Financial Accounting Reporting and Auditing Handbook

FIRST EDITION
Central and Operational Accounting Division
The World Bank
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ACRONYMS AND ABBREVIATIONS

ARCS - Audit Reporting Compliance System
BP - Best Practices
CAAT - Computer Assisted Audit Techniques
CIS - Computer Information System
COD - Country Operations Division
CPFR - Country Portfolio Performance Review
EDP - Electronic Data Processing
FARAH - Financial Accounting Reporting and Auditing Handbook
IAPC - International Audit Practice Committee (of IFAC)
IAS - International Accounting Standards
IASC - International Accounting Standards Committee
IBRD - International Bank for Reconstruction and Development
IDA - International Development Association
IFAC - International Federation of Accountants
INTOSAI - International Organization of Supreme Audit Institutions
ISA - International Standard on Auditing
GAAP - Generally Accepted Accounting Principles
GAAS - Generally Accepted Auditing Standards
OP - Operational Policy
PFS - Project Financial Statement
PSC - Public Sector Committee (of IFAC)
RVP - Regional Vice President
SA - Special Account
SAI - Supreme Audit Institution
SAL - Structural Adjustment Loan
SAR - Staff Appraisal Report
SECAL - Sector Adjustment Loan
SGSA - Second Generation Special Account
SOD - Sector Operations Division
SOE - Statement of Expenditure
TM - Task Manager
TOR - Terms of Reference
VAT - Value Added Tax
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PREFACE

This Financial Accounting, Reporting, and Auditing Handbook (FARAH) sets out good practices to facilitate implementation of the operational policies and procedures in OP and BP 10.02 in the Bank's Operational Manual. Its primary purpose is to provide guidance in these areas to the Bank's Task Managers. FARAH will also be a useful guide to borrowers in the implementation of Bank assisted projects. It provides a minimum level of understanding of the role of financial management in overall project management and the importance of the various elements, from accounting system design, the linkage of financial information to key indicators of project objectives and financial reporting, to audits. In a world of scarce financial resources and complex projects, it is imperative that the financial management system of a project or an implementing organization is strong enough to provide timely, reliable, and useful information for accountability and decision making.

Accounting and auditing are fundamental elements of stewardship—achieving the greatest benefit for the funds invested. This implies an integration of financial and program disciplines to manage scarce resources to achieve common goals. From the initial project design to project completion, all the elements of good management work together to contribute to good governance and to improve project performance and enhance the benefits derived.

The Handbook should be seen as a guide only, as it does not cover all systems, or prescribe specific solutions for particular problems. Use of the Handbook should be accompanied by consultations with qualified Bank accountants and consultants with respect to matters that require professional judgment. It will, however, provide non-accounting professional staff with a framework for an initial view of the financial management capacity of the borrower, make preliminary judgments as to strengths and weaknesses, and more importantly, recognize when professional assistance is required. This is particularly important for transitional economies unfamiliar with financial techniques required in market economies, revenue earning projects, and other complex situations where the financial management system is an issue -- or does not exist.

FARAH has been prepared by the Central and Operational Accounting Division (ACTCO), with the primary author being George Russell (Financial Advisor), with assistance from Margaret Bartel (Consultant). It draws from guidelines published by the International Accounting Standards Committee (IASC), the International Federation of Accountants (IFAC), and the International Organization of Supreme Audit Institutions (INTOSAI), whose standards on accounting and auditing are supported by the Bank. It has incorporated guidelines previously issued by Country Policy Notes (CPN), Financial Reporting and Auditing of Projects Financed by the World Bank for the Asian Regions, and work done by Mr. Maurice Mould on Country Assessments. It has also taken into consideration comments from a wide body of Bank financial analysts and other staff, of whom Messrs. Randolph Andersen, Jose Collell, and Albert Kennefick were the most involved.

ACTCO is responsible for policy and guidance on accounting and auditing issues.

Michael E. Ruddy
Director
Accounting Department
January 1995
I: INTRODUCTION

1.01 The Bank's Articles of Agreement require that proceeds of loans\(^1\) be used economically, efficiently and only for the purposes for which the financing is provided as described in the loan agreements. Proper execution of this fiduciary responsibility is critical in maintaining the Bank's access to the capital markets. Therefore, the Bank (i) requires borrowers to ensure that financial management and accounting systems are adequate to generate timely and reliable financial information; (ii) requires and reviews periodic financial reports to be submitted regularly for each lending operation; and (iii) normally requires verification of such financial reports via regular audits.

1.02 Accountability affects the Bank's relationship with external investors and its ability to borrow, as well as borrowing countries' credibility with the Bank and with internal constituencies. By accountability, we mean:

- every act or action is transparent - open to law, regulation and prudent judgment;

- all participants are responsible for their own actions;

- every act or action is subject to independent, professional, unbiased review (audit), and the results made available to all concerned.

1.03 Borrowers need timely and reliable financial information to serve as an early warning system for problems in project implementation, and to allow corrective action to be taken to resolve difficulties before they become major problems. This enables borrowers to better meet their own fiduciary responsibilities to their government, taxpayers, investors, beneficiaries, etc.

1.04 Task Managers (TMs) also require financial information to monitor a project's progress toward achieving its objectives. For both parties -- the Bank and the borrower -- reliable and timely financial information assists good decision-making to ensure that project objectives are achieved and the plans negotiated during project preparation and appraisal are followed. A good financial information system is vital for a strong management information system. Independent audits of financial statements provide faith and credibility to the Bank, its stockholders and members and to third parties including the parliaments, chief executive, and citizens of those national governments which are the Bank's owners and financiers.

1.05 The Bank's ability to fulfill its fiduciary responsibilities and the borrower's ability to implement a successful project are fundamentally affected by the quality of the financial management system used in project implementation. This quality must be built in from the very beginning. Once expended, financial resources can rarely be recovered. Without strong internal controls, there can be no assurance that financial resources are being used effectively and efficiently for project purposes. Without a well-designed accounting system, the right financial data will not be collected and aggregated to provide useful and timely information for decision-making. Without qualified staff, transactions may be recorded incorrectly, which could destroy the usefulness and reliability of financial reporting. A good financial management system will facilitate the last step of verification and establish the credibility of the information gained from the audit. On the other hand, if an audit reveals inadequate financial management, it is almost certain that significant financial resources have already been lost.

\(^1\) Reference to Bank (IBRD) loans is also a reference to IDA credits throughout this Handbook.
1.06 A good financial management system produces information/reports with certain key qualities. The information must be understandable by the user, relevant to required decisions, reliable -- i.e. free from material error and bias -- and comparable with previous information. To be comparable, the measurement and display of the financial effect of like transactions and events must be treated in a consistent way throughout an entity, within an industry, and over time. Timeliness is an important constraint on the relevance of information -- undue delays in reporting information cause it to lose its relevance and consequently, its utility.

1.07 Project and financial management are closely linked. The financial management cycle of budgeting, execution, accounting, and financial reporting mirrors and provides basic support to the project cycle of planning, implementation, recording results, and reporting. Financial management supports project management and helps assure that resources go towards the successful completion of the project and are not wasted.

1.08 A key element in the financial management system is budgeting -- the process in which the financial implications of planned activities or programs are laid out and resources allocated. Budgeting, to be effective, must be integrated with accounting. If it is not, management does not receive the feedback necessary to adjust planned activities to expected resources. Problems in project implementation can go undetected until it is either too late, or very costly, to fix them. Similarly, if accounting is not tied to planned expenditures, the financial information produced is limited in its usefulness for project management.

1.09 The financial management system supporting a project should reflect the characteristics of the project. The financial reporting for a dam construction project will be different from a rural development project -- focusing on different costs and producing different cost structures. Good financial management demands a solid understanding of the underlying "business."

Main Features Of The Handbook

1.10. Chapter II -- Project Appraisal -- discusses those aspects to be addressed during the Project preparation/appraisal cycles.

    Chapter III -- Project Implementation -- discusses monitoring for performance and summarizes the TM's duties with respect to monitoring borrowers' accountability.

    Chapter IV -- Financial Reporting -- discusses the financial statements required and their relationship with each other.

    Chapter V -- Audit Compliance -- discusses the audits required and the selection of auditors, and provides guidance with respect to the audit product.

    Chapter VI -- Country Review of Financial Accountability -- provides guidance as to the main aspects of such a review.

1.11 Users of this Handbook will also find useful Glossary of Terms Used in Financial Management of Bank Projects (GP 10.03).
II: PROJECT APPRAISAL

2.01 The Bank's operational objectives require that a borrower should have accounting and control systems capable of reliably recording and reporting all financial transactions. This is not only to fulfill the Bank's fiduciary requirements but, more importantly, to provide the financial management information that the borrower requires to measure expectations of the Project against the actual achievements. These systems should be operational when project expenditures begin. The financial reporting requirements under the project will depend on the needs of the project.

2.02 In view of its importance, financial management should be viewed as one of the fundamental items as each project enters the Project Cycle. As the general accountability environment in a country will affect the financial management of all investment initiatives, it is important that the Bank has an understanding of this environment, including related laws and regulations, and of the financial management and accounting capacity of the country in which the Bank assistance is proposed. This information should be obtained on a country basis and made available to all Bank staff as required. Countrywide assessments are discussed in Chapter VI of the Handbook.

2.03 It is in the background of the country environment that the TM should, as soon as possible, obtain a review of the financial management structure of the proposed implementing organization. If the structure is not acceptable, then the entity must be willing to introduce the necessary revisions to the structure in time for project implementation. Unless this review is carried out early in the preparation cycle, where significant development of the structure is necessary, it is likely that the project would be appraised and processed without an adequate system being in place.

2.04 It is therefore extremely important that all project appraisals include, in at least one of the relevant missions, a competent staff member or consultant to assess the capability and reliability of the financial management structures and controls of the proposed project implementing organization (which may be a separate organization or merely part of the responsibilities of a government department). The review should cover aspects such as:

- system of budgeting and accounting, including accounting standards used;
- internal control system and procedures;
- flow of funds to support the project organization and the project (including Bank funds);
- financial reporting arrangements, including linkages to key performance indicators, and
- auditing arrangements.

2.05 In assessing the strength of the financial management structure, certain other key considerations must be evaluated. These include the project type (such as revenue or nonrevenue, industry or activity involved), legal and regulatory environment, internal controls, and the quality of staff.

2.06 This review would be followed, as the project design becomes clearer, by the more specific designs of the financial management and accounting structure directly related to the proposed project, including staffing. The availability and quality of auditors should also be determined at this time.

Accounting Structure

2.07 The accounting structure should be a reflection of the project itself. Where the project is only
concerned with expenditures and its financing is earmarked for specific purposes in the Staff Appraisal Report (SAR), then the accounting structure and controls would only be concerned with such expenditures and financing. This applies whether or not the project is a part of a larger program or a part of an operating entity with which the project has no concern. Where the project is concerned with the sustainable financial health of the project implementing organization or has an interest in its institutional development, then the focus would also be on the accounting structure and controls of the overall implementing organization. Concern with the overall structure is usual for revenue earning and other commercial type organizations.

2.08 Similar types of projects usually have similar accounting structures, however, projects vary widely and an adequate accounting structure for one project may not be adequate for another. Issues will take on a different level of importance depending on the project and therefore, care should be exercised when assessing the adequacy of the accounting structure for a particular project. There are, however, some key points to consider for all projects:

1) The accounting system should be fully integrated, whenever possible, with all other financial management systems (budget, treasury and debt management) to assure that it provides a single, common database for financial information.

2) There should be a linkage between the cost categories used by the accounting system and the inputs needed to carry out the project as reflected in the SAR. This linkage should be transparent. Important costs should be segregated. Cost groupings should be logical and key inputs apparent. More important costs should be tracked at a less aggregated level. The correspondence between actual cost and budget, as determined in the SAR, should be clear.

3) Project related costs and revenues should be grouped together so that the sources and uses of project funds can be readily matched. This segregation of project costs can be problematic when the project is part of a larger program being implemented by the project organization. This type of problem is common in nonrevenue producing projects which are managed by the government.

4) Interfaces with the government accounting systems should be transparent and the impact of government regulation determined. This is especially important when the project is partially or wholly incorporated into a government agency/department. Where there is no direct correspondence between government and project accounting categories, sub-categories under established government accounts can be used to establish a linkage. However, in some cases, parallel accounting will be required.

5) Recurrent and investment costs should be distinguished by establishing separate sub-categories.

6) The accounting and budgeting system (see Box 2.01) should be the simplest consistent with the complexity of the project.

7) Periodic financial reports produced from the accounting system should compare actual to projected/budgeted costs for the current period and the total project to date.

8) The financial data produced by the system should be capable of providing some measurement of performance when linked with the outputs of the project. The selection of key performance indicators and accompanying financial data must be planned for during the appraisal period, and should be incorporated into the accounting and reporting system design.

9) The accounting system should follow clearly documented accounting standards. The Bank requires International Accounting Standards as the benchmark, with all deviations clearly identified (paras 2.15-16).
at operational levels such as project sites is transferred to a central location. Unless these systems are properly designed, fully integrated, and highly computerized, delays and loss of data may result, which affect prompt and accurate reporting. Conversely, decentralized systems, which permit localized financial operations, usually require more extensive controls and increased staff.

2.09 Regardless of the type of project, sector involved, or means of disbursing funds, it is important that the project organization maintain adequate and clear accounting records of all expenditures. Support documentation should be maintained for each project for at least a year after the last disbursement of funds for the project and until it has been examined by the project's auditors.

2.10 Whether the accounting structure of the implementing organization is highly centralized or decentralized will affect the financial management of the project. Large industrial and commercial organizations, governments, or large parastatals may operate centralized financial management and accounting systems, whereby all information generated...
Accounting Standards

2.11 Accounting Standards are formal guidelines that specify how certain types of transactions or events are to be recorded and what disclosures should be made in the notes to the financial statements. Standards are usually issued for the purpose of achieving uniformity of accounting treatment and comparability of financial data where a wide variety of possible accounting practices exist. In individual countries the body of accounting standards, policies and concepts generally or widely adopted by professional accountants, associations of accountants, and other authorities are referred to as Generally Accepted Accounting Principles (GAAP). These comprise published guidance (often in the form of published accounting standards or guides) as well as subjective, accepted practices. The government's role in determining accounting policies, standards, and disclosure requirements differs among countries, often depending on the degree of sophistication of the country's economy. In some countries, accounting standards are set primarily by government regulation or simply based on tax regulations.

2.12 An integral part of financial reporting is the accounting standards on which it is based. Accounting principles and standards provide basic guidelines to determine how and when financial transactions are recognized, calculated, classified, posted, summarized, and ultimately reported. Standards can be quite specific and may be implemented through a variety of accounting policies and methods -- for example, the accounting principle of matching income with the expenses required to generate it (see Box 2.03).

2.13 The accounting method used can have a dramatic affect on the apparent performance of the project or organization, even doubling the amount of an expense recognized in a particular year. In the private sector, a difference of accounting methods used can transform a loss into a profit and vice versa (see Box 2.04 on Accounting for Leases). In the public sector, significant budget overruns can be hidden on a short-term basis if costs are recorded only when paid and not when incurred. It is very important to understand the accounting methods used in producing a particular financial report.

2.14 International Accounting Standards (IAS) have been developed by the International Accounting Standards Committee (IASC) to resolve differences in accounting standards adopted by different countries and to harmonize accounting treatments. The membership of the International Federation of Accountants (IFAC) and therefore of IASC is currently comprised of 110 professional accounting organizations belonging to more than 80 countries.

Acceptable Accounting Standards

2.15 In the absence of any superior national standards, the Bank requires the use of IASs in the preparation of financial statements because their use facilitates comparability between projects and countries, ensures consistent presentation of financial statements, and facilitates their interpretation. However, the Bank recognizes that local practices, standards, or legal requirements may not fully reflect such standards. Government agencies serving as implementers may be required by their own laws and regulations to use an accounting methodology which does not meet IAS. Where national standards are used, the Bank requires financial statements to disclose any material departures from IAS, and the impact of such departures on the financial statements as presented must be stated.

Box 2.03

Matching

A simple example is with inventory. Cash is disbursed and costs incurred to buy raw materials and pay for labor to produce a product. These costs are not expensed, but are instead capitalized, i.e., treated as assets--in this case inventory. When the product is sold from the inventory, then the costs of producing the related products will be recognized to "match" the revenue received from the sale.
Box 2.04

Accounting for Leases

Many companies lease equipment, sometimes as a means of financing equipment, sometimes to increase flexibility especially for equipment with a high rate of obsolescence. In the United States, leases which meet particular criteria (e.g. the period of the lease is 75% or more of the useful life of the equipment or the ownership of the asset transfers to the lessee at the end of the lease), must be capitalized, or accounted for as a “financing” (Company A below). This means that the asset being leased is recorded and depreciated in the books of the lessee and the present value of the lease payments are recorded as a liability. Other countries, such as France, do not allow the capitalization of financing-type leases (Company B below). The effect on the income statement of the two approaches — capitalized or accounted for as financing — is illustrated below.

<table>
<thead>
<tr>
<th>Equipment Costs</th>
<th>Useful Life</th>
<th>Lease Term</th>
<th>Lease Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td>$15,000</td>
<td>5 years</td>
<td>5 years</td>
<td>$3,800/year</td>
</tr>
</tbody>
</table>

Note that the balance sheet of Company A would show an asset of $15,000 and a liability of $15,000 at the beginning of the lease term. Company B’s balance sheet would not reflect the lease at all.

Income Statement – Year 1 of Lease Term

<table>
<thead>
<tr>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income</td>
<td>20,000</td>
</tr>
<tr>
<td>Expenses</td>
<td></td>
</tr>
<tr>
<td>Personnel</td>
<td>5,000</td>
</tr>
<tr>
<td>Depreciation</td>
<td>3,000</td>
</tr>
<tr>
<td>Interest Expense on Lease</td>
<td>1,275</td>
</tr>
<tr>
<td>Lease Expense</td>
<td>--</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>9,275</td>
</tr>
<tr>
<td>Net Income</td>
<td>10,725</td>
</tr>
</tbody>
</table>

In this example, Company A shows a smaller profit in the first year of the lease term even though the transaction is identical. Depending on the terms of the lease, the total expenses over the lease term could be the same under each of the two methods or they could be different.

2.16 Accounting standards deal with issues such as accrual and cash accounting, the question of good financial information, balance and reasonableness, and internal controls. These are discussed in Annex

I. A Summary Matrix of some important areas to consider when reviewing Accounting Standards is shown as Annex I-1. Annex II provides a summary of International Accounting Standards.²

² Notes on Accounting Practices in the Former Soviet Union and other blocks are available from ACTCO.
Assessing Internal Control

2.17 The internal control system embodies policies and procedures adopted by the management of an organization to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, 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. There are two basic types of internal controls -- administrative and accounting (Annex II, paras. 14-23 discusses some important aspects of Internal Control). Administrative controls are broader and concerned with the control environment for the whole organization, including the overall efficiency of the operation and adherence to the policies and procedures of the organization. Examples are personnel procedures for the hiring of staff, quality controls, or operational ratios and other statistics such as inventory turnover. Accounting controls deal more directly with assuring that assets are protected and that accounting records are complete and accurate. Examples are budget reporting, bank reconciliation's (independent verification), and safeguarding checks. A strong control environment with tight budgetary controls and an effective audit function complements specific accounting controls and improves accountability over the use of resources.

Quality of Staff

2.18 Accounting deals with a myriad of transactions, each of which must be properly classified and recorded. The quality of the staff, their understanding of accounting concepts as well as government regulations, and their accuracy is very important to prevent material misstatements. The TM should verify that the borrower has an adequate number of skilled and experienced accountants and bookkeepers at each project participating organization compatible with their accounting responsibilities. One key to staff qualifications is educational background. Staff with an accounting education will be better prepared to handle more complex transactions for which the accounting treatment is not always evident and understand the importance of audit trails and internal controls. Extended experience is also important, but sometimes, especially in the public sector, staff with experience are aware of government regulations, but understand little about the "why" of what they are doing. This may be adequate (though not desirable) at the clerical level, but not at the professional level. Obviously, larger and more complicated organizations require more staff highly skilled in financial management.

2.19 Related to both education and experience is the quality of on-the-job training, in particular the use of continuing education to ensure that staff maintain their current skills and learn new ones. Staff should be encouraged to participate in professional accounting associations and their training programs.

2.20 Finally, it is important to carefully evaluate the match between the complexity and responsibility of the job and the qualifications of the person filling the position. An accounting unit may have good clerical support, but lack a manager who understands the significance of the financial information being produced and is committed to timely and accurate information. A controllership function should have specific staff in the following areas: financial planning and budgetary control; general and cost accounting systems; financial systems and procedures; and data processing and management information systems. Staff for the treasury function should have skills in cash-flow forecasting, drawings from cash collection, banking relationships, and general cash management.

Project Types and Sector Characteristics

2.21 The Bank mainly supports investment and adjustment projects with some projects being a mix of both--termed hybrid projects. Investment projects may be of a revenue earning or a non-revenue earning nature. However, in both cases, the Bank is concerned with the security of assets as well as the
proper and efficient use of all project related funds. Within each project type, there will be important differences between sectors, such as financial, utilities, industry, and the social sector, particularly in terms of the financial information required for efficient project management. These differences are discussed below; adjustment projects are discussed in paras 4.32-33.

Revenue-Earning Entities

2.22 Revenue earning projects are usually implemented by a commercially-oriented enterprise in the private or public sector, an organization which generates revenues either by consumer charges or forms of local taxation, or both. These enterprises are likely to be autonomous, or nearly so, with powers to determine financial policies. State-owned entities may be required to conform to a standardized national accounting plan. It will be important to determine their legal status and the degree of autonomy exercised.

Box 2.05

Checklist for Assessing Financial System
Revenue-Earning Projects

- Statutory requirements for accounting and financial reporting
- Status of entity—autonomous or under government control
- Accounting policies and practices in force
- Management and control systems
- Centralized or decentralized management and accounting systems
- Financial regulations
- Financial management and control

2.23 In assessing a revenue earning project an underlying concern is the current and continuing financial viability of the organization. The financial management system should be strong enough to identify on a timely basis the need for additional revenues, serious cost leakage, or of potential cost savings. It should be able to provide signals as to the need for tariff increases as well as the extent of public sector subsidies. Guidelines for reviewing a revenue earning financial management system are given in Annex IV.

Non-Revenue Earning Entities

2.24 Most non-revenue earning projects will be implemented by government agencies. These projects may come under government regulations and requirements. Government budgetary and accounting systems may involve seemingly excessive bureaucratic prepayment authorization measures, fund flow problems, and performance delays caused by apparent lack of delegated responsibility. Staff are urged to obtain an understanding of government budgetary and accounting systems and to seek revisions or mitigating actions where the above will affect project implementation. However, it is very important that existing checks and controls in a system are not removed without substitution of adequate new measures and without the trained staff to implement them. Guidelines for reviewing a non-revenue earning financial management system are given in Annex V.

Accounting for Sectors

2.25 Financial management including accounting systems and controls may vary from organization to organization and between sectors. Each sector has certain key characteristics which should be reflected in the financial management system. For those sectors of a revenue earning nature such as financial, utilities and industry sectors, the Bank is usually concerned with their financial management structure, including the accounting system of the overall project implementing organization.

2.26 However, it is important that TMs approach the design of accounting procedures within the background of the respective implementation capac-
ity of the project organization, and examine imaginative and innovative approaches where necessary. Box 2.06 shows such an example; however, such an approach requires strong accounting and control systems at the District and State levels. The specific financial management and accounting issues relating to the individual sectors supported by the Bank would each warrant their own handbook. However, for this Handbook, some of the main characteristics of selected sectors are summarized in Annex VI.

**Legal and Regulatory Environment**

2.27. Understanding the legal and regulatory environment in which the implementing organization operates is important in ensuring the best financial management for the project. The degree of autonomy exercised by the organization will determine how readily changes in the financial management system can be made. Most countries have a Companies Act which sets up the legal environment in which firms must operate. Sometimes the accounting structure is dictated by law. Some industries will be more regulated than others and might have another set of regulations in replacement of or as an addition to the basic Companies Act. There may also be variances with the International Commercial Code establishing business law. State-run agencies may have legally required accounting practices and procedures which can only be changed via legislation.

**Incorporation into Staff Appraisal Report**

2.28 The Staff Appraisal Report (SAR) should include a detailed explanation and assessment of the financial management system and any additional requirements for the particular project. It should address the design of the project accounts, procedures required for consolidating reporting from various sub-projects, the use of SOEs, and any other activities required to assure accountability. This will be especially important when the project involves several agencies and the methodology for consolidating total project expenses is not clear. The SAR should also outline the format for project reporting, including the audited and unaudited financial statements required, and their frequency.
2.29 In the event that the financial management system is weak, an action plan for its improvement should be negotiated with the borrower and incorporated into the SAR. As needed, technical assistance can be provided within the context of the project or even as a totally separate financial management strengthening project. An actual plan should be worked out in time to be included in the SAR, and incorporated into the loan agreement as necessary. In extreme circumstances, it may be necessary to contract out the accounting, but this should only be on a temporary basis and within a technical assistance plan to improve the overall financial management of the entity.

2.30 The Bank includes in all legal agreements one or more accounting, financial reporting, and auditing covenants as a means of ensuring accountability for the use of its funds. The legal agreements, including the Agreed Minutes of Negotiation, are the authoritative source of all financial reporting and auditing requirements.

2.31 Loan covenants should be used to assure compliance with general Bank policy. In consultation with the legal department, the TM should ensure that standard audit covenants are appropriate for every project as well as any special covenants related to financial reporting or independent reviews of project progress by experts. Once the Bank's requirement of basic accountability has been met, additional reporting requirements should not be burdensome on the borrower or on future Bank staff trying to ensure compliance with the covenants.

Provision for Audit

2.32 The groundwork for a timely and thorough audit should be laid during the project design. The TM will need to be aware of any legal considerations in the selection of an auditor, including whether or not the project is to be audited by government auditors and their acceptability to the Bank. The TM should also be aware of the overall status of the accounting and auditing profession and its adherence to international standards relating to both accounting and auditing. In consultation with a qualified accountant, the TM should determine that any auditors proposed by the borrower are qualified to perform the audit, are independent, and have been provided with terms of reference satisfactory to the Bank. Auditing is discussed in more detail in Chapter V of the Handbook.
III: PROJECT IMPLEMENTATION

3.01 The Task Manager (TM) is charged with the physical and financial oversight of the project. By integrating financial management techniques into the overall monitoring plan, the TM increases the likelihood that project implementation will be successful.

Monitoring for Performance

3.02 Monitoring for performance is one of the key outputs of a well-designed and constructed financial management and accounting system. The frequency, content, and format of reported information should closely match the needs of the users. Borrowers who are implementing a particular program might need more frequent reporting and less aggregated financial information in order to make the necessary corrections to project implementation and keep activities on track. TMs might be able to use the same information, but at less frequent intervals (perhaps quarterly instead of monthly or weekly), and at a more aggregated level.

3.03 Regardless of the frequency or level of aggregation of the report, actual performance should be compared to projected performance. Key performance indicators, some of which combine physical and financial data, should be determined and reported on.

3.04 Neither financial nor physical data by itself can provide sufficient information for the borrower or Bank to determine whether or not the project is progressing properly. The project may be achieving its physical goals, but at a rate of cost which will consume financial resources so rapidly that they will not be sufficient to finish the project. Similarly, the consumption of financial resources does not imply the accomplishment of physical milestones. When the two are linked, the TM and borrower can get a much clearer picture of project progress and take appropriate actions as needed.

3.05 In planning the project budget it is important to structure the financial statements and reporting in such a way as to gather appropriate data for a meaningful linkage between the physical and the financial data. The focus should be on one or two key indicators rather than a myriad of combinations. In selecting the key indicators, the TM should carefully evaluate the impact of the measurement on the underlying incentive structures for project performance. However, care must be exercised when using key indicators. While helpful, key indicators are not a replacement for good project management and oversight.

Box 3.01

Key Indicator

A common indicator used in the construction of roads is the cost per mile/km of road completed. This indicator gives a clear indication of whether or not the financial resources will be adequate to complete the projected number of miles, but says nothing about the quality of those roads. Nonetheless, the combination of physical and financial data is superior for monitoring project progress to either of the two taken alone. Such performance indicators can increase the ability to monitor a project for financial accountability as well as physical completion.

3.06 The nature of the project will determine the interplay between financial and production data. Projects which closely resemble commercial enterprises will lend themselves to the development of key indicators which are heavily "bottom-line" (or financially) oriented. Comparative values may be available from the private sector. In nonrevenue earning projects progress toward completing the project objectives may be harder to quantify, but key indicators based on throughput can have a beneficial impact on the overall management of a project.
3.07 One of the key tools in monitoring for performance is the project financial report showing projected sources and uses of funds, for the period and for the period to date, compared to the percentage of the project completed in the period and for the period to date. Sometimes this comparison can be made on the basis of financial resources consumed as a percentage of the completion of some key indicator, such as miles of road laid.

3.08 The key question to ask in evaluating a project financial statement/report is whether or not the costs appear to be reasonable given the progress of the project. For example, salary expense on a technical assistance project in the social services sector might be expected to be fairly evenly disbursed across the life of the project. If an interim project financial report showed the salary line item being disbursed in disproportion to the project life, the Project Manager and the TM would focus on this exception and investigate it further. There may be a perfectly reasonable explanation for the variance, but by highlighting exceptions to expected results the project financial report points to areas where problems are most likely to occur. Annex VIII summarizes the Use of Financial Information to Monitor Physical Project Implementation.

Performance Monitoring and the Audit

3.09 There is a very clear and important linkage between interim financial reporting used for performance monitoring and the audit. The audit of the annual financial statements would confirm the accuracy and reliability of the interim financial statements. Any significant difference between the audited figures for a particular period and those reported on the interim financial statements should be reconciled and explained.

Monitoring by the Bank

3.10 The following summarizes some guidelines for the TM to monitor Financial Reporting (Chapter IV of the Handbook) and Audit Compliance (Chapter V) during project implementation. In addition, Annex IX provides some model Form Letters that will facilitate the monitoring for audit compliance.

During the Fiscal Year:

1. Follow up with project management on the completeness and timeliness of the financial records and reports including periodic unaudited financial reports and information required for monitoring project implementation;

2. Ensure not only the receipt, but also the review of the periodic financial information that may be requested for project management. Issues identified should be followed up, in particular audit qualifications and internal control weaknesses included in the audit report and management letter respectively;

3. Send out reminders for audit reports (i) close to the end of the entities' fiscal year, (ii) shortly before they become due in the Bank, and (iii) each 30 days thereafter;

4. Send a brief acknowledgment to the borrower on receipt of the reports with a statement that comments, if any, will be sent later; and

5. Ensure that adequate audit arrangements are in place so that the audited financial statements will be available as soon as possible within the grace period provided in the legal agreements. Arrangements should include the agreement of the TOR for the audit (paras 5.39-41).

End of Fiscal Year:

1. Ensure the receipt of the audited financial statements. These should be received within the grace period allowed in the legal covenants. The grace period should be no more than six months after the close of the fiscal year. The usefulness of reports received much later is reduced.
2. Have all audited financial statements (including SOEs and SAs) reviewed by qualified Bank staff within 30 days of their receipt to ensure that they are complete, that they have been properly reported upon by the auditors, and that the data provided appears reasonable. The liability to the Bank as shown in the financial statements should be reconciled with the disbursements shown in the Bank records. Annex X provides Guidelines for the Desk Review of an Audit Report.

3. Obtain a report from the reviewer (when the reviewer is not the TM) and ensure that it is copied to the Division Chief. The letter to the borrower with any comments relating to earlier reviews and actions taken or proposed should be attached to the report.

4. Notify the borrower in writing of the findings of the review of the financial statements immediately after the review. Where issues are identified in the course of the review which cannot be addressed through correspondence, these should be followed up during subsequent supervision missions. Items which would be covered in the written review should include the following, as necessary:

- reference to the qualifications or other points of significance in the auditor's report;
- whether all the Bank's financial reporting requirements have been met;
- relationship between the results shown in the accounts and financial covenants;
- aspects of financial performance and internal control including a comment on the liquidity of the implementing organization and as appropriate, on any other financial ratios; and
- acceptability of presentation with respect to use of Bank funds.

3.11 The importance of timely compliance with the Bank's financial reporting and auditing requirements should be emphasized. The TM will follow-up promptly all instances of non-compliance and all unsatisfactory financial or audit reports submitted.

3.12 In the case of non-compliance for the receipt of financial statements, the TM should, within 60 days of the compliance date, investigate the reasons for non-compliance and make recommendations to the SOD or COD chief who should notify the borrower of the need for compliance, the remedial actions required to be taken by the Borrower, and the Bank's remedies if such action is not taken. Where compliance is not achieved within six months from the notice, action should be taken to exercise the Bank's remedies for that loan, unless the TM is satisfied that acceptable remedial action is in process to allow compliance within another six months. (For more guidance, see OD 13.40.)

3.13 Where non-compliance relates to SOE procedures, the borrower should be notified within 30 days of the due date for compliance and the remedies available to the Bank. The borrower should be given no more than three months from the date of notice to come into compliance, after which the Bank will no longer permit disbursements against expenditures eligible for the use of SOE procedures.

3.14 Where Bank staff consider it necessary to allow an extension for the receipt of financial statements for the project implementing organization and for the project (para 3.12), separate SOE and SA audited financial statements should be required within the above three month period. The above timetables and procedures follow OD 10.60 which is currently under review as OP/BP 10.02. Reference should therefore be made to OP/BP 10.02 to ascertain any changes.

3.15 Where there is a loan financing several projects, compliance is viewed separately for each project (see Box 3.02). Thus the Bank may stop SOE dis-
bursements for one project which is not in compliance, while continuing SOE disbursements for another project which is in compliance under the same loan.

**Box 3.02**

A multi-state loan is made to Government A with six state governments each participating under the loan. If one state is in non-compliance for the submission of audited financial statements, disbursements would continue to the other five states that are in compliance.

3.16 The principle outlined above may even be extended to cover situations where, for example, the same Ministry of Government has two separate projects implemented by different departments or agencies, one in compliance, one not. However, care must be exercised to ensure that new departments or agencies are not created under the same Ministry for the purpose of negating Bank actions for non-compliance by another department or agency.

3.17 Where the implementing organization is in non-compliance, no new loans to be implemented by that organization would be made by the Bank until compliance under the current project agreements had been achieved. This also applies to extensions of loan closing dates for ongoing projects.

3.18 TMs are also required to review, during missions, selected SOEs. Annex VII provides a guideline for such review.

**Audit Reporting Compliance System**

3.19 The Audit Reporting Compliance System (ARCS) is a part of the MIS and contains information relating to the audit reports required, dates for their submission to the Bank, details of the auditor and the quality of the reports received (see OD 13.10). The ARCS should be used to monitor audit compliance on an on-going basis. Audit reports received and their status are required to be entered into the ARCS on a timely basis. The ARCS cycle consists of:

- receipt of audit reports
- assessment of audit reports and follow-up
- monitoring of audit compliance; and
- entering of data in the ARCS.

The TM has the primary responsibility for keeping the data in the ARCS up to date and for obtaining an assessment of the reports received. Entries into the ARCS should be made on:

- Project effectiveness;
- receipt of an audit report;
- any follow-up action on overdue audit reports; and
- decision that remedial action is required.

Standard ARCS reports and sample report formats are provided in the *ARCS User's Guide*.

**Country Review**

3.20 Where there is pervasive non-compliance, the TM should propose an assessment of the country's accounting and auditing capabilities, across both private and public sectors, examining laws, standards, training, the independence of auditors, the availability of skilled technicians, etc. These assessments would be undertaken under the umbrella of the country department, and may form the foundation for a separate technical assistance project or a component of a project. In addition, country portfolio performance reviews (CPPRs) should routinely include a review of the borrower's implementing organizations' accounting and auditing capabilities. Country Assessment is discussed in Chapter VI of this Handbook.
IV. FINANCIAL REPORTING

4.01 The financial reporting requirements will vary from project to project, and as embodied in the legal covenants of the loan. Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. Accounting Standards lay the benchmarks which the accounting and financial reporting would be expected to follow (para 2.15).

4.02 The Bank has always required annual financial statements provided by the borrower showing the project’s performance for each fiscal year. More recently, however, a strong need is also being felt for interim statements and reports, quarterly and half yearly, to be designed as a fundamental tool for monitoring project implementation and management in general. These interim reports are rarely audited, but their accuracy can be determined by comparison with the final audited figures for the fiscal year.

4.03 Financial reporting is based on the underlying financial management structure and accounting system, which should be developed and agreed during the appraisal process. Financial reports required from borrowers can generally be classified into categories: Implementing organization’s financial statements, project specific financial statements including those for adjustment operations, statements of expenditure, and special accounts. TMs frequently refer to some, or all of the above, as Project Accounts. It is important to understand the specific role of each of the above financial statements. Each of these financial statements should be designed so that they provide the borrower with needed information to manage the project, and to provide the TM with the information needed to monitor project progress. Efforts should be made to consolidate reporting requirements so that they are relevant to the task, but not unnecessarily time consuming.

Implementing Organization’s Financial Statements

4.04 In projects where the financial viability of the implementing organization is vital to the success of the project or where one of the objectives of the project is to improve the institutional capability of the implementing organization, particularly in financial management, the Bank requires their full financial statements. These will include the balance sheet, income statement, cash flow statement (sources and application of funds), and accompanying notes and supplementary information, on the organization as a whole. Annex XI summarizes the Elements of Financial Statements. Most revenue earning projects fall into this category.

Balance Sheet

4.05 The balance sheet is a financial snapshot taken at a particular point in time which is used to evaluate the overall financial condition of the organization at that date. The elements directly related to the measurement of financial position in a balance sheet are assets, liabilities, and equity. The balance sheet provides information as to what resources are currently available for the future performance of the organization. It also provides information regarding the funding of those assets, such as whether they are funded through debt or net worth.

4.06 A balance sheet normally is prepared as of the close of the reporting period and should provide details of all assets (fixed, current, and other), liabilities (accounts payable, short and long-term debt), and equity (paid-in capital, accumulated earnings, or
deficits). Where possible, the balance sheet should be compiled to highlight important characteristics such as the capital structure, the liquidity position, or the reserves, to illustrate the nature and business of the organization. Presentation of comparable data from the previous year is required by IAS.

**Income Statement**

4.07 An income statement reports the results of operations or performance for the period covered. The elements directly related to the measurement of performance in the income statement are income and expenses. Amounts should be classified in the major categories of financial information which may include but are not limited to: operating revenue by categories of sales of service; operating expenses by category; income other than from operations, interest and financing costs and net income. In nonrevenue earning projects, financial resources may also come from other donors or the government itself.

4.08 When budget data is utilized, along with performance indicators, it is one of the best instruments for performance monitoring. It is easy to incorporate budget data into an Income Statement so long as there is a solid linkage between budget and accounting data. Budgets should be developed and accounting systems improved until there is a close linkage between the two. An integrated budgeting and accounting system should be used by implementing agencies.

**Cash Flow Statement**

4.09 A cash flow statement shows the cash provided by and used in operating, investing and financing activities for the period covered by the income statement. An alternative "statement of sources and applications of funds" or "statement of changes in financial position" may be prepared in some countries. A cash flow statement is important because it focuses on what happened to an organization’s cash and where it came from. By removing non-cash transactions it helps to reveal the effects of different account-

**Notes and Supplementary Information**

4.10 The notes should include the main accounting policies followed, and other important disclosures including risks and uncertainties affecting the organization and any resources and obligations not recognized in the financial statements. Information about geographical and industry segments and any other information such as key indicators required for the particular project would be included as supplementary information.

4.11 Additional supplementary schedules or reports may also be required. Reporting requirements should be kept to the minimum needed to ensure good project monitoring and management while complying with IAS disclosure requirements (see Box 4.01).

**Treatment of the Project Financial Statements**

4.12 In almost all instances, the Bank-assisted project represents only a part of the overall activities of the organization. Unless separate project financial statements are prepared (see para 4.13), the implementing organization financial statement including supplementary information should clearly and separately show the expenditures and financing of the project. However, for those projects requiring management information and linkage to physical performance, a separate project financial statements would be more suitable. See Annex XII for a sample of an Organization’s Financial Statement integrating the project.
Project Financial Statements

4.13 The Bank requires annual audited financial statements reporting on expenditures and its financing for each project, in order to monitor its overall financial performance, and the effective utilization of the loan. There may be more than one project to a loan, as in a multi-state project with separate project agreements. Separate financial reporting is required to coincide with each project. In addition, many projects involve more than one implementing organization, each subject to the Bank's requirement for accountability. In these instances, it is strongly recommended that the financial information from each implementing organization be combined by the umbrella project implementing organization to form a single project financial statement.

4.14 Project financial statements are central to financial reporting. Regardless of type, every Bank assisted project should submit regular periodic reports of receipts and expenditures against the budget for each project. A stand alone project usually requires the Project Financial Statements, without the Implementing Organization's Financial Statements.

4.15 The main feature of the Project Financial Statement is the Source and Application of Funds for the project during the current financial year, and cumulatively since the start of the project. Related comparisons of actual expenditures should be shown against SAR original or amended projections, and explanations provided for significant variations. The source of funds should be shown separately -- funds received from the Bank, donors, and other main resources. Funds provided by the Bank should be further separated to show those provided a) through SOE procedures, and b) through other procedures.

4.16 The Bank is interested in the total project, irrespective of whose funds are used to undertake a particular activity or operation in a project for which it has provided part of the funding. Application of funds should be summarized to show expenditures
and allocations by main project categories as laid down in the SAR (Bank funds by categories shown in the loan agreement for disbursement purposes may also be shown for information.) Where project expenditure includes assets required for project implementation (such as motor vehicles and other equipment) these should be categorized separately and supported by a listing of such assets to enable their control/security.

4.17 Where accrual accounting is adopted, a balance sheet is always required. Accrual accounting is necessary particularly when there is an income aspect to the project. The summary balance sheet should show the assets and liabilities of the project, and the net fund created by the project. When liabilities are large, a supplementary schedule should disclose significant creditors and commitments. Depending on the nature of the project, the notes to the financial statements should identify the major contracts awarded and being awarded. Where applicable, a comparison to the previous year is desirable. Notes to the project financial statement should include a statement of the basis of accounting followed, and the accounting policies under which the financial records were prepared. However, the majority of projects implemented by government departments are on a cash basis, and frequently financed as a part of the government's own budgetary system and procedures.

4.18 The project accounting system provides an opportunity to use the management accounting discipline to develop a linkage between financial accounting information and the key physical indicators required to efficiently manage and monitor project implementation. Interim reports therefore are an important aspect of the overall management by the borrower of the project, and for monitoring by the Bank. Program implementation decisions and necessary midterm corrections may be based on the financial and performance information provided via interim project accounts. The format of these reports may be very similar to the year-end audited statements except that the period involved is shorter, there may be additional budget information and analysis, and the reports are not audited. Reliable interim reports will facilitate good decision-making. An audit at year-end provides assurance that the interim reports were reliable and that future such reports are also likely to be reliable.

4.19 Where Statement of Expenditure (SOE) procedures are used for loan disbursement, the SOE financial statement should be integrated to become a part of the Project Financial Statements (Annex XIII).

**Statements of Expenditure**

4.20 Under the SOE procedure, the borrower periodically requests withdrawal of loan proceeds through submission of a statement indicating expenditures for certain items referred to in the loan agreements. The SOE procedure simplifies and accelerates the Bank's loan disbursement process by eliminating the requirement for Bank staff to review supporting documentation for many small expenditures prior to authorizing disbursements. The SOE statements are not accompanied by supporting documentation. Implicit in the SOE submission by the borrower is the adequacy and veracity of documentation, maintained by the borrower, which supports the disbursements.

4.21 During the early stage of the project design, the TM in consultation with the Loan Department would have decided if SOE procedures would be used for disbursements under the project. In considering the use of SOEs, the TM must also consider the previous record of the borrower in complying with SOE requirements, the current timeliness and completeness of the accounting records, a clear methodology linking the SOE to the project financial statements, and where more than one organization is involved, a means of aggregating the various organizations' SOEs into one submission without losing the audit trail. Satisfactory arrangements for external audit of the SOEs must be in place prior to authorizing their use.
4.22 Once the Bank and the borrower agree to the use of SOEs for certain categories or items of expenditure, SOE use is always required for these types of expenditure. The nominated amount eligible for disbursements against SOE procedures will vary from project to project. The TM should provide for periodic reconciliation between disbursements made via SOEs, through direct disbursements, and Special Accounts (SAs) if used, and the total disbursements reflected by the Bank's records. This type of reconciliation is essential to maintain control over project resources. SOE procedures are fully discussed in OP/BP 12:30, "Statement of Expenditures."

4.23 As discussed in para 4.20, disbursements under SOE procedure do not require the borrower to submit receipts and other supporting documentation for expenditures. This poses a greater risk to the Bank compared to other Bank disbursements which require the submission of supporting documents. To mitigate this risk, the Bank strengthened its enforcement for the receipt of SOE related audits.

4.24 In addition, SOEs are also subject to review by Bank staff during missions; Annex X provides guidelines for this review (see also para 3.18). As stated in para 4.19, the SOE Financial Statement should be integrated into the Project Financial Statement. This will, however, require the Bank to strengthen its enforcement for the receipt of the integrated Project Financial Statement, to bring compliance in line with that now required for SOEs.

4.25 The suggested format for integration would be to separately list, as an Annex to the Project Financial Statement, the individual SOE withdrawal applications, with the totals extended under columns showing the main project expenditure categories. The total withdrawals should equal the amount shown in the Project Financial Statement -- see Bank financing through SOE procedures (para 4.15). Annex XIII shows a model Project Financial Statement with an Annex showing SOE withdrawals.

**Special Accounts**

4.26 A Special Account (SA) mechanism may be established to enable more effective project implementation, mainly by assisting the borrower in overcoming cash flow problems. SAs are revolving account arrangements under which the Bank advances funds into a special bank account (at the central or at a commercial or depository bank). When the Bank administers funds provided by a co-financier, a single SA may be established provided the funds are fungible.

4.27 Under an SA controlled by a central agency, sub-accounts may be established within the depository bank and operated by agencies that are implementing the project. Although funds are not transferred from the SA, the accounting records must monitor disbursements against amounts allocated to each of the sub-accounts. In exceptional circumstances, the Bank may authorize the borrower to draw funds from an SA and use them as an advance into a second-generation special account (SGSA).

4.28 The SA is usually managed by the respective Ministry of Finance or by the project implementing organization. The managers of the SA should maintain appropriate records to control and identify the movements in the SA, and are required to submit a monthly statement summarizing such movements. The implementing organization must maintain proper books of account including all original records of receipts and payments, bank statements and reconciliations.

4.29 Disbursements from SAs are made either for direct project payments or to reimburse for project expenditures already paid by the borrower. The Bank then replenishes the special bank account on the basis of appropriate withdrawal applications submitted for these disbursements. Interest earned on the SA belongs to the borrower who will need to decide how it will be used -- for the project or otherwise.
4.30 The Special Account (SA) Financial Statement (Annex XIV) is simply a summary of the Source and Application of funds through the SA during the reporting period, with the Bank usually being the only "Source" (para 4.26). Source is usually the Bank's initial deposit to the SA plus "replenishments." Withdrawal applications are usually in the form of either direct disbursements from the SA, or reimbursements to the borrower for expenditures already paid for. Other activities in the account would be interest on outstanding balances and bank charges. The manager of the SA should maintain appropriate records to control and identify the movements in the account, and are required to submit an annual report to the Bank summarizing such movements, also showing the financial status of the account at the end of each reporting period. It is important that the SA Financial Statement be reconciled with the Bank's records, taking into consideration items in transit at the end of the reporting period, and also with the Bank's financial as shown in the Project Financial Statement.

4.31 In some countries where the banking system has not yet been developed (such as in the former Soviet Union countries), project expenditures are made using the SA as a regular bank account. In these instances, the SA may be incorporated to form a part of the Project Financial Statement. SAs are discussed in OP/BP 12.20, "Special Accounts." Auditing is discussed in Chapter V of the Handbook.

Adjustment Operations

4.32 While most Bank loans finance investment projects, the Bank also makes Structural Adjustment Loans (SALs) or Sector Adjustment Loans (SECALs). Adjustment loans generally provide funds to the borrower for budget support, subject to the borrower's implementation of specified economic reforms. SALs focus primarily on broad macroeconomic policies while SECALs focus on sector-related economic policies.

4.33 Typically, SALs and SECALs provide quick disbursing foreign exchange which would relate to the import of goods and services from a Bank approved list of such items ("positive list"). Alternatively, the Bank may provide a list of goods and services against which the disbursement could not relate ("negative list"). Accounting for such projects is merely maintaining a listing of the invoices and supporting customs certificates applied against the loan. The listing should at least cover the amount of the loan disbursed. However, it is important that the borrower retain the supporting customs or similar certificates for at least one year after the submission of the related audit report. It should be noted that other additional procedures relating to procurement may be necessary. See Annex III.

Hybrid Operations

4.34 A hybrid loan has elements of both an investment project and an adjustment operation. The accounting for each component of a hybrid loan follows the specified guidelines for that particular type of operation. For example, the development of physical infrastructure included in a hybrid loan would be subject to the accounting and reporting requirements for investment projects, while the funds disbursed in return for policy changes would be subject to the accounting and reporting requirements for adjustment operations. There would be really two parts to the reporting requirements, even when they may be consolidated into one financial report.

Emergency Operations

4.35 Accounting for emergency operations should follow the guidelines for non-revenue earning or adjustment operations discussed above, depending on the project design. These operations may cover several different sectors, such as human resources and infrastructure. One of the main differences may relate to the several different sources of financing, some of which may require specific identification for those expenditures financed by individual funds. However, it is important that the control system take into account the rapid delivery of funds required under these operations.
V: AUDIT COMPLIANCE

Types of Audits and Auditors

5.01 An audit is an *ex post* review of the implementing organization’s financial statements, financial systems, records, transactions, and operations performed by professional accountants for the purpose of providing assurance of accountability, giving credibility to the financial statements and other management reports, identifying weaknesses in internal controls and financial systems, and making appropriate recommendations for improvements. Audits can differ considerably, depending on their objectives, the activities for which the audits are employed, and the products or reports expected from the audits. In general, audits can be classified into three basic types: financial statement audits, compliance audits, and operational audits. For financial statement audits, the Bank would be concerned with the audit of the financial statements of the implementing organization as a whole and of the specific project (see paras 4.04 and 4.13). Compliance audits are discussed in para 5.18, and operational audits in para 5.19.

Audits of Implementing Organization Financial Statements

5.02 The overall objective of the typical audit of an organization’s financial statements is for the auditor to express an opinion as to whether the statements are fairly presented in conformity with international accounting standards and generally accepted accounting principles applied on a basis consistent with that of the preceding year. The auditor evaluates whether the financial statements are fairly presented by gathering audit evidence in a thorough and conscientious manner. When, on the basis of adequate, sufficient, competent, and pertinent evidence, the conclusion is reached that the financial statements are unlikely to mislead a prudent user, the auditor gives an audit opinion on their fair presentation and associates that opinion with the statements. Although the auditor is not an insurer or a guarantor of the fairness of the presentations in the statements, there is considerable responsibility for notifying users as to whether the statements are properly stated. If the auditor believes the statements are not fairly presented or if a conclusion cannot be reached because of insufficient evidence or prevailing conditions, then the auditor has the responsibility of notifying the users of the statements through the auditor’s report.

5.03 However, an unqualified opinion on the fairness of financial statement presentations should not be construed as an independent auditor’s endorsement of an enterprise’s policy decision, its use of its resources, or the adequacy of its internal control structures. Audit conclusions about whether financial statements are fairly presented are not reached in a precisely defined manner. Instead, evidence is obtained and conclusions are reached throughout the course of an audit. The auditor starts with relatively little information about whether the organization’s statements are fairly presented. Impressions about the integrity and competence of management and the results of previous audits are also considered. As the audit proceeds, each additional piece of evidence either confirms or contradicts the initial impression. At the completion of the audit, the auditor should have strong beliefs about the fairness of the presentation, which will lead to an opinion.

Understanding the Organization

5.04 Each audit should begin with the auditor obtaining an understanding of the organization being audited. This understanding is generally obtained through consideration of the nature of the
organization's activities and its background, and through analytical procedures designed to high-light significant trends and relationships. In addition, the auditor should be familiar with the SAR and any agreements, including Minutes of Negotiation and the loan covenants, which are pertinent to financial operations.

Evaluation of Internal Controls

5.05 As part of an audit of financial statements, the auditor normally examines the system of internal accounting control for the purpose of determining the audit tests required in order to form an opinion of the financial statements. If the auditor is convinced that the organization has an adequate system which includes controls for providing reliable data and for safe-guarding assets and records, the amount of audit evidence to be accumulated can be significantly less than if the system is not adequate.

5.06 The degree to which an auditor will evaluate an organization's internal controls is largely dependent upon the extent to which reliance will be placed on such controls in order to reduce the extent of other audit tests. When considering the system of controls, the auditor should first determine, at least broadly, how it operates and then make a preliminary evaluation of whether the system has been designed effectively to accomplish the objectives of preventing or detecting errors that may be significant to the financial statements.

5.07 Where the auditor has identified an effective control, or a strength in the system, the auditor is entitled (but not required) to rely on this control to enhance the reliability of financial information. Hence, there is a reduction in the extent to which the accuracy of that information must be validated through the accumulation of evidence related directly to it. To justify this reliance, however, the auditor must test the effectiveness of the controls. The procedures involved in this type of testing are commonly referred to as "tests of compliance" or "test of transactions." It is important to recognize that the auditor's review of internal controls is intended primarily to determine the extent of testing of actual transactions to be carried out in the subsequent examination of account balances. Therefore, the auditor's report on the financial statements should not be considered to be an endorsement of the overall adequacy of the internal control systems.

Testing the Financial Statement Balances

5.08 The year- or period-end balances in the balance sheet and the amounts shown on the income statement are verified by obtaining various types of evidence. Examples include physical presence at stocktaking, verification of fixed assets, direct written communication with third parties for confirmation of accounts receivable, bank balances, observation of actual inventory, and examination of vendor's statements for accounts payable. Independent verification from external sources is one of the most valuable means of verifying accounting data. These tests of ending balances are essential to the conduct of the audit because for the most part the evidence is obtained from a source independent of the client, and thus is considered to be of high quality. For example, in the course of conducting an audit of a project, the auditor should contact the Bank to confirm the project balances independent of the implementing organization's records.

5.09 There is a close relationship between the general review of the client's circumstances, the results of the evaluation and testing of the system of internal control, and the direct tests of the financial statement account balances. If the auditor has obtained a reasonable level of confidence about the fair presentation of the financial statements through the general review of internal control and test of its effectiveness, the direct tests can be significantly decreased. In all instances, however, some tests of the financial statement account balances are necessary.
Audits of Project Financial Statements

5.10 The overall objectives of audits of Project Financial Statements are to determine whether the statements, particularly the Sources and Applications of Funds, are fairly presented for the specified period, as well as cumulatively for the project; and that the reported disbursements were made in accordance with loan agreements and the SAR. The audit would also look at the fair presentation of balance sheets, with particular attention to the treatment of assets.

The Audit Process

5.11 The process followed for auditing a project specific financial statement, while generally simpler, is similar in most respects to the process followed for an audit of the financial statements of an executing organization, as outlined above. This includes an evaluation of internal controls and tests of the underlying transactions. The auditor is, however, expected to rely heavily on an inspection of valid supporting documentation and to perform other steps, such as physical observation of significant items purchased, where practical, to substantiate the validity of the expenditure in accordance with the loan agreements and the SAR.

5.12 Where a borrower uses the SOE procedure in claiming loan withdrawals, the expenditures reported in a project's statement of Sources and Application of Funds will also include those expenditures under SOE procedures.

Audits of Statements of Expenditure

5.13 Audits of Statements of Expenditure (SOEs) should be considered a part of the overall audit of Project Specific Financial Statements. However, a greater effort of compliance checking is usually necessary as, unlike Bank disbursements for project expenditures where the submission of full documentation is required, the withdrawal requests are not supported by documentation submitted to the Bank. The primary objective of this submitted to the Bank. The primary objective of is part of the audit is to ascertain that the individual expenditures which comprise the SOE totals are fully supported by documentation retained in the borrower's files, properly authorized and eligible under the Loan Agreement, and appropriately accounted for (see para 5.54). The Bank will also use the results of the audit to determine whether continued use by the borrower of the SOE procedure is warranted, or if adjustments to disbursements on subsequent claims are needed to offset disallowed claims.

Audits of Special Accounts

5.14 Where Special Accounts (SAs) are established, annual audits are also required. The primary objectives of such audits are to verify that SA statements are fairly presented and that disbursements from SAs are proper and in accordance with the respective loan agreements. Accordingly, the auditor should perform procedures to enable him/her to conclude that the SA statement fairly reflects the activity of the SA, and that SA funds are used solely for purposes of the project.

5.15 Audits of SA should, by nature, be quite simple. SA audits consist of a review of the SA records maintained by the nominated manager of the SA, along with the statements of the SA account as provided by the central or commercial bank in which the SA is maintained. Movements in the account will include advances and replenishments from the Bank, and project-related disbursements based on withdrawal requests. (The appropriateness of the composition of the withdrawal requests form a part of the audit required for the organization/project financial statements). Special attention will need to be given to the direct verification of balances from the Bank, and the tracking of items in-transit both between the Bank and the SA, and between the SA and project-implementing organizations. The audit should also cover the treatment and disclosure of interest earned on the SA.
Audit of Adjustment Loans

5.16 The audit of adjustment loans would focus primarily on the adequacy of procedures used to prepare customs or similar certificates. It would therefore be limited to an examination of the certificates on which the SOEs have been based, and an opinion as to the reliability of the procedures applied in verifying or issuing such certificates. Because of the nature of adjustment loans there are several issues which will require particular care: (i) the TOR must satisfy the financial covenants of the loan agreement, (ii) it must be clear that documentation for an adjustment loan has not also been used to justify another adjustment loan, (iii) the nature of the claims must be verified to ensure that items are correctly documented, (iv) negative list items should be verified, and (v) cut-off dates considered.

Audits of Hybrid Loans

5.17 The audit of a hybrid loan would follow the procedures of a normal audit of an investment project for the investment component, and of an adjustment loan for the adjustment component.

Compliance Audits

5.18 Compliance audits encompass review, testing and appraisal of controls and operating procedures in an organization. In commercially-oriented enterprises these reviews normally involve accounting, financial and other operations as a service to management. For government organizations such reviews also cover compliance with regulations, contracts and laws to which the organizations are subject. Compliance audits of private enterprises, and many state-owned enterprises, normally are performed by internal auditors, who are employees of the enterprise. Compliance audits of most government operations are performed by government auditors, who in a sense serve as the government’s internal auditors. In many instances internal and government auditors are not required to meet the standards prescribed for the licensing of professional accountants, since their reports ordinarily are not intended for the use of third parties.

Operational Audits

5.19 Operational audits are more comprehensive examinations of an organization’s management, techniques, and performance. The objective of such audits is to measure the extent to which enterprises or government operations are achieving their objectives. The primary product of an operational audit is a report recommending improvements to increase the efficiency and effectiveness of operations. In this sense it is the broadest type of audit in scope, and encompasses all of the major functions of an organization. Operational audits are performed by all types of auditors. However, internal auditors and government audit agencies tend to be more active in this area than independent professional accountants.

Standards on Auditing

5.20 Audits of financial statements are governed by the standards of auditing, and the Bank requires adherence to the International Standards on Auditing (ISAs) promulgated by the International Federation of Accountants (IFAC). In addition, there is the International Organization of Supreme Audit Institutions (INTOSAI), which sets similar standards targeted to the work of the Auditor Generals of its member countries. The ISA and INTOSAI standards are summarized in Annexes XV and XVI. Important aspects of the auditors’ work relate to (i) their understanding of the organization and/or project being audited, (ii) their evaluation and advice on the internal controls and arrangements, and (iii) their testing of accounting and supporting documentation with respect to the financial statements being audited.

The Auditor

5.21 ISAs require the following of all audits and related services rendered by practicing accountants:
• Personnel in the firm should adhere to the principles of integrity, objectivity, independence and confidentiality.

• The audit firm (should also apply to audit body) should be staffed by personnel who have attained and maintain the skills and competence required to enable them to fulfill their responsibilities.

• Work should be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

• There should be sufficient direction and supervision of work at all levels to provide the firm (audit body) reasonable assurance that the work performed by the firm (audit body) meets appropriate standards of quality. Whenever necessary consultation should be made with those who have appropriate expertise.

5.22 The basic auditing postulates of INTOSAI promotes independence, competence, and due care. Field standards are based on planning, supervision and review, study and evaluation of internal controls, compliance with applicable laws and regulations, audit evidence, and analysis of financial statements.

Selection of Auditors

5.23 Bank staff should strongly promote the use of independent audit firms for all revenue earning and commercial type projects in recognition of the limited experience and training that government auditors usually have in these areas. Every effort should be made to select auditors who fulfill the criteria required by ISA, and whenever possible, auditors who are members of bodies affiliated with the International Federation of Accountants (IFAC). Where the local law requires government auditors to audit government entities, then the government audit institution should be encouraged to sub-contract the audit work to independent auditors. Annex XVII is a Preliminary Questionnaire which will assist the TM in reviewing proposed audit firms.

5.24 Supreme Audit Institutions (SAIs) are usually acceptable for the audit of project financial statements including SOEs and for SA audits, but it is important to assure both their independence and their technical competence. Delays in the submission of audited financial statements of government entities are sometimes encountered where the local law first requires the presentation of an annual report by the SAI to the parliament before final clearance for distribution. In these circumstances the government should be required to submit a copy of the draft-audited financial statements and report, subject to subsequent clearance by the parliament.

5.25 In the event of a change of auditors, the borrower should notify the Bank prior to the change. The appointment of the new auditor (paras 5.30-35), which should be acceptable to the Bank, should be expedited to allow sufficient time for the auditor to become familiar with the project and the implementing organization and to complete the audit by the due date. Where the Bank project finances the auditor, there are certain special procedures (paras 5.56-57).

Government Auditors

5.26 The position of the head of a government's SAI normally is established by a country's constitution or laws. These precepts should prescribe the professional qualifications and experience for the person to be appointed, but often do not. Government auditors are frequently not professionally qualified accountants -- many are political appointees, and some are public service administrators. SAIs often do not possess institutional independence and often are understaffed, under-financed, and subject to political pressure. True independence of these auditors is frequently difficult to prove.
5.27 Where public sector auditors appear to be the best option, their level of independence should be carefully assessed. The level of independence of a government auditor may be acceptable if the auditor does not report to the operational management of the implementing organization, nor engages in any approval process for transactions, nor is otherwise involved in the internal control or financial management systems of the organization. The degree of independence can be enhanced to a level of acceptability by a form of external supervision such as an audit board, audit examiners, or a similar specialized group.

5.28 The lack of professional expertise and audit experience of senior government auditors hinders effective development of the public sector auditing profession in many countries. This is further aggravated by the relatively low salaries in many public sectors in the developing countries, when compared to the salary levels of similar audit professionals in the private sector. This lack of experienced leadership often affects the morale of the few experienced and skilled auditors, and results in disillusioned managers, and poor staff recruitment and training.

5.29 Country reviews of financial accountability (see Chapter VI) by technically qualified staff should be used to make decisions as to the continued acceptability of government auditors. In those countries where the competence of the public auditor is an issue, the Bank should promote the involvement of private auditors, while seeking to upgrade the professional quality of government auditors. Bank staff should in these circumstances seek to develop either free-standing technical assistance projects or components of other projects, dedicated to the development of the SAI and, where necessary, the accounting professions in general. Government audit work should be equal in quality to that of private independent auditing firms and should be subject to the same type of review of working papers as private firms.

Private Sector Auditors

5.30 A frequent problem in developing countries is the wide range in the quality of private audit firms. The firms with direct links to foreign major audit firms or which maintain full membership in international professional auditing organizations can usually be relied upon to provide an acceptable level of performance. Firms which are merely associated by name with international firms and not subject to their quality controls may not conform to acceptable standards.

5.31 In order to ascertain satisfactory performance, qualified Bank staff should carry out periodic reviews of the work papers of selected auditors in each country in order to develop a list of acceptable auditors.

Box 5.01

Private Sector Auditors

The quality of private sector auditors is dependent on:

1. the quality of the corporate and accountants' laws and regulations which specify accounting and auditing requirements, and the rigor of their monitoring and enforcement;

2. the moral strength of the accounting profession, particularly its willingness to enforce a meaningful code of ethics; and

3. the quality of the profession, including high quality training and entrance requirements and rigorously applied continuing professional education.
Appointing the auditor

5.32 The auditor should be appointed well before the beginning of each fiscal year to allow the auditor to become familiar with the objectives of the systems and operations of the implementing organization and of the project, and to make whatever arrangements are necessary for interim work and for year-end verifications.

5.33 It is the responsibility of the borrower to advise the Bank of the proposed auditors for a lending operation, even when the government auditor is the statutory auditor. It is thereafter the responsibility of the TM, backed up by qualified professional advice, to determine the acceptability of that auditor. Acceptability is best determined by having a professionally qualified member of staff or a consultant meet with the auditor, at which time they would review working papers of prior audits in connection with projects financed by the Bank and discuss among others, the following points:

- evidence of independence;
- qualifications and experience of the partner-in-charge, the proposed audit manager and proposed key audit staff;
- experience of the auditor in conducting audits of a similar size and scope;
- time requirements for the audit in terms of elapsed time and personnel inputs;
- back-up facilities available to the firm in the event that special research is required;
- experience in auditing Bank-financed lending operations;
- experience in the type of operations to be audited; and
- peer review, quality control, and professional continuing education policies of the firm.

5.34 In those cases where an auditor is already appointed, including a government auditor, the TM should be satisfied that the auditor will continue to be acceptable.

5.35 For the appointment of auditors, the borrower should provide draft Terms of Reference (paras 5.39-41) which have been approved by the Bank, to the auditor. The auditor may also provide an Engagement letter (para 5.42-43). In determining the Bank’s approval, consideration should be given to the past experience and references of the selected auditors as a basis for judging the acceptability of the firms concerned. If the Bank has objections, these should be explicitly stated to enable the borrower to understand the Bank’s concerns.

Independence of Auditors/Conflict of Interest

5.36 Auditors should be impartial and independent of the control of the institution and persons appointing them. In particular, no auditor should be employed by, or serve as a director of, or have any financial or close business relationship with the institution when engaged as an independent professional auditor. Audit fees should not be contingent on a given income of the audited organization or established in such a way that the auditor’s independence is impaired.

5.37 Auditors should not be appointed to carry out any duties that may be construed to be those of employees or of management for the institution for which they are appointed auditor. The overriding point is that auditors should play no part in decision making and management. IFAC’s Ethics for Professional Accountants permits audit firms to carry out non-audit work, provided that this does not impair the auditor’s objectivity and independence. Normally, auditors should not be appointed as management consultants responsible for designing accounting and control systems on which they would be required, as auditors, to comment. This increases the risk that internal control and accounting failures will not be reported by the auditor since they may be indicative of short-comings in the sys-
tem design or other consulting work provided by
the firm. This risk increases to the degree the work
performed represents a significant portion of the
firm's business.

5.38 Auditors should respect the confidentiality
of information acquired during the course of their
work and should not disclose any such information
to a third party without specific authority, or unless
there is a legal or professional duty to disclose.

Terms of Reference

5.39 For different types of audits, the scope of
the audit will vary according to the nature of the
implementing organization and the type of opera-
tion being audited. See Annex XVIII for Guide-
lines for a TOR and Annex XIX for a model TOR.
For example, the Terms of Reference (TOR) for the
audit of a financial intermediary will require the
auditor to pay particular attention to the loan port-
folio, while the area of greatest emphasis may be
different for the auditing of a public utility.

5.40 ISA and the standards of most countries' pro-
nessional auditing organizations suggest that the
auditor normally determines the scope of the audit
of financial statements in accordance with require-
ments of legislation, regulations, and generally
accepted auditing standards (GAAS). Therefore,
the TORs must not restrict the auditor's obligations
with respect to such requirements. In other words,
the auditor should not be allowed to claim in the
event of poor performance that the TORs prevented
him/her from performing to statutory, regulatory or
professional requirements.

5.41 However, the TOR provides the opportu-
"nity for drawing special attention to areas of con-
cern that may not be covered or emphasized under
a normal audit, such as compliance with loan cove-
nants; for example, the special review of procure-
ment documents. When in doubt, the TOR should
specifically relate to aspects of the operation and its
accounts that require special review. The scope of
the audit should always include the requirement to
give an opinion on the specified financial state-
ments. If the auditor will be in a position to obtain
a view of much of the workings of the institution,
management should take advantage of this inde-
pendent view and ask for a Management Letter
(para 5.55). This letter should not be confused with
the audit report in which the auditor is required to
express an opinion.

Contract or Engagement Letter of an
Auditor

5.42 Where a formal contract is used, it is nor-
mally prepared by the client institution or its legal
counsel; often a simple engagement letter is used
which is essentially prepared by the auditors. In
either case the contract or letter sets out the re-
 sponsibilities of the auditor, and in effect, consti-
tutes the contract between the auditor and the cli-
ent. Where it is not submitted by the auditor, the
client should provide the letter to the auditor. See
Annex (XIX) for sample.

5.43 The contract or engagement letter should
include, but not be limited to:

- confirmation of acceptance of the appointment
  including reference to the TOR;

- the client's responsibilities, particularly the
  preparation of financial information, i.e. the fi-
nancial statements;

- access to whatever premises, records, documen-
tation and other information the auditor may re-
quest in connection with the audit;

- the form of audit reports;

- arrangements regarding the involvement of
  internal auditors and of any other external
  auditors (such as government auditors);

- the expected date of issuance of the audit re-
  port, etc.; and
- the basis on which fees are computed, and any billing arrangements.

Auditors' Opinions

5.44 The audit report should contain a clearly written expression of opinion on the financial information. An unqualified opinion indicates the auditor's satisfaction in all material respects with the matters dealt with in the paragraph above. 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 an opinion.

5.45 ISA provide guidance to auditors on the form and content of the auditor's report issued in connection with the independent audit of the financial statements of any organization. Much of the guidance provided can be adapted to audit reports on financial information other than financial statements.

5.46 The Bank requires the preparation of reports in accordance with ISA. ISA specifies that all audit reports should include: title, addressee, identification of the financial information audited, a reference to auditing standards or practices followed, and expression or disclaimer of opinion on the financial information, signature, the auditor's address and the date of the report.

5.47 Samples of audit reports which the Bank expects to receive in satisfaction of its audit requirements are included in Annex XXI. Note that the examples are indicative of clean or unqualified opinions, and should be appropriately altered when the qualifications or modifications, such as the period under audit, are appropriate.

5.48 An auditor's opinion may be: unqualified; qualified, adverse; or disclaimer of opinion.

5.49 An unqualified opinion indicates the auditor's satisfaction in all material respects with the following matters, in accordance with the auditor's TOR:

- the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
- the financial information complies with relevant regulations and statutory requirements;
- the view presented by the financial information as a whole is consistent with the auditor's knowledge of the business of the entity/agency;
- there is adequate disclosure of all material matters relevant to the proper presentation of the financial information; and
- additional requirements that may have been requested in the TOR have been met.

5.50 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.

5.51 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.

5.52 A disclaimer of opinion is issued when the possible 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.

5.53 Some government auditors try to avoid giving a clear-cut, specific opinion, preferring instead to provide a report covering all the mistakes, misfeasances and malfeasances found by the audi-
tor, but without confirming their materiality and impact on the financial statements. The TM should be sure that the government auditors understand that while the detailed comments will be welcome, an opinion on the accounts in accordance with the above is required for it to be acceptable to the Bank.

5.54 In addition, where SOE procedures are used, the auditor’s opinion to the Project Financial Statements is required to include a paragraph certifying to the eligibility of those expenditures against which SOE disbursements were made. Any exceptions or disallowed expenses should be referred to.

Management Letter

5.55 In the case of the implementing organization, 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 institution, covering all aspects included during the normal course of the audit. This is not a substitute for the short form audit report which is always required. Because an auditor is unlikely to cover all activities of a client during an annual audit, the Management Letter may address only those specific activities which came to the attention of the auditor during the review. The management and the auditor may agree at the commencement of the audit on particular subjects to be addressed in the Management Letter, but it should still 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 management's attention. (See Annex XXI for sample.)

Financing

5.56 The Bank normally does not finance the costs of auditing services where these represent an ongoing part of the operating expenditures of a borrower; exceptions must be approved by the RVP. There may be circumstances, however, when the costs of auditing services may be considered for inclusion in the costs of the project and financed from the Bank loan. This could apply particularly if audit costs are incremental because of the project nature (if they would not have been incurred otherwise to the same extent, if at all, such as when private audit firms are required), or in cases of countries with limited foreign-exchange resources that have to engage foreign auditors. The costs of audits performed by government audit institutions should not be financed by the Bank except in very unusual circumstances.

5.57 Where an auditor's services are to be included in a project's costs and are to be partly or wholly financed from a Bank loan, the borrower would be expected to use the Bank's selection procedures. The borrower should seek proposals from a short list of firms based on their ability to audit the lending operation, including the implementing organization, where necessary. For further information, see 'Guidelines for the Use of Consultants.” It is expected that those to be included on the shortlist should be acceptable to the Bank; price would then carry a larger weighting than for the engagement of consultants.

Timing of Submission of Audit Reports

5.58 During project preparation, the Bank and the borrower agree on the required timing for submission of financial statements and audit reports. Where required, all audited financial statements should normally be submitted within six months following the fiscal year-end of the project implementing organization. In general, longer allowances for submission of audited financial reports should be considered only for borrowers who are undertaking a time bound program to overcome deficiencies in accounting and auditing capabilities, after which the normal timetable should apply (paras 3.11-15).

5.59 It is the responsibility of the TM to ensure that the audited financial statements are adequately reviewed as they are submitted (see para 3.10). Where questions arise or the project is high risk, the
Financial Intermediary Operations

5.61 For projects that are conducted through financial intermediaries for onlending to sub-borrowers, there may be a requirement for the audit of the subprojects. In these instances, it would be the responsibility of the financial institution to obtain the subproject audit reports and to review them for acceptance. The main auditor would examine these reviews to the extent considered necessary, taking this into consideration when giving an opinion on the overall financial statements of the intermediary, including its loan portfolio. Also, a separate comment may be necessary, if required by the legal covenants.
NOTES
VI: COUNTRY REVIEW OF FINANCIAL ACCOUNTABILITY

Overview

6.01 Lending operations in each country, whether conducted in the public or the private sector, are dependent on the capability and capacity of the country's financial services. Therefore, economy and efficiency in Bank operations demand that there should be a continuing review of the efficacy of these services, with experience from ongoing projects available to TMs and other Bank staff concerned with understanding and using the performance of these services in a country.

6.02 The implementing agencies are made responsible by the government concerned for responding to Bank requirements to provide timely and adequate and audited financial statements for projects. Lending operations in a country range over multiple sectors and usually a central unit (often in a Ministry of Economic Affairs, or in the Treasury of a Ministry of Finance) acts as a counterpart to the Bank for identifying and managing the logistics of lending operations. It is left to Bank staff to ensure that the accountability arrangements agreed to by the borrower are, in practice, discharged in accordance with loan agreements.

6.03 It is in the borrowers' interests to ensure that their resources (including Bank funds) are effectively managed. Many do not appear to do so, nor to have any mechanism for providing the necessary assurances. Bank staff need to emphasize the importance of efficient financial and project information in the management and monitoring of project implementation.

6.04 To ensure that each government meets its responsibilities for financial accountability with regard to its legal agreements with the Bank, Country Operations Divisions should ascertain that a satisfactory mechanism is in place in the concerned Regional Department to:

- identify within a country the authority(ies) responsible for the development and administration of the financial services and, in the absence of clearly identifiable responsible authorities, to agree with the government concerned on mechanisms to provide the government and the Bank with satisfactory evidence of financial accountability with respect to each lending operation in the country;
- maintain a dialogue with the above authorities to prepare and implement, where necessary, a development plan for effective financial service within the country;
- ensure that Bank staff, when requiring borrowers to use the financial services available:
  (i) are fully informed as to the levels of efficiency of financial accountability likely to be available; and
  (ii) institute changes or upgrading of the services as part of a proposed lending operation which are in conformity with the national development plan outlined above.

6.05 The levels of efficiency of the financial services in a country are likely to comprise two distinct categories, namely the performances of the public and private sectors respectively. Proficiency levels may vary extensively between these two sectors, as described below. With each sector proficiency levels may be relatively uniform; and there may be discrepancies in skill levels between international and local private sector firms.
6.06 Country Operations Divisions with the assistance of qualified financial staff or consultants, should establish an information system on the general proficiency of the financial services in the public and private sectors of each country through Country Financial Accountability Assessments to:

- advise Bank staff on prospects for, and steps likely to be necessary to achieve financial accountability;
- identify or approve inputs of technical assistance, or other means, by the Bank and other lenders and donors, to upgrade the services to efficient levels; and
- identify those sectors and key institutions where it will be to the advantage of the government and the Bank to include the costs of auditing services for lending operations as part of expenditures to be financed from the proceeds of the loan.

Public Sector Accounting Services

6.07 The responsibility for accounting services in public sectors is frequently difficult to identify. In some countries, even the concept of a public sector accounting service is not readily recognized, nor appreciated. Instead it may be a budgetary control operation under a Director of Budget, with the sole objective of reporting expenditures against budgets, while revenues are separately "controlled" outside the budgetary system. These systems rarely provide meaningful forms of financial accountability.

6.08 Each country should be the subject of an ongoing analysis in order to enable Bank staff, when preparing and appraising lending operations, to determine the current status and performance of the services, and to recommend the most appropriate means of achieving the accountability requirements for a particular lending operation.

6.09 Assistance from the government's counterpart to Bank staff may be necessary to determine the point of entry into the government accounting system, which may not be obvious in some countries, an example might be the question of which government agency makes the decisions on accounting rules and systems and the necessity for further approvals.

6.10 The review should determine any laws which specifically form part of public sector accounting. Specific laws relating to sectors and activities (e.g. power sector, municipalities and urban authorities, water and sanitation authorities, railways) may identify accounting and auditing requirements. Each authority responsible for designing, administering and monitoring accounting systems in government should be determined. These details should be obtained for all the primary systems which are in place, including:

- budgeting and budgetary control of expenditures for routine and development (project) operations;
- budgeting for revenues (income taxes, VAT, customs and excise, etc.);
- debt management;
- accounting and financial reporting;
- foreign exchange control and management;
- public sector enterprises in the various sectors; and
- consolidated reporting from other levels of government.

6.11 The review should provide a brief description of each form of accounting system, the accounting standards in use, and who established and updates these (see Annex XXII for model TOR). Linkages between different systems should be identified, with the manner of operation and reasons clearly explained. In particular, the ability of managers at all levels to make useful changes to a sys-
tem should be established, with brief descriptions of any mechanisms available to achieve modifications.

6.12 The assessment should offer judgment on the efficiency of each system, and provide recommendations for possible improvements, together with the means by which they could be achieved, including estimates of time and cost requirements. Such recommendations may need to include proposing a detailed study of the governmental system in order to provide the government and the Bank with a detailed picture of system deficiencies and long-term solutions.

6.13 It is important that a review should record whether existing accounting systems generate meaningful management information with financial accountability. If they do so, the ways in which these are achieved should be detailed in the final report. Failure to generate such information should be reported with recommendations for improvements.

6.14 An assessment should be made of the capability and capacity of accounting managers and staff responsible for designing, operating and monitoring the systems, including the methods of recruitment, and adequacy of compensation. An identification of training needs is required including approaches to training, methods, facilities and budget adequacy. In addition, an assessment should be made of the overall perception by accounting managers of their role in financial accountability.

6.15 Financial reporting should be evaluated at the organization level, as well as the national level, including timeliness, usefulness, and reliability of the nation's annual financial report. The review should aim to provide as complete a picture as possible of a government's efforts to achieve financial accountability, not only for Bank lending operations but for national resources. The need for improvement and possible means of achieving these should be detailed in the final report.

Public Sector Auditing

6.16 Unlike accounting services, public sector auditing in most developing countries has an established identity, usually in the form of a Supreme Audit Institution (Auditor-General, Comptroller-General, an Audit Commission, or a Court of Accounts). Many SAIs belong to INTOSAI, which with United Nations and donor support, has provided considerable assistance to its members to upgrade their operations, particularly by developing auditing standards and other guidelines.

6.17 The review should establish the legal authority for government auditing activities, including the role of internal auditors who provide audit services to ministries, departments and agencies and support the work of SAI. The review should indicate the principal controlling authority(ies) for auditing. In most countries, this is likely to be one authority, but there are countries which have multiple authorities, of which the majority are forms of internal auditors. Their responsibilities should be defined and their independence, ability, and willingness to provide unbiased reports specifically determined. In larger countries it will be necessary to obtain an audit organization structure chart to ascertain how the various states or provinces of a country are covered, and to determine how the central management monitors the effectiveness of the organization to plan and offer adequate audit cover.

6.18 The auditing standards which the auditor applies should be determined together with the manner in which the audit management ensures their application. In the absence of meaningful audit standards, the principles and methods adopted by the audit management to control the quality and nature of audit activities should be explained.

6.19 A number of government auditors participate in the expenditure approval process by conducting priori reviews and approvals. This effectively precludes them from providing independent
opinions, because they are using their staff to per-
form functions on which they later offer an opinion. 
It is difficult for such auditors to be unbiased. 
Therefore the existence of such practices should be 
fully researched, and the impact on the auditor's 
independence commented upon.

6.20 The budgetary allowances of government 
auditors frequently may be a constraint. It is 
therefore necessary to estimate the extent to which 
the auditor is able to conduct meaningful annual 
audits of all government services (priori reviews 
should be excluded). This will require identifying 
the number and qualifications of audit staff, and the 
availability of non-accounting skills to provide other 
forms of professional expertise. In particular, the 
extent of any performance, or "comprehensive" 
audits should be established by examining samples 
of performance reports.

6.21 The activities of internal auditors who pro-
vide reports to ministries, departments and agencies 
should be described, including the standards used, 
justification for their role, and its possible effective-
ness. The nature, form and typical timing of report-
ing by government auditors should be defined, 
particularly the facility--if any--to provide reports 
directly to management of governmental agencies 
(rather than initially to a legislature).

6.22 An appraisal should be made of the profes-
sonal capability and capacity of audit managers and 
staff responsible for designing, operating and 
monitoring the audit programs and systems, includ-
ing the methods of recruitment, and adequacy of 
compensation. An identification of training needs is 
required including approaches to training methods, 
facilities and budget adequacy. In addition, an 
assessment should be made of the overall percep-
tion by audit managers of their role in financial 
accountability.

6.23 Finally, it is necessary to determine the 
SAI's attitude towards financial accountability, as 
well as the extent to which it is organized and pro-
essionally qualified. Participation by government 
auditors in professional accountancy organizations 
should be evaluated.

6.24 Among other things, the country review of 
public sector accounting and auditing should ad-
dress the responsibility of the government in fulfill-
ing its role as a borrower, i.e. ensuring that Bank 
loans are used for the purposes intended. The re-
port should identify whether any government de-
partment or organization is required to take any 
responsibility for ensuring that information provided 
to the Bank under legal agreements is satisfactory 
and timely. If these features are not present, rec-
ommendations should be included to address mat-
ters.

Private Sector Accounting and Auditing

6.25 The objective of a country review of private 
sector accounting and auditing services should be 
to:

- evaluate corporate accounting, financial report-
ing and auditing requirements, capacity and ca-
pabilities and recommend steps to be undertaken to achieve short, medium and long term 
 improvements; and

- provide the Country Operations Division con-
cerned with an information system to enable it 
to advise and guide Bank staff in making ac-
countability arrangements for ongoing and fu-
ture investments in the private, and where ap-
propriate, the public sector of the country.

6.26 A country review of private sector financial 
services should address certain key concerns, in-
cluding appropriate legislation, regulations and 
management of the accounting profession and cor-
porate practices. Each professional accounting 
organization should be assessed as to its ability to 
promote a truly professional approach to account-
ing and auditing and the service it provides to its 
members.
6.27 The review should ascertain the ability of the profession to provide the requisite high quality services at fee rates which provide an equitable return to the firms and which can give reasonable assurances of independence and impartiality. It should evaluate the adequacy of corporate legislation, including national accounting standards and principles and regulation of accountants, to encourage investment and to provide investor protection by encouraging the use of accounting services under appropriate regulatory approaches. It should appraise the complete range of training facilities and standards accessible to those who would enter the profession and to those who continue in the profession, to ensure their continuing professional education. Finally, it should address any technical assistance requirements to achieve the necessary standards of performance by the accounting profession and the government, as its regulator.

6.28 The review should provide a complete picture of the private sector accounting profession of a country, together with the nature and adequacy of the services which are provided. It should identify the degree of independence achieved from government and impartiality from client interference in providing opinions and reports. The extent to which foreign links assist, or are allowed to do so, should be ascertained. Linkages with the public sector from basic education, through regulation, to the provision of services should be identified. The objective should be to determine whether the profession is competent, independent and thriving, or otherwise; whether it is in need of support, and if so, the nature of, and likely sources required to give such support; and a possible role for the Bank in future development of private sector accounting in the country. Selected accounting firms should be interviewed and classified according to strengths, specialties, degree of professionalism, quality controls, and staff training programs.

6.29 The following are matters which should be addressed as part of the review:

- establishment and regulation of the accounting profession
- a commercial code or corporate law requiring appropriate accounting, financial reporting and auditing
- setting of accounting and auditing standards

Structure and Strength of the Accounting Profession

- Numbers of members in profession
- Classification of profession by financial accounting, management/cost accounting, taxation, auditing, management consultancy, etc. and related numbers
- Nature and locations of pre-entry training for accountancy, taxation, auditing, etc.
- Acceptability and quality of professional examinations
- Licensing
- Nature of accounting standards and their observance
- Nature of auditing guidelines and their enforcement requirements for continuing professional education
- Existence and enforcement of a code of ethics and other disciplinary measures
- Requirements for third party liability insurance
- Existence and quality of peer reviews
- Fee structures
Quality of Accounting Firms and Individual Practitioners

- Type of affiliation and degree of support from international accounting firms
- Local facilities to provide back-up support for researches and training
- Independence and impartiality
- Work availability from private sector and public sectors
- Availability (admissibility to country) of expatriates
- Oversupply or undersupply of accountants

Bank Experience of Working with Firms and Practitioners

- Possible legislative requirements to improve independence and performances
- Possible technical assistance requirements

Technical Assistance

6.30 The County Review and Assessment will identify steps which may be needed to support improvements and changes to financial services in the public and private sectors. These steps may range from simple organizational and management changes in institutions and firms to major investigations and the construction of completely new systems.

6.31 Staff or consultants engaged as country reviewers are encouraged to be explicit about recommended changes. In doing so, they should specify the nature of any local or foreign technical assistance which may be required to achieve the desired modifications and improvements.

6.32 Technical assistance toward strengthening the financial management in both the public and private sectors may include:

- drafting new or revised legislation and regulations for all primary purposes, systems reviews, design of modified or new accounting, financial reporting, and auditing systems
- development of accounting standards and auditing guidelines
- design of new or modified educational programs at secondary schools, university, qualifying or post-qualifying levels
- training of trainers at all levels

6.33 Recommendations in a final report on a country review for technical assistance should include, wherever possible, the nature and form of required inputs, the reasons for their inclusion, estimates of time requirements and cost, and governmental reactions to any such proposals. In some cases it may not be possible to estimate the final costs, particularly in those cases where further in-depth investigations are recommended. In such cases, an estimate of the investigatory costs only should be included.
ANNEXES
NOTES
ACCOUNTING STANDARDS

1. Accounting standards address issues such as accrual and cost basis accounting; qualities of good financial information; balance and reasonableness; and internal control.

Accrual vs. Cash Basis

2. One of the most basic aspects of accounting which must be understood in order to properly evaluate financial information is the timing of the recognition of revenue and expenses. Under Accrual Basis accounting, the financial effects of transactions and events are recognized in the periods in which they occur, irrespective of whether or not cash has been received or paid. This allows transactions to be recorded in the accounting records and reported in the financial statements of the period in which the service was received (expense) or rendered (revenue). There occurs a matching of the revenue and the expenses required to generate that revenue.

3. Financial statements prepared on the accrual basis inform users not only of past transactions involving payment and receipt of cash, but also of obligations to pay cash in the future and of resources that represent cash to be received in the future. Hence, they provide the type of information about past transactions and other events that is most useful to users in making economic decisions.

4. Accrual accounting is generally the most accepted method for recognizing income and expense in the private sector. It is increasingly seen and encouraged in the public sector, but remains relatively rare. Occasionally, a cash basis is used where the recording of cash receipts and payments is the primary interest or where there is a legal requirement. Many associations which fund-raise for a specific purpose operate on a cash basis. They may be required to distribute all the funds raised within a specified period of time. Another example of a cash basis system is tax systems which allow cash basis accounting to help ensure that taxpayers have adequate liquidity to pay the taxes involved in the period.

5. Under the Cash Basis system receipts and payments (as differentiated from income and expense) are recognized only when cash is received or paid. The cash basis of accounting is often used in the preparation of financial statements for government funded entities. This is because the primary objective of government accounting is to identify the objects and purposes for which funds have been received and paid out during a particular period and to maintain budgetary control over such activity. Cash basis is also used when the accounting system lacks enough sophistication to implement accrual accounting and benefits of major changes do not justify the cost. However, in both of these cases, if trade credit is used in any significant way, a cash basis treatment can result in serious off-budget/book liabilities being incurred but not recorded against the current budget because payment is delayed.

6. Under some circumstances, especially in central government operations and municipalities, the most appropriate method of recording transactions may be a combination of the cash and accrual basis. Under this Modified Accrual Basis, revenue is re-

Budget Management Under the Cash Basis

Many governments operate under a cash basis of accounting—record cash receipts and expenses as they are received or disbursed. Bills are accounted for when they are paid. So long as bills are paid as they are received, such a system can effectively monitor costs. In countries where there is a strong encumbrance system, i.e. charges are made against budgets when purchase orders are issued, this system works fairly well in keeping the organization within its budget. However, where countries are under severe budget constraints, where the encumbrance system is weak or non-existent and budgets often unrealistic, a common occurrence is for payments on bills to be delayed often from one budget period to another. As a result, budget controls break down and unpaid bills accumulate, sometimes in excess of next year's budget allocation for the same sub-head or line item.
corded only when cash is received, while expenses and related liabilities are recorded when incurred, irrespective of the time of cash disbursements. The modified accrual basis generally is followed in cases where revenues cannot be measured until they are actually received (e.g. certain types of taxes, fines and fees), or where the timing and amounts to be collected on customer accounts receivable may be highly uncertain.

Modified Accrual Basis
A modified accrual basis can sometimes be a more conservative approach to financial statement presentation. This is true in the recognition of interest income for lending organizations. In some countries interest is accrued for all performing loans as it is due from the borrower. Only when a loan is classified as non-performing (usually payments in arrears for 90 to 120 days) is interest income recorded on a cash basis. All expenses are accrued as incurred. Some countries use a modified cash basis in which expenses are accrued as incurred but interest income is recorded as received. This causes some mismatching of income and expense. However, the result is a more conservative income statement because the ability to collect any interest income recognized is absolutely assured because it has already been collected. Under a full accrual method, interest income could be accrued that would never be collected and would have to be written off at a later date when the loan was declared non-performing.

Qualities of Good Financial Information
7. Qualitative characteristics of a financial management system require that the information it provides be useful for decision-makers. For Bank projects, this means useful to the Project Manager (borrower) and the TM (Bank). The purpose of a Bank project is to bring a concrete benefit to the project beneficiaries and to the country in general. Financial information generated for project implementation must support the project purpose. To know how much has been spent is of limited use unless one also knows how much of the project has been completed and what additional resources it will take to achieve the project goals.

8. To be useful, financial reports must be both relevant and reliable. The relevancy of financial reports will be largely dependent on the degree to which the underlying accounting system reflects the demands of implementing the project, i.e. the way in which it segregates, classifies, and aggregates accounting data.

9. Pervading any accounting system are certain elements which affect the quality and quantity of information produced by an accounting system. Timeliness is a key element of any financial report. If there is undue delay in the reporting of information it may lose its relevance.

Balance and Reasonableness
10. Balance is a very important concept to bear in mind in analyzing the adequacy of a financial management system for full accountability and management usefulness. For example, management may need to balance the relative merits of timely reporting and the provision of reliable information. The achievement of total accuracy and absolute control might delay the release of the information so long as to make it irrelevant for decision-making. The financial losses of poor management may outweigh the resources conserved via accuracy and micro controls. However, failure to establish an adequate control environment may result in a high rate of leakage of financial resources and may render the information so inaccurate as to also make it irrelevant for decision-making. In achieving a balance between relevance and reliability, the overriding consideration is how best to satisfy the economic decision-making needs of users who need to make the best use of the financial resources available.

11. Reasonableness is another key concept in assessing a financial management system and its data. There must be a reasonable relationship between the cost of obtaining accounting information and the benefit obtained. The benefits of a basic accounting system which controls and reports on costs can be enormous and the outlay relatively low. The level of aggregation of data in an accounting system will affect the cost of gathering and reporting it, as will the number and type of cost classifications. Both the level of aggregation and the number of cost classifications and centers should be carefully designed to focus on areas where costs are significantly controllable, material in
their impact on the project, and useful in both planning and monitoring project performance. A system which is too complex for an organization or project will rapidly incur costs with little marginal benefit. Its complexity may result in a total break-down of the system because of inadequate personnel and materials to maintain it.

12. Reasonableness also affects the design of internal controls. These controls should be designed so there is a reasonable expectation that material losses of financial resources will not occur either through error or theft and that the accounting records reflect in all material aspects a true and fair presentation of the financial transactions which transpired. The controls required to achieve absolute assurance of the above may hamper if not prevent the implementation of the project.

13. Hence a balancing, or trade-off, between qualitative characteristics is often necessary. Generally the aim is to achieve an appropriate balance among the characteristics in order to meet the objective of financial statements. The relative importance of the characteristics in different cases is a matter for the professional judgment of a qualified accountant.

Internal Controls

14. Country Risk Country risk deals with the overall environment for internal controls and auditing within the country. Factors affecting country risk are:

- Support of sound financial management and internal controls at the highest level of government;
- Salary structure within the public sector and between the public and private sectors. Public sector salaries which are below a reasonable standard of living for the country often contribute to the acceptance of corrupt practices as a means of supplementing income. Additionally, wide discrepancies between private and public sector salary scales contributes to a migration of trained and qualified staff to the private sector;
- Historical and cultural support for a strong civil service ethic;
- Degree of independence of the civil service from politics;
- Position of the accounting and auditing profession within the culture; and
- Technical development of the accounting and auditing profession in the country.

15. Organizational Risk There are some basic characteristics of a good control environment within an organization. Of primary importance is the presence of honest and capable employees. This can be assessed by considering compensation, education, and experience levels. Where compensation is inadequate there may be strong incentives for the misappropriation of funds; this diversion may be relatively minor, such as the use of an official car for personal business or may involve more serious losses such as the diversion of cash, the loss of other tangible assets, or the sale of patronage for goods and services.

16. The education and experience levels of staff will have a major impact on the accuracy and completeness of the accounting records. Both should be strongly represented on the staff. Education without experience may result in confusion especially when dealing with unusual transactions. An experienced person may have no problem with routine transactions, but be unable to think through the correct accounting treatment for unusual transactions or new circumstances.

17. Another fundamental aspect of organizational control is clear delegation and segregation of duties. No one person should have control over the entire processing of any given transaction (segregation of responsibilities). Authorizing a particular transaction, such as the procurement of a fixed asset, should be kept separate from recording the transaction, which in turn should be kept separate from maintaining physical custody of the asset. If all three functions are fulfilled by three separate individuals then the diversion of financial resources requires collusion between two or more persons—making it more unlikely and riskier. However, executive override and/or collusion can circumvent even the strongest internal control. This is why internal and independent audit is important.
Sample Internal Controls

Authorization of Expenses: Expenses should be authorized by a designated person in a department—generally the head of the department. Accounting personnel should not authorize expense except for accounting.

Pre-numbered Documents: Pre-numbering controls documents (especially checks, purchase orders, and cash receipts) and helps assure that unauthorized transactions do not take place. For example, by using pre-numbered cash receipts and by informing the public that they should get a receipt, it makes it harder for a cashier to pocket money received from customers.

18. Financial regulations setting authority limits, and clear procedures for the processing of transactions are other important aspects of a good internal control environment. Documented procedures help assure a consistency in recording and classifying the financial transactions. A Chart of Accounts is the primary tool for achieving consistency in account classification. Written procedural manuals help assure that new employees follow the same guidelines. Manuals should not be unduly detailed nor cumbersome or they will be ignored. Many computer-based accounting systems also enhance consistent accounting treatment.

19. Accounting documents filed in logical sequence which support financial reports help establish a clear audit trail and provide feedback from other parties regarding the accuracy of the financial reports.

20. A key concept in financial reporting is that of responsibility reporting, where a manager can be called upon to explain a particular cost and attest to its validity and relate it to physical performance. A budget report comparing actual to projected expenses, reviewed by the manager in charge (as well as others) is one of the best and simplest internal control mechanisms.

21. Physical control over assets is another basic internal control principle. A limited number of persons should have access to the assets, and responsibility for their protection should be clearly indicated. Most funds should be in a bank account but some operating cash may be kept in a locked safe. In both cases a minimum number of persons should be able to sign checks and have access to the safe. Inventory should be secured under the custody of one person at any given time. Blank checks should be locked safely away. All of these techniques are designed to protect the organization’s assets against unauthorized use.

22. Independent verification is the final principle of good internal control. This means that the person charged with reconciling the monthly bank statement should be someone who is not involved with the receipt of disbursement of cash. By reconciling the accounting records to the bank's records any discrepancy can be investigated. Because the person has no access to cash it is doubtful that there will be any incentive to cover up any discrepancies which might be evidence of theft. In regard to fixed assets, periodic physical counting of assets on hand and then comparing the results with the accounting records provides an independent verification. Again the person doing the inventory cannot also be responsible for either the physical custody of the inventory or recording inventory transactions in the accounting records.

23. One of the key indicators of a good internal control environment is accounting records which are both accurate and up-to-date. Where accounting is in arrears, internal controls are often weak if only because there is no feedback on the utilization of financial resources through financial reporting. Additionally, under pressure to catch up, internal controls may be cast aside or circumvented. A summary matrix of some important areas to be considered when reviewing Accounting Standards is shown as Annex I -1.
## REVIEW OF ACCOUNTING STANDARDS

<table>
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<th>WHAT</th>
<th>HOW TO ASSESS</th>
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<tr>
<td>Accounting Standards</td>
<td></td>
<td>1. Standards used by government or quasi-government entities may be dictated by law. Needed changes for good management of the project may require changes in the law which can be a lengthy process.</td>
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</table>
| Guidelines which specify the accounting treatment for particular financial transactions Used to ensure comparability, consistency, and completeness for the financial records. | 1. Determine standards used, particularly in regards to important costs or financial areas.  
2. Compare to IASC standards.  
3. Determine the impact of differences on project reporting. | 2. Deviations from IASC Standards must be disclosed in project financial reports and/or audits. |
| Quality of Financial Information          |                                                   | 1. If part of larger agency, it may be difficult to segregate the financial information pertaining to the implementing organization. |
| Good financial information is timely, relevant, and reliable. | Determine if financial information currently produced by organization is timely (When were the last financial reports issued?), relevant (Do the Accounts correspond to budget accounts? Does the information provided relate to project activities?) and reliable (Has information been independently audited, and what was the result?). | 2. Entity accounts may have very little correspondence to the cost structure of the project and hence financial information would have little value.  
3. Centralized accounting may cause delays in financial reporting and information to be less relevant. |
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| Internal Control | Determine control systems.  
- Who does finance function report to?  
- Is that person independent of management or is there other means of independent verification of records such as an audit?  
- What steps are required to process payment?  
- Is one person in charge of generating the invoice, recording it, and paying it? | Micro-controls focused on form and not substance can lead to loss of control because agency has insufficient resources to maintain the system and those resources used do not focus on the reasonableness of the costs, only their allowability. |
| Country Risk | Review country assessment if available.  
- What is reputation of civil service within country? Are salaries sufficient?  
- Contact professional groups. How strong is accounting/auditing profession within country? | Problems associated with country risk will probably require longer-term solutions which probably cannot be addressed within the scope of the project. Project-specific controls such as special units and outside consultants may be required to ensure adequate control over resources. |
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<tr>
<td>Organizational Risk</td>
<td>1) Review staffing levels, filled and unfilled positions.</td>
<td>Restrictions on civil service compensation, recruitment, and firing may adversely affect staff quality.</td>
</tr>
<tr>
<td>-- Honest and capable</td>
<td>• Is there at least one manager with sound enough credentials and experience in accounting to make good judgments on the production of financial information?</td>
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<tr>
<td>employees</td>
<td>• Are there skilled staff for each of the primary functions of the financial management system?</td>
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<td></td>
<td>2) Review staff retention, recruitment, and training opportunities.</td>
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<tr>
<td></td>
<td>• What is the staff turnover rate?</td>
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<td></td>
<td>• Does the recruitment process attract and screen for qualified applications?</td>
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<tr>
<td></td>
<td>• What are the training opportunities and how frequently are staff trained?</td>
<td></td>
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<td></td>
<td>• Is there an adequate performance review process?</td>
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| Organizational Risk – Segregation and delegation of duties | • Review financial procedures.  
• Would collusion be required between two or more employees for theft to occur undetected?  
• Are duties rotated either because of vacations or as a part of a general staffing pattern? | Organizations which are small may not have sufficient employees to provide for adequate segregation of duties. |
| Organizational Risk – Clear procedures | Review written procedures.  
• Are there written procedures and do they match actual procedures?  
• Do the prescribed account classifications provide adequate control over expenses especially in relation to the project? | Procedures within government organizations are often out-of-date with modern financial management. However, their replacement may not be as practical within the scope of the project. Damage to internal controls can occur if old procedures are discarded before new ones are thought out and developed. |
| Organizational Risk -- Physical control | Review physical control.  
• Is an annual inventory conducted of equipment and other physical assets?  
• Who has access to cash, equipment and other assets? |  |
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<tr>
<td>Organizational Risk</td>
<td>1) Review prior audits, external or internal.</td>
<td>1) When accounting records are behind, independent verification is often pushed aside and either done late or not at all.</td>
</tr>
<tr>
<td>-- Independent verification</td>
<td>• Was the audit qualified, disclaimed, or in any way adverse?</td>
<td>2) Statements from outside organizations can also be late, especially if they originate from a centralized agency.</td>
</tr>
<tr>
<td></td>
<td>2) Review internal documents such as bank statements, inventories, etc.</td>
<td></td>
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<td></td>
<td>• Does a separate entity (bank or government agency) report on cash</td>
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<td>transactions independent of the records of the organization?</td>
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<td></td>
<td>• Are these reports reconciled to the entity’s records by a staff person</td>
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<td>not directly associated with the transactions?</td>
<td></td>
</tr>
<tr>
<td>Project Types</td>
<td>1) Revenue earning projects:</td>
<td>1) The implementing organization may have non-revenue mandates which interfere with financial decisions and may lack sufficient autonomy from the public sector to tailor financial systems to its needs.</td>
</tr>
<tr>
<td></td>
<td>• Determine financial viability of enterprise as a whole through analysis</td>
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<td>of past and projected financial performance.</td>
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<td>• Determine independence of entity via examination of legal documents and</td>
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<td></td>
<td>enquiries.</td>
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<td></td>
<td>2) Non-revenue earning projects:</td>
<td>2) In transitional economies, it may be difficult to determine boundaries of enterprise.</td>
</tr>
<tr>
<td></td>
<td>• Determine how financial management of project will fit into the overall</td>
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<td>management of the implementing agency.</td>
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<td></td>
<td>3) Adjustment operations - See Annex III.</td>
<td>3) Sector differences will affect emphasis of financial management assessment.</td>
</tr>
<tr>
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<td>• Determine means by which borrower will ensure that disbursements are</td>
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<td>made only for items on the positive list or conversely, that no</td>
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<td></td>
<td>disbursements are made for items on the negative.</td>
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</table>
| Availability and Quality of Auditors | Groundwork for selection of auditors should be done prior to project implementation. | 1) Auditing expertise may be scarce and require significant resources to find satisfactory solution.  
2) Public sector auditors may have jurisdiction, may lack expertise. |
SUMMARY OF INTERNATIONAL ACCOUNTING STANDARDS
OF IASC

IAS 1 - Disclosure of Accounting Policies
All significant accounting policies which have been adopted in the preparation and presentation of financial statements need to be disclosed as an integral part of the financial statements.

Exception: following fundamental accounting assumptions of going concern, consistency, and accrual need not be disclosed, but if a fundamental accounting assumption is not followed, the fact should be disclosed, together with reasons.

Changes in accounting policy which have a material effect in the current period or in subsequent periods should be disclosed, together with reasons.

IAS 2 - Valuation and Presentation of Inventories in the context of the Historical Cost System
Inventories should be valued at the lower of historical cost and net realizable value. Such valuation should be done item by item or by group of similar items.

Generally FIFO or weighted cost approach should be used to ascertain historical costs of inventories. Exception:

1) Inventories which are specifically identifiable or not ordinarily interchangeable may be valued by specific identification of individual costs, and

2) LIFO may be used, provided that the difference between such valuation and

(a) the lower of FIFO (or weighted cost approach) and net realizable value, or

(b) the lower of current costs and net realizable value, is disclosed.

Estimates of net realizable value should be based on general market prices rather than on temporary fluctuations in prices. Exception: Net realizable value of firm sales should be based on contract value. When inventories are written down to their net realizable value, the profit or loss for the period should be charged with the difference. Disclosure is required for the main categories of inventories.

IAS 3 - Consolidated Financial Statements
Superseded by IAS 27 and IAS 28.

IAS 4 - Depreciation Accounting
The depreciable amount of a depreciable asset should be allocated by using a systematic depreciation method to each accounting period during the useful life of the asset. The depreciation method selected should not be changed from period to period. If depreciation method changed, the reason and quantified effect of the change should be disclosed in the period of adoption of change. Factors to be considered for estimating the useful life of period are expected physical wear and tear, obsolescence, and legal or other limits on use of the assets. Useful life estimates for each asset or group of assets should be periodically reviewed, and any significant change should be disclosed. For each class of assets the depreciation method, the useful lives or the depreciation rates, the total depreciation allocation for the period, the gross amount of depreciable asset, and accumulated depreciation should be disclosed.

IAS 5 - Information to be Disclosed in the Financial Statements
Minimum disclosure requirements set out. Divided into general and specific disclosures as follows:

- all material information, and
- corresponding figures for preceding period.

Major categories of specific disclosures for Balance Sheet are:

- Long Term Assets: Separate disclosure required for property, plant, and equipment, and other long-term assets.
• Current Assets: Separate disclosure required for cash, marketable securities and other short term investments, receivables, and inventories.

• Long-Term Liabilities (net of portion repayable within one year): Separate disclosure required for secured loans, unsecured loans, intercompany loans, and loans from associated companies.

• Current Liabilities: Separate disclosure required for Bank loans & overdrafts, current portion of long-term liabilities, payables, and other liabilities and provisions.

• Shareholders’ Interest: Separate disclosure required for Share Capital and other equity.

Disclosures should also be made for restriction on asset titles, security given against liabilities, method for provision for pension and other liabilities, contingent assets and liabilities, and amounts committed for future capital expenditure.

**Major categories of specific disclosures for Income Statement are:**

- Sales or other operating revenue,
- depreciation,
- interest income,
- income from investments,
- interest expense,
- taxes on income,
- unusual charges,
- unusual credits,
- significant intercompany transactions, and
- net income.

**IAS 6 - Accounting Responses to Changing Prices**
Superseded by IAS 15.

**IAS 7 - Cash Flow Statements**
Requires preparation of Cash Flow Statement for all enterprises and including it as part of the financial statements. Procedure for preparation of the Cash Flow Statement is detailed in the statement. The main categories under which movements of cash needs to be shown are cash flow from:

- Operating Activities
- Investing and Financing Activities,
- Foreign Currency,
- Extraordinary items,
- Interest and Dividends,
- Taxes on Income,
- Acquisitions and Disposal of Subsidiaries and Other business units, and
- Non-cash transactions.

Further components of cash and cash equivalents should be disclosed and reconciliation presented between the amounts in the cash flow statement and equivalent items reported in the balance sheet.

**IAS 8 - Unusual and Prior Period Items and Changes in Accounting Policies**

Any prior period items and adjustments resulting from changes in accounting policies should either be reported by adjusting the opening balance of retained earnings in the financial statements (and amending the comparative prior year information presented) or adjusted against current income with separate disclosure. Corrections resulting out of a change in the accounting estimate should be adjusted against current income as an ordinary item in the period of change and in future periods if the change affects those periods. Any material effect should be quantified and disclosed separately.

**IAS 9 - Accounting for Research and Development Costs**

Guidance given on identifying Research and Development costs incurred in house or contracted from others. Research and Development costs should be expensed unless all of the following criteria are satisfied, then they should be deferred:

- the product or process is clearly defined and the associated costs are clearly identifiable,
- the technical feasibility of the product or process has been demonstrated,
the enterprise will produce and market or use the product or process,

- clear indication exists of the future market potential or usefulness to the enterprise, and
- resources available to complete the project.

Allocation of deferred Research and Development costs to future periods should be done on a systematic basis. The total Research and Development costs, including any movement, along with amortization of the costs should be disclosed together with the basis of allocation.

**IAS 10 - Contingencies and Events Occurring after the Balance Sheet Date**

Guidance given to identify contingencies and events occurring after the Balance Sheet date.

The existence of contingent loss should be disclosed in the financial statements unless it is remote; contingent gains should be disclosed if it is probable that gain will be realized. The value of assets and liabilities should be adjusted for events after balance sheet date that effect the values as of the balance sheet date. Other events after balance sheet date that are significant should be disclosed for the user to make proper evaluations. The nature of the event or contingency with its estimated financial effect should be disclosed. For contingencies the uncertain factors should also be disclosed.

**IAS 11 - Accounting for Construction Contracts**

The percentage of completion method or the completed contract method should be used in accounting for construction contracts. The standard gives guidelines for (i) usage of both the methods and (ii) disclosures required for such contracts.

**IAS 12 - Accounting for Taxes on Income**

The expense on tax should be determined by tax effect accounting, using either deferral or liability methods. Tax effect accounting considers taxes as an expense to accrue income, and thus taxes should be accrued in the same period as the revenue and expenses to which they relate to. The standard has laid down disclosure requirements for tax accounting.

**IAS 13 - Presentation of Current Assets and Current Liabilities**

If an enterprise presents current assets and current liabilities separately from other assets and liabilities, then the standard is applicable. The standard sets out items to be considered as current assets and current liabilities, and sets out presentation and disclosure requirements for such assets and liabilities.

**IAS 14 - Reporting Financial Information by Segment**

This standard requires segment information disclosure for publicly traded enterprises and economically significant industries, including subsidiaries. Disclosures required include bifurcation by industry and geographical segments.

**IAS 15 - Information Reflecting the Effects of Changing Prices**

The statement applies to enterprises whose revenues, profits, assets or employment are significant in the economic environment in which they operate. The standards detail two acceptable methods, viz., General Purchasing Power and Current Cost Approach. The disclosures required should be as a supplemental information to the financial statements.

**IAS 16 - Accounting for Property, Plant and Equipment**

The definition of property, plant and equipment has been set out under the standard. The purchase price, any improvement costs, and any costs directly attributable to bringing the costs to its working condition, but excluding any general repair and maintenance costs, should be included in the cost of the asset. Costs of self-constructed property, plant and equipment should include specific costs directly related to the specific asset and should not include any cost inefficiencies. Property, plant and equipment acquired on exchange should be priced at book value of similar assets, or at fair value, when similar assets is not owned by the enterprise. If their is a permanent impairment to any item or group of items, so that the recoverable amount falls below the net carrying value, then the net carrying value should be reduced to the net recoverable amount.
For revalued property, plant and equipment, any upward revaluation should be credited to shareholders interest directly and not credited to income statement. Any decrease due to downward revaluation of property, plant and equipment, should be charged to income, except the amount of downward revaluation related to any earlier revaluation should be charged to shareholders interest.

Disclosure required over and above IAS 4 & 5 are methods used for determining gross value of property, plant and equipment, and revaluation method used for any revaluations.

**IAS 17 - Accounting for Leases**

The standard discusses lease accounting under two sub categories: finance leases and operational leases, and included are discussions on sale and leaseback transactions. Disclosure requirements have been set out for both the lessor and lessee.

**IAS 18 - Revenue Recognition**

Revenue should be recognized if it meets certain standards of transfer of ownership, uncertainty, collectibility, and measurability criterions, as set out in the standard. Disclosure requirements include disclosures as to any postponement of any revenue recognition.

**IAS 19 - Accounting for Retirement Benefits in the Financial Statements of Employers**

The standard sets accounting requirements for retirement benefits for defined benefit plans and defined contribution plans. Minimum disclosure requirements have also been set out.

**IAS 20 - Accounting for Government Grants and Disclosures of Government Assistance**

Government grants related to assets, including fair value of non monetary grants, should be disclosed in the financial statements either as a deduction from the carrying value of the assets, or, as a deferred income. Other government grants related to assets, including fair value of non monetary grants, should be recognized over the periods in which the related costs occur and are accounted in the income statement of the enterprise. Disclosures required for accounting policy, nature and extent of grant, and any unfulfilled conditions for the grant.

**IAS 21 - Accounting for the Effects of Changes in Foreign Exchange Rates**

Transactions in foreign currencies should be recorded at the reporting currency of the enterprise, and revalued at the closing exchange rate for reporting purposes (exception being forward exchange contracts, where special accounting treatment is given). Exchange differences arising out of such treatment should be recognized in the income for the period (exception being in case of certain long-term items, exchange differences can be recognized to income of current and future periods on a systematic basis). Procedures have been laid out for translation of financial statements of a foreign entity and for financial statements of foreign operations of an enterprise. Disclosure requirements has been specified.

**IAS 22 - Accounting for Business Combinations**

Business combinations should generally be accounted for under the purchase method, exception in rare cases being the pooling of interests method. Both these methods are discussed in the standard. Disclosure requirements have also been set out.

**IAS 23 - Capitalization of Borrowing Costs**

Circumstances when borrowing costs can be capitalized when they meet certain criteria, has been discussed. Generally, during the time an asset is being made ready for use or sale, any borrowing costs incurred can be capitalized. Borrowing costs capitalized should be disclosed.

**IAS 24 - Related Party Disclosures**

Disclosure required for related party transactions if they meet certain criteria. Related party transactions have been defined.

**IAS 25 - Accounting for Investments**

Investments can either be accounted for as short-term (current) or long-term. For short-term investments, the carrying value should either be the market value, or, lower of cost or market value. For long-term investments, the carrying value should either be cost, revalued amounts, or, in case of marketable equity securities: the lower of costs or market value.
Investment properties can either be accounted for in accordance with IAS 16, with depreciation, in accordance with IAS 4, being charged to the income statement, or, investment properties can be accounted for as long-term investments.

Accounting for changes in carrying value of investments, transfers and disposals has been discussed. Disclosure requirements have been set out in the standard.

**IAS 26 - Accounting and Reporting by Retirement Benefit Plans**

This standard sets out reporting requirements for the plans, and should be distinguished from IAS 19, which discusses reporting requirements in the financial statements of employers having such plans.

**IAS 27 - Consolidated Financial Statements and Accounting for Investments in Subsidiaries**

Preparation and presentation of consolidated financial statements for a group of enterprises under the control of a parent is discussed in the standard.

**IAS 28 - Accounting for Investments in Associates**

Investment in associated companies should be accounted for by using the equity method; exceptions are noted in the standard. Disclosure requirements have also been set out.

**IAS 29 - Financial Reporting in Hyperinflation Economies**

The financial statements should be restated at measuring units as applicable on the balance sheet date. The resulting gain and loss in the net monetary position should be included in net income and separately disclosed. Disclosures are required for restatement of the financial statement figures, the basis of measuring applied to the financial statements, and the identity of the current measuring unit or price index.

**IAS 30 - Disclosures in the Financial Statements of Banks and Similar Financial Institutions**

The disclosure requirements set out in this standard are in addition to those set out in other standards. Required disclosure has been discussed under (i) Income Statement, (ii) Balance Sheet, (iii) Contingencies and Commitments including Off Balance Sheet Items, (iv) Maturities of Assets and Liabilities, (v) Concentrations of Assets and Liabilities, (vi) Losses on Loans and Advances, (vii) General Banking Risks, and (viii) Assets Pledged as Security.

**IAS 31 - Financial Reporting of Interest in Joint Ventures**

Disclosure requirements for interest in joint ventures has been discussed separately for jointly controlled operations, and jointly controlled assets. Reporting requirements for an enterprise have also been discussed as a venturer and as an investor.
NOTES
ACCOUNTING AND AUDIT ARRANGEMENTS FOR ADJUSTMENT OPERATIONS

Arrangements Required

1. Ensure that the Borrower introduces arrangements to record the Customs Certificates, relating to the underlying import documents, to be used to support Bank disbursements under the loan. (The Customs Certificate will include the supplier name, supplying country, value, description of goods, the importer and the date of importation.)

2. The arrangements should ensure that:
   
   a. the goods are eligible based on a positive or negative list.
   b. the goods are supplied by a member country.
   c. the date of importation is available to determine eligibility.

3. Ensure that arrangements are in place to retain, with easy access, the Customs Certificates for at least one year after the submission of the related audit report.

Audit Required and Opinion

1. Ascertain the adequacy of the procedures used to prepare customs or similar certificates.
2. Examine the customs certificates on which the Bank’s disbursements have been used.
3. Issue an opinion as to the reliability of the procedures applying in verifying or issuing the customs certificates in support of the Bank’s disbursements.
NOTES
REVIEWS OF FINANCIAL MANAGEMENT AND ACCOUNTING SYSTEMS FOR ENTITIES IMPLEMENTING REVENUE EARNING PROJECTS

1. Most revenue earning entities are autonomous, or have a high degree of autonomy, with powers to determine financial policies and the design and operation of financial management and accounting systems. Some state-owned enterprises, on the other hand, may be required to conform to a national accounting plan. The following is a checklist of items to be considered when reviewing these arrangements. The reviews should take place early as possible in the project cycle of identification, preparation, preappraisal or appraisal.

- Statutory requirements for accounting and financial reporting
- Status of the entity — autonomous or under government control
- Accounting policies and practices in force
- Management and control systems
- Centralized or decentralized management and accounting systems
- Financial regulations
- Financial management and accounting
  (i) Management accounting
  (ii) Corporate planning, budgeting and budgetary control
  (iii) Financial accounting
  (iv) Cost accounting
  (v) Internal control and internal audit systems
  (vi) Data processing
- Financial staff: management, competence and training

The extent of the review required for each of the above is discussed in the following paragraphs. In general, staff should ensure that each review is adequate to advise the Bank prior to negotiations for a loan on the adequacy of financial management and accounting information.

Statutory or General Legal Requirements

2. Laws, government regulations and/or rules under which an entity operates should be examined, and the entity’s observance or nonobservance of them should be identified, so as to determine any possible effects on the project early in the project cycle, because introducing new legislation or amending any existing laws may require considerable time. Legal Department’s advice should be sought if it appears that legislative changes may be required.

3. 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). Detailed financial or accounting requirements may not be part of specific legislation relating to the entity or in the entity’s “charter” but may be addressed in general laws to which the “charter” may refer. Particular attention should be paid to concession agreements, which are generally found in utilities in some French-speaking countries. Under this system, which requires special accounting treatment, a government may give an entity the right,
for a fixed term, to operate, manage and develop the service and to recover its investments at the end of the concession. If existing statutory requirements may inhibit normal reporting of project performance, this should be discussed with the government and the borrower, so as either to obtain changes in the statutes or to redesign the project’s reporting requirements.

**Status of an Entity**

4. In order to determine a borrower’s authority and ability to formulate and implement financial policy, and to design and install financial management systems, and thereby indirectly to determine how much time may be needed for making changes, it may be necessary to establish the extent of its autonomy and/or control by higher authorities. The following questions should be resolved:

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

(b) Can it contract, and sue and be sued in its own name?

(c) Can it determine its own financial policies?

(d) Is it government-controlled? If so, what is the extent of that control and influence on financial policies and accounting requirements?

(e) Is there a specified code or chart of accounts?

(f) Is it a government agency? If so, does the entity’s management have any powers to decide financial policy and accounting systems, or are these prescribed by government? For example, there could be separate accounting rules for parastatals.

(g) Is the project to be executed by a part only of an entity?

(h) Is it necessary or desirable to require a separation of accounts and/or funds for that part only, and would such a step be feasible?

**Accounting Policies and Practices in Force in the Entity**

5. The acceptability of the accounting policies, including standards of financial reporting and general accounting practices in force in the project entity, should be examined against the background of the related chapter in the handbook on financial reporting and budgeting compliance. If the policies do not conform to accepted international or national standards and practices, the borrower should be informed of any required modifications and the latest date for their introduction, e.g., before project implementation commences, or by a date to be specified in a covenant. On the other hand, if only minor items are in dispute (e.g., methods of apportionment of overheads or valuation of inventories), as long as these variances are revealed in the annual financial statements and the auditor’s report, their continued use may be acceptable.

**Management and Control**

6. To judge the effectiveness of an organizational structure, the following should be reviewed to judge their suitability to support project implementation and operation and the extent of their observance in practice:

- By-laws of the entity
- Executive orders (if any)
- Statements of objectives and policies
- Organizational structure, including the reporting level of the chief financial officer
- Internal control and internal auditing
- The need to furnish financial information on an entity’s performance to concerned parties within, and external to, the entity, and the extent of the achievement of such dissemination.
7. The impact of management and control systems on the operation of the financial management and accounting systems should be examined by seeking answers to the following:

(a) What is the background and experience of those who represent the finance function on the Board of Management?

(b) Who in management reports on financial performance to the entity's owners?

(c) Who reports on finance to the management? What is the status of this official?

(d) In what form and how frequently does management require and receive information about financial performance -- type of reports and distribution of such to various levels of management? Is it adequate?

(e) What are the control systems and linkages between top management and financial management, and between other managers and the financial managers?

(f) Do the answers to questions (a) through (e) above add up to a system acceptable to the Bank for project implementation? If not, can they be amended in a timely manner to achieve project implementation?

Centralized and Decentralized Accounting Systems

8. Large industrial and commercial organizations, governments, or large parastatals may operate centralized financial management and accounting systems, whereby all information generated at operational levels (e.g., project sites) is transferred to a central location for making payment to contractors, etc.; for data processing; and for compilation of accounting records. Delays and loss of data may result, which affect, inter alia, prompt and accurate reporting. Conversely, decentralized systems, which permit local financial operations, usually require more extensive controls and more staff. Therefore, before recommending changes to a borrower on project (and, where applicable, project entity) financial management and accounting systems, it would be prudent to examine the advantages and disadvantages of existing and proposed systems with regard to the efficiency of centralized or decentralized operations. Key factors to be considered are the competence of management, security, communications, and the availability of trained staff.

Financial Regulations

9. These regulations are usually designed to define the objectives of, and responsibilities within, a financial management and accounting system. They may form part of Standing Orders or Operating Rules or be a preface or annex to a Manual of Accounting, or they may be restricted to limited definitions of budgetary, accounting or internal auditing responsibility within an entity. They may range from statutory regulations to financial managers' informal rules with no legal status, and should facilitate the examination of the financial management systems by defining their structure and subsystems, and by designating responsibilities. Regulations, if any, should be reviewed for their form and context, and for their observance. Normally, at the time of appraisal, the extent to which Financial Regulations satisfactorily address the following should be examined:

(a) Basic financial policy with regard to revenues and expenses

(b) Appropriation of surpluses/treatment of deficits

(c) Programming and budgeting, including medium/long-term investment planning

(d) Budgetary control

(e) Accounting organization

(f) Recording of assets and inventories

(g) Inventory control

(h) Depreciation rules

(i) Debt management

(j) Billing and collection

(k) Write-offs

(l) Bidding procedures

(m) Payment procedures

(n) Form and timing of financial statements and balance sheets
(o) Internal checks and controls

(p) Internal audit

(q) External audit

10. Regulations should also clearly define who is responsible for their implementation. The provision of new regulations or the improvement of existing regulations should preferably be sought before loan negotiations. Technical assistance to help introduce or improve regulations and systems should be encouraged, where necessary, through the use of a free standing project or a project component.

Financial Management and Accounting

Management Accounting System

11. A management accounting system should collect and promptly report financial and related statistical information about an entity’s operations to the various management levels, supplying each level with the necessary details at the appropriate times. It should incorporate procedures for budgeting and financial planning, record-keeping and reports, and cost accounting (including cost control and analysis) for recording costs. Such a system, which is often best illustrated in chart form, should also provide for adequate internal checks, controls and, if appropriate, internal auditing.

12. In the absence of a chart of a management accounting system, an organization chart of the entity’s structure should be obtained or drawn up. It should be suitably amended to illustrate the areas of management served, or to be served, by the management accounting system. The chart should show, inter alia, the linkages between the system and the management centers of the entity, and to a central organization, if the entity or system is a decentralized unit. The chart should also show the main and subordinate activity areas, e.g.:

Controllership function

Treasury function

  Programming and budgeting
  Cash collection

Financial accounting
  Payments
  Costing, etc.
  Banking operations
  Billing
  Debt management
  Inventories

Finally, it should show established posts/salary levels, and posts occupied and vacant.

13. The borrower should be notified of any concerns about inadequacies, or changes required in the management accounting system to achieve satisfactory to project implementation.

Corporate Planning, Budgeting and Budgetary Control

14. Long-, medium- and short-term planning should be primary elements in financial management. Long- and medium-term plans are usually referred to as corporate planning and require different planning approaches, often characterized by “rolling program” techniques, or “indicative planning” only, compared to the short-term budgeting and budgetary control procedures, which are normally based on annual plans. In addition, examination of corporate planning and budgeting systems adopted by an entity should focus on the emphasis placed on profit maximization compared to routine expenditure and revenue control. Answers to the following groups of questions may provide an adequate overview of the corporate planning and budgetary systems:

(a) Characteristics of Planning

  (i) is there overall corporate planning?
  (ii) what is the time span of corporate plans?
  (iii) how are corporate plans expressed?
  (iv) are corporate plans summarized in financial terms (pro forma annual financial statements and balance sheets)?
(v) are overall financial plans supported by appropriate subsidiary budgets (revenues and operating expenditures, capital expenditures, debt-equity proposals)?

(vi) what are the critical monitoring indicators in corporate plans?

(b) Responsibility for Planning

(i) who prepares and approves corporate plans and annual budgets?

(ii) is there a review system for tariffs, prices and changing mechanisms?

(iii) is there a review system for capital expenditures?

(iv) do the corporate plans and annual budgets identify specific managerial responsibilities for implementation and review?

(c) Timetables for Planning and Budgets

(i) what is the timetable for preparation and approval of corporate plans and annual budgets?

(ii) does the timetable allow sufficient time for generation of all inputs and management reviews of corporate plans and annual budgets (consider the extent of centralization/decentralization of the entity)?

(iii) who prepares and controls these timetables?

(iv) are there sufficient time allowances and arrangements for preparation and incorporation of revisions in corporate plans and annual budgets?

(d) Control of Plans, Budgets and Performance

(i) what is the system of control of actual performance vis-à-vis corporate plans and annual budgets?

(ii) how does the accounting system serve control in (i)?

(iii) who prepares financial reports relating to performance, corporate plans and annual budgets?

(iv) does the reporting system allow control and variation of corporate plan execution by functional managers? On a timely basis? With adequate information?

(v) are adequate corrections made to corporate plans and annual budgets on a timely basis? By whom?

(vi) what controls exist over contingencies?

(e) Structure and Contents of Budgets

(i) what is the analytical structure and degree of detail of the annual budget?

(ii) is there a physical budget in addition to a financial budget?

(iii) what identification and form of presentation of capital and recurrent expenditures and revenues are in use?

(iv) are line-item classifications objective or subjective? 3

(v) is a cash or accrual accounting system in use?

(vi) what period(s) of forecasting (month, year, multiyear) are in use?

(f) Bases for Forecasting

(i) what controls exist over contingencies?

(ii) are analytical supporting data used (statistical analysis, financial ratios)?

3 Objective classification is analysis by operational units or by output (e.g., for a power utility, generation, transmission, distribution, etc.). Subjective classification is analysis by basic inputs (e.g., salaries, wages, fuel, supplies).
(iii) are corresponding results or data for previous and current years available?

(g) Cash Flow Budget

(i) how is the cash flow budget operated?
(ii) who approves and executes it?
(iii) how frequently is it prepared (daily, weekly, monthly, annually)?
(iv) who relates forecasts to actual position and how regularly?
(v) can the cash flow budget override the main budget(s) (e.g., by stopping payments or by stopping excessive short-term borrowing)?

15. The foregoing review should be used to judge the effectiveness of corporate planning and budgetary processes, and the degree to which changes should be sought to improve their efficiency. In particular, it should be used to determine the borrower's ability to achieve controlled implementation of the project and covenanted financial performance (e.g., levying of taxes and charges), after taking account of any constraints which may be imposed by superior authorities. Where possible, the borrower should be asked to remedy any deficiencies before the project begins. If extensive modifications are required, agreement should be sought during negotiations, on what is to be done, the timetable for implementation, external assistance requirements, and whether the improvements should form a project component (for example, a new budgeting system).

Financial Accounting

16. A borrower may use an Accounting Manual or a Procedures Manual, or both to prescribe regulations and responsibility for operating the accounting system. The system flow, record keeping and authorization procedures for making amendments or corrections are normally described in the latter manual, together with machine accounting or computing procedures, where applicable. A system may be based either on an internally constructed coding system or on a national Chart or Code of Accounts. Such a chart, or internal coding system, and the manuals mentioned above, where available, should be reviewed to determine the effectiveness of the accounting system with regard to (a) sound design and ability to respond to project, and, where applicable, entity requirements and (b) the extent of compliance in practice with the manuals and codes. Updating of manuals or redevelopement of an ill-structured code system may need to be addressed before or during project implementation.

17. A financial accounting system should consist of at least the following:

(a) a system of records or accounts of individual transactions, sometimes referred to as books of "prime entry," e.g., cash books;
(b) a self-balancing system of "control and total accounts" derived from the totals of accounts in the books of prime entry, sometimes referred to as the "general ledger;"
(c) a system for making transfers and adjustments between accounts, sometimes referred to as the "journal."

The individual transactions may be grouped into separate accounts (or account books) for each category, such as cash, salaries and wages, purchases, loans received, etc. The general ledger should be the principal source of information for financial statements and financial reporting. The foregoing is oversimplified, but a preparation or appraisal mission should satisfy itself that in an existing entity these records at least can be traced in some form. Many systems will use data processing with possible difficulties in tracing the flow of entries. Reviews may require the use of specialists; alternatively it may be sufficient to discuss the systems flow with the internal and/or external auditors. On the basis of these discussions, it should be possible to determine the suitability and quality of the system.

18. The principle by which accounting entries are made should be determined. Ideally, the books of an autonomous revenue earning entity should be maintained in accordance with double-entry accrual principles. A government entity's accounting system that operates on a double-entry cash basis may be ac-
cepted, however, as long as the entity maintains subsidiary records that make it possible to determine capital and current expenditure transactions, a cash flow and an analysis of commitments and receivables where necessary, at the beginning and end of each fiscal year.

19. In the absence of confirmatory evidence, e.g., auditors’ reports, limited checks should be made to establish that accounting records are kept up-to-date, with regular balancing (monthly, quarterly) and provision of financial reports on predetermined dates, by requesting and examining trial balances, the dates on which they are taken, and the period covered by the transactions. As a guide, a trial balance taken later than one month after the close of an accounting period may be unsatisfactory. Selected items may be traced from the annual financial statements through the appropriate books of account (e.g., fixed assets to the assets register) (a) to confirm the statement entries and (b) to understand the information assembly and low in the system.

Cost Accounting

20. Cost accounting systems may not be available or necessary in many project entities. Specialized costing systems may, however, offer substantial benefits to some projects or specified parts of some entities.

4 Simply defined, cash accounting records transactions only as cash is paid or received; in accrual accounting, transactions are recorded at the time expenses are incurred or income earned.

5 In this context, a trial balance is a listing of all debit and credit balances in a ledger system, used as an initial test only to determine if a double entry system is in balance. It is not a verification, because it cannot reveal certain types of errors.

6 An accounting period in this context is a period (one week, one month, three months, etc.) chosen to allow regular accounting control. It should not be confused with a fiscal year, which is usually a legal accounting period.

operations both in determining costs of services as well as costs of products, by providing early and measurable comparisons of performance against determined standards. It is preferable if the cost accounting is an integral part of the financial accounting system so that all inputs each system are mutually consistent. Costing systems separate from the accounting system may exist; in such cases, however, confirmation should be obtained that adequate controls are used in each system to reconcile the data.

21. A costing process may require a considerable degree of analysis to enable managers to control all inputs to a production process. Staff should ensure that: (a) the entity is using its costing system to provide valuable management information, (b) costs and benefits are evaluated before recommending such a system and (c) the entity is capable of operation a costing system.

Internal Control and Internal Auditing

22. One of management’s more important functions is the design and maintenance of internal controls to achieve accountability at all levels in an entity. Typical elements of internal control should include:

(a) enabling legislation
(b) by-laws, standing orders
(c) policies, objectives
(d) systems and procedures
(e) organization structures providing for segregation of duties
(f) job descriptions
(g) planning and budgeting
(h) accounting
(i) financial and physical performance reports
(j) internal auditing
23. Sound management and effective internal control require the organizational independence of the operating, custodial and accounting departments. Operating departments should not have any principal accounting or custodial functions, even though they may be responsible for producing and recording initial or basic data. Initiation and authorization of a transaction, its recording and custody of the resulting asset should be separated. Thus, receipts and disbursement of funds should be divorced from accounting. A materials department should not have access to the principal accounting records used for checking storekeeping integrity and a production department should not compute its own costs. Normally, duties and responsibilities should be so segregated that no one person will handle a transaction completely from beginning to end.

If that division is not feasible, other protective practices must be devised. These internal checks help establish the reliability and integrity of the accounting records and information.

24. While small entities have to rely on internal checks and controls, larger organizations should have some form of internal audit. Internal auditing's unique role consists of assessing how well the other control elements work and the extent to which they are relevant to the systems. In most entities, the internal auditor is also expected to propose remedial action when called for. An internal audit unit consists of a person or a group reporting to the management — if possible, independently of the financial managers. Ideally, the internal auditor should have as much freedom to decide on his role and operations as the external auditor; otherwise, his position may become untenable and be of little use for assuring accountability.

25. Typical matters which internal audit should appraise and report on to management include:

(a) the effectiveness of accounting, financial and operational controls, and any needs for revision;
(b) the extent of compliance with prescribed policies, plans and procedures;
(c) the reliability of accounting systems, data and financial reports;
(d) methods ofremedying weak controls or creating them where there are none;
(e) verification of assets and liabilities.

26. An internal auditor should work within a well-defined framework of programs and reporting requirements. If there is a data processing installation, the internal auditor should be authorized to ensure that computer program changes and amendments are consistently monitored to prevent irregularities. To examine the extent and effectiveness of internal checks and controls, their associated costs may be reviewed against those of the external audit; without the former, the external system may be overly expensive; conversely the costs of an internal audit by permanent staff may be much higher than those of an external auditor.

Data Processing Systems

27. Two main features of the systems may require examination:

(a) the effectiveness and security of existing systems and related equipment; and
(b) any proposals by a borrower to install new equipment and/or systems as part of a project. Complex systems, may require the advice of a specialist. The first feature will require examination for the compatibility of the data processing system with other elements of the financial accounting process, and any directly related activities of the borrower, e.g., inventory and experienced managerial, supervisory accounting, bookkeeping, clerical and data processing staff. Well-run organizations have professionals who specialize in staff selection and training arrangements. In a revenue earning entity, there should be at least one senior manager in the system with financial experience and an accounting background sufficient to enable him to make adequate judgments about staffing matters in the accounting/finance department(s).

28. Appraisal should include a review of staff numbers and quality to ensure that these are appropriate for the kinds of activity and output required. For example: cash management (i.e., the treasury function)
should have staff who specialize in cash-flow forecasting, drawings from cash collection, bank deposit arrangements and general cash stewardship. A controllership function should have specific staff to address, inter alia, financial planning and budgetary control general and cost accounting financial systems and procedures; and data processing and management information systems.

29. Recruitment procedures should be examined for their suitability. There should be an adequate employee training program and periodic personnel review to judge whether employees are performing satisfactorily. These programs may involve formal training given before the position is occupied or on-the-job training or some combination of both. It may also be necessary to examine the quality of internal and external training programs to advise the borrower and/or the entity on the need for improvement or expansion. Judgments on the effectiveness of hiring procedures, the quality of existing staff, and on the quality of training programs should be reflected in a mission’s report on the financial management system.
NOTES
REVIEWS OF FINANCIAL MANAGEMENT AND ACCOUNTING SYSTEMS FOR ENTITIES IMPLEMENTING NON-REVENUE EARNING PROJECTS

1. Most non-revenue earning projects will be implemented by government agencies. The following checklist is therefore designed mainly to promote examination of typical government budgeting, accounting and internal control systems, and should be read in conjunction with Annex IV, which contains detailed recommendations for reviews which are common to both revenue earning and non-revenue earning projects.

- Government accounting
- Status of entity
- Financial regulations
- Financial management and accounting:
  (i) Budgeting and budgetary control
  (ii) Financial systems and procedures
  (iii) Financial accounting and costing
  (iv) Internal control

Basic systems to establish and maintain accountability

**Government Accounting**

2. Many non-revenue earning projects will be executed by entities that are part of a government, government-controlled, or government-sponsored. A full understanding of the principles and operation of each budgetary and accounting system involved in such cases should be obtained before a project is implemented. Government budgetary and accounting systems may include seemingly excessive bureaucratic pre-payment measures, repetitive bookkeeping maintained at different level or locations. Performance delays caused by apparent lack of delegated responsibility, and "old-fashioned" rules and regulations. Staff are urged to seek improvements in government budgetary and accounting only when they, and the government, are fully satisfied that the new procedures will at least maintain and, wherever possible, improve accountability and facilitate project implementation. Dismantling existing checks and controls in systems, without substituting adequate new measures and without the trained staff to implement them, can have serious consequences.

3. Governments undertake a wide range of services, often as the largest collectors and users of funds in a country. This requires sound financial systems within government, with mandated methods of budgeting and accounting. These are usually established on a "cash" basis, however, in contrast to the accruals system usually adopted in commercial practice. When a project entity forms part of a government administration; a government’s financial management and accounting practices would normally apply to it, unless agreement can be reached on specialized accounting arrangements for a project, and, where applicable, the project entity.

4. The location of responsibility of government accounting services varies among countries. In some, an accountant-general or comptroller may be responsible; in others, the Ministry of Finance may assume jurisdiction; in others, it may be difficult to identify responsibility -- the systems having been established under earlier regimes, with no continuity of responsibility. Determination of this responsibility may be necessary if accounting changes are required to implement a project, or to improve a project entity’s operations.

5. The senior financial staff of a recognized government accounting service may hold responsible roles (e.g., accountants-general), from which they can influence the development and maintenance of sound
accounting practices. The existence of these services cannot, however, be taken to imply that government practices are automatically sound and acceptable for prospective project entities. Prescribed government practices may have been unofficially modified at the local level because they are too detailed, misunderstood or ill-supervised.

6. Staff should familiarize themselves with the precise roles which responsible officials play in controlling and monitoring the performance of accounting in government before seeking their assistance on specific project matters. The term "accountant" in government often has a very different meaning or interpretation from "public accountant" in the private sector. An accountant-general may be a designation for an official post, whose incumbent may have little or no knowledge of finance and accounting.

Status of the Entity

7. The status of an entity should be established to determine, in particular, its ability to:

(a) budget for and obtain budget approvals for required funds;
(b) furnish funds promptly for project implementation and operation and maintenance;
(c) institute, operate or amend financial accounting systems to respond to Bank requirements;
(d) provide the necessary staff, with requisite skills, for project implementation;
(e) institute satisfactory internal and external controls and audit arrangements.

To the extent that any of the above requirements is outside the entity’s jurisdiction, staff should conduct the examination with the responsible institution(s) to ensure either their agreement to fulfill the requirements promptly or to delegate to the entity the right(s) to implement them during the project period.

Financial Regulations

8. Any existing regulations on the operation of financial management and accounting systems (Annex IV, para 9) should be reviewed to ensure their compatibility with the Bank’s requirements. Any amendments to regulations should be made only to strengthen an entity’s internal systems, in addition to supporting the project.

Financial Management and Accounting

Budgeting and Budgetary Control

9. The reviews relating to annual budgets and budgetary control recommended in Annex IV are also appropriate as far as they apply to a non-revenue earning project. Experience with these projects, however, emphasizes the importance of determining the budgetary system that will apply during the project period. At appraisal, staff should be satisfied that they fully understand the system and that they have obtained (or can obtain at negotiations) agreement on:

(a) The budget procedures to be used by an entity and by controlling institutions giving higher level approvals which will ensure timely and adequate project implementation;
(b) the timing of all budget framing and approval operations to ensure annual allocation and release of funds; and
(c) the timing of release of counterpart funds provided in budgets.

10. If a borrower’s fiscal year in which the project is due to begin starts before the date of loan effectiveness, it is essential to ensure that the budget for project start-up (including the costs of operating the project entity and its accounting system, and of engaging auditors) is available for the initial fiscal year. The availability of such funds should be mentioned in the SAR. If there are no budget provisions the SAR should describe how the project will be funded pending budget authorization.
Financial Accounting and Costing

11. It is preferable that an entity maintain at least the records specified in Annex IV, para. 16, but in some accounting systems (particularly those of governments) many such records -- particularly control accounts -- may not be maintained. Typical government accounts may reflect only budget heads for services. A project or project component may utilize only one line in an expenditure “block,” or it may even be contained with other items in a one-line entry. Unless staff make early requests for more detailed reporting, project subcomponent expenditures may be impossible to control when the project starts.

12. When a government budgetary and accounting system is to be used, it is useful to decide the details of project expenditures for which regular reporting will be required, and whether these can be introduced into the accounting or costing system without difficulty. If they cannot, then the borrower and/or the entity should be asked to establish a subsystem to meet the Bank’s accounting and financial reporting requirements. An entity should be encouraged to use the resultant totals of a subsystem to support or reconcile the data in the standard system; i.e. the subsystem should become an integral costing system of the main accounting system.

13. Whichever system an entity uses, it must be capable of clear and timely disclosure of:
   (a) project costs by components agreed on between staff and the entity for each project;
   (b) operating costs by budget heads analyzed in enough detail to provide control of incremental current expenditures; and
   (c) the basis for all types of claims for disbursement of loans.

   Item (a) is particularly important in government accounting, where asset records covering a period of years are not often maintained.

14. The Bank may agree to finance incremental recurrent expenditures, i.e., expenditures above a particular level established at an agreed time with a borrower. Government accounting systems may not distinguish between base and incremental expenditures, particularly in the case of salaries, wages and related overheads. It is therefore necessary to agree with a borrower on adequate means of identifying both budgetary provisions and accounting data that can provide for and report on these expenditures. The following steps could be taken: establishing appropriate accounting for special heads of expenditure, subcodes, subsystems and special reports; agreeing on accounting for only the main heads of expenditure concerned and developing a formula for periodic application to total expenditures under those budget heads to obtain a reasonable apportionment of incremental expenditures; and continuously revising base and incremental costs.

Internal Control

15. Any system to support a project should include the basic control measures mentioned in Annex IV. If the internal checks and control systems are not satisfactory, and the effectiveness of the external audit is not established, then the project should not be allowed to proceed until the borrower and/or entity has agreed to strengthen the internal control systems.
ACCOUNTING FOR SECTORS

1. The following are some key features affecting the accounting for selected sectors.

Financial Sector

2. The success of a financial sector program depends on the preservation of capital and the introduction of control and tracking mechanisms which monitor the quality of the portfolio and the financial returns accruing to it. Many Bank projects will be involved with Development Finance Institutions (DFI) whose credit activities and financial health are required to be self-sustainable. To be self-sustainable, it is important that the financial institution earns sufficient net income to maintain its equity in real economic terms (i.e. after allowing for inflation). To achieve this position, interest income which will be influenced by the market rates should be sufficient to cover the costs of financing, operating expenses and any reasonable loss on its portfolio. However, in some instances the government may wish to finance an element of subsidy to cover abnormal operating costs and portfolio losses arising from lending to targeted groups and areas. It is important that revenues and costs are properly segregated to provide the information needed to calculate the subsidy necessary to cover the impact of the targeted operation, and the performance indicators used in the financial sector to measure efficiency. Some key concerns which should be addressed in evaluating a financial management system in this sector are:

- Degree of independence of the finance institution from government policies and interventions.
- Conservative principles regarding the recognition of interest income;
- Clear accounting policies on the classification of performing and non-performing loans and provision for bad debts;
- Separate income categories for interest, non-interest charges associated with the loan, and other non-loan sources of income such as a direct subsidy payment for operating expenses;
- Separate categories for each major source of funding. Many DFIs receive subsidies via below market interest rates. To calculate the subsidy, concessional loans funds must be segregated in the books.
- Ability to generate key performance indicators such as return on equity, average interest income to the portfolio, operating expenses to income, loan losses to income, arrears to amount collectible, average cost of funds, average return on equity; percent performing loans, portfolio at-risk, etc.

Infrastructure

3. Infrastructure activities relate to almost all sectors, for example, the construction of irrigation dams, schools, roads, etc. These are usually large investments over a period of time that require careful monitoring for implementation against the plan. Some specific aspects requiring attention include:

- the management of large contracts with possible cost overruns compared to original plans, including estimation of costs to completion;
- the effects of foreign exchange movements in local currency on costs of imported equipment and foreign denominated aspects of contracts;
- capitalization of construction costs; and
- delays caused by a delay of early securing of land and other rights; the need for a large amount of counterpart financing which may pose a problem for borrowers.

Utility and Transportation Sectors

4. The utility sector is usually comprised of energy, water, and telecommunications projects. The transportation sector includes ports, railways and pub-
lic road transportation. Associated issues could include:

- Management of large contracts with possible cost overruns compared to original plan;
- Foreign exchange movements in local currency which could have a significant impact on indebtedness, and on operating costs (fuel and spare parts);
- Hyper inflation environment requiring the revaluation of assets;
- Projects usually require a large amount of counterpart financing which may pose a problem on liquidity;
- Good financial information for tariff or rate setting, for monitoring usage and billing, for collections, and other performance indicators;
- Separation of production and costs of key monitorable areas such as power generation, transmission, and distribution in the energy sectors and similar process functions in the water sector.

Industry and Agri-Business Sectors

5. These sectors would include many of the features of the utility sector; associated issues include:

- Foreign exchange movements in local currency which could have significant effect on indebtedness, and on operating costs for raw materials, fuel, spare parts, and other inputs, and on export prices particularly for the agri-business sector.
- Hyper inflation environment requiring the revaluation of assets which affect operating costs, and on export oriented activities which would affect income;
- Separation of manufacturing and other production costs from overhead costs, and of fixed assets from production assets.

The recording and valuation of inventories taking into consideration net realizable value of inventories (perishability in agri-business);
- The production cycle, particularly in agri-business e.g. tree farming.

- Degree of independence (where controlled by governments) on price setting.

Human Resource and Agriculture Sectors

6. For those sectors of a non-revenue earning nature, such as human resources which covers health, education, population, etc.; and agriculture, which covers research, farmers' technical assistance including extension; and irrigation—the projects are usually implemented by the government through one of its departments or agencies. These projects are, therefore, heavily affected by the condition and sophistication of the government's financial management structure of which they may become a part. On occasion, they may be accounted for entirely separately from the government accounts. For these projects, the Bank would usually be concerned with the structure and controls affecting the project. Because the government does not measure performance via profitability, performance indicators have to be carefully constructed using both physical and financial data. Some common items to be considered in providing for the financial accountability of the above projects are:

- Clear segregation of project expenditures within the government accounting system;
- Establishment of linkages between project expenditures and the government's accounting system;
- Identification and linkage of projects expenditures and physical information required for performance indicators;
- Clear identification of how the projects are financed whether through government budget and expenditure system or whether separately financed, including the identification of counterpart and/or donor financing;
- The consolidation of sub-project accounts where there are several sub-implementing agencies;
- Accounting treatment of assets utilized by the project:
- The requirements of co-financing and/or donors, where applicable;
- The segregation of recurring cost from investment cost; and
• Any other additional issues which relate to the specific sectors.

Agriculture

7. The agricultural sector is composed of both revenue and nonrevenue earning entities. The revenue earning entities are covered in the discussion on Industry and Agri-Business (para 5). Among nonrevenue projects, such as research, technical assistance and extension projects, accounting requirements would be similar to those discussed above. Agricultural credit projects would have similar characteristics to those discussed under the financial sector. Some specific characteristics of agriculture are:

• A long operating or production cycle. Operating cycles may range from a low of 6 months (where there are two growing seasons a year) to 6 years and more in the case of tree farming (citrus fruits, for example).
• Agricultural projects use net realizable worth or lower of cost to value agricultural products.
• Seasonal aspects and perishability of production.
TM REVIEW OF STATEMENTS OF EXPENDITURE

The TM should use the following as a guide and may omit some procedures he/she considers unnecessary after consultation with an Accounting and Auditing Professional.

1. Through discussion with borrower staff, obtain an understanding and document (or update previous documentation of) the process and related controls by which expenditures are committed, reviewed, approved, paid, and identified for inclusion in loan withdrawal applications.

2. Consider the effectiveness of the following controls and document any instances where controls are lacking or are considered in need of strengthening:

   • Appropriate levels of review and approval are in place and are followed for each stage of the expenditure process.
   • Procedures and responsibilities are clearly defined and are adequately documented.
   • Adequate segregation of duties exists between the initiation, authorization, disbursement, and recording functions.
   • Authorization and approval is obtained prior to incurring of the expenditure.
   • Documentation is maintained for an adequate period of time for purposes of fulfilling audit requirements as well as review by Bank staff.
   • Commitments are made after applicable procedures have been followed.

3. Obtain a listing of all SOEs submitted during the period under review and for selected SOEs from this listing, and have borrower staff retrieve the supporting documentation for the expenditures.

4. For each expenditure, perform the following:
   (a) Evaluate the adequacy of the supporting documentation which should normally include one or more of the following:

      • procurement documents (bid documents, invitation, evaluation, award
      • purchase contract
      • purchase order
      • letter of credit
      • supplier’s invoice and certificate of origin
      • shipping or import documents and inspection certificates
      • contractor’s invoices or certificates
      • other evidence of receipt of goods or services
      • force account records
      • recurrent cost records
      • authorization for payment
      • evidence of payment/bank statements
      • accounting records of approvals, disbursements, and balances available
      • evidence that refunds have been made by suppliers and corresponding adjustments made in subsequent applications in instances where goods have been returned.

   (b) Ascertained that the expenditure was properly authorized and approved.

   (c) Verify that the expenditure is eligible for Bank disbursement under the loan agreements. Ineligible expenditures would include:
- duplicate invoices;
- payments made in advance of receipt of good or delivery of services, unless these payments are consistent with contract provisions and are established commercial practice;
- payments that should have been made under normal disbursement procedures with full documentation (e.g., payments against contracts subject to the Bank's prior review, or payments against contracts with values exceeding defined SOE limits; and
- payments for items that are not procured in accordance with the legal agreements, such as:
  - payments for items from countries that are not eligible under the Bank's Procurement Guidelines;
  - payments for items not specified in the procurement;
  - payments made prior to loan signing or before the eligible date specified for retroactive financing;
  - payments for items on the negative list or not on the positive list (for adjustment operation lending).

(d) Verify the mathematical accuracy of the SOE.

(e) Agree the percentage used to determine the Bank's share of the total disbursements to the loan agreements. Verify that the proper amount was requested for reimbursement.

(f) Summarize the results of the work performed on a summary form.

(g) Notify borrower of all instances of negative findings.

5. Where appropriate and practical, consider physically observing significant items purchased on a test basis to confirm their existence.
USE OF FINANCIAL INFORMATION TO MONITOR PHYSICAL PROJECT IMPLEMENTATION

Need for Financial Information

Project Managers need to have accurate, timely and reliable financial information not only to evaluate performance but more importantly to help dynamic problem solving by anticipating the latent problems and risks at different steps of project implementation in a dynamic social, economic, and financial environment.

Financial information on project implementation becomes of prime importance when there exists an endemic inadequacy of managerial information systems in the borrowing developing country.

Use Financial information to:

**Ongoing projects**
- Evaluate project implementation status
- Analyze the variance of projects costs against budget and by sector
- Identify end-use of resources used
- Identify and anticipate problems and risks
- Decide necessary modifications to project design
- Reassess project objectives in light of experience and new developments
- Reallocate resources

**Ex-post**
- Analyze project objectives variance
- Identify project features that should be replicated and pitfalls to be avoided
- Identify potential for improvement through hindsight

Major methods to monitor project performance
- Key Factor monitoring
- Variance Analysis
- Financial Analysis and Projection

**Key Factor Analysis**

Key Factor analysis is an inexpensive way of providing a simple indicator of project health and of potential and actual problems. The majority of projects have a few factors whose performance is a very sensitive indicator of overall project performance. Such factors are designated as key factors. Key factor variance ranges may be set up for each project for every step of project implementation and at the time of commitment to the project; and key factor variance analysis is regularly carried out by the project manager to monitor project implementation performance. Any major variance from key factor tolerance limits is an indicator of actual or potential problems and should be investigated. If major variance is a reason for unavoidable circumstances, and cannot be corrected, key factor variance tolerance limit for future project implementation stages should be changed accordingly.

**Examples of Key Factors**

**At the project implementation stage:**
- In the Energy Sector, key factors may be — for an hydro-electric project — percentage of completion per dollar of resource input, which may vary according to the stage of completion of the project.
- In the Agricultural Sector — for an irrigation project — $ cost incurred per canal mile may be the key factor.
- In the Education Sector — for a primary education project — cost incurred per 1,000 pupils at education facility may be the key indicator.
At the ex-post performance evaluation:

In the Energy Sector, key factors may be:

- kilowatt-hour per dollar of resource input, where resource input can be;
- replacement price of a non-renewable resource (like crude oil);
- socio-economic cost of displacement of people; and/or
- environmental damage resulting from the construction of a hydro-electrical generation station

Variance Analysis

Variance analysis with plan is the most widely used method of using financial information to measure project implementation and ex-post project performance; it requires a more extensive monitoring system than the key factor analysis method. Actual expense and performance is compared with the plan, to identify actual and potential problems by expense category. Any variance is investigated, and if it is justified, the plan is revised to take the variance into account for future analysis.

For an irrigation project, for example, the expense categories may be:

- canal building
- installation of pump sets

- electrical systems
- soil analysis
- dredging expenses
- education of farmers
- relocation cost of displaced farmers

Financial Analysis and Projection

This is the most extensive and forward-looking method in monitoring projects, and should be used as a complement to the other methods. The aim is to analyze the current performance data of project implementation and forecast the expected next steps to complete the project. Potential problems become more evident, and optional solutions surface.

Sources of Financial Information

- cost accounting data of the project
- balance sheet, income statement, and sources and uses of funds statement, and other accounting data
- financial analysis carried out during project analysis at the time of commitment
- social, financial and economic data from the borrower/country
FORM LETTER

Annual Reminder to Borrower of Requirement to Appoint Auditors

(for audits by private firms only)

Send before end of each year

re: Loan/Credit _________

Dear _________:

This is to remind you that the Bank's Guidelines regarding independent audits recommend that the auditor be appointed before the beginning of each year.

Please notify us of the name of the firm and whether the same firm, ________________, has been appointed to perform the annual audit for ____________. If not, please furnish names of firms being considered and the other information set out in Guidelines, paragraphs __________, so that this may be reviewed and communication made to you regarding acceptability in time to appoint the auditor before the start of the new year.

Sincerely yours,
FORM LETTER

Reminder to the Borrower of Requirement for Timely Submission of Report

Send before end of each year

re: Loan/Credit _________

Dear _________:

This is to remind you that the annual audit of ________________ pursuant to the above indicated Loan Agreement is required to be submitted to the Bank no later than ________________ according to Section _____ of the Loan/Credit Agreement.

We appreciate very much your reminding the auditors of their need to begin the planning interim and year-end audit work in such a way as to ensure compliance with this requirement. Please advise us directly if you contemplate any difficulty in compliance.

Thank you for your cooperation,

Sincerely yours,
Notice to Borrower of Failure to Receive Audit Report

Send 1st day after deadline has passed

AUDIT REPORT REQUIRED BY SECTION _________
LOAN/CREDIT AGREEMENT NO _________ HAS NOT BEEN
RECEIVED AS AT _________________. PLEASE ADVISE STATUS
BY RETURN TELEX. REGARDS

(Note: If not answered or answered unsatisfactorily subsequent telex should be more forceful and should be sent at least every 15 days.)
Acknowledgment of Audit Report

Send to the borrower immediately upon receipt of audited financial statements

re: Loan/Credit _________
Dear _________,

We acknowledge the receipt of the audited financial statements of _________ _________ as required under the above indicated Loan/Credit Agreement.

We will review it within the next few days and if we have any comments or questions, we will communicate accordingly.

Thank you for your cooperation.

Sincerely yours,

or

Dear _________,

We acknowledge the receipt of the audited financial statements of ________________________ for the fiscal year end December, 19xx.

We will review it and if we have any comments, we will communicate with you accordingly as soon as possible.

Sincerely yours,
GUIDELINES FOR THE DESK REVIEW OF
AUDIT REPORT

1. The following Guidelines are for the Desk Review of the audit report (financial statements and audit opinion) received by the Bank. However, it is important to understand that these guidelines will not cover all the scenarios and that the TM should seek the assistance of a professional accountant whenever considered necessary. For example, the review of the financial statements of a revenue earning organization is much more involved than the review of a simple project financial statement involving the Receipt and Expenditure of funds only.

Background

2. Obtain from LOALA the Loan balance of the project as at the report date, with a printout of disbursements a month before and after the report date of the financial statements (e.g December 31 for the year ended on that date).

3. Note date of the receipt of the report and ensure that an acknowledgment is sent to the borrower.

4. Compare the name of the auditor with that agreed by the Bank. The acceptability of the auditor including qualifications, independence and competence should have been agreed from the time of appointment.

5. Ascertain that the report received compares with that required by the Loan covenants i.e organization (entity) financial statements; project financial statements; separate SOE financial statements; special account financial statements.

6. Ascertain from the Loan Agreement and the Terms of Reference (TOR), which should have been given to the auditor, those financial covenants that should be covered under the audit, and any special requirement such as those that may require verification for compliance.
Review of The Audit

7. The audit opinion should be signed by the auditor and dated on the letter head of the audit firm or on paper showing the name and address of the auditor.

8. The audit report should be addressed to the borrower (implementing agency).

9. Ascertain if the audit opinion is unqualified, qualified, adverse or is a disclaimer (see Annex XX).

10. The audit opinion should show what accounting principles have been applied in the presentation of the financial statements (usually generally accepted accounting principles or it may say international accounting standards). The Bank’s Country Department should have already been aware of what are the generally accepted accounting principles of the borrower and their acceptability to the Bank.

11. The audit opinion should show the auditing standards applied (the Bank requires international standards on auditing or its equivalent).

12. Ensure that there is a definite opinion given by the auditor. In many audit reports (particularly government audits), there is a long discussion of issues without a clear conclusion or opinion on the financial statements. Recommend the use of a management letter (representation letter) for issues that are not sufficiently important to affect the true and fair view of the f/s.

13. Review the notes to the financial statements and the management letter (where available) to ascertain that there are no important issues that would require a change in the opinion given. For example, the notes and the management letter may indicate circumstances that would require that an unqualified opinion be changed to that of a qualified opinion.

14. Where SOE procedures are used, the opinion should have a separate reference to the use of SOEs (see Annex XX).

15. Where Special Accounts are integrated in the Project f/s, the opinion should have a separate reference to the use of the Special Account.

16. Where the TOR required compliance testing, ensure that the audit has addressed these in the opinion, possibly through a separate reference to the verification requested.

17. Generally, conclude whether or not the auditor has performed reasonable.
Review of The Financial Statements

18. The auditor may have done a good job but the report does not have an unqualified opinion. In these instances it is important to identify the main reasons for the qualifications, adverse or disclaimer opinion and to require explanations and follow up action, as necessary, from the borrower.

19. In reviewing the report the Reviewer should:

- ensure that the audit report was presented bound with all its sections identified (opinion, balance sheet, income statement, cash flow statement, notes to financial statements).
- identify the project where the project f/s are an integrated part of the entity f/s.
- identify the SOE Bank withdrawals where the SOE f/s is integrated in the project f/s (as recommended by the guidelines).
- identify the linkage with the Special Account f/s (usually a separate audit report but may be integrated in the project account).

20. Reconcile the Bank’s financing with the audit report (using the Bank’s printouts (from LOALA) and the movements through the special account where applicable). The cash flow statement (sources and application of fund statement) will be useful in this review.

21. Where interim unaudited f/s were received - compare the report to identify any significant differences in trends between the unaudited and audited reports and request from the borrower an explanation of significant changes.

22. Review the contents of the financial statement in total to ascertain the performance of the organization and/or the project and compare it with the SAR or budget for the period under review. The notes and management letter usually provides a wealth of information. The borrower should be asked to explain any significant variations to the results expected.

23. The receipt of the report and the results of the review should be entered into the ARCS.
NOTES
THE ELEMENTS OF FINANCIAL STATEMENTS
(Summarized from IASC's Framework for the Preparation and Presentation of Financial Statements)

Financial statements portray the financial effects of transactions and other events by grouping them into broad classes according to their economic characteristics. These broad classes are termed the elements of financial statements. The presentation of these elements in the balance sheet and the income statement involves a process of sub-classification. Elements may be classified by their nature or function in the business of the enterprise in order to display information in the manner most useful to users for purposes of making economic decisions.

Financial Position—The Balance Sheet

The elements directly related to the measurements of financial positions are assets, liabilities, and equity. These are defined as follows:

- An asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.

- A liability is a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits.

- Equity is the residual interest in the assets of the enterprise after deducting all its liabilities.

Classification of items in the balance sheet should be made in such a way as to be meaningful to the users of the financial statements. The following represent some typical items which should be considered for separate disclosure in the balance sheet:

- segregation of current assets and current liabilities from long-term assets and long-term liabilities

- current assets might include cash, marketable securities, receivable, and inventories

- current liabilities might include bank loans and overdrafts, the short-term portion of long-term liabilities, and payables

- long-term liabilities might include the long-term portion of loans, provisions, deferred taxes, and deferred income

- equity might include the various classes of share capital, paid in capital, revaluation surplus, reserves, and retained earnings.

Cash Flow Statement

Information about the cash flows of an enterprise is useful in providing users of financial statements with a basis to assess the ability of the enterprise to generate cash and cash equivalents and the needs of the enterprise to utilize those cash flows. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events.

The cash flow statement should report cash flows during the period classified by operating investing and financing activities. Further discussion of each of these classes of cash flows appears below:

1. Operating Activities The amount of cash flows arising from operating activities is a key indicator of the extent to which the operations of the enterprise have generated sufficient cash flows to repay loans, maintain the operating capability of the enterprise, pay dividends and make new investments without recourse to external sources of financing. Examples of cash flows from operating activities are:

- cash receipts from the sale of goods and the rendering of services
• cash receipts from royalties, fees, commissions, and other revenues; cash payments to suppliers for goods and services
• cash payments to and on behalf of employees
• cash receipts and cash payments of an insurance enterprise for premiums and claims, annuities, and other policy benefits
• cash payments or refunds of income taxes unless they can be specifically identified with financing and investing activities
• cash receipts and payments from contract held for dealing or trading purposes

2. **Investing Activities** The separate disclosure of cash flows arising from investing activities is important because the cash flow represents the extent to which expenditures have been made for resources intended to generate future income and cash flows. Examples of cash flows arising from investing activities are:

• cash payments to acquire and cash receipts from sales of property, plant and equipment, intangibles, and other long-term assets
• cash payments to acquire and cash receipts from sales of equity or debt instruments of other enterprises and interest in joint ventures
• cash advances and loans made to other parties
• cash receipts from the repayment of advances and loans made to other parties
• cash payments and cash receipts from futures contracts, forward contracts, option contracts, and swap contracts.

3. **Financing Activities** The separate disclosure of cash flows arising from financing activities is important because it is useful in predicting claims on future cash flows by providers of capital to the enterprise. Examples of cash flows arising from financing activities are:

• cash proceeds from issuing shares or other equity instruments
• cash payments to owners to acquire or redeem the enterprise shares

• cash proceeds from issuing debentures, loans, notes, bonds, mortgages, or other short or long-term borrowing
• cash repayments of amounts borrowed
• cash payments by a lessee for the reduction of the outstanding liability relating to a finance lease

**Financial Performance—The Income Statement**

Profit is frequently used as a measure of performance or as a basis for other measures, such as return on investment or earning per share. The elements directly related to the measurement of profit are income and expenses: these are defined as follows:

• Income is increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in increases in equity, other than those relating to contributions from equity participants.

• Expenses are decreases in economic benefits during the accounting period in the form of outflows or depletion of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distribution to equity participants.

Income and expenses may be presented in the income statement in different ways so as to provide information that is relevant for economic decision-making. For example, it is common practice to distinguish between those items that arise in the course of the ordinary activities of the enterprise and those that do not. Items which should be disclosed in the income statement include, but are not limited to:

• sales or other operating revenue
• depreciation
• interest income
• income from investments
• taxes on income
• unusual income
• significant intercompany transactions
• net income
SAMPLE OF PARTS OF FINANCIAL STATEMENTS OF A PROJECT IMPLEMENTING ORGANIZATION

1. This sample is to demonstrate the integration of a World Bank-assisted Project’s Financial Statement into that of an Implementing Organization’s Financial Statement.

2. The sample (pages 2-6) is based on a set of financial statements prepared by a borrower/country following the UK style presentation. A Sample Balance Sheet and Income Statement of the same entity following the US style is also attached on pages 7-8.

3. Note 13 to the financial statement summarizes the fixed assets of the organization:

   a) **Version 1** (Page 4) of this note shows separately the Bank-assisted project (called the Project). From this version, it is possible to see how much has been spent to date. The amount financed by the Bank would be agreed by the Auditor in the reconciliation of the loan (note 12 would summarize the loans, showing that due to the Bank). In this version, no separate Project Financial Statement may be necessary. However, other expenses, such as Financial Assistance, would need separate identification in the Notes to the Financial Statement.

   b) **Version 2** (Page 5) does not separately show those assets of the Bank-assisted Project. In this version, a separate Annex (which would need to be referred to in the Auditor’s Report) would be necessary.

4. Where a separate Project Financial Statement is required -- See page 6 for the Sample. This Financial Statement would require a separate audit report.

5. It is also suggested that, where practicable, the financial statements be presented for submission to the Bank in both US$ and the local currency.
ABC Power Company, Ltd.

**BALANCE SHEET**

As of June 30, 19XX and June 30, 19XY

(Indicate type of currency.)

<table>
<thead>
<tr>
<th>Notes</th>
<th>19XX</th>
<th>19XY</th>
</tr>
</thead>
<tbody>
<tr>
<td>SHARE CAPITAL</td>
<td>10 218,800</td>
<td>218,800</td>
</tr>
<tr>
<td>RESERVES</td>
<td>8 1,240,000</td>
<td>955,800</td>
</tr>
<tr>
<td>SHAREHOLDERS' FUNDS</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DEFERRED LIABILITIES</td>
<td>11 1,458,800</td>
<td>1,174,600</td>
</tr>
<tr>
<td>LOAN</td>
<td>12 50,000</td>
<td>76,600</td>
</tr>
<tr>
<td>CAPITAL EMPLOYED</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>2,794,800</td>
<td>2,515,200</td>
</tr>
</tbody>
</table>

Represented by:

| FIXED ASSETS | 13 2,965,000 | 2,556,700 |

CURRENT ASSETS

| Stocks | 14 889,200 | 738,900 |
| Debtors | 15 776,000 | 595,900 |
| Short term investments | 85,700 | 2,000 |
| Bank and cash balances | 16 64,300 | 56,300 |
| Subtotal: Current Assets | 1,815,200 | 1,393,100 |

CURRENT LIABILITIES

| Creditors | 17 1,786,000 | 998,600 |
| Taxation | 6 10,800 | 50,800 |
| Dividends - payable | 4,000 | 3,200 |
| - proposed | 22,900 | 22,900 |
| Loans repayable within one year | 12 53,400 | 142,300 |
| Deferred liabilities due within one year | 11 26,800 | 26,800 |
| Bank Overdraft | 16 81,500 | 190,000 |
| Subtotal: Current Liabilities | 1,985,400 | 1,434,600 |

NET CURRENT LIABILITIES

| (170,200) | (41,500) |

NET ASSETS

| 2,794,800 | 2,515,200 |

The accounts on this page and the pages to follow were approved by the Board of Directors and were signed on its behalf by:

______________________________ Directors
ABC Power Company, Ltd
REVENUE ACCOUNT AND STATEMENT OF RETAINED EARNINGS
For the Years Ended June 30, 19XX and 19XY
(Indicate type of currency.)

<table>
<thead>
<tr>
<th>Notes</th>
<th>June 30, 19XX</th>
<th>June 30, 19XY</th>
</tr>
</thead>
<tbody>
<tr>
<td>REVENUE</td>
<td>2,629,700</td>
<td>2,434,600</td>
</tr>
<tr>
<td>OPERATING EXPENSES</td>
<td>2</td>
<td>2,532,700</td>
</tr>
<tr>
<td>OPERATING INCOME</td>
<td></td>
<td>97,000</td>
</tr>
<tr>
<td>EXCHANGE LOSS</td>
<td>3</td>
<td>14,690</td>
</tr>
<tr>
<td>NET OPERATING INCOME</td>
<td></td>
<td>82,310</td>
</tr>
<tr>
<td>NET INTEREST EXPENSE</td>
<td>4</td>
<td>34,500</td>
</tr>
<tr>
<td>PROFIT BEFORE EXCEPTIONAL ITEM</td>
<td></td>
<td>47,810</td>
</tr>
<tr>
<td>EXCEPTIONAL ITEM</td>
<td>5</td>
<td>266,650</td>
</tr>
<tr>
<td>PROFIT BEFORE TAXATION</td>
<td></td>
<td>314,460</td>
</tr>
<tr>
<td>TAXATION</td>
<td>6</td>
<td>5,175</td>
</tr>
<tr>
<td>PROFIT AFTER TAXATION</td>
<td></td>
<td>309,285</td>
</tr>
</tbody>
</table>

RETAINED PROFITS

Prior year balance | 479,040 | 438,840 |
Retained profit for the year | 309,285 | 93,000 |
| | 788,325 | 531,840 |

Less: Dividends declared | 7 | 24,800 | 24,800 |
Taxation equalization reserve | 8 | 30,000 | 28,000 |
| | 54,800 | 52,800 |

Retained profit carried forward (see Note below) | 8 | 733,525 | 479,040 |

Note: Retained profit-carried-forward is part of Reserves that would be detailed in Note 8.
### ABC Power Company, Ltd.

**NOTES TO THE ACCOUNTS**

- Version 1 -

As of June 30, 19XX

(Indicate type of currency.)

#### 13. FIXED ASSETS

<table>
<thead>
<tr>
<th></th>
<th>Land and Buildings</th>
<th>Transmission Lines</th>
<th>Plant and Machinery</th>
<th>Motor Equipment</th>
<th>Furniture, Equipment, and others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>WB Project</td>
<td>Other</td>
<td>WB Project</td>
<td>Other</td>
<td>WB Project</td>
<td>Other</td>
</tr>
<tr>
<td><strong>Cost</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>July 1, 19XY</td>
<td>30,000</td>
<td>709,000</td>
<td>127,000</td>
<td>1,511,800</td>
<td>32,500</td>
<td>478,600</td>
</tr>
<tr>
<td>Prior year adjustment</td>
<td>0</td>
<td>435</td>
<td>0</td>
<td>680</td>
<td>0</td>
<td>191</td>
</tr>
<tr>
<td>Additions</td>
<td>10,000</td>
<td>105,327</td>
<td>50,410</td>
<td>36,190</td>
<td>17,500</td>
<td>48,200</td>
</tr>
<tr>
<td>Disposals</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>(865)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>June 30, 19XX</strong></td>
<td>40,000</td>
<td>814,762</td>
<td>177,410</td>
<td>1,546,445</td>
<td>50,000</td>
<td>526,991</td>
</tr>
</tbody>
</table>

**Depreciation**

<table>
<thead>
<tr>
<th></th>
<th>Land and Buildings</th>
<th>Transmission Lines</th>
<th>Plant and Machinery</th>
<th>Motor Equipment</th>
<th>Furniture, Equipment, and others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>WB Project</td>
<td>Other</td>
<td>WB Project</td>
<td>Other</td>
<td>WB Project</td>
<td>Other</td>
</tr>
<tr>
<td>July 1, 19XY</td>
<td>2,500</td>
<td>88,170</td>
<td>27,500</td>
<td>355,760</td>
<td>5,500</td>
<td>198,300</td>
</tr>
<tr>
<td>Charge for the year</td>
<td>1,000</td>
<td>9,700</td>
<td>10,000</td>
<td>50,400</td>
<td>2,200</td>
<td>16,000</td>
</tr>
<tr>
<td>On disposals</td>
<td>-</td>
<td>-</td>
<td>(25)</td>
<td>(775)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>June 30, 19XX</strong></td>
<td>3,500</td>
<td>97,870</td>
<td>37,475</td>
<td>405,385</td>
<td>7,700</td>
<td>214,300</td>
</tr>
</tbody>
</table>

**Net Book Value**

<table>
<thead>
<tr>
<th></th>
<th>Land and Buildings</th>
<th>Transmission Lines</th>
<th>Plant and Machinery</th>
<th>Motor Equipment</th>
<th>Furniture, Equipment, and others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>WB Project</td>
<td>Other</td>
<td>WB Project</td>
<td>Other</td>
<td>WB Project</td>
<td>Other</td>
</tr>
<tr>
<td>June 30, 19XX</td>
<td>36,500</td>
<td>716,892</td>
<td>139,935</td>
<td>1,141,060</td>
<td>42,300</td>
<td>312,691</td>
</tr>
<tr>
<td>Add: Construction in Progress</td>
<td>10,000</td>
<td>15,000</td>
<td>37,500</td>
<td>94,000</td>
<td>0</td>
<td>57,472</td>
</tr>
<tr>
<td><strong>TOTAL FIXED ASSETS</strong></td>
<td>46,500</td>
<td>731,892</td>
<td>177,435</td>
<td>1,235,060</td>
<td>42,300</td>
<td>370,163</td>
</tr>
<tr>
<td>June 30, 19XY</td>
<td>27,500</td>
<td>620,830</td>
<td>99,500</td>
<td>1,156,040</td>
<td>27,000</td>
<td>280,300</td>
</tr>
<tr>
<td>Add: Construction in Progress</td>
<td>90,430</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total at June 30, 19XX</strong></td>
<td><strong>2,556,700</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* World Bank Project expenditures are summarized on Page 6.
### 13. FIXED ASSETS

<table>
<thead>
<tr>
<th></th>
<th>Land and Buildings</th>
<th>Transmission Lines</th>
<th>Plant and Machinery</th>
<th>Motor Vehicles</th>
<th>Furniture, Equipment, and others</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>July 1, 19XY</td>
<td>739,000</td>
<td>1,638,800</td>
<td>511,100</td>
<td>206,600</td>
<td>314,950</td>
<td>3,410,450</td>
</tr>
<tr>
<td>Prior year adjustment</td>
<td>435</td>
<td>(680)</td>
<td>191</td>
<td></td>
<td>(1,235)</td>
<td>(1,289)</td>
</tr>
<tr>
<td>Additions</td>
<td>115,327</td>
<td>86,600</td>
<td>65,700</td>
<td>75,100</td>
<td>81,500</td>
<td>424,227</td>
</tr>
<tr>
<td>Disposals</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>(3,340)</td>
<td></td>
</tr>
<tr>
<td>June 30, 19XX</td>
<td>854,762</td>
<td>1,723,855</td>
<td>576,991</td>
<td>278,360</td>
<td></td>
<td>3,829,183</td>
</tr>
</tbody>
</table>

#### Depreciation

|                      |                    |                    |                     |                |                                |         |
|----------------------|                    |                    |                     |                |                                |         |
| July 1, 19XY         | 90,670             | 383,260            | 203,800             | 128,150        | 138,300                        | 944,180 |
| Charge for the year  | 10,700             | 60,400             | 18,200              | 24,600         | 23,700                         | 137,600 |
| On disposals         |                    | (800)              | -                   | (2,825)        |                                |         |
| June 30, 19XX        | 101,370            | 442,860            | 222,000             | 149,925        | 162,000                        | 1,078,155 |

#### Net Book Value

|                      |                    |                    |                     |                |                                |         |
|----------------------|                    |                    |                     |                |                                |         |
| June 30, 19XX        | 753,392            | 1,280,995          | 354,991             | 128,435        | 233,215                        | 2,751,028 |
| Add: Construction in Progress | 25,000 | 131,500 | 57,472 | - | - | 213,972 |
| TOTAL FIXED ASSETS   | 778,392            | 1,412,495          | 412,463             | 128,435        | 233,215                        | 2,965,000 |

|                      |                    |                    |                     |                |                                |         |
|----------------------|                    |                    |                     |                |                                |         |
| June 30, 19XY        | 648,330            | 1,255,540          | 307,300             | 78,450         | 176,650                        | 2,466,270 |
| Add: Construction in Progress | - | - | - | - | 90,430 |
| Total at June 30, 19XX |                    |                    |                     |                |                                | 2,556,700 |
ABC Power Company, Ltd.
Expansion Project - World Bank Loan No. 99999
Project Expenditures and Financing as of June 30, 19XX
(Indicate type of currency.)

<table>
<thead>
<tr>
<th></th>
<th>Current Period</th>
<th></th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Actual</td>
<td>Budget</td>
<td>Actual</td>
</tr>
<tr>
<td><strong>EXPENDITURES</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Civil Works:*</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loodney Power House</td>
<td>35,000</td>
<td>42,000</td>
<td>133,000</td>
</tr>
<tr>
<td>Glasney Power House</td>
<td>25,410</td>
<td>21,000</td>
<td>84,410</td>
</tr>
<tr>
<td>Subtotal: Civil Works</td>
<td>60,410</td>
<td>63,000</td>
<td>217,410</td>
</tr>
<tr>
<td>Plant and Machinery:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loodney Power House</td>
<td>10,000</td>
<td>10,000</td>
<td>28,000</td>
</tr>
<tr>
<td>Glasney Power House</td>
<td>7,500</td>
<td>7,500</td>
<td>22,000</td>
</tr>
<tr>
<td>Subtotal: Plant &amp; Mach.</td>
<td>17,500</td>
<td>17,500</td>
<td>50,000</td>
</tr>
<tr>
<td>Technical Assistance:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consultants - Institutional Dev</td>
<td>9,500</td>
<td>10,000</td>
<td>19,500</td>
</tr>
<tr>
<td><strong>TOTAL EXPENDITURES</strong></td>
<td>87,410</td>
<td>90,500</td>
<td>283,910</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>FINANCING</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>World Bank</td>
<td>55,600</td>
<td>54,300</td>
<td>180,000</td>
</tr>
<tr>
<td>Central Govt. Loan</td>
<td>17,700</td>
<td>18,100</td>
<td>60,000</td>
</tr>
<tr>
<td>Company Resources</td>
<td>14,110</td>
<td>18,100</td>
<td>43,910</td>
</tr>
<tr>
<td><strong>TOTAL FINANCING</strong></td>
<td>87,410</td>
<td>90,500</td>
<td>283,910</td>
</tr>
</tbody>
</table>


Land & Buildings           | 10,000 | 40,000 |
Transmission Lines         | 50,410 | 177,410 |
                                | 60,410 | 217,410 |

This Annex, Project Financial Statement, is required as an annex to the organization's financial statements where project cannot be identified (version 2). In version 1, this may not be needed.
### ABC Power Company, Ltd.

**BALANCE SHEET**

As of June 30, 19XX and June 30, 19XW (preceding year)

*(Indicate type of currency)*

<table>
<thead>
<tr>
<th>Notes</th>
<th>June 30</th>
<th>June 30</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>19XX</td>
<td>19XW</td>
</tr>
</tbody>
</table>

#### ASSETS

<table>
<thead>
<tr>
<th>Current Assets (A)</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>16</td>
<td>64,300</td>
</tr>
<tr>
<td>Stocks</td>
<td>14</td>
<td>889,200</td>
</tr>
<tr>
<td>Short term investments</td>
<td></td>
<td>85,700</td>
</tr>
<tr>
<td>Accounts Receivable (net of allowances)</td>
<td>1</td>
<td>776,000</td>
</tr>
<tr>
<td>Total Current Assets</td>
<td></td>
<td>1,815,200</td>
</tr>
</tbody>
</table>

| Fixed Assets (net of depreciation) | 13 | 2,965,000| 2,556,700|

**TOTAL ASSETS**

|       | 4,780,200| 3,949,800|

#### LIABILITIES AND STOCKHOLDER'S EQUITY

<table>
<thead>
<tr>
<th>Current Liabilities (A)</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Payable</td>
<td>17</td>
<td>1,786,000</td>
</tr>
<tr>
<td>Taxes Payable</td>
<td>6</td>
<td>10,800</td>
</tr>
<tr>
<td>Dividends - Payable</td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td>- Proposed</td>
<td></td>
<td>22,900</td>
</tr>
<tr>
<td>Loans Payable</td>
<td>12</td>
<td>53,400</td>
</tr>
<tr>
<td>Deferred Liabilities</td>
<td>11</td>
<td>26,800</td>
</tr>
<tr>
<td>Bank Overdraft</td>
<td>16</td>
<td>81,500</td>
</tr>
<tr>
<td>Total Current Liabilities</td>
<td></td>
<td>1,985,400</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Long-term Debt (A)</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans Payable</td>
<td></td>
<td>1,286,000</td>
</tr>
<tr>
<td>Deferred Liabilities</td>
<td></td>
<td>50,000</td>
</tr>
</tbody>
</table>

**TOTAL LIABILITIES**

|       | 3,321,400| 2,775,200|

<table>
<thead>
<tr>
<th>Stockholder's Equity</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>18</td>
<td>218,800</td>
</tr>
<tr>
<td>Retained Earnings</td>
<td></td>
<td>733,525</td>
</tr>
<tr>
<td>Reserves</td>
<td>3</td>
<td>506,475</td>
</tr>
<tr>
<td>Subtotal</td>
<td></td>
<td>1,240,000</td>
</tr>
</tbody>
</table>

**TOTAL STOCKHOLDER'S EQUITY**

|       | 1,458,800| 1,174,600|

**TOTAL LIABILITIES AND STOCKHOLDER'S EQUITY**

|       | 4,780,200| 3,949,800|
ABC Power Company, Ltd.

STATEMENT OF INCOME AND RETAINED EARNINGS
For the years ended June 30, 19XX and June 30, 19XW (preceding year)
(Indicate type of currency)

<table>
<thead>
<tr>
<th>Notes</th>
<th>June 30 19XX</th>
<th>June 30 19XW</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Revenue</td>
<td>2,629,700</td>
</tr>
<tr>
<td></td>
<td>Operating expenses</td>
<td>2,532,700</td>
</tr>
<tr>
<td></td>
<td>Income from operations</td>
<td>97,000</td>
</tr>
<tr>
<td>2</td>
<td>Other income/(expense):</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Exchange gain/(loss)</td>
<td>(14,690)</td>
</tr>
<tr>
<td>4</td>
<td>Interest expense</td>
<td>(34,500)</td>
</tr>
<tr>
<td></td>
<td>Total other income/(expense)</td>
<td>(49,190)</td>
</tr>
<tr>
<td></td>
<td>Income from operations before income taxes</td>
<td>47,810</td>
</tr>
<tr>
<td>6</td>
<td>Income Taxes</td>
<td>5,175</td>
</tr>
<tr>
<td></td>
<td>Income before extraordinary item</td>
<td>42,635</td>
</tr>
<tr>
<td>5</td>
<td>Extraordinary item - gain/(loss) net of tax</td>
<td>266,650</td>
</tr>
<tr>
<td></td>
<td>Net income</td>
<td>309,285</td>
</tr>
</tbody>
</table>

STATEMENT OF RETAINED EARNINGS:
Retained earnings at beginning of year | 479,040 | 438,840
Add:
Net income | 309,285 | 93,000
Subtotal | 788,325 | 531,840
Less appropriations:
Dividends declared | 24,800 | 24,800
Taxes | 30,000 | 28,000
Total appropriations | 54,800 | 52,800
Retained earnings at end of year | 733,525 | 479,040
SAMPLE OF PROJECT FINANCIAL STATEMENT
with SOE integrated

1. This sample summarizes Project expenditures by main disbursement categories with sub-headings. It may also be summarized by Project Activities, as per the SAR, whichever may be preferred. To demonstrate:

<table>
<thead>
<tr>
<th>Land Development heading</th>
<th>sub-heading</th>
</tr>
</thead>
<tbody>
<tr>
<td>Civil works</td>
<td>Earth works</td>
</tr>
<tr>
<td>Structure and building</td>
<td></td>
</tr>
<tr>
<td>Land costs</td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td></td>
</tr>
</tbody>
</table>

2. In addition, the financing of the Project is summarized to agree with the total Project costs.

3. Expenditures and Financing are summarized by:
   - Budget or Plan for the period and accumulated to date;
   - Actual for the period and accumulated to date;
   - Variance between Budget or Plan and Actual for the period and accumulated to date.

4. Investment costs are separated from recurrent expenditures.

5. **Balance Sheet** This is required where there are assets and liabilities. However, in most government projects, expenditures are financed through the budget and operate on a cash basis. Where accrual accounting is followed, a balance sheet is essential. Whether the cash or accrual basis of accounting is followed, a record should be kept of all the fixed assets (vehicles and equipment) required for project implementation. This may form a listing to be added to the Summary Project Expenditures.

6. **SOEs** The SOE expenditures should be integrated in the Project Financial Statements. Total financing will show “Loan from Bank/IDA -- via SOE procedures”, and the expenditures would be incorporated into the headings/sub-headings as necessary. An Annex summarizing withdrawal applications as in Page 3 would facilitate agreement with the Bank’s record.

7. Where the TM considers it necessary, or where the SOE (for some exceptional reason) is separately presented, then the withdrawals should be extended to show the categories of expenditures; see Page 3.

8. **Special Account** Where the SA is used to directly pay project expenditures, the SA may also be integrated into the Project Financial Statements. In these instances, the SA Financial Statement would be attached as an Annex. The amount shown in the Project Financial Statement as being financed by the Bank would correspond with that provided through the SA, with a reconciliation provided where necessary.

9. The Audit Report would also include a sentence to cover the audit of the SA (see Chapter V of Handbook).
XYZ Project Financial Statement
Summary of Sources and Uses of Funds
as of June 30, 19XX
(Indicate type of currency)

<table>
<thead>
<tr>
<th></th>
<th>Actual YTD</th>
<th>Actual Cumulative</th>
<th>Budget (SAR) YTD</th>
<th>Budget (SAR) Cumulative</th>
<th>Variance YTD</th>
<th>Variance Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>FINANCING:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Loan from Bank/IDA</td>
<td>10,000.00</td>
<td>15,597.84</td>
<td>13,000.00</td>
<td>19,500.00</td>
<td>(3,000.00)</td>
<td>(3,902.16)</td>
</tr>
<tr>
<td>Direct Payment</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(A) SOE Procedures</td>
<td>5,000.00</td>
<td>10,900.00</td>
<td>3,000.00</td>
<td>8,000.00</td>
<td>2,000.00</td>
<td>2,900.00</td>
</tr>
<tr>
<td>Central Government</td>
<td>6,007.60</td>
<td>7,500.00</td>
<td>3,500.00</td>
<td>8,000.00</td>
<td>2,507.60</td>
<td>(500.00)</td>
</tr>
<tr>
<td>Provinces</td>
<td>3,300.00</td>
<td>5,360.00</td>
<td>2,500.00</td>
<td>8,000.00</td>
<td>800.00</td>
<td>(2,640.00)</td>
</tr>
<tr>
<td>Prefectures and Counties</td>
<td>3,000.00</td>
<td>5,560.00</td>
<td>1,000.00</td>
<td>10,500.00</td>
<td>2,000.00</td>
<td>(5,350.00)</td>
</tr>
<tr>
<td>Farmers (cash or labor)</td>
<td>2,500.00</td>
<td>4,440.00</td>
<td>800.00</td>
<td>6,000.00</td>
<td>1,700.00</td>
<td>(1,560.00)</td>
</tr>
<tr>
<td><strong>TOTAL FINANCING</strong></td>
<td>29,807.60</td>
<td>49,297.84</td>
<td>23,800.00</td>
<td>60,350.00</td>
<td>6,007.60</td>
<td>(11,052.16)</td>
</tr>
<tr>
<td><strong>PROJECT EXPENDITURES (B):</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land Development</td>
<td>11,303.34</td>
<td>19,603.34</td>
<td>13,200.00</td>
<td>23,050.00</td>
<td>(1,896.66)</td>
<td>(3,446.66)</td>
</tr>
<tr>
<td>Conservation Engineering</td>
<td>5,407.21</td>
<td>9,707.21</td>
<td>2,775.00</td>
<td>10,400.00</td>
<td>2,632.21</td>
<td>(692.79)</td>
</tr>
<tr>
<td>Forest Development</td>
<td>6,640.70</td>
<td>13,940.70</td>
<td>4,500.00</td>
<td>20,500.00</td>
<td>5,140.70</td>
<td>(6,559.30)</td>
</tr>
<tr>
<td>Processing</td>
<td>833.13</td>
<td>1,613.68</td>
<td>600.00</td>
<td>1,550.00</td>
<td>233.13</td>
<td>63.68</td>
</tr>
<tr>
<td>Support Services</td>
<td>854.22</td>
<td>1,603.68</td>
<td>800.00</td>
<td>1,550.00</td>
<td>54.22</td>
<td>53.68</td>
</tr>
<tr>
<td>Institutional Development</td>
<td>1,276.99</td>
<td>1,829.23</td>
<td>1,450.00</td>
<td>2,300.00</td>
<td>(173.01)</td>
<td>(470.77)</td>
</tr>
<tr>
<td>Recurrent Costs</td>
<td>492.01</td>
<td>1,000.00</td>
<td>475.00</td>
<td>1,000.00</td>
<td>17.01</td>
<td>0.00</td>
</tr>
<tr>
<td><strong>TOTAL PROJECT EXPENDITURES</strong></td>
<td>29,807.60</td>
<td>49,297.84</td>
<td>23,800.00</td>
<td>60,350.00</td>
<td>6,007.60</td>
<td>(11,052.16)</td>
</tr>
</tbody>
</table>

Notes:
(A) Refer to Annex XIII, page 5 for SOE withdrawal schedule format.
(B) Expenditure breakdowns represent main disbursement categories as identified in the SAR.
Refer to Annex XIII, page 3 for a detailed breakdown of each category.
### XYZ Project
### Expenditure Detail
#### as of June 30, 19XX

(Indicate type of currency)

<table>
<thead>
<tr>
<th>INVESTMENT COSTS (A)</th>
<th>Actual</th>
<th>Budget (SAR)</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>YTD</td>
<td>Cumulative</td>
<td>YTD</td>
</tr>
<tr>
<td>Land Development</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(B) Civil Works</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>1,056.23</td>
<td>1,856.23</td>
<td>2,000.00</td>
</tr>
<tr>
<td>Materials</td>
<td>1,516.97</td>
<td>3,516.97</td>
<td>2,000.00</td>
</tr>
<tr>
<td>Subtotal</td>
<td>11,303.34</td>
<td>19,603.34</td>
<td>13,200.00</td>
</tr>
<tr>
<td>Conservation Engineering</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Civil Works</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>1,628.35</td>
<td>3,128.35</td>
<td>1,275.00</td>
</tr>
<tr>
<td>Maintenance</td>
<td>1,215.83</td>
<td>2,015.83</td>
<td>1,200.00</td>
</tr>
<tr>
<td>Subtotal</td>
<td>4,840.20</td>
<td>8,140.20</td>
<td>4,775.00</td>
</tr>
<tr>
<td>Forest Development</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>5,632.98</td>
<td>7,632.98</td>
<td>5,375.00</td>
</tr>
<tr>
<td>Materials</td>
<td>1,056.23</td>
<td>2,056.23</td>
<td>1,200.00</td>
</tr>
<tr>
<td>Training</td>
<td>312.58</td>
<td>706.25</td>
<td>300.00</td>
</tr>
<tr>
<td>Subtotal</td>
<td>7,001.79</td>
<td>13,001.79</td>
<td>6,875.00</td>
</tr>
<tr>
<td>Processing</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>415.23</td>
<td>638.95</td>
<td>300.00</td>
</tr>
<tr>
<td>Materials</td>
<td>105.32</td>
<td>268.48</td>
<td>100.00</td>
</tr>
<tr>
<td>Training</td>
<td>312.58</td>
<td>706.25</td>
<td>300.00</td>
</tr>
<tr>
<td>Subtotal</td>
<td>833.13</td>
<td>1,613.68</td>
<td>630.00</td>
</tr>
<tr>
<td>Support Services</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>212.35</td>
<td>314.23</td>
<td>100.00</td>
</tr>
<tr>
<td>Technical Assistance</td>
<td>641.87</td>
<td>1,289.45</td>
<td>700.00</td>
</tr>
<tr>
<td>Subtotal</td>
<td>854.22</td>
<td>1,603.68</td>
<td>800.00</td>
</tr>
<tr>
<td>Institutional Development</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equipment</td>
<td>312.78</td>
<td>516.78</td>
<td>500.00</td>
</tr>
<tr>
<td>Technical Assistance</td>
<td>964.21</td>
<td>1,312.45</td>
<td>1,000.00</td>
</tr>
<tr>
<td>Subtotal</td>
<td>1,276.99</td>
<td>1,829.23</td>
<td>1,500.00</td>
</tr>
<tr>
<td><strong>TOTAL INVESTMENT COSTS</strong></td>
<td>29,315.59</td>
<td>48,297.84</td>
<td>23,325.00</td>
</tr>
<tr>
<td>Recurrent Costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Salaries and Wages</td>
<td>278.56</td>
<td>500.00</td>
<td>275.00</td>
</tr>
<tr>
<td>Repairs and Maintenance</td>
<td>213.45</td>
<td>500.00</td>
<td>200.00</td>
</tr>
<tr>
<td><strong>TOTAL RECURRENT COSTS</strong></td>
<td>492.01</td>
<td>1,000.00</td>
<td>475.00</td>
</tr>
<tr>
<td><strong>TOTAL PROJECT EXPENDITURES</strong></td>
<td>29,807.60</td>
<td>49,297.84</td>
<td>23,800.00</td>
</tr>
</tbody>
</table>

**SUMMARY BY SUB-CATEGORY (B):**

**INVESTMENT COSTS**

<table>
<thead>
<tr>
<th></th>
<th>Actual</th>
<th>Budget (SAR)</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>YTD</td>
<td>Cumulative</td>
<td>YTD</td>
</tr>
<tr>
<td>Civil Works</td>
<td>11,293.37</td>
<td>18,793.37</td>
<td>10,300.00</td>
</tr>
<tr>
<td>Equipment</td>
<td>5,257.92</td>
<td>14,087.52</td>
<td>5,375.00</td>
</tr>
<tr>
<td>Maintenance</td>
<td>1,215.63</td>
<td>2,015.63</td>
<td>1,200.00</td>
</tr>
<tr>
<td>Materials</td>
<td>4,271.60</td>
<td>7,934.76</td>
<td>3,600.00</td>
</tr>
<tr>
<td>Technical Assistance</td>
<td>1,606.06</td>
<td>2,601.00</td>
<td>1,650.00</td>
</tr>
<tr>
<td>Training</td>
<td>1,570.99</td>
<td>2,846.66</td>
<td>1,200.00</td>
</tr>
<tr>
<td><strong>TOTAL INVESTMENT COSTS</strong></td>
<td>29,315.59</td>
<td>48,297.84</td>
<td>23,325.00</td>
</tr>
</tbody>
</table>

**RECURRENT COSTS**

<table>
<thead>
<tr>
<th></th>
<th>Actual</th>
<th>Budget (SAR)</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>YTD</td>
<td>Cumulative</td>
<td>YTD</td>
</tr>
<tr>
<td>Salaries and Wages</td>
<td>278.56</td>
<td>500.00</td>
<td>275.00</td>
</tr>
<tr>
<td>Repairs and Maintenance</td>
<td>213.45</td>
<td>500.00</td>
<td>200.00</td>
</tr>
<tr>
<td><strong>TOTAL RECURRENT COSTS</strong></td>
<td>492.01</td>
<td>1,000.00</td>
<td>475.00</td>
</tr>
<tr>
<td><strong>TOTAL PROJECT EXPENDITURES</strong></td>
<td>29,807.60</td>
<td>49,297.84</td>
<td>23,800.00</td>
</tr>
</tbody>
</table>

**Notes:**

(A) Investment cost categories are broken down based on main disbursement categories identified in the SAR.

(B) May be further detailed in subsequent schedules (see Annex XIII, page 4).
### XYZ Project

**Expenditure Detail - By Subcategory**

**as of June 30, 19XX**

*(Indicate type of currency)*

#### Actual vs. Budget (SAR) Variance

<table>
<thead>
<tr>
<th>CIVIL WORKS (A):</th>
<th>Actual YTD</th>
<th>Actual Cumulative</th>
<th>Budget (SAR) YTD</th>
<th>Budget (SAR) Cumulative</th>
<th>Variance YTD</th>
<th>Variance Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earth Works</td>
<td>2,348.96</td>
<td>3,568.97</td>
<td>3,500.00</td>
<td>4,500.00</td>
<td>(1,151.04)</td>
<td>(931.03)</td>
</tr>
<tr>
<td>Structure and Building</td>
<td>5,680.00</td>
<td>6,512.38</td>
<td>4,600.00</td>
<td>8,000.00</td>
<td>1,080.00</td>
<td>(1,487.62)</td>
</tr>
<tr>
<td>Land Costs</td>
<td>3,264.41</td>
<td>8,712.02</td>
<td>2,200.00</td>
<td>8,950.00</td>
<td>1,064.41</td>
<td>(237.98)</td>
</tr>
<tr>
<td><strong>TOTAL CIVIL WORKS</strong></td>
<td><strong>11,293.37</strong></td>
<td><strong>18,793.37</strong></td>
<td><strong>10,300.00</strong></td>
<td><strong>21,450.00</strong></td>
<td><strong>993.37</strong></td>
<td><strong>(2,656.63)</strong></td>
</tr>
</tbody>
</table>

**Notes:**

(A) This one category is shown for example purposes only.
EXAMPLE OF SOE WITHDRAWAL SCHEDULE

XYZ Project
SOE Withdrawal Schedule
For the current year through: June 30, 19XX
U.S. Dollars (may also show local currency)

<table>
<thead>
<tr>
<th>W/D Number</th>
<th>Civil Works</th>
<th>Equipment</th>
<th>Technical Assistance</th>
<th>Materials</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>16</td>
<td>534.87</td>
<td>0.00</td>
<td>0.00</td>
<td>524.89</td>
<td>1,059.76</td>
</tr>
<tr>
<td>17</td>
<td>0.00</td>
<td>0.00</td>
<td>250.00</td>
<td>0.00</td>
<td>250.00</td>
</tr>
<tr>
<td>18</td>
<td>0.00</td>
<td>498.32</td>
<td>0.00</td>
<td>0.00</td>
<td>498.32</td>
</tr>
<tr>
<td>19</td>
<td>542.31</td>
<td>0.00</td>
<td>250.00</td>
<td>0.00</td>
<td>792.31</td>
</tr>
<tr>
<td>20</td>
<td>234.57</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>234.57</td>
</tr>
<tr>
<td>21</td>
<td>547.52</td>
<td>85.32</td>
<td>0.00</td>
<td>0.00</td>
<td>632.84</td>
</tr>
<tr>
<td>22</td>
<td>0.00</td>
<td>298.32</td>
<td>0.00</td>
<td>0.00</td>
<td>298.32</td>
</tr>
<tr>
<td>23</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>400.00</td>
<td>400.00</td>
</tr>
<tr>
<td>24</td>
<td>0.00</td>
<td>0.00</td>
<td>250.00</td>
<td>0.00</td>
<td>250.00</td>
</tr>
<tr>
<td>25</td>
<td>0.00</td>
<td>583.88</td>
<td>0.00</td>
<td>0.00</td>
<td>583.88</td>
</tr>
<tr>
<td>TOTAL</td>
<td>1,859.27</td>
<td>1,465.84</td>
<td>750.00</td>
<td>924.89</td>
<td>5,000.00</td>
</tr>
</tbody>
</table>

Note:
(A) Disbursement category as defined by loan/credit agreement.
NOTES
FORMAT FOR SPECIAL ACCOUNT STATEMENT

For year ending 31 December, 19xx
Account No
Depository Bank [Foreign Commercial Bank]
Address
Related loan/credit LN

Currency US$
Initial deposit (mm/dd/yy)

Add:
  World Bank replenishments $
  Total interest earnings (if deposited in account) $ $

Deduct:
  Direct payments for goods and $ $
  SOE reimbursements -- to borrowers
  Total service charges if not included above in amount withdrawn $ $

Ending balance (mm/dd/yy) $ $

Note: 1. Project payments (both direct and SOE reimbursements) should be compared and agreed to "Bank Financing," as shown in the Project Financial Statement.

2. Special account financial statement is usually a separate report. However it is sometimes treated as a part of the project financial statements, particularly where the special account acts as the bank account of the project.
NOTES
This Appendix is a summary of IFAC/IAPC ISAs 1 to 31 (July 1994). It should be noted that the summary of each ISA is not a substitute for the ISA itself. Reference should always be made to the text of Standards when seeking guidance. (Paragraph references pertain to those contained in the applicable ISA.) Where no public sector perspective is provided after the Summary of the ISA then the ISA has the same applicability in the public sector as it has for the private sector.

**ISA 1: Objective and Scope of the Audit of Financial Statements**

**Summary.** The Guideline describes management’s responsibility for financial statements and the overall objective and scope of the audit of financial statements of an entity by an independent auditor.

**Public Sector Perspective.** The objective and scope of an audit, whether in the private or public sector, are determined by the audit mandate. The audit mandate is usually based on the law, professional standards and auditee requirements. Audit mandates in the public sector may be more specific than those in the private sector, and often encompass a wider range of objectives and a broader scope than is usually applicable for the audit of private sector financial statements.

Paragraph II or ISA I deals with the action a private sector auditor may take when there are attempts to restrict the scope of the audit. In the public sector a different approach may be needed. Specific requirements may exist within the legislation governing the audit mandate; for example, the auditor may be required to report directly to a minister or the legislature if management (including the department head) attempts to limit the scope of the audit.

**ISA 2: Audit Engagement Letters**

**Summary.** An auditor’s engagement letter to the client is designed to document and confirm the auditor’s acceptance of the appointment, the scope of the auditor’s work, the extent of the auditor’s responsibilities and the form of any reports. The Standard describes the principal contents of an engagement letter, and the appendix contains an example of a letter.

**ISA 3: Basic Principles Governing an Audit**

**Summary.** This Guideline describes the basic principles governing an auditor’s professional responsibilities which should be exercised whenever an audit is carried out. The basic principles identified involve: integrity, objectivity and independence, confidentiality, skills and competence, work performed by others, documentation, planning, obtaining audit evidence, reviewing accounting systems and internal control, reviewing conclusions reached, and reporting. These basic principles are the cornerstone of all succeeding International Standards on Auditing.

**Public Sector Perspective.** Irrespective of whether an audit is being conducted in the private or public sector, the basic principles of auditing remain the same. What may differ for audits carried out in the public sector is the audit objective and scope, and certain judgments criteria for risk and materiality. These differences are often attributable to differences in the audit mandate and legal requirements of the form of financial reporting; for example, audit mandates in the public sector may be more specific than in the private sector and public sector entities may be required to prepare additional financial reports. Differences in audit approach and style may also exist. However, these differences would not constitute a difference in the basic auditing principles.
ISA 4: Planning

Summary. The guidance applies to the planning process of the audit of both financial statements and other financial information. It is framed in the context of recurring audits, identifies key elements in the planning process and provides practical examples of items which should be considered when planning an audit. Adequate audit planning helps to ensure that appropriate attention is devoted to important areas of the audit, that potential problems are promptly identified, and that the work is completed expeditiously. Planning also assists in proper utilization of assistants and in coordination of work done by other auditors and experts.

ISA 5: Using the Work of Another Auditor

Summary. The auditor's consideration to be made intending to use the work of another auditor are described. The guidance applies when an independent auditor reporting on the financial statements of an entity uses the work of another independent auditor with respect to the financial statements of one or more divisions, branches, subsidiaries or associated companies included in the financial statements of the entity.

ISA 6: Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit

Summary. Management is responsible for maintaining an adequate accounting system incorporating various internal controls to the extent appropriate to the size and nature of the business. However, the auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information which should be recorded has, in fact, been recorded. Internal controls normally contribute to such assurance. This Standard describes accounting systems, elements, objectives and limitations of internal control and the audit procedures for the study and evaluation of internal control.

Public Sector Perspective. In respect of paragraph 4 of ISA 6, the auditor should be aware that the "Management objectives" of public sector entities may be influenced by concerns regarding public accountability and may include objectives which have their source in legislation, regulations, government ordinances, and ministerial directives. "Compliance procedures" in this Standard refer to tests adopted to evaluate and determine whether the internal controls on which reliance is to be placed are operating effectively. These procedures should not be confused with compliance audits undertaken with the public sector for the purpose of establishing the compliance by the entity with legislation, ordinances, regulations and ministerial directives, including the probity of those dealing with public funds.

ISA 7: Control of the Quality of Audit Work

Summary. Controlling the quality of audit work is essential in maintaining the high standards of the profession. This Standard distinguishes between controls on individual audits and general quality controls adopted by an audit firm. While recognizing the interrelationship of the two types of controls, generally quality controls "augment and facilitate" controls on individual audits but do not replace them. Controls over delegation of work to assistance on an individual audit in order to comply with the basic auditing principles are addressed, and practical assistance is provided to an audit firm in controlling the general quality of their practice.

ISA 8: Audit Evidence

Summary: Audit evidence is information obtained by the auditor in arriving at the conclusions upon which an opinion on the financial information is based. The nature and sources of audit evidence are described as well as the sufficiency and appropriateness of audit evidence and the methods by which it is obtained by the auditor in the performance of compliance and substantive procedures.

Public Sector Perspective. When carrying out audits of public sector entities, the auditor will need to take into account the legislative framework and any other relevant regulations, ordinances or ministerial directives which affect the audit mandate and any special auditing requirements. Such requirements might affect, for example, the extent of the auditor’s discretion is establishing materiality and judgments on the nature and scope of audit procedures to be applies. Paragraph 9 of this ISA has to be applied only after giving consideration to such restrictions on the auditor’s judgment.
ISA 8: Addendum 1, Additional Guidance on Observation of Inventory, Confirmation of Accounts Receivable and Inquiry Regarding Litigation and Claims

Summary. Guidance is provided on the application of audit evidence gathering procedures (attendance at stocktaking, direct confirmation of accounts receivable and direct communication with a client's lawyers) that are generally accepted as providing the most reliable audit evidence in relation to certain assertions. The Addendum outlines the circumstances when these procedures should be applied and the matters to be considered in their implementation. Observation of inventory is required (unless impracticable) when inventories are material to the financial statements in order to secure evidence of the physical existence and condition of inventory. Confirmation of accounts receivable is required when accounts receivable are material, and provides evidence of the existence of debtors and the accuracy of recorded balances. Guidance is given on the selection of accounts to be confirmed, the use of positive and negative confirmations and the use of alternative procedures when confirmation is inappropriate or replies to confirmations contain exceptions. Direct communication with the entity's lawyer is required when litigation or claims have been identified or are believed may exist. Guidance is given on the form and content of the communication, and the need for the auditor to consider meetings with the lawyer if matters are complex or there is a disagreement.

ISA 9: Documentation

Summary. Guidance is provided on the general form and content of working papers as well as specific examples of working papers normally prepared or obtained by the auditor. Ownership and custody of working papers is also discussed.

ISA 10: Using the Work of an Internal Auditor

Summary. The internal audit function constitutes a separate component of internal control undertaken by specially assigned staff within an entity. An objective of the internal auditor is to determine whether internal controls are well-designed and properly operated. Much of the work of the internal audit department may be useful to the independent auditor for the purpose of his examination of the financial information. Guidance is provided as to the procedures that should be considered by the independent auditor in assessing the work of the internal auditor.

ISA 11: Fraud and Error

Summary. The Standard defines fraud and error, and indicates that the responsibility for the prevention of fraud and error rests with management. The auditor should plan the audit so that there is a reasonable expectation of detecting material misstatements resulting from fraud and error. Suggested procedures are provided which should be considered when the auditor has an indication that fraud or error may exist. An appendix sets out examples of conditions or events which increase the risk of fraud or error.

ISA 12: Analytical Procedures

Summary. A description of the nature of analytical review procedures is provided as well as guidance on the objectives, timing and extent of reliance to be placed on such procedures in performing an audit. Also discussed is the auditor's investigation of unusual fluctuations.


Summary. Guidance is provided to auditors on the form and content of the auditor's report issued in connection with the independent audit of the financial statements of an entity. The Standard includes suggested wording to express an unqualified opinion and discusses circumstances that may result in other than an unqualified opinion. An appendix sets forth examples of an unqualified, and adverse auditor's reports and a denial of opinion.

Public Sector Perspective. While the basic principles contained in this Standard apply to the audit of financial statements in the public sector, the legislation giving rise to the audit mandate may specify the nature, content and form of the audit report. Readers should note that the ISA does not address is the form and content of the auditor's report in circumstances where financial statements are prepared in conformity with a disclosed basis of accounting, whether mandated by legislation or ministerial (or other) directive.
ISA 14: Other Information in Documents Containing Audited Financial Statements

Summary. This Standard defines "other information" as financial and non-financial information included in a document which contains an entity’s audited financial statements together with the auditor’s report thereon. An entity usually issues such a document on an annual basis which is frequently referred to as the "annual report." In circumstances, the auditor has statutory obligation to report on other information and in other circumstances he has no such obligation. This guidance discusses the auditor’s consideration of other information on which he has no obligation to report and the actions he should undertake if a material inconsistency or material misstatement of fact is discovered.

ISA 15: Auditing in a Computer Information Systems (CIS) Environment

Summary. Guidance is provided to auditors on the additional procedures necessary to comply with ISA 3, "Basic Principles Governing an Audit," when auditing in a CIS environment. The skills and competence required of the auditor are described as well as his responsibility when he delegates such work to assistants or uses work performed by others.

ISA 16: Computer-Assisted Audit Techniques

Summary. This Standard provides guidance to the auditor when using computer-assisted audit techniques (CAATs) --particularly audit software and test data. The ISA outlines instances when CAATs may be used, factors to consider in determining whether to use a CAAT and the major steps to be performed in CAAT application. In addition, special considerations when using CAATs in a small business computer environment are highlighted.

ISA 17: Related Parties

Summary. Discussed are procedures to be considered in obtaining sufficient appropriate audit evidence concerning the existence of, and transactions with, related parties. This Standard is premised on the definition and disclosure requirements set out in International Accounting Standard (IAS) 24, "Related Party Disclosures." ISA 17 provides guidance to assist auditors in determining whether management of an entity has properly disclosed related party relationships and transactions with such parties in accordance with the provisions of IAS 24.

Public Sector Perspective. In applying the audit principles in this Standard auditors should make reference to legislative requirements which are applicable to public sector entities and employees in respect of related party transactions. Such legislation may prohibit entities and employees from entering into transactions with related parties. There may be also a requirement for public sector employees to declare their interests in entities with which they transact on a professional and/or commercial basis. Where such legislative requirements exist, the audit procedures would need to be expanded to detect instances of non-compliance with these requirements.

Readers should note that while PSC Guideline 1 indicates that all IASs apply to business enterprises in the public sector, IAS 24 does not require that transactions between state controlled enterprises be disclosed. Readers should also note that definitions of related parties included in IAS 24 and ISA 17 do not address all circumstances relevant to public sector entities. For example, the status for purposes of application of ISA 17, of the relationship between ministers and departments of state and departments of state and statutory authorities of government agencies is not discussed.

ISA 18: Using the Work of an Expert

Summary. This Standard provides guidance to the auditor in instances when using the work of an expert (specialist) engaged or employed by the client or auditor. The ISA outlines examples of cases when an auditor may need to use the work of an expert and provides guidance on considerations relating to the expert's skills, competence and objectivity. ISA 18 outlines considerations that should be made by the auditor for communicating with the expert and offers specific guidance on evaluating the work of an expert.

ISA 19: Audit Sampling

Summary. The factors that an auditor should consider when designing and selecting an audit sample and evaluating the results of audit procedures are identified. The ISA applies to both statistical and non-statistical sampling methods and provides fundamental yet practical guidance on such matters as sampling,
risk, stratification, selection methods and projection of errors.

**ISA 20: The Effects of an EDP Environment on the Study and Evaluation of the Accounting System and Related Internal Controls**

**Summary.** This Standard addresses the study and evaluation of the accounting system and related internal controls in an EDP environment and is an extension of the guidance contained in ISA 6, “Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit” and ISA 15, “Auditing in an EDP Environment.” It describes the common characteristics of an EDP environment, including the factors that affect the organization and structure, nature of processing and design and procedural aspects of the system of accounting and internal control and differentiates and explains the interrelationship of general EDP controls (those that affect the EDP environment) and EDP application controls (those that affect accounting applications).

**ISA 21: Date of the Auditor’s Report; Events After the Balance Sheet Date; Discovery of Facts After the Financial Statements Have Been Issued**

**Summary.** Guidance is provided on dating of the auditor’s report; the auditor’s responsibility in relation to subsequent events, which are significant events occurring after the balance sheet date; and the auditor’s responsibility in connection with the discovery of facts after the financial statements have been issued. The Standard describes steps the auditor generally performs to identify subsequent events, responsibilities in relation to events after the date of the auditor’s report but before the financial statements are issued, and discovery of facts after the financial statements are issued. An appendix sets forth an example of an auditor’s report on revised statements.

**ISA 22: Representation by Management**

**Summary.** This Standard provides guidance to the auditor on using management representations as audit evidence, procedures the auditor should apply in evaluating and documenting them, and circumstances in which written representations should be obtained. It indicates that with regard to representations for material financial statement matters, the auditor should seek corroborative evidence, evaluate the representations for reasonableness and consistency with other evidence and other representations, and consider whether the individual making the representation can be expected to be well-informed.

**ISA 23: Going Concern**

**Summary.** Guidance is provided to auditors in discharging their responsibilities in situations in which the appropriateness of the going concern assumption as a basis for the presentation of financial statements is in question. The Standard notes that an entity’s continuance as a going concern is assumed in the absence of information to the contrary. If this assumption is unjustified, an entity may not be able to realize its assets at the recorded amounts and there may be changes in the amount and dates of maturity of liabilities resulting in the need for financial statements to be adjusted.

**Public Sector Perspective.** The appropriateness of the going concern assumption is generally not in question when auditing either a central government or those public sector entities having funding arrangements backed by a central government. However, where such arrangements do not exist, or where central government funding of the entity may be withdrawn and the existence of the entity may be at risk, the ISA will provide useful guidance.

**ISA 24: Special Purpose Auditor’s Reports**

**Summary.** This Standard provides guidance to auditors that issue audit reports that are other than those covered by ISA 13, notably, (A) financial statements prepared in accordance with a comprehensive basis of accounting other than international accounting standards or relevant national standards, (b) specific accounts, elements of accounts, or items of financial statements, (c) compliance with contractual agreements, and (d) summarized financial statements. Appendices contain illustrations of special purpose auditor’s reports.

**ISA 25: Materiality and Audit Risk**

**Summary.** This Standard defines the concepts of materiality and audit risk, their interrelationship and the application of these concepts by an auditor when planning and conducting an audit and evaluating the results of his procedures. Materiality is defined as the magnitude or nature of a misstatement including an
omission of financial information either individually or in the aggregate that, in the light of surrounding circumstances, makes it probable that, as a result of the misstatement, the judgment of a reasonable person relying on the information would have been influenced or his decision affected. The assessment of materiality is a matter of the auditor’s professional judgment and is considered at both an overall level and in relation to the individual account balances and disclosures.

Public Sector Perspective. In assessing materiality the public sector auditor must, in addition to exercising professional judgment, consider any legislation or regulation which may impact on that assessment.

ISA 26: Audit of Accounting Estimates

Summary. Guidance is provided to auditors on the audit procedures that should be performed in order to obtain reasonable assurance as to the appropriateness of accounting estimates contained in financial information. An accounting estimate is defined as an approximation of the amount of an item in the absence of a precise means of measurement. It is noted that management is responsible for making accounting estimates based upon its judgment of the uncertain outcome of events that have occurred or are likely to occur and that the auditor is responsible for evaluating the reasonableness of such estimates.

ISA 27: The Examination of Prospective Financial Information

Summary. This Standard deals with the examination and reporting procedures where an auditor is asked to report on prospective financial information being either a forecast, based on best-estimate assumptions, or a projection based on hypothetical assumptions. Recognizing the future oriented nature of the engagement, the examination procedures recognize the speculative nature of the evidence available to the auditor, and while acknowledging a consistent audit objective, differentiates between the evidence requirements and process for best-estimate as distinct from hypothetical assumptions. Emphasis is given to the importance of adequate disclosure of significant assumptions to an understanding of prospective financial information and the auditor’s role in ensuring this occurs.

ISA 28: First Year Audit Engagements--Opening Balances

Summary. This Standard provides guidance as to the auditor’s responsibilities for opening balances when the financial statements are being audited for the first time or were audited by another auditor in the prior year. The ISA outlines the audit procedures by which sufficient appropriate audit evidence may be obtained in both circumstances to determine whether the opening balances were misstated, correctly brought forward or restated and appropriate accounting policies consistently applied. The auditor’s reporting considerations are set out where the auditor is unable to obtain sufficient appropriate audit evidence and where the prior year audit report was other than unqualified. Appendices contain illustrations of other than unqualified reports.

ISA 29: Inherent and Control Risk Assessments and Their Impact on Substantive Procedures

Summary. Guidance is provided to the auditor in assessing inherent and control risk and using such assessments to determine the nature, timing and extent of substantive procedures so as to restrict detection risk to an acceptable level.

ISA 30: Knowledge of the Business

Summary: This Standard provides guidance on what is meant by a knowledge of the business, why it is important to the auditor and to members of the audit staff working on an engagement, why it is relevant to all phases of an audit, and how the auditor obtains and uses that knowledge. In performing an audit of financial statements, the auditor should have or obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions, and practices that, in the auditor's judgment, may have a significant effect on the financial statements or on the examination or audit report. The auditor's level of knowledge for an engagement would include a general knowledge of the economy and the industry within which the entity operates, and a more particular knowledge of how the entity operates. A list of matters to consider in a specific engagement is set out in the appendix to this ISA.
ISA 31: Consideration of Laws and Regulations in an Audit of Financial Statements

Summary: This Standard provides guidance on the auditor’s responsibility to consider laws and regulations in an audit of financial statements. When planning and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognize that noncompliance by the entity with laws and regulations may materially affect the financial statements. However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

The Standard also defines management’s responsibility to ensure that the entity’s operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with the management.

The Standard also provides guidance on procedures for the auditor’s consideration of compliance with laws and regulations. The auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework. The auditor should then perform procedures to help identify instances of noncompliance with those laws and regulations to be considered when preparing financial statements and should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The appendix to the ISA sets out examples of the type of information that might come to the auditor’s attention that may indicate noncompliance. The Standard also outlines procedures to follow when noncompliance is discovered and when noncompliance is reported to management, to the users of the auditor’s report on the financial statements, and to regulatory and enforcement authorities.

Public Service Perspective. Many public sector engagements include additional audit responsibilities with respect to consideration of laws and regulations. Even if the auditor’s responsibilities do not extend beyond those of the private sector auditor, reporting responsibilities may be different as the public sector auditor may be obliged to report on instances of noncompliance to governing authorities or to report them in the audit report. (In respect of public sector entities, the Public Sector Committee intends to supplement the guidance included in this ISA with a Study.)
NOTES
INTERNATIONAL ORGANIZATION OF SUPREME AUDIT INSTITUTIONS (INTOSAI)

Auditing Standards

The INTOSAI auditing standards consist of four parts:

(a) Basic postulates
(b) General standards
(c) Field standards
(d) Reporting standards

a) Basic Postulates

The basic auditing postulates stipulate that:

1) The Supreme Audit Institution should consider compliance with the INTOSAI standards in all matters that are defined material. Certain may not be applicable to some of the work done by SAIs those organized as Courts of Account, nor to the non-audit conducted by the SAI. The SAI should determine the appropriate standards for such work to ensure that it is of consistent quality.

2) The SAI should apply its own judgment to the diverse situations that arise in the course of government auditing.

3) With increased public consciousness, the demand for public accountability of persons or entities managing public resources has become increasingly evident so that there is a greater need for the accountability process to be in place and operating effectively.

4) Development of adequate information, control, evaluation and reporting systems within the government will facilitate the accountability process. Management is responsible for correctness and sufficiency of the form and content of the financial reports and their information.

5) Appropriate authorities should ensure the promulgation of acceptable accounting standards for financial reporting and disclosure relevant to the needs of the government, and audited entities should develop specific and measurable objectives and performance targets.

6) Consistent application of acceptable accounting standards should result in the fair presentation of the financial position and the results of operations.

7) The existence of an adequate system of internal control minimizes the risk of errors or irregularities.

8) Legislative enactments would facilitate the cooperation of audited entities in maintaining and providing access to all relevant data necessary for a comprehensive assessment of the activities under audit.

9) All audit activities should be within the SAIs audit mandate.

10) SAIs should work towards improving techniques for auditing the validity of performance measures.
11) SAIs should avoid conflict of interest between the auditor and the entity under audit.

b) General Standards
1) The auditor and the SAI must be independent.

2) The auditor and the SAI must possess the required competence.

3) The auditor and the SAI must exercise due care and concern in complying with INTOSAI auditing standards.

4) The SAI should adopt policies and procedures to recruit personnel with suitable qualifications.

5) The SAI should adopt policies and procedures to develop and train SAI employees to enable them to perform their task effectively.

6) The SAI should adopt policies and procedures to prepare materials and offer written guidance and instructions concerning the conduct of audits.

7) The SAI should adopt policies and procedures to support the skills and experience available within the SAI and identify those skills which are absent.

8) The SAI should adopt policies and procedures to review the efficiency and effectiveness of the SAIs internal standards and procedures.

c) Field Standards
1) The auditor should plan the audit in a manner which ensures that an audit of high quality is carried out in an economic, efficient and effective way in a timely manner.

2) The work of the audit staff at each level and audit phase should be properly supervised during the audit and documented work should be reviewed by a senior member of the audit staff.

3) The auditor in determining the extent and scope of the audit, should study and evaluate the reliability of internal control.

4) In conducting regularity (financial) audits, a test should be made of compliance with applicable laws and regulations.

5) In conducting regularity (financial) audits, a test should be made of compliance with applicable laws and regulations. The auditor should design audit steps and procedures to provide reasonable assurance of detecting errors, irregularities, and illegal acts that could have a direct and material effect on the financial statement amounts or the results of regularity audits. In conducting performance audits, an assessment should be made of compliance with applicable laws and regulations when necessary to satisfy the audit objectives. The auditor should design the audit to provide reasonable assurance of detecting illegal acts that could significantly affect audit objectives. The auditor also should be alert to situations or transactions that could be indicative of illegal acts that may have an indirect effect on the audit results The regularity audit is an essential aspect of government auditing. One important objective which this type of audit assigns to the SAI is to make sure, by all the means put at its disposal, that the State budget and accounts are complete and valid. This will provide Parliament and other users of the audit report with assurance about the size and development of the financial obligations of the State. To achieve this objective the SAI will examine the accounts and financial statements of the administration with a view to assuring that all operations have been correctly undertaken, completed, passed, paid and registered. The audit procedure normally results, in the absence of irregularity, in the granting of a “discharge.”
6) Competent, relevant and reasonable evidence should be obtained to support the auditor’s Analysis of financial statements should be performed to such a degree that a rational basis is obtained to express an opinion on financial matters, judgment and conclusions regarding the organization, program, activity or function under audit.

7) In regularity (financial) audit, and in other types of audit when applicable, auditors should analyze the financial statements to establish whether acceptable accounting standards for financial reporting and disclosure are complied with. Analysis of financial statements should be performed to such a degree that a rational basis is obtained to express an opinion on financial matters.

d) Reporting Standards

1) At the end of each audit the auditor should prepare a written opinion or report, as appropriate, setting out the findings in an appropriate form; its content should be easy to understand and free from vagueness or ambiguity, include only information which is supported by competent and relevant audit evidence, and be independent, objective, fair and constructive.

2) It is for the SAI to which they belong to decide finally on the action to be taken in relation to fraudulent practices or serious irregularities discovered by the auditors. With regard to regularity audits, the auditor should prepare a written report, which may either be a part of the report on the financial statements or a separate report, on the tests of compliance with applicable laws and regulations. The report should contain a statement of positive assurance on those items tested for compliance and negative on those items not tested. With regard to performance audits, the report should include all significant instances of non-compliance that are pertinent to the audit objectives.
REVIEW OF AUDIT FIRMS -- PRELIMINARY QUESTIONNAIRE
(mainly for Private Auditors\(^7\))

Basic Information

Legal name of Auditor or Audit Firm(s):

Audit Law Registration Number:

Date of commencing Audit Practice:

Street Address:

Postal Address:

Telephone (with area code):

Telefax/Telex Number:

Address and Telephones of
Branches (if any):

Name/Address of Foreign
Affiliations (if any:

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\(^7\) The acceptability of government auditors would normally be reviewed on a country basis and this annex would only
apply for limited aspects.
OUTLINE OF THE AUDIT FIRM

1. State the legal nature of the Audit Firm (sole proprietor, partnership etc.)

2. State the total number of auditors (excluding support staff) who are owners or employees of the Firm. Indicate how many of these are licensed auditors.

3. Indicate which of the following services are provided by the Firm and show approximate share of each service to the Firm's total Fee Income.

   % of Total Fee Income

   Auditor
   Accounting
   Other share

   TOTAL 100%

4. For EACH licensed auditor who is an owner/employee, provide a separate attachment with their names and a brief summary of their qualifications and experience, including:
   - academic education and qualifications
   - memberships of professional audit or accounting associations
   - details of audit and accounting work experience, including any work experience outside the Country
   - written and spoken fluency in English or other languages

5. Does the firm have any association or affiliation with any other professional firm such as auditors, accountants, consultants or lawyers, either in the Country or abroad? If so, please supply details.

INDEPENDENCE

6. Are any of the individuals listed above (or spouses or close relatives) employed by any level of Government or Legislative Body or Public Agency? If so, please supply details.
7. If a potential client -- the agency executing a World Bank-financed project -- proposed your firm for consideration as auditors for the project, would you be prepared to provide written confirmation (at that time) that the Firm has no conflict of interest or lack of independence in accepting appointment as an auditor.

    YES/NO

8. Confirm that, should your Firm be appointed auditor to a World Bank-financed project, you would allow World Bank staff to carry out a quality assurance review of the audit working papers supporting any Audit Report issued.

    YES/NO

**Audit Practice**

9. Attach (separately) a list of the Firm’s major current and past clients (particularly any international or joint venture clients) and state the type of service (audit, consulting advice, accountancy) provided to each client.

10. Have you performed any audits jointly with international audit firms? If so, please provide details.

11. Are you willing to conduct audits jointly, under the general direction of an international audit and accounting firm?

    YES/NO

12. State briefly the basis on which you determine fees charged to clients for professional services that you provide.

**Audit Standards and Procedures**

13. State whether the Firm is aware of internationally accepted auditing and accounting standards, and of local accounting rules?

    YES/NO
14. How do the Firm’s audit procedures and methods ensure that these auditing and accounting standards are complied with? State briefly.

15. Are the Firm’s audit procedures and methods recorded in a manual or similar document?

**YES/NO**

If not, how are audit staff trained in auditing and accounting concepts? Also, how is day-to-day guidance in audit techniques provided to them?

16. State briefly how the work of employees is supervised.

17. State briefly the internal procedures you employ to assure internal quality of work and service, such as a second review (for quality assurance) within the Firm, consultation with experts, or review of work by external parties.

18. Should the World Bank wish to consider you for selection as auditor to World Bank-financed projects, would you permit World Bank representatives to review the Firm’s audit procedures and method?

**YES/NO**

**GENERAL**

19. Attach copies of any references from clients, any brochures, or other promotional material describing your Firm.

List below the headings and number of pages of any attachments that you have enclosed with this questionnaire.
GUIDELINES FOR AUDITORS
TERMS OF REFERENCE AND ENGAGEMENT LETTER

1. Normally, the Bank approves the terms of reference (TOR) of the auditor to be engaged by a borrower or project entity. Preferably staff should not be involved in the drafting of the TOR, though there is no objection to staff members giving advice to the borrower based on these guidelines.

2. The guidelines 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 and add relevant matters that are not in the guidelines. This relates only to the appointment of auditors to carry out an audit of an organization's financial statements, project financial statements, adjustment operations, statements of expenditure (SOEs), and special accounts (SAs). It is not intended for any special reviews, investigation, or consulting work.

3. Terms of reference for an Auditor
The form and content of the TOR may vary for each project, and some aspects may be included in an engagement latter. In general, it should include the points outlined below.

4. Summary of Contents of TOR/Engagement Letter

a) Description of the employing authority or entity,

b) Delivery of audit report,

c) Description and timing of the financial statements and other material to be provided by the management for the audit,

d) the fact that the audit should be carried out in accordance with international standards on auditing,

e) "management letter,"

f) statement of access to records and personnel available to the auditor,

g) submission of proposal and work plan by the auditor.

5. **Detailed Contents to be Included in the TOR/Engagement Letter**

a) The TOR should describe the institution engaging the auditor and whether it is acting on behalf of, or is a constituent part of, a larger determining his/her independence and the scope of work.

b) Both a legal and a general description of the entity should be provided in sufficient detail to enable the auditor to understand fully the nature and objective of the entity. The following additional information would be helpful:

   (i) organizational charts;
   (ii) names of senior managers;
   (iii) name and qualification of the person(s) responsible for financial management, accounting, and internal audit;
   (iv) name and address of any existing external auditor;
   (v) data processing facilities in use; and
   (vi) a copy of the latest financial statements (where available).

c) The auditor should be invited to:

   (i) submit a proposal for the audit of the financial statements
      (i.e., financial statements of the executing entity, adjustment operations, project financial statements, SOEs, SAs, or a combination of the above);

   (ii) deliver an opinion based on the scope and detail of the audit of such statements; and
(iii) provide a "management letter" describing the improvements needed, if any, in the accounting and internal control systems of the entity and the proper use of resources.

The TOR/Engagement Letter should specify whether the engagement is for more fiscal years (or for another specified period).

d) While the auditor is responsible for forming and expressing opinions on the financial statements, the responsibility for their preparation lies with the management of the entity. Therefore, the form of the annual financial statements and supporting documentation that will be supplied to the auditor should be specified. The estimated time for the provision of these documents to the auditor should be given (e.g., two months after the close of the fiscal year).

e) The scope and detail of the audit should be clearly explained so an auditor can determine if there are requirements beyond those of a routine audit. Below are examples of typical requirements:

(i) The audit should be carried out in accordance with international standards on auditing. The auditor should indicate the extent (if any) to which the examination would not conform to those standards.

(ii) The auditor should comment on and confirm the extent to which generally accepted accounting principles have been and are being consistently applied. The auditor should indicate any material differences from international accounting standards, where relevant, and their effect on the annual financial statements.

(iii) Statement of Expenditures (SOEs)

The auditor should be required to verify SOEs with accounting records, supporting documentation, and physical inspection of work done, or goods and services
acquired. He/she should also establish (with reference to the disbursement letter) that expenditures claimed for reimbursement are eligible for financing under the Loan Agreement.

(iv) Special Account (SA)

The auditor should be required to verify the correctness of SA financial transactions, including the reconciliation of receipts with payments by the Bank, the fund balances, and the operation and use of SAs in accordance with the Loan Agreement.

Management Letter

The management letter should include comments and recommendations for improvements to the borrower's financial and administrative systems and controls, as well as remarks on other matters to which the management's attention should be drawn. To supplement the management letter, the auditor may be asked to conduct a special review of one or more of the following:

A. economy, efficiency, and effectiveness in the use of resources;
B. achievement of the planned results of the project;
C. legal/financial obligations and commitments of the entity and extent of compliance or noncompliance;
D. specific systems (e.g., improvements in accounting and data processing operations that may be under development) on which the auditor's comments are necessary to ensure accuracy, efficiency, and proper controls; and
E. any other activities on which an auditor may report.

---

8 Provided these matters are within the scope of the auditor's professional competence.
9 The foregoing list is not exhaustive, nor should all matters be addressed in every project. The scope and detail of an audit are likely to be unique to each project or project entity.
6. **Other Aspects Related to the Audit Engagement**

a) The selected auditor should be asked to prepare an engagement letter (see Annex XX). In countries where an auditor's specific obligations are provided for by law, this step may not be necessary, but such a letter would still be informative for the borrower. To help avoid misunderstandings, it is in the interest of both the auditor and the borrower that the auditor send the engagement letter before the engagement commences. The form and content of the audit engagement letter may vary for each client, but it should generally include reference to the matters addressed in this annex. In addition, it should:

(i) State management's responsibility for specifying the timing and nature of financial statements, and disclosing requirements or other information that is expected to be provided under the audit arrangements.

(ii) Establish a timetable for providing the audit opinion and reports.

(iii) Estimate staff time and audit fees as an indication of the intensity of the audit effort and the level of staff engaged on the assignment.

b) On recurring audits, the auditor should not be asked to issue a new engagement letter each year. However, the following factors could call for a new letter:

(i) any indication that the client misunderstands the objective and scope of the audit,

(ii) any revised or special terms of the engagement,

(iii) a recent change of management,

(iv) a significant change in the nature or size of the client's business, and

(v) legal requirements.
7. The reporting package to be provided by the auditor would normally comprise

a) the annual financial statement of the implementing organization (where required), of the project including SOEs and the SA;

b) an opinion by the auditor acceptable to the Bank on (i) the required financial statements, (ii) a separate reference in the above opinion on the audit of the special account in accordance with the stipulations of the legal documents, and (iii) a separate reference in the above opinion on withdrawals from the loan account on the basis of SOEs in accordance with the Legal Agreements:

c) a management letter; and

d) where required in the TOR, the status of compliance with the legal covenants.
SAMPLE TERMS OF REFERENCE FOR THE
AUDIT OF PROJECT FINANCIAL STATEMENTS
(and Accompanying SOE and SA Where Applicable)

Objective

The objective of the audit of the Project Financial Statement (PFS) is to enable the auditor to express a professional opinion on the financial position of [________] project at the end of each fiscal year and of the funds received and expenditures for the accounting period ended mm/dd/yy, as reported by the PFS, [as well as an opinion on the Statement of Expenditures].

The project accounts (books of account) provide the basis for preparation of the PFS and are established to reflect the financial transactions in respect of the project, as maintained by the project implementing agency [________].

Scope

The audit will be carried out in accordance with International Standards of Auditing, and will include such tests and controls as the auditor considers necessary under the circumstances. In conducting the audit, special attention should be paid to the following:

(a) All external funds have been used in accordance with the conditions of the relevant financing agreements, with due attention to economy and efficiency, and only for the purposes for which the financing was provided. Relevant financing agreements are (-------name of loan agreement);
(b) Counterpart funds have been provided and used in accordance with the relevant financing agreements, with due attention to economy and efficiency, and only for the purposes for which they were provided;
(c) Goods and services financed have been procured in accordance with the relevant financing agreement;
(d) All necessary supporting documents, records, and accounts have been kept in respect of all project ventures [including expenditures reported via SOEs or SAs]. Clear linkages should exist between the books of account and reports presented to the Bank.
(e) Where Special Accounts have been used, they have been maintained in accordance with the provisions of the relevant financing agreement.
(f) The project accounts have been prepared in accordance with consistently applied International Accounting Standards and give a true and fair view of the financial situation of the project at mm/dd/yy and of resources and expenditures for the year ended on that date.

**Project Financial Statements**

The Project Financial Statements should include

(a) a Summary of Funds received, showing the World Bank, project funds from other donors, and counterpart funds separately;

(b) a Summary of Expenditures shown under the main project headings and by main categories of expenditures, both for the current fiscal year and accumulated to date; and

(c) a Balance Sheet showing Accumulated Funds of the Project, bank balances, other assets of the project, and liabilities, if any.

As an annex to the Project Financial Statements, the auditor should prepare a reconciliation between the amounts shown as “received by the project from the World Bank” and that shown as being disbursed by the Bank. As part of that reconciliation, the auditor should indicate the mechanism for the disbursement, i.e. Special Accounts, Statements of Expenditures, or direct reimbursement.

**Statements of Expenditures**

In addition to the audit of the PFS, the auditor is required to audit all SOEs used as the basis for the submission of withdrawal applications. The auditor should apply such tests and controls as the auditor considers necessary under the circumstances. These expenditures should be carefully compared for project eligibility with the relevant financing agreements, and with reference to the Staff Appraisal Report for guidance when considered necessary. Where ineligible expenditures are identified as having been included in withdrawal applications and reimbursed against, these should be separately noted by the auditor. Annexed to the Project Financial Statements should be a schedule listing individual SOE withdrawal applications by specific reference number and amount. The total withdrawals under the SOE procedure should be part of the overall reconciliation of Bank disbursements described above.

**Special Accounts**

In conjunction with the audit of the Project Financial Statements, the auditor is also required to audit the activities of the Special Accounts associated with the Project. The Special Accounts usually comprise

- deposits and replenishments received from the Bank
- payments substantiated by withdrawal applications
- interest that may be earned from the balances and which belong to the borrower; and
- the remaining balances at the end of each fiscal year.

The auditor must form an opinion as to the degree of compliance with the Bank’s procedures and the balance of the Special Account at year-end. The audit should examine the eligibility and correctness of financial transactions during the period under review and fund balances at the end of such a period, the operation and use of the SA in
accordance with the financing agreement, and the adequacy of internal controls for this type of disbursement mechanism.

For this project, the Special Accounts are referred to in [cite references] of the relevant financing agreements. Special Accounts statements and the auditor’s report should with the Project Financial Statements.

Audit Opinion

Besides a primary opinion on the Project Financial Statements, the annual audit report of the Project Accounts should include a separate paragraph commenting on the accuracy and propriety of expenditures withdrawn under SOE procedures and the extent to which the Bank can rely on SOEs as a basis for loan disbursement. The financial statements, including the audit report, should be received by the Bank no later than [three to six] months after the end of the accounting period to which the audit refers. The auditor should submit the report to the borrower’s designated agent rather than to any staff member of the project entity. The agent should then promptly forward two copies of the audited accounts and report to the Bank.

Management Letter

In addition to the audit reports, the auditor will prepare a “management letter,” in which the auditor will:

(a) give comments and observations on the accounting records, systems, and controls that were examined during the course of the audit;

(b) identify specific deficiencies and areas of weakness in systems and controls and make recommendation for their improvement;

(c) report on the degree of compliance of each of the financial covenants on the financing agreement and give comments, if any, on internal and external matters affecting such compliance;

(d) communicate matters that have come to attention during the audit which might have a significant impact on the implementation of the project; and

(e) bring to the borrower’s attention any other matters that the auditors considers pertinent.

General

The auditor should be given access to all legal documents, correspondence, and any other information associated with the project and deemed necessary by the auditor. Confirmation should also be obtained of amounts disbursed and outstanding at the Bank [and of amounts disbursed under [specify other donor, loan or grant, if any]]. Bank Task Managers can assist in obtaining these confirmations.

It is highly desirable that the auditor become familiar with a copy of the Bank’s Guidelines on Financial Reporting and Auditing of Projects Financed by the World Bank, which summarizes the Bank’s financial reporting and auditing requirements. The auditor should also be familiar with the Bank’s Disbursement Manual. Both documents will be provided by the Task Manager.
EXAMPLE OF AN AUDIT ENGAGEMENT LETTER

(usually prepared by the auditor)

To the Board of Directors or the appropriate representative of senior management:

You have requested that we audit (insert names of financial statements) as of and for the year ending......................We are pleased to confirm our acceptance and our understanding in this engagement by means of this letter. Our audit will be made in accordance with applicable authoritative pronouncements in [name of country] with the objective of our expressing an opinion on the financial statements.

In forming our opinion on the financial statements, we will perform sufficient tests to obtain reasonable assurance as to whether the information contained in the underlying accounting records and other source data is reliable and sufficient as the basis for the preparation of the financial statements. We will also decide whether the information is properly communicated in the financial statements.

Because of the test nature and other inherent limitation of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that even some material misstatements may remain undiscovered.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in internal control which come to our notice.

May we remind you that the responsibility for the preparation of financial statements including adequate disclosure is that of management. This includes the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies, and the safeguarding of the assets. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information are requested in connection with our audit.

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus direct out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

XYZ & Co.

Note: Additional items may be included in accordance with the Guidelines for TOR and Engagement Letters -- Annex XVIII.
**MODEL AUDIT REPORT**  
Unqualified Opinion  
(For an Organization)

**Introductory Paragraph**

We have audited the accompanying [indicate names of each financial statement] of the XYZ Company as of December 31, 19XX [indicate any other additional years necessary] for the year(s) then ended. These financial statements are the responsibility of [identify Borrower]. Our responsibility is to express an opinion on these financial statements based on our audit.

**Scope Paragraph**

We conducted our audit 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 material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

**Opinion Paragraph**

In our opinion, the financial statements give a true and fair view of the financial position of the XYZ Company as of December 31, 19XX, and of the results of its operations and its cash flows for the year then ended in accordance with [indicate International Accounting Standards or relevant national standards].

[Name and Address of Audit Firm]  
[Date - Completion Date of Audit]

---

10 The auditor’s report should be appropriately addressed as required by the circumstances of the engagement and local regulations.
MODEL AUDIT REPORT
Unqualified Opinion
(for Project Financial Statement including SOE)

Addressee

Introductory Paragraph

We have audited the accompanying financial statements of the [_________] Project [financed under World Bank Loan No._____/IDA as of December 31, 19XX [indicate any other additional years necessary] for the year(s) then ended. Our responsibility is to express an opinion on these financial statements based on our audit.

Scope Paragraph

We conducted our audit in accordance with International Standards on Auditing [or relevant national standards or practices, and/or World Bank guidelines]. Those Standards and/or World Bank guidelines require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

Opinion Paragraph

In our opinion, the financial statements give a true and fair view of the Sources and Application of Funds of [_________] Project for the year ended December 31, 19XX, in accordance with [indicate International Accounting Standards or relevant national standards. Add “financial position” at December 31, 19XX where a balance sheet is required.]

In addition, (a) with respect to SOEs, adequate supporting documentation has been maintained to support claims to the World Bank for reimbursements of expenditures incurred; and (b) which expenditures are eligible for financing under the Loan/Credit Agreement [Ln/Cr. ____________].

[Name and Address of Audit Firm]
[Date - Completion Date of Audit]

---

11 The auditor's report should be appropriately addressed as required by the circumstances of the engagement and local regulations.

12 A “Source and Application of Funds” statement is always required for each project. A balance sheet is also required where the project has assets and liabilities.
MODEL AUDIT REPORT
Unqualified Opinion
(Special Account)

Introductory Paragraph
We have audited the accompanying [Sources and Application of Funds] of the "Special Account" of the ___________ Project (Loan/Cr. No. _____) for the year ended December 31, 19XX. Our responsibility is to express an opinion on the financial statements of the Special Account based on our audit.

Scope Paragraph
We conducted our audit in accordance with International Standards on Auditing [or relevant national standards or practices, and/or World Bank guidelines for Special Accounts]. Those Standards and World Bank guidelines require that we plan and perform the audit to obtain reasonable assurance that the Special Account financial statement is free of material misstatement. We believe that our audit provides a reasonable basis for our opinion.

Opinion Paragraph
In our opinion, the financial statements of the Special Account give a true and fair view of the financial position of the Special Account as of the ___________ Project (Loan/Cr. No. _____) December 31, 19XX, for the year then ended in accordance with International Accounting Standards [or relevant national standards and World Bank guidelines], and of the Sources and Application of Funds.

[Name and Address of Audit Firm]
[Date - Completion Date of Audit]

---

13 The auditor's report should be appropriately addressed as required by the circumstances of the engagement and local regulations.
EXAMPLES OF AUDIT REPORTS
OTHER THAN UNQUALIFIED

Qualified Opinion:

Exception:  (Separate paragraph required after Scope paragraph)

The company is defendant in a lawsuit which alleges that the company has infringed patent rights amounting to $30 million. Directors and counsel believe that the company has a reasonable prevailing, but the ultimate outcome of the lawsuit cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

(Revised Opinion paragraph)

In our opinion, subject to the effect, if any, on the financial statements of the matter discussed in the preceding paragraph, the financial statements.

Adverse:  (Separate paragraphs required after Scope paragraph)

Note X to the Financial statements of the company states that value of shares in ZZZ Company, a subsidiary of the XYZ company, at cost, to be $2 million. The accounts of the company as of December 31, 19XX report significant losses on operations for the period ended as of that date.

The value of the investment recorded in the ZZZ Company exceeds the market value by $1.5 million. In our opinion the investment should have been written down by $1.5 million and a charge of $1.5 million should have been made to the income statement. Such a charge would result in the net income of the company to be reduced from $2.3 million to $0.8 million.

(Revised Opinion paragraph)

In our opinion, subject to the matter discussed in the preceding paragraph, the financial statements. do not give a true and fair view .........

Disclaimer:  (Revised Introductory paragraph)

We were engaged to audit the accompanying ... for the years then ended. These financial statements are the responsibility of [borrower].  (Omit the sentence stating the responsibility of the auditor.)

(Scope paragraph would either be omitted or amended according to the circumstances.)

(Separate paragraph required after Scope paragraph, if any.)

In the value of the year-end inventory, as shown in the balance sheet, an amount of $50 million has been included as the estimated margins on sales. The XYZ Company has not conducted a physical verification of its inventory since the end of the previous reporting period. The company’s records do not permit the application of alternative audit procedures to determine the existence of such inventories.

(Revised Opinion paragraph)

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.

---

An auditor may not be able to express an unqualified opinion when there is a limitation on the scope of the auditor’s work; or there is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.
OUTLINE OF A MANAGEMENT LETTER

Dear:

We have audited the financial statements of the (company name) for the year ending mm/yy and have issued our report date mm/yy. In planning and performing our audit of (company name), we considered its internal accounting control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal accounting control structure. We noted no matters involving the internal accounting control structure and its operation that we consider to be material weaknesses in accordance with the standards referred to above.

This report is comprised of three sections. Section I contains recommendations related to certain improvements in the existing systems and procedures noted in the current year. Section II contains prior year recommendations which have not yet been fully implemented. Section III contains prior year recommendations which have been fully resolved (managements’ comments would be noted following each recommendation).

This report is intended solely for the information and use of management and others within the organization and should not be used for any other purpose.

During this year’s audit we note that the (company name) has addressed most of the recommendations included in our prior year report. With respect to our current and carryover recommendations, we suggest that an implementation timetable continue to be prepared and approved by appropriate management.

Yours very truly,
NOTES
[name of country]

TERMS OF REFERENCE FOR REVIEW OF GOVERNMENT ACCOUNTING AND AUDITING ARRANGEMENTS

(Part of Country Assessment)

(This TOR does not cover the Public Sector management issues of laws, regulations, staffing and training.)

1. The objective of this assignment is to assess the status of accounting, financial reporting and auditing for all spending units financed by funds from the Government of [name of country]. (Approximately two thirds of the time allocated for the assignment will be spent on accounting and financial reporting aspects and about one third on auditing arrangements.)

2. Accountability Background -- managing public programs rests on an elaborate structure of relationships among all levels of government. Officials and employees, who manage these programs, need to render an account of their activities to the public. While not always specified by law, this accountability concept is inherent in the governing processes of most countries. While the present review is fact finding, the consultant will inevitably observe situation where organizations, programs and services are not being operated economically and efficiently; these should be noted.


3.1. A government accounting system must make it possible both (1) to present fairly and with full disclosure the financial position and results of financial operations of the funds and account groups (or spending units) of the governmental unit in conformity with the generally accepted accounting principles, and (2) to determine and demonstrate compliance with finance related legal and contractual provisions. With this in mind, the consultant will carry out an assessment of

(a) the financial systems, procedures and regulations manuals of Government for use by spending units.

(b) the accounting standards (Generally Accepted Government Accounting Standards) that are required by Government to be used by the spending units and the extent to which they relate to accounting standards in the private sector, to international accounting standards of IASC or recommendations of the public sector committee of the International Federation of Accountants, and

(c) prepare an evaluation of the appropriateness of the systems, procedures, regulations and standards and the extent to which they reflect modern practice.

3.2. Review with each Spending Unit (or Ministry, Department or Agency for several spending units) the status of their accounting and financial reporting by determining:
the type of financial reporting required
last period for which reports are available
applicable accounting standards
basic of accounting (cash, modified cash, modified accrual or full accrual)
last period audited
date of audit certificate
Auditor's Opinion (clean, qualified, adverse, or disclaimed)
Name of Auditor (Government/Private)

4. Auditing Arrangements

4.1 Auditing of annual financial statements of spending units will generally be undertaken by the Auditor-General. However, in certain circumstances, especially for revenue earning/commercially oriented enterprises, the audit may be carried out by an independent audit firm from the private sector. The Consultant will assess the general competency of such audit firms to carry out such audits and note any cases where impartiality may be questionable (for example, where more than about 30% of the firm's fee income may come from a single client). Compliance with International Standards on Auditing of IFAC or national audit standards should be noted.

4.2 Where the audits are carried out by the Auditor-General there is a general obligation on him/her for ensuring that:

a) the audit is conducted by personnel who collectively have the necessary skills;

b) the Auditor-General is independent;

c) applicable standards (IFAC/IAPC, INTOSAI, Government's own standard etc.) are followed in planning and conducting audits and reporting the results;

d) the Auditor-General has an appropriate internal quality control system in place; and

e) the Auditor-General's office periodically undergoes an external quality control review.

These matters will need to be discussed with the Auditor-General to assess the extent of his own compliance with the above obligations.

4.3 Similarly the types of audits carried out should be reviewed to determine that in the case of financial audits, (including financial statement audits)-

(a) they provide reasonable assurance about whether the financial statements of an audited spending unit present fairly the financial position, results of operations, and cash flows in conformity with generally accepted accounting principles;

(b) they determine whether (1) financial information is presented in accordance with established or states criteria, (2) the spending unit has adhered to specific financial compliance requirements, or (3) the spending unit's internal control structure over financial reporting and/or safeguarding assets is suitably designed and implemented to achieve the control objectives.

c) they may also include audits of:
4.4 The consultant should also comment on the extent to which performance audits have been carried out by either private sector or government auditors. A performance audit is an objective and systematic examination of evidence for the purpose of providing an independent assessment of the performance of a government organization, program, activity, or function in order to provide information to improve public accountability and facilitate decision-making by parties with responsibility to oversee or initiate corrective action. Performance audits include economy and efficiency and program audits.

(a) Economy and efficiency audits include determining (1) whether the entity is acquiring, protecting and using its resources (such as personnel, property, and space) economically and efficiently, (2) causes of inefficiencies or uneconomical practices, and (3) whether the entity has complied with laws and regulations on matters of economy and efficiency. Questions and issues to be raised by the consultant in this area would include the extent to which the spending unit is:

- following sound procurement practices;
- acquiring the appropriate type, quality, and amount of resources at an appropriate cost;
- properly protecting and maintaining its resources;
- avoiding duplication of effort by employees and work that serves little or no purpose;
- avoiding idleness and overstaffing;
- using efficient operating procedures;
- using the optimum amount of resources (staff, equipment and facilities) in producing or delivering the appropriate quantity and quality of goods or services in a timely manner.
- complying with requirements of laws and regulations that could significantly affect the acquisition, protection, and use of the spending unit’s resources;
- has an adequate management control system for measuring, reporting, and monitoring a program’s economy and efficiency; and
- has reported measures of economy and efficiency that are valid and reliable.

(b) Program audits include determining (1) the extent to which the desired results or benefits established by the legislature or other authorizing body are being achieved, (2) the effectiveness of organizations, programs, activities, or functions, and (3) whether the entity has complied with significant laws and regulations applicable to the program. The consultant may be able to determine from specimen program audits whether the following matters have been addressed to give credibility to such reports for scope and depth:
• assess whether the objectives of a new, or ongoing program are proper, suitable, or relevant;
• determine the extent to which a program achieves a desired level of program results;
• assess the effectiveness of the program and/or of individual program components;
• identify factors inhibiting satisfactory performance;
• determine whether management has considered alternatives for carrying out the program that might yield desired results more effectively or at a lower cost;
• determine whether the program complements, duplicates, overlaps, or conflicts with other related programs;
• identify ways of making programs work better;
• assess compliance with laws and regulations applicable to the program;
• assess the adequacy of the management control system for measuring, reporting and monitoring a program's effectiveness; and
• determine whether management has reported measures of program effectiveness that are valid and reliable.

The consultant will report his findings in writing within 4 weeks of the completion of his field visit. Such report shall also include a suggested action plan to indicate how improvements can be made in both financial reporting/accounting arrangements as well as for the annual or other periodic audit reports.
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