the risk that the borrower will be unable to make interest payments or principal repayments on debt. The greater a firm's financial leverage, the higher its financial risk.

Financial statement

Statement containing financial information about an organization. A set of financial statements usually includes a balance sheet, income statement, sources and applications of funds statement (sometimes referred to as a cash flow or funds flow statement) and the notes to the financial statements. Financial statements may be combined with various supplementary statements to form the financial report on the status and performance of the organization.

Financial structure

How a firm's assets are financed, constituting the entire right side (liabilities and equity) of the balance sheet. It is broader than capital structure because it also includes short-term debt and all reserves.

Financial sustainability

The assessment that a project will have sufficient funds to meet all its resource and financing obligations, whether these funds come from user charges or budget sources; will provide sufficient incentive to maintain the participation of all project participants; and will be able to respond to adverse changes in financial conditions.

Financial viability

The ability of an entity to continue to achieve its operating objectives and fulfil its mission over the long term.

Financial year (see Fiscal Year)

Period of twelve months, beginning anywhere in the calendar year, used for company accounting purposes.

Fiscal year

Twelve consecutive months used by a business to account for and report on its operations, especially to determine profit or loss. Many entities use the natural business year, that is, a year ending at the annual low point in business activity or at the end of a season. Sometimes referred to as financial year.

Fixed asset

Item that has physical substance and an economic life in excess of one year. It is bought for use in the operation of the business and not intended for resale to customers. With the exception of land, fixed assets are subject to depreciation. Term usually refers to property and plant and equipment.

Fixed charge

Cost that does not vary in amount with the level of output, particularly a fixed financial cost, such as interest, a lease payment, or a sinking fund payment.

Forecast

To estimate or calculate expected business results in advance. To plan the business course for the future. A document that sets down the plan.

Foreign exchange

Currency of a foreign country, and the buying and selling of such services.

Foreign exchange cost

Generally, for Bank projects, the sum of (a) direct payments made in currencies other than the currency of the borrowing country for equipment and materials, consulting services, and contractors (including depreciation on imported plant and equipment); and (b) estimates of the import component (raw materials, fuel, and--for imported plant and equipment--depreciation) embodied in goods and services that are paid for in local currency. Where present, these two elements should be reflected in the foreign costs column of each project's cost table.

Foreign exchange rates

In finance, the exchange rate between two currencies specifies how much one currency is worth in terms of the other.

Foreign exchange risk

Risk taken in buying or selling foreign currency.

Free cash flow

Net income plus non-cash charges to income, specifically depreciation and amortization less capital expenditures, to sustain the basic business.

Fund

A pool of money normally set apart for a purpose, for example, a pension fund to provide pensions.

Funds flow

Though this term is often (incorrectly) used interchangeably with cash flow, funds flow focuses on increases and decreases in a firm's working capital (cash and cash equivalents) between two points in time, usually the beginning and end of the fiscal year or defined intermediate or longer term period.

G

Generally Accepted Accounting Practices (GAAP)

A recognized common set of accounting principles, standards, and procedures. GAAP is a combination of accepted methods of doing accounting and policy board set authoritative standards.

Going concern

An enterprise that is normally viewed as continuing in operation for the foreseeable future, having neither the intention nor the necessity of liquidating or materially curtailing the scale of its operations. General assumption used in preparing financial statements.

Goods

Items of merchandise, finished products, supplies, or raw materials. Sometimes the term is extended to cover all inventory items or assets, such as cash, supplies, and Fixed assets.

Governance

The manner in which power is exercised in the management of a country's economic and social resources for development. The Bank regards good governance as synonymous with sound development management. It involves both the public and private sectors. It includes the effectiveness with which development assistance is used, and has a direct effect on the impact of development programs and projects (including those financed by the Bank).

Grant

Funds provided by a government, government body or other institution.

Gross margin

The ratio of gross profit to sales revenue. (sometimes used as a synonym for gross profit). For a manufacturer, gross margin is a measure of a company's efficiency in turning raw materials into income; for a retailer it measures their mark-up over wholesale. Gross margin is gross income divided by net sales, expressed as a percentage.

Gross National Product (GNP)

The total dollar value of all final goods and services produced for consumption in society during a particular time period. The GNP does include allowances for depreciation and indirect business taxes such as those on sales and property. Gross national product is the output of labour and property of US nationals regardless of the location of the labour and property. Gross National Product includes income earned by the factors of production (assets and labour) owned by a country's residents but excludes income produced within the country's borders by factors of production owned by non-residents.

Gross sales

Total sales before sales discounts and sales returns and allowances. It equals total unit sales times the selling price per unit.

Growth rate

The percentage change per period (typically per year).

Guarantee

- n. It is a document stating that goods or services are of good quality.
- v. It is a promise to pay the debt of someone else in the event that the debtor defaults. A guarantee is not to be confused with indemnity.

Guarantor

A person who guarantees, if necessary, to pay someone else's debt.

H

Hidden reserves

Results from the practice of understating the value of certain assets in financial reports, with the corresponding understatement on reported reserves. This practice is common among banks in some countries.

Historical cost (see Acquisition Cost)

Original cost incurred at the date an asset (or service) is acquired. It could also be the value of an identical item received through exchange, plus or minus any payment made or received as part of the exchange.

Hyperinflation

Situation in which a country experiences a cumulative inflation rate over three years approaching or exceeding 100 percent.

I**Idle capacity**

Presence of unused capacity; the difference between practical capacity and operating capacity.

Illiquid

When cash flows generated by the firm are insufficient to meet the debt service. When speaking of money or an economy: being very liquid means it is driven primarily by cash, checking/saving accounts, treasury bills, stocks and bonds, etc; while being very illiquid means it is driven primarily by human capital.

Imputed cost

Cost that (a) does not at any time involve actual cash outlay, and (b) does not appear in accounting records but is relevant to the decision at hand. Some costs, such as interest, may have to be imputed for tax purposes despite the lack of a cash outlay.

Income

- (a) During an accounting period, revenue earned that results in an increase in total assets.
- (b) Revenue arising from sales of goods and services.
- (c) Excess of revenue over expenses and losses for an accounting period (i.e., net income).

Income statement

Form showing the elements used in arriving at an entity's net income for the accounting period; also called a profit and loss statement. Also called result of operations.

Income tax

Government levy on the net earnings of an individual, corporation, or other taxable unit. The Tax rate is usually graduated as earnings go from one tax bracket to another. The income tax provision is shown as an expense in the income statement.

Incorporation

Legal authorization from a state or other political authority for an entity to operate according to its approved articles of incorporation or charter. Incorporated entities share basic attributes: an exclusive name, continued existence independent of shareholders or members, paid-in capital, and limited liability.

Incremental

Is increasing gradually by regular degrees or additions.

Incremental cost

All additional costs that result from the execution of a project (or from the addition of one unit of output).

Indexation

Normally, adjustment of costs and income for general price-level changes.

Indicator

Measurable variable used to suggest overall change among a group of linked variables too complex to yield to simple analysis. Thus a variety of economic indicators - such as price, income, imports, exports, money supply and so on - are studied in an attempt to estimate the state of a national economy.

Indirect cost

Expense that is not directly incurred for one specific activity or unit of production. General administration expenses are an example.

Ineligible items

Items that are not eligible, as a rule, for LCF include taxes and duties, costs of land acquisition and payments of rights-of-way, working capital other than incremental and initial working capital, interest and financial charges other than those on Bank loans, and expenditures not directly attributable to Bank-financed projects.

Inflation

An increase in the general price level of goods and services; alternatively, a decrease in the purchasing power of the dollar or other currency.

Inflation rate

The annual rate of change of the price index.

Institution

Organization, particularly one concerned with the promotion of a specific subject or some public object.

Intangible asset

Right or other non-physical resource that is presumed to represent an advantage to a firm in the marketplace. Such assets include copyrights, patents, trademarks, goodwill, technical information, capitalized advertising costs, organization costs, licenses, leases, franchises, exploration permits, and import and export permits.

Interest

In law, is a right or legal share of something or a financial involvement with something; in finance, it is a fixed charge for borrowing money; usually a percentage of the amount borrowed.

Interest coverage ratio

Ratio that equals income, before interest and taxes, divided by interest. The ratio reveals the number of times interest is covered by earnings. A potential creditor likes to see a high ratio because it indicates that a company is able to meet its interest obligations easily.

Interest During Construction (IDC)

Interest payable on long-term or short-term debt incurred to finance capital works (e.g., plant or road construction in progress in a fiscal year). Financing charges, including commitment charges, are also included. IDC is frequently capitalized (or charged to the project cost) until the asset is commissioned or treated as a capital expenditure item and transferred to a deferred charges or deferred capital expenditure account. For Bank projects, IDC is computed as part of project costs to determine total financing requirements.

Interest rate

The rate of interest charged for the use of money, usually expressed as an annual rate. The rate is derived by dividing the amount of interest by the amount of principal borrowed.

Intermediation cost

In finance, is the cost involved in the placement of money with a financial intermediary. The person or institution empowered as the intermediary to make investment decisions for others. Examples: banks, savings and loan institutions, insurance companies, brokerage firms, mutual funds, and credit unions.

Intermediation cost ratio

Ratio of non-interest expenses to total income of a FI. (Measures the efficiency of banking operations).

Internal audit

An independent appraisal function established within an organization to examine and evaluate its activities as a service to the organization. The objective of internal auditing is to assist members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost.

Internal auditor

An auditor who works directly for a company auditing its activities throughout the year. Internal auditors of corporations are often not certified auditors, though they usually have significant accounting experience. They should report directly to the board of directors of the corporation.

Internal cash generation

Gross income from all sources less all administrative and operating expenditures, excluding depreciation, interest, and other non-cash charges, but including taxes.

Internal check

Accounting procedure or physical control to safeguard assets against loss due to fraud or other irregularities. Internal check is an element of internal control. Weak internal check mechanisms mandate a greater degree of auditing procedures.

Internal control

Plan of organization and all the methods and measures used by an entity to monitor assets, prevent fraud, minimize errors, verify the correctness and reliability of accounting data, promote operational efficiency, and ensure that established managerial policies are followed. Accounting controls encompass safeguarding assets and the accuracy of financial records. They are designed to assure that transactions are properly authorized and are recorded to allow for financial statement preparation in accordance with generally accepted accounting principles.

Internal Rate of Return (IRR)

Rate of return that equates the present value of future cash flows to the initial investment. Also referred to as the yield on investments.

International Accounting Standards (IASs)

Standards issued by the International Accounting Standards Committee (IASC) to bring direction and uniformity to the practice of professional accounting in different countries. These standards do not override regulations laid down by regulatory bodies in the countries concerned. IASC is the international body recognized by the International Federation of Accountants (IFAC). International accounting standards are recommended by the Bank for use in countries where national standards have not been fully developed.

International Standard on Auditing (ISA)

Standards formulated by the IFAC for the purpose of standardizing audit practices among countries and achieving international uniformity within the profession. The Bank encourages the use of international standards on auditing.

Inventory

For companies: includes raw materials, items available for sale or in the process of being made ready for sale (work in process); for securities: it is securities bought and held by a broker or dealer for resale.

Inventory turnover

Ratio of annual sales to inventory, showing how many times the inventory of a firm is sold and replaced during an accounting period. Computed as cost of sales divided by the average inventory of finished goods (valued at cost).

Invested capital

Equity plus long-term debt. In calculating the return on investment, it is preferable to use the total asset base as invested capital. However, when assessing the effectiveness of assets employed, it may be preferable to include only the investments in those assets employed in the enterprise's operations.

Investment

The purchase of real property, stocks, bonds, collectible annuities, mutual fund shares, etc, with the expectation of realizing income or capital gain, or both, in the future. Investment is longer term and usually less risky than speculation.

Investment funds

A collective investment scheme as defined under the laws of the local jurisdiction.

J

Joint financing

Co-financing operation for which (a) a common list of goods and services exists, and (b) disbursements for all or certain items are shared by the Bank and the co-lender in agreed proportions.

Joint venture

Specific business undertaken jointly by two or more entities. Joint ventures are often formed when one party lacks technological expertise, financial resources, government ties, a distribution network, or manufacturing capability. They may also be formed when partners wish to create separate venture operations and their own parent company balance sheet.

L**Lease**

A contract where a party being the owner (lessor) of an asset (leased asset) provides the asset for use by the lessee at a consideration (rentals), either fixed or dependent on any variables, for a certain period (lease period), either fixed or flexible, with an understanding that at the end of such period, the asset, subject to the embedded options of the lease, will be either returned to the lessor or disposed off as per the lessor's instructions.

Lending

Temporary grant of money, goods, equipment, people, and so on, made on the understanding that the thing lent, or its equivalent, will be returned, often with an additional (interest) payments.

Letter of credit (L/C)

A legal document issued by a buyer's bank that upon presentation of required documents payment would be made. Usually confirmed by the seller's bank, protection is given to the seller that payment will be made if the goods are shipped correctly, and protection is given to the seller that the goods will be shipped before payment is made.

Leverage

Ability of fixed costs to magnify returns to a firm's owners. operating leverage, a measure of operating risk, refers to the fixed operating costs found in a firm's income statement. Financial leverage, a measure of financial risk, refers to financing a portion of the firm's assets bearing fixed financing charges in hopes of increasing the return to owners. Total leverage is a measure of total risk. The way to measure total leverage is to determine how Earnings Per Share (EPS) are affected by a change in sales. Leverage is using given resources in such a way that the potential positive or negative outcome is magnified.

Liability

Present obligation of the entity arising from past events, the settlement of which is expected to result in and outflow from the entity of the resources embodying economic benefits.

LIBOR (London Inter-bank Offered Rate)

The rate that the most creditworthy international banks that deal in Eurodollars charge each other for large loans. It is equivalent to the federal funds rate in the U.S.

Line of credit

Arrangement whereby a financial institution (bank or insurance company) commits itself to lend up to a specified maximum during a specified period. Usually a commitment charge is levied on the unused funds during the contractual period.

Liquid asset

Cash and any asset that can quickly be converted into cash (e.g., cash, checks and easily convertible securities).

Liquidation

Process of closing a business entity, including selling or disposing of the assets, paying the liabilities, and returning the balance (if any) to the owners.

Liquidity

Ability of current assets to meet current liabilities when due. An asset's degree of liquidity is the time period anticipated until the asset is realized or otherwise converted into cash. A liquid company has less risk of being unable to meet debt obligations than an illiquid one.

Liquidity covenant

Provision in an agreement concerned with maintaining adequate financial liquidity of an entity. Typical liquidity covenants are the current ratio and the dividend limitation covenants.

Liquidity indicator

Liquidity indicators are intended to measure the adequacy of an enterprise's working capital, i.e., an excess of current assets over current liabilities, to meet its current obligations in a timely manner and conduct its operations effectively without financial constraints.

Liquidity ratio

Measures of a business entity's liquidity, such as the current ratio, acid test ratio, accounts receivable turnover, and inventory turnover .

Loan

An agreement under which an owner of assets (the lender) allows another entity (the borrower) to use the assets for a specified time period. In return, the borrower agrees to pay the lender a payment (interest) and return the assets (cash) at the end of the agreed upon time period.

Loan capital

Forms of debentures and other long-term loans to a business.

Loan covenant

A legally enforceable promise or restriction in a mortgage. For example, the borrower may covenant to keep the property in good repair and adequately insured against fire and other casualties. A breach of covenant in a mortgage usually creates a default, defined by the mortgage, and can be the basis for foreclosure.

Loan loss ratio

Indicates extent of uncollectible loans over the last period. Any loan more than one year past due should automatically be considered uncollectible.

Loan period

Total number of years from a Bank loan's date of effectiveness, which normally falls three months after signature, to its last payment (including the grace period).

Local cost

In a Bank-assisted project, the local currency value of all goods and services that are procured for the project and are assumed to be produced within the country. Local cost excludes the value of supplies that are imported into the country, independently of the project, and that form the indirect foreign component. Local costs are sometimes called onshore costs.

Local currency

Currency of a foreign country with which an exporter or trader is dealing.

Long-term asset

Asset whose future benefit is expected for a number of years; includes such non-current assets as buildings and equipment.

Long-term debt

Debt that does not come due within one year.

Long-term liability

Liabilities of a business that are due in more than one year. An example of a long-term liability would be a mortgage payable.

M

Management accounting

The process of identification, measurement, accumulation, analysis, preparation, interpretation, and communication of financial information used by management to plan, evaluate, and control within an organization and to assure appropriate use of and accountability for its resources. Management accounting also comprises the preparation of financial reports for non-management groups such as shareholders, creditors, regulatory agencies, and tax authorities.

Management information system (MIS)

Computer-based or manual information system to aid decision making. An MIS generally performs three functions: (a) generating reports (e.g., financial statements, inventory status reports, or performance reports); (b) answering "what if" questions asked by management; and (c) supporting decision making. An MIS is sometimes also called a decision support system (DSS). It attempts to integrate the decision maker, the data base, and the quantitative models being used.

Management Letter

Identifies issues not required to be disclosed in the Annual Financial Report but represent the auditor's concerns and suggestions noted during the audit.

Management Representation Letter

A letter from the entity's management to its auditors assuring (or making representations) that all financial information has been provided, the information is complete to the best of their knowledge and no material misstatements exist.

Margin (see Gross Margin)

Difference between realized sales and the cost of goods sold, expressed as unit value percentage or total value. Since the margin may be calculated at different stages, the terms net and gross are used to differentiate the levels.

Marginal cost

Change in total cost for an extra unit of production. It is useful to calculate marginal cost to determine whether the rate of production should be changed. In general, as activity increases, economies of scale set in because of greater experience and manufacturing efficiency. Eventually, however, diseconomies of scale (e.g., increased management supervision needs) occur, causing

marginal costs to rise. When a company is at optimum output, marginal cost coincides with average total unit cost. The marginal cost curve is usually shown as a U-Shape on a graph.

Market failure

Inability of the market to function in its normal manner.

Market price

Price at which a security or commodity is quoted or offered for sale.

Market risk

The risk that the value of your investment will decrease due to moves in market factors.

Market value

In general, is the price at which buyers and sellers trade similar items in an open marketplace. In the absence of a market price, it is the estimated highest price a buyer would be warranted in paying and a seller justified in accepting, provided both parties were fully informed and acted intelligently and voluntarily.

Maturity

Due date of a debt, at which time the principal and outstanding interest must be repaid fully.

Maturity mismatch

For a financial institution, a mismatch between the maturity terms of its borrowings and its loans. This condition could mean, for example, that borrowings a bank has made on the capital market to finance certain loans it has made are due before it has received the money from the loans. A significant maturity mismatch creates risk, particularly when interest rates are volatile.

Maturity risk

Maturity risk relates to mismatching of investments and borrowing operations.

Micro-finance

A financing mechanism designed to provide small loans/credit to poor people (farmers, small entrepreneurs) at, or immediately above, the poverty level to stimulate productive activities at low cost with the overall objective of raising the economic performance of those at the poverty level.

Minority interest

The interest or percentage ownership of a group of stockholders who, in total, own less than 50% of the shares in the corporation.

Money market

Market for short-term debt instruments, such as certificates of deposit, commercial paper, banker's acceptances, U.S. Treasury bills, and discount notes. These instruments are all liquid and tend to be safe.

N

Net assets

The difference between total assets and current liabilities including non-capitalized long-term liabilities.

Net cash flow

Equals cash receipts minus cash payments over a given period of time; or equivalently, net profit plus amounts charged off for depreciation, depletion, and amortization. Also called cash flow. Net cash flow is a measure of a company's financial health.

Net income

Gross income from all sources less all administrative and operating expenditures, depreciation, taxes, and interest and other charges on debt.

Net loss

Amount by which total costs and expenses exceed total revenue for the accounting period.

Net operating income

Income after deducting for operating expenses but before deducting for income taxes and interest.

Net present value (NPV)

A method used in evaluating investments, whereby the net present value of all cash outflows (such as the cost of the investment) and cash inflows (returns) is calculated using a given discount rate, usually required rate of return. An investment is acceptable if the NPV is positive. In capital budgeting, the discount rate used is called the hurdle rate and is usually equal to the incremental cost of capital.

Net profit

See Net Income

Net worth

Total assets less total liabilities. Net worth represents shareholder equity.

Nominal

Means small payment, or value.

Nominal interest rate

Contracted or stated interest rate, not deflated for price-level changes.

Non-current assets

Includes PPE (property, plant and equipment) as opposed to current assets which includes cash, cash equivalents (e.g. securities, short-term notes, etc.), inventory and accounts receivable.

Non-revenue-earning entity

An entity typically implementing a Bank-financed project that does not seek cost recovery for a substantial amount of the costs incurred, nor recovery of the costs of the entity's non-Bank-financed operations.

Non-revenue-earning Project

Project for which cost recovery is not generally sought, or is partial or indirect. Non-revenue-earning projects are usually implemented and operated by public entities that are largely dependent on government budget allocations.

Note payable

Written promise to pay money at a future date. The payment consists of principal and usually interest. A note payable may be classified as either a current liability (due within one year or less) or a non-current one.

Note receivable

Written promise that money will be received at a future date, comprising principal and usually interest. A note receivable may be classified as either a current asset (due in one year or less) or a non-current one.

O

Objective

A statement that is written in terms of specific measurable time-based and verifiable outcomes that challenge the organization to be more responsive to the environment to achieve the desired goals. Dependent upon usage, goals are general in nature, while objectives are specific, measurable and time-based. In some organizations, the meanings for goal and objective are reversed.

Obsolescence

Reduction or cessation of an asset's usefulness, resulting from technological or market changes, wear and tear from use, or natural deterioration. Obsolescence is a major factor in determining depreciation.

On-lending

Equivalent of re-lending in connection with new money loans. The funds are recorded as a deposit in the central bank, but the foreign bank and the contractual borrower (usually the central bank) agree that the loan proceeds will be made available to a third party within the country of the borrower.

Operating cost

Expenses incurred in the day-to-day running of a company.

Operating expenditures

Expenditure that is incurred in operating, maintaining, and administering an entity from day to day; usually expenditure on the physical and human resources necessary to operate and maintain the assets engaged in providing an output. The use of an asset is also recorded as an operating expenditure, in the form of a depreciation charge.

Operating expenses

All selling and general & administrative expenses. Includes depreciation, but not interest expense.

Operating income

Revenue less cost of goods sold and related operating expenses that are applied to the day-to-day operating activities of the company. It excludes financial related items (i.e., interest income, dividend income, and interest expense), extraordinary items, and taxes.

Operating ratio

Measures a firm's operating efficiency; calculated: company operating expenses divided by its operating revenues.

Operating ratio covenant

Form of revenue covenant that requires the borrower to set its tariffs at a level that meets a certain operating ratio; the ratio expresses operating costs including depreciation as a percentage of total operating revenue.

Operating revenue

Net sales plus other regular income sources related to the normal business operations of the entity.

Opportunity cost

The benefit foregone from not using a good or resource in its best alternative use.

Ordinary Capital Resources (OCR)

A pool of funds available for Bank's lending operations. These resources are replenished by borrowings from the world's capital markets. The Bank has a triple-A credit rating. OCR loans are made at near-market terms to better-off borrowing countries.

Overhead cost

Cost of materials or services not directly traceable to a specific product but necessary for the productive or administrative process. Examples of such costs include general office salaries and apportioned costs of premises shared by multiple activities.

Over/under capitalization

Surplus or deficiency of permanent capital in relation to the current level of a business's activity.

Owners' equity

Interest of the owners in the assets of the business; the interest is represented by capital contributions and retained earnings.

P

Paid-in capital

Capital received from investors for stock, equal to capital stock plus paid-in capital, NOT that capital received from earnings or donations. Also called contributed capital.

Paid-up capital

The total amount paid by shareholders for their shares of capital stock.

Parallel financing

Tied co-financing, that is a co-financing operation in which the Bank and another lender(s) finance defined and often different goods and services, or components, of a project.

Payable (see Liabilities)

Amount owed to another party. It is presented as a liability in the balance sheet. A payable is an item that is unpaid, whether or not due.

Payback period

In capital budgeting, is the length of time needed to recoup the cost of capital investment. The payback period is the ratio of the initial investment (cash outlay, regardless of the source of the

cash) to the annual cash inflows for the recovery period. The major shortcoming for the payback period method is that it does not take into account cash flows after the payback period and is therefore not a measure of the profitability of an investment project. For this reason, analysts generally prefer the discounted cash flow methods of capital budgeting; primarily, the internal rate of return and the net present value methods.

Performance indicator

Those empirical data points that indicate how well, or poorly, an entity is performing against preset goals and objectives. Normally, in business or strategic planning, a company will set targets over a specified period that the business believes are attainable and track performance over time to those targets or objectives.

Physical contingency

Contingency allowance that reflects expected increase in the base-cost estimate of a Bank-financed project because of changes in quantities and methods of implementation. Physical contingencies are shown in the project cost table as a financial cost and as percentages of the base costs.

Portfolio

A term for describing all the investments that an entity owns. A diversified portfolio contains a variety of investments.

Predictability

Refers to the (i) the existence of laws, regulations, and policies to regulate society; and (ii) their fair and consistent application. The rule of law encompasses well-defined rights and duties, as well as mechanisms for enforcing them and settling disputes in an impartial manner.

Prepayment

Means repayment in advance of the maturity period specified in the loan agreement.

Present value

Discounted current worth of future cash flows from an investment. The discounted value of a payment or stream of payments to be received in the future, taking into consideration a specific interest or discount rate. Present Value represents a series of future cash flows expressed in today's dollars. A given amount of money is almost always more valuable sooner than later, so present values are generally smaller than corresponding future values.

Price

See Real Price

Price contingency

A contingency allowance used in Bank project cost tables, that reflects expected cost increases due to changes in unit prices for the various project components/parts beyond the date of the base-cost estimate. Price contingencies in an Appraisal Report are expressed as percentages of the base costs plus physical contingencies, for the project as a whole and also separately for the local and foreign expenditures of the project.

Private company

One whose shares are not publicly traded and usually are owned by only a few people. A private company is distinguished from a public company, whose shares are traded on a stock exchange.

Procurement

From a business perspective, is the purchasing of services or materials.

Professional bodies

A professional body or professional organization is an organization, usually non-profit, that exists to further a particular profession, to protect both the public interest and the interests of professionals.

Profit margin

Ratio of net income to net sales.

Profitability

Company's ability to generate revenues in excess of the costs incurred in producing those revenues.

Profitability ratio

Measures of performance showing how much the firm is earning compared to its sales, assets or equity.

Program Loan

A program loan is provided by the Bank to assist a regional member country in developing a sector (or sub-sector, sectors) as a whole and improving the performance of a sector through appropriate policy and institutional improvements over the medium to long term. Program loans are relatively quick disbursing to cover the immediate adjustment costs arising from policy reforms. The Bank makes program loans only to regional member countries governments.

Project appraisal

The assessment of the viability of proposed long-term investments in terms of shareholder wealth.

Project cost table

A summary of base costs, physical contingencies, and price contingencies (and where appropriate, risk contingencies) to determine the estimated total cost of a Bank-financed project.

Project design

Project design is an evolving process from the time of conceptualization at the CSP stage through design stage to Board approval of the project.

Project framework

A design tool that logically links the goal or rationale of a project, its objectives, inputs and activities, expected outputs, key indicators, key risks and assumptions, the analysis that needs to be undertaken, the manner in which data is collected, the expected beneficiaries, and the stakeholders.

Project Preparatory Technical Assistance (PPTA)

PPTA may be for a single project, a series of subprojects, or a program or sector loan. This type of TA is utilized for developing a pipeline of projects suitable for financing by the Bank or other external sources, or both. In some cases, the preparation of a preliminary sectoral survey or a sectoral review to identify sectoral issues to be addressed by the project or a master plan may be included under the TA.

Projection

An approximation of future events. Usually a projection is made by extrapolating known information into the future period, considering events that could affect the outcome.

Public accountant

Accountant who offers professional services to the public for a fee, as distinguished from an accountant employed in government service or in a private enterprise.

Public sector

The parts of the economy that are not controlled by individuals, voluntary organizations or private companies. This includes national and local government, and government owned firms.

Public Sector Accounting Standards

Public Sector Accounting Standards (PSAS) have been developed, exposed for review, and published by the International Federation of Accountants since 1998, in collaboration with the International Organization of Supreme Audit Institutions (INTOSAI). They are intended for use by all public sector institutions, including national, state local and governments. The United States has its own version of Government Accounting Standards. See also International Accounting Standards and Accounting Standards.

Public sector enterprise

A revenue-earning entity in the public sector that typically seeks to recover the costs of its investments and operations and which may, or may not, seek to make a profit for distribution to the owner(s), who will probably be a government organization(s).

Purchasing power parity

Purchasing power parity (PPP) is a theory which states that exchange rates between currencies are in equilibrium when their purchasing power is the same in each of the two countries. This means that the exchange rate between two countries should equal the ratio of the two countries' price level of a fixed basket of goods and services.

Q

Qualified audit report

Audit report opinion in which the auditor expresses reservations, doubts, or exceptions regarding certain items in the report, or draws attention to a limitation in the auditor's examination. An audit report may be qualified because of departures from generally accepted accounting principles, lack of consistency in GAAP application, significant uncertainties affecting the financial statements, or restrictions in the scope of the auditor's examination. There are four types of auditor's opinions: (a) unqualified, (b) qualified, (c) adverse, and (d) disclaimer or denial of opinion.

Qualified opinion

The auditor's opinion accompanying a financial statement that calls attention to limitations in the audit or exceptions the auditor has taken with the audit of the statements.

Quick ratio

(or Acid Test Ratio) a more rigorous test than the Current Ratio of short-run solvency, the current ability of a firm to pay its current debts as they come due. This ratio considers only cash, marketable securities (cash equivalents) and accounts receivable because they are considered to

be the most liquid forms of current assets. A Quick Ratio less than 1.0 implies "dependency" on inventory and other current assets to liquidate short-term debt.

R

Rate

Amount of money charged or paid, calculated according to a certain rule or ratio.

Rate of return

The gain or loss for a security in a particular period, consisting of income plus capital gains relative to investment, usually quoted as a percentage. The real rate of return is the annual return realized on that investment, adjusted for changes in the price due to inflation.

Ratio

Expression used to define a relationship between two or more factors; for example a current ratio that is used to report the relationship of operating income to operating expenditures

Real interest rate

Interest rate adjusted for inflation.

Real price

Current price expressed in terms of a base year that is adjusted for inflation and the impact of foreign exchange fluctuations. Prices are expressed in terms of a common unit of measurement of constant value, as in a price index.

Receivable

See Accounts Receivable.

Recurrent expenditure

See Current Expenditure.

Reimbursement

To pay back to someone, e.g. to pay an employee for travel expenses that was paid by the employee out of that employees own personal funds.

Re-lending

Re-lending becomes necessary when a Bank loan is extended to a beneficiary that is not the direct borrower of the Bank loan. The terms of re-lending depend on the nature of the beneficiary.

Representation Letter

See Management Representation Letter

Reserve

Appropriation of retained earnings for a designated purpose, such as plant expansion or a bond sinking fund. The purpose of the reserve is to tell stockholders and creditors that part of retained earnings is unavailable for dividends.

Reserve ratio

Fraction of demand deposit money that a commercial bank must keep in its reserve account. This ratio determines the maximum amount of money a bank may lend. In the United States, the legal reserve requirement is imposed on depository institutions by the Federal Reserve.

Retained earnings

Profits of the business that have not been paid out to the owners as of the balance sheet date. The earnings have been "retained" for use in the business (Retained Earnings is an account in the equity section of the balance sheet). It is comprised of the balance, either debit or credit, of appropriated or un-appropriated earnings of an entity that are retained in the business. NOTE: Appropriated earnings are not available for dividends, but may be used to reduce a deficit or may be transferred to stated capital. Other appropriations of profits require a vote of the shareholders.

Retroactive financing

Bank disbursements against eligible expenditures made by borrowers within specified periods prior to signing a loan agreement.

Return on Assets

Shows the after tax earnings of assets. Return on assets is an indicator of how profitable a company is. Use this ratio annually to compare a business' performance to the industry norms: The higher the ratio the greater the return on assets. However this has to be balanced against such factors as risk, sustainability and reinvestment in the business through development costs.

Return on Equity

Measures the overall efficiency of the firm in managing its total investments in assets and in generating a return to stockholders. It is the primary measure of how well management is running the company. ROE allows you to quickly gauge whether a company is a value creator or a cash consumer. By relating the earnings generated to the shareholders' equity, you can see how much cash is created from the existing assets. Clearly, all things being equal, the higher a company's ROE, the better the company.

Return on Investment (ROI)

A profitability measure that evaluates the performance of a business. ROI can be calculated in various ways. The most common method is Net Income as a percentage of Net Book Value (total assets minus intangible assets and liabilities).

Revaluation

In general, is the reconsideration of the value or worth of a property. In currency, it is the increase in the exchange rate of a currency as a result of official action.

Revenue

The inflows of assets from selling goods and providing services to customers; including the reduction of liabilities from selling goods and providing services to customers.

Revenue-Earning Project

Project that is usually executed, in whole or significant part, by a financially autonomous or semiautonomous entity (such as a corporate business or a public authority) that supplies products or services to customers in return for payment of a price or charge. Projects in the following fields are typically revenue earning: industry, public utilities, railroads, and ports (sea and air). Agricultural projects frequently involve revenue-earning components. These may include specialized government agencies, farmer cooperatives, and ad hoc project management units that

supply inputs to farmers (e.g., fertilizer distributors); entities engaged in processing and marketing an agricultural output, such as sugar, tea, or lumber; nucleus estates around which smallholder production is organized; and agro-industries, such as grain storage companies. Projects in rural development, urban development, and health and population may also involve entities that are required to generate revenues by levying user charges to recover costs of housing, public transportation, utilities, and other services.

Revenue-earning project entity

An entity responsible for implementing and operating a revenue-earning project, often referred to as a public sector or a private sector enterprise.

Revenue expenditure

An outlay than only benefits the current business year. It is treated as an expense that is matched against revenues.

Risk

The measurable possibility of losing or not gaining value. Risk is different from uncertainty. Uncertainty is not measurable.

Risk analysis

The analysis of project risks associated with the value of key project variables, and therefore the risk associated with the overall project result. Quantitative risk analysis considers the range of possible values for key variables, and the probability with which they may occur. Simultaneous and random variation within these ranges leads to a combined probability that the project will be unacceptable. When deciding on a particular project or a portfolio of projects, decision makers may take into account not only the expected scale of project net benefits but the risk that they will not be achieved.

Risk contingency

An allowance that may be added to a project cost table after including physical and price contingencies to provide funding for an event or circumstance that is difficult to quantify prior to start-up of the project and before the completion of the principal biddings to procure goods and services. It is rarely used, but may be necessary, for example, when potential political or operating conditions may deter contractors and suppliers from participating in a bidding process, with a possible result that high prices may be quoted as a means of covering contractors'/suppliers' unusual risks.

Risk management

The selection of those risks a business should take, and those which should be avoided or mitigated, followed by action to avoid or reduce risk.

Risk premium

In a particular investment, the extra yield the investment must pay over the risk-free rate owing to various types of risk inherent in the investment. In the U.S., for example, any bond issuer other than the government must pay a higher interest rate because the risk of default on U.S. government securities is less than on those of other issuers.

S

Salvage value

a) Realizable value of a fixed asset after deducting costs associated with its sale; b) Scrap value or the value to a junk dealer; or c) The amount remaining after all depreciation has been deducted from the original cost of a depreciable asset.

Second generation imprest account

A sub-account of a project Imprest Account set up by an Executing Agency with the Bank's agreement for local use.

Sector lending

Sector lending is a form of Bank assistance to a regional member country for project-related investments based on considerations relating to a sector or sub-sector as a whole.

Securities market

Primary and secondary market for negotiable equity (stocks) and long-term debt instruments (bonds).

Self-financing ratio

A sometimes referred to as Cash Generation Ratio, Contribution to Expansion ratio.

Sensitivity analysis

The analysis of how sensitive outcomes are to changes in the assumptions. The assumptions that deserve the most attention should depend largely on the dominant benefit and cost elements and the areas of greatest uncertainty of the program or process being analyzed.

Sensitivity indicator

The ratio of the percentage change in NPV to the percentage change in a selected variable. A high value for the indicator indicates project sensitivity to the variable.

Share capital

(a) Authorized: The type, class, number, and amount of the shares that a company may issue. (b) Called up: The amount that the company has required shareholders to pay on the shares issued. (c) Issued or subscribed: The type, class, number, and amount of shares held by shareholders. (d) Paid up: The amount that shareholders are deemed to have paid on the shares issued and called up. (e) Uncalled: The amount of the share price of issued shares that has not been called up by the company. (f) Un-issued: The amount of the share capital authorized but not issued.

Share premium

Excess paid to a company by a shareholder, either in cash or in other consideration, over the nominal value of the shares issued.

Short-term asset

An asset expected to be converted into cash within the normal operating cycle (usually one year), e.g. accounts receivable and inventory.

Short-term debt

Any debt incurred by an entity and maturing in one year or less from the date that it was originally borrowed.

Short-term liability

A liability that will come due within one year or less.

Sinking fund

Required annual payment to an asset account that is set apart for the amortization of debt, redemption of preferred stock, protection of an investment in depreciable property, or other specified purposes. A sinking fund may be held in cash or marketable securities until needed.

Solvency

Condition of a company able to satisfy its debt obligations as they fall due. Various financial ratios measure a company's degree of solvency, such as the debt-equity ratio and the debt service ratio. Solvency partly depends on corporate earning power, since a company sustaining losses will sooner or later become insolvent. A solvent business is assumed to be a going concern.

Sovereign risk

Risk that a government will default on a loan or fail to honour other business commitments because of a change in national policy.

Spin-off

Form of corporate divestiture that results in a subsidiary or division becoming an independent company. In a traditional spin-off, shares in the new entity are distributed to the parent corporation's shareholders of record on a pro-rata basis. Spin-offs can also be accomplished through a leveraged buy-out by the subsidiary or division's management, or through an Employee Stock Ownership Plan (ESOP).

Standing orders

Also known as banker's order, an order to a bank to make (usually) a series of payments on the customer's behalf. It is used to pay bills that are due at regular intervals.

Statement of Expenditure (SOE)

Part of a borrower's claim procedure that totals specific expenditures for withdrawing loan proceeds. It is used instead of original documentation. Normally, the Bank requires an SOE to be audited; the conditions are usually set out in the loan documentation.

State-owned enterprises

An enterprise, often a corporation, owned by a government.

Statutory Liquidity Ratio (SLR)

A ratio which every banking company shall maintain in the form of cash, gold or unencumbered approved securities, an amount which shall not, at the close of business on any day be less than such percentage of the total of its demand and time liabilities as the Reserve Bank may specify from time to time.

Statutory powers

Statutory powers or requirements may relate directly to the entity's operations (e.g., power to fix tariffs and levy charges for products or services) or they may define criteria within which an entity may operate (e.g., banking laws which define borrowing/lending limits).

Subprojects

Refers to projects that make up a sector loan.

Straight-line depreciation

Allows an equal amount to be charged as depreciation for each year of the expected use of the asset. It is computed by dividing the adjusted basis of a property by the estimated number of years of remaining useful life.

Subsidiary

A company whose voting stock is more than 50% owned by another company.

Subsidy

Sum paid to companies in certain industries to enable them to sell their goods or services at a price close to the prevailing market price. A subsidy is also used to provide financial support to a commercial or quasi-commercial activity that would otherwise not be viable in narrow profit-and-loss terms, usually in order to sustain broader economic or social benefits.

Supreme Audit Institutions (SAIs)

Supreme audit institutions (SAIs) are the national agencies responsible for auditing government revenue and spending. Their primary purpose is to oversee the management of public funds and the quality and credibility of the government's financial reporting.

Sustainability

Sustainability is the ability of a development activity to deliver substantial benefits for an extended period of time after financial, managerial and technical assistance from a donor finishes.

Swap (transaction)

Spot purchase of foreign exchange (currency swap), fixed or floating rate funds (interest rate swap), or assets (asset swap) with simultaneous forward sale or vice versa.

Switching Value

The SV of a variable is that value at which a project's FNPV becomes zero (or the FIRR equals the discount rate). The SVs are normally given in terms of the percentage change in the value of the variable needed to turn a project's FNPV equal to zero. SVs are useful to determine those variables that are most likely to affect project outcomes. SVs of the more important (or potent) variables should be presented in order of declining sensitivity.

T

Takeover

Form of acquisition by one company of another; usually followed by a merger. Takeover can be hostile or friendly. The public tender offer is a means of acquiring a target firm against the wishes of its management. In a friendly takeover, the acquiring firm negotiates with the targeted company and the subsequent agreement, reached in an amiable atmosphere, is put up for approval by shareholders.

Tangible asset

Normally refers to assets that can be held or seen and that are capable of being appraised at an actual or approximate value (e.g. inventory, land & buildings, etc.).

Tariff

(a) Tax on imports or exports, most often calculated as a percent of the price charged for the good by the foreign supplier. The money collected is duty. A tariff may be imposed as a source of revenue for the government. It may also be imposed to protect domestic firms from import competition. (b) Schedule of rates or fares in the transportation industry and public utilities.

Tax

Compulsory levy imposed by the state/country to individual property or transaction use to defray necessary expenses of the government.

Tranche

Payment (disbursement) by a lender of a portion of an agreed loan commitment.

Transparency

Refers to availability of information to the general public and clarity about government rules, regulations, and decisions and how these affect both public and private sector functioning.

Turnover

Frequency with which an item (i.e., fixed asset, inventory, accounts receivable, personnel) is replaced during an accounting period.

U

Underwriting

Acceptance of risk in return for payment. In a new securities issue, the underwriter--known as the investment banker--may perform an underwriting function by purchasing the securities at a fixed price from the issuer, hoping to sell them at a higher offering price and make a profit on the spread. Investment bankers usually form an underwriting group, also called a syndicate, to pool the risk and assure successful distribution of the issue.

Unqualified Audit Opinion

The auditor's opinion accompanying a financial statement that the auditor concludes that the financial statements are presented fairly in all materials respects in accordance with the identified financial reporting framework.

V

Valuation

Approach by which the realistic value of an asset is determined for proper financial reporting. For example, accounts receivable from a credit sale transaction may be legitimate, but if the customer is bankrupt and unable to pay, the valuation is lower.

Value-at-Risk (VaR)

In economics and finance, the Value at risk, or VaR, is a measure used to estimate how the value of an asset or of a portfolio of assets could decrease over a certain time period (usually over 1 day or 10 days) under usual conditions.

Value added

The difference, at each stage of production or the provisioning of a service, between the price of a product or service and all materials or activities paid for to produce the product or provide the service.

Variable costs

Expenses that vary in total in direct proportion to changes in activities, such as machine hours or labour hours within the relevant range. Examples are direct materials used to manufacture an item and gasoline expense based on mileage driven. Variable cost per unit is constant.

Venture capital

Financing source for new businesses or turn-around ventures that usually combine high risk with high return potential. There are various stages of venture capital, such as beginning with seed money and then proceeding to the development stage. Sources of venture capital include wealthy individuals, small business investment companies, and limited partnerships.

Viability

In economics, is the capability of developing and surviving as a relatively independent social, economic or political unit.

Value Added Tax (VAT)

A consumption tax where taxes are levied at each step of a manufacturing process where value is added to that product at that point in the manufacturing cycle; as well as at the point where the consumer purchases the end product.

W

Warrant

In government accounting, is an order drawn authorizing payment to a designated payee. In securities, it is a security entitling the holder to buy a proportionate amount of stock at some specified future date at a specified price, usually one higher than current market. This "warrant" is then traded as a security, the price of which reflects the value of the underlying stock. Warrants are issued by corporations and often used as a "sweetener" bundled with another class of security to enhance the marketability of the latter. Warrants are like call options, but with much longer time spans -- sometimes years. In addition, warrants are offered by corporations whereas exchange traded call options are not issued by firms.

Weighted Average Cost of Capital (WACC)

An average representing the expected return on all of a company's securities. Each source of capital, such as stocks, bonds, and other debt, is weighted in the calculation according to its prominence in the company's capital structure.

Working capital

Current assets minus current liabilities; also called net current assets or current capital. It measures the margin of protection for current creditors. It reflects the ability to finance current operations.

Working capital ratio

Working capital expressed as a percentage of sales.

Working ratio

Ratio of gross operating revenues from all operational sources to total operating expenditures, excluding depreciation and non-cash charges.

Write-off

To decrease the value of an item, e.g., a tax write-off decreases tax liability, a vehicle involved in an accident can be declared a write-off if the cost to repair is in excess of the value of the vehicle.

Y

Yield

(a) On a security, the real rate of return to the investor or the effective cost to the issuer for a specified period. It differs from the coupon rate, since it takes into account the market price of the security. (b) Return from an asset or service provided.

Yield curve

Graph showing the term structure of interest rates by plotting the yields of all bonds of the same quality with maturities ranging from the shortest to the longest available. The resulting curve shows whether short-term rates are higher or lower than long-term rates.

Yield to maturity

Effective rate of return an investor will receive if a long-term, interest-bearing investment, such as a bond, is held to its maturity date. It takes into account the bond's face value, market price, nominal interest rate or coupon rate, time to maturity, and the time between interest payments. Recognizing time value of money, it is the discount rate at which the present value of all future payments would equal the present price of the bond. Also known as the internal rate of return. It assumes that coupons are reinvested at the yield to maturity rate.

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