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Financial Management in ADB Sovereign Operations

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The ADB logo, consisting of the letters "ADB" in a white, serif font, centered within a dark blue square. The square is positioned in the bottom right corner of the slide, partially overlapping a decorative graphic of vertical lines and rounded rectangles in green and blue.

Why is FM Important?

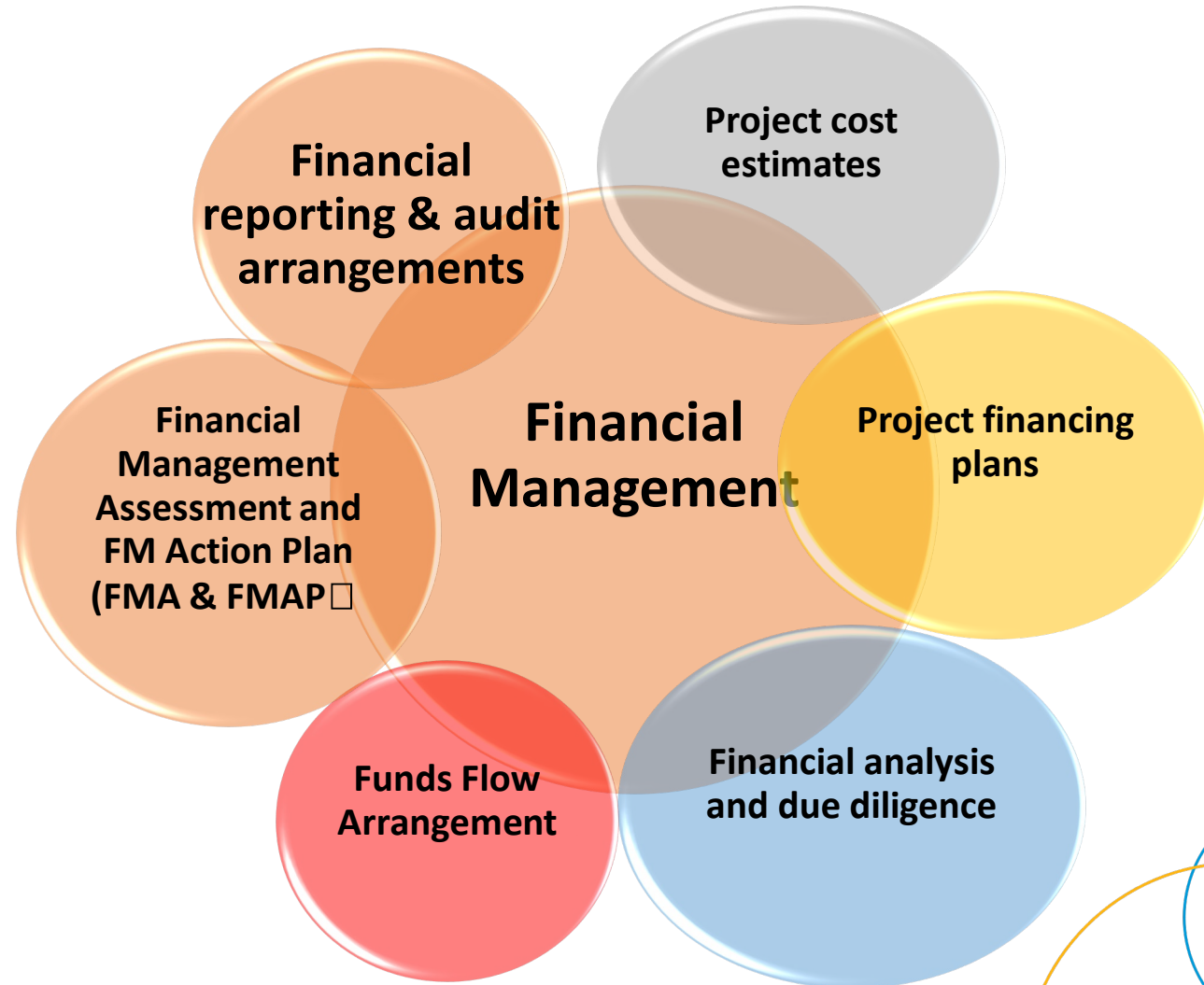
A Fundamental Charter Requirement

Article 14 of ADB Charter (1966)

- The Bank shall pay due regard to the prospects that the borrower will be in a position to meet their obligations under the loan contract
- Proceeds of any loan made are used for the purpose for which the loan was granted
- And with due attention to considerations of economy and efficiency.
- Bank shall be guided by sound banking principles in its operation

Financial Management Elements

- Prepared during project processing
- Updated during project implementation
- Applicable to loans and grants (excl PBL)





Financial Due Diligence Documents

Project Processing

Financial Management Assessment

- FM risk and mitigating action plan
- accounting and auditing requirements
- funds flow arrangements

- ✓ RRP Section IV: Due Diligence
- ✓ RRP Table 4: Summary of Risks and Mitigating Measures
- ✓ Project Administration Manual (PAM) Section V: Financial Management,
- ✓ PAM FMAP Table
- ✓ PAM Section IX: Performance Monitoring, Evaluation, Reporting and Communication
- ✓ Risk Assessment and Action Plan (RAMP)
- ✓ Legal Agreement, APFS/AEFS covenants

Cost Estimates and Financing Plan

- ✓ RRP Section II (B): Summary Cost Estimates and Financing Plan
- ✓ PAM Section IV: Costs and Financing

Entity Financial Analysis Project Financial Evaluation

- ✓ RRP Section IV: Due Diligence
- ✓ Legal Agreement, financial covenants
- ✓ Financial Analysis Linked Document



Cost estimates



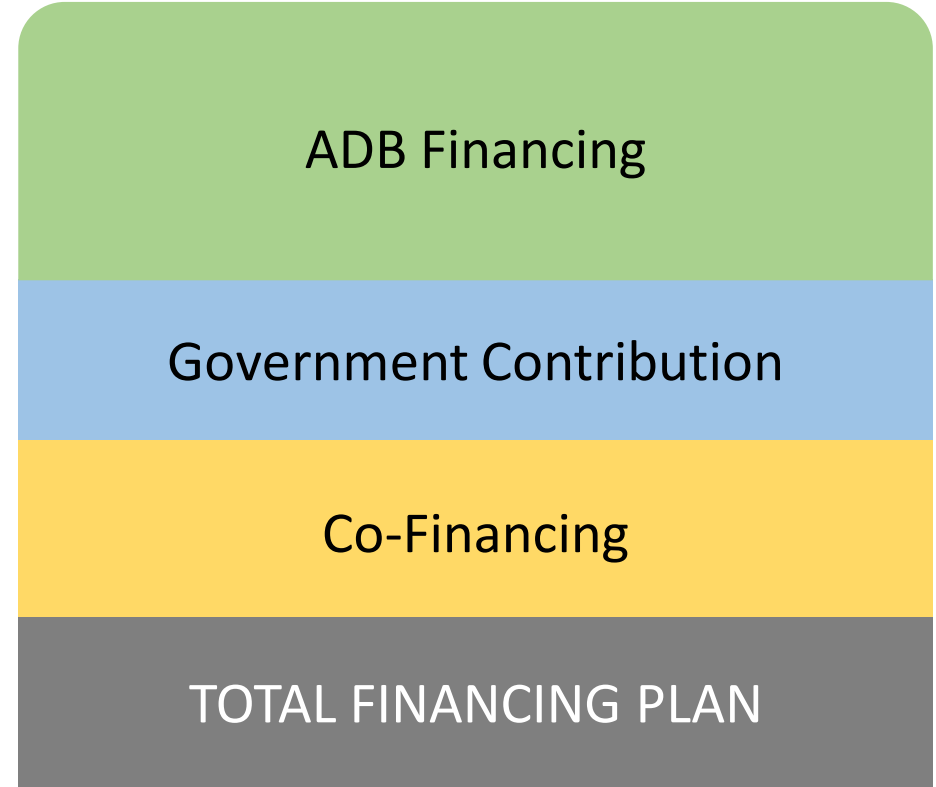
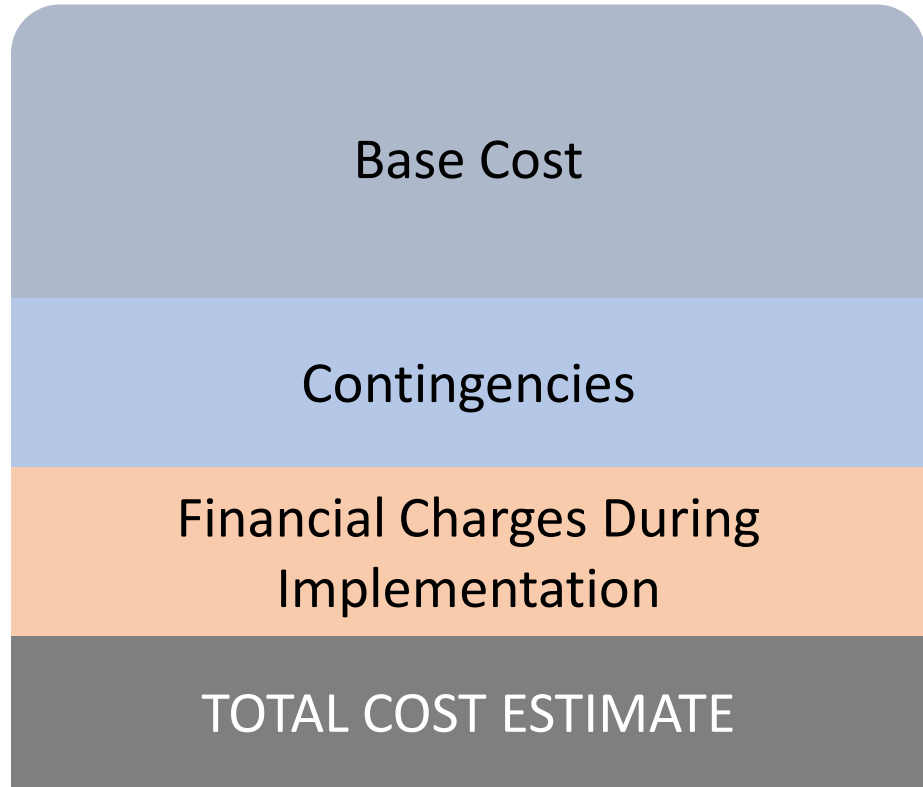
Detailed Costs



| | Total Cost | % of Total Base Cost |
|--|--------------|----------------------|
| A. Investment Costs | | |
| Civil works | 13.94 | 15.0% |
| Equipment | 22.25 | 24.0% |
| Consultants | 5.24 | 5.7% |
| Subtotal (A) | 41.43 | 92.2% |
| B. Recurrent Costs | | |
| Project Management | 7.27 | 7.8% |
| Subtotal (B) | 7.27 | 7.8% |
| C. Total Base Cost (A+B) | 48.70 | 100.0% |
| D. Contingencies | | |
| Physical | 4.87 | 5.0% |
| Price | 7.50 | 8.1% |
| Subtotal (C) | 12.37 | 13.1% |
| E. Interest Charges During Implementation | 5.19 | 5.6% |
| Total Project Cost (A+B+C+D+E) | 66.27 | 118.7% |



Financing Plan



Is it permissible for the financing plan to show zero government contribution?



Ensure timeliness of cost estimates

Less than 6 month from date of presentation to ADB management

- acceptable

6-12 months before presentation

- Revised through indexation*

More than 12 months before presentation

- Reappraised*

**Unless the base cost has not changed materially in the interval*



Financial Analysis & Financial Evaluation



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Financial Analysis and Evaluation

Financial Evaluation

Assesses the project's inherent **FINANCIAL VIABILITY** without any reliance on external support, and whether, during the operational phase, it will generate adequate cash resources for the project owner to operate and maintain the investment, and service the capital.

Financial Analysis

Provides basis to conclude whether the executing agency and/or implementing agency is financially capable to implement the project and operate and maintain it in a **FINANCIAL SUSTAINABLE** manner over the project's economic life.

Types of Financial Analysis

| Type of Entity | Type of Financial Analysis |
|---------------------------------------|-------------------------------------|
| General Government Sector Unit (GGSU) | Incremental recurrent cost analysis |
| Public or private corporation, NGO | Financial statement analysis |

How are Financial Intermediaries historical financial performance Assessed?

- C** **Capital Adequacy** assesses the extent to which the FI is capitalized to meet its risk exposures.
- A** **Asset Quality** - assets are classified into performing assets and nonperforming assets (NPAs).
- M** **Management Quality** is covered under the governance and risk management framework sections of institutional assessment.
- E** **Earnings Quality** is measured through a standard set of ratios: return on average assets, return on equity, etc.
- L** **Liquidity** - the FI may have a sound asset portfolio but not all of it may be quickly convertible to cash.
- S** **Sensitivity** of financial performance to market risks – interest rate risks, foreign exchange risks.

Incremental Recurrent Cost Analysis

Table 1: Fiscal Analysis of Operations and Maintenance Allocations
(local currency million)

| Item | Year 1 without ADB project | Year 2 with ADB project | Difference (%) |
|---|----------------------------------|-------------------------------|-------------------|
| Unconstrained O&M requirement | 1,000 | 1,100 | 10.00 |
| Allocation | 800 | 825 | 3.12 |
| Utilization or execution | 700 | 750 | 5.00 |
| O&M shortfall (to unconstrained requirement) | 30% | 32% | |
| Other information | | | |
| Increase in budget | | 3.12% | |
| Annual inflation | | 5.00% | |
| Inflation-linked increase in O&M requirement for existing network in Year 2 (A) | | 50 | |
| Incremental requirement for ADB project in Year 2 (B) | | 50 | |
| Total increase in O&M requirement in Year 2 (A + B) | | 100 | |

ADB = Asian Development Bank, O&M = operations and maintenance.

Source: Asian Development Bank.

Project Financial Evaluation Approach



Prepare
Cost
Estimate

Forecast
incremental
net cash
flow

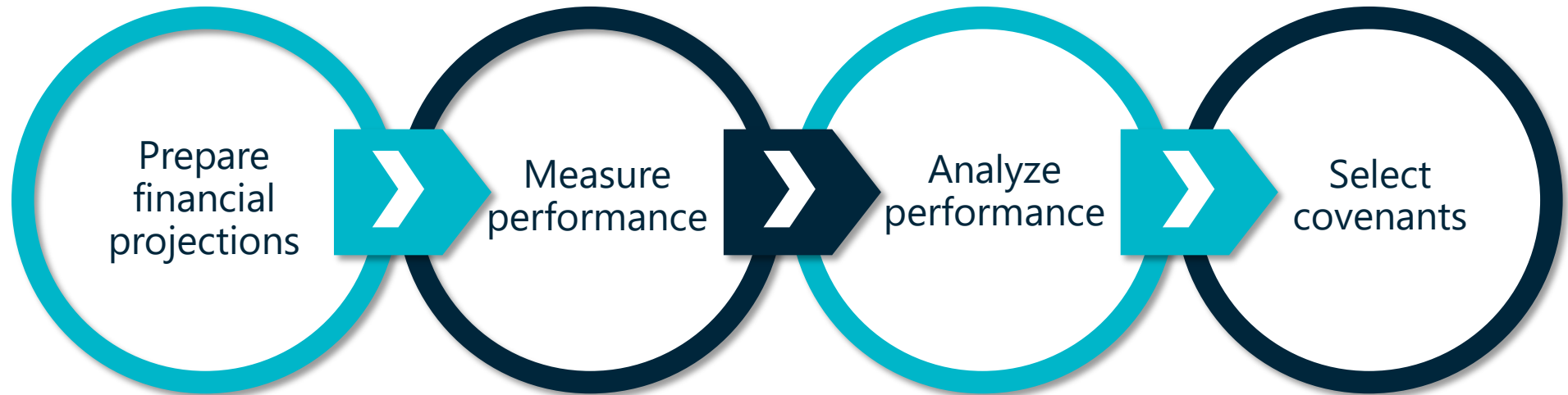
Compute WACC

Compute
FNPV at the
WACC and
FIRR

Conduct Risk
and
Sensitivity
Analysis

Evaluate
Financial
Sustainability

Entity Financial Analysis



- Historical Financial Statements and projected future growth per business plan
- Project incremental costs and benefits analysis
- Project impact on key ratios and financial indicators.



Assurances and Covenants

Assurances

- Declaration of intent

Covenants

- Rooted in the financial projections of the entity
- Legally binding
- Measurable and objective
- Reasonable and Actionable

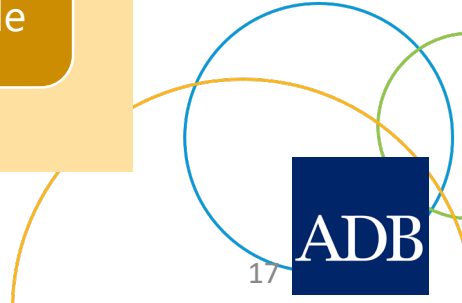


Financial Ratios as Loan Covenants

- Debt to Equity
- Debt Service Coverage
- Self-financing Ratio
- Fixed Asset Turnover
- Return on Assets

- Capital Adequacy
- Liquidity
- Non-performing Loans
- Operating Cost to Revenue

- Current Ratio
- Collection Efficiency
- No. of Days Accounts Receivable / Payable





Financial Management Assessment



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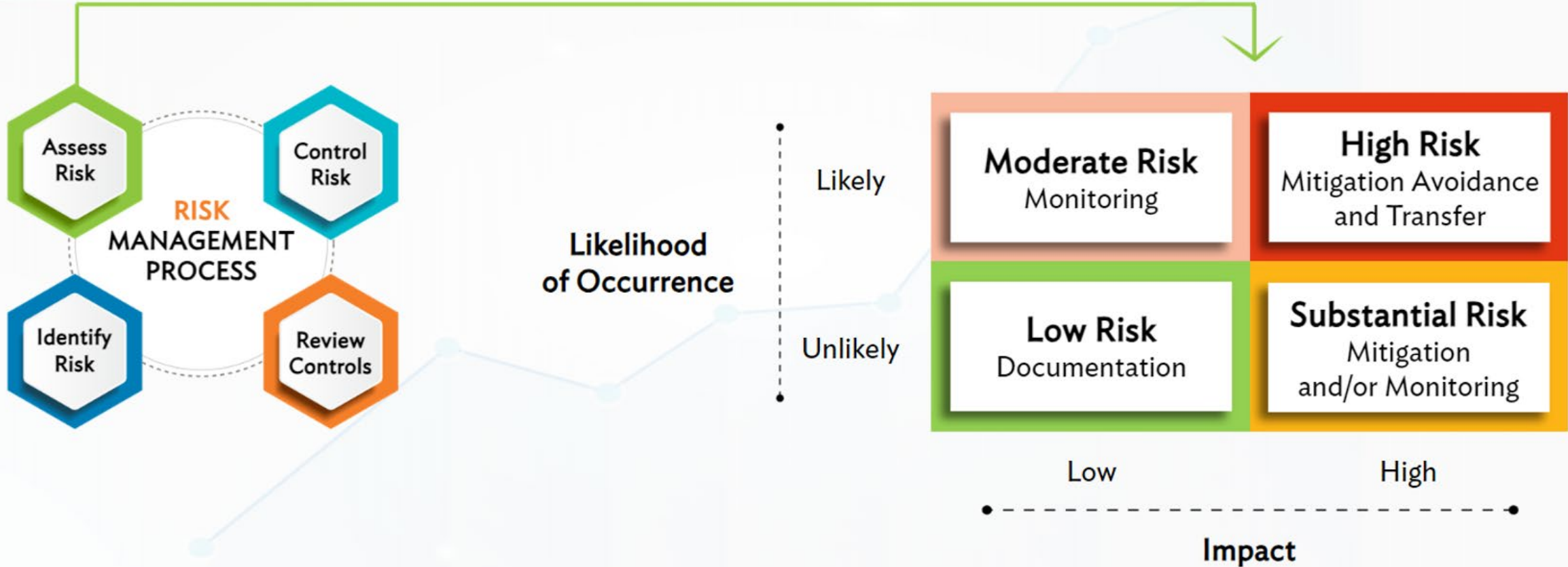
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Elements of Sound Financial Management System



 Staffing and capacity required to support financial management system must be assessed.

FM Risk Rating



Different Lending Modalities - Different Focus of FMA

Sovereign Investment Loans



Financial Management Assessment (project & sector loans)



Institutional assessment of the entity (financial intermediation)



| FM Areas | Risk Description | Risk Rating | Mitigating Action | Time frame |
|---------------------------------|--|-------------|---|--|
| Staffing of IAs and PIUs | Lack of familiarity with ADB loan policies and procedures. | S | IAs have project experience by ADB. 8 out of 15 PIUs have foreign fund experience. These entities will support the other PIUs to comply with ADB financial management procedures and requirements | During project implementation |
| | | | Training on ADB’s financial management requirements, especially accounting, financial reporting and monitoring | 1 month before the first withdrawal application and any other time as needed |
| Funds flow | Delay project implementation due to lack of familiarity with ADB disbursement procedures | S | Training on ADB’s withdrawal application and disbursement procedures and requirements | 1 month before the first withdrawal application and any other time as needed |



Financial Reporting



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Financial Management Reporting

Audited Project Financial Statements (APFS)

Annually, 6 months after fiscal year end

Auditor's Opinion on use of loan proceeds

Annually, 6 months after fiscal year end

Management Letter

Annually, 6 months after fiscal year end

Audited Entity Financial Statements (AEFS)

As per statutory requirements but not later than 12 months after fiscal year end

Auditor's Opinion on compliance with financial covenants

Annually – based on AEFS

Financial information in project progress report

Monthly/quarterly/semi-annually, as agreed in PAM

Audited Entity Financial Statements

When the EA's annual financial statements are subject to audit under the statutory or regulatory requirements of the DMC or are required for project monitoring (OMJ7)

Following **generally accepted accounting standards** followed in the country

Audit opinion on compliance with financial covenants

First AEFS submission = the fiscal year in which the project became effective

Last AEFS submission = the fiscal year in which the loan closing date or financial closing date falls, depending on the agreement

Public Disclosure

- ADB's Access to Information Policy regulates disclosures of the annual APFS on the website.
- Disclosing procedure for APFS is agreed upon with the Borrower and is a part of each loan or grant agreement



Disclosed documents on ADB's website

- Auditor's opinion on financial statements
- Audited project financial statements, including associated Notes



Non-disclosed documents on ADB's website

- Additional auditor's opinions
- AEFS
- Calculated financial covenants
- Management Letter



Country Specific FM Issues

Key FM Issues

- **Timeliness of Audits:** Slow audit process and delays in the submission of audited financial statements (AEFS in particular). Lack of coordination between the EA/IA and AGP is noticed generally.
- **Quality of Financial Statements:** Capacity issues sometimes leading to issues such as incomplete disclosures, inaccurate/incomplete data and non-compliance with financial reporting standards.
- **Non-compliance with Loan Covenants:** There seems to be lack of understanding of the loan covenants on part of EA/IA leading to non-compliances of the loan/project agreements. Non-submission of assurance opinion over the financial covenants as required per the loan/project agreements.
- **Implementation of Audit Recommendations:** Delays in implementing the audit recommendations and proposed action items by ADB FM team results in recurring audit/financial management issues. Management letter observations mostly remain un-resolved and delays in conducting the Departmental and Public Accounts Committees meetings.



THANK YOU



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