

Audit Guide of Project Financial Statements



**Office of the Auditor General of
Nepal**



Auditor General of Nepal



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Foreword

Office of the Auditor General of Nepal (OAGN) is conducting audits of Projects Financial Statements of the Projects funded by the Development Partners. Development Partners greatly rely on auditor's report regarding truthfulness and fairness of financial information included in the audited financial statements. Further, financial information prepared by the government and responsible agencies also get enhanced credibility once they get certified by the auditors. In this regards, OAGN has prepared and developed this audit guide to provide guidance to the auditors in conducting audits of donor funded projects.

As most of the projects are funded by the World Bank and the Asian Development Bank ('ADB'), this audit guide has been tailored based on the requirements of these two development partners. Donors have been referred to as development partners in this guide.

Utmost care has been done to make this guide error free. However, we will be grateful if the user could inform any suggestion on this guideline to the concerned Directorate of the OAGN.

At last, I would like to appreciate team of OAG Nepal, SOAGP and stakeholders who gave their efforts in the preparation and development of this guide.

A handwritten signature in black ink, appearing to read 'Sukudev Kharty', is written over a light blue horizontal line.

(Sukudev Kharty)

Acting Auditor General



Table of Content

CHAPTER 1

| | | |
|--------|---|----------|
| 1.1 | INTRODUCTION..... | 1 |
| 1.1.1 | <i>Development projects and Financial Management.....</i> | <i>1</i> |
| 1.1.2 | <i>Purpose of the project financial statements audit guide.....</i> | <i>1</i> |
| 1.2 | PROJECT FINANCIAL STATEMENTS..... | 1 |
| 1.3 | PREREQUISITES FOR PROJECT FINANCIAL STATEMENTS AUDIT | 2 |
| 1.3.1 | <i>Project Implementation Agreement.....</i> | <i>2</i> |
| 1.3.2 | <i>Funding and implementation process.....</i> | <i>2</i> |
| 1.3.3 | <i>Annual budget and funding arrangement</i> | <i>3</i> |
| 1.3.4 | <i>Budget release and expenditure</i> | <i>3</i> |
| 1.3.5 | <i>Disbursement of Development Partners' Funds.....</i> | <i>3</i> |
| 1.3.6 | <i>Expenditures category/component</i> | <i>3</i> |
| 1.3.7 | <i>Records to be maintained.....</i> | <i>4</i> |
| 1.3.8 | <i>Audit Reports and Management Letter.....</i> | <i>5</i> |
| 1.3.9 | <i>Payment procedures.....</i> | <i>5</i> |
| 1.3.10 | <i>Procedures for Opening Special/Imprest Account</i> | <i>7</i> |
| 1.3.11 | <i>Special/Imprest Account - Operation</i> | <i>7</i> |
| 1.3.12 | <i>Transfer of fund to consolidated account</i> | <i>7</i> |
| 1.3.13 | <i>Closing of Special/Imprest Accounts.....</i> | <i>7</i> |

CHAPTER 2

| | |
|--|-----------|
| AUDIT OF PROJECT FINANCIAL STATEMENTS..... | 8 |
| 2.1 <i>Audit of the project financial statements.....</i> | <i>8</i> |
| 2.2 <i>Audit objectives.....</i> | <i>9</i> |
| 2.3 <i>Standards on auditing.....</i> | <i>10</i> |
| 2.4 <i>Documents required for the audit.....</i> | <i>11</i> |
| 2.5 <i>Audit procedures.....</i> | <i>12</i> |
| 2.6 <i>Checking of project financial statements</i> | <i>13</i> |
| 2.7 <i>Checking of withdrawal application.....</i> | <i>14</i> |
| 2.8 <i>Risks assessment and responding to the risk (Check list).....</i> | <i>15</i> |
| 2.9 <i>Auditors' Opinion</i> | <i>20</i> |
| 2.10 <i>Management Letter</i> | <i>21</i> |
| 2.11 <i>Written Representation from Management</i> | <i>22</i> |

CHAPTER 3

| | |
|----------------------------------|-----------|
| SECTORWIDE APPROACH (SWAPS)..... | 23 |
| 3.1 <i>Introduction.....</i> | <i>23</i> |

| | |
|--|----|
| <i>3.2 Pooling of funds</i> | 24 |
| <i>3.3 Reporting</i> | 24 |
| <i>3.4 Audit requirements</i> | 25 |
| <i>3.5 Audited annual Financial Statements</i> | 25 |
| ANNEXURES | 26 |
| ANNEXURE – 1 PROJECT FINANCIAL STATEMENTS | 27 |
| ANNEXURE – 2 MAIN LOAN/ GRANT REGISTER | 30 |
| ANNEXURE – 3 WITHDRAWAL MONITORING REGISTER | 31 |
| ANNEXURE – 4 SUBSIDIARY LOAN/ GRANT REGISTER | 32 |
| ANNEXURE – 5 SPECIAL/ DESIGNATED OR IMPREST ACCOUNT | 33 |
| ANNEXURE – 6 STATEMENT OF EXPENDITURE (SOE) | 34 |
| ANNEXURE – 7 UNQUALIFIED AUDIT OPINION | 35 |
| ANNEXURE – 8 QUALIFIED AUDIT OPINION | 37 |
| ANNEXURE – 9 DISCLAIMER OF OPINION | 39 |
| ANNEXURE – 10 ADVERSE AUDIT OPINION | 41 |
| ANNEXURE – 11 AUDIT OPINION WITH EMPHASIS OF MATTER PARAGRAPH | 43 |
| ANNEXURE – 12 MANAGEMENT LETTER | 44 |
| ANNEXURE - 13 ILLUSTRATIVE AUDIT PROGRAM | 45 |
| ANNEXURE -14 MODEL WRITTEN REPRESENTATION LETTER | 55 |
| ANNEXURE – 15 SECTORAL PROJECT FINANCIAL STATEMENTS | 57 |



Chapter 1

1.1 Introduction

1.1.1 Development projects and Financial Management

Government of Nepal (GoN) has been investing in various infrastructures for development, social and public utilities, economic activities, etc. The development efforts have been supported by various development partners, along with the internal resources of the government. Assistance from the development partners is received in the form of soft loans and grants. Development activities funded by the development partners are designed/ operated as separate projects with specific budget allocations. Various programs are thus reflected in separate budget heads in order to achieve project objectives. Such development projects have to provide for the flow of accounting and related information as per the agreement made with the development partners.

1.1.2 Purpose of the project financial statements audit guide

This guide has been prepared on the basis of International Standards of Supreme Audit Institutions (ISSAIs), Financial Procedural Act and Regulation thereon and considered the basic requirement of development partners assisting GoN in carrying out various projects/programmes etc.

This Guide has been written to provide guidance to public sector auditors in the audit of Project Financial Statements with a purpose of:

- providing a guidance to audit staff in carrying out the audit of Project Financial Statements,
- providing a basis for conducting training to audit staff.

1.2 Project Financial Statements

If the assistance rendered is on a Project basis, expenditures incurred in the development projects implemented by GoN are recorded in the books and accounts prescribed by the government. The financial statements prepared for the purpose of GoN and the records providing information, like the amount of loan or grant received by the project, special/

imprest fund accounts reporting and reimbursement/replenishment amounts to be received from the development partners together is called the “Project Account” designed to meet these requirements. The project executing/implementing agencies/entities prepare separate project financial statements from the accounting records and information, in order to show a complete and up to date picture of the project as per the requirements of GoN and the development partners concerned.

In the event the assistance is used in the form of sectoral or sub-sectoral budget, the financial statements showing each development partner’s contribution should be prepared.

1.3 Prerequisites for project financial statements audit

1.3.1 Project Implementation Agreement

This document is the legal agreement between the development partner and GoN. It describes the implementation procedures, project costs, budget allocations to different activities, the duration of the project, reporting requirements, accounting and auditing requirements. The activities of the project are implemented according to the terms and conditions of this agreement. The basis of the Financing Agreement document in case of World Bank and Asian Development Bank is the Project Appraisal Report. In case of other development partners, Memorandum of Understanding and Project Implementation Letter form the basis of agreement.

1.3.2 Funding and implementation process

Information as to the source of funding of a Project can be obtained from the “Source Book for Foreign Aided Projects” published by the Ministry of Finance. Information as to project operated under bilateral or multilateral funding is also available in the Financing Agreements. A project may be operated with funding from GoN and any one country or International Organisation is called **Bilateral**; those operated with funding from GoN and more than one country or International Organisations is called **Multi-lateral** and those operated with only one source of funding is called **Unilateral**.

Generally, Project Implementation is managed in one of the following three ways:

- (1) Full management by GoN
- (2) Joint management by GoN and development partners
- (3) Full management by the development partner.

This Audit Guide is applicable in cases of (1) and (2) stated above. In case of (3), all aspects of management are under the control of development partner.

1.3.3 Annual budget and funding arrangement

Project implementation may exceed one fiscal year depending on the agreement. Resources needed for each fiscal year is provided by means of an annual budget. The “Source Book for Foreign Aided Projects” contains resource allocations to each project operation by activities as well as by source and modalities of funding of each project for the particular fiscal year. Anything not specifically mentioned in the Source Book is normally cleared by the Ministry of Finance.

The total budget from foreign sources mentioned in the Source Book is variously classified by the Ministry of Finance into cash loan and cash grant and includes the amounts to be paid directly and reimbursable amounts.

1.3.4 Budget release and expenditure

The District Treasury Controller Office either releases the cash budget of GoN portion and foreign portion of the budget allocated in the budget book to the project office or in case of treasury single accounts, makes arrangement for payments as authorised by the project office. The development partner’s portion of funds released is pre-funded by GoN, which is reimbursed from the development partners after expenditure is incurred. Projects also incur expenditures provided in the Budget which are directly reimbursable from foreign source.

1.3.5 Disbursement of Development Partners’ Funds

Generally, development partners make payments to foreign suppliers directly and reimburse local expenditure on receipt of the withdrawal application. Some development partners have opened special/imprest accounts in the Central Bank in order to ease the fund position of the government. GoN can withdraw money from the special/imprest account as soon as expenditure is incurred by the project. Disbursement procedures are explained in detail in the Guidelines issued by the development partners.

1.3.6 Expenditures category/component

Projects must maintain separate accounts for each fiscal year clearly showing all transactions of release and expenditure of funds according to the Financial Procedural Regulations of GoN. For projects operating under foreign loan/grant or assistance

additional requirements are prescribed in the Financing Agreements to keep records of expenditure classified into various components or categories. Expenditures under Loan/Grant assistance are generally categorised into the following groups:

- civil works;
- consultants' services;
- community service providers
- goods;
- local training, grants and scholarships;
- incremental salaries and operating costs; and
- land & building, plant, equipment and vehicles.

As classification of budget release and expenditure for loan or grant projects may not exactly tally with the components/categories provided in the loan/grant agreement, projects are required to keep separate accounts for specific component/category. Project financial statements in case of multilateral or bilateral projects should also provide for separate accounts of each development partner. Consolidated Statement of Accounts must be prepared in case of projects whose programmes are operated by different agencies in various districts.

1.3.7 Records to be maintained

In addition to the books of accounts normally required to be maintained, project should also maintain the following records, ledgers and subsidiary ledgers with a view to provide the development partners' information on the position of the Fund, special/imprest account, reimbursement, replenishment and also to ease the process of preparation of "Project financial statements":

- Project Accounts
- Main Loan/Grant Register
- Withdrawal Monitoring Register
 - Direct Payment
 - Reimbursement

- Subsidiary Loan/Grant Register/Category Register
- Special/Imprest account
- Statement of Expenditure

Illustrations of the above records are provided in ***Annexure 1 to 6***.

Note: *The format of Illustrations given in annexure may be different as per practice of the development partners may have been maintained electronically using software.*

1.3.8 Audit Reports and Management Letter

In case of many projects, audit report has to be sent to the development partner after completion of audit works in the prescribed format. The illustrative format of such audit reports, depending upon the circumstances of the results of each audit, is prescribed in the following annexure:

| <u>Particulars</u> | <u>Annexure</u> |
|----------------------------------|-----------------|
| Audit Report | |
| (1) Unqualified Audit Opinion | 7 |
| (2) Qualified Audit Opinion | 8 |
| 3) Disclaimer of Opinion | 9 |
| (4) Adverse Opinion | 10 |
| (5) Emphasis of Matter Paragraph | 11 |
| (6) Management Letter | 12 |

1.3.9 Payment procedures

Reimbursement Procedure - Disbursement of development partner's funds is either done directly by the development partner or by reimbursement of GoN expenditure. After expenditure is incurred, the project should submit withdrawal application for reimbursement of the development partner's portion. This should be done promptly and according to the procedures laid down by the development partner.

Statement of Expenditure (SOEs) –This is part of the reimbursement system. Normally, applications for reimbursement of expenditure should be accompanied by supporting expenditure documents. In the case of small expenses, submitting an SOE is sufficient. The types of expenditure that can be covered by SOEs are described in the Agreement. The project entity should keep all supporting documents for later audit of SOEs or for review by a development partner’s mission. Specimen record of SOE is given in **Annexure-6**.

Direct Payments:Payment for goods and services is done directly by the development partner through transfer of funds into the bank accounts of recipient supplier, contractor and consultant, on the submission of an application by the project. The development partner issues a commitment letter to pay to the supplier through a letter of credit. The objective of such arrangements is to curtail delay in payment from the development partner to the project and through it, to the recipients.

The currency of direct payment is determined by the agreement. The exchange rate for accounting purpose should basically be followed as per agreement, and, if agreement does not provide for this, the exchange rate at the date of transaction should be applied.

Payment against contract: The bill/invoice of the contract is to be submitted in the currency as specified in the Contract document. If any portion of the contract bill is to be paid in a foreign currency, it is to be paid at the exchange rate specified in the contract document or at the prevailing rate.

Special/Imprest Accounts: Development partners have opened special /imprest accounts in some projects in order to expedite fund flow and ease the cash position of GoN. It is opened in the Central Bank. The Guidelines of the development partners describe all the necessary procedures for the operation of the Special/Imprest Account.

The World Bank replenishes payments made from the Special/Imprest Account. The Asian Development Bank liquidates the imprest fund balance as expenditures are transferred from this fund to the Consolidated Fund. Thus it is a kind of “Revolving Fund”. The currency, procedure of operation, etc. is determined by the agreement itself. Amount expended from GoN source should be withdrawn from this Account according to the procedures mentioned in the agreement, and reimbursed to the consolidated fund of GoN. In course of spending from this Account replenishment should be made to the Account through Withdrawal Application. The development partner, after checking the documents submitted along with withdrawal application, replenishes the applicable amount.

Information of such replenishment is sent by the development partner to the concerned project, the Central Bank, and the Financial Comptroller General’s Office. The portion of withdrawal which is not in compliance with the scope of the agreement or the

percentage to be met from the development partner's fund is deducted before making such replenishment. The amount not replenished is notified by the development partner to the project for review.

1.3.10 Procedures for Opening Special/Imprest Account

The conditions of the financing agreement may permit the project to have a special/imprest account in a local bank. It is opened by submitting an application to the development partner. On receipt of the application, the development partner deposits the agreed amount of funds in the special/imprest account and informs FCGO and the concerned Project or Programme Office. The procedures are to be followed in the opening and operation of such account.

1.3.11 Special/Imprest Account - Operation

The operational procedures of the special/imprest account are described in the Guidelines of the development partners. This account is opened in the Nepal Rastra Bank (Central Bank) or bank authorised by the Nepal Rastra Bank and operated by the Project. In the case of special/imprest funds, some selective projects have been authorized to operate it.

1.3.12 Transfer of fund to consolidated account

Transfer of funds from the special/imprest account to GON's Consolidated Fund is done periodically on the basis of the Statement of Expenditure received from the project entity. A certified SOE is sufficient to make the transfer and these transfers are effected by the Central Bank as per instructions from the Project.

1.3.13 Closing of Special/Imprest Accounts

The special/imprest account balance is recovered from funds to be replenished towards the end of the project period. Any fund balances not recovered must be refunded to the development partner which is then adjusted in the total amount of loan/grant.

Chapter 2

Audit of Project Financial Statements

2.1 Audit of the project financial statements

2.1.1 For projects carried out by the GoN with external assistance, the audit requirements of the project are spelled out in the Agreement signed with the provider of assistance or development partner. They relate to the type of audit, its duration and when the audit report must be submitted. According to the Constitution of Nepal 2015, the Auditor General of Nepal is the sole authority to audit GoN implemented Project Financial Statements. The Auditor General conducts such audit with due consideration to regularity, economy, efficiency, effectiveness and propriety, as provided by law. Audit of the Project Financial Statements requires extra effort as this needs a separate statement to be produced by the project specifying that the fund is spent for the prescribed works effectively. This statement must be approved by the Project Chief, the Secretary of the concerned Ministry and the Financial Comptroller General, before it is certified by the Auditor General/ or Deputy Auditor General.

2.1.2 The format of financial statements should have been decided in the agreement with the development partner. Thus, documents like Statement of Expenditure, Memorandum Statement of Special/Imprest Account, GoN's and development partners' Fund Status, Statement of Direct Payment as well as Reimbursement must be submitted for audit along with the Project Account.

2.1.3 Project financial statements: Audited financial statements showing cumulative status of the projects/program, should be submitted by the respective project management/ or by the concerned ministry to each development partner as per the Agreement. If development partner has prescribed a specific format, in such a case, project financial statements should be prepared accordingly. However, development partners do not generally prescribe the format of such statement. Considering the requirement of development partners, project financial statements is to be prepared showing cumulative figure at the end of the fiscal year to report on financing and expenditure by the project where development partner(s) is involved. The project financial statements prepared using information available in existing accounting records of GoN's accounting system. One project financial statements should be prepared for each individual project.

2.1.4 The project is required to make available to the development partner, unaudited Financial Statement with certification by the Secretary of the concerned Ministry and the Financial Comptroller General, within the timeframe specified in the financing agreement. Copies of the audited Financial Statement and Auditors' Report thereof must be certified by the above mentioned officials as well as by the Auditor General or his nominee, and should be submitted by the project management or by the concerned ministry to the development partner within the period specified in the agreement. For World Bank funded projects, audited financial statements are normally required to be submitted within six months of the end of the fiscal period. Such financial statement must mainly include the Project Financial Statements, Statement of Expenditure and Audit Report.

2.2 Audit objectives

2.2.1 An audit's overall objective is to enable an auditor to express an opinion as to whether the financial statements present a true and fair view of the Project(s), or are presented fairly in all material respects, in conformity with relevant practices in project accounting or other standards acceptable to the development partner, and that the reported disbursements were made in accordance with the financing agreements.

2.2.2 Statement of Expenditure

The primary objective of this 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 authorised and eligible under the Agreement, and appropriately accounted for. The development partner 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.

2.2.3 Special/Imprest account

The primary objectives of such audits are to verify that special/imprest account's statements are fairly presented and that disbursements from special/imprest accounts are proper and in accordance with the respective Agreements. Accordingly, the auditor should perform procedures to enable him/her to conclude that the special/imprest account statement fairly reflects the activity of the special/imprest account, and that special/imprest funds are used solely for purposes of the project.

Special/Imprest account's audits consist of a review of the special/imprest account records maintained by the Project, along with the statements of the special/imprest account as provided by the central or commercial bank in which the special/imprest account is maintained. Movements in the account will include advances and replenishments from

the development partner, 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 Project financial statements). Special attention will need to be given to the direct verification of balances from the development partner, and the tracking of items in-transit both between the development partner and the special/imprest account, and between the special/imprest account and project-implementing entity.

2.2.4 The main audit objectives are to ensure that:

- books of accounts and records have been properly maintained as per the regulation;
- amounts appearing in the project financial statements is in agreement with books of accounts and records;
- adequate disclosure has been made in the project financial statements;
- projects have been properly authorised;
- the annual program and budget allocation of the project are in accordance with the project description and periodic plan of the country;
- project money is used for the purpose it has been allocated for,; and
- the objectives of implementing the projects have been achieved.

2.3 Standards on auditing

2.3.1 Audits of financial statements are governed by the standards of auditing. OAGN has formulated Government Auditing Standards, various guidelines and Manuals. The development partner requires that audit of project financial statements should be in accordance with the ISA and/or ISSAIs or the standards largely in line with ISA/ISSAI. So, the auditors should use this audit guide in the context of OAGN's Government Auditing Standards, guidelines and manuals. Audits may find Financial audit Manual issued by the office useful in carrying out audit of project financial statements.

Important aspects of the auditor's work relate to:

- their understanding of the organisation and/or project being audited;
- their evaluation and advice on the internal controls and arrangements; and
- their testing of accounting and supporting documentation with respect to the financial statements being audited.

2.4 Documents required for the audit

2.4.1 Besides the documents required for the audit of GoN accounts, the following additional documents are needed for the audit of development partner funded development project financial statements.

Acts, Rules and Directives

- Financial Procedural Act 1999;
- Financial Procedural Regulation 2008;
- Other circulars, directives, notification etc.

Project/Programme related documents

- legal/financing agreement;
- project appraisal document;
- guidelines of the development partner;
- guidelines for financial reporting and auditing

Financial statements and supporting documents

- financial statement of current fiscal year;
- project accounts and subsidiary records/ledgers/reports;
- development partner's fund transactions records, e.g. loan/grant applications, withdrawals;
- assets and depreciation records (for corporate bodies).

Budget documents and reports

- source books of foreign funds (The White Book);
- annual budget (The Red Book);
- annual programme of activities;
- progress reports (showing cumulative target and achievement);

- reports received from the supervision missions, e.g., aide memoir;
- internal audit reports;
- inventory inspection report;
- Technical Audit report; and
- Project Management Report ('PMR')

Other information

Documents that are pertinent to the project and project account audit, complaints and user groups reports and media information.

2.5 Audit procedures

The process followed for auditing a project specific financial statement is similar in most respect to the process followed for an audit of the financial statements of an executing organization, as explained, *but not limited to*, below. 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 Financing Agreements.

- ✓ Ascertain that there are Financing Agreements/project documents between the executing agencies and development partners
- ✓ Ascertain that project resources are allocated in accordance with Financing Agreements/project documents.
- ✓ Prepare a list of the offices responsible for the operation of the project activities.
- ✓ Compare the budget allocation with expenditures incurred and funds available. Ascertain whether budget revisions were signed by the executing agencies and development partners.
- ✓ Reconcile Withdrawal Application Account to confirm with application submitted and reimbursement received.
- ✓ Reconcile Loan/Grant Account with Withdrawal Application Account.
- ✓ Obtain special/imprest account bank statement.

- ✓ Review progress reports and financial statements and compare the total expenditure incurred and achievements made to date with the project objectives.
- ✓ Review internal audit reports.
- ✓ Review previous year's irregularities and actions taken.
- ✓ Ensure that all direct payments are made timely and included in the project account.
- ✓ Verify that reimbursable fund balance is actually receivable; otherwise action should be taken to charge it to GoN.
- ✓ Review that procurement of goods and services has been done according to the project description. (See the Procurement Audit Guide)
- ✓ Determine if a fixed asset register is maintained, all assets supplied by the development partner are properly included and submitted to the development partner at the beginning of each year.
- ✓ Check that all expenditures are incurred for the project.
- ✓ Ascertain through inspection that in case of equipment, the operational completion should result in a transfer of the project equipment.
- ✓ Ascertain contribution of user groups and counterparts is as per the financing agreement.

In addition, *Annexure-13* also provides audit programs that could be used during audits of project.

2.6 Checking of project financial statements

Project financial statements is one of the main statements to be submitted to development partners, hence auditor has to carefully check the project financial statements. While checking project statements, auditor has to confirm that:

- project financial statements has been prepared in approved format;
- project financial statements is duly signed by Project Authority, Financial Comptroller General and Secretary of concerned ministry;
- opening and closing balances tallies with previous year's balances and bank balance of current year;

- consistency in application of Accounting Policies;
- project expenditures have not exceeded the funds allocated, by each expenditure category;
- total expenditures incurred are in agreement with the budget allocation;
- reimbursement of money is claimed and received in time, and that the retention money is recorded properly;
- grants/loan proceeds have not been used other than for the project/programme purposes;
- project expenditures have not exceeded the funds allocated, by each expenditure category;
- total expenditures incurred are in agreement with the budget allocation; and

2.7 Checking of withdrawal application

2.7.1 As the loan/grant amount has to be spent according to the procedure prescribed by the agreement, the auditor should give special attention, while checking the withdrawal application, to the following:

- whether the amount applied for falls within the scope specified in agreement;
- whether the expenditure was properly authorised and approved;
- whether prior approval from the development partner (if applicable) has been received;
- whether documents relating to expenditure are according to the prevalent laws;
- whether the amount agrees with the proportion of share to be borne from the development partner's fund;
- whether the categories maintained is consistent with the categories in the agreement;
- whether the application of foreign exchange rates is in accordance with the agreement;
- whether expenditure incurred is within the validity period of the agreement; and

- whether the expenditure is eligible for development partner’s disbursement under the financing agreement. Ineligible expenditures would include:
 - duplicate invoices;
 - payments made in advance of receipt of goods 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 with values exceeding defined SOE limits; and
 - payments for items that are not procured in accordance with the financing agreement.

While the reimbursement or withdrawal is arranged on the basis of SOE, the auditor should ensure that the expenditure is within the ceiling fixed by the agreement and that payments were made for procurement of goods and services within the scope and according to the procedure prescribed by the agreement.

2.8 Risks assessment and responding to the risk (Check list)

2.8.1 Whilst examining the project financial statements, records and documents, the auditor should ascertain the following:

- Ledgers clearly showing receipts, expenditure and balances are kept according to GoN’s regulations;
- Disclosure of the total loan/grant amount to be received from the development partner, as per the agreement;
- Ledgers and records showing receipt expenditure and balance on each specific category are maintained;
- The records of Budget Release and Expenditure maintained by projects agree with the Annual Statement;
- Implementing agency has performed reconciliation of Project Loan/Grant Account and the Statement of Loan/Grant received from the development partner;
- Ledgers and records position of reimbursement made, reimbursable expenditure and reimbursable amounts are maintained;

- In case of special/imprest accounts, separate bank account is being operated;
- Records of user group contributions are properly maintained;
- Bank reconciliation is done regularly; and
- Reconciliation with FCGO is done regarding Reimbursement, special/imprest account and Loan/Grant Expenditure.

2.8.2 The Auditor needs to be familiar with risk factors in Project financial management and complying with the development partner’s terms and conditions, as they relate to withdrawal applications, SOEs, treatment of taxation, advances, retention money and operation of special/imprest accounts.

A brief checklist, as an illustration, for general risks and control techniques of auditing Project Account are provided below:

Risks and Control Techniques

Name of Project:

| Risks | Control Techniques |
|---|---|
| 1. Withdrawal Application | |
| 1.1 Claim of the project expenditure before the effective date of the credit agreement unless there is retrospective financing. | 1.1 Refer to the agreement prior to submitting the initial withdrawal claim for expenditure incurred before the effective date of the credit agreement. |
| 1.2 Project expenditure claim allowed for retroactive financing cut-off date are not properly maintained hence unallowable expenditure claimed. | 1.2 Record of expenditures incurred after the retroactive date are properly maintained. |
| 1.3 Claims made for expenditure not approved by the development partner or for wrong procurement. Procurement clearance from the development partner is required in case of procurement exceeding NRsxxx. | 1.3 As per the Agreement, concurrence is required from the development partner for any procurement, and should be done before claim for expenditure is submitted. |
| 1.5 Mistake in allocation of expenditure between GON and the development partner’s fund. | 1.5 Calculation of expenditure between GoN and the development partner should be verified according to the Agreement. |

| Risks | Control Techniques |
|---|---|
| 1.6 Claims made not in accordance to the changed disbursement percentages. | 1.6 Any change in the disbursement percentage should be noted in the credit Agreement. |
| 2. Claims | |
| 2.1 Claims not made regularly worsening to ease GoN fund position and increasing overdraft. | 2.1 Documents should be collected regularly from the field offices and claims submitted when disbursements have reached the threshold amount. Reconciliation statement is prepared and verified with FCGO's records. |
| 2.2 Claims not made in accordance with the development partner's guidelines, resulting in return of application and delays. | 2.2 The accountant should be conversant with the development partner's disbursement procedures. If in doubt, the accountant should consult the development partner's country office. |
| 2.3 Non-submission of claims within the prescribed time frames subsequent to the closing date of the credit. | 2.3 All claims should be submitted within the prescribed time frame subsequent to the closing date of the credit. This date should be closely monitored, as any claim submitted after this date will not be honoured. Notice should be provided to the development partner as soon as the application is submitted. |
| 2.4 Submission of expenditure claims incurred after the closing date of the credit. | 2.4 Expenditure incurred after the closing date should be uniquely marked to avoid confusion with pre-closing dated expenses. A rubber stamp marked "AFTER CLOSE" can be used. |
| 3. Statement of Expenditure (SOE) | |
| 3.1 SOE prepared without adequate supporting documents. | 3.1 Verifier should check and initial that SOE are supported with necessary supporting documents. |
| 3.2 Difficulty in verifying the SOE during the course of audit. | 3.2 SOE should be cross-referenced to the supporting documents for easy verification by the bank officials and the auditors. |

| Risks | Control Techniques |
|--|---|
| 4. Taxation | |
| 4.1 The amount of tax claimed from the development partner. Taxes are not funded by the development partners. | 4.1 Adequate tax provision should be made from GoN's budget. |
| 4.2 Taxes not disclosed in suppliers' invoices. | 4.2 Tax component of certain items purchased locally cannot be separated but the tax should be deliberately included in the invoices to facilitate claims from the development partner. |
| 5. Advances | |
| 5.1 Advances for expenses claimed from the development partner's. Only advances provided in the supplier's agreement can be claimed. | 5.1 Advances are not allowable expenditure unless they are provided in the contract with the supplier. A system should be established to separate advances from expenditure. |
| 5.2 Deduction of advances from the bills not adjusted in the claim amount. | 5.2 Supplier's invoiced amount should be adjusted to show the total bill and deductions made for advances to avoid risk of double claim. |
| 6. Retention Money | |
| 6.1 Claim over the retention money in the withdrawal application. | 6.1 Retention money should be deducted from the total bill amount to avoid the risk of claims on this amount. |
| 6.2 Retention money is due to the suppliers long after the closing date of the project. | 6.2 Retention money payable should be provided in the contract in such way that it is due for payment before the allowable time limit for the submission of claim. |
| 7. Special/Imprest account | |
| 7.1 Special/imprest account balance not maintained above the threshold level. Balance below this level indicates untimely submission of application for replenishment. | 7.1 A monitoring system to check special/imprest account balance should be developed so that application for replenishment is submitted as soon as it falls below the threshold level. |

| Risks | Control Techniques |
|--|---|
| 7.2 The project office should maintain special/imprest account records and the balance should be reconciled regularly. | 7.2 A monthly reconciliation of the special/imprest account should be prepared. |
| 7.3 Wrong exchange rate used by the Central Bank to convert local currencies into US Dollar may cause wrong debit in the special/imprest account. | 7.3 Special/Imprest account fund transfer exchange rates should be verified with the daily exchange rate in order to confirm the accuracy of the exchange rate used. |
| 7.4 Unauthorised withdrawal from the special/imprest account. | 7.4 All withdrawals from the special/imprest account should be properly authorised by the Project Office. |
| 8. Budgets | |
| 8.1 Budgets prepared without inclusion of direct payments will understate the actual project expenditure. | 8.1 All direct payments made by the project should be reflected in the annual budget. |
| 8.2 Change in the disbursement percentage has implications on the budget provisions which should be correctly made. | 8.2 Budget preparation should be based on the percentage of funding byGoN and the development partner. Any change in the funding ratio should be taken into account. |
| 9. Loan/Grant Account reconciliation | |
| 9.1 Loan/Grant account maintained by the project may be inaccurate if the loan/grant account is not periodically reconciled with the Status of Credit disbursed by the development partner and FCGO. | 9.1 The loan/grant amount utilised by the project should be reconciled monthly with the disbursement records of the development partner and every three months with FCGO. |
| 9.2 Inability to utilise the commitment charge payable on the loan/grant prior to the project closing date. | 9.2 Inability to utilise any portion of the credit before the close of the project should be cancelled in order to save the commitment charge. |

2.9 Auditors' Opinion

2.9.1 The audit report should contain a clearly written expression of opinion on the financial information. An auditor's opinion may be: unqualified; qualified; adverse or disclaimer of opinion.

An unqualified opinion indicates the auditor's satisfaction in all material respects with regards to the project financial statements.

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.

ISSAIs 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 organisation.

The development partner requires the preparation of reports in accordance with ISSAIs. ISSAIs specify 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.

2.9.2 Illustrations of audit reports which the development partner expects to receive in satisfaction of its audit requirements are included in *Annexure 7 to 11*.

2.9.3 An unqualified opinion indicates the auditor's satisfaction in all material respects with the following matters:

- 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; and
- there is adequate disclosure of all material matters relevant to the proper presentation of the financial information.

2.9.4 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 impact must be clearly stated in the auditor's report.

2.9.5 A disclaimer of opinion is issued when the possible effect of a limitation on the scope of the auditor of an uncertainty is so significant that the auditor is unable to express an opinion on the financial statements.

2.9.6 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

2.9.10 In addition to the audit report, auditors provide the project management with Management Letter (See *Annexure 12*) which includes matters to be improved for better project management and ensure to achieve project objectives in timely manner with efficiency and in effective manner.

2.10 Management Letter

2.10.1 In addition to the audit report, auditors provide the project management with Management Letter (See *Annexure 12*) which includes matters to be improved for better project management and ensure to achieve project objectives in timely manner with efficiency and in effective manner.

The contents of management letter include:

- a. Brief introduction of the project;
- b. Current years audit observations; which highlights the following matters:
 - ✓ comments and observations on the accounting records, systems and internal controls;
 - ✓ specific deficiencies and areas of weaknesses in the system and make recommendations for improvement;
 - ✓ highlight to the development partner any other matter that the auditor considers pertinent.
- c. Compliance Status of Previous year's audit observations
- d. Compliance status of the financial covenants in the financing agreement

The project management and the auditor may agree at the commencement of the audit on particular subjects to be included in the audit engagement (TOR) and be addressed in the Management Letter. However, it should be the prerogative of the auditor to address any matter not agreed upon, but which, in the auditor's opinion, should be drawn to the management's attention. (*see Annexure 12 for sample*)

2.11 Written Representation from Management

2.11.1 Written representation from management is a statement that management makes to the auditors concerning matters relating to the financial statements. Representations from management may be oral or written, formal or informal. They are not a substitute for other audit evidence the auditor requires to satisfy the audit objectives.

Throughout the audit, the auditors obtain written management representations in response to the enquiries. When the representations relate to matters that are material to the financial statements, the auditor should perform audit procedures to obtain audit evidence to support the representation; and consider whether the representations appear reasonable and consistent with other audit evidence obtained, including other representations.

2.11.2 Responsibility of Project management

Representations from management on matters that are material to the financial statements should be documented and signed by members of management who have primary responsibility for the operations and project's financial aspects. Such letters are ordinarily dated on the same date as the audit report.

Please refer to *Annexure-13* for a specimen of the management representation letter.

Chapter 3

Sectorwide Approach (SWAps)

3.1 Introduction

3.1.1 SWAps are mechanisms by which development partners collaborate to support sector programs that are based on a country's long-term vision for its development. SWAps aim to strengthen government ownership and coordination of projects, facilitate budgeting of sufficient funds to cover operating costs, integrate capital investment budgets in overall country budgets, and support policies and efforts to build domestic capacity.

3.1.2 A SWAp is a borrower-managed approach by which development partners support country-led programs whose scale is greater than that of traditional projects. It typically encompasses an entire sector, or large portions of one. In general, SWAps are characterized by the following:

- ***Country ownership***: Development partners come together to support the government's own program for the development of a particular sector;
- ***Partnership and consultation***: The government directs the program and coordinates the participation of development partners and the involvement of other stakeholders. Partners are committed to openness, consultation and sharing of information;
- ***Comprehensive sector policy framework***: This framework typically includes a medium-term (five years) strategy articulated in a program of specific interventions for the short term (two to three years);
- ***Expenditure framework and resource envelope***: Derived from the sector policy framework and integrated into the government's overall medium-term expenditure framework, the expenditure framework and resource envelope identify prioritised activities and plans. Developing partners resources are channeled increasingly through government systems; and
- ***Uniform implementation structures and procedures***: As circumstances permit, partners aim to synchronize their own processes through joint appraisal, programming, review, monitoring and evaluation. There is an emphasis on using and strengthening government institutions, procedures, and staff, rather than establishing parallel systems. The aim is to have a single reporting and auditing system for all activities in the sector.

3.2 Pooling of funds

3.2.1 The main feature of SWAps is the pooling of development partner and government funds for disbursement through jointly agreed channels (that is, a Foreign Exchange Account and government treasury system) rather than use of special purpose bank accounts for individual development partner funds. Funds are deposited into and disbursed from a Foreign Exchange Account, with development partners participating in the pool to finance agreed proportions of the overall sector program. The fund in the Foreign Exchange Account needs to be reconciled with the expenditures.

3.2.2 The main objectives of SWAps are:

- to provide reasonable assurance that the program's resources are used for their intended purpose;
- better contribute to the development of sustainable borrower capacity in financial management and procurement; and
- significantly reduce costs to borrowers of meeting the diverse requirements of development partners.

3.3 Reporting

3.3.1 Ad-hoc and regular financial reports should be produced for program management. Also, trimester financial monitoring reports and audited annual financial statements should be prepared and submitted to the development partners for the purpose of monitoring program implementation. There should be adequate procedures to ensure full compliance with the reporting requirements that have been agreed with the development partners. The contents of financial monitoring reports should include, but not limited to, the following:

- Financial Reports that include a statement showing for the period and cumulatively (program life or year to date) inflows by sources and outflows by main expenditure classifications; beginning and ending cash balances of the program; and supporting schedules comparing actual and planned expenditures. The reports will also include cash forecasts for the next two trimesters;
- Physical Progress Reports that include narrative information and output indicators (agreed during sector preparation) linking financial information with physical progress, and highlight issues that require attention; and

- Procurement Reports that provide information on the procurement of goods, work, and related services, and the selection of consultants, and on compliance with agreed procurement methods. The reports will compare procurement performance against the plan agreed at negotiations or subsequently updated, and highlight key procurement issues such as staffing and building borrower capacity.

3.4 Audit requirements

3.4.1 The borrower would be required to have consolidated (or sector) financial statements audited by an auditor acceptable to all development partners appointed on terms of reference ('TOR') acceptable to all such participating developing partners, with remedies to be applied if misuse of funds is identified.

3.4.2 According to the Constitution of Nepal, the Auditor General is the auditor for audits of all public expenditures in Nepal.

3.4.3 All development partners should agree on a set of applicable auditing arrangements. The arrangements should include the scope of the audit, criteria for selection of auditors, period for submitting audit reports, and arrangements for reviewing and following up on audit findings, including recommendations made by the auditors in the management letter. While audit reports should normally be provided annually, they might be required more frequently where particular risks have been identified.

3.5 Audited annual Financial Statements

3.5.1 The audited annual financial statements should include:

- a Consolidated Statement of Sources and Uses of funds (by disbursement/procurement category/by activity, showing sources of funds);
- statements reconciling the balances on the various bank accounts to the bank balances shown on the Consolidated Statement of Sources and Uses of funds; and
- Notes to the Financial Statements.

A specimen of the Sectoral Financial Statements is attached in *Annexure-15*.

ANNEXURES

Annexure – 1 Project Financial Statements

.....Project
Project Financial Statements

Fiscal Year 20.../20... (17 July 20...to 16 July 20...)
Loan/Grant No.

| Resources | Notes to account | Up to 20../20.. NRs | FY 20.../... NRs | Up to 20../20.. NRs | Applications | Category | Notes to account | Up to 20../20.. NRs | Up to 20../20.. NRs |
|--|------------------|---------------------|------------------|---------------------|---|----------|------------------|---------------------|---------------------|
| A: | | | | | | | | | |
| GoN Fund | IIA | | | | A: | | | | |
| GoN Reimbursable Development partner(s) reimbursable | IIB | | | | Civil Works: | | | | |
| Total Reimbursable | | | | | Consultants' services: | 1 | 1 | | |
| - Loan/Grant Reimbursement | | | | | Community Service Providers: | 2 | 1 | | |
| Replenishment | | | | | Goods: | | | | |
| Transfer to Central Treasury | | | | | Local Training, Grants and Scholarships: | 3 | 1 | | |
| Direct payment | | | | | Incremental Salaries and Operating Costs: | 4 | 1 | | |
| Charged in the next year | | | | | Land Purchase: | 5 | 1 | | |
| Sub Total | | | | | | 6 | 1 | | |
| | | | | | | - | 1 | | |
| B: | | | | | | | | | |
| Development Partner(s) | | | | | B: | | | | |
| Special/Imprest Account/initial deposit | | | | | Special/Imprest Account/initial deposit balance | | | | |
| Exchange Gain | | | | | Outstanding Replenishment Exchange Loss | | | | |
| Sub Total | | | | | | | | | |
| Grand Total | | | | | | | | | |

() () () () () () () () () ()
 Account-In-Charge Project Manager/ Secretary Financial Comptroller Auditor General
 Project Coordinator Ministry of General (or Deputy auditor General)

Notes to Account

A. Accounting Policy

The Project has maintained the accounts as per the GoN's accounting system i.e. on a cash basis. In the GoN accounting system, all the disbursements including advances are treated as expenditure.

Notes to Account: I

| Item code | Description | Up to 20.../20.. NRs | 20.../... NRs | Up to 20.../20.. NRs |
|-----------|--|----------------------------|------------------|----------------------------|
| | Incremental Salaries and Operating Costs (Category 6): | | | |
| | | | | |
| | Training, Grants and Scholarships (Category 5): | | | |
| | | | | |
| | Goods (Category 4): | | | |
| | | | | |
| | Community Service Providers (Category 3): | | | |
| | | | | |
| | Consultants' Services (Category 2): | | | |
| | | | | |
| | Civil Works (Category 1): | | | |
| | | | | |
| | Land Purchase | | | |
| | | | | |
| | Grand Total | | | |

Annexure - 1
(cont'd)

Notes to Account II

GoN Replenishment and Reimbursable:

| Particulars | Up to 20.../20.. NRs | 20.../20.. NRs | Up to 20.../20.. NRs |
|--|----------------------------|-------------------|----------------------------|
| A. Release: GoN Less a. Unspent BalanceGoN b. Deposit GoN Non-project costs: | | | |
| GoN | | | |
| B. Developing partner(s) Release (FCGO) Freeze (FCGO) Expenditure (FCGO) Exp according to agreement To be Source Change Reimbursable Developing partner(s) loan/grant <div style="text-align: right;">Reimbursable</div> | | | |

Annexure – 6 Statement of Expenditure (SOE)

Statement of Expenditure (SOE)

Fiscal Year 20.../20...
(..... July 20.. to ... July 20..)

| Withdrawal Application No. | Withdrawal Authorisation No. | Value Date | Category | | | | Total NRs |
|-------------------------------|------------------------------------|---------------|----------|-----|-----|-----|--------------|
| | | | 1 | 2 | 3 | 4 | |
| | | | NRs | NRs | NRs | NRs | |
| | | | | | | | |

Annexure – 7 Unqualified Audit Opinion

Ref. No.–

Date:

INDEPENDENT AUDITOR’S REPORT

*The Secretary
Ministry of Finance
Singh Durbar, Kathmandu*

Report on the Financial Statements

We have audited the accompanying Project Financial Statements including Statement Designated/Imprest Account (and Statements of Expenditures SOEs) of the “xxxxxxxxxxxxxxxx” financed by IDA/ADB Grant/Loan No. xxxxxx as at xx July 20xx (xx Ashad, 20xx) and for the year then ended and a summary of accounting policies and other explanatory notes.

Management’s Responsibility for Financial Statements

Management is responsible for the preparation and fair presentation of the Financial Statements in accordance with the Government of Nepal (GON) accounting policies and relevant practices. This responsibility includes: designing, implementing and maintaining internal control relevant to preparation and fair presentation of project financial statements that are free from material misstatement, whether due to fraud and error.

Auditor’s Responsibility

Our responsibility is to express an opinion on these Project Financial Statements based on our audit. We conducted our audit in accordance with the INTOSAI (International Organisation of Supreme Audit Institutions) Fundamental Auditing Principles. Those Principles require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

Management letter highlighting areas for improving financial management including compliance with financial covenant is attached herewith.

In our opinion, the Project Financial Statements including Statement of Designated/ Imprest Account, in all material respects, give a true and fair view of the financial position of the “xxxxxxxxx” as of xx July 20xx(3x Ashad, 20xx), and of the results of its operations and its cash flows for the year then ended in accordance with GON accounting policies. We also report that funds provided under IDA/ADB Loan/Grant no-- have been utilized for intended purposes.

In addition, with respect to SOEs, a) adequate supporting documentation has been maintained to support claims to donors for reimbursement of expenditures incurred; and b) expenditures are eligible for financing under the above mentioned Loan/Grants.

(.....)

Deputy Auditor General

Annexure – 8 Qualified Audit Opinion

Ref. No. -

Date:

INDEPENDENT AUDITOR’S REPORT

*The Secretary
Ministry of Finance
Singh Durbar, Kathmandu*

Report on the Financial Statements

We have audited the accompanying Project Financial Statements including Statement Designated/Imprest Account (and Statements of Expenditures SOEs) of the “XXXXXXXXXXXXXXXX” financed by IDA/ADB Grant/Loan No. xxxxxx as at xx July 20xx (xx Ashad, 20xx) and for the year then ended and a summary of accounting policies and other explanatory notes.

Management’s Responsibility for Financial Statements

Management is responsible for the preparation and fair presentation of the Financial Statements in accordance with the Government of Nepal (GON) accounting policies and relevant practices. This responsibility includes: designing, implementing and maintaining internal control relevant to preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud and error.

Auditor’s Responsibility

Our responsibility is to express an opinion on these Project Financial Statements based on our audit. We conducted our audit in accordance with the INTOSAI (International Organisation of Supreme Audit Institutions) Fundamental Auditing Principles. Those Principles require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness

of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Qualified Opinion

(Description of material qualification and limitation in the scope of the audit examination)

Qualified Opinion

Management letter highlighting areas for improving financial management including compliance with financial covenant is attached herewith.

In our opinion, except the effect of the matter described in the Basis for Qualified Opinion paragraph, the Project Financial Statements including Statement of Designated/Imprest Account, in all material respects, give a true and fair view of the financial position of the “xxxxxxxxxx” as of xx July 20xx(3x Ashad, 20xx), and of the results of its operations and its cash flows for the year then ended in accordance with GON accounting policies. We also report that funds provided under IDA/ADB Loan/Grant no-- have been utilized for intended purposes.

In addition, with respect to SOEs, */except the above mentioned observations/,* a) adequate supporting documentation has been maintained to support claims to donors for reimbursement of expenditures incurred; and b) expenditures are eligible for financing under the above mentioned Loan/Grants.

(.....)

Deputy Auditor General

Annexure – 9 Disclaimer of Opinion

Ref. No. -

Date:

INDEPENDENT AUDITOR’S REPORT

*The Secretary
Ministry of Finance
Singh Durbar, Kathmandu*

Report on the Financial Statements

We have audited the accompanying Project Financial Statements including Statement Designated/Imprest Account (and Statements of Expenditures SOEs) of the “xxxxxxxxxxxxxxxx” financed by IDA/ADB Grant/Loan No. xxxxxx as at xx July 20xx (xx Ashad, 20xx) and for the year then ended and a summary of accounting policies and other explanatory notes.

Management’s Responsibility for Financial Statements

Management is responsible for the preparation and fair presentation of the Financial Statements in accordance with the Government of Nepal (GON) accounting policies and relevant practices. This responsibility includes: designing, implementing and maintaining internal control relevant to preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud and error.

Auditor’s Responsibility

Our responsibility is to express an opinion on these Project Financial Statements based on our audit. We conducted our audit in accordance with the INTOSAI (International Organisation of Supreme Audit Institutions) Fundamental Auditing Principles. Those Principles require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the

circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

(Description of inability to obtain sufficient appropriate audit evidence)

Disclaimer of Opinion

Management letter highlighting areas for improving financial management including compliance with financial covenant is attached herewith.

Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

(.....)
Deputy Auditor General

Annexure – 10 Adverse Audit Opinion

Ref. No. -

Date:

INDEPENDENT AUDITOR’S REPORT

*The Secretary
Ministry of Finance
Singh Durbar, Kathmandu*

Report on the Financial Statements

We have audited the accompanying Project Financial Statements including Statement Designated/Imprest Account (and Statements of Expenditures SOEs) of the “xxxxx” financed by IDA/ADB Grant/Loan No. xxxx as at xx July 20xx (xx Ashad,20xx) and for the year then ended and a summary of accounting policies and other explanatory notes.

Management’s Responsibility for Financial Statements

Management is responsible for the preparation and fair presentation of the Financial Statements in accordance with the Government of Nepal (GON) accounting policies and relevant practices. This responsibility includes: designing, implementing and maintaining internal control relevant to preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud and error.

Auditor’s Responsibility

Our responsibility is to express an opinion on these Project Financial Statements based on our audit. We conducted our audit in accordance with the INTOSAI (International Organisation of Supreme Audit Institutions) Fundamental Auditing Principles. Those Principles require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor’s judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity’s preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity’s internal control. An audit also includes evaluating the appropriateness

of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Basis for Adverse Opinion

(Description of material and pervasive misstatement in Financial Statements leading to an adverse opinion)

Adverse Opinion

Management letter highlighting areas for improving financial management including compliance with financial covenant is attached herewith.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the Project Financial Statements including Statement of Designated/ Imprest Account, in all material respects, do not present fairly (or *do not give a true and fair view of*) of the financial position of the “xxxxxxx” as of xx July 20xx(3x Ashad, 20xx), and of the results of its operations and its cash flows for the year then ended in accordance with GON accounting policies.

We also report that funds provided under IDA/ADB Loan/Grant no—have (*not*) been utilized for intended purposes.

In addition, with respect to SOEs, */except the above mentioned observations/*, a) adequate supporting documentation has been maintained to support claims to donors for reimbursement of expenditures incurred; and b) expenditures are eligible for financing under the above mentioned Loan/Grants.

(.....)
Deputy Auditor General

Annexure – 11 Audit Opinion with Emphasis of Matter Paragraph

Emphasis of matter paragraph can be included with any types of audit opinion discussed in Annexure 7 through 10. In a situation where auditor decides to add Emphasis of Matter Paragraph in his/her audit report s/he should add such paragraph as below immediately after opinion paragraph.

Emphasis of Matter

We draw attention to Note X to the financial statements which describes the (write in short the nature of the matter emphasized). Our opinion is not qualified in respect of this matter.

Annexure – 12 Management Letter

Reference:

Date:

Sub: Project, operating under No.

The Secretary,
..... Ministry

Dear Sir,

I wish to draw your attention towards the enclosed audit findings regarding audit of Project under your Ministry for the fiscal year These findings have been selected from the Preliminary Audit Report sent to you through our letter reference (dated)....., after taking into consideration the responses and evidences received from the concerned Project/Office.

I also wish to state that none of the contents of this enclosure will have any material effect on the Audit Report and Opinion of this Office sent to you on or on the rest of the contents of the Preliminary Audit Report.

Copy to:

The Director General
..... Department.

(Assistant Auditor General)

The Financial Comptroller General.
..... Project,
.....

Annexure -13 Illustrative Audit Program

Note: *This audit program is a brief guide designed to assist the auditor in developing an appropriate audit approach for each area. If the auditor believes that additional testing should be performed to achieve the objectives of the audit then audit scope should be expanded.*

[A] Audit Planning Matters

| | Audit Step | W/P Ref. | Initial/ Dates |
|---|---|---------------------|---------------------------|
| 1 | Obtain (update) an understanding of the project and its operations: <ul style="list-style-type: none"> ▪ Understand the goals, objectives and methods of the project; ▪ Understand the core activities of the implementing entity; ▪ Understand the mission, organization, and structure of the project; and ▪ Identify and interview key management personnel. | | |
| 2 | Review pertaining project documentation to identify and understand relevant financial and other requirements or guidelines set forth in the following documents: <ul style="list-style-type: none"> ▪ Financing Agreement and pertaining supplements/ project document; ▪ Project Appraisal Document; ▪ Agreed minutes of loan/grant negotiations; ▪ Related subcontracting agreements with the third parties; and ▪ Other development partner's correspondences and implementing documents as applicable. Identify key compliance issues for the project and design appropriate compliance testing steps. | | |
| 3 | Identify significant transaction cycles (for example: cash receipts and cash disbursements), project financial statements' line item or general ledger account balances that the auditor plans to test. Through interviews with key management personnel, identify important accounting issues and any significant changes in policies and procedures made during the current year. | | |
| 4 | Perform preliminary analytical procedures: <ul style="list-style-type: none"> ▪ Compare current year's project financial statements' line item or general ledger/project balances to comparable balances for one or more comparable periods; ▪ Compare current year account balances to budgeted balances; and ▪ Obtain explanations for significant fluctuations or expand planned audit testing as appropriate. | | |
| 5 | Gain an understanding of the EDP control environment, if applicable. Specifically, determine: <ul style="list-style-type: none"> ▪ management's philosophy toward security over access to its EDP operations; ▪ the types and volume of transactions processed; ▪ completeness and appropriateness of the audit trail; and ▪ the demands of software and hardware, both existing and planned. | | |

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| 6 | Develop an audit sampling approach for each major testing area, if applicable. | | |
| 7 | Determine and document the preliminary risk analysis for each material project financial statements' line item or general ledger account balances, focusing on the applicable financial statements assertions. Through analysing each material account balance, identify significant areas of risks, the controls to mitigate those risks and weaknesses noted. | | |
| 8 | For the second and subsequent years' audits, review the status of prior findings and recommendations. Determine whether corrective actions have been fully implemented. | | |
| 9 | Develop audit programs and have them approved by audit supervisors. | | |

[B] Review of Internal control

| | Audit Step | W/P Ref. | Initial/ Dates |
|---|---|-----------------|-----------------------|
| | Understanding the Project or Implementing Entity's Internal Control Structure | | |
| 1 | Through interviews, observations, walkthroughs, and review of policies and procedures obtain an understanding of management's commitment to establish and maintain an adequate internal control structure. Determine tools used to monitor the utilisation of project financial resources, plan and perform monitoring actions. | | |
| | Document Understanding of the Internal Control Structure | | |
| 2 | For a first year audit, document your understanding of the internal control structure by each significant cycle by preparing cycle memoranda and, if appropriate, flowcharts. Cycle memoranda explain the flow of processes within cycles, and flowcharts can be useful by displaying these processes graphically. For subsequent years' audits, through interviews with the project or implementing entity's personnel, determine if any changes in policies and procedures have occurred during the past fiscal year that would have an impact on the auditor's assessment of the internal control structure. Update prior year cycle memoranda and flowcharts accordingly. Verify that any changes in policies and procedures have been documented, approved by management, and guidance has been distributed and training has been provided to appropriate personnel. Evaluate the impact of new policies or changes in existing policies on the audit and modify scope accordingly. | | |
| | Identify Control Objectives with Relevant Control Procedures | | |

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|---|---|--|--|
| 3 | Based on understanding of the internal control structure and steps performed above, develop an analysis of the key controls. | | |
| | Determine the Nature, Timing, and Extent of Control Tests | | |
| 4 | Based on the work performed above, evaluate the entity's structure of internal controls and determine the expected extent of reliance to be placed on those controls. Determine specific control techniques to test and the nature, timing and extent of internal control compliance testing. | | |
| | Analyzing the Impact of Internal Control Compliance Testing | | |
| 5 | Note that illustrative non-sampling and sampling control tests are described in the individual component audit programs. After completing the internal control compliance testing phase of the audit, complete the steps below. | | |
| 6 | Based on the results of testing the key controls in the internal control structure, the auditor should determine if the materiality levels should be revised and document these changes appropriately in the work papers | | |
| 7 | Based on the results of testing the key controls in the internal control structure, the evaluation of audit risks should be reviewed by the auditor and updated, accordingly. Audit scope may need to be adjusted, as appropriate. | | |

[C] Project cash balances

| | Audit Step | W/P Ref. | Initial/Dates |
|---|--|-----------------|----------------------|
| | Tests of Internal Control Compliance and Substantive Testing | | |
| 1 | Through interviews, observation, and inspection determine whether appropriate custody of cash is maintained: <ul style="list-style-type: none"> ▪ bank accounts are properly and formally authorized. Signatories for cash transactions are properly authorized and the names are documented; ▪ unused and voided warrants, checks, and cash, including petty cash fund, are properly safeguarded; and ▪ responsibilities for preparing bank reconciliation are segregated from reconciliation approval and from all other cash receipts and disbursements functions. | | |
| 2 | Through interview and inspection verify that the project funds are not commingled with funds belonging to other projects or with funds owned by the implementing entity. If funds are commingled, determine whether adequate accounting and other records exist to segregate the cash balances, receipts and disbursements for each project (or account within a project, if necessary). Determine if the donor agency portion of project funds can be separately accounted for. | | |

| | Audit Step | W/P Ref. | Initial/ Dates |
|---|---|---------------------|---------------------------|
| 3 | Obtain and review all or selected bank statements and reconciliations for the period under audit (12 months usually) and determine whether all activity noted within the bank accounts is reasonable given the nature of the project’s activities. Test that reconciliations were timely and properly approved; and that all outstanding items were researched, supported and cleared in a timely manner. | | |
| 4 | Reconcile cash balances and receipts at period-end and for the period to information received from the donor agency. Ensure that periodic reconciliations between the project’s or implementing entity’s records and the donor agency’s records are performed. Verify that all parties have contributed their promised portion of project funding. | | |
| 5 | Assess the degree of reliability of external confirmation. Send a bank confirmation to confirm cash balances as of the end of period under audit. Trace confirmed balances to the applicable bank reconciliations. Investigate any significant differences. | | |
| 6 | <p>If a Special Account is used, the auditor may chose to expand audit scope in testing that all funds are maintained for project purposes only, and have not been “borrowed” for other purposes. In addition to the above procedure, the auditor should perform the following additional steps for a Special Account reconciliation:</p> <ul style="list-style-type: none"> ▪ trace the total amount deposited, advanced, and recovered by the donor agency to the supporting documentation for the period (for example, bank confirmations, donor agency transfers, etc.); ▪ trace the amounts deposited to cover ineligible disbursements to the supporting documentation (memos, statements, etc.); ▪ trace the amount withdrawn, bank charges and interest earned to supporting documentation; and ▪ trace amounts withdrawn and amounts claimed but not yet credited as claims to donor agency to supporting withdrawal documentation and to bank statements. | | |
| 7 | On a test basis, review the activity in petty cash funds for the last month of the audit. Reconcile petty cash amounts to the general ledger. Review selected reconciliations or surprise counts performed during the year for significant unreconciled differences. Review the volume of procurement performed in cash over the period for reasonableness in amount. | | |
| 8 | Conclude on project cash balance(s). | | |

[D] Project cash receipts

| | Audit Step | W/P Ref. | Initial/ Dates |
|---|--|-----------------|-----------------------|
| | Internal Control Compliance and Substantive Testing | | |
| 1 | Through interviews, observation, and inspection determine whether adequate segregation of duties exists: <ul style="list-style-type: none"> ▪ trace the total amount deposited, advanced, and recovered by the donor agency to the supporting documentation for the period (for example, bank confirmations, donor agency transfers, etc.); ▪ cash collection and deposit functions are segregated from the recording and reconciliation functions; ▪ the custody over cash function custody is segregated from the recording and authorization; and ▪ if an automated environment is used, that persons performing EDP functions do not have access to cash or collections. | | |
| 2 | On a sample of receipts, determine whether they were deposited into an authorized bank account in a timely manner, both at headquarters and at selected locations. | | |
| 3 | Confirm the total of cash receipts from the donor agency, the local government and other developing partners. Alternatively, if confirmations cannot be obtained, correspondence received from external parties can be reviewed which indicates the amounts provided to the project by those parties. | | |
| 4 | Reconcile the total of a listing of all cash receipts during the period to the applicable general ledger balance. Investigate any significant variances. | | |
| 5 | Select a sample of receipts from the detailed listings and trace them to supporting documentation to determine if they are properly supported. | | |
| 6 | Review reconciliations of cash receipts per accounting records to the supporting cash collection documentation (for example, deposit tickets or equivalents) and to the bank statements. On a sample basis, trace receipts from the reconciliations to the listing of all receipts. | | |
| 7 | Review the loan agreement and, in conjunction with this, determine whether cash receipts collected during the period under audit are for a valid project purpose, are properly allocated in accordance with the loan agreement terms, and are consistent with the project's objectives. | | |
| 8 | If invoices are issued, review a sample of invoices to determine whether they are properly approved by reviewing authorization of appropriate officials and trace them to the accounting records to ensure that they are properly recorded. | | |
| 9 | Conclude on project cash receipts balance(s). | | |

[E] Project Cash Disbursements

| | Audit Step | W/P Ref. | Initial/ Dates |
|---|---|-----------------|-----------------------|
| | Internal Control Compliance and Substantive Testing | | |
| 1 | <p>Through interview, inspection, and observation determine whether appropriate segregation of duties exists:</p> <ul style="list-style-type: none"> ▪ trace the total amount deposited, advanced, and recovered by the donor agency to the supporting documentation for the period (for example, bank confirmations, donor agency transfers, etc.); ▪ responsibilities for the cash receipt functions are segregated from the cash disbursements functions; ▪ responsibilities for the voucher preparation, authorization, recording and compiling information in the general ledger are adequately segregated; and ▪ access to cash, checks and wire transfers are segregated from persons who requested, prepared, or recorded the related payment vouchers. | | |
| 2 | <p>Verify that unused or voided cheques are properly safeguarded. If the project or implementing entity uses a cheque-signing machine, determine whether it is properly safeguarded. If signature plates are used, they are maintained in the custody of only authorized persons. Determine whether appropriate controls exist to ensure that all cheques or warrants signed are sequentially accounted for.</p> | | |
| 3 | <p>Determine whether procedures ensure that project funds were used in compliance with the procurement guidelines of the donor agency. Determine whether the project or implementing entity is using appropriate procurement procedures, under the loan agreement and donor agency guidelines.</p> | | |

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| 4 | <p>Obtain a listing of all project disbursements for the period under review (or up to the interim date). Verify that all disbursements are included (population); and select a sample (possibly, statistically) for attribute testing, using appropriate testing parameters. Ensure that all disbursements have an equal opportunity to be included in your sample. Test the following attributes and summarise your results:</p> <p>Proper value and purpose. Review the expenditures to determine whether they have been incurred for a valid purpose allowable under the loan agreement and the donor agency procurement guidelines, and are consistent with the objectives of the project. If competitive bidding procedures are required, review the evidence of such procedures. If competitive bidding procedures have not been used, review the evidence that several price quotations have been obtained before placing the order. In case of larger expenditures (for example, construction contracts, service contracts), determine whether the award procedures have been adequately documented.</p> <ul style="list-style-type: none"> ▪ Proper authorisation. Review purchase orders (or other equivalents) to determine whether the expenditure is properly approved by an official within the authorization limits. Determine whether the invoice is approved for payment by the person who is authorized to do so within the established limits and in a timely manner. Determine whether the purchase is made from the approved vendors' list, and the vendor does not have a negative history of dealing with the project or implementing entity; ▪ Proper acceptance. If goods or services have been received, obtain and review evidence that they were accepted (for example, receiving reports, work order reports, memos); ▪ Accuracy. Verify that invoices supporting disbursements are mathematically accurate and the information on the invoice (quantity, price, terms) is the same as on the related purchase order. Verify that the quantity on the invoice is the same as on the related receiving report. In case of discrepancies, there is an evidence of management's approval of the change; ▪ Proper recording. Review that the disbursement is accurately recorded, classified and categorised within the accounting system; and ▪ (Other attributes as appropriate.) | | |
| 5 | <p>Obtain the project's or implementing entity's asset registers, and perform the following analytical procedures with the financial data: obtain the listing of all disbursements, and reconcile the totals to the asset register totals and the total of disbursements expensed.</p> | | |

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| 6 | <p>Obtain <u>all</u> Loan/Credit Withdrawal Applications and related Statements of Expenditures (SOEs), if applicable, for the period under audit (or up to the interim date). Select a sample of SOEs and perform same tests as in Step 4 above. Ensure that each disbursement category is represented in your sample.</p> | | |
| 7 | <p>If the project incurred personnel costs, perform the following:</p> <ul style="list-style-type: none"> ▪ review compensation rates, bonuses and other benefits for reasonableness; ▪ determine if personnel costs are allowable under the project; determine whether the time charges are reasonable. Compare current year's amounts to the prior year's amounts and to the budget, investigate any significant fluctuations. If prior year's amounts are not available, compare monthly charges for the period under audit to determine their reasonableness; ▪ obtain the total amount of personnel costs for the year and divide it by the total number of employees to arrive at the average salary. Compare an average salary per employee to the actual compensation rates to determine the reasonableness of the total charge; and ▪ obtain the breakdown of the total charge of personnel costs by person. On a sample basis, trace the names from the list to the actual persons. | | |
| 8 | <p>If the project or implementing entity records accounts payable or maintains unpaid vendor invoice files, perform tests to ensure that the accounts payable are reported in the correct period. Review unusually old accounts payable or vendor invoices and determine the reasons for delays or instances of nonpayment.</p> | | |
| 9 | <p>Based on the testing performed above, summarize and quantify any questioned costs noted. All costs which are not supported by adequate documentation or are not in compliance with the loan agreement and procurement guidelines should be questioned. Questioned costs should be presented into two categories (1) ineligible costs - questioned costs that are explicitly ineligible because they are not program related, are not reasonable in amount, or are not considered allowable under the terms of the loan agreement, and (2) unsupported costs - questioned costs that are not supported by adequate documentation or are not approved or authorized.</p> <p>Questioned costs that are pending reimbursement from the donor agency or that have not been yet submitted to the donor agency should be identified as such.</p> | | |
| 10 | <p>Conclude on project cash disbursements balance(s).</p> | | |

[F] Project Assets and Materials

| | Audit Step | W / P Ref. | Initial/ Dates |
|---|---|-----------------------|---------------------------|
| | Tests of Internal Control Compliance and Substantive Testing | | |
| 1 | Through interview, inspection, and observation determine whether appropriate segregation of duties exists, specifically: <ul style="list-style-type: none"> ▪ responsibilities for initiating, evaluating, and approving asset purchases are segregated from accounting for them; and ▪ initiation of asset purchases is segregated from the final approval; ▪ asset accounting and record-keeping are segregated from their custody. | | |
| 2 | Through interview, inspection, and observation determine whether assets are appropriately safeguarded and proper asset records are maintained. Also, ascertain if periodic asset counts are performed and reconciled to the asset records. | | |
| 3 | If purchasing of assets should be performed under certain procedures (for example, loan agreement provisions or the donor agency procurement guidelines), identify the project’s procedures which ensure that these provisions/guidelines have been followed. Testing of the project adherence to these procedures should be performed in conjunction with the attribute testing in the project cash disbursement program. | | |
| 4 | If authorization limits are established for asset purchases, review a sample of purchase orders and payments to ensure that authorization limits are being followed. | | |
| 5 | If a separate capital budget is prepared, review comparison of the actual results to the budget to ensure that no significant deviations from the budget have been occurring. Potential or actual significant cost overruns should be identified and analyzed as to their impact on the project’s ability to achieve its objectives. | | |
| 6 | If assets have been acquired during the period under audit, obtain a list of the significant acquisitions and perform tests to ensure that: <ul style="list-style-type: none"> ▪ documentation supporting acquisition is approved by an appropriate official within authorization limits and acquisitions are in accordance with the loan agreement, the donor agency procurement guidelines, and internally developed guidelines, if applicable; ▪ all acquisitions are recorded in the accounting system timely and at the proper amounts; ▪ newly acquired assets are controlled using a unique identification system; and ▪ all acquired assets have been included into the asset listings (or asset registers) | | |
| 7 | If any assets have been disposed during the period under audit, obtain a list of disposals and perform tests to ensure that: <ul style="list-style-type: none"> ▪ the documentation supporting disposals is properly approved by an authorised official and disposals are reasonable under circumstances and consistent with the objectives of the project; ▪ disposed assets are removed from the accounting system timely and at the proper amounts and all gains and losses are properly calculated and recorded. | | |

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| 8 | Determine the reasonableness of the assets balances: add the amount of acquisitions to the current year's beginning balance and then subtract the amount of disposals, compare the calculated amount to the general ledger ending balance. | | |
| 9 | Select a sample of disbursements from the cash disbursement records which, in the judgment of the auditor, procured items which should be on the asset register. Trace these purchases to the registers. | | |
| 10 | From the project's asset registers, as prepared by the auditee, perform full and false inclusion testing by selecting samples as follows: <ul style="list-style-type: none"> ▪ Physically locate a sample of assets selected from the asset registers; ▪ select a sample of physically observed assets and trace them to the asset registers; and ▪ compare the totals of assets physically counted to those recorded in the asset registers, quantify unexplained differences. | | |
| 11 | If materials have been purchased for the project, compare the amount of purchased materials to the amount budgeted for the project and estimate, if appropriate progress has been made towards completion based on the volume of materials used. Compare this estimate to the overall progress of the project. Identify unexplained variances and instances where budgets will be significantly exceeded. | | |
| 12 | Analyze the volume of assets identified as obsolete, damaged, or lost for reasonableness. Identify and investigate unusually high instances of such asset losses. | | |
| 13 | If circumstances warrant, specialists may be used to assist the auditor in assessing value of assets and materials, or the project's technical progress. | | |
| 14 | Estimate the amount of unexplained differences in assets noted from the above testing steps. | | |
| 15 | Conclude on project asset and material balance(s). | | |

Prepared by Audit Officer:

Name Date

Endorsed by Director:

Name Date

Approved by AAG/DAG:

Name

Date

Annexure - 14 Model Written Representation Letter

Date: _____

The Audit Team leader/Auditor

Office of the Auditor General

Subject: Written Representation Letter

Dear Sir/Madam,

We acknowledge that you have been assigned for the audit and express an audit opinion on the financial statements of the project (*Insert name of project*) for the fiscal year 20../20..

In connection to this audit, we hereby submit you this Written Representation Letter related to financial transaction of the project.

We acknowledge that we as management are responsible for the accuracy of the accounting records and the fair presentation financial statements in accordance with prevailing statutes and accounting standards and the auditor's responsibility is to express an opinion on these financial statements based on audit examination.

We confirm, to the best of our knowledge and belief, the following representations given to you in connection with the financial statements submitted to you with our letter dated.....

1. There have been no Irregularities, fraud and illegal acts involving any member of management or employees who have significant roles in the operation of financial transactions and management of internal control in the project;
2. We have made available to you all books of account and relevant documents along with the supporting evidences, executive orders, decisions and minutes of meetings and no such information or document has been withheld without producing you;
3. We have not operated any other financial transactions except those presented in the attached financial statements;
4. We have complied all relevant statutes and terms and conditions of the project agreement in connection with operation of financial transactions;
5. Our project has satisfactory title to all owned assets and they are free from any

liens or encumbrances, except those disclosed in the separate Notes to the financial statements;

6. We confirm that our financial statements are fairly presented on the basis of true and factual matters in accordance with relevant statutes and are free from material misstatements including omission;
7. For the subsequent events affecting the financial statements, that occurred after the date of financial statements, we have prepared and attached herewith separate statements of (Statement of advance settlement, unpaid checks, Cash in transits, Recovery of excess paid amounts etc) without revising the financial statements;
8. We express our commitment for the maintaining clean and fair financial transactions by taking necessary actions in connection to the audit observations;
9. In connection to financial transactions, no litigation or legal proceedings has taken place and no document or account has been taken to any entity;
10. We express our responsibility for implementing effective internal controls to prevent and detect error, misstatements, and frauds.

We will further acknowledge you if we any information come to our notice against the above mentioned representation.

Chief Finance Officer

Chief of the Project

Name: _____

Name _____

Annexure – 15 Sectoral Project Financial Statements

Sectoral Project Financial Statement

Fiscal Year 20.../20... (. July 20...to ... July 20...)
 Loan/Grant No.

| Resources | Notes to account | Up to 20.../20... NRs | FY 20.../... NRs | Up to 20.../20... NRs | Expenditure | Budget Heads | Notes to account | Up to 20.../20... NRs | Up to 20.../... NRs |
|--|------------------|-----------------------|------------------|-----------------------|--|--------------|------------------|-----------------------|---------------------|
| A: | | | | | A: | | | | |
| GON Fund | | | | | Per Government's chart of accounts | 1 | 1 | | |
| GON Reimbursable Development partner(s)* reimbursable | | | | | <i>Note: Additional supplementary information notes may be added to reflect details of expenditures incurred under the programme</i> | 2 3 4 | 1 1 1 | | |
| Total Reimbursable | | | | | | 5 | 1 | | |
| Development partner(s)* - | | | | | | 6 | 1 | | |
| Loan/Grant | | | | | | - | 1 | | |
| B: | | | | | B: | | | | |
| Developing Partner(s) | | | | | Foreign Exchange Account balance | | | | |
| Foreign Exchange Account | | | | | Outstanding Replenishment | | | | |
| Exchange Gain | | | | | Exchange Loss | | | | |
| Sub Total | | | | | | | | | |
| Grand Total | | | | | | | | | |

* To indicate number of development partners

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 Account-In-Charge Sector Coordinator Secretary Financial Comptroller Auditor General

Ministry of General (or Deputy Auditor General)