Annexure- 25

Project Financial Management Manual

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PREFACE

The Financial Management Manual is meant to be a "*living document*" to be updated on the basis of implementation changes necessitated by experiences on the ground. Any changes to this manual will need to be approved by the NPMU and the World Bank. This document is meant primarily for the financial management staff of the Rural Water Supply and Sanitation Project for Low Income States and others involved in implementation of the Project. For a complete understanding of the financial management arrangements in the Project, this document should be read in conjunction with the Financing Agreement, the Project Agreement, the Minutes of Negotiation and the Project Implementation Plan.

Chapter – 1

Project Costs and Budgeting

Project Costs and Financing:

- The total Project cost USD 1 Billion which when converted at the current exchange rate, amounts to INR 6000 cores. This will be financed through a combination of GOI financing (under the NRDWP umbrella), State Government contribution by the governments of the four participating States (as per NRDWP guidelines to match GoI funding for the Program) and community contribution to the extent of 1% of the Project cost. The World Bank will provide an IDA credit of USD 500 Million to GoI which actually goes to finance a part of the overall GoI share of the Project costs.

Sources of Funding	Total	% to Total
	(INR Crores)	
Government of India	1861	31%
State Governments	1092	18%
World Bank	3000	50%
Community Contribution	47	1%
Total	**6000**	**100%**

- The Project will support RWSS programs in 33 districts in Assam, Bihar, Jharkhand, and Uttar Pradesh, based on priority needs for piped water and sanitation coverage. The State-wise /Component-wise break-up of the Project Costs is shown in the table below:

Components	Assam	Bihar	Jharkhand	UP	MoDWS	Total	% of Total
Component A: Capacity & Sector Development	86	117	99	173	94	**569**	**9.5%**
Component B: Infrastructure Investments	1311	1366	729	1734	0	**5139**	**85.7%**
Component C: Project Management Support	51	76	51	76	38	**292**	**4.9%**
Total	**1448**	**1559**	**879**	**1983**	**132**	**6000**	**100%**
State wise Share	**24%**	**26%**	**15%**	**33%**	**2%**	**100%**	

Note: The total Project cost has been calculated at an exchange rate of 1 USD = INR 60

- Interventions related to sanitation component of the Project will be complemented by GoI's NBA and MNREGA programs. While the NBA/MNREGA will fund all new household toilets and SLWM activities, the Project will only partly finance SLWM activities, apart from providing additional support for IEC/BCC, capacity development & formative research, incentives to households etc.

Budgeting

- Preparation of proper budget plays an important role in timely implementation of any project. Budgeting involves quantifying the financial costs of undertaking specific tasks/objectives planned for the project to be achieved in a given timeframe. Before seeking funds from the Government of India, the participating States must estimate funds required for accomplishment of the project activities in a given financial year. It would be mandatory on the part of the Centre/State to make sufficient provision in their own budget for meeting their share of estimated expenditures to be incurred under the Project. The project's financial planning process for each financial year will follow the normal budgeting cycle of the Central/State Governments i.e. April to March and will be completed when the project budgets are included in the State and Central Government's Budgets, presented to and approved by the relevant Legislatures.

- The Central share of the Project (including the share to be financed by the World Bank) will be budgeted for in the Demands for Grants of the Union Ministry of Drinking Water Supply and Sanitation as a separate budget line under the National Rural Drinking Water Program. The budget for the State share will be provided for in the Demands for Grants of the Public Health Engineering Department of the respective States (Drinking Water Supply Department in case of Jharkhand) as part of the States' overall budget for the National Rural Drinking Water Program. The Project budget for each financial year will grow out of the Annual Work Plan (AWP) of the NMPU, SPMU (in SWSM), DPMU (in DWSC) [1], GPWSCs, SHWSCs and MVSWSCs across the four participating States. The planning process of each implementing entity will follow a "bottom-up" approach i.e. it will start from SHWSC/GPWSCs/MVSWSCs , further consolidated at each DPMU, then at each SPMU and finally the AWP of the four SPMUs will get consolidated at the NPMU along its own AWP. In the States, adequate consultation should be held at the level of SPMU with all spending units to finalise the project budget for the State.

- The AWP of each State will be approved by the respective SWSM. The Annual Action Plans as approved by each of the State SWSMs would be placed before the National level Steering Committee for information The AWP of the NPMU will be approve by the National level Steering Committee The draft AWP of NPMU and each of the four 4 States will be shared with the World Bank for comments before they are approved by the respective approving authorities..

- It should be borne in mind that the detailed activity-wise cost table prepared at the time of project preparation is the best estimation at the time it is prepared. Within the envelope of overall expenditure approved by the CCEA and the outlay for the three project components laid down in the financing agreements, it may undergo revision during implementation based on the ground realities and implementation needs with the prior approval of the respective NPMU, SWSM and after consultation with the World Bank. The component-wise break-up of costs documented in the financing

[1] DPMU budget in case of Uttar Pradesh will also include the budget of UP Jal Nigam.

agreements of the World Bank are sacrosanct and can only be changed with the prior approval of the World Bank.

- Every quarter a thorough review of budget should be undertaken by the SPMU at the State level vis-à-vis the actual progress and necessary actions should be initiated for revisions/ reallocation of funds by the competent authority, for effective implementation of the project. Similar exercise should be undertaken by the NPMU for activities implemented by NPMU.

- During the process of preparation of budget estimates, the following points need to be considered:-

- Budgets should be linked with the Annual work plan/physical targets/procurement Plan.

- Any variation in the budget with the actual should be analysed; reasons for adverse variation should be analysed and considered for corrective measures/future budgeting.
- The NPMU and the SWSM of each Implementing state should have a Budget Review Committee consisting of heads of Engineering, Finance, Procurement, Monitoring, etc. This committee should review the various aspects of the budget and submit its quarterly observations to Head of the NPMU/SWSM as part of project MIS.

Chapter – 2

Flow of Funds

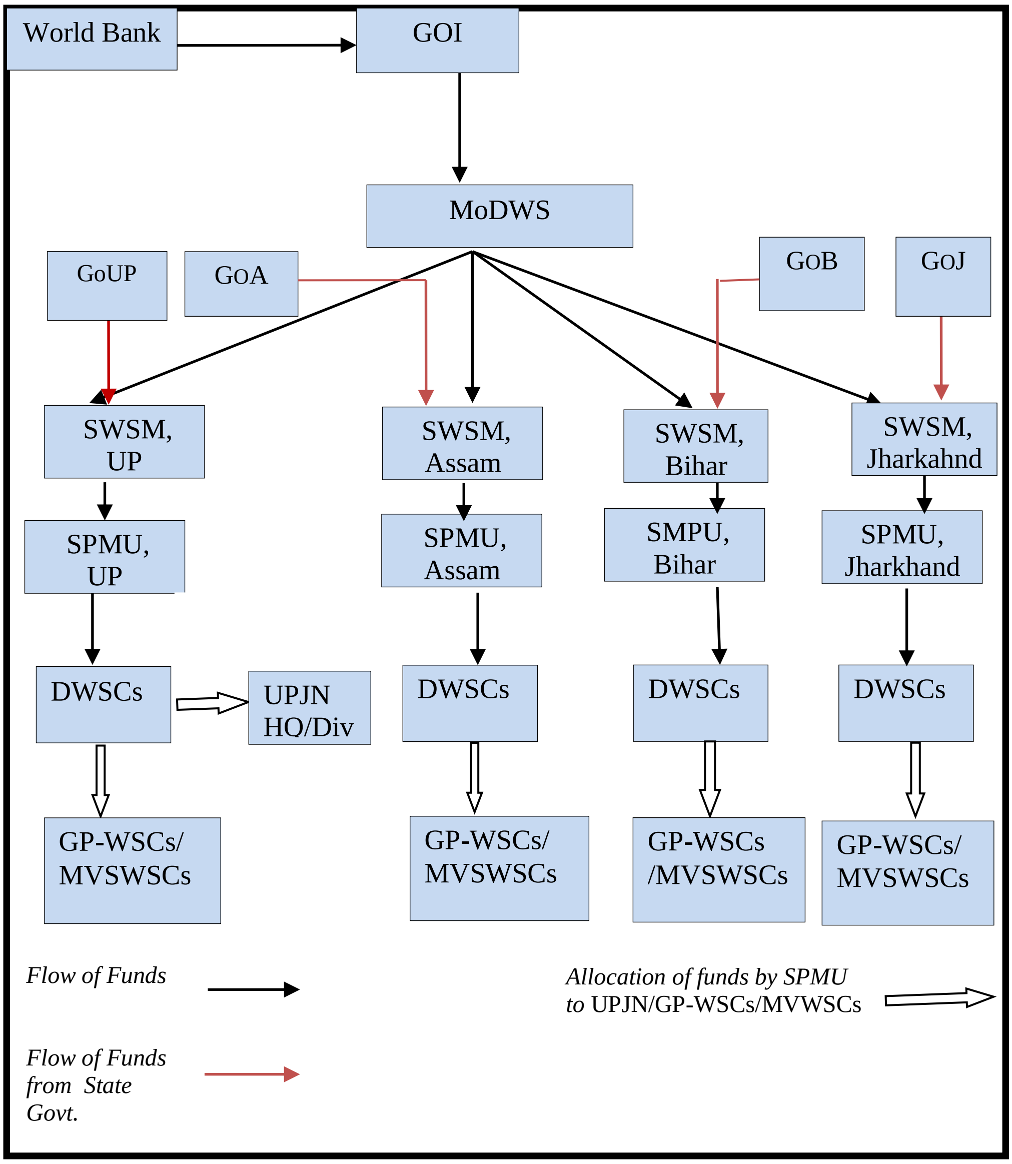
Fund Flow Design

1. Each SPMU will open a bank account in which Project funds will be held. Once the Annual Work Plan of the Project is approved by the SWSM and submitted to NPMU for information, the NPMU will transfer the central share of the Project funds through RTGS to the SWSM bank account in which NRWDP funds are held. SWSM will transfer the Central share of Project funds to the SPMU bank account within 5 working days from the date of receipt. Similarly the State share of project funds will also be received in the SWSM account and transferred within 5 working days to the SPMU account. In a financial year, funds will be released in two instalments. The first instalment of 50% of the annual budget (based on the Project Annual Work Plan approved by the SWSM) will be released at the beginning of the financial year. On utilization of 60% funds released by the NPMU in the first instalment, the second instalment of the balance 50% will be released. Release of each instalment will be accompanied by a Component-wise allocation order of the NPMU which will be in line with the approved AWP.

2. In order to streamline the financial management arrangements, funds will be held only in SPMU and DPMU project bank accounts in each participating State. As mentioned above, the SPMU in each State will have a project bank account where funds received from the NPMU (via SWSM) for both Drinking Water and Sanitation (only funds for sanitation activities to be financed by the Project) along with the state contribution for the project will be held. SPMU will make component-wise and scheme-wise quarterly allocation of funds and transfer the same through RTGS to the DPMU based on the scheme-wise demands raised by DPMUs and utilisation reported. Each SHWSC/GPWSC/MVSWSC will be given at par cheque books linked to the respective DPMU account to enable it to make payments upto the limit of quarterly or six monthly allocations made by the DPMU based on the SHWSC/GPWSC/MVSWSC's fund requirements as incorporated in the approved AWP for activities undertaken by them

The fund flow design is illustrated in Diagram below:

Figure 1: Fund Flow Diagram



3. The above-mentioned fund flow arrangements will do away with unnecessary parking of funds with GPWSCs/MVWSCs and allow efficient cash management by the SPMU and DPMUs. It will address the issue of large float of idle funds across project bank accounts with no effective system to monitor the same . This fund flow mechanism will also simplify the book-keeping requirements at the level of GPWSCs and strengthen internal controls.

4. Interventions related to sanitation component of the Project will be complemented by GoI’s NBA and MNREGA programs. While the NBA/MNREGA will fund all new household toilets in the GPs identified for project intervention in the four States, the Project will only partly finance the SLWM activities, apart from providing additional support for IEC/BCC, capacity development & formative research, incentives to households etc. The NBA and MNREGA funds for the GPs selected for the Project will flow through the existing mechanism. The SWSM/SPMU in each State should ensure that funds under these programs are available in a timely manner to respond to the demands of the single scheme cycle integrating water and sanitation processes at the GP level.

Chapter – 3

Financial reporting & Significant Accounting Policies

Accounting System

1. The success of any project to a great extent depends on its financial discipline and its accountability for the funds provided. Accounting plays crucial role in directing and guiding the project to its goals and objectives. A sound accounting and reporting system informs the management of the financial progress in implementation and reflects the variations from planned goals and alarms the organization of any major changes or adverse situations so that corrective action is taken.

2. The accounts and financial statements prepared should be in accordance with generally accepted accounting principles in India and significant accounting policies documented in this Chapter. This would also ensure uniformity and hence comparability across accounting units/implementing agencies, for effective implementation and monitoring of the project. The fund flow design of the Project will make possible accounting of all central level expenditures by the NPMU and State level expenditures by the SPMU (in SWSM) & DPMUs (in DWSCs). SHWSCs/GPWSCs/MVSWSCs will have very basic and minimalistic book-keeping requirements.

3. Each SHWSC/GPWSC/MVWSC will submit to DPMU , by the 10th of every month, the following:

   (i) Invoices of suppliers/contractors against which cheques have been issued by them in the previous month. These invoices will be accompanied by a covering letter giving the Name of the Scheme, Type of scheme (SHS/SGS/MVS (intra-village), Name of the Contractor, Invoice No., Invoice Date, Gross Amount, Deductions, and net amount of payments made (Standard format to be prepared and appended to this Manual). A copy of the invoices will be retained by the GP.

   (ii) A list of contracts signed during the previous month()

   (iii) Opening balance of allocation received from DWSC/DPMU, allocation received during the month, amount paid against water and sanitation components of the Project, NBA and MNREGA shown separately and unutilized allocation at the end of the month

   Standard formats in the local language will be developed for reporting by the GPWSCs/MVSWSCs to ensure uniformity across the States.

4. Based on the above-mentioned submissions, the DPMU will write the books of accounts for expenditures at the level of SHWSCs/GPWSCs/MVSWSCs together with its own. The chart of accounts will be designed in a manner to be able to give GPWSC/MVSWSC wise, scheme-wise, contract-wise and contractor-

wise financial information. Based on the GPWSC/MVSWSC's monthly submission, the TDS can also be paid by the concerned DWSC/DPMU.

5. Project accounts at NPMU[2], SPMU and DPMU will be maintained by using an off-the shelf accounting package, Tally, which allows synchronisation and on-line consolidation of accounts. Project The project accounts will be maintained using double-entry modified cash based accounting system.

6. Based on accounting information maintained on Tally, each SPMU will submit quarterly Interim Unaudited Financial Reports (IUFRs) to the NPMU. The NPMU will consolidate the IUFRs received from the four SPMUs along with its own, and submit a quarterly consolidated IUFR to the Bank within 60 days from the end of each quarter. Once the Bank reviews the IUFR and communicates acceptability, the NPMU will submit consolidated quarterly reimbursement request based on the consolidated IUFRs to the Office of the Controller Aid Accounts and Audit (CAAA). CAAA will review and approve the claim and then pass it onto the World Bank for reimbursement.

7. Accounting Centres: The accounting centres are the offices where the accounting for the financial transactions of the project activities shall be carried out. These accounting centers shall be responsible for maintaining the relevant books of account for of the project. The Tally accounting centers for the project shall be as follows :

Name of Accounting centre	Level	Nos.	Consolidation	Units to be Consolidated	IUFRs to be submitted to	Frequency of submission of IUFRs
NPMU	Centre	1	Yes	Four SPMUs	World Bank	Quarterly
SPMU Assam	State	1	Yes	DWSCs	NPMU	Quarterly
SPMUBihar	State	1	Yes	DWSCs	NPMU	Quarterly
SPMU Jharkhand	State	1	Yes	DWSCs	NPMU	Quarterly
SPMU Uttar Pradesh (U.P.)	State	1	Yes	DWSCs	NPMU	Quarterly
DWSC Assam	District	7	Yes	GPWSCs/MVSWSCs		
DWSCs Bihar	District	10	Yes	GPWSCs/MVSWSCs		
DWSCs Jharkhand	District	6	Yes	GPWSCs/MVSWSCs		
DWSCs Uttar Pradesh (U.P.)	District	10	Yes	GPWSCs/MVSWSCs		
Total		38				

[2] Since NPMU will operate through the existing Pay and Accounts System of the Ministry, NPMU may opt for the existing system of maintaining manual accounts. However, if NPMU sees benefit in maintaining Project accounts on Tally, it can do so. Both options are available. If NPMU decides to maintain accounts on Tally, quarterly reconciliation with accounts maintained by Pay and Accounts Office will be necessary.

8. Account Heads: A uniform chart of accounts will be developed for NPMU, SPMUs, DWSCs/DPMU, GPWSCs and MVWSCs. NPMU should take the lead in preparation of chart of accounts in consultation with the SPMUs. (The Chart of Accounts once prepared should be appended to this Project FM Manual).

9. At NPMU[3], SPMU and DWSCs, the books of accounts should be maintained in the standard format as available in Tally software. The Primary books of accounts to be maintained for each accounting center will include Cash Book, General ledger, Subsidiary ledgers like Contractors' ledger, Scheme ledger, Advances ledger etc. journal register, Fixed Asset Register (Manual) and Bank Reconciliation Statements. Besides this, any other books and accounts, which may be considered necessary for the day-to-day work of the NPMU/SPMU, shall also be maintained. For e.g. Guarantee Register, Bill Register etc. Each accounting unit will generate a monthly Trial Balance. This will facilitate timely preparation of the quarterly IUFRs.

10. The monthly accounts should be submitted to Head of Finance at each accounting unit for review as part of the Project MIS. The Head of Finance shall then submit a signed copy of the monthly accounts to the Administrative Head of the concerned NPMU/SPMU/DWSC as part of Project MIS.

11. Some Significant Accounting Policies and Eligibility for Bank Reimbursement:

12. All advances to employees including travel advances will be accounted for as advances when paid and expenditure accounted for when advances are cleared on submission of statements of expenditure with supporting bills/vouchers. These payments can be claimed from the Bank only when expenditure is accounted for on receipt of bills/vouchers.

13. Secured mobilization advances paid to contractors according to the terms of contract and backed by valid bank guarantees /Fixed Deposit Receipts should be accounted for as advances when paid and expenditures accounted for on adjustment against invoices submitted after receipt of goods/ services as per agreed standards. However, these advances can be claimed from the Bank when paid and need not be delayed till expenditure is accounted for. However advances other than secured advances as per the terms of the contract may only be claimed after expenditure is accounted for on submission of invoices after receipt of goods /services as per agreed standards. Therefore under the Advances control account the following accounting sub-heads should be maintained – Eligible Advances and Ineligible Advances. Under Eligible advances there could be sub-heads like Secured mobilization advances, and under Ineligible Advances there could be sub-heads like Unsecured advances, Travel advance, Staff advances, and any other advances.

14. The retention money/security deposits (other than refundable deposits) should be claimed from the Bank after they are actually paid. Refundable deposits should not be claimed from the Bank. All paid taxes (including taxes deducted at source and paid) can be claimed from the Bank.

[3] Please refer foot-note 2 on page 11

Chapter- 4

Disbursement

Disbursement (This section may need to be changed based on legal agreements and discussions during negotiation with DEA)

1. Release of funds by the World Bank against the expenditures incurred by implementing agencies on project activities is referred to as disbursement. The terms and details of disbursement are specified in the Credit Agreement and the Disbursement Letter (To be enclosed to this document later)

2. The total project cost is USD 1 Billion. The Bank will finance 50% of the of the eligible project expenditures. **The Bank will not finance the cost of purchase or acquisition of any land under the project.**

3. The NPMU will submit consolidated withdrawal application for reimbursement to the Bank through CAAA based on expenditures incurred during the last quarter. The disbursement methods that may be used are (i) Reimbursement and (ii) Direct Payment. Funds will be disbursed by the Bank under the following disbursement categories:

	Category	**Amount Allocated (SDR Million)**	**Amount Allocated (US$ million)**	**Percentage of Gross Reported Expenditures to be Financed (Inclusive of Taxes)**
			IDA Credit	
1.	Goods, Works, Services, Consultancy Services, Training and Incremental Operating Cost.		500	50%
	Total Amount		**500**	

4. As mentioned earlier, the Bank will disburse funds on the basis of quarterly IUFRs. All the four SPMUs will send quarterly IUFRs to NPMU. NPMU will consolidate these IUFRs received from the States along with its own and submit the same in pre-agreed formats to the World Bank Task Team Leader (TTL). Once endorsed by the TTL, NPMU will submit the IUFR along with documentation of the TTL's endorsement to CAAA (with a copy to the TTL) for processing the claims for payment. CAAA will then forward the claims to the World Bank Chennai Office for further processing. The Loan Agreement requires the NPMU/SPMU to ensure that loan proceeds are used only for the purposes set out in the loan documents and that the goods and services

financed by the Project are procured with due regard to economy and efficiency. The agreement further stipulates that the funds may be withdrawn only to meet paid project expenses.

5. NMPU staff should undergo training held by the CAAA and the Bank periodically regarding filing of claims and use of the Client Connection Database (Bank's Loan Database) respectively.

6. The Bank will not finance the following:

- Items of expenditure not related to the Project components as defined by the legal agreements.
- Goods works or services not procured in accordance with procurement guidelines of the World Bank.
- Payments made or due for goods, works and services provided after the closing date of the project.
- Land acquisition Costs.
- Late payment penalties that were incurred in connection with a disputed payment which was under arbitration.
- Advance payments other than secured mobilisation advances paid to contractors as per the terms of contracts.
- Amounts parked in deposit/Bank accounts and accounted for as expenditure without expenditures being actually incurred and paid

7. Retroactive Financing: Expenditures incurred with the Bank's concurrence on or after ……., 2012, but within 12 months before the date of loan signing, and following the Bank's procurement guidelines are eligible for retroactive financing up to an overall ceiling of US$ ……….. Million. The expenditure could be claimed by the NPMU on the basis of a consolidated IUFR submitted to the Bank after the project is declared effective.

8. Disbursement Letter: After the loan agreement has been signed the World Bank will issue a Disbursement Letter to the Government of India, with a copy to the Project Implementing Agency, outlining the disbursement procedures. (A copy of the Disbursement letter once received should be appended to this Manual.)

9. Before withdrawals from the credit account can begin, the following must occur:

- The credit must be declared effective by the Bank,
- The Bank must receive a formal notification listing those officials who have authority to sign withdrawal application together with specimen of their signature This will be done by the Comptroller Aid Audit and Accounts (CAAA – a division of the Department of Economic Affairs, Ministry of Finance).

10. Before submission of reimbursement requests to the Bank through CAA&A, the NPMU should ensure that the consolidated IUFRs are submitted in prescribed formats; expenditure on each component, sub component has been correctly included in the IUFR and properly classified.

11. Stopping of Disbursements: The World Bank, as per its Operational/Business Policy may apply remedies if the NPMU or the SPMU fails to furnish its Annual external audit report within four months from the due date of submission of Audit Report to the Bank[4]

12. Cancellation: Under the General conditions, the borrower country may request cancellation of any undisbursed loan/credit balances The Bank may cancel loan/credit balances, in full or part, under the following circumstances:

- If the right to make withdrawals has been suspended for a continuous period of 90 days.
- If, in consultation with the borrower, the Bank determines that an amount is not required to finance the costs that were to have been financed from the loan.
- In certain instances of non- compliance with procurement procedures (provisions).
- If undisbursed loan balances remain in the loan account after the closing date has lapsed.
- The action in this respect, if any, is to be taken by Union Ministry of Rural Development and the Ministry of Finance.

[4] The due date for submission of audit report is 6 months from the end of the financial year.

Chapter – 5

Internal Control Framework

Internal Control Framework

1. The Financing Agreements, The Project Implementation Plan, Procurement and Financial Management Manuals together with relevant Ministry/State/ departmental Rules/Codes/Circulars/GO Guidelines constitute the internal control framework.

2. The Annual Work Plan (AWP)of the Project approved by the Steering Committee (for NPMU) and SWSMs (for States) will form the basis of implementation. The World Bank will also review this AWPbefore finalisation. The delegation of the administrative and financial powers mandated for the Project both at the Centre and the State will constitute the control framework.

3. Under the Infrastructure Component, no schemes can be undertaken by a State unless Technical Clearance is given by the State level Scheme Sanctioning Committee (SLSSC) wherein a representative of MoDWS is also a member. Delegation of power for administrative and technical sanction of schemes is also well laid out in each State (Please refer to the section on "Proposed Technical and Administrative Approval" under "Institutional and Implementation arrangements" for each State in PIP Vol I). All variations[5] in contracts for MVS schemes awarded under the Project will have to be approved by the competent authority as per existing rules of PHED/DWSSD/UPJN. In case of Single Village/Single Habitation Schemes, variations will have to be approved as per standard norms laid down by State Governments. As per the Bank's Procurement guidelines, for all contracts subject to the Bank's prior review[6], before agreeing to cumulative variations exceeding 15% of the contract amount, the implementing agency needs to seek the World Bank's no-objection. These controls will ensure efficient contract management. However, if there is any change in the scope of a prior-review contract, it will tantamount to an amendment of the contract and therefore will need to be sent to the Bank for no-objection even if changes in the contract amount due to such change in scope is less than 15%.

4. Payments should be made to contractors/consultants/suppliers within the time limit stipulated in the contract documents. The standard contract documents lay down such timelines for payment of acceptable invoices. If the invoice is not acceptable, the reasons of non-acceptance should normally be communicated to the contractor/supplier/consultant no later than two weeks of the receipt of the invoices. The standard contract documents also lay down norms for penalties for non-payment within the prescribed timeline as well as penalties for failure of delivery of goods/ works of agreed standards within prescribed timeline.

[6] Please refer to the Procurement Manual (Annexure 32 of PIP Vol II) for prior-review thresholds

5. Under the Infrastructure Component capex contribution by the households in case of Multi-village Schemes are not required to be collected by the technical agency such as UP Jal Nigam or the State line departments. These contributions will remain with the SHWSC/GPWSCs and will be used for the intra-village component of the schemes executed by the respective SHWSC/GPWSCs.

6. The SPMUs and DPMUs will reconcile their bank balances with the books by preparing monthly Bank Reconciliation Statements (BRS). The Monthly BRS should be reviewed and signed by the Finance in-charge of the SPMU/DPMU. These signed monthly BRSs should be filed and made available for verification by the Internal/External Auditors and Bank Review Missions. Bank interest earned should be aacounted for and reported in the IUFRs and such interest should be strictly utilized for the purpose of the Project. Project funds should not be even temporarily diverted to any other project/schemes at any level of implementation.

7. Thus some of the key internal controls built in the Project design are:

   - Approval of transactions in accordance with the prescribed delegation of administrative and financial powers mandated for each implementing entity;
   - Independent construction quality supervision
   - Incurring expenditure on activities only if they are included in the approved Annual Work Plan of the Project.
   - Inspections of works by the next hierarchy in the Technical Agency as per the departmental norms /norms of the concerned technical agency.
   - Monthly BRS by SPMU and DPMU
   - The Project M&E System including beneficiary assessment at least once a year
   - Performance Audit at mid-term
   - Annual Financial Audit of the Project in each State by Chartered Accountant Firms empanelled with the C&AG for Major Audits. The audit of NPMU will be done by the C&AG as per the existing audit arrangements under NRDWP.
   - Social Audits

8. In each State a Project Audit Committee will be formed. Similarly a Project Audit Committee will be formed at the level of NPMU. The Mission Director NPMU will chair the Audit Committee at NPMU. These Audit Committees will approve appointment of the Auditors, consider the key findings of the External, Internal and Performance audits and monitor timely action on these findings by the implementing agencies.

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Chapter - 6

Audit

The Development Credit Agreement requires adequate auditing arrangements acceptable to the Bank for an annual external audit of Project Financial Statements. The Annual Audited Financial Statements together with the Audit Report is required to be submitted to the Bank within 9 months of the end of the financial year. Bank requires that the borrower disclose the audited financial statements in a manner acceptable to the Bank; following the Bank's formal receipt of these statements from the borrower, the Bank makes them available to the public in accordance with The World Bank Policy on Access to Information.

The following External Audit Reports are required for the Project:

Audit Report	Auditor	Responsible Implementing Agency	Due date
Project Financial Statements	C&AG	NPMU, MoDWS	December 31
Project Financial Statements - Assam	Empanelled CA Firm	SPMU, SWSM Assam	December 31
Project Financial Statements - Bihar	Empanelled CA Firm	SPMU, SWSM Bihar	December 31
Project Financial Statements - Jharkhand	Empanelled CA Firm	SPMU, SWSM Jharkhand	December 31
Project Financial Statements - Uttar Pradesh	Empanelled CA Firm	SPMU, SWSM Uttar Pradesh	December 31
Designated Account	C&AG	DEA/GOI	December 31

(A) External Audit

Each SPMU and the NPMU will prepare annual financial statements and have them audited by an independent external auditor appointed under terms of reference agreed with the Bank. Each SPMU and NPMU will submit individual annual audited financial statements together with the audit report to the Bank. The CA firms hired by the SPMUs and NPMU should be empanelled with the C&AG for Major Audits. SPMU audit should cover project operations at the DWSC/DPMU and SHWSC/ GPWSC/ MVWSC levels also.

TERMS OF REFERENCE FOR THE AUDIT OF PROJECT FINANCIAL STATEMENTS

Background[Project Aims, Timelines and Objectives][7]

Objective

The essence of the World Bank[8] audit policy is to ensure that the Bank receives adequate independent, professional audit assurance that the proceeds of World Bank loans were used for the purposes intended,[9] that the annual project financial statements are free from material misstatement, and that the terms of the loan agreement are complied with in all material respects.

The objective of the audit of the Project Financial Statement (PFS) is to enable the auditor to express a professional opinion as to whether (1) the PFS present fairly, in all material respects, the sources and applications of project funds for the period under audit examination, (2) the funds were utilized for the purposes for which they were provided, and (3) expenditures shown in the PFS are eligible for financing under the relevant loan or credit agreement. In addition, where applicable, the auditor will express a professional opinion as to whether the Interim Unaudited Financial Reports (IUFRs) submitted by project management may be relied upon to support any applications for withdrawal, and whether adequate supporting documentation has been maintained to support claims made by project management for reimbursement of expenditures incurred.

The books of accounts that provide the basis for preparation of the IUFRs are established to reflect the financial transactions of the project and are properly maintained by the implementing units.

Standards

The audit will be carried out in accordance with the Auditing Standards issued by the Institute of Chartered Accountants of India**.** The auditor should accordingly consider materiality when planning and performing the audit to reduce audit risk to an acceptable level that is consistent with the objective of the audit. Although the responsibility for preventing irregularity, fraud, or the use of loan proceeds for purposes other than as defined in the legal agreement remains with the borrower, the audit should be planned so as to have a reasonable expectation of detecting material misstatements in the project financial statements.

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7 The background should normally include a detailed description of the project including information on project sources of funding; the purposes for which the funds are intended; and a general description of implementation arrangements, including the organizational structure of all implementing entities.

8 "World Bank" includes the International Development Agency and the International Bank for Reconstruction and Development. "Loans" includes credits and grants to which the TORs would apply; and "borrower" includes recipients of such loans.

9 The Bank's charter [Article III Section V (b) of IBRD's Articles of Agreement and Article V Section 1(g) of IDA's Articles of Agreement] specify that: "The Bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency and without regard to political or other non-economic influences or considerations."

Scope[10]

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 legal agreements and only for the purposes for which the financing was provided. Relevant legal agreements include the Financing Agreement, the Project Agreement, and the Minutes of Negotiations;

(b) Counterpart funds have been provided and used in accordance with the relevant legal agreements and only for the purposes for which they were provided;

(c) All necessary supporting documents, records, and accounts have been kept in respect of all project transactions including expenditures reported via IUFRs where applicable. Clear linkages should exist between the books of account and reports presented to the Bank; and

(d) The project accounts have been prepared in accordance with consistently applied Accounting Standards and present fairly, in all material respects, the financial situation of the project at the year end and of resources and expenditures for the year ended on that date.

Project Financial Statements

The Project Financial Statements should include-

a. Statement of Sources and Applications of Funds: The contents of Project Financial Statements (PFS) are specific to the sector, the project design and the type of implementing entity. These formats therefore vary from one Project to another. The formats of PFS are prepared in consultation with the implementing entity during the preparation of the Project.
b. Reconciliation of Claims to Total Applications of Funds. The PFS include reconciliation between expenditure reported as per the Statement of Sources and Applications of Funds and expenditure claimed from the World Bank through IUFRs
c. Other Statements or Schedules as may be applicable in particular circumstances and as specified in the relevant legal agreements, such as:
d. A statement showing appropriate major heads of expenditure. (say by Project Component/Sub-components
e. Management Assertion: Management should sign the project financial statements and provide a written acknowledgement of its responsibility for the preparation and fair presentation of the financial statements and an assertion that project funds have been expended in accordance with the intended purposes as reflected in the financial statements. An example of a Management Assertion Letter is shown at Appendix 1.

The auditor should ensure reconciliation of the Annual Project Financial Statements with the four quarterly IUFRs submitted to the Bank. The auditor should apply such tests as the auditor considers necessary under the circumstances to satisfy the audit

[10] In response to identified project risks, the scope may be expanded to include a report or the expression of an opinion on specific aspects of the operation such as internal controls, compliance with Bank procurement policies, or efficiency and effectiveness in the use of loan proceeds.

objective. In particular, these expenditures should be carefully examined for project eligibility by reference to the relevant financing agreements. Where ineligible expenditures are identified as having been included in withdrawal applications and reimbursed against, these should be separately noted by the auditor.

Audit Report

An audit report on the project financial statements should be prepared in accordance with the Auditing Standards promulgated by the Institute of Chartered Accountants of India. Those standards require an audit opinion to be rendered related to the financial statements taken as a whole, indicating "unambiguously whether it is unqualified or qualified and, if the latter, whether it is qualified in certain respects or is adverse or a disclaimer of opinion." In addition, the audit opinion paragraph will specify whether, in the auditor's opinion, (a) with respect to IUFRs adequate supporting documentation has been maintained to support claims to the World Bank for reimbursements of expenditures incurred; and (b) except for ineligible expenditures as detailed in the audit observations, if any, appended to the audit report, expenditures are eligible for financing under the Loan/Credit Agreement.

Management Letter

In addition to the audit report on the project financial statements the auditor may prepare a management letter containing recommendations for improvements in internal control and other matters coming to the attention of the auditor during the audit examination which do not affect the audit opinion but are required to be brought to the management's attention.

Where a management letter is prepared by the auditor, a copy of the same will be supplied to the Bank. Else, a written advice may be made that no management letter was prepared together with the audit report on the project financial statements.

General

The auditor should be given access to any information relevant for the purposes of conducting the audit. This would normally include all legal documents, correspondence, and any other information associated with the project and deemed necessary by the auditor. The information made available to the auditor should include, but not be limited to, copies of the Bank's Project Appraisal Document and the relevant Legal Agreements, It is highly desirable that the auditor become familiar with other Bank policy documents, such as OP/BP 10.02, the Bank's internal guidelines on Financial Management that include financial reporting and auditing requirements for projects financed by the World Bank. The auditor should also be familiar with the Bank's Disbursement Manual. Both documents will be provided by the Project staff to the auditor.

Appendix 1

Example of a Management Assertion Letter[11]

(Project Letterhead)

(To Auditor) (Date)

This assertion letter is provided in connection with your audit of the financial statements of the ______________ Project for the year ended ___________. We acknowledge our responsibility for the fair presentation of the financial statements in accordance with the cash basis of accounting followed by the Government of India, and we confirm, to the best of our knowledge and belief, the following representations made to you during your audit:

- The project financial statements are free of material misstatements, including omissions.
- Project funds have been used for the purposes for which they were provided.
- Project expenditures are eligible for financing under the Loan/Credit agreement.
- There have been no irregularities involving management or employees who have a significant role in internal control or that could have a material effect on the project financial statements.
- We have made available to you all books of account and supporting documentation relating to the project.
- The project has complied with the conditions of all relevant legal agreements, including the Financing Agreement, the Project Agreement, the Project Appraisal Document, the Minutes of Negotiations, and the Borrower's Project Implementation Plan.

____

(Senior Executive Officer)

____

(Senior Financial Officer)

[11] This sample management assertion letter is based on ISA 580, "Management Representations," *Handbook of International Auditing, Assurance and Ethics Pronouncements*, International Federation of Accountants, 2007

(B) **Internal audit**

The NPMU and SPMUs will hire private firms of chartered accountants as internal auditors to assess effectiveness of internal controls and to provide independent assurance on the adequacy of internal controls to mitigate financial risks in the Project. The internal auditors will be appointed no later than 6 months of the date of effectiveness under Terms of reference and selection criteria agreed with the Bank. The internal auditors will work in close coordination with the technical supervision consultants to obtain assurance that the fiduciary controls in contract management are in place and are operating as intended. The NPMU/SPMUs will ensure that the work of internal auditors is duly considered by the external auditors when planning the scope of their audit examination. The NPMU will share with the Bank a report on actions taken in response to the internal audit.

Terms of Reference of Internal Audit

Scope:

Internal audit should play a role in assisting management in bringing a systematic, disciplined approach to evaluate and improve the effectiveness of the internal control system. In conducting the audit, special attention should be paid to assessing whether adequate controls have been established and complied with to ensure:

(e) All project funds have been used in accordance with the conditions of the relevant legal agreements and only for the purposes for which the financing was provided;

(f) Project assets are adequately safeguarded and used solely for their intended purposes; and

(g) All necessary supporting documents, records, and accounts have been kept in respect of all project transactions; including expenditures reported in the Interim Unaudited Financial Reports (IUFR).

(h) Procurements for the Project have been done in accordance with the agreed Procurement procedures

Objective

The objective of internal audit is to provide management with an independent, objective and professional assessment that implementing entity's internal control systems are operating satisfactorily. Internal audit will provide project management with information on financial risk management and controls to enable the management to take timely corrective actions, wherever necessary. The internal auditor would recommend cost-effective methods for strengthening controls to prevent or detect significant financial irregularities or losses due to insufficient attention to economy, efficiency and effectiveness in the use of project funds.

Coverage

The internal audit will include such tests and controls as the Internal Auditor considers necessary under the circumstances. Specific areas of coverage of the internal audit will include the following.

- An assessment of the effectiveness of and degree of compliance with the financial controls laid down in the FM and Procurement Manuals. Whether funds have been used with due regard to economy, efficiency and effectiveness and for the purposes for which they were provided.
- Whether realistic annual work plans and procurement plans are prepared and the approval process of AWPs followed as intended. Whether there are links between the AWP and Procurement Plan.
- Whether expenditures are incurred as per approved plans and variances if any are monitored, analysed and the learning used for preparing plans for subsequent years.
- Timeliness of flow funds to the spending units. Whether the fund flow arrangements are creating any bottlenecks for implementation and if so the possible remedies.
- Whether the selection criteria for selection of GPs have been complied with
- Whether there is appropriate documentation of check measurement/inspection of works by technical agencies/SOs
- Whether contract payments have been made as per the terms of the contract. In doing so the auditors should consider the reports of the technical supervision consultants.
- Whether an appropriate system of accounting and financial reporting exists by which expenditures are properly recorded and eligible expenditures are claimed from the Bank in a timely manner. Whether adequate supporting documentation is being maintained for all project expenditures
- Whether an adequate system is in place to ensure that goods, works and services are being procured in accordance with guidelines prescribed in the Procurement Manual.
- Whether there is an appropriate contract management system commensurate to the size and nature of the sub-project executed by the Technical Agencies/SHWSC/GPWSC/MVSWSC. Whether payments are being made to contractors/suppliers/consultants within the time limits stipulated in the contract documents by all implementing agencies.
- Whether appropriate controls as laid down in the FM/Procurement Manual are complied with for variation in contracts.
- Whether Bank balances are reconciled with the books by the SPMU.
- Anything else that the auditor considers pertinent.

Timing

The Internal Audit will be conducted on a half-yearly basis, although the auditor will not cover all spending units every six-months. Internal audit at the will cover the entire project on a sample basis at all levels i.e. NPMU, SPMU, DPMU, Technical Agency like Jal Nigam, SHWSC/GPWSC/MVSWSC. However the auditor need not cover samples from all types of agencies in every audit. The auditor will draw up an audit plan and decide on the sample for coverage in each half-yearly audit at the beginning of the financial year in consultation with the respective management. The sample selection would be based on an assessment of the risks applicable to the operation.

Reporting

The Internal Auditor will provide a report to the project management highlighting findings within 30 days of completing the audit to enable the management to take timely corrective action. Copies of the Internal Audit Report together with actions taken by management to address the audit observations will be submitted to the Bank. One of the most serious concerns from other Projects in the Bank's India portfolio is that despite widespread knowledge of control weaknesses there is limited response from implementing agencies by way of timely remedial actions on the findings of audits. This will need to be improved by continued follow-up and monitoring of resolution of audit observations by the Project Audit Committees both at Centre and State levels.

General

The internal auditor should be given access to all relevant documents (Loan Agreement and Project Agreements, Minutes of Negotiation, Project Appraisal Document, Project Implementation Plan, Bank Procurement Guidelines, M&E assessments, technical assessment, Aide-memoires and relevant correspondences, and any other information associated with the project and deemed necessary by the auditor. It is highly desirable that the auditors become familiar with Bank's Guidelines on Disbursements, Procurements and Financial Reporting. These documents will be provided to the Internal Auditor by the NPMU/SPMU.