NEPAL

Country Financial Accountability Assessment (CFAA)

A Joint Exercise of
His Majesty's Government of Nepal
and the World Bank

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NEPAL
COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT

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ABBREVIATIONS AND ACRONYMS

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ADB	ASIAN DEVELOPMENT BANK
ADBN	AGRICULTURAL DEVELOPMENT BANK OF NEPAL
ADDCN	ASSOCIATION OF DISTRICT DEVELOPMENT COMMITTEES OF NEPAL
AG	AUDITOR GENERAL
AGM	ANNUAL GENERAL MEETING
ASB	AUDITING STANDARDS BOARD
ASOSAI	ASIAN ORGANIZATION OF SUPREME AUDIT INSTITUTIONS
BAS	BOARD OF AUDITING STANDARDS
BPI	BRIBE PAYERS INDEX
CA	CHARTERED ACCOUNTANT
CAPA	CONFEDERATION OF SOUTH ASIAN AND PACIFIC ACCOUNTANTS
CAS	COUNTRY ASSISTANCE STRATEGY
CCSC	CORRUPTION CONTROL SUGGESTION COMMITTEE (1999)
CF	CONSOLIDATED FUND
CFAA	COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT
CIAA	COMMISSION FOR THE INVESTIGATION OF ABUSE OF AUTHORITY
CONSTITUTION	CONSTITUTION OF THE KINGDOM OF NEPAL, 1990
CMED	CENTRAL MONITORING AND EVALUATION DIVISION
CPAR	COUNTRY PROCUREMENT ASSESSMENT REPORT
CPI	CORRUPTION PERCEPTION INDEX
CPPR	COUNTRY PORTFOLIO PERFORMANCE REVIEW
DAP	DEVELOPMENT ACTION PLAN
DAO	DISTRICT ADMINISTRATION OFFICE
DC	DISTRICT COUNCIL
DDA	DISTRICT DEVELOPMENT AREA
DDC	DISTRICT DEVELOPMENT COMMITTEE
DFID	DEPARTMENT FOR INTERNATIONAL DEVELOPMENT (U.K.)
DTCO	DISTRICT TREASURY AND CONTROLLER OFFICE
ECA	EUROPE & CENTRAL ASIA REGIONAL OFFICE
FASB	FINANCIAL ACCOUNTING STANDARDS BOARD
FAR	FINANCIAL ADMINISTRATION REGULATIONS, 1999
FCGO	FINANCIAL COMPTROLLER GENERAL OFFICE
FM	FINANCIAL MANAGEMENT
FMIS	FINANCIAL MANAGEMENT INFORMATION SYSTEM
FMR	FINANCIAL MONITORING REPORT
FMS	FINANCIAL MANAGEMENT SPECIALIST
FNCCI	FEDERATION OF NEPALESE CHAMBERS OF COMMERCE & INDUSTRY
FSTAP	FINANCIAL SECTOR TECHNICAL ASSISTANCE PROJECT
FY	FISCAL YEAR
GFS	GOVERNMENT FINANCIAL STATISTICS
HM	HIS MAJESTY THE KING
HMGN	HIS MAJESTY'S GOVERNMENT OF NEPAL
HRD	HUMAN RESOURCE DEVELOPMENT
IAD	INTERNAL AUDIT DEPARTMENT
IAS	INTERNATIONAL ACCOUNTING STANDARDS
IASB	INTERNATIONAL ACCOUNTING STANDARDS BOARD
IC	INTERNAL CONTROL
ICAI	INSTITUTE OF CHARTERED ACCOUNTANTS OF INDIA
ICAN	INSTITUTE OF CHARTERED ACCOUNTANTS OF NEPAL

ICB	**INTERNATIONAL COMPETITIVE BIDDING**
IDA	**INTERNATIONAL DEVELOPMENT ASSOCIATION**
IDF	**INSTITUTIONAL DEVELOPMENT FUND**
IFAC	**INTERNATIONAL FEDERATION OF ACCOUNTANTS**
IMF	**INTERNATIONAL MONETARY FUND**
INGO	**INTERNATIONAL NON-GOVERNMENTAL ORGANIZATION**
INTOSAI	**INTERNATIONAL ORGANIZATION OF SUPREME AUDIT INSTITUTIONS**
ISA	**INTERNATIONAL STANDARDS ON AUDITING**
IT	**INFORMATION TECHNOLOGY**
JBIC	**JAPAN BANK FOR INTERNATIONAL COOPERATION**
JC	**JUDICIAL COUNCIL**
LSGA	**LOCAL SELF-GOVERNANCE ACT, 1999**
MA	**MUNICIPAL AREA**
MC	**MUNICIPAL COUNCIL**
MDAC	**MINISTERIAL DEVELOPMENT ACTION COMMITTEE**
MOF	**MINISTRY OF FINANCE**
MOLD	**MINISTRY OF LOCAL DEVELOPMENT**
MTEF	**MEDIUM-TERM EXPENDITURE FRAMEWORK**
MWCSW	**MINISTRY OF WOMEN, CHILDREN, AND SOCIAL WELFARE**
NASC	**NEPAL ADMINISTRATIVE STAFF COLLEGE**
NAS	**NEPAL ACCOUNTING STANDARDS**
NCB	**NATIONAL COMPETITIVE BIDDING**
NDAC	**NATIONAL DEVELOPMENT ACTION COMMITTEE**
NDF	**NEPAL DEVELOPMENT FORUM**
NEPSE	**NEPAL STOCK EXCHANGE**
NGO	**NON-GOVERNMENTAL ORGANIZATION**
NGSDO	**NON-GOVERNMENTAL SOCIAL DEVELOPMENT ORGANIZATION**
NIDC	**NEPAL INDUSTRIAL DEVELOPMENT CORPORATION**
NPC	**NATIONAL PLANNING COMMISSION**
NRB	**NEPAL RASTRA BANK**
NSC	**NATIONAL STEERING COMMITTEE**
OAG	**OFFICE OF THE AUDITOR GENERAL**
OIC	**OFFICE-IN-CHARGE**
PAC	**PUBLIC ACCOUNTS COMMITTEE**
PAAN	**PUBLIC ADMINISTRATION ASSOCIATION OF NEPAL**
PER	**PUBLIC EXPENDITURE REVIEW**
PERC	**PUBLIC EXPENDITURE REVIEW COMMISSION**
PMR	**PROJECT MANAGEMENT REPORT**
PREM	**POVERTY REDUCTION AND ECONOMIC MANAGEMENT**
PRSP	**POVERTY REDUCTION STRATEGY PROGRAM**
PSC	**PUBLIC SERVICE COMMISSION**
PWD	**PUBLIC WORKS DIRECTIVES**
RATC	**REVENUE ADMINISTRATION TRAINING CENTER**
RID	**REVENUE INVESTIGATION DEPARTMENT**
ROC	**REGISTRAR OF COMPANIES**
RMC	**REFORM MONITORING COMMITTEE**
SAI	**SUPREME AUDIT INSTITUTION**
SAR	**SOUTH ASIA REGION**
SAFA	**SOUTH ASIAN FEDERATION OF ACCOUNTANTS**
SBD	**STANDARD BIDDING DOCUMENTS**
SDC	**SWISS AGENCY FOR DEVELOPMENT AND COOPERATION**
SEBO	**SECURITIES BOARD**

SOE	**STATE-OWNED ENTERPRISE**
SPD	**SPECIAL POLICE DEPARTMENT**
SWC	**SOCIAL WELFARE COUNCIL**
TIN	**TRANSPARENCY INTERNATIONAL OF NEPAL**
UNDP	**UNITED NATIONS DEVELOPMENT PROGRAM**
VAT	**VALUE ADDED TAX**
VC	**VILLAGE COUNCIL**
VDA	**VILLAGE DEVELOPMENT AREA**
VDC	**VILLAGE DEVELOPMENT COMMITTEE**
WB	**WORLD BANK**
WPFR	**WORLD PRESS FREEDOM REVIEW**

FOREWORD

NEPAL
COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT (CFAA)

FOREWORD

1. The Nepal-Country Financial Accountability Assessment (CFAA) analyzes the budgeting, accounting, financial reporting and auditing systems, standards and practices in both the public and private sectors of Nepal's economy. The objectives are to (a) assess the strengths and weaknesses of the system, as well as the fiduciary risk that investments in both the public and private sectors are subject to, and (b) identify needs for capacity building in these areas.

2. The study was conducted throughout as a joint exercise of His Majesty's Government of Nepal (HMGN) and the World Bank (WB), with strong participation by donors as well as private agencies. In December 2001, HMGN formed a high level National Steering Committee (NSC) to work with the Bank's CFAA team. The NSC has been playing a pivotal and strong leadership role which provided not only a high level of government ownership, but also extremely useful quality assurance, particularly with regard to ensuring the factual accuracy of the CFAA. The Concept Note for the CFAA (see Annex 1) was prepared with significant input of the NSC and, as part of the initial phase of the CFAA, the NSC prepared a Position Paper focusing on most of the topics to be covered by the CFAA, explaining the current position and initiatives of HMGN. The NSC has been meeting regularly with the WB Team to discuss progress, facilitated and participated in the fact-finding visits by the WB Team in February 2002, and called a donors meeting the same month to brief them about the CFAA. The NSC reviewed every draft of the CFAA report, coordinating and transmitting all government comments thereon; and organized the CFAA stakeholders' workshop (see below).

3. Very early in the exercise, the CFAA team reviewed previous analytical work by the WB, the Asian Development Bank (ADB), the United Kingdom Department for International Development (DFID), and others. In addition, national consultants with expertise in relevant sectors covered in the CFAA conducted in-depth research and interviews with a large number of stakeholders representing both the policy and implementation levels, and submitted written findings. Their findings were incorporated in the first draft of the CFAA report which was circulated to a limited group of people on March 28, 2002. This draft was tested and supplemented with additional information collected during fieldwork in Nepal in February 2002. This draft was revised incorporating the comments from the WB's peer reviewers and the NSC members. A revised draft was produced on April 30, 2002. The revised draft was again circulated to a limited group of people but included the external peer reviewers representing the donor group, the NSC members, various government agencies, oversight agencies and private sector agencies. Comments were received from donor peer reviewers (ADB, DFID, SNV and UNDP), various agencies in the government and the private sector, the Social Welfare Council, the Public Accounts Committee, the Office of the Auditor General and from the NSC. A final draft CFAA report incorporating all these comments was then used to make a presentation to a stakeholders' workshop held in Kathmandu on June 11, 2002. The workshop was attended by about 200 participants representing government agencies, private entities, donor partners, NGOs/INGOs, academicians, representatives of various political parties, media and others.

4. The recommendations of the workshop were, thereafter, incorporated in the final CFAA report, before formal discussions and adoption of the Development Action Plan by HMGN in June 2002.

5. The NSC members were: Bansidhar Ghimire, Financial Comptroller General, FCGO, until April 2002 and following his retirement the new Financial Comptroller General Madhab Prasad Ghimire effective May 9, 2002 (Convener); Rameshore Prasad Khanal, Joint Financial Controller General, FCGO (Member Secretary); Ram Kumar Shrestha, Joint Secretary, National Planning Commission (Member); Ramesh Raj Satyal, Assistant Auditor General, Office of the Auditor General (Member); Madhav Prasad Ghimire, Joint Secretary, Budget Division, Ministry of Finance (Member); Ram Krishna Kharel, Under Secretary, Ministry of General Administration (Member); Pramod Koushik, General Secretary, Association of Chartered Accountants of Nepal (Member); and Purushottam Lal Shrestha, Secretary, Institute of Chartered Accountants of Nepal (Member). Durgesh Kumar Pradhan, Accounts Officer, FCGO, provided administrative support to the NSC.

6. The WB's CFAA Preparation Team was led by Bigyan Pradhan, Senior Financial Management Specialist (CFAA Task Team Leader) at the WB's Nepal Country Office, and supported by Uche Mbanefo (Chairman of PROFIMA Limited and a former WB Regional Financial Management Advisor for the Africa Region), as Lead Consultant, Narayan D. Sharma (Procurement Liaison), Ahmed Ahsan and Roshan Bajracharya (Public Expenditure Review Liaison), as well as the following national consultants: Upendra Pradhanang; Nagendra Rajbansh; Chandra Bahadur Nemkul; Harihar Regmi; and Pradeep Shrestha. Nagendra Nakarmi provided administrative support to the CFAA Team.

7. Peer reviewer from the South Asia Region (SAR) who provided comments was: Vinod Sahgal, Public Financial Accountability Specialist. External peer reviewers who provided comments were: Ivonna Kratynski, Loan Department (WB); Pierre Messali and David Shand (WB FM Anchor); Paul Edwin Sisk (LCOAA - WB); Allister Moon, (PREM ECA - WB); John Fitzsimon (former Acting Regional Financial Management Advisor, South Asia Region); Richard Vokes and Krishna Ram Panday (Asian Development Bank); Stephen Sharples (DFID); Biswas Gauchan (UNDP); and Addie van Dallen (SNV - Dutch Aid Agency). Messrs. Kenichi Ohashi (Country Director, Nepal) and Robert Saum (Acting Regional Financial Management Adviser) provided guidance and support to the CFAA team. Numerous other persons in both the public and private sectors, including training institutions, the Office of the Auditor General and the Public Accounts Committee provided much information, which made this CFAA possible.

8. The NSC and the CFAA team sincerely thank all the persons and institutions listed above and all persons whom the team met (listed in Annex 2), as well as many others not specifically mentioned, for their contributions and support to the work of preparing this assessment.

EXECUTIVE SUMMARY

EXECUTIVE SUMMARY

The six specific objectives of this CFAA set out in paragraph 5 of the Concept Note (see Annex 1 attached) have been accomplished, and the 13 areas identified for review in paragraph 8 of the same Note have been covered. The Government is serious and committed to improving public and private sector financial management. Reforms in financial management are now critical and should be approached in an integrated way covering planning, budgeting, accounting, internal control, internal audit, external audit and oversight. Reform in only one area of financial management will not result in the same degree of expected benefits. The failure to comply with the impressive legal and regulatory fiduciary framework that exists makes fiduciary risk in Nepal "High" by the standards of that same framework, whose faithful implementation would have brought risks closer to "best practice" standards found in developed countries. Rather, fiduciary risk in Nepal is at a level similar to that found in many developing countries. Various actions, including capacity building, aimed at systemic improvements in both public and private sector financial accountability still leave a large gap between precept and practice. Further capacity building recommended in the Development Action Plan is designed to close this gap, and introduce international accounting and auditing standards in both the public and the private sectors.

The Public Sector

1. Nepal's legal and regulatory framework for ensuring public sector financial accountability is very impressive for a country at its level of economic development. The Constitution of the Kingdom of Nepal, 1990 requires the National Budget to be presented with an account of the goals achieved from previous spending. It accords the Auditor General (AG) complete legal and professional independence, exempting his emoluments and the budget of his office, Office of the Auditor General (OAG), from parliamentary vote. The Constitution also created a Commission for the Investigation of Abuse of Authority (CIAA) to investigate and recommend action against errant and corrupt officials, and prosecute them, if necessary.

2. The Public Accounts Committee (PAC), headed by a member of the main Opposition Party in the Parliament, is very proactive. It meets all the year round, discussing, not only the public accounts and the AG's annual report and recommendations thereof, but also practically every aspect of public sector financial management. Its meetings are open to, and receive full coverage in, the press. It intervenes in the procurement process, even while it is still going on, if it suspects any impropriety. Its collaboration with the AG is exemplary. It sends the AG's recommendations to Government with a directive for the implementation of such recommendations.

3. The Financial Procedures Act, 1999 and the Financial Administration Regulations (FAR), 1999, contain very detailed and comprehensive provisions for: *budget preparation and approval*; and *accounting and reporting* on budget implementation, every four months; *a detailed report (Schedule 2 of the FAR)* requiring a statement, not only of the expenditure, but also of the physical results and goals achieved; elaborate *procurement and internal control procedures*; *annual financial statements* at all levels, with *a consolidated financial statement* for the whole government at the end of each fiscal year; *internal and external audits*; *Ministerial review of project implementation* at regular intervals throughout the year, with rewards for good performers, and explanations for poor performance. As required by the Constitution 1990, the Ministry of Finance (MOF) every year submits a detailed report to the

Parliament just before the presentation of the budget, comparing the achievement with the set target for each line ministry. Since the progress report is required to be submitted during the budget session around May/June, it is able to report the actual progress only for nine months of the current fiscal year and provide estimated figures for remaining three months. An actual figure for the full year can only be realistically provided if this requirement of submitting the physical progress report is shifted to the winter session of the Parliament. This is an area which His Majesty's Government of Nepal (HMGN) might wish to review to make the report more meaningful with actual figures of achievements achieved in the past, followed by some analysis of major achievements and failures, and the suggestions for improved performance in subsequent years.

4. For the local level, the Local Self-Governance Act (LSGA), 1999 explains the local government structure so well as to make it crystal-clear even to someone who has never known Nepal. The roles, responsibilities, and relationships of District Development Committees (DDCs), Municipalities, and Village Development Committees (VDCs), and the Councils which govern them are very clearly explained in the Act. The regulations for financial accountability at the local level are, if anything, even more impressive than those at the center. They contain sensible provisions and instructions for: *budget preparation*; *proper accounting and reporting*; *creation of an Accounts Committee* in every local body to oversee financial management; *internal and external audit*; *project monitoring*; and a most elaborate and impressive system for *"ex-post" evaluation of projects*, which assesses, not only the direct costs and benefits of each project, but also its employment creation effects, and even its impact on the ecology.

5. In practice, however, most of the impressive laws and regulations described above are more honored in the breach than in the observance. The Schedule 2 of the FAR reporting on physical and goal achievements is almost never monitored. If this was prepared and monitored, the linkage between financial progress and physical outputs/outcomes could be measured in ways that would fully meet World Bank's financial management requirements for projects it finances. Monitoring of compliance with the provisions of the FAR either does not take place, or is not accorded the priority implied by the Regulations. The penalties and fines prescribed by the FAR for non-compliance with reporting or other requirements are almost never imposed. About 95% of the cases brought by the CIAA at the court of law against errant officials failed, although the success rate is said to have improved to as much as 50% more recently. Good performers are rarely rewarded and poor performers rarely probed or penalized; such rewards as are awarded often baffle many officials as to their justification. Monitoring is severely weak both at the central and local levels. Most local bodies do not monitor projects or evaluate their impact as required by the LSGA 1999. Accounting staff, though they possess minimum technical qualifications required for the job, are generally weak in project accounting and financial management. Technical staff often give low priority in terms of allocating resources to institute a good financial management system in their respective entities/projects. Compliance with internal controls is weak, and internal audit is ineffective at all levels. In short, a culture of non-compliance makes a mockery of an exemplary legal and regulatory framework. Lack of compliance and poor implementation of the regulations is the single most important problem that affects public sector financial accountability in Nepal. Further, whether justified or not, there is a widely held belief that proactive intervention of the PAC and the CIAA, has often caused delays in decision making in government offices. If proactive involvement of the PAC during the implementation process has helped in many respects to check any malpractices or misdeeds, it has also caused severe delays in decision-making, with negative effects on development. A right balance is required, and their roles will be more significant in cases of serious malpractice operations where post-mortems are required.

6. Several reasons are advanced for the dichotomy between precept and practice noted above. They include: insufficient political commitment to, or demand for, compliance with financial accountability rules and regulations; a reluctance to punish or impose sanctions on anyone; reported corruption in civil service appointments, promotions and transfers; politicization of the civil service and its decision-making processes; and some donors and foreign development partners bypassing the government's system in establishing financial systems and requirements for projects they support, thereby contributing to lack of respect for the law and regulations of the country.

7. In seeking to explain the lack of compliance, two factors have had a significant and practical impact. Firstly, the implementation of a good legal and regulatory framework for accountability such as exists in Nepal requires a good financial management framework, which was never put into operation. For example, tying expenditures to outputs and outcomes requires: a budgetary system which budgets output or results expected from expenditures as well as funds; an accounting system which records quantitative and qualitative achievements as well as financial data; a reporting system which includes quantitative and qualitative results as well as financial statements; and an auditing system which enables an independent auditor to trace expenditures and their results through the entire system. Secondly, there were so many sources of distractions and instability, including frequent government changes, that other urgent pre-occupations crowded out financial management from the political radar screen.

8. Flowing from the above analysis, the challenge faced in this CFAA is how to bring about the behavioral and attitudinal change that will shift government and other officials from a culture of non-compliance to one based on **implementation** of the country's existing impressive legal and regulatory framework. The diagnosis of issues in this CFAA does not come as a surprise to many government staff or other professionals working in the development arena. The matters covered are subjects of almost continuous discussion. The key challenge is <u>how to bring about change in the way one thinks and in the way one acts, how to reinforce the country's laws and regulations, and how to motivate a large group of de-motivated civil servants who are capable of producing better results and outcomes.</u> Changes do not happen by preaching – they require "*leaders*" or "*change agents*", both at the political and bureaucratic levels, whose demonstration effect can motivate people for better results. Development and implementation of capacity building plans at institutional/organizational levels, involving Human Resource Development plans including training, can help to bring about sustainable change in behavior and attitude.

9. Certain principles are helpful in confronting this daunting task. As a proverb says, "*an ounce of prevention is worth a pound of cure*". It is important to accord high priority to preventive measures which will help to promote the accountability culture. Therefore, (a) individuals (or offices) should not be entrusted with funds, unless it has been confirmed beforehand that they can properly account for them; and (b) since managers are either unable or unwilling to impose sanctions, it is best, if possible, to avoid putting them in a position where they have to decide whether or not to impose a sanction. Translating these principles into practice requires a strong political will and incentive or disincentive structure.

10. The two principles enunciated in the preceding paragraph have led to a number of recommendations which are elaborated in the Development Action Plan (DAP), attached to this Executive Summary The recommendations are essentially designed to bring about compliance with existing public sector financial accountability laws and regulations. Any new legislation or regulation the Government finds it necessary to introduce in this connection should have the same objective of strengthening the implementation of what already exists.

Budgeting and Accounting

11. The **key recommendation** is for HMGN to show leadership by requiring that:

- Only a competent and qualified individual be appointed to any position involving the handling of state funds, and transparent criteria be developed to prove the competency of such an individual. Only a competent individual should be allowed to handle any State funds, whether in the form of revenue, or as a spending budget. A key criterion of such competence is the ability to properly account for the funds as required by existing regulations, including reports on physical results or measurable goals (a) achieved from previous expenditures, and (b) to be achieved from the proposed program/development expenditure.

- No budget should be accepted or approved from anyone or any office, whether at village, municipal, district, Department or Ministry level, nor should Parliament approve any National budget, unless the budget contains (a) a retrospective account of physical or other measurable achievements or goals resulting from previous expenditures, and (b) a prospective forecast of the physical results or other measurable goals expected from proposed expenditures. A suitable simplified framework should be developed that can be realistically implemented at the local (village, municipal and district) level.

- Every disbursement to any office (whether at local or at central level) should be against a report from that office showing (a) expenditures for the immediately preceding period and their physical or other measurable achievements, and (b) the proposed expenditures and their anticipated physical or other measurable achievements.

12. Implementation of these recommendations will require officials to take a positive act of either deliberate defiance or error not to comply, not just a passive failure to call for reports after the funds have already been disbursed. Compared with the new recommendations, the existing system is like shutting the gate after the goats have escaped.

13. Three recent developments justify a feeling that the time is ripe for meaningful reform: (a) indigenous Nepalese clamour for improved financial accountability and control of corruption has risen to a crescendo that can no longer be ignored; (b) shrinking earnings and rising expenditures have created a budgetary squeeze necessitating considerable budgetary support; and (c) Nepal's development partners have become more insistent than ever on visible improvements in transparency and accountability as a condition for providing budgetary support. The confluence of these three currents have produced a powerful wind of change, forcing good financial accountability to the forefront as a social, political, and economic desideratum. Given opportunities must be seized in order to bring about reforms in financial management in an integrated approach covering planning, budgeting, accounting, internal control, internal audit, external audit and oversight. Reform in only one area of financial management will not result in the same degree of expected benefits.

Independent Auditing and Parliamentary Oversight

14. In addition, the CFAA revealed two Nepalese institutions, the OAG and the PAC, which are identifying weaknesses in the system and pressing government to implement remedies. In fact, it was largely through their reports and activities that the extent of non-compliance with existing laws and regulations became evident. Therefore, to improve the

chances that the recommendations in paragraph 11 will be complied with, it is **further recommended** that:

- the Monitoring Section of the National Planning Commission (NPC) be strengthened ensuring full ownership by NPC to institute a realistic system in order to monitor all development projects, in addition to the core projects, in close collaboration with concerned line ministries, and to report the progress three times a year;

- the Financial Comptroller General Office (FCGO) and the internal audit services at central and local levels be strengthened to enable them to (a) certify offices qualified to receive and properly account for funds, (b) monitor compliance with the new regulations (i.e., the above recommendations) all through the year, and (c) take proactive actions to rectify any issues that are against rules and regulations, before they are pointed out by the external auditors;

- the OAG be strengthened to improve its capacity to confirm each year whether or not the new rules are being complied with, to provide services in financial auditing and outcome based performance auditing;

- the capacity of the line ministries be strengthened to be able to effectively monitor their programs and also prepare a time-bound action plan to rectify issues or implement recommendations in the OAG's report – and the MOF to monitor the implementation of such action plans of all ministries;

- the Ministry of Finance (MOF) be strengthened by establishing an effective monitoring system to follow up reported irregularities and periodically report on the actions taken. Such a monitoring function should include the status of the following: (a) audit backlogs and action plan to keep all audits up-to-date, (b) revenue realization, (c) clearing reimbursable grants and loans, (d) tax deduction at source, (e) repayment of principal and interest made by HMGN on guaranteed loans but not recovered from concerned institutions, (f) dividends receivable, and other receivables, from corporate bodies and boards, (g) amounts to be paid by HMGN to various entities, and (h) follow-up on the recommendations of the PAC; and

- the PAC be strengthened to improve its capacity to insist on political demand for accountability and transparency, and on compliance with the new regulations.

Other capacity building needs, in addition to the six listed above, may very well surface as HMGN contemplates the detailed capacity implications of implementing the DAP.

<u>**Fiduciary Risk and Programmatic Lending**</u>

15. The failure to comply with the impressive legal and regulatory fiduciary framework that exists makes fiduciary risk in Nepal "High" by the standards of that same framework, whose faithful implementation would have brought risks closer to "best practice" standards found in developed countries. Even some developed countries also have similar problems, but the real challenge is the effective use of scarce resources for fighting poverty. Fiduciary risk in Nepal is, however, at a level similar to that found in most developing countries.

16. The area of attention important for minimizing fiduciary risk on programmatic lending is compliance with the impressive framework that exists. If the joint efforts by the OAG and PAC succeed in improving compliance with existing regulations, programmatic lending to Nepal should face fiduciary risks similar to those found in developed countries. It is, therefore, critically important to begin implementing the DAP designed to enforce compliance with existing laws and regulations. For fiduciary risk on programmatic lending to approximate the fiduciary risk now accepted for project lending, accountability and internal control standards in the whole civil service must approximate those currently existing in the WB-financed projects. The existing legal/regulatory framework meets these standards. It remains to get compliance to attain the same level. The objective for HMGN should be to harmonize the reporting system, making it acceptable to all donors, in "one reporting system" coming out of the government's accounting and reporting framework.

17. Some budgetary support or programmatic lending should be possible almost immediately through a combination of:

(a) A pragmatic program of targeted assessment and "sanitization" of sectors and institutions scheduled to benefit from such lending; and

(b) The implementation of the recommendations made in the DAP for the public sector as a whole, likely to be completed over the medium term.

For example, to ensure that no urgently-needed budgetary support for poverty reduction and other worthwhile objectives is held up by the implementation of the above recommendations, **it is recommended** that sectors, Ministries, and institutions scheduled to benefit from budgetary support be the first to be assessed and certified by a panel of independent experts representing the accountability institutions which include, MOF, FCGO, NPC and OAG (may also include experts designated by donor partners participating in budgetary support), as complying with the accountability standards recommended above. As of June 15, 2002, the following Ministries had already been identified for possible budgetary support, and therefore for such early review: Health, Education, Water Resources, Works and Physical Planning, and Agriculture and Cooperatives. Any weak points revealed should be strengthened as an indispensable element and component of the budgetary support package. Implementation of such actions should be closely monitored and reported. Necessary pre-conditions for budgetary support lending are likely to involve the implementation of some other DAP actions or sub-actions, including, for example: report on HMGN actions in response to the PAC directives regarding the implementation of about 82 past OAG recommendations; the establishment in the MOF of a system for the regular monitoring and reporting of actions taken in response to OAG reports; the publication, every four months, of a financial statements by the FCGO comparing budgeted with actual receipts and payments; enhance independence of OAG and enhance audit quality of OAG by making an external peer review arrangements; and discussion with donors on the modalities for the inclusion of all foreign financial assistance in HMGN budgets and accounts.

18. Following the full implementation of the proposed integrated financial management improvement program, a quick review would be desirable to confirm the effectiveness of the compliance system, before a generalized programmatic lending benefiting all sectors, Ministries, and institutions is launched. Based on current evidence, this situation may arrive sooner in central government than in local bodies. All levels of government would need to be reviewed for adequate compliance before moving forward. The guiding principle always should be that no office at central or local level should receive any funds without first demonstrating the capacity to the civil society at large, to budget and account for them in a manner which links them to outputs and outcomes and which presents such accounts for OAG audit in a timely manner. A Task Force or a Reform Monitoring Committee should continue to be in action to monitor the implementation of the recommendations of the CFAA (see end

of this Executive Summary). The status of implementation should be periodically reported to the Finance Committee of the Parliament, the Finance Secretary, and Nepal's development partners.

The Private Sector and Non-Governmental Organizations

19. Development of private sector accounting and auditing is relatively new. A professional body for accounting and auditing professionals, the Institute of Chartered Accounts of Nepal (ICAN), was established in 1997 through the enactment of the Chartered Accountants Act, 1997. In the private sector, three key issues are:

(a) the lack of accounting and auditing standards,

(b) the weakness of the very young ICAN, which would ordinarily spearhead (or at least play a key role) in the development of private sector accounting and auditing standards; and

(c) the weakness of most of the oversight institutions, such as the Nepal Rastra Bank (NRB), which monitors the banking sector; the Registrar of Companies; and the Social Welfare Council, which monitors non-governmental organizations (NGOs).

20. To improve the financial accountability situation in the private sector, this CFAA recommends (among others):

- support for the on-going efforts by the Government and ICAN to create an Accounting Standards Board and an Auditing Standards Board;
- a realistic assessment and determination of the appropriate role for ICAN, in view of its sustainable resources; and
- agreement on a level of Government grant support to ICAN until it achieves financial self-sufficiency.

Considerable capacity building (human resource development including training and consultancy) will also be required at ICAN to implement the needed changes.

21. To improve the financial accountability situation in NGOs, this CFAA recommends (among others):

- formulation of policies for streamlining the administrative and legal framework within which NGOs operate, in order to enhance their functional and financial accountability, transparency and effectiveness;
- enactment of comprehensive legislation exclusively for registration and governance of NGOs, including international NGOs (INGOs); and
- strengthening the Social Welfare Council (SWC) to enable it to effectively monitor the activities and finances of all NGOs, and to require all NGOs and INGOs to register, and file annual audited accounts with the SWC.

Development Action Plan (DAP) and Overall Implementation Strategy

22. There are close to about 100 detailed recommendations in the chapters of this CFAA. They clearly cannot all be implemented at the same time, nor should they be accorded the same priority, even though they are all important. Therefore, **eight** key recommendations are presented in the Development Action Plan (DAP) as deserving the highest priority attention at the national level. They are:

- compliance with the constitutional, statutory and regulatory framework by tying budgets and cash releases to forecasts of, and reports on, results and outputs;
- improvement of Nepalese public sector accounting and auditing standards and practices;
- strengthening of financial accountability at the local level;
- strengthening the independence and capacity of the OAG;
- strengthening the PAC and the CIAA;
- reducing fiduciary risks on projects;
- strengthening private sector accounting and auditing standards; and
- strengthening the regulation and monitoring of NGOs.

The implementation of the DAP itself constitutes a ninth action. The other recommendations not included in the DAP should be included in detailed development plans at the sector or institutional level. The selection rationale and DAP Implementation Strategy are presented in Part F - Chapter XIII.

23. The close collaboration between HMGN and the WB, and the lead role taken by the NSC in directing the CFAA, are clear indications that HMGN accords a high priority to improving financial accountability and implementing the recommendations in the DAP. **A Reform Monitoring Committee (RMC), with members representing appropriate public and private sector agencies, will monitor the implementation of the DAP. The RMC is expected to nominate specific individuals (or groups of individuals) within the committee as sub-committees to monitor specific actions in the DAP. They are to liaise with HMGN or other agencies responsible for taking actions, and report back to the full RMC every quarter.** The RMC will report implementation progress to the Nepalese public and development partners at pre-determined intervals.

24. HMGN will formally constitute the RMC (with representation from private sector as well), name its members, and issue it with terms of reference incorporating the work and operating procedures outlined in the attached DAP and Chapter XIII by **August 31, 2002**. The RMC will hold its first quarterly meeting and nominate its sub-committees by no later than **September 30, 2002**. It will issue its first DAP Implementation Progress Report by **December 31, 2002** and issue its first report to the next NDF.

25. The DAP, and progress in its implementation, will also feature prominently in the Governance and Accountability section of the WB's next Country Assistance Strategy (CAS). This CFAA should also serve as a useful working document for policy makers, as well as set the stage for all development partners interested in assisting HMGN to promote financial accountability and good governance.

DEVELOPMENT ACTION PLAN

DEVELOPMENT ACTION PLAN

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
A. HMGN comply with the Constitution of the Kingdom of Nepal, 1990, and the Financial Administration Regulations (FAR), 1999 by tying all budgets and cash releases to forecasts of and reports on, the physical achievements, goals or outcomes resulting from such public expenditure.	1. **Reinforcement of Rules:** Demand retrospective report and prospective forecasts as part of all budgets (i) initially under five sectoral ministries (Agriculture, Education, Health, Water Resources and Works & Physical Planning) where MTEF is being piloted; (ii) during the medium term, work out a plan for implementation in other ministries; and (iii) as the third phase, extend to local bodies.	**Lead: MOF** **Others: NPC, MOLD, Line Ministries**	✓	✓	✓	◆ Confirms that funds are being spent on the intended purpose.
	2. **Linking Fund Release to Progress Report:** Reject every cash disbursement request from any office, central or local, failing to submit retrospective report and prospective forecast of measurable outputs and goals, as well as financial report and forecast.	**Lead: FCGO** **Others: MOF, NPC**	✓	✓		
	3. **Amendment of FAR and LSGA:** Review existing Schedules, particularly Schedules 2, 3 and 5 of FAR and the LSGA for their adequacy in implementing sub-actions 1 and 2 above, and supplement them as needed.	**Lead: FCGO, MOLD** **Others: MOF, OAG, NPC**	✓	✓		

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
	4. **Budget Monitoring:** Strengthen the Monitoring Section of the NPC ensuring full ownership by NPC to institute a realistic system to monitor all development projects on a regular basis requiring mandatory reporting on a four monthly basis. Further, FCGO prepare budget implementation reports and make such reports available in the same frequency.	**Lead:** **NPC, FCGO** **Others:** **MOF**	✓			• Timely alert regarding problems and issues in development projects
	5. **Effective Internal Audit:** Verify all offices, central and local, at least once during the year and report to the OAG on their compliance with Sub-Actions 1 and 2 above, and certify their capacity to comply.	**Lead:** **FCGO,** **Others:** **DTCOs**	✓	✓		◆ Confirms that funds are being spent on the intended purpose.
	6. **Effective External Audit:** Confirm in OAG Annual Report whether every office, central and local, complied during the year with Sub-Actions 1 and 2 above, name non-compliers, and recommend actions for them.	**Lead:** **OAG**	✓	✓		

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
	7. **Output Monitoring Report:** Accounting and reporting systems be expanded by creating codes to permit the recording of quantitative and other output data to compare with benchmarks established in budgets; and upgrade the current software used by FCGO to accommodate output monitoring codes.	**Lead:** FCGO **Others:** NPC, MOF, Line Ministries **Support:** Donors		✓	✓	
	8. **Reinforcement of Rules on Sanctions or Penalties:** Direct HMGN to take legal actions in consideration of recommendations of OAG.	**Lead:** PAC	✓			
	9. **Amendment of Laws:** Review and amend existing Acts and other related Rules and By-laws for compatibility with all actions and sub-actions above, particularly to ensure that laws permit appropriate sanctions and penalties.	**Lead:** MOF **Others:** FCGO, NPC, OAG, Line Ministries	✓	✓		

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
	10. **Capacity Building:** Prepare capacity building plan covering a comprehensive human resources development plan to bring about sustainable change in attitude and behavior to implement suggested reforms. The plan should include amongst others training of all budget, accounting, auditing, PAC and legal staff, central and local, in implementing the above sub-actions.	**Lead:** FCGO **Others:** NPC, MOF, OAG, MOLD, Line Ministries **Support:** Donors	✓	✓		
B. Improve Nepalese Accounting and Auditing Standards and Practices.	1. **Creation of ASB and BAS:** Create and support the Financial Accounting Standards Board (ASB) and the Board of Auditing Standards (BAS) to formulate appropriate accounting standards for the use of public sector, private sector, local bodies, and NGOs.	**Lead:** MOF **Others:** FCGO,OAG, ICAN, FNCCI		✓		◆ Country will, for the first time, have recognized national accounting and auditing standards, in public and private sectors, based on IASB and IFAC accounting and auditing standards.
	2. **Dissemination of Standards:** Issue accounting and auditing standards applicable to Government, banks, insurance companies, state-owned enterprises, corporations, non-governmental organizations and other entities.	**Lead:** ICAN **Others:** FCGO, OAG, Universities	✓	✓		

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
	3. **<u>Formulation and Enforcement of Accrual Accounting System in Government:</u>** Develop a roadmap and a realistic time-bound action plan for the medium to long-term introduction of accrual accounting in government based on a carefully-phased plan.	**<u>Lead:</u>** **FCGO** **<u>Others:</u>** **OAG, ICAN** **<u>Support:</u>** **Donors**		✓	✓	◆ Enable the monitoring of debtors, creditors, accrued expenses and other assets and liabilities including other financial transactions
	4. **<u>Policy Decision for Inclusiveness of all Resource Inflow:</u>** (a) Discuss with donors the inclusion of all loans, grants, direct donor payments, and beneficiary contributions for all projects in Nepal within the National Budget, accounting and audit; (b) Implement the plan agreed with donors.	**<u>Lead:</u>** **MOF** **<u>Others:</u>** **NPC, OAG, Line Ministries** **<u>Support:</u>** **Donors**	✓	✓		◆ Promote transparency and good governance to be able to keep track of all incoming resources on accrual accounting basis
	5. **<u>New Chart of Accounts:</u>** Introduce new accounting codes and classifications by activity, which correspond to (i) budget codes and classifications, and (ii) codes and classifications used in project budgets and accounts, including for donor-funded projects.	**<u>Lead:</u>** **FCGO** **<u>Others:</u>** **MOF, NPC, OAG**		✓		◆ Facilitate (i) comparison of financial statements with the budget, and (ii) harmonization of reporting system

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
	6. **<u>Capacity Building in Internal Audit Service:</u>** Strengthen the internal audit service at all levels of government – central and local – through Human Resource Development (HRD) including training.	**<u>Lead:</u>** **FCGO** **<u>Others:</u>** **MOF, MOLD** **<u>Support:</u>** **Donors**	✓	✓		◆ Improved internal control and assurance of compliance with the legal provisions
	7. **<u>Integrated Treasury System:</u>** Consider the possibility of introducing integrated treasury system to reduce the number of accounting centers.	**<u>Lead:</u>** **FCGO** **<u>Others:</u>** **MOF, OAG** **<u>Support:</u>** **Donors**		✓		◆ Pre-audit of financial activities can minimize irregularities ◆ Overall cost of accounting can be reduced ◆ Account consolidation can be faster
	8. **<u>Amend Laws:</u>** Introduce whatever legislative or regulatory changes are needed to implement Sub-Actions 1-7 above.	**<u>Lead:</u>** **MOF** **<u>Others:</u>** **FCGO, MOLJ,**	✓	✓		◆ Improved regulatory framework network for financial accountability
	9. **<u>Capacity Building:</u>** Train staff, including trainers, to implement 1 - 7 above.	**<u>Lead:</u>** **FCGO** **<u>Others:</u>** **MOF** **<u>Support:</u>** **Donors**	✓	✓		◆ Capacity to implement improved financial accountability provisions

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
C. Strengthen Financial Accountability at the Local Level.	1. **Reinforcement of Laws:** Implement Actions A and B (those that are relevant at local level) fully in VDCs, Municipalities, and DDCs.	**Lead:** **MOLD** **Others:** **MOF, FCGO**	✓	✓		◆ Improved transparency and accountability of local bodies in financial transactions
	2. **Simplification of Accounting System Procedures:** Simplify accounting procedures at VDC level, without sacrificing accuracy, timeliness, or the principle of matching expenditures with outputs and outcomes.	**Lead:** **FCGO** **Others:** **MOLD, ADDCN**	✓	✓		◆ More timely VDC reporting
	3. **Promote Participation:** Include in Accounts Committees at local levels, the major stakeholders as well as financial experts.	**Lead:** **MOLD** **Others:** **VDCs, Municipalities, DDCs**	✓	✓		◆ Improved transparency by better participation of stakeholders and financial experts
	4. **Effectiveness of Accounts Committees:** Require Accounts Committees to remain active all the year round.	**Lead:** **MOLD** **Others:** **VDCs, Municipalities, DDCs**	✓	✓	✓	◆ Better financial accountability at the local level

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
	5. **Capacity Building:** Re-assign sufficient numbers of existing qualified FCGO staff to VDCs, Municipalities and DDCs to speed up capacity building at the local levels.	**Lead:** **FCGO** **Others:** **MOLD**	✓	✓	✓	◆ Improved local level capacity in financial accountability
	6. **Capacity Building:** Organize appropriate human resource development programs including training, and any capacity building activity necessary to implement Sub-Actions 1 - 5 above.	**Lead:** **MOLD** **Others:** **FCGO**	✓	✓		◆ Enhanced local level capacity in financial accountability
	7. **Fiscal Decentralization:** Review and consider the reduction of the number of administrative districts, local and regional offices. Ensure that fiscal decentralization efforts go in parallel with budget planning by MOF and decentralized auditing by OAG.	**Lead:** **MOF** **Others:** **FCGO, OAG, MOLD**	✓	✓		◆ Effective resource allocation, planning and implementation, monitoring and evaluation

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
D. Strengthen the Independence, Capacity, and Usefulness of Reporting of the OAG	1. **Enhance Independence of OAG:** Provide the annual budget requested by the OAG without any modification. Any differences that may arise between the AG and the MOF in the budget request, should be reviewed and resolved in a tripartite meeting comprising the Public Accounts Committee of the Parliament, the MOF and the OAG.	**Lead: OAG** **Others: MOF, PAC**	✓	✓		◆ Improved effectiveness and independence of OAG
	2. **Increase Resources to OAG:** Increase the OAG annual budget adequately to cope with the needs for more staff numbers, human resource development programs including training, equipment and skills, particularly to cope with the additional compliance auditing called for by this DAP, and for expanded performance auditing to measure the outputs and outcomes.	**Lead: OAG** **Others: MOF, PAC**	✓	✓	✓	◆ A more effective OAG

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
	3. **Increase Staff Resources to OAG:** Empower the AG to adjust staff within an agreed limit; if more staff than the agreed numbers are required, OAG in closed coordination with MOF and MOGA determine staff positions as per "business needs".	**Lead:** **MOGA** **Others:** **OAG, MOF,**	✓	✓		◆ A better staffed and more effective OAG
	4. **Capacity Building:** Revise OAG audit guidelines to comply with INTOSAI auditing standards.	**Lead:** **OAG** **Support:** **Donors**	✓	✓		◆ Internationally recognized public sector auditing standards
	5. **Capacity Building:** Strengthen OAG's Training Division; train more staff; and recruit needed consultants; provide exposure through visits to successful SAIs and "twinning"; develop human resource development plans.	**Lead:** **OAG** **Support:** **Donors**	✓	✓		◆ A self-sustained staff training capacity within OAG; better staff quality

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
	6. **<u>Compliance with Audits:</u>** Submit to OAG a time-bound action plan for clearing all audit backlogs, and keeping audits up-to-date. Establish a monitoring and follow-up system to evaluate audit backlogs and the clearance of irregularities, and periodically report on their status (see Main Report paragraphs 6.21 – 6.23)	**<u>Lead:</u> MOF** **<u>Others</u>: Line Ministries, Departments, other implementing agencies**	✓			◆ All audits up-to-date; irregularities reduced; and improved public financial management
	7. **<u>Enhance Audit Quality:</u>** Arrange for an external peer review of and report on OAG's work at least once every two years by a reputable private audit firm.	**<u>Lead:</u> OAG**	✓	✓	✓	◆ Assurance for quality audit
	8. **<u>Independence on Audit of OAG:</u>** Arrange for external audit of OAG's accounts by a reputable private auditor.	**<u>Lead:</u> OAG**	✓	✓	✓	◆ Improved transparency and better financial accountability by OAG

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
E. Strengthen Oversight Institutions	1. **Monitoring and Dissemination of Information:** Report publicly the implementation status of the 82 directives issued by the PAC to HMGN based on the OAG report findings in FY1998/99 and FY1999/00. Establish a system for regular reporting of implementation status of PAC directives.	**Lead:** **MOF** **Others:** **PAC, FCGO, OAG**	✓	✓		◆ Improved transparency and better financial accountability
	2. **PAC Capacity Building:** Provide the PAC, through grant funds, improved and additional office space, meeting rooms, recording equipment, office staff, computer equipment, translation facilities, and travel facilities to promote exposure to successful PACs in other countries.	**Lead:** **PAC** **Others:** **MOF** **Support:** **Donors**	✓	✓		◆ An even stronger, more proactive, and more effective PAC
	3. **Improved PAC Directives:** Classify PAC directives according to materiality, responsibility, impact, and realistic implementation time-frame. Also, take decision on actions and recommendations not later than one year of the receipt of the AG's Annual Report.	**Lead:** **PAC**	✓	✓		◆ Better chance of getting PAC directives implemented and easier to monitor

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
	4. **English Version of PAC Reports:** Translate summaries of PAC reports and directives into English, particularly to facilitate the PAC's international collaboration with other PACs.	**Lead:** **PAC**	✓	✓	✓	◆ Stronger, more effective PAC
	5. **Strengthening of CIAA:** (a) Prepare plan for the phased establishment of regional CIAA offices. (b) Implement the agreed plan.	**Lead:** **CIAA** **Others:** **MOF**	✓	✓		◆ Wider coverage of oversight by CIAA
	6. **Strengthening of CIAA:** Increase considerably the budgetary, physical, human and technological resources available to the CIAA.	**Lead:** **CIAA** **Others:** **MOF** **Support:** **Donors**	✓	✓		◆ A more effective CIAA
	7. **Improved Coordination:** Improve coordination of CIAA activities with those of other anti-corruption agencies.	**Lead:** **CIAA**	✓	✓		◆ Reduction in corruption and abuse of authority

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
F. Reduce Fiduciary Risks on Project Funds.	1. **Harmonization of Procedures:** Harmonize HMGN's reporting system to "one reporting system" which satisfies the requirements of HMGN and other development partners; in order to effect this, review and make necessary revisions to Schedules 2, 3 and 5 from the FAR, 1999 and other reporting forms.	**Lead:** **FCGO** **Others:** **MOF, OAG** **Support:** **Donors**		✓		◆ One reporting system applicable for reporting to all donor agencies
	2. **Competitive Selection Process:** Develop selection criteria and parameters for selection of project managers/coordinators on the basis of technical and managerial competence.	**Lead:** **MOGA** **Others:** **MOF, PSC, Line Ministries**	✓			◆ Competent project coordinators recruited on a merit basis as per prescribed selection criteria

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
	3. **Placement of Accounts Staff in Development Projects:** Adopt and strictly enforce a concrete policy about the placement of accounts staff in development projects (the underlying principles of such a policy are that only competent and appropriately trained staff are placed in development projects; transfers will not be made on an ad hoc basis but will follow HMGN's Civil Service Rules; and proper hand over and continuity will be assured).	**Lead:** **FCGO** **Others:** **MOF, MOGA, Manager in Line Ministry**	✓	✓	✓	◆ Competent accounts staff posted on a merit basis as spelled out by the concrete policy
	4. **Capacity Building:** Orient/train all project managers/coordinators and accountants in project financial management, procurement and disbursement before they are assigned to projects (if they have no exposure to project financial management).	**Lead:** **FCGO** **Support:** **Donors**	✓	✓		◆ Project staff familiarized with financial management system before taking up project responsibilities

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
	5. **<u>Capacity Building:</u>** Prepare a scheme to encourage and enroll competent accounting staff in the public sector who are likely to be posted to projects, in professional accounting courses or in Chartered Accountants preparation courses, or financial management courses.	**<u>Lead:</u>** **FCGO** **<u>Support</u>:** **Donors**	✓	✓		◆ Accounts staff in the public sector are trained and acquire professional skills
G. Strengthen Private Sector Accounting and Auditing Standards	1. **<u>ICAN Strategic Plan:</u>** Agree on a realistic role, functions and program for ICAN vision and reflect these in a Mission Statement and Strategic Plan, including financial projections.	**<u>Lead:</u>** **ICAN** **<u>Others:</u>** **MOF, OAG**	✓			◆ Clarity on vision, mission and role of ICAN
	2. **<u>HMGN Grant to ICAN:</u>** Agree on a reasonable time-frame for an appropriate level of guaranteed budgetary support on a grant basis to ICAN, after which ICAN should be financially independent.	**<u>Lead:</u>** **ICAN, MOF**	✓			◆ ICAN able to propose and monitor accounting and auditing standards

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
	3. **Study on the Supply and Demand of Accountants and Auditors:** Organize and grant finance a study on the current and projected supply and demand of accountants and auditors in Nepal.	**Lead:** **ICAN** **Others:** **FCGO, OAG** **Support:** **Donors**	✓			◆ Reliable information for planning future development of the profession
	4. **Amendment to Company Act, 1997:** Amend the Company Act, 1997 to require all companies to apply Nepal Accounting Standards based on IAS.	**Lead:** **MOF** **Others:** MOICS	✓			◆ Application of Nepal Accounting Standards and Auditing Standards by all companies – improved financial accountability framework
	5. **ICAN Membership of IFAC:** Establish links with IFAC designed to move ICAN towards early IFAC membership.	**Lead:** **ICAN**	✓	✓		◆ Assurance that ICAN will inherit and apply IFAC standards
	6. **ICAN Capacity Building:** Establish a "twinning" relationship between ICAN and well-established IFAC-member Institute whose experience and capacity building can benefit ICAN.	**Lead:** **ICAN** **Support:** **Donors**		✓		◆ Better exposure to IFAC-member institute which will promote professional growth of ICAN
	7. **Capacity Building:** Prepare and implement a plan to upgrade the skills of Registered Auditors.	**Lead:** **ICAN, OAG**	✓	✓		◆ Improved accounting and auditing services in the country

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
	8. **Code of Ethics:** Finalize and issue a Code of Ethics and establish a Disciplinary Committee for ICAN members.	**Lead:** **ICAN**	✓			
	9. **Peer Review System:** Introduce a system of peer review among accounting and auditing firms in Nepal.	**Lead:** **ICAN**		✓		
	10. **Networking Commercial Banks with NRB:** Link all banks electronically to NRB to facilitate and accelerate data reporting and exchange.	**Lead:** **NRB** **Support:** **Donors**		✓		◆ Faster commercial bank reporting to NRB
	11. **Impose Sanctions:** Impose penalties on cooperative societies, unions, and their directors conducting saving and credit business without NRB approval.	**Lead:** **NRB**	✓			◆ Protection of the public from fraudulent and unscrupulous cooperatives management
	12. **NRB Inspection:** Require regular NRB inspection of all saving and credit cooperatives and submission of monthly financial statements in approved form, from such societies to NRB.	**Lead:** **NRB**	✓	✓		◆ Stability in the financial market can be ensured

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year) Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	Expected Benefits
H. Strengthen the Regulation and Monitoring of Non-Governmental Organizations, Local (NGOs), and International (INGOs).	1. **Formulation of Policies:** Formulate and enforce appropriate policies to streamline and strengthen the NGO's administrative and functional accountability, transparency and effectiveness.	**Lead:** SWC **Others:** NPC, MOF MWCSW	✓			◆ Improved control and monitoring of NGOs, INGOs, and funds flowing into Nepal
	2. **Enactment of Legislation:** Enact legislation as suggested in Chapter XII (para 12.18 b) recommendations to implement the policies formulated in (1) above.	**Lead:** MWCSW **Others:** SWC	✓			
	3. **SWC Capacity Building:** Strengthen the SWC, and the SDC (if created), by restructuring its internal organizational analysis which is recommended to be carried out separately.	**Lead:** SWC **Support:** Donors		✓		◆ Improved monitoring of capital flows into the country
	4. **Audited Accounts of NGOs:** Require all NGOs and INGOs to register and file annual audited statements, with the SWC (or the SDC, if created).	**Lead:** SWC	✓			
	5. **Enactment of Legislation:** Enact whatever legislation or other statutes are required to implement sub-actions (1) to (4) above.	**Lead:** SWC **Others:** MWCSW	✓			

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
I. Implement the Development Action Plan	1. **National Steering Committee:** Continue the National Steering Committee as a sub-committee under a Reform Monitoring Committee (RMC) to monitor and report on DAP implementation (the committee should have representation from HMGN, the private sector, and development partners).	**Lead:** **MOF**	✓	✓		◆ Improved chance that this DAP will be implemented and monitored effectively and efficiently
	2. **Periodic Meetings:** Hold quarterly meetings of the RMC to review progress of implementation of DAP.	**Lead:** **MOF**	✓	✓		
	3. **Progress Reporting:** Report implementation progress to the Nepalese public, the Finance Committee of the Parliament and development partners at pre-determined intervals.	**Lead:** **MOF**	✓	✓		

Key Action	Sub-actions	Responsibility	Timing (Fiscal Year)			Expected Benefits
			Priority 2002/03	Medium-term 2003/04-2006/07	Long-term 2006/07+	
	4. **Progress Monitoring:** Report to the PAC on progress of implementation of the DAP, and recommend appropriate sanctions against non-implementers. PAC to demand HMGN sanctions against non-implementers.	**Lead:** **MOF** **Others:** **PAC**	✓	✓		
	5. **Report to NDF:** Report on progress of implementation of the DAP to each meeting of the Nepal Development Forum.	**Lead:** **MOF**	✓	✓		

PART A:

INTRODUCTION

CHAPTER I

INTRODUCTION

Nepal is one of the world's poorest countries with a per capita income of US$220 a year. The economy has suffered from the lack of proper management of public expenditures, stagnant real revenues, large and inefficient parastatals, and a weak financial sector. Development challenges are enormous. HMGN has accorded high priority to the assurance of good accountability and transparency in public sector financial management. HMGN's budget for FY2001/02 and the forthcoming Tenth Plan have highlighted the strengthening of good governance and financial accountability. A diagnostic study through the joint effort of HMGN and the World Bank, is an attempt to enhance knowledge of the country's financial accountability arrangements in the public, private and non-government organization sectors of the economy. It is an important factor in efforts to improve the investment climate, monitor public expenditure, improve governance, and promote financially accountable decentralization.

A. Economic and Historical Background

1.1 With a per capita income of US$220 a year, Nepal is one of the world's poorest countries. In the rural areas, where 85 percent of Nepalese live, population increase has outpaced agricultural growth in recent years. Inconsistent and ineffective policy implementation and increasingly unstable governments have hampered more rapid progress in the fight against poverty. While macroeconomic management has generally been acceptable, the economy has suffered from the lack of proper management of public expenditures, stagnant real revenues, large and inefficient parastatals, and a weak financial sector. As a result, Nepal has not been able to adequately exploit its assets - fertile land in the Terai, access to generous donor aid, strong tourism appeal, and enormous, if partly seasonal, water resources and hydropower export potential. The economy is currently experiencing a severe downturn and passing through a very critical stage, in which the effects of the world recession have been aggravated by a Maoist insurgency necessitating greatly increased expenditures on security. All these factors have had a severe negative impact on the national budget, as well as on tourism, exports and other sectors of the economy.

1.2 The government's priority is to reduce poverty by strengthening the liberal and market oriented economic policies pursued earlier for building a healthy and strong economy. The FY2001/02 budget highlighted the following five measures: (a) improve the environment for investment, (b) bring dynamism in the financial sector, (c) keep public sector expenditures to affordable limits, (d) enhance the access of the deprived class to productive resources, and (e) strengthen good governance and decentralization. The Government's forthcoming Tenth Plan (FY2002/03 – FY2006/07) focuses on "Poverty Alleviation" as the main theme. The Government aims to address this agenda by improving economic, human and social indicators through the expansion of economic and employment opportunities and the effective mobilization of resources in joint participation with government, local bodies, private sector and civic society. It also aims to enhance the access of women, down-trodden, people living in rural areas as well as poorest and backward groups to economic achievements through empowerment, human development, security and targeted programs. Major strategies of the forthcoming Tenth Plan are proposed as follows: (i) population control and good governance, (ii) promotion of economic opportunities through high, sustainable and broad-based economic growth, and (iii) empowerment of women through expansion of investment in social services. A Country Financial Accountability Assessment (CFAA) is an important factor in efforts to improve the investment climate, monitor public expenditure, improve governance, and promote financially accountable decentralization

B. Government Interest and Programs to Improve Financial Accountability

1.3 His Majesty's Government of Nepal (HMGN) has demonstrated a long and abiding interest in good accountability and transparency in public financial management. The Constitution of the Kingdom of Nepal, 1990, Part 10, is devoted to financial procedure. It defines the Consolidated Fund; creates a privileged position for the Auditor General and the Judiciary by (among other things) exempting their emoluments and the administrative expenses of their offices from parliamentary vote; and creates the Commission for the Investigation of Abuse of Authority (CIAA). More recently, HMGN has implemented several donor-funded projects designed to strengthen the government accounting system, independent auditing system, and the Public Accounts Committee (PAC) at the Parliament. It has also passed a law creating the Institute of Chartered Accountants of Nepal (ICAN) to improve private sector accountability and transparency. HMGN also enacted the "Financial Administration Regulations (FAR), 1999" under the Financial Procedures Act, 1999 designed to update and consolidate rules governing public sector financial management standards and practices. In addition, HMGN has created a Public Expenditure Reform Recommendation Implementation Monitoring Committee under the convenorship of the National Planning Commission (NPC) Member, to implement the recommendations submitted by the Public Expenditure Reform Committee (PERC) formed in 2001 based on the 2000 Public Expenditure Review (PER); is preparing to introduce a Medium-Term Expenditure Framework (MTEF); is stepping into the forthcoming Tenth Plan focusing on Poverty Alleviation from July 16, 2002; is already implementing the findings of a recent Country Procurement Assessment Report (CPAR), and has participated actively in the preparation of this CFAA with full commitment to implement the recommendations that come out of the assessment, to improve the country's overall financial accountability. Further, the forthcoming Tenth Plan, provides for the improvement of public expenditure management in order to attain the goal of poverty reduction by channeling public resources to priority sectors. The MTEF will be implemented to gradually increase government investment in priority sectors, complete programs and projects in time, and ensure adequate budget for such programs. The Government's initiative to introduce MTEF was a result of the recommendations made by the Public Expenditure Review Commission, in order to prioritize expenditures in line with poverty reduction and broad based growth, as outlined in the Interim Poverty Reduction Strategy Paper. Appropriation of public expenditure, budget release, expenditure authorization, decision-making process, accounting, auditing, reporting and dissemination of financial information will be made transparent, prompt and outcome based.

1.4 Given the long-standing and extensive interest in good financial accountability discussed above, many observers have been surprised by the degree of non-compliance with the country's fundamental legal and regulatory framework for good public financial management. Firstly, the implementation of a good statutory framework such as exists in Nepal requires a good financial management infrastructure, which was never put in operation. For example, to ensure that expenditures are tied to outputs and results, the budgeting system must budget, not only funds, but also the output or results expected from their expenditure; the accounting system must be designed to capture quantitative as well as financial data; the reporting system must provide for quantitative and qualitative results, as well as financial results; and an independent auditor must be able to trace both the expenditures and their results through the system. This infrastructure was not established. Secondly, there were so many sources of instability, including frequent government changes, that other urgent pre-occupations crowded out financial management from the political radar screen.

1.5 Three recent developments have greatly enhanced the chances of bringing practice into line with the excellent intentions implied by the existing public financial management framework: (i) indigenous Nepalese clamor for improved financial accountability and control of corruption has risen to a crescendo that can no longer be ignored, (ii) diminishing earnings and rising expenditures have created a budgetary squeeze necessitating considerable budgetary support, and (iii) Nepal's development partners have become more insistent than ever on visible improvements in transparency and accountability as a condition for providing budgetary support. The confluence of these three currents has produced a powerful wind of change, forcing good financial accountability to the forefront as an economic desideratum.

C. Country Assistance Strategy Provisions Relating to Financial Accountability

1.6 The Nepal Country Assistance Strategy (CAS) (November 17, 1998) had quite a lot to say in relation to financial accountability. For example, in the Executive Summary:

> *"Our strategy has two new prongs: bringing resources closer to the beneficiaries, where they are most likely to be productively used; and collective donor action to foster the stronger governance needed to reduce waste and mismanagement."*

Paragraph 25 (Lessons from IDA's Existing Portfolio) cited five specific steps the World Bank (WB) was taking to improve the financial management of the IDA portfolio.

1.7 The CFAA will considerably foster the CAS objectives of decentralization, governance, and improvement of financial management of the IDA portfolio by: (a) assessing the financial management standards of local governments and the public sector in general; and (b) reviewing progress achieved in improving financial management of WB's portfolio since the CAS was published nearly four years ago.

D. Objectives of the Country Financial Accountability Assessment

1.8 A CFAA is a diagnostic tool designed to enhance the WB's and its client's knowledge of financial accountability arrangements in the public and private sectors of the economy. It supports the WB's and its client's exercise of their fiduciary responsibilities by identifying the strengths and weaknesses of financial arrangements in the public sector, and the risks that these may pose to the use of WB and non-WB funds in that sector. The CFAA also supports the WB's development objectives by facilitating a common understanding by the borrower, the WB, and other development partners of the country's financial management arrangements, as a necessary prerequisite for the design and implementation of appropriate capacity building programs.

1.9 In addition to the CAS role described in Section C above, this particular CFAA - the first full CFAA in Nepal - sharply focuses on the broad objectives stated in the preceding paragraph in order to achieve:

- an assessment of the fiduciary risk attaching to the use of funds in the public sector, including at the local and non-governmental organization (NGO) levels;
- the implications of that fiduciary risk for programmatic and adjustment lending, budgetary support, decentralized development and the use of NGOs for project implementation;

- an assessment of the system's capacity to link expenditures to outputs and outcomes;

- an assessment of the prerequisites for bringing private sector accounting and auditing standards and practices up to international levels; and

- an understanding of the training and capacity building needs revealed by all these diagnostic assessments, and the extent to which such needs are not yet being addressed.

1.10 This CFAA primarily focuses on public sector accountability including the oversight arrangements. As the corporate sector and NGOs are also playing an increasing role in development efforts in Nepal, the CFAA also examines their financial accountability arrangements, but the scope of coverage has been limited to only key aspects. **The Financial accountability assessment and analysis carried out in this report covers the period up to June 15, 2002.** This CFAA, however, does not examine public procurement, as a CPAR has addressed this issue in depth. This CFAA covers developments since CPAR was completed. Although this CFAA reviews accountability for both receipts and payments, it does not discuss details of revenue assessment or administration, nor does it assess corruption or anti-corruption measures. Such assessments require focused attention by revenue and anti-corruption experts not usually included in a CFAA team. In addition, discussions of budget preparation and management are limited to aspects relevant to financial accountability and fiduciary risk, without delving into such details as the economic budget classifications, and other issues normally discussed in the PER, but not in the CFAA (see below).

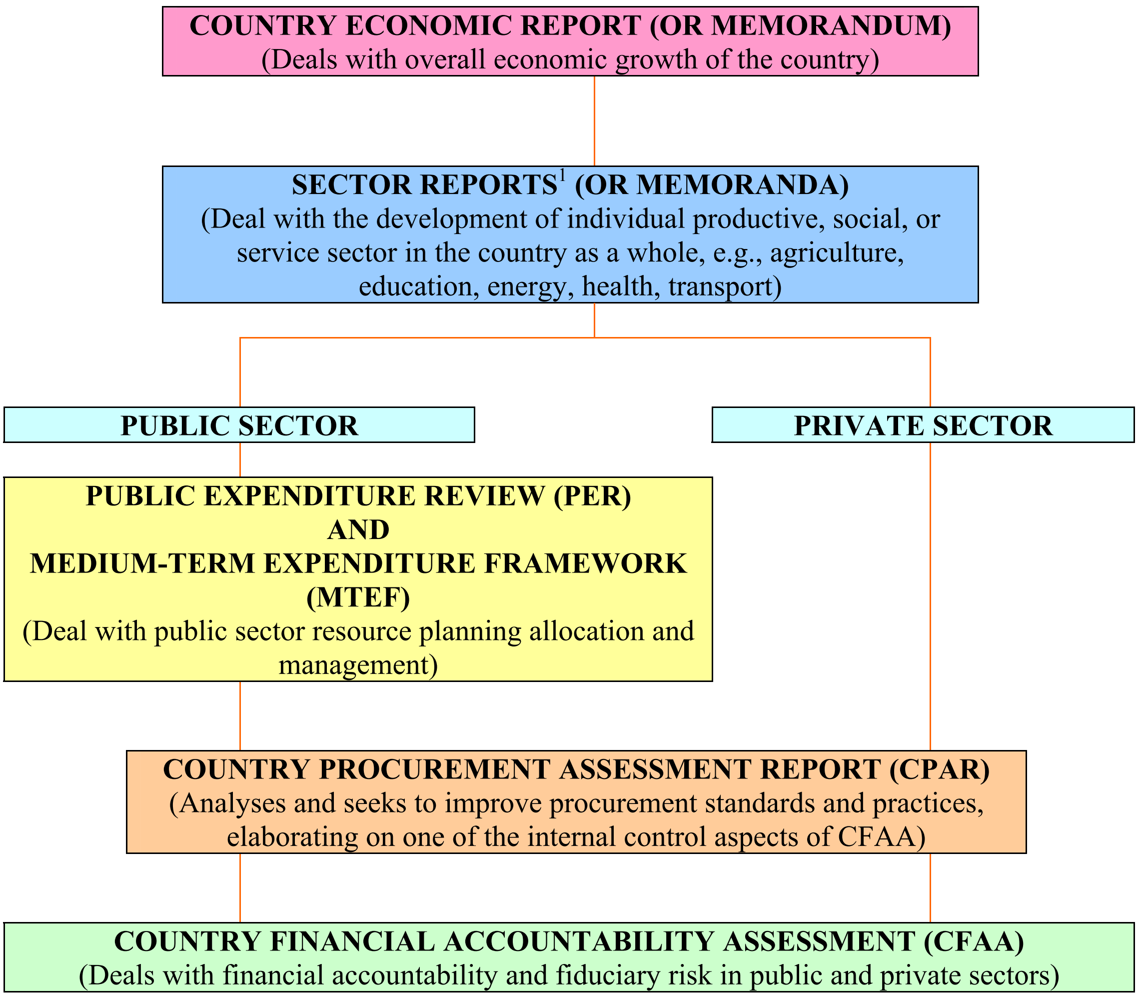
E. Related Recent and Ongoing Studies

1.11 There have been many studies of Nepal's financial accountability and management systems in the last two years that only a few of the major ones can be mentioned here. Some of these studies have been executed or directed by the WB. Others have been carried out by DFID, ADB, and other agencies. WB-led studies include a Country Profile of Financial Accountability (CPFA) completed in 1999, a Country Procurement Assessment Review (CPAR) completed in 2001, a 2000 Public Expenditure Review (PER), an April 2000 report on Accounting and Auditing in Nepal, and several reports dealing with the introduction of a Medium-Term Expenditure Framework (MTEF). ADB reports include sector as well as project-related reports dealing with governance in the private sector. ADB has also financed technical assistance to promote good governance in the private sector, as well as the development of the accounting and auditing standards for the private sector working closely with the Institute of Chartered Accountants of Nepal (ICAN). DFID has reported on the government budgetary and accounting systems and financed projects aimed at improving them.

1.12 Because all the recent WB studies mentioned in the preceding paragraph touch on one or more aspects of financial accountability, it is important to understand their specialized roles, why they are all necessary, and how they relate to one another. This CFAA will review accounting and auditing systems in both the public and private sectors from the technical viewpoint aimed at assessing fiduciary risk and identifying capacity building needs. The PER has looked at many of the same public sector financial management institutions and practices as the CFAA, but through different "lenses," the objective being to assess their economic impact, including their efficiency and effectiveness in allocating resources so as to achieve the declared objectives of economic policy. Its discussion of the budgeting system, for example, is far more detailed, and its treatment of accounting and auditing issues and fiduciary risk far more limited, than discussions of the same subjects in the CFAA. The CPAR singles out for deeper analysis one element of internal control (i.e. of financial management), namely procurement, which is also said to be one of the biggest sources of corruption. All three sector studies -- CFAA, PER, and CPAR -- represent three major tools in a toolkit designed to promote accountability and transparency. The MTEF attempts to introduce a medium-term (three-year) horizon to the national annual budget (main focus of the PER), linking it with the government's five-year development plan. **Chart 1** below schematically presents these relationships.

Chart 1

RELATIONSHIP BETWEEN VARIOUS SECTOR STUDIES



1.13 The PER, CPAR and the MTEF reports predate this CFAA and are already being implemented. The authors of this CFAA have tried to ensure consistency between its recommendations and those of previous WB and non-WB studies. In addition, action on several of this CFAA's recommendations have been either discussed or initiated by government officials in collaboration with the ADB and other development partners. Such activities, which are consistent with the CFAA recommendations, should be incorporated in the implementation of the Development Action Plan (DAP). The contribution of the CFAA, and its value to various stakeholders are discussed in the Concept Note (Annex 1).

[1] A CFAA falls within this category of sector reports.

1.14 This CFAA report is presented in six parts. Part A: Introduction; Part B: dealing with the Public Sector including Local Government, Independent Auditing, and Oversight Arrangements; Part C: assessment of Fiduciary Risk in the Public Sector; Part D: covering the Private Sector; Part E: covering the Non-Governmental Organization sector; and Part F: the Development Action Plan and Implementation Strategy.

PART B:

PUBLIC SECTOR

CHAPTER II

CENTRAL GOVERNMENT BUDGETING, FINANCIAL PLANNING, AND CASH FLOW MANAGEMENT

The Government's framework for central government budgeting and planning is an adaptation of a medium-term expenditure framework, to make budgets compatible and consistent with periodic plans, and to give due attention to multi-year projects. There are numerous problems and challenges in the current system, and one significant aspect is weak monitoring of budget implementation. Another significant weakness of the system is its failure to link financial expenditures with the results, outputs, or outcomes to be attained through those expenditures. While serious efforts are underway to introduce Medium-Term Expenditure Framework from FY 2002/03, from a financial accountability viewpoint, it is equally important to institute a strong monitoring system to track expenditures against outputs or outcomes. Strengthening of monitoring capability is required at the sector ministry level as well as at the National Planning Commission and the Ministry of Finance.

A. Statutory and Legal Framework

2.1 The Constitution of the Kingdom of Nepal, 1990 ties budgetary allocations to outcomes or results. Article 77 of the Constitution requires that His Majesty the King shall, in respect of every financial year, cause to be laid before a joint sitting of Parliament an annual estimate of revenues, and the monies required to meet (a) charges on the Consolidated Fund, and (b) expenditure to be provided for by an Appropriation Act. Article 77 also requires the estimate to be accompanied by a statement of each Ministry's previous year's budgetary allocations and "particulars of whether the objectives of the expenses have been achieved".

2.2 In addition to the Appropriation Bill, the Constitution also provides for a Supplementary Appropriation Bill (for cases where the budgetary allocation proves insufficient); a Vote on Account Bill (for advancing budgeted funds ahead of the passing of the Appropriations Bill); a Vote of Credit in a national emergency giving only a description of the proposed expenditures, and a Contingency Fund whose disbursements should be reimbursed as soon as possible by an Act.

B. Consolidated Fund

2.3 Government financial planning and budgeting is mostly a matter of planning and budgeting cash flows into and out of the Consolidated Fund (CF). The Constitution (Article 74) defines CF inflows as all revenues (except those of religious endowments) received by HMGN, all loans raised on the security of revenues, and all monies received in repayment of any loan made under the authority of any Act.

2.4 Payments from the CF are limited (Article 75 of the Constitution) to:

- monies directly charged to the CF (expenditures of the Royal Family and remuneration and budgets of the Chief Justice, Judges of the Supreme Court, and several other state officials and, Heads of the Constitutional bodies including the Auditor General);

- Expenditures under an Appropriation Act; and

- Funds required on a Vote on Account or Vote of Credit to replenish the CF.

2.5 The Constitution 1990, Part 10, paragraphs 75, 77 and 78, has envisaged all monies received must be reflected in the annual budget, and such monies can be spent only after they are incorporated in the budget. But in reality, this is not happening. Extra-budgetary funds appear to be quite significant. According to the Auditor General's Annual Report, 2001, about Rs 3.27 billion on income side (unbudgeted revenues and receipts) and about Rs 2.57 billion on unbudgeted expenditures side are reported to have been operated outside of the budgetary framework during FY 1999/00. These figures could be larger since the reported figures are based on statements available to the auditors. According to the same source, based on few years data, on an average, it is roughly estimated that around Rs 12 billion of government funding has been unbudgeted annually. Extra budgetary funds include, for example, (a) those created under the Revolving Fund Act, which specifies how and where the funds are to be used, and include Health Tax Fund, Alcohol Control Fund, Heavy Equipment Funds, and Road Maintenance Fee Fund, (b) various types of grant assistance provided by donor partners that do not appear in government's budget (Annex 11 of the AG's Annual Report provides the details which reports about Rs 71.22 billion funded through extra budgetary funds under various Technical Assistance and other Grants committed by various donors over a period of 6 to 7 years), and (c) various types of development committees fund created under the Development Committee Act.

C. Budget Preparation and Implementation

2.6 HMGN considers the budget as a tool of macro-economic policy and aggregate fiscal discipline. The macro-economic policy is guided by the five year plans and the availability of resources and macro-economic indicators of the country. The budgeting procedures – preparation, approval, implementation, and monitoring – are elaborated in "Financial Administration Regulations (FAR), 1999," framed by HMGN in exercise of powers conferred by Section 36 of the Financial Procedures Act, 1999. The National Planning Commission (NPC) is the key player in the development budget of Nepal. The yearly plan is based on the guidelines provided by the five year plan. In the beginning of the fiscal year, NPC and the Ministry of Finance (MOF) set budget ceilings for all Line Ministries considering the overall development policy of HMGN and availability of financial resources to support the Plan. They also issue budget preparation guidelines. The ceilings and guidelines are passed on through the Ministries to the lowest level spending units, from which regular and development budgets flow back up to MOF. The NPC, MOF, and Line Ministries then meet at the MOF for budget discussions. Thereafter, the Finance Minister submits the regular and development budget to Parliament. Following Parliamentary approval, the MOF releases authorizations for expenditure to Line Ministries, which, in turn, release authorizations to spending units.

2.7 The main responsibility for the initiation and preparation of budget is of the spending ministries and departments. NPC and MOF do not initiate the budget. Ministries and departments are supposed to prepare and submit to MOF, within a time limit and format set by MOF, budget proposals for the next year as well as reports on the performance of the first six months of the current year. Currently, most reports on performance only include actual financial flows, not focused on results or the achievement of goals as required by the Constitution.

2.8 ***Budget Classification:*** The total budget is divided into *Regular*, denoting basically the government operating costs, repayment of loan and cost of security, and *Development*, covering costs of projects and programs. The budget classification into recurrent and budgetary categories is said to require some bridge tables by International Monetary Fund (IMF) missions to bring them into the same format as IMF Manual of Government Financial Statistics (GFS). The budget classification into two headings causes accounting of the expenditures twice: once while spending development expenditures funded from loan and the next while repaying the same loan. In order to avoid this problem, it is necessary to separate budget into Regular, Development and Loan Repayment. Regular and development budget will denote actual government expenditures, and loan repayment budget will denote liquidation of loan liability. The economic classification of the budget is quite opaque. The classification of the budget presented in the budget speech (Annex 9 of the Budget Speech) is too detailed, and at the same time, there is no summary of annual financial statements that provide detailed budget classifications by Ministries and major programs (i.e., there are no tables that present Ministry/Department versions of Annex 9 of the Budget speech). The budget classification is not detailed enough to isolate key expenditures (e.g. expenditures on repairs and maintenance and new capital expenditures are classified together under line item 6.03 and 6.04; line items 3.02 includes salaries and supplies for schools but also block grants for VDCs and DDCs). In general, the presentation is not consistent with the IMF's GFS. There are now efforts to change the economic classification starting from FY2002/03 to make it more meaningful for expenditure productivity and cost control, and to be more consistent with GFS.

2.9 ***Planning System:*** Government planning is generally bottom-up, although it is said that the role of the center is predominant in defining the resource availability and also in screening of the proposed projects. The NPC and MOF set annual limits and broad parameters for the investment and regular budgets respectively, but lowest level units submit budget proposals for expenditures within those limits. Considering the overall development policy of HMGN, five year plans and their own sectoral plans, line ministries are responsible to commission their yearly planning. Many line ministries have their own long term plans approved by HMGN (for example, 20 years Agriculture Perspective Plan, Forestry Plan etc.). District level plans are annually prepared by District Development Committees (DDCs), and district level projects are prepared to support such plans. These projects are discussed at the DDC level, at the concerned line ministry, and at the NPC level before incorporation into the budget.

2.10 ***Monitoring and Evaluation System:*** HMGN has instituted a system whereby projects are monitored during the year as follows:

- National Development Action Committee (NDAC) at the apex level is a body headed by the Prime Minister, which meets every four months;

- Ministerial Development Action Committee (MDAC) is headed by the Minister of the Ministry concerned, and meets every two months;

- Central Monitoring and Evaluation Division (CMED) of the NPC monitors the core projects selected for monitoring by the NPC (others are monitored by the respective divisions of the NPC Secretariat and the concerned ministries), and sends a report every four months to the NDAC; and

- A separate Poverty Monitoring Section has been established in the NPC Secretariat for monitoring poverty, and the policy and programs related to poverty reduction.

2.11 In practice, the monitoring and evaluation system described above does not function as it should. It is very difficult to find information on budget implementation during the year, apart from the very aggregate numbers prepared by the MOF or lending numbers by Nepal Rastra Bank (NRB). Recently, the Financial Comptroller General Office (FCGO) has built its capacity to issue good reports on budget implementation. It is recommended that FCGO should prepare such reports three times a year and make these reports more public.

2.12 ***Budget Implementation Process:*** Following the budget presentation before the Parliament, Vote-on-Account Bill is normally approved if the budget is not approved before the commencement of the fiscal year. On the basis of the Vote-on-Account Bill, the MOF issues expenditure authorization to the Ministry concerned. The sequence of events thereafter is as follows:

- Concerned Ministries issue expenditure authorization to spending offices, either directly or through departments, giving a copy, among others, to District Treasury Controller Offices (DTCOs).
- The DTCOs release money to spending offices when they are in receipt of authorizations. In the case of a development budget the spending offices are also required to present the approved programs.
- Initially DTCOs release one-sixth of the total budget and reimbursement is made every month based on the statement of expenditures produced by the spending offices. No monitoring of activity is done at this stage.
- At the end of the year, however, if any spending office is requesting large reimbursements then DTCOs ask for the invoices/statements of the work done.
- If the monthly replenishment is not sufficient then spending offices can request an additional imprest (over and above one-sixth) and based on the merit of the request, the additional fund is given.
- Reallocation of budget from one heading to other or from one project to another are all recorded according to the FAR (if these are not recorded, these are reported as irregularities by the Auditor).

2.13 With regard to actual expenditures as compared to budget forecast, HMGN almost spends all the amount equal to the forecast on the regular budget, whereas, on development budget, about 70 to 80 percent of the budget is actually spent. Within the year, budget reallocation often takes place during budget implementation. Regulation 39 of FAR requires the MOF, to approve justified request for re-allocations, and to send copies of the approval to FCGO and the Office of the Auditor General (OAG). Reallocation between different sources of funds rarely happens within the same year. Budget transfer normally takes place between budget sub-heads and between budget line items. In case of shortage of funds during the financial year, MOF adopts various rationing measures which include, reduction of operating expenses, withholding of vacant posts, curbing unproductive expenses through austerity measures, curtailment of foreign trips and study tours, and even postponement of non-core development programs.

2.14 ***Reforms Proposed in Budgeting***: Because the budget is prepared for one year at a time, projects requiring longer time period to complete do not often get enough resources in subsequent years. In addition, it is said that budgets do not consider periodic development plans every year. As a result, it is alleged that periodic plans and budgets are far apart in the third and fourth year of the periodic plan. In order to eliminate this anomaly, efforts are underway to introduce "medium-term budget framework" (sometimes referred to as medium term expenditure framework). The objective is two-pronged: (a) to make budgets compatible and consistent with periodic plans, and (b) to give due attention to multi-year projects.

2.15 ***Major Issues related to Budget Preparation and Implementation*:** There are several issues connected with budget preparation and implementation:

- The financial budgets are not linked to any results or goal achievement.
- Demands often exceed the resource availability, and the number of projects proposed every year in the budget is said to be more than the capacity to implement both in terms of institutional capability and in terms of resource availability.
- Budget requests are deliberately inflated in expectation of cuts.
- Ad hoc MOF cuts in the budget have increased the inability of the system to provide government counterpart finance for externally-funded projects. Although a well-spelled out Budget Formulation Manual exists, it is not followed properly; hence, roles to be played by various agencies in budget planning and formulation are not effectively exercised.
- The use of regular and development expenditure in budgets is archaic, and should be replaced by recurrent, capital and loan repayment budget. The loan repayment budget should be separated to allow for the presentation of actual government expenditures, avoid double accounting of expenditures, and to account for the reduction of the outstanding loan.
- Despite three changes of budget classifications in ten years, budget codes still do not reflect activities. The possibility of adopting an activity-based budget classification to enable measurement of outputs/outcomes should be studied.
- As required by the FAR, every office implementing the budget is supposed to send its immediate controlling office a four monthly report on Schedule 2 of the FAR (Physical Target Progress Report), showing quantitative program or budget goals, and the extent to which they have been achieved (linkage between physical progress vs. financial progress). In practice, most agencies are not reporting quantitative or goal achievements.
- The salary of any officer who fails to submit Schedule 2 of the FAR within the prescribed time is supposed to be withheld. This has never been known to happen.
- Copies of foreign aid agreements are sometimes not provided within 30 days to the OAG and FCGO as required by the FAR.
- Very few Secretaries send spending authorization to their subordinate offices within 15 days after receiving them from the MOF, as required by FAR. Budget releases are said to be sometimes based on personal approach and bias.

- The review of the development budget in isolation from the review of the regular budget has led to produce some undesirable results including, for example, failure to provide adequately for maintenance of capital assets; and the inclusion in the development budget of items which should be in the regular budget.
- Poor forecasting of revenue and foreign aid leaves budget makers in line ministries with an inadequate knowledge of the resources available.

D. Debt Management

2.16 The Public Debt Act, 1960 prescribes the methods, procedures, and limits for internal government borrowing. This can take the form of Treasury Bills, Promissory Notes, or Development Bonds. The Loan and Guarantee Act, 1968 provides the basic guidelines for foreign loans and their management. HMGN receives many foreign loans for terms as long as 30 or 40 years. HMGN has also provided guarantees for loans taken by state-owned enterprises, such as the Nepal Electricity Authority and the Nepal Telecommunications Corporation. The FCGO is responsible for all loan and grant accounting. Record keeping for loans has improved in recent years, and reconciliation of accounts with lenders is no longer as problematic as in the past. Accounting for loan guarantees, however, still has to attain the same level of accuracy and completeness, as mentioned in the Auditor General's latest report. Over the past two decades, Nepal's debt outstanding has risen from 15% to about 65% of GNP. External debt is now about 50% of the GNP. External debt service payments account for about 60% of Nepal's total debt service, and are nearly 7 to 8% of its earnings from exports of goods and services.

E. Financial Management of Externally-Funded Projects

2.17 In the case of nationally executed externally-funded projects, the responsible central project office sends a budget release request to the FCGO and the DTCO. The FCGO checks whether all necessary procedures have been completed, and whether reimbursement has been received or requested from the external development partner. The FCGO then issues an order to the concerned DTCO to release funds to all district level offices of the project. The DTCO then checks for any irregularities, authorization, work plans, and bank balances, before releasing the budget in response to the FCGO order. After the expenditure of funds, the project submits a withdrawal application, with all bills and vouchers, to the development partner, which, after careful analysis, reimburses the expense by sending a credit note to FCGO and the project. To ensure that projects do not run out of funds between request for reimbursement and receipt of the credit note, some development partners open a dollar-denominated special account operated by concerned project implementing units at NRB for the project. Projects can request the NRB to transfer their funds from this account to the CF.

F. Recommendations

2.18 From the viewpoint of financial accountability, the most significant weakness of the budgeting system is its failure to link financial expenditures with the results, outputs, or goals to be attained through those expenditures as required by both the Constitution and the FAR. On the other hand, reports on outputs and goals are not very meaningful unless there are some forecasts or benchmarks to which they can be compared. While it is sometimes difficult to link certain expenditures, particularly on operating costs, to specific outputs, practically all government expenditures are designed to finance services, and can, therefore, be linked to effectiveness in the provision of such services. In order to link the physical progress and results with the financial progress and in order to adapt to the MTEF framework, HMGN should reinforce the implementation of existing regulations with slight amendment on rules and procedures. Accordingly, **it is recommended that** (a) the three measures described below be implemented initially in the five Ministries (Agriculture, Education, Health, Water Resources, Works & Physical Planning) being considered for the implementation of MTEF; secondly, for all the other central Ministries; and finally for all the local bodies. The three measures are that:

- HMGN link physical progress or results with budget release in which case, HMGN should not present, and Parliament should not approve a budget unless it is accompanied by:

    (i) a retrospective review of the quantitative and other measurable goals, results and outputs achieved through the preceding year's budgetary receipts and payments; and

    (ii) a prospective forecast of quantitative and other measurable goals, results, and outputs to be achieved through expenditures in the budget.

- No budget request be accepted from any office unless it contains retrospective and prospective quantitative reports and measurable goals as described above for the national budget.

- During the year, cash reimbursements to every office out of its approved budget be disbursed only on presentation by that office of a quarterly financial, as well as quantitative, report on the past expenditures for which reimbursement is being claimed, as well as a similar forecast of the results expected from the expenditure of the requested funds.

Other **recommendations** are as follows:

(a) HMGN review Schedules 2, 3, and 5 of FAR, to confirm the extent to which they can be used to report the information required by the above recommendations, and introduce any necessary amendments or revisions.

(b) The Internal Audit Division of FCGO provide guidelines to DTCOs requiring them to verify and specifically report on the compliance with the above recommendations, and the OAG also verify compliance during the course of its audit.

(c) FCGO prepare budget implementation reports and make such reports publicly available three times a year.

(d) HMGN strengthen the Monitoring Section of the NPC ensuring full ownership by NPC to institute a realistic system. Instead of monitoring only the core projects, NPC in close collaboration with the line ministries should strengthen the existing system whereby all development projects can be monitored on a quarterly basis.

(e) The budget circular should call for a joint review, and ultimately a joint proposal, for both regular and development budgets.

(f) The revenue and foreign aid forecasting of the MOF needs to be strengthened, perhaps supplemented by good independent evaluation.

(g) HMGN conduct a study to develop activity based budget coding classification in order to match with output or outcome based expenditures, and plan to implement such a system in the medium term.

(h) HMGN effect whatever amendments in relevant legislation and regulations are necessary to implement the above recommendations.

(i) HMGN also prepare and implement Human Resource Development Plan, which should include training all budgeting, accounting, and auditing staff in the implementation of the recommendations.

CHAPTER III

CENTRAL GOVERNMENT ACCOUNTING AND FINANCIAL REPORTING

HMGN has a well-defined central government accounting and financial reporting system in most important aspects. The main challenge is, however, implementation of the system. One good example is the failure to link expenditures to outputs or outcomes, as required by the system. Other system weaknesses include the failure to reveal debtors, creditors, and accrued expenses, as well as the exclusion of significant activities related to grants, commodity aid, and direct payments from donors. While HMGN is already considering the possibility of moving towards an accrual accounting system, it is important that this transition be made gradually only after building on the current system with gradual improvements. Staff mix and skills present another challenge. The reasonably well-qualified staff need to be motivated to produce better outcomes. Internal audit is weak partly due to lack of capacity to cover a large number of payment centers. Measures that could facilitate easing the pressure include the introduction of an Integrated Treasury System to reduce the number of accounting centers.

A. Statutory and Legislative Framework

3.1 The Financial Procedures Act, 1999 together with the Financial Administration Regulations (FAR) 1999, specifies the responsibilities of the Ministry of Finance (MOF), the Financial Comptroller General Office (FCGO), the District Treasury and Controller Office (DTCO), other central level agencies, and operating level entities. It prescribes financial procedures relating to collection, disbursement, recording, internal control, checking, internal auditing, independent audit by the Office of the Auditor General (OAG), and the clearing of irregularities.

3.2 Public accounting involves three main responsibility centers - namely, the MOF, Line Ministries/Constitutional bodies, and FCGO. The MOF, upon enactment of the Appropriation Act or vote on account, issues authorization to the Secretary of Line Ministry or Constitutional Body, with copies sent to FCGO and OAG. The Secretary of the Line Ministry or the Head of the Constitutional Body subsequently issues authorizations to Heads of Department, and the Heads of Departments in turn issue authorizations to Heads of subordinate offices. Overall cash and debt management is handled by the MOF through FCGO. The Financial Procedures Act, 1999 designates the Secretary as the Chief Accounting Officer, and he is accountable for all accounting units in or under his Ministry/Authority to administer expenditures within the limits of the allocation, regulate collection of revenues into the consolidated fund, cause accounts to be maintained, and submit statements thereof. The FCGO, an independent department under the MOF, is the central accounting organ of the government and custodian of the government treasury. The FCGO is responsible for the accounting of all loans, investments and treasury funds.

3.3 The FCGO releases funds to 3,729 paying offices spread over 75 districts and ensures proper book-keeping thereof. It collects, monitors, and records revenues, maintains records of inventories, expenditures and outstanding irregularities. The FCGO is also responsible for the management of accounting personnel and internal audit of all operating entities. It consolidates monthly cash flow information of the government and produces a report in time, and upon completion of the financial year, submits for auditing to the OAG the national statements of receipts and expenditures.

B. Book-keeping and Accounting

3.4 Accounting functions in HMGN system can be summarized into two levels: Operating Level (which handles payments and collections) and the Central Level (which issues authorizations to operating level and oversees them).

- **Operating level agency** - Records expenditures by budget items and revenue by item codes, and reports to the central level agency (line department/ministry, project management office to DTCO).

- **Central level agency** - consolidates accounts by each budget head/sub-head, from statements submitted by paying offices, and submits integrated accounts statements to FCGO once every four months.

3.5 The accounting system is maintained on a cash basis. Although government regulations allow for debtors (e.g., outstanding staff advances) and creditors (e.g., suppliers not paid until the next fiscal year), the cash basis of accounting does not provide for these items to be recognized in government financial statements. Expenditure is maintained in a double entry accounts system, but revenue accounting is still on a single entry basis. The expenditure accounting system is supplemented by a property accounting system (1963), and a public works accounting system (1974). Each system contains standard recording formats as approved by OAG. Under the expenditure accounting system, HMGN has adopted a common accounting structure (coding and classification) in order to integrate planning, budgeting, accounting, and reporting functions. The property accounting system makes no provision for depreciation of assets. Valuation is on historical cost.

3.6 Accounts are maintained manually but computers are used at central agencies like FCGO, some line ministries, departments and selected DTCOs and project offices for integration of statements collected from various operating units. The FCGO has introduced computerized release and expenditure data capturing system in 45 districts in FY 2000/01. This system has been expanded to 64 districts by the end of June 2002.[2] These efforts have speeded up the account compilation. FY 2000/01 accounts reconciliation was ready at the end of the third month of this fiscal year. However, the finalization of accounts was delayed because of delayed receipt of accounting statements concerning direct payments and commodity grants from a few donors. FCGO finalized the accounts only on January 10, 2002, with subsequent follow-on adjustment on March 22, 2002. If all donor accounts are available on time, FCGO now has the capability to finalize annual accounts latest by the end of the fourth month after the end of the concerned fiscal year.

C. Accounts Staff

3.7 Accounts staff are deputed by FCGO to each office to assist the office chief in conducting and recording financial transactions as prescribed in the laws, and maintaining accounting records duly supported with documentary evidence. Each transaction bears a consecutive number and unless approved by the designated approving authority, it is not posted to the corresponding books of accounts, which are self-balancing. Accountants are

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[2] Due to Maoist attack on several power plants, a few districts e.g., Taplejung, Panchthar and Salyan, are unable to use the system.

responsible for ensuring proper compliance with FAR. Any error of omission or non-compliance or missing documentary evidence must be reported to the approving authority. Procurement functions, safe custody of assets and accounting functions are separate responsibilities within the financial sphere. Funds are operated through bank accounts. A petty cash box is provided for the safe keeping of cash in hand and checkbooks.

3.8 The accounting staff including financial controllers and internal auditors constitute the Accounting Service Cadre, consisting of about 4,400 staff. The Public Service Commission (PSC) handles recruitment of accounts staff, and the FCGO is responsible for administering this Service Group according to the Nepal Civil Service Rules, 1993, within the policy guidelines issued by the Ministry of General Administration (MOGA). The functions and duties of the Chief of Accounts Section at various operating level offices are specified under the FAR.

D. Financial Reporting

3.9 Financial reporting procedures and responsibilities may be summarized as follows:

(a) All operating offices should submit, within seven days after completion of each month, the financial statements (statement of expenditures, revenue collection and guarantee deposits), supported with the bank reconciliation statement, and the details of outstanding advances to line departments and DTCOs.

(b) The central level accounting entities (line departments) are required to monitor and consolidate such financial statements for each department and send them to the line ministry every four months.

(c) The line ministry having monitored such statements would prepare the consolidated financial statements of the whole of the ministry and submit them to FCGO and OAG within four months (by end of Kartik) following the end of the fiscal year; FCGO submits consolidated accounts to OAG no later than six months (by end of Poush).

(d) The FCGO consolidates the ministerial financial statements, which it receives from DTCOs through the Financial Management Information System (FMIS), supplements them with consolidated bank statements from NRB, and prepares integrated annual financial statements for Nepal which it submits to OAG within six months following the year end.

3.10 The annual government financial statements (prepared in Nepali language only) reports the following: (a) budget allocation and uses, (b) estimated revenue and collections, (c) details of guarantee deposits, and (d) statement of irregularities identified by internal audit. The statement is prepared by ministry (and by budget) and contains allocation (budget estimate), release, expenditure and balance unspent, each with budget itemized details. For development budget, the statement also specifies sources of funds. Budget allocations and revenues are accounted for by district and by revenue code, whereas deposits and details of internal audit observations are prepared by office.

E. Procurement and Assets Management

3.11 The discussion on procurement policies and practices is postponed to Chapter V, where it is reviewed as a cross-cutting issue. There are many legal provisions in FAR dealing with the custody, maintenance, management, accounting, and reporting of government assets, inventories, land and buildings. Chapter 6 of the FAR is devoted to the custody of government assets, inventory, and their protection. It designates an appropriate officer to maintain the inventory and custody of government materials. Depending on the staffing of the particular office, that officer could be the procurement officer, store officer, storekeeper, or other official designated by the officer-in-charge (OIC). Even commodity aid is supposed to be recorded, included in the central financial statement, and inspected by the FCGO (Rule 48 of the FAR). Each Office is required to prepare an annual report within three months following the end of the fiscal year, stating the balance of goods and the materials brought forward from the previous year, acquisitions, transfer, and disposals during the current year, and balances carried forward to the following year (Rule 53 of the FAR), to maintain an inventory of its land and buildings, ensure that they are properly registered, and send a copy to the statement of land and buildings, in a format approved by the FCGO, to the District Administration Office, Pertinent Superior Department, Ministry and DTCO. Although this is done, the quality of asset and inventories, records and reports is poor due to inadequate monitoring. Also, there are no consolidated registers or reports for the country as a whole; there are only records of operational level offices.

F. Internal Audit

3.12 Several legal provisions require verification, inspections, and confirmations, which bear all the attributes of internal audit, even when the activities are not so described. Chapter 14 of the FAR deals specifically with internal audit. According to Rule 142 (6):

> *"The Financial Comptroller General Office and the concerned District Treasury and Controller Office (DTCO) may, on a spot check or from time to time, examine as to whether the books of account required to be maintained by any Office have been maintained accurately or not, whether cash balance is accurate or not."*

A report of such examination should be sent to Chief of the "Pertinent Superior Office", who is required to give the necessary direction, or take necessary action within seven days of receiving the report. The OIC is required to direct that missing inventory records be established within three days, and any recoverable losses be recovered within 15 days, and to inform both the OAG and the FCGO of any such action.

3.13 It is the responsibility of the OIC and the chief of financial administration to update accounts of revenue, deposit, and appropriated amounts and to get such accounts audited internally (Rule 145). The FCGO is required (Rules 145 - 146) to prepare and enforce an internal audit manual. Such a manual has been prepared and introduced with financing from the WB under an Institutional Development Fund (IDF) grant.

3.14 The Accountable Officer is to check whether the OIC or "Responsible Person" has settled any irregularities revealed in internal audit reports, and to get them settled. The OIC submits the accounts and financial statement to OAG for external audit in accordance with the format approved by OAG (Rule 146). Irregularities reported in a letter from the internal auditor or OAG are required (Rule 148) to be settled within the time limit specified in the letter, and where no time limit is specified, within 35 days. The role of internal audit in assessing internal controls and recommending improvements to systems and procedures is very limited. Internal audit rarely assesses internal controls or recommends improvements. Its normal role is to examine whether or not prescribed legal provisions are being followed.

G. Problems and Issues

3.15 Principal accounting and reporting issues may be summarized as follows:

***Linkage between Financial Progress and Physical Output/Outcomes**:* Even though the reporting regulations provide for reporting of quantitative or measurable achievements or their linking to financial data, this is not yet reflected in the accounting process.

***Advances**:* Advances are treated as expenditures and are booked under the corresponding budget items. Advances are also included in the consolidated accounts. They are posted in sub-ledgers and reconciled only when advances are settled. Chapter 11 of FAR requires the ascertainment of the exact sum to be provided in advance and also requires timely settlement of such advances. Despite this, every year OAG has been observing a substantial amount of irregularities related to advances which include, excess amounts provided in advance, spending beyond the budget limit, and negligence in clearing advances.

***Commitments**:* Commitments are not recorded.

***Budget Codes**:* The budget item codes are primarily meant for providing a uniform basis for control and accountability at various levels. They do not conform to the expenditure categories and the corresponding activities and sub-activities as defined in development project documents. Therefore, expenditures incurred under various budget items have to be processed further by means of work-sheets.

Item Codes: The present item codes do not capture commodity grants and direct funding. Based on the information collected from various agencies, a statement of foreign assistance in the form of direct payments and commodity aid is prepared. But this does not provide a complete and accurate accounting.

Beneficiary Participation: Similarly, beneficiary participation in projects is neither budgeted nor accounted for.

***Accounting Formats**:* The prescribed accounting formats being used at the operating level have no columns to record by sources of funding, annual appropriation, amount released, expenditure incurred, and commitment made thereof.

Cumulative Figures: The formats do not provide cumulative figures for preparing project accounts.

***Financial Reporting**:* HMGN regular financial report is not directly comparable or compatible with the cost tables in most project documents.

Contingent Liabilities: Like many governments, HMGN does not show contingent liabilities in its accounting and annual financial statements. In view of possible liabilities resulting from HMGN commitments and guarantees on behalf of state-owned enterprises, some rough indication of the magnitude of such contingent liabilities would greatly improve the disclosure standards of HMGN's annual financial statements.

Accounts Reconciliation: There are reconciliation delays which affect timely financial reporting. Delay in reconciliation of accounting information between banks, DTCOs and FCGO is primarily due to delays in reporting by commercial banks. Most branches of commercial banks operating government accounts maintain records manually - a factor causing delays in preparing financial statements.

Monitoring: Due to inadequate monitoring and follow-up, preparation and submission of four-monthly financial statements, at both inter-agency level and intra-agency level, are often neglected.

Internal Audit: Internal audit is not as effective as it might be, due to the large number of accounting and payment centers relative to the auditing capacity available and the limit of the internal audit role to transaction checking. An Integrated Treasury System reducing the number of accounting centers (an initiative that was under consideration by HMGN in 1999) might help to ease the pressure on internal audit (and accounting) staff.

Revenue Reconciliation: Revenues are deposited in 78 different account categories (codes) through the authorized banks. Small revenues often create problems of bank reconciliation. No matter how little, cash has to be deposited the next day. Offices having banks far off are therefore reluctant to accept cash. The whole revenue accounting system may need restructuring in this respect.

Staffing: The total number of accounting staff in government is about 4,400, of which about 500 are officers, and about 3,900 assistant level staff. These personnel are apparently having some difficulty in coping with consolidation of information from more than 3,700 accounting locations every year, with the result that the preparation of consolidated accounts of HMGN takes a very long time. In addition, accounting staff have dual accountability – professional responsibility towards FCGO, and reporting responsibility towards the assigned authority. This sort of dual reporting and establishing relationship with both FCGO and the reporting authority has been a great challenge.

Staff Quality: Although the accounting staff is reasonably qualified and handle accounting jobs satisfactorily, the number of accountants and internal auditors who are trained and experienced in project accounting is still very small. In many cases, and particularly at the lower levels and in the field, the accounting expertise is very poor. This problem is further complicated by donors' requirements, which are complex, non-standard, and have to be met in English.

Staff Morale: Compensation provided to accounts staff in projects is not competitive and attractive to retain good quality accounts staff of right caliber in view of growing demand of quality staff in the private sector where compensation levels are considerably higher. Good performing accounts staff, in general, appear to be highly frustrated due to absence of a performance evaluation system which recognizes and rewards good performance. Motivating good accounts staff is a challenge.

Staff Training: Regular training of accounts and audit staff is provided, particularly in the Revenue Administration Training Center (RATC) and the Nepal Administrative Staff College (NASC). NASC is an independent training institute created by a special Act to provide on-the-job training to civil servants. RATC is a sector-training center under the MOF. However, much of the training provided is routine, and designed to satisfy the statutory requirement that all candidates for promotion must undergo training.

H. Recommendations

3.16 The legal framework for accounting and financial reporting is sound in most important respects, but there are weaknesses of which the most significant have to do with: failure to link expenditures to outputs or outcomes; failure to reveal debtors, creditors, or accrued expenditures; exclusion of significant activities related to grants, commodity aid, and direct payments from donors; inadequate project accounting due to failure to accumulate project expenditures; mismatch between budget, normal government accounting, and project accounting codes; and inadequate staff capacity and weak internal audit.

3.17 Accordingly, it is recommended that:

(a) The accounting and reporting systems be expanded by creating codes to permit the recording of quantitative and other output data to compare with benchmarks established in budgets (see Chapter II recommendations). In order to permit this in the system, the current software used by FCGO needs to be upgraded.

(b) HMGN develop a roadmap for the medium to long term introduction of accrual accounting based on a carefully-phased plan, and a realistic timetable. The new system would permit reporting of debtors, creditors, accrued expenses and other assets and liabilities. While the immediate priority should be to improve the cash based accounting system[3], transition to accrual based accounting system should be made only after improving the current capacity and developing a realistic plan. FCGO is currently considering the modalities and timing of such a system in the context of a proposed ADB-financed project.

(c) HMGN should enforce a rule that requires all spending offices to regularize all expenses incurred during a fiscal year within 35 days of the closing of the fiscal year so that financial statements prepared and submitted do not contain irregular expenditures[4].

(d) All aid funds, grants, commodity aid, direct donor payments, and beneficiary contributions to projects in Nepal be included in the National Budget, accounted for by FCGO, and audited by the OAG. MOF to discuss with all donors to reach a consensus on the modalities for reflecting these in the National Budget. Managers of projects seeking to be exempted from this requirement should apply to the OAG, citing reasons for a special exemption – the process should be kept transparent.

(e) HMGN set up an Accounting Standards Board (ASB) and a Board of Auditing Standards (BAS) to formulate appropriate accounting standards for the use of the public sector, the private sector, local bodies, and non-governmental organizations (NGOs).[5] The Board should include

3 Improvements in cash based system should consider, for example, implementation of recording of commitments, ways to reduce the advances, maintain asset register.

4 Provision of disciplinary action to be enacted for those who fail to comply within the stipulated time frame.

5 ICAN has formed two Standards setting committees – Accounting Standards Committee and Auditing Standards Committee, with the assistance of ADB Technical Assistance; these two Committees will be recognized as the Accounting Standards Board and Auditing Standards Board after the Nepal Chartered Accountants Bill 2058 (amendment) receives the Royal Seal.

representatives from the accounting profession, MOF, OAG, FCGO, the Institute of Chartered Accountants of Nepal (ICAN), and academicians.

(f) HMGN introduce new accounting codes and classifications, which correspond to (i) budget codes and classifications, and (ii) codes and classifications to be used in project specific budgets and accounts, including for donor-funded projects.

(g) Internal audit be strengthened through staff training, and its coverage and scope of work expanded in line with its capacity.

(h) FCGO together with MOGA to review performance measuring indicators of accounts staff in order to recognize the contribution of good performers, and to review how the current system of dual reporting arrangements can be made more effective to result in better outcomes from the accounts staff.

(i) HMGN introduce an estimate of contingent liabilities into its annual financial statements.

(j) HMGN continue producing its annual financial statements in English for wider dissemination to donors. Annual financial statements, in Nepali or English, be made available at zero or nominal cost to public, and even posted in the MOF's website.

(k) HMGN develop Human Resource Development plans including on-the-job training of accounts and internal audit staff through greater training of trainers, improved material and human resources for the RATC, and better organization and staffing of the training function in FCGO.

(l) HMGN ensure that appropriate training is provided to accounts and audit staff to enable them to implement the above recommendations.

(m) HMGN effect whatever amendments in the relevant legislations and other legal provisions are necessary to implement the above recommendations.

(n) HMGN consider the possibility of introducing an integrated treasury system in order to reduce the number of accounting centers.

(o) HMGN to introduce cumulative accounting for all projects, including those solely financed by HMGN.

CHAPTER IV

LOCAL GOVERNMENT ACCOUNTING AND FINANCIAL REPORTING

The Constitution of the Kingdom of Nepal, 1990 recognizes the decentralization of authority as a means of providing maximum opportunity to people in their governance, and the Local Self-Governance Act, 1999, while devolving wide sectoral authority to local bodies, has provided for more accountable and transparent local governments through village, municipal, and district councils, committee system, and audit committees. Although the Country has an impressive financial accountability framework set up by the Local Self-Governance Act, 1999, there is very limited institutional capability at the grass roots level to implement the accountability requirements as set forth in the Act. Fiduciary risk at the local government level appears to be high. Internal control is very weak. Many District Development Committees and Municipalities do not still have internal audit units as required by LSGA, 1999. The prime focus of HMGN should be capacity building at the grass roots level to comply with the accountability arrangements as set forth by the Act. Central level monitoring of district level activities is also weak.

A. Statutory and Legal Framework

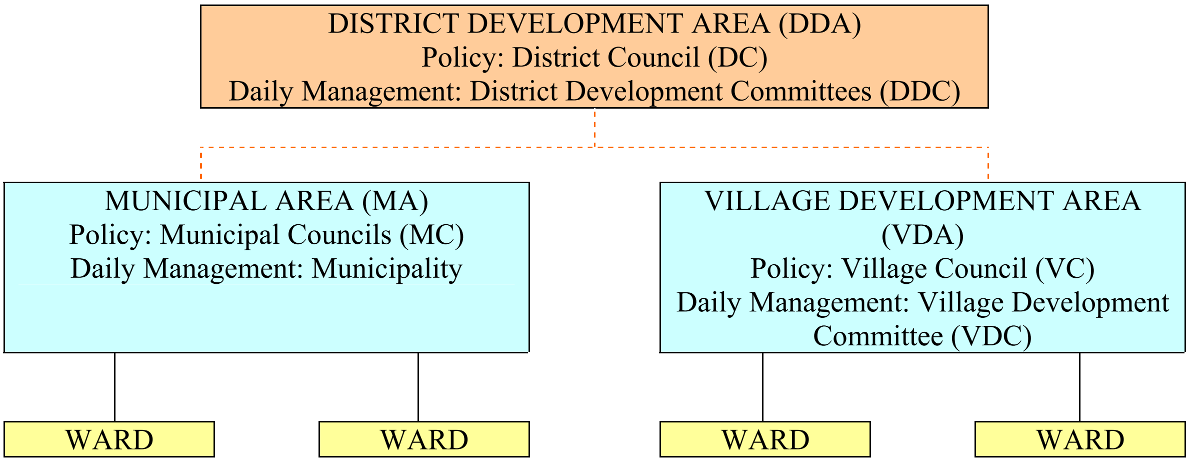
4.1 The Local Administration Act, 1971, divided Nepal into 75 districts. The country has 75 District Development Committees (DDCs), 58 Municipalities, and 3,913 Village Development Committees (VDCs). The latest definitive laws governing local government in Nepal is the Local Self-Governance Act (LSGA), 1999. This Act enables HMGN to retain the districts created by the 1971 Act, designate each as a "District Development Area" (DDA) and to divide each DDA into a minimum of nine and a maximum of 17 areas. Depending on their population, infrastructure, economic, and other characteristics, these areas could be designated either as Municipal Areas (MAs) or Village Development Areas (VDAs).

4.2 DDAs, MAs, and VDAs are governed by elected governing councils, which meet twice a year[6] to decide policies, approve budgets and accounts, and to authorize specified major decisions of elected committees, which meet monthly, and run the day-to-day affairs of each area. Chart 2 below shows the structure and relationships of local government areas. Each MA and each VDA is divided into nine wards of approximately equal population, each run by a ward committee. However, the number of wards in each municipality depends on the population of the municipality.

6 DDAs meet only once a year

Chart 2

LOCAL GOVERNMENT STRUCTURE AND RELATIONSHIPS



B. Financial Accountability Provisions of the Local Self-Governance Act, 1999

4.3 The three local government executive bodies - VDC, Municipality, and DDC - are each defined in the Act as a "Local Body". Each is endowed with powers of a legal person able to own property, contract in its own name, and to sue or be sued. Members of all three "local bodies" are required to swear an oath before assuming office, and to publish a statement of their personal and joint family moveable and immovable property within 30 days after swearing the Oath of Office. In addition, the Chairperson and Deputy Chairperson are required to publish a similar declaration of assets within 30 days after relinquishing their posts.

4.4 The LSGA defines the functions, powers, duties, and sources of funds of each of the three types of local bodies. Each council (the supreme governing body) is required to create an "accounts committee" under the chairpersonship of any Council Member, consisting of three members in VDC and maximum of 5 in MC and DDC. Each body is required to prepare an annual budget and development plan in collaboration with other operators and stakeholders in its jurisdiction (including government bodies and NGOs); maintain up-to-date accounts of its income and expenditure; and to have such accounts audited.

4.5 The Secretaries of the VDC and the Municipality have almost identical financial management responsibilities, which include: maintenance of up-to-date accounts and records of income, expenditure and projects; incurring of expenditure; arranging for audit of accounts and clearance of audit queries; maintenance of records of moveable and immoveable property; and control of all staff.

4.6 In addition to the common financial management (FM) provisions discussed above, the LSGA has FM provisions specific to each of the three local bodies.

4.7 For the VDC:

- The internal audit shall be carried out by the DDC within four months following the end of the fiscal year. The external audit shall be carried out by an auditor approved by the DDC on the recommendation of the accounts committee constituted by the Village Council. The Chairperson of the VDC shall take action on audit queries and points, and submit the audit report and details of actions taken to the accounts committee, which should study the report and submit it, with its recommendations and opinions to the Village Council. The Village Council considers the report and recommendations and sends appropriate instructions to the VDC. Statement of expenditures of VDCs have to be made available publicly to all wards within one month following each meeting of the Village Council.

4.8 For the Municipality:

- The budget of the Municipality is prepared by its secretary, approved by the Municipality, whose Mayor submits it to the Municipal Council for approval. The Secretary signs all contracts and countersigns all checks with the Accounts Chief. Statements of expenditure of the Municipality have to be made available publicly to all the wards within one month following each meeting of the Municipal Council. The Municipality itself carries out the **internal** audit of its income and expenditure. Its **external** audit is carried out by a registered auditor appointed by the Municipal Council on the recommendation of the accounts committee. The Mayor submits the final (external) audit report to the accounts committee for deliberation, and then to the Municipal Council, with the accounts committee's opinions and recommendations. The Council gives directions to the Municipality for the ultimate resolution of queries.

4.9 Municipal level projects are supposed to undergo quarterly monitoring by the Municipality, and a formal examination, release, and clearance upon completion, on the basis of a work completion report and evaluation submitted by a technician and approved by the Council. Aspects to be evaluated include employment creation, other benefits generated, and ecological impact of the project. This (and the quarterly review) is an important opportunity to tie project expenditure to outcomes.

4.10 For the DDC:

- Each DDC is required to plan the development of the district by creating an "Integrated Plan Formulation Committee," which co-ordinates and sets priorities among projects proposed by various plan formulation committees.

- The District Council approves the DDC budget. Most of the DDC projects are implemented by user groups or VDCs, and the DDC is responsible for ensuring that accounts of those groups and VDCs are audited. The DDC must form a Supervision and Monitoring Committee to monitor project implementation. The DDC is supposed to evaluate the effect of every completed project after one year, and evaluate on-going projects every six months, to assess: provisions for repair and maintenance; community benefits; increase in production and employment; and impact on the ecology. The DDC is required to carry out its own internal audit (Section 232 - 1 of LSGA). The external ("final") audit is done by the OAG. The District Council reviews the audit report with suggestions of the accounts committee, and directs the DDC on settlement of unsettled audit queries and regularization of unregularized items.

C. Implementation Status of the Legal Provisions

Book-keeping and Accounting

4.11 The books of accounts in local bodies are double entry based and maintained on a cash basis, but the municipalities have the option to adopt the accrual basis. The system contains a wide range of formats to be used by the local bodies for bookkeeping, accounting and financial reporting. Many local bodies are still continuing with the HMGN accounting system, although the present regulations have prescribed new accounting formats for use in the local bodies, specific to VDCs, Municipalities and DDCs. The chief of financial administration section in DDCs is still deputed from the FCGO. Municipalities appoint their own accounts staff. In VDCs, the secretary alone handles the accounting records. Accounting function in DDCs is complex, since DDCs are required to handle both local level and the district level HMGN/donor-funded development programs on behalf of the central government. Moreover, they are intermediaries between VDCs/Municipalities and the Ministry of Local Development (MOLD).

4.12 Accounting is done manually at the offices of local bodies. Some DDCs and Municipalities, however, are equipped with computers to internally share data. The MOLD has recently provided an accounting software package to be used in DDCs under the Participatory District Development Program (PDDP) financed by the UNDP[7]. The authority and the chief of the financial administration section in each local body maintain records duly supported with evidence of transactions, and have them audited by the internal auditor. They are jointly responsible to confirm, prior to inviting the external auditor, that irregularities pointed out by the internal auditor (such as, sanctions, evidence and recovery) are duly regularized. The administrative and fiscal decentralization will be enhanced with the formulation of subsequent projects by UNDP in partnership with various donors like DFID, SNV, DANIDA and GTZ. The World Bank is carrying out the sector work on Fiscal Decentralization to offer Government policy assistance on specific aspects of fiscal decentralization. HMGN has formed a Fiscal Commission in March 2002 with a mandate to manage the fiscal devolution process. It will primarily focus on: (a) distribution of public expenditures among three levels of government – central, DDCs, and municipalities/VDCs; (b) setting-up a fiscal framework for transfers from central government; and (c) devolution of right to collect revenues proposing effective systems for local revenue administration.

Reporting

4.13 The local bodies are required to submit to the MOLD and also to DTCO the statement of income and expenditure along with details of outstanding advances and bank reconciliation statement within seven days after each month. VDCs submit such statements to DDCs. The project offices handling budgets involving foreign assistance also need to report on grants-in-kind, direct payments, assistance on turnkey basis, technical and other assistance, and reimbursable amount. The VDCs and Municipalities should, within 35 days after the year-end, submit the yearly statement of income and expenditure, and progress report to the DDCs. In turn, DDCs prepare their own statement along with a summary statement for submission to MOLD. Most of the above currently happen in all municipalities and DDCs, but not in all VDCs.

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7 Accounting software package for financial accounting and reporting has been implemented in a few pilot DDCs on a phased basis.

Internal Control

4.14 The chief of financial administration section is responsible to safeguard the checkbook, cash and bank deposits, receipts and records. Likewise, the storekeeper safeguards the physical assets. The local body authority in person, or through his nominees, conducts stock verification at a minimum once every year. Procurement, safe custody of property, and accounting fall under separate responsibilities. The procedures are prescribed under the regulations. The MOLD has recently provided internal audit guidelines to the local bodies. Bye-laws have been formulated pursuant to Section 275 of the LSGA to provide detailed operational guidelines on the procedures relating to financial administration, personnel management and creation of local development fund. Transactions are to be counter-checked and recorded upon approval by the chief. In Municipalities and DDCs, the bank accounts are operated under the joint signature of the Secretary, the authority, and the Head of Finance Section. In VDCs, the chairperson and the secretary operate the bank accounts. Accounting records are kept up-to-date with regular balancing. Assets registers also need to be maintained. The DDC Secretary, however, with the assistance from DTCO, examines at least once every year, the financial transactions of VDCs and municipalities, and subsequently submit report to the respective local bodies and MOLD.

Internal Audit

4.15 Prior to enforcement of the LSGA, the DTCOs used to conduct internal audit of Municipalities and DDCs. DDCs conduct internal audit of VDCs within four months following the year end. Although the LSGA and associated regulations require all DDCs, and all Municipalities with revenues in excess of Rs 10 million, to set up internal audit sections headed by Internal Auditors of the officer rank. Such sections are gradually being established in some DDCs[8] and municipalities. MOLD is following-up with other DDCs and municipalities to comply with oversight arrangements set out in LSGA.

Procurement

4.16 The local bodies execute, within the authorized limit, the procurement of goods and other works, as per Rule 5 of local body financial regulations (1999). Modes prescribed, include off-the-shelf (up to Rs 25,000), direct quotation up to (Rs 50,000) and tender or open bidding (over Rs 200,000). However, the local bodies need to accord priority in hiring the users' group for execution of works amounting to Rs 1,000,000 or above. The local bodies can hire expertise through direct negotiation (up to Rs 25,000), through a simple technical and financial proposal (over Rs 25,000 to Rs 150,000), and through a detailed technical and financial proposal (above Rs 150,000). In a situation where some projects are centrally financed and executed by the local body (mainly at the DDC level) under the delegated authority by a secretary of a line ministry or a departmental head, the DDC will have to follow the provisions of FAR.

Independent Auditing

4.17 External audit practice follows the legal requirements laid down by the LSGA (see paragraphs 4.7 – 4.10 above). The village level accounts are audited by an auditor appointed by the VDC from a list approved by the DDC on the recommendation of its Accounts Committee. For the final audit of income and expenditures of the municipalities, the Municipal Council appoints a registered auditor on the recommendation of its accounts committee. The final audit of income and expenditures of the DDCs is carried out by the Auditor General. The government is currently having a dialogue with the Auditor General with regard to the audit of the VDCs. The AG is most likely to accept the HMGN proposal

[8] About 21 DDCs now have internal audit sections

that the OAG should audit the VDCs. The AG has also proposed that the government grants provided to schools and communities should also be audited. The AG is now working out the modalities for carrying out these additional responsibilities, and is weighing the outsourcing of the audit of both the VDCs and the grants to registered auditors.

Oversight Arrangements

4.18 Currently, the most effective financial accountability oversight outside the local bodies and MOLD is by the OAG. Some of the common weaknesses reported in the Annual Audit Report of the OAG for 2001 include: spending in excess of the budgetary limit; holding back the unexpended balances; mounting uncleared advances; poor accounting; non or incomplete submission of statements of income and expenditure; pending audits; lack of maintenance of assets records and the list of completed projects; over recruitment of staff; adoption of write-off measures for the adjustment of advances and pending taxes; delays in preparation of budget and plan; delays in implementation; and poor monitoring and evaluation. All these indicate that the financial management capacity is very weak in local bodies. It is, therefore, necessary to strengthen the financial accountability of the local bodies prior to implementation of full scale fiscal decentralization.

Other Implementation Issues

4.19 The decentralized expenditure program that expanded rapidly since 1995 largely represented a top-down effort at decentralization. As pointed out above in paragraph 4.12, the government has recently formed a Fiscal Commission under the convenorship of a NPC Member and with representatives from the local bodies and the private sector, to make proper recommendations for ensuring better coordination between the local bodies and the central government to achieve a greater degree of decentralization. The main task of the commission is to recommend to government measures for achieving a more efficient financial administration and revenue mobilization at the local level to ensure effective implementation of decentralized policies. The decentralized expenditure program was pushed through more as a legal enactment, without considering the institutional capacity both at the center and at the local level and without enacting the monitoring provision. In general, one gets the impression that the institutional capacity and practices are still struggling to catch up with the excellent financial accountability framework set up by the LSGA. In addition to the weaknesses reported by the OAG (paragraph 4.18 above), one may note the following implementation issues:

- The office-bearers are not making property declarations as required by the LSGA.
- The cost of administering so many districts, local and regional offices, appears to be far too high for a resource constrained country to finance.
- Comprehensive budget and program guidelines are still lacking. The budgetary system is not properly developed; presentation methods are inconsistent; and there is no financial monitoring system in the local bodies.
- The elaborate linking of expenditures to results provided by the LSGA is not yet happening. Benchmarks are yet to be established.
- Project selection is made without rational criteria or even without considering the costs and benefits and continuity of the program. Involvement and empowerment of beneficiaries has been limited in most cases. Allocation of funds is done on an ad hoc basis, not closely linked to community needs and performance, and worked out with little awareness of the need for targeting funds to focused groups.

- The internal audit sections required by regulations in DDCs and Municipalities are still absent in many cases.

- Technical capacity is limited at all levels for project preparation, design, implementation and monitoring, and for effective use of funds and accountability. Accounting records are incomplete due to non-inclusion of user's contribution and inadequate columns in the accounting format. The quality of financial record keeping is poor; records are not up-to-date and do not provide source data.

- Although the release of funds against the program grants is subject to submission of financial statements duly supported with physical progress at various levels - from VDC to DDC and DDC to DTCO, it is not effective due to poor monitoring capacity at the central level including MOLD. The OAG Report, 2001 stated that the MOLD could not produce a complete record of direct payments made by various donors. Actions warranted under these circumstances are to be specified in the local self-governance regulations.

- The accounting software package to be used in DDCs has not been effective due to incomplete records and limited computer knowledge and capacity among the end users including accounting staff.

- There are neither accounting nor auditing standards at the local bodies. Therefore, reporting varies between DDCs and VDCs. At present, MOLD is initiating some measures to strengthen local government accounting and auditing in close collaboration with the related partners. It has been proposed that within three years, an Accounting and Auditing Board for local governments will be set up. Ideally, that "Board" should be a Committee of the national Accounting Standards Board (ASB) recommended in Chapter III.

- The local bodies revenues and expenditures are not adequately reflected in the national accounts.

- The inventory accounting system is said to be very weak, particularly in the DDCs.

- Accountability of direct and block grant flows to the local bodies needs to be reviewed and strengthened.

- The division of responsibility between the MOLD Secretary and the DDCs for the funds used in the local bodies needs to be clarified.

- New positions are being created so rapidly in the DDCs, and there are so many local bodies, that there is a danger that much of the funding being granted to them will go to the employees' payroll.

D. Recommendations

4.20 Given the severe financial accountability weaknesses discussed in this chapter, **it is recommended** that:

(a) No development budget be adopted by a local body unless it includes quantitative benchmarks or forecasts of measurable outputs or results expected from proposed expenditures.

(b) No disbursement be made to any local body unless:

(i) An initial financial assessment by the FCGO confirms that there is a financial management system capable of properly accounting for the funds, including reporting on quantitative results and measurable goals;

(ii) The initial disbursement for the fiscal year is made against a budget showing quantitative forecasts of results, as described in (a) above.

(iii) Every replenishment of an imprest or any disbursement during the year is against presentation of a retrospective report on expenditures of a preceding period, including quantitative achievements measured against the measurable results forecast for that period; and a prospective forecast of physical and/or other measurable results expected from proposed expenditures.

(c) HMGN designate and appropriately fund an independent agency to monitor compliance with the recommendations in (a) and (b) above, and enforce penalties against non-compliers. A Local Body Fiscal Commission might be suitable for this purpose.

(d) HMGN review and consider the reduction of the number of administrative districts, local and regional offices, to promote effective resource allocation, planning and implementation.

(e) HMGN ensure that fiscal decentralization efforts go in parallel with budget planning by MOF and decentralized auditing by OAG.

(f) To speed up the creation of accounting capacity in the local bodies, HMGN require DDCs, VDCs and municipalities to recruit properly qualified accountants and train sufficient numbers of accountants.

(g) HMGN strengthen internal audit capacity which is weak at both central and local levels.

(h) HMGN simplify accounting procedures at the VDC level, and introduce comprehensive accounting and auditing manuals, supported where practicable by computer software packages, for local government.

(i) The accounts committees prescribed by LSGA, include representatives of stakeholders, as well as financial experts, and remain active throughout the year.

(j) HMGN discuss and agree with OAG on how to ensure the effective audit of VDCs and grants provided by the government to schools and communities.

(k) HMGN improve overall accountability and cost-effectiveness of the local bodies by: (i) ensuring that their revenues and expenditures are adequately reflected in the national accounts; (ii) improving the accounting for inventories and assets in DDCs; (iii) reviewing the flow of grants to local bodies; (iv) clarifying the responsibilities of the Secretary of the concerned Ministry and the local bodies; (v) clarifying the existing regulations to make the concerned line ministry functionally accountable for implementation of sector related program through local bodies; and (vi) considering the introduction of some norms or guidelines regarding appropriate staffing strength for DDCs.

(l) HMGN conduct revenue potential study and also review various local levies and fees, and sort out if there are any overlap with the central level taxes.

(m) HMGN formulate a policy to channel all donor support to local bodies through central government agencies.

(n) HMGN introduce amendments to the LSGA, and relevant legal provisions necessary to allow the implementation of the above recommendations.

(o) The MOLD, FCGO, and OAG undertake appropriate capacity building measures needed to implement the above recommendations.

(p) A national level conference of representatives of Accounts Committees be organized every year in order to share experiences, lessons of best practices, and general information, and also to promote as a “pressure group” to promote transparency and financial accountability.

CHAPTER V

CROSS-CUTTING ISSUES IN PUBLIC SECTOR'S FINANCIAL ACCOUNTABILITY

Internal control checks in government are numerous and elaborate. But, the main issue is ineffective implementation of the system, as pointed out by the Auditor General in his report. While efforts are underway to strengthen the internal control system, the most important point is to ensure compliance with the existing system. On procurement, a Country Procurement Assessment Review (CPAR) has highlighted major procurement related issues, including the need for capacity building, all of which are being addressed. As more emphasis is being placed on good financial management to ensure financial accountability, staff training and capacity building is another major area that needs focus. Records management needs to be improved by commissioning the preparation and implementation of guidelines for the management of both paper and electronic records. With regard to reporting, HMGN should accord priority to enforcing the use of Schedule 2 contained in the Financial Administration Regulations (FAR), 1999, which allows the linkage between financial input and physical outputs and results. Compliance with this requirement with slight modification should be made standard, which will facilitate harmonization of government and donor requirements for financial reporting. Developing information technology policy is a useful first step in developing an effective computerized financial management information system.

A. Internal Control Procedures

5.1 Internal control checks and balances in government are numerous and elaborate. Almost all of the 204 rules in the "Financial Administration Regulations (FAR), 1999" have to do with internal control (IC). Typical of these IC related rules is Rule 45, which requires the Competent Authority, in sanctioning government expenditure, to pay attention to 18 specific matters "from the view point of regularity, economy, efficiency, effectiveness, and propriety." The same regulation goes on:

> "*Even after the transactions have been carried out and accounted for, he/she (i.e. the Competent Authority) shall carry out, or cause to be carried out, material inspection/examination of the transactions carried out and become confident of accuracy and correctness*."

5.2 One of the 18 items to which attention must be paid is that:

> "*There exists such an internal control system as to prevent loss of and damage to and misuse of cash and goods and other government properties as well, and the system is being followed*." Thus, the Regulations not only require the existence of an IC system, but also that the system should actually work.

5.3 The regulations go on to spell out detailed authorizations, approvals, verifications, confirmations, and other checks and balances for: operation of the Consolidated Fund; revenue collection, accounting, reporting and auditing; budget preparation, approval, sanctions, implementation and monitoring; foreign aid management and accounting; fixed assets and inventory management, accounting and reporting; procurement, and public works; ration contracts; asset sales; deposits; advances; central accounts, financial statements and work completion reports; construction materials, wage rates and house rent; accounts, audits, and settlement of irregularities; daily and traveling allowances; and miscellaneous matters. Apart from procedures for staff recruitment, and for the preparation, payment and accounting for salaries, it is hard to think of any subject for whose IC Regulations do not cater. These two matters (i.e., staff recruitment and salaries administration) are covered in the Civil Service Regulations.

5.4 Every year the payroll needs to be certified by either the DTCO or the Civil Service Records Office. The possibility of "ghost workers" collecting public salaries to which they are not entitled is slim. Two sources of leakage have, however, been discovered, and action taken, by internal auditors. The first concerns "ghost teachers" who collect salaries from several schools at the same time, apparently with the connivance of persons in the District Education Office. The opportunity for such a fraud occurs particularly when there are vacancies. The second concerns the so-called "Muster Roll", where many temporary positions are created on a construction site for manual labor or clerical work, often on a donor-funded project. Such work is usually financed from a contingency fund in a construction budget, not out of the salary fund. Neither of these leakages is considered to have a significant impact on the government payroll.

5.5 While it is possible to think of more IC regulations in government, a more fruitful inquiry may be to assess how well the elaborate IC system is, which already exists, and functions in practice. One of the most reliable sources of information for such an assessment is the OAG's Annual Report. The OAG's Report for FY 2000/01 reveals numerous examples of failure to comply with existing IC-related regulations. For example:

- With regard to foreign-assisted projects: some entities and Ministries did not submit the agreements to the OAG; include foreign aid in their budgets; or prepare progress reports as required by Regulations. Of the 266 agreements submitted to the OAG, 16 did not contain any provision for audits. Twenty-four grant-funded projects did not submit any reports to OAG for audit.

- Reconciliation of accounts is one of the most effective ways to avoid errors and losses. Revenue collected by offices could not be reconciled with total revenues reported by the central bank. The foreign grants, disbursements and expenditures reported by Ministries did not agree with those reported by the FCGO. The government loan investments recorded by FCGO did not agree with those reported by the borrowing enterprises.

- There has been inordinate delay in imposing penalties prescribed against persons who owe taxes or other government revenue.

- Thirty-eight (38) state-owned enterprises have not submitted income tax returns for several years (at least for three years for many of them, and even more for many others).

- Many taxable enterprises do not maintain up-to-date books of accounts.

- The Department of VAT (now called Department of Inland Revenue) and offices under it have not been able to compile up-to-date records of businesses subject to VAT.

- Irregularity realizable[9] has increased by 245.77 percent during the last five years.

- Irregularities are often realized without the additional charges and penalties prescribed by the law. In the words of the OAG 2001 Report: "The apparent leniency has motivated the commission of irregularity".

- Basic policies pursued in the preceding year and their achievements are not reviewed in the current budget speech, as required by Article 77 (2) of the Constitution.

- Some budgets were proposed without preparing cost estimates, and some cost estimates were approved after awarding contracts, in contravention of the legal provisions.

- Many projects have not prepared work schedules, or submitted progress-monitoring reports every four months as required by the Regulations.

- Several state-owned enterprises did not make adequate provisions for losses, taxes, or royalties payable, maintain fixed assets registers, or physically verify the existence of fixed assets, or the serviceability of inventories.

5.6 All is not gloom, however. The OAG's 2001 Report also recorded a number of noticeable improvements in various aspects of IC. For example:

> "*Positive changes were observed in irregularity compared to the previous year*." Also "*Recovery of revenue is increasing gradually every year*."

5.7 Internal controls prescribed by existing legal framework appear adequate. The OAG's annual review of the IC system covers not only how well the system is working but also the robustness and adequacy of the system itself. OAG recommends reinforcement of the system when necessary. It would seem that the most promising direction of efforts is more in ensuring compliance with the existing systems than in introducing new ones.

5.8 **It is recommended** that HMGN take measures to enforce the existing internal control system and the existing sanctions designed to make it work. Specific recommendations in Chapters II and III are also designed to assist in this regard.

B. Procurement Policies and Practices

5.9 The Regulations (FAR), Chapter 7, contain some 40 rules governing public procurement. These rules cover such matters as tendering procedures and exemptions there from. Donor- or lender-financed procurements are expressly exempted from these regulations, and offices are supposed to comply with any procurement procedures agreed with the donor or lender.

[9] The Financial Procedures Act, 1999 defines Realizable Irregularity as any funds disbursed or provided in excess which should not have been disbursed according to prevailing laws or any revenues realized less than what should have been realized or any misappropriation or embezzlement of funds or any other items that are payable to HMGN.

5.10 The WB prepared a Country Procurement Assessment Report (CPAR) in 2001, which concluded that the procurement rules in the regulations were "poorly organized and substantially problematic." The report was finalized in January 2002. To prevent the harmful effects of co-existence of these rules with others, the CPAR recommended "inter alia" :

- enactment of a modern Public Procurement Law (PPL)[10] based on the United Nations Model Law for Procurement;

- creation of a small, independent procurement regulatory agency; and

- formal repeal of all existing procurement related Acts, Laws, and Rules following the enactment of the PPL.

5.11 The CPAR also recommends that, pending the new PPL, the rules in the FAR be amended in 15 specific respects to improve procurement transparency, economy, and efficiency. The CPAR also contained a number of additional recommendations (e.g. related to capacity building) to improve procurement in Nepal.

5.12 HMGN has taken a number of steps to implement the recommendations of the CPAR, the most significant of them being the publication of a draft PPL, whose provisions are currently under discussion between HMGN and WB. The procurement dialogue between HMGN and WB regarding the implementation of the CPAR recommendations is ongoing, and there is no need to duplicate either the CPAR detailed recommendations, or the related dialogue in this CFAA.

5.13 HMGN has submitted a request for an Institutional Development Fund (IDF) grant to the WB to assist HMGN with:

- simplification of procurement procedure to ensure transparency and efficiency;

- institutionalization of procurement training, including the training of trainers; and

- preparation of a draft PPL.

5.14 In response to the CPAR recommendation that, pending the passing of a new comprehensive PPL, HMGN should change anti-competitive rules and practices identified in the CPAR summary, HMGN revised the FAR, but failed to remove several of the important anti-competitive provisions criticized by the CPAR. Recent revisions are more control oriented, something that may not facilitate quality procurement and contract administration.

5.15 In addition, HMGN assisted by an ADB Technical Assistance (TA), has prepared Public Works Directives (PWDs) designed to supplement existing procurement laws and regulations, introduce international best practices, and remove or minimize contradictions between provisions in different laws. The WB has sent HMGN written comments aimed at revising, correcting, and fine tuning the PWDs. These PWDs have been approved by the Cabinet in April 2002. Under the same ADB TA, the draft Standard Bidding Documents (SBDs) for Major Works, Consulting Services and Goods (based on WB approved country

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10 It is important to closely monitor the discussion in the Parliament following the submission of the Public Procurement Bill to the Parliament, to ensure that the content of the Bill includes all important clauses acceptable to the World Bank and the Asian Development Bank.

specific ICB) and Smaller Works (in Nepali) have also been produced. Country specific National Competitive Bidding, SBDs for Works and Goods prepared for WB financed projects and adopted for ADB and HMGN's own financed contracts have also been reviewed and amended to suit HMGN rules.

5.16 In addition to structural and systemic issues addressed in the CPAR, the OAG's 2001 Report has identified instances of failure to comply with the existing system. Examples of non-compliance include:

- Restricting competition by not posting procurement notices in office as required by FAR;

- Awarding contracts on the basis of negotiations rather than on the basis of the approved tendering procedures; and

- Failure to approve and award contracts within the period specified in FAR.

5.17 HMGN has been experiencing and reporting that the system requiring the submission of bid in only one place has facilitated forced cartelling, imposed by obstruction to the probable bidders. HMGN/WB dialogue and HMGN actions on procurement are all being undertaken, and are in fact quite advanced, in the context of the CPAR, and are best left there. For the purpose of this CFAA, suffice it to observe that the systemic issues being addressed through the CPAR, and the instances of non-compliance recorded by the OAG, suggest that actions are needed on both fronts: systemic reform and compliance improvement. Meanwhile, **it is recommended** that HMGN continue and complete the implementation of the CPAR recommendations.

C. Staffing

5.18 The total number of accounting cadre staff in the government is about 4,400 out of which nearly 3,900 are assistant level staff and 500 are officer level staff. The annual turnover is around 4 percent. New intake needs to be trained, and there is also the question of updating the knowledge and skill of existing staff. Skill level is generally considered not sufficient for complex fund accounting system (involving many donors and different types of funding) of the government. Number of staff assigned to project planning and budgeting in departments and field offices is sufficient. The problem is not with the number of staff but with motivation to perform better. Staff working in the Planning Unit consider themselves as less privileged than others. (*For details, please refer to Chapter VIII: Fiduciary Risk*).

5.19 Based on their categories, the assistant level staff must have either a School Leaving Certificate (SLC) or Higher Secondary Education (+2 or Intermediate or Proficiency Certificate) or equivalent. All officer level staff must have a minimum Bachelor's Degree in academic discipline such as, commerce or business studies or business administration (many have a Master's Degree). In-service training is provided, either in the National Administrative Staff College (NASC) - an independent college established by act of Parliament, and providing training annually for a broad range of civil servants; or the Revenue Administration Training Center (RATC) - a specialized sector training institution owned by MOF. With the growing use of information technology in accounting, it is also now important for HMGN to offer courses on computerized accounting systems and make use of information technology to improve business efficiency.

D. Records Management

5.20 Various chapters of FAR require government offices to maintain complete and accurate records of revenue, advances, deposits, land and buildings, fixed assets, inventories, income and expenditure. There are, however, no specific rules dealing exclusively with how to manage these records. More specifically, there appears to be a need for a body of rules to insure that documents, registers, journals and vouchers can be stored and retrieved without too much difficulty or waste of time. The modern trend towards electronic record keeping (Section F below) introduces a whole new dimension to the subject (i.e. the management of electronic records).

5.21 The need for specific records (paper and electronic) management guidelines is reinforced by negative comments in the OAG 2001 Report, which, although not specific as to the nature of the records management problems encountered, suggested, nevertheless, that the OAG has complained about this for several years. The exact statement:

> "*The concerned department has to enhance effectiveness of its monitoring efforts by ensuring maintenance of records by offices of work to be accomplished and their monitoring and inspection. No improvement has taken place despite these suggestions made in the reports of prior year*."

5.22 **It is recommended that** HMGN (a) commission the preparation and implementation of guidelines for the management of both paper and electronic records, and (b) take measures to enforce compliance with the guidelines.

E. Output Monitoring With Respect to Budget Allocation and Expenditure: Issues and Challenges

5.23 The principle that expenditure should be directly linked to, and should only be justified by, the outcome or results there from is well established and documented in Nepal by statute and written regulations. A few specific examples:

- The Constitution of Nepal 1990, Section 77 (2) requires that estimates (i.e. budgets) presented by His Majesty the King to the Parliament be accompanied "by a statement of the expenses allocated to each Ministry in the previous financial year and particulars of whether the objectives of the expenses have been achieved";

- Rule 137 of the FAR requires every office to prepare and submit to the concerned Ministry and DTCO within three months following the end of the fiscal year, an annual Work Completion Report containing 17 specific items of information. One of these is "(m) description of goals of functions or programs of a particular office and progress thereof";

- As part of the budget preparation exercise, Rule 21 of FAR requires that the budget and program submitted by the Officer-in-Charge (OIC) to the MOF shall be accompanied by "the progress report of up to six months of the current year." This report (Schedule 2) compares goals or targets with outputs in quantity and percentages; compares budgeted with actual expenditure; and contains reasons for lack of progress; and

- The LSGA requires DDCs, VDCs, and Municipalities to have their projects monitored during implementation, and evaluated on completion for impacts and outcomes in such areas as income increases, employment creation, and even their impact on the ecology.

5.24 According to the summary of the OAG 2001 Report:

"*The basic policies and strategies implemented and their achievements as also non implementation of others with underlying reasons are not reviewed in the subsequent year's budget speech*."

The remarks quoted above imply that the requirement of Article 77 (2) of the Constitution (see above) is not being fully complied with. The Finance Minister submits a detail progress report on the targets and achievements to the House of Representatives. HMGN should review the observations made by the Auditor as pointed above, and make improvements in the reporting including the reporting in the budget speech.

5.25 Hardly any office prepares the Work Completion Report required by Rule 137. Very few report physical achievements or outputs on Schedule 2 of the FAR. The use of Schedule 2 goes beyond budget preparation. It is intended as a genuine project monitoring exercise throughout the year. Offices are supposed to submit them to their superior offices, which should consolidate reports from all offices, review progress, identify persons responsible for slow progress, and take appropriate corrective action. The Pertinent Superior Office is supposed to send a reminder to any office failing to submit the quarterly progress report. According to Rule 25 (5) of the FAR: "*The salary of the Officer-in-Charge who does not send the progress report within the specified time should be withheld*."

5.26 The four-monthly reporting system described above is not only an excellent discipline tying budgetary expenditures to outputs and outcomes, but also a good system for reporting to donors and international financiers on the projects they finance. The summary of the OAG 2001 Report reveals, however, that, with regard to foreign-assisted projects, most of the entities/ministries have not submitted statements of expenditure or progress reports. Schedule 2 could easily be adapted with some modification as recommended in Chapter II (2.18 e) as part of the Financial Monitoring Report (FMR) now required by the WB for all its projects.

5.27 With regard to the linking of expenditure with outputs and outcomes at the local level, the requirement of the LSGA on this point is clear (paragraph 5.23 above). In practice, however, there is little or no ex-post evaluation at the district level, village level, and municipal level. The OAG 2001 Report points out that many DDC projects go on for several years. Also, several selected projects are not completed due to resource constraints. Of the 4,178 projects undertaken by DDCs over several years, only 1,643 were completed by end of FY2000/01, and 2,535 were still ongoing. The Ministry of Local Development (MOLD) is now introducing measures to create benchmarks and targets for monitoring of outputs in Municipalities and DDCs. VDCs are not expected to be able to comply for some years to come.

5.28 In few developing countries can one find such pervasive and elaborate insistence on linking expenditure directly with outcomes as one finds in Nepal. There is, unfortunately, a broad consensus that none of the four requirements in paragraph 5.23 above is being complied with. Monitoring of outputs and comparing results with the costs of achieving them are among the best tools for ensuring that funds are spent for the intended purpose.

5.29 **It is recommended that** HMGN: (a) enforce the use of Schedule 2 of FAR, with outputs, quantitative and other results, as the trigger mechanism for release of budgeted funds, and its implementation should be monitored at the highest level at NPC or even at the Prime Minister's Office; (b) consider the adoption of Schedule 2 (modified as necessary) coming out of the HMGN system to comply with the WB requirement for FMR; (c) introduce output monitoring immediately in municipalities and DDCs and prepare a time-based action plan for introducing it in villages; and (d) require such reporting from every accounting unit or center. These recommendations are linked to, and reflect, similar recommendations in Chapters II and III.

F. Use of Information Technology

5.30 The use of information technology in HMGN's financial management systems is still very limited. Line Ministries and Departments use computers for preparation of budgets and expenditure statements, but the basic ledgers are still maintained manually everywhere. Computer use is still piecemeal. Many offices still use computers as substitute for typewriters and calculators. Few of the computers are networked.

5.31 FCGO, through a system called Financial Management Information System (FMIS), has one of the well advanced information technology (IT) systems in the civil service. Although use of computerized accounting systems at the district level is limited, for the most part, to districts benefiting from foreign aid, FCGO is nevertheless linked to 64 DTCOs with the help of dial-up modem. All fund releases and financial statements of connected districts can be monitored from FCGO. ORACLE platform is used for database management.

5.32 At present, it is extremely difficult to reconcile financial statements between FCGO, Nepal Rastra Bank (NRB), and DTCOs. This problem could be considerably reduced by extending the computer links currently existing between FCGO and DTCOs to NRB and commercial banks in which government accounts are operated.

5.33 It is recommended that HMGN:

- Get the IT Advisory Council and a Computer Board under the Ministry of Science & Technology to develop urgently, an IT policy covering such matters as IT strategy, priorities for computerization, policy towards choice of hardware and software, as well as their compatibility, policy and priorities for networking, government IT support, service and maintenance, and staff recruitment and training; and

- Link FCGO, NRB, and DTCO financial statements together through a common computerized network.

G. Financial Accountability in State-owned Enterprises

5.34 Accounting and auditing regulations applicable to state-owned enterprises (SOEs) are prescribed in the legislation setting up the enterprises. Generally, such Acts provide for accounting in accordance with generally accepted accounting principles (as provided for in the Company Act) and for auditing by an independent auditor licensed by the OAG. For companies in which the State owns 50 percent or more of the shares, the external auditor must be approved by the OAG. A generic problem faced in several SOEs is the failure to prepare financial statements and get them audited in a timely manner.

5.35 SOEs also suffer from the same lack of nationally recognized accounting and auditing standards as the rest of the economy, public and private. It has been recommended in Chapter II that HMGN establish an Accounting Standards Board to develop accounting standards applicable to all sectors of the economy. **It is also recommended that** HMGN set up a Board of Auditing Standards (BAS) to develop and enforce auditing standards in all sectors of the economy (Board of Auditing Standards to be set up under ICAN Act will formulate Auditing Standards which will be applicable to both the public and private sectors.) Accounting and auditing standards developed for private sector companies should also apply to SOEs. **It is further recommended that** the accounting standards be based on the accounting standards issued by the International Accounting Standards Board (IASB) and the auditing standards on standards issued by the International Federation of Accountants (IFAC) and the International Organization of Supreme Audit Institutions (INTOSAI) standards followed by the OAG in the audit of HMGN accounts.

CHAPTER VI

INDEPENDENT AUDITING

The Office of the Auditor General (OAG) has a strong and dedicated leadership and has set a good example of Fearless reporting. Unlike in many other countries, the OAG has forged a strong partnership with the Public Accounts Committee (PAC) to follow-up on irregularities and other accountability issues. Lack of independence on OAG's financial resources has sometimes constrained it from fully exercising its constitutional independence. OAG requires support for its capacity development, including a need for introducing modern technology and skills to upgrade its institutional capacity. OAG also needs to further enhance its professional skills in financial auditing as well as performance auditing, which is a yardstick to measure inputs against outputs and outcomes.

A. Legal Framework

6.1 Article 99 of the Constitution of the Kingdom of Nepal, 1990, requires the country to have an Auditor General (AG) appointed by His Majesty the King for a term of six years, on the recommendation of the Constitutional Council. The Constitution requires the Auditor General to:

- hold a Bachelor's Degree from a University recognized by HMGN;
- have worked for at least five years "as a special class officer" of HMGN, or have experience in the field of accounting of not less than 15 years;
- not be a member of any political party immediately before appointment; and
- be at least 45 years and under 65 years old.

6.2 The Constitution, 1990 and the Audit Act, 1991 empowers the Auditor General to:

- audit the accounts of the Supreme Court, Parliament, the "Raj Parishad" (the State Council - a top Advisory Council of State which includes the AG himself), and all organs of HMGN, as determined by law, and with due consideration given to regularity, economy, efficiency, effectiveness and propriety;
- audit the corporate bodies fully owned by HMGN;
- be consulted while appointing the auditor for auditing of the corporate bodies substantially owned by HMGN;
- issue directives to the concerned government offices, and corporate bodies wholly or substantially owned by HMGN, from time to time to make proper arrangements on matters of accounts and to maintain regularity therein;

- have access (with his assistants) at all times to all documents related to the government accounts;

- prescribe the form in which all government accounts should be maintained;

- audit the accounts of any other institution, which the law requires him to audit; and

- submit an annual report to His Majesty, who shall cause such report to be laid before Parliament.

6.3 The Office of the Auditor General (OAG) has been a member of the International Organization of Supreme Audit Institutions (INTOSAI) since 1968 and of the Asian Organization of Supreme Audit Institutions (ASOSAI) since its creation in 1979. It has also served on special committees of these international auditing bodies. The Audit Act, 1991, further elaborates on the powers and duties of the AG. One of the powers conferred on the AG by the Auditors' Act, 1974 is that of licensing all auditors practicing in both the private and public sectors of the economy.

B. Independence

6.4 Constitutionally and professionally, the AG enjoys complete and unfettered independence. His/her remuneration and other conditions of service cannot be changed to his/her disadvantage during his/her term of office. The AG's remuneration and office budget are charged directly to the consolidated fund without a Parliamentary vote. Tenure can only be terminated by attainment of age 65, death, resignation submitted in writing to, and accepted by His Majesty the King, expiry of the six year term of office, or removal on the same grounds and in the same way as a judge of the Supreme Court. The AG can be removed from office only for reasons of incompetence, misbehavior, or failure to discharge the duties of his/her office in good faith. Removal under these circumstances requires:

- Approval of a resolution to that effect by a two-thirds majority of the total membership of the House of Representatives.

- Approval of the resolution by His Majesty the King.

These two requirements, as well as the other examples of constitutional protection cited above, accord the AG a highly independent professional and constitutional status.

6.5 The only two areas in which the very commendable independence enjoyed by the AG appears somewhat curtailed are in:

- The method of determining the budget of the AG's office.

- The AG's freedom to create the number of staff positions that he/she considers necessary, and appointment of such staff.

C. Budget

6.6 In FY2000/01, the OAG spent about Rs 61.5 million, of which about 92 percent was operational cost (regular budget in Nepalese parlance) and about 8 percent was investment (development expenditure) on such items as training, experts, and equipment purchase and maintenance. While no country can realistically grant its AG an unlimited budget, it is extremely important that the budget is sufficient to enable the AG to carry out his/her constitutional duties with the degree of competence and efficiency envisaged by the framers of the Constitution. The appropriate size of budget for an AG's office depends on the agreed workload, the costs of staff and other audit inputs, the size of the country, accessibility of auditees, and other particular circumstances of each country. One thing is clear, however: leaving the size of the budget to the discretion of one of the auditees (i.e. the Ministry of Finance), as most developing countries do, is not a good practice. In Nepal, the regular (i.e., recurrent) budget of the OAG is not subject to parliamentary discussion, but the development budget is.

6.7 In order to enhance the independence of the Auditor General, **it is recommended that** the annual budget requested by the OAG should be provided without any modification. Any differences that may arise between the AG and the MOF in the budget request, should be reviewed and resolved in a tripartite meeting comprising the Public Accounts Committee of the Parliament, the Ministry of Finance (MOF) and the OAG.

D. Staff Recruitment and Conditions of Service

6.8 One of the reasons for advocating greater budgetary independence for the OAG is to enable it to hire adequately qualified and experienced expert from the open market. **It is, therefore, recommended** that :

- The AG be empowered to adjust the number and positions of his/her staff within agreed reasonable limits (e.g. by not more than a certain percentage each year or number of years). Should the AG require to create more staff (in number or position) beyond the approved threshold, a joint committee consisting of a high level representation from OAG, MOF and MOGA should be created, to recommend staff positions in OAG on the basis of "business needs";

- Develop an independent "compensation (salary and other fringe benefits) plan" for OAG professional staff in consideration of the national wage standard; and

- Review the selection criteria for staff in OAG by the Public Service Commission based on the recommendation of OAG.

6.9 As of February 2002, the OAG had a staff of about 465 of whom 396 were audit staff and the rest administrative staff. Practically, all audit staff have university degrees and some audit training. Most of the nearly 200 officer level staff have Master's Degrees in commerce or business management. There is no chartered accountant, however. OAG has granted study leave on full salary plus 50 percent allowance for tuition, books, and periodicals to six staff members to enable them to train as chartered accountants. They are bonded to serve the OAG for five years following their training, or refund the full cost to OAG.

6.10 Turnover, in general, is very low as compared to other government organizations. Although there are some records of some junior level auditors leaving to take up other jobs elsewhere, turnover at senior levels is negligible.

6.11 Staff training receives a great deal of attention. There is a training division, which organizes specialized training, sometimes in collaboration with the Nepal Administrative Staff College (NASC). Training support has been received from the Comptroller and Auditor General of India, the OAG of Canada, and the USAID Cooperation Mission. Many of the officers also receive audit training abroad. During FY1999/00, 14 officers were trained abroad, while 130 were trained in-house. In FY2000/01, in addition to the six candidates for chartered accountant qualifications (see above), 10 officers were trained abroad and 92 received training in Nepal.

E. Equipment, Vehicles, and Information Technology

6.12 Given the national dimension of its work, the OAG could use more vehicles and equipment to enable it to cover some of the more outlying districts faster and more effectively. The OAG also does not have enough computers, vehicles, or fuel for optimal operational effectiveness. The independently negotiated budget recommended above should ensure that the OAG would have adequate transport and other equipment for optimal operation. Currently, OAG is making use of its limited technology to produce its annual report. OAG has also created its own homepage in the Internet to widely share information with interested groups. For its capacity building, OAG requires support in introducing new technology, including using IT devices for staff training.

F. Auditing Standards and Guidelines

6.13 OAG has developed its own audit standards based broadly on INTOSAI and other recognized audit standards. Most of these standards (Government Auditing Standards 1996) were developed with the assistance of the WB funded TA through Institutional Development Fund (IDF) Grants. Most of the applicable standards have been published in the following OAG guidelines:

- ***Booklets***: Government Auditing Standards; Administrative Expenditure Audit Guide ; Procurement Audit Guide ; Project Accounts Audit Guide; Revenue Audit Guide; Directives of the Auditor General of the Kingdom of Nepal; Government Auditing and Office of the Auditor General - few Contemporary Issues; Code of Conduct, applicable to employees of the Auditor-General; General Directives relating to Government Auditing; Compendium of Suggestions made in the Auditor General's Annual Reports 1996-2000; Performance Audit Guide 2000.

- ***Internal Guidelines***: General Guidelines for the Audit of Revenue and Deposit; Directives for Composite Audit Team; General Directives for the Audit of Foreign Assistance (Loan and Grant); Audit Follow-up and Review System; Check-list on Account Keeping and Financial Management.

6.14 A special study (beyond the scope of this CFAA) would be needed to establish how closely the audit standards and guidelines in the above-listed documents approximate to the INTOSAI standards, on which they are supposed to be based, or to the International Standards on Auditing (ISAs) issued by the International Federation of Accountants (IFAC). Further, most of the above guidelines need to be updated in light of changes in various rules and regulations. It is also high time to revise all guidelines according to INTOSAI standards. Since INTOSAI standards are accepted worldwide (including by the WB) as the appropriate auditing standards for auditors of government accounts, it is recommended that the OAG apply the standards of INTOSAI (of which it is a member) and issue its own auditing standards only on matters for which INTOSAI standards do not exist. OAG has recently submitted a draft proposal to the WB for assistance to review the Guidelines as per applicable INTOSAI or ISA standards and to make appropriate revision to these guidelines. The request also includes provision for strengthening OAG staff training and auditing capacities.

G. Audit Backlog

6.15 The OAG's workload has been increasing over the years; so has the sophistication of the demands placed on the OAG, for example by the introduction of such innovations as Value Added Tax (VAT) and Performance Auditing. In FY1999/00, 16,385 units/entities needed to be audited and 13,869 (85 percent) accounting for total expenditures of about Rs 485 billion were actually audited. In FY2000/01, out of 16,620 units/entities that needed to be audited, 13,513 (81 percent) accounting for total expenditure of about Rs 439 Billion were actually audited. So, although the number of units to be audited increased by 235 from FY1999/00 to FY2000/01, the number of units (and the values) actually audited declined. The consequence was that the number of outstanding (i.e. uncompleted) audits increased from 2,716 in FY1999/00 to 3,107 in FY2000/01 - an increase of 14 percent. Audit backlogs date back many years, and are due to a number of reasons, principal among which is failure of auditees to submit accounts for audit in a timely manner. **It is recommended** that HMGN in consultation with OAG, prepare a time-bound action plan designed to clear all audit backlogs and to keep audits up-to-date thereafter.

H. Quality of Work and Audit Reporting

6.16 There is an **internal quality review** process, to ensure adherence to the standards and guidelines discussed above. Each unit reviews the work of another. A system has also been set up to review the audits of corporate bodies, to ensure that their appointed auditors adequately fulfill their terms of reference and apply acceptable auditing standards. There is, however, no **external quality review**. The OAG is already planning to arrange for peer review of its work by a respected private auditor outside the OAG in order to make candid assessment of OAG's work and to suggest new ideas. **It is recommended** that the OAG pursue this plan and arrange for peer review of its work by a respected private auditor outside the OAG at least once every two years, as a means of further enhancing and ensuring quality standards and bringing in fresh ideas and suggestions to improve quality. With regard to the independent audit of the OAG, the Constitution has empowered the AG to conduct the audit of the OAG. The AG currently appoints a team of his staff for the audit of his office. For greater independence of the audit of OAG, the AG is now planning to recruit a reputable private auditor outside the OAG for the external audit of his office. The AG has already submitted to the Parliament a draft proposal introducing the amendments to the Audit Act, 1991 needed to implement this external audit. This is indeed a positive move, and **it is recommended that** the AG recruit a reputable private auditor starting from FY2002/03.

6.17 The OAG's Annual Report is typically published in the following four volumes:

- Volume 1 - Budget appropriation, revenue, deposit and other income-expenditure of the government offices.
- Volume 2 - Performance Audit.
- Volume 3 - Corporate Bodies, Boards, other institutions and District Development Committees.
- Volume 4 - Financial statements of appropriation, revenue and deposit of the government offices.

6.18 In addition, the OAG prepares a fairly detailed summary - typically more than 100 pages long - which, because it is now usually translated into English, is the most easily accessible part of the OAG Annual Report. The summary is long and detailed enough to provide a reliable flavor of the OAG's findings. Although there is no formal opinion page or paragraph as such, the AG's statements in various parts of the summaries lead to the conclusion that most of the figures reported in the HMGN accounts and financial statements could not be relied upon as presenting a true, fair, or realistic view of government incomes and expenditures. In traditional audit parlance, the AG's opinions, for both FY1999/00 and FY2000/01, could be described as, at best a disclaimer of opinion, and, at worst an adverse opinion.

I. Recent Reliability and Timeliness

6.19 The Financial Procedures Act 1999 requires Ministries to submit their accounts to the OAG within three months following the end of the fiscal year, and the FCGO to submit the HMGN consolidated financial statements within six months. However, neither the Constitution nor any legislation or regulation prescribes a time limit for the publication of the audited financial statements or the auditor's report. Every year, the OAG issues the timetable for submitting the various reports, and for issuing its own report and it usually adheres to that timetable. In FY2000/01, about 2 percent of auditees did not submit their accounts for audit, and another 2 percent submitted them late. In both FY1999/00 and FY2000/01, the AG's report was discussed with the PAC early enough for the PAC to be able to send HMGN recommendations for the improvement of the accounting system by May following the end of the fiscal year (July 15) (i.e. within 10 months). This is a fairly commendable record of timeliness, for a developing country.

J. Reporting Destination and Follow-up

6.20 The AG's report goes directly to His Majesty the King, not to HMGN, or anyone in the executive branch of government. The Constitution requires His Majesty to lay the report before Parliament. As will be discussed more fully in the next chapter, the PAC receives and discusses the AG's report and has at least in FY1999/00 and FY2000/01, issued instructions to HMGN to implement the AG's recommendations. The OAG's report is a public document available to any member of the public on request, free of cost. By all standards of international practice, Nepal scores high on both the level to which the AG reports, and the action taken by those to whom he reports. The CFAA team could not obtain confirmation precisely on how many of the PAC instructions to HMGN have been complied with. Although OAG keeps track of the status of such PAC instructions, there is no systematic system in OAG or in HMGN to closely monitor the implementation of recommendations. The evidence available, however, suggests that most irregularities within the power of the auditees are cleared quickly and the relevant offices inform the PAC and the OAG of compliance. Those that are difficult (e.g., requiring legislation) could drag on for much longer, however.

6.21 The OAG is progressively improving its approach to auditing and presenting audit observations. This initiative of the OAG should gradually improve the quality of its report. The OAG has been reporting on specific types of irregularity since 1998. The AG's Annual Report 2001 has pointed out that about 48% of the total irregularities are of the nature that can be realized[11] if there is a strong monitoring and follow-up system in the Government. His report has strongly recommended the Government to take action and settle irregularities, for example, with respect to revenue arrears (31%), reimbursable foreign grants and loans (11%), and dividends receivable from corporate bodies and other receivables (2%). The nature of the realizable irregularities suggests that they are results of negligence, deliberate intention, inefficient internal control or internal audit system, or lack of monitoring and follow-up. Annex 19 of the OAG summary report provides the details of irregularities by entity and by type of irregularities. It has also classified the irregularities which can be regularized and those which are of the nature of embezzlement.

[11] Definition of Realizable Irregularity explained in footnote 8 of Chapter V.

6.22 OAG Annual Report 1999 has defined various types of irregularities[12] under 8 major headings as follows: ***Irregularities to be Recovered***: (1) **Misappropriation and Embezzlement** (e.g. nature of embezzlement of cash, misappropriation of cash and assets, forgery documents, fraud etc.); (2) **Other recovery to be made** (e.g. collection of less revenue than required by existing laws, not collecting required fines, charges or additional charges as per existing laws; over expenditures than authorized by existing laws, providing more facilities than authorized by specific laws etc.); ***Irregularities to be Regularized***: (3) **Not regularized** (e.g. irregularities pertaining to non-compliance with given authority, incurring expenditures beyond authority or ceiling, conducting transactions not following the regulations etc.); (4) **Loss or wastage** (e.g. loss or wastage incurred due to delay in decision making, loss caused due to negligence or wrong plan or design etc.); (5) **Supporting Documents not presented** (e.g. lack of supporting documents with income/expenditure accounts, lack of contract agreement or procurement related decisions etc.); (6) **Revenue balance not carried forward** (e.g. failure to carry forward cash and goods required for next year, revenue arrears not carried forward, and advances not carried forward); (7) **Outstanding Reimbursements** (e.g. reimbursements not requested on time from respective donors and replenished to government's concerned account, goods or other assets taken on loan but not returned on time etc.); and ***Advances to be settled:*** (8) **Outstanding Advances** (e.g. non-settlement of any form of advances provided to employees, institutions, officials etc. by the end of fiscal year).

6.23 Irregularity figures published by the AG in his report appear to be alarming. Annex 20 of the AG's Annual Report 2001 estimates cumulative irregularity figures as of 2001 Report, as NRs 26.40 billion. This can be substantially minimized by (a) improving overall financial management system by HMGN, and (b) establishing an effective monitoring system to verify the clearing of irregularities by each entity based on AG's report. With regard to the first, an integrated approach towards improving the overall public sector financial management addressing the issues of planning, budgeting, accounting, internal control and internal audit (recommended in various chapters) will minimize the irregularities. With regard to the second, an effective monitoring system can be developed by HMGN and there are various options, of which, the following are the key ones: (i) Strengthen the capacity of MOF to monitor against reported irregularities and periodically report on the action taken, (ii) Strengthen the capacity of OAG for the same function (but this will be an additional responsibility for OAG and may not fall under its jurisdiction), and (iii) Strengthen the capacity of PAC Secretariat with sufficient staff and office infrastructure to allow the PAC to monitor the AG's recommendations on a selective basis based on materiality.

6.24 Of these options, it makes the most sense for this capacity to be established in MOF, with the PAC overseeing the follow-up actions taken by MOF. This monitoring function should include the status of the following: (a) audit backlogs and action plan to keep all audits up-to-date, (b) revenue realization, (c) clearing reimbursable grants and loans, (d) tax deduction at source, (e) repayment of principal and interest made by HMGN on guaranteed loans but not recovered from concerned institutions, (f) dividends receivable, and other receivables, from corporate bodies and boards, (g) amounts to be paid by HMGN to various entities, and (h) follow-up on the recommendations of the PAC.

6.25 The AG's Annual Report of 2001 also reveals that out of total irregularities reported amounting to Rs 8.12 billion, about 19.86% is reported to be embezzlement, overpayment and under-realized, about 58.93% to be regularized, and about 21.21% accounts for uncleared advances. Of the total audited transactions of about Rs 122.85 billion, the average amount of irregularity is about 6.6%. It also reports that progress was noted in clearing the irregularity

12 These classifications were not defined in Annual Reports 2000 and 2001.

in 2001 which reported about 29 percent of irregularities cleared up from about 17 percent in 2000. Recovery of cash reported in AG's Annual Report 2000 was about Rs 1.11 billion and about Rs 519.58 million in 2001 -- as a result of follow-up actions taken by the auditees on audit observations. According to the same report, the Ministry of Finance accounted for the highest irregularity with about 39%, followed by the Ministry of Physical Planning & Works and the Ministry of Water Resources with about 10% each.

K. Implementation of OAG Recommendations

6.26 The OAG makes all best efforts to report its findings and recommendations for improvement in overall financial management. But, most often its recommendations do not get timely implemented due to which most recommendations reported in earlier years get repeated in successive annual reports. OAG's reporting on overall financial irregularity picture is getting serious year by year due to inadequate attention to the issues raised by the AG in his report. Increasing irregularity figures may reflect a negative financial picture. Inadequate focus and attention to issues and suggestions made by the AG may be due to insufficient political and bureaucratic commitment. Inability to prioritize the recommendations by the auditees may often dilute their required attention to translate them into actions. Based on observations of the Summary of the OAG Annual Report, all recommendations seem to have been accorded equal weight. It is important that each auditee should be accountable to prepare a time-bound action plan to rectify issues or implement suggested recommendations[13] made by the AG in his report. The Chief Accounting Officer of each line ministry (the Secretary) should ask all subordinate offices/units under the ministry, for action plan to rectify issues raised by the audit. Each subordinate offices/units should submit their action plans to the Secretary of the concerned Line Ministry and copy to the MOF and the OAG. As suggested in paragraph 6.24, the MOF should then monitor the implementation of such action plans of all ministries. These efforts should help to reduce the volume of irregularities.

L. Performance Auditing - Linking Expenditure to Outputs and Outcomes

6.27 The Constitution of the Kingdom of Nepal 1990, the FAR, and the LSGA, all require that public expenditures be directly linked to, and justified by, the outputs or outcomes resulting from them. Performance auditing is one of the ways of independently confirming this linkage, because it looks beyond issues of regularity and compliance, to delve into the efficiency, effectiveness and economy with which public expenditures attain their objectives.

6.28 The OAG started performance auditing in FY1990/91, but real progress only came about with the issue of "Performance Audit Guide" in 1995. In 1999, an IDF grant of $300,000 from the WB financed technical assistance to OAG by the international accounting firm, KPMG, which issued its final report on the project on April 14, 2000. This report was the basic document discussed in a National Workshop, which brought together heads of constitutional bodies, and participants from the WB, ADB, UNDP, MOF, FCGO, the Chairman of the PAC and project managers.

6.29 The OAG carried out performance auditing of three pilot projects in FY1999/00. The Deputy Auditor General of Malaysia was invited to Kathmandu, and contributed to the evaluation of the quality of the performance audit of the three pilot projects. He also provided a favorable Peer Review Report on the Nepal OAG. Thereafter, OAG staff were trained in

13 AG's recommendations are generally of two types – preventive type to improve observed deficiencies in the system, and curative type to regularize the observed irregularity.

performance auditing. On the basis of all these experiences, a new Performance Audit Guide, prepared with the assistance of KPMG, was issued in July 2000.

6.30 The number of government projects activities and entities subjected to performance audit has fluctuated, with a noticeable growth over time, as follows: 1997:16; 1998:37; 1999:47; 2000:48; 2001:29. In FY2000/01, it was decided to de-emphasize number of audits done, but to focus more on quality. As a result, OAG targeted 40 activities, but completed the audit of only 29. One of the reasons for the shortfall was a realization that the results or outcomes of many projects do not become evident in the year of expenditure. Results appearing in subsequent years will be recorded in performance audits of those years.

6.31 The 29 entities audited for performance in FY2000/01 are listed, and the main results of the audit are summarized in the OAG Report, 2001. The OAG's performance audit reports contained in its 2001 Summary Report are quite impressive and informative. The activities are diverse, ranging from the collection of taxes, fines and the Customs Office to several agricultural, irrigation, water supply and management, forestry, transport, health, electricity and tourism projects and institutions as well as the Central Archives, the Social Welfare Council, the Free Books Distribution Program and the Foreign Employment Promotion Program.

6.32 Performance auditing, because of its focus on results and outcomes, calls for skills beyond accounting and financial management. To be able to audit the performance of the activities and institutions listed above, OAG temporarily recruited the services of electrical, mining, civil and irrigation engineers, as well as environmental and mechanical engineers, and of a hydrologist.

6.33 The results were worth the effort. These performance audits are the most reliable indicators to date of the links between expenditure and results required by statutes and regulations. Until all the various HMGN institutions comply with such legal provisions, the OAG performance audit reports should receive considerable attention as independent indicators of outcomes, results and effectiveness of government expenditure. The OAG is also right to focus on quality of coverage rather than on superficial coverage of an ever-increasing number of activities and institutions. If, however, most donors were to move to budgetary support, a substantial increase of the OAG performance auditing coverage might be necessary. This should be matched, and the need for it could be minimized, by increased compliance with existing legal provisions by the auditees themselves.

6.34 The concept of performance auditing is relatively new to Nepal. Many auditees have not yet realized the benefits of a few performance audits that has been carried out by OAG. The OAG reports its findings and recommendations of performance auditing of various units or projects or centers in a separate volume. The PAC instructs the respective line ministries or agencies to implement the recommendations of such reporting. But, in reality, there is inadequate system or mechanism to monitor the implementation of recommendations of performance auditing. It has not yet received a full recognition by auditees to translate the suggestions made in the report into the development or refinement of sectoral policies. For output and outcome based monitoring, performance auditing is one of the key tools which help policy makers to translate the suggested actions into policy framework, and these should be considered seriously if sectoral benefits are to be realized.

M. Recommendations

6.35 The OAG has many strong points, including: unfettered statutory and professional independence; a dedicated team of staff; strong, dedicated and fearless leadership; transparent approach of disseminating AG's report to the civil society and through its web page; and an unusually effective and supportive PAC, with which it has forged an enviably close relationship. The most significant weakness is the lack of independence in its budget due to MOF control of the OAG budget (and therefore its operational capacity). Capacity for performance auditing is also still quite limited in relation to demand, and the effectiveness and implementability of the reports could be improved.

6.36 **It is recommended that**:

HMGN:

- Increase the OAG's independence by granting the budget requested by OAG without any modification. Any differences that may arise between the AG and the MOF in the budget request, should be reviewed and resolved in a tripartite meeting comprising the Public Accounts Committee of the Parliament, the MOF and the OAG.

- Increase the OAG budget substantially to cope with the needs for more training, equipment, and expertise, particularly for compliance auditing. OAG should work out an independent "compensation plan".

- Empower the AG to adjust staff members within an agreed limit. If more staff than the agreed numbers are required, OAG in close coordination with the MOF and the MOGA determine staff positions as per "business needs".

- Strengthen the capacity of the line ministries to be able to effectively monitor their programs and also establish a monitoring and follow-up system to monitor audit backlogs and the clearance of irregularities, and periodically report on their status (details described in paragraphs 6.21-6.26), including development of time-bound action plans by respective auditees for rectification of issues or implementation of suggested actions for financial management improvement.

- Set priority to the recommendations relating to performance auditing and develop action plan to translate the recommendations into actions and also into the development of sectoral policies, as appropriate.

The OAG:

- Review its audit guidelines to comply with the INTOSAI auditing standards.

- Arrange for an external peer review of, and report on, its work at least once every two years by a reputable private audit firm.

- Arrange for OAG accounts to be audited independently each year by a reputable private sector auditor.

- Develop Human Resource Development Plan including the strengthening of its training division to create a strong and fully equipped training unit capable of providing quality training to its staff.

- Provide exposure to senior officials of OAG through carefully planned, monitored, and evaluated programs of short term training secondment and training exchanges with well-developed SAIs abroad and “twinning” with another successful SAI.

- Improve the quality and effectiveness of its auditing by decentralizing its audit function through the setting up of field offices, which can liaise more closely with DTCOs, thereby reducing the number of irregularities (this recommendation goes on parallel with the recommendation made in Chapter IV with regard to reducing the number of administrative, local and regional offices including DTCOs).

CHAPTER VII

OVERSIGHT ARRANGEMENTS

Various agencies are playing a pivotal role in oversight function of the public financial accountability. A good practice example is the collaboration between the Office of the Auditor General (OAG) and the Public Accounts Committee (PAC). The PAC has been extremely supportive in efforts to get the OAG's audit findings and recommendations implemented. Both OAG and PAC require support in their capacity building to enable them to prioritize the follow-up actions. The Commission for the Investigation of Abuse of Authority (CIAA) is the supreme autonomous body responsible for control of corruption and abuse of office, and the Government is strengthening the CIAA through several anti-corruption bills which have recently been approved by the Parliament.

A. Role of Civil Society

7.1 The role of civil society organizations, including Nepalese and international non-governmental organizations (NGOs) (see chapter XII) and sister or affiliated concerns of the political parties, has increased spontaneously since the promulgation of the multi-party Nepal Constitution, 1990, which guarantees freedom of association. The Civil Rights Act, 1955, accords citizens the right to sue the State in a court of law for infringement of their civil rights. In addition, HMGN has introduced several statutory and administrative measures designed to make government more pro-public, transparent, efficient, and accountable.

7.2 Nepalese civil organizations working to reduce corruption and increase financial accountability, transparency, and public information include: Transparency International of Nepal (TIN), Public Administration Association of Nepal (PAAN), and Federation of Nepalese Chambers of Commerce and Industry (FNCCI). The 24-point TIN resolution and the 14-point PAAN demand for corruption control, were publicized in the late 1990s. The political parties affiliated concerns are more vocal against corruption, non-transparency, non-accountability and undesirable behavior of public servants.

B. Role of the Press

7.3 Although the Constitution guarantees the press freedom of opinion, expression, and information, the press is, nevertheless, subject to regulation and restriction under the Press Council Act, 1991, the Press Publication Act, 1991, and the Journalist Code of Conduct, 1998. Some of the mass media are said to be under the control of political and other vested interests, corrupt or otherwise unethical.

7.4 One of the greatest difficulties in assessing the freedom of the press to call for transparency and condemn corruption and financial abuses is that it is often difficult to ascertain how much curtailment of press freedom is due to efforts to hide corrupt practices and how much results from efforts to contain Maoist attacks on the government and fight irresponsible journalism. Although there have been reports of journalists being jailed for publishing allegations of corruption, particularly within the judiciary, such allegations, as well as other articles critical of government officials, appear in Nepal's press almost everyday.

7.5 **It is recommended that** HMGN thoroughly investigate allegations of corruption including allegations against the judiciary, publish the findings of such investigations in the daily newspapers, and take actions against any officials found guilty of corruption, as well as against any person found to have published baseless accusations.

C. Official Oversight Arrangements

7.6 Nepal has had several oversight institutions over the years, which may be classified as:

- ***Government Bodies***: (i) Special Police Department (SPD); (ii) District Administration Offices (DAOs); and (iii) Revenue Investigation Department (RID).

- ***Constitutional Bodies***: (i) Commission of Investigation of Abuse of Authority (CIAA); (ii) Judicial Commission (JC); and (iii) Office of the Auditor General (OAG).

There is also the Public Accounts Committee (PAC). The CIAA, PAC and OAG are discussed in separate sections of this chapter, while the three government bodies are discussed in the rest of this section.

7.7 The Special Police Department (SPD) is a subordinate organization of the Ministry of Home Affairs, established in 1953, as the Anti-Corruption Department, under Nepal's first Corrupt Practice (Abolition) Act, 1953, which was repealed by the Public Servants Prevention of Corruption Act, 1956. The SPD's role has been considerably reduced since 1977, mainly due to the establishment of other anti-corruption agencies and the Supreme Court verdict of 1996. **It is recommended that** the SPD be absorbed by the CIAA.

7.8 The District Administration Offices (DAOs), basically law and order maintaining government offices in the whole Kingdom of Nepal, are used by the HMGN Ministry of Home Affairs to carry out anti-corruption activities in the 72 districts outside the Kathmandu valley (out of the 75 in Nepal as a whole). They investigate corruption cases under authority delegated by the CIAA. They have very limited capacity and resources for anti-corruption work and their role should be limited to remote and specially designated districts after the creation of CIAA regional offices.

7.9 The Revenue Investigation Department (RID) was established by MOF in 1993, and operates under the Revenue Leakage (Investigation and Control) Act, 1995. The RID is empowered to investigate government revenue leakage and corruption cases involving the revenue-service personnel of the civil service and other accused persons. The Corruption Control Suggestion Committee (CCSC) in 1999 suggested that the RID should be dissolved after the establishment of the proposed "National Vigilance Center" under the Prime Minister's Office with the basic responsibility of investigating and controlling corruption.

D. Role of the Office of the Auditor General

7.10 The role, status and functions of the Auditor General (AG) have been extensively discussed in Chapter VI above. In many respects, the AG of Nepal is more powerful and influential than that of most other countries. Three simple examples illustrating this influence are that the AG:

(a) sits on the Raj Parishad (the State Council) - one of the most prestigious councils of State in Nepal;

(b) licenses all auditors in the country, including those practicing in the private sector - perhaps the only country in the world in which this happens;

(c) approves the accounting and reporting systems of the government, instead of just reporting on them 'ex post'. This unusual "privilege" may, however, involve a conflict of interest, as the AG may be required to pronounce judgment on a system he had approved 'ex ante'.

Also, as pointed out in Chapter VI, judging by audit reports of the last two years, the OAG apparently does a thorough and commendable job, and the AG's reports, even in summary form, give the reader a good appreciation of the status of government accounting and reporting.

7.11 One of the key tests of the effectiveness of a Supreme Audit Institution (SAI) is the follow-up action taken by government to implement the auditor's recommendations. This action is usually beyond the influence of the SAI. But, even in this difficult area, the AG of Nepal has succeeded in greatly improving the chances of his recommendations getting implemented. He has done this by forging an unusually close and successful alliance with the Public Accounts Committee (PAC), whose role is discussed in the next section.

E. Role of the Public Accounts Committee

"The PAC has been performing its role as an important instrument for cautioning the government in enforcing financial discipline by observing and creating awareness of responsibility at every level of government and the public sector. It has been taking special interest in my annual report and prodding the government through section-wise comprehensive discussions on the report."

- *Auditor General's Annual Report, 2001: Executive Summary*

7.12 The PAC is one of nine parliamentary committees of the House of Representatives formed under the House of Representatives Rules, 1997. It is headed by a member of the main Opposition Party. Its membership, which includes all the parties represented in Parliament, is usually 25, but may vary from time to time. For example, during CFAA team's field visit, there were only 16 members, as several members had recently been appointed Ministers. Normal tenure is five years (like Parliament's) and the PAC meets all the year round.

7.13 PAC functions, described in the House of Representatives Rules, 1997, are to:

- examine HMGN accounts as it thinks fit, and
- discuss OAG's report.

Seven sub-committees discuss various aspects of the OAG report, report back to the full PAC, which reports to Parliament. The PAC also monitors progress reports on budget implementation. Many Ministries write to acknowledge PAC request and report actions they have taken in response. The PAC also investigates financial operations, including procurement, while the operation is still on-going, and intervenes if it suspects, with sufficient reasons, any malpractice or lack of transparency.

7.14 The collaboration between the OAG and the PAC is exemplary. The PAC has been highly supportive in efforts to get the OAG's audit findings and recommendations implemented. Highlights of the OAG's Annual Report for 2000 were presented to the PAC on August 24, 2000, and were followed by two more presentations on August 31, and September 1, 2000. Thereafter, a committee was formed with the Joint Financial Comptroller General as the Coordinator, and members from the OAG, Ministries of Finance, Law and Justice, and Parliamentary Affairs, and the Secretary to the PAC to study some of the OAG's recommendations. Following the committee's report, the PAC issued directives to the government on May 4, 2001, to implement 31 specific recommendations dealing with a very wide range of changes.

7.15 Earlier, following the OAG 1999 Annual Report, the PAC decided on May 16, 2000, to support the implementation of 38 specific recommendations of the OAG, dealing with a broad range of accounting, reporting and internal control issues, and directed the Cabinet Secretariat to implement them. These 38 actions concerned HMGN ministries and departments; 13 additional actions were sanctioned for public corporations and committees. The importance of these PAC activities on efforts to improve public accountability and transparency can be gauged from the following words from the AG's 2001 Annual Report Summary:

> *"Decisions of the Committee (i.e., the PAC) and comprehensive discussions on other points and suggestions given in the report have enhanced effectiveness of the points and suggestions made in my Annual Report and have given further inspiration towards improving the auditing standard. The activities of the Committee are expected to increase in the future. I am confident of receiving invaluable cooperation from the Committee in the coming days."*

7.16 One nagging question is: how many of the 82 specific directives of the PAC in the last two years were actually implemented? One or two of the directives contained strenuous efforts to ensure compliance. For example, one directive required that all audit transactions shall be carried out in proper time, and the audit of the backlog should be completed within six months. Furthermore: "details of actions taken by office chiefs and staff who have not submitted documents or accounts as per directives of the Committee or have failed to submit clarification of irregularity in time shall be submitted to the committee by mid-July 2000." A review of the compliance records maintained by the PAC and OAG suggests that corrective actions within the capacity of the audited department are dealt with fairly promptly, and reported back to the PAC. Actions (e.g. legislative changes) beyond the competence of the audited department could drag on, however. Responses to OAG and PAC exhortations to refrain from certain actions or behavior only show up in subsequent years. Because none of these records distinguishes weaknesses according to their materiality, it is hard to judge the impact of compliance or non-compliance by concerned departments.

7.17 **It is recommended that** HMGN undertake a study with a view to establishing how many of the 82 directives issued by the PAC on the basis of the OAG audit report findings in FY1998/99 and FY1999/00 have been implemented. The report of the study should be made available to all members of the Nepal Development Forum. There is a general perception that the PAC sometimes gets involved in executive type functions interfering in the decision-making affairs of the government, state-owned enterprises, and other public institutions. If proactive involvement of the PAC during the implementation process has helped in many respects to check any malpractices or misdeeds, it has also caused severe delays in decision-making with negative effects on development. In this respect, the PAC's role should be more of a guiding agency during implementation, and should be involved in serious malpractice operations where post-mortems are required.

7.18 Meetings of the PAC are open to members of the press who report on PAC activities almost on a daily basis. The combination of the OAG and the PAC currently represents the most effective financial accountability oversight in the country. It deserves to be strengthened.

7.19 The PAC is currently benefiting from a $80,000 technical assistance grant from the Danish Fund on Governance executed by WB. The purpose of the Grant is to assist the Parliament Secretariat, through the PAC of the House of Representatives, undertake an initiative of Consensus Building for Public Expenditure Reforms through the development of key monitorable performance indicators for expenditure and development outcomes, focus group meetings, orientation sessions and workshops and follow-up on the AG's Annual Report. The PAC's need for capacity building, however, far exceeds what could be financed by that grant. More funds are needed for: more office space to protect PAC documents; a more appropriate meeting room with recording facilities; an information center to facilitate public information; more and better trained staff to analyze information, monitor HMGN responses, and inform the public; computer equipment; more administrative and technical staff; and exposure to successful PACs in other countries.

7.20 **It is recommended that**:

(a) HMGN:

- carry out the study recommended in paragraph 7.17 above; and
- seek grant funds to finance the capacity building described in the preceding paragraph; and that

(b) the PAC:

- classify its report and requests in the manner suggested for the OAG (Chapter VI), establishing priorities, responsibilities, and time frames, and translate summaries of its directives and reports into English, to facilitate its international collaboration with other PACs, and such a report should be published on a half-yearly basis.

F. Role of the Commission of Investigation of Abuse of Authority

7.21 The CIAA is the supreme autonomous body responsible for control of corruption and abuse of office. It is the only Nepalese institution mandated to prosecute corruption cases. It was established by Article 97 of the Constitution to conduct inquiries or investigations of improper conduct or corruption by a person holding public office. The Chief Commissioner and Commissioners are appointed by His Majesty the King on the recommendation of the Constitutional Council. A Commissioner must:

- be neither younger than 45, nor older than 65 years of age;
- hold a Bachelor's Degree from a University recognized by HMGN;
- have at least ten years of experience in one or more of the fields of law, accounting, revenue, construction, development or research;
- be "a distinguished person"; and
- not be a member of any political party immediately before appointment.

7.22 Commissioners for the CIAA are appointed for a term of six years. Their appointments may be renewed, but they may not subsequently be appointed to any government office. Their remuneration or other conditions of service may not be altered to their disadvantage while they are in office. A Commissioner can be removed from office only on the same terms as a Judge of the Supreme Court, i.e., only for misconduct, incompetence or failure to perform his/her functions, and only on the vote of two-thirds of the members of the House of Representatives.

7.23 If the CIAA finds any public official guilty of improper conduct (defined by the CIAA Act, 1999), the CIAA may: admonish the public servant; or recommend that the appropriate authority take departmental or other appropriate action against the official. If the CIAA finds a public official guilty of any action defined by law (the Anti-Corruption Act, 1960) as corrupt, the CIAA may bring (or cause to be brought) action against the guilty official in a court of competent jurisdiction. The Constitution requires the CIAA to submit a report on its activities annually to His Majesty the King, who is required to lay the report before Parliament.

7.24 The CIAA still does not have the authority to investigate judges, CIAA Commissioners, Auditor General, members of the Public Service Commission, or members of the armed forces. The Bills (see paragraph 7.26) recently approved by the Parliament but still awaiting endorsement by His Majesty the King, empower the CIAA to investigate or accuse these constitutional authorities after they have been relieved of their posts by process of impeachment by the Parliament in accordance with the Constitution, 1990. Special powers conferred on the CIAA by the Anti-Corruption Act include seizure of goods and documents, issuing of arrest warrants, and detention. The CIAA may also call on the police or other government authorities to assist with its investigations.

7.25 According to the CIAA's 11th Annual Report FY 2000/01, the CIAA received 900 new complaints and brought 361 outstanding cases in FY 2000/01 against 407 complaints and 452 outstanding cases in FY 1999/00. With regard to clearance of such cases, the CIAA settled 698 cases in the FY 2000/01 in comparison to 498 cases in the previous fiscal year. This shows the increased capacity of the CIAA. Traditionally, only about 8 percent of total cases have been subject to comprehensive investigation. In the past, more than 95 percent of cases filed by the CIAA have been unsuccessful, and only 10 of the 31 cases filed in various appellate courts have been successful. Reasons for the low success rate include inadequate investigation, non-observance of the legal processes, and ambiguities and uncertainties in applicable laws. More recently, the overall success rate in prosecutions is reported to have improved to about 50%.

7.26 Several Anti-Corruption bills (CIAA Bill 2002, Corruption Control Bill 2002, and Impeachment (regularization of the procedures) Bill, 2002) recently approved by the Parliament contain provisions for anti-corruption measures including the strengthening of the CIAA. **It is recommended that**:

- HMGN
  - considerably increase the budgetary, physical and human resources available to the CIAA (it is currently being assisted by the ADB, Danish Cooperation Fund, and UNDP, but this assistance should be extended and augmented).
  - authorize the CIAA to investigate the Auditor General, and members of the Public Service Commission.

- CIAA
  - prepare a plan for the phased establishment of regional offices,
  - formulate and implement a human resource development program,
  - strengthen its use of modern scientific investigation skills, and improve its intelligence system, and
  - improve the coordination of its activities with those of other anti-corruption agencies.

G. Oversight by the Judicial Council

7.27 The Judicial Council (JC) is a statutory body created under the Article 93 of the Constitution, 1990, for conducting personnel administration of the Judges and for working as recommending body for judicial administration. The JC is also empowered by the Judicial Council Act, 1990, to investigate charges of corruption, misconduct or indiscipline against judges of Appellate and District Courts, but not against judges of the Supreme Court who are subject to removal by a two-thirds majority of Parliamentary votes and Royal consent. The JC is headed by the Chief Justice of the Supreme Court, with the Minister of Justice and the two most senior judges as 'ex-officio' members plus a jurist nominated by His Majesty the King.

7.28 The JC's investigative mechanism is an Investigation Committee to be established after preliminary investigations. The JC may, on approval of His Majesty, file charges in an Appellate Court against an accused corrupt judge.

7.29 It is unclear, however, what impact the JC has had on perceived corruption in the judiciary, about which there are frequent reports and allegations in the press. It is unknown, for example, how many judges have been removed from office as a result of JC action.[14]

7.30 **It is recommended that** HMGN**:**

- Sustain the JC as also an anti-corruption agency.
- Empower the JC to act against all judges, including the Chief Justice of the Supreme Court.
- Strengthen the JC Secretariat to cope with anti-corruption issues.
- Provide for the JC to request the CIAA to investigate any judge.
- Require publication of the JC's Annual Report.

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[14] It is noted that 14 Judges of Appellate and District Courts were taken some sort of actions since 1993.

H. Oversight by Transparency International of Nepal

7.31 Transparency International of Nepal (TIN) is an NGO dedicated to curbing corruption, and promoting public accountability, transparency, and integrity. It was established in 1996, registered at the Kathmandu District Administration Office as part of Transparency International, the world's leading anti-corruption NGO established in Berlin in 1993.

7.32 TIN has developed a code of conduct for its members. Its General Assembly is the apex body, which elects the Executive Committee responsible for the day-to-day running of TIN. It conducts a dialogue with parliamentarians, the PAC, CIAA, and OAG, and generally reinforces pressures in civil society in favor of transparency, probity, and integrity in public affairs. It has not developed either a Corruption Perception Index (CPI) or a Bribe Payers Index (BPI) for Nepal. It is surprising that despite all the talk of endemic corruption in the country, Nepal does not feature among the 91 countries covered by the CPI.

7.33 TIN is receiving financial support from the Swiss Agency for Development and Cooperation (SDC).

PART C:

FIDUCIARY RISK ASSESSMENT

CHAPTER VIII

FIDUCIARY RISK

Some fiduciary risks of Class A (i.e., visible from records) are failures to comply with a fairly comprehensive system of internal controls, poor procurement practices, failure to comply with financial procedures, and failure to tie expenditures to outputs and outcomes. Many of these risks are also related to low capacity, motivational factors and inadequate coordination between various agencies. With the possible exception of procurement risks, the bulk of these Class A risks result, not from faulty design or legal framework, but from failures to comply with that framework. These risks can be mitigated only through the government's firm commitment to Implement….. Implement ….and… Implement, what already exists in the system. Recommendations made in the analysis of various chapters give direction to mitigate these risks. Support for programmatic lending or budgetary support should be contingent on the government's commitment to reform, moving from the current culture of non-compliance to improved environment of compliance.

A. Nature of Fiduciary Risk

8.1 Fiduciary responsibility is the obligation of someone to whom funds have been entrusted for a particular purpose to ensure and demonstrate to the funds' provider, that the funds have been applied to their intended purpose. HMGN owes this responsibility to the Nepalese people. The WB and ADB, for example, owe it to their shareholders and member countries. Bilateral donors owe it to their governments and taxpayers.

8.2 Fiduciary risk is anything that threatens to divert funds to uses other than those for which they were intended by their providers. There are two basic classes of fiduciary risk:

- **Class A** – visible from records, and
- **Class B** – invisible, or hard to detect, from records.

Class A Fiduciary Risk

8.3 This is the risk discussed by the bulk of every CFAA. Its assessment involves a review of the planning and budgeting, internal controls (including procurement and internal audit), bookkeeping and accounting, financial reporting, and independent auditing systems, and their capacity to prevent the diversion of funds to unintended or unauthorized uses.

8.4 Other possible sources of Class A fiduciary risk in Nepal include: failures to comply with the HMGN's fairly comprehensive system of internal controls; poor procurement procedures; and failure to tie expenditures to outputs and outcomes, as required by the country's Constitution, legislation, and other statutes. With the possible exception of procurement risks, the bulk of these Class A risks result, not from faulty system design or legal framework, but from failures to comply with them. Most of the recommendations in this CFAA are, therefore, aimed at improving compliance, rather than at creating new laws or systems.

8.5 Fiduciary risk is considered high in Nepal on the basis of international "best practice" in financial management observed in most developed countries. The failure to comply with the impressive legal and regulatory fiduciary framework that exists makes fiduciary risk in Nepal "High" by the standards of that same framework, whose faithful implementation would have brought risks closer to "best practice" standards found in developed countries. This level of fiduciary risk in Nepal is, however, similar to the level in many developing countries. A common finding of CFAAs carried out so far in other WB borrower countries is the failure to comply with financial legislation and statutes. Every other weakness discussed in this CFAA exists in those countries to a greater or lesser extent. This is why the WB has found it necessary to "ring-fence" the projects it finances in most of these countries, by demanding more rigorous accounting and auditing standards for them than are found in the government system as a whole. As will be explained at the end of this Chapter, the objective of the recommendations in this CFAA is to widen the "fence" until it includes the whole of HMGN. When that happens, all of HMGN will comply with the existing legislative and regulatory framework. Fiduciary risk will then be reduced all round, and there will be no further need to "ring-fence" specific projects.

Class B Fiduciary Risk

8.6 The collapse of the ENRON empire has reminded everyone that it is possible to have an ultra-modern computerized accounting system, books that are neatly balanced, and financial statements certified by one of the most respected auditors in the world - all in a system that is essentially rotten at the core. Bribes, for example, represent a Class B fiduciary risk not detectable from the books. The auditor is only a watchdog, not a bloodhound.

8.7 Unfortunately, Class B fiduciary risks are often dismissed by the omnibus term "corruption". But, corruption can mean many different things. Every time people claim to be doing things according to certain rules, but deviate from those rules, they are being corrupt. From this viewpoint, corruption is in every human organization and in every home, and everyone is guilty of it from time to time. Examples of corruption include: bribery (*providing an inducement in cash or kind for someone to break the law or regulations*); theft (*misappropriation or diversion of funds or goods*); fraud (*failure to deliver promised value for a consideration received*); breaking the law (*while others comply*); lack of accountability (*for funds, resources, political power, etc*); and lack of transparency (*no one can tell what is happening with regard to the other five examples of corruption mentioned above*).

8.8 Some forms of corruption, for example, theft and lack of accountability are actually Class A fiduciary risks capable of detection from records, while others (e.g., bribery) are Class B fiduciary risks incapable of such detection. Thus, a discussion of corruption without specifying which type is often, at best, a waste of time, and at worst, a source of confusion and misunderstanding.

8.9 In Nepal, hardly a day passes without a newspaper reporting on some form of corruption. Allegations include: bribes for jobs with any kind of power or influence, including for lucrative positions in a donor-funded project or other offices; bribes to win construction or supply contracts; insider loans that have nearly bankrupted two state-owned banks; bribes to tax officers and customs officers to avoid paying taxes; bribes to get the job of tax collector or tax officer; and various types of corrupt practices by members of the judiciary.

8.10 None of the above allegations is unusual in a developing country. It is also difficult to verify many of them. It is harder still to quantify them or identify the sources of funds for these activities or their impact on fiduciary risk. As noted in earlier chapters, the CIAA and other anti-corruption bodies in the country have had very limited success.

8.11 In March 2002, the Prime Minister set up a Judicial Commission to probe the assets of all persons who have held high office in the last 10 years, and to report within six months. While this is a very commendable beginning, it is still unlikely to reveal sources of ill-gotten wealth, or whose fiduciary responsibility has been damaged (other than HMGN's, of course). Also, whether the measure succeeds in restoring public and investor confidence will depend on how it is handled.

8.12 Neither the Concept Note, nor the CFAA Team envisaged any investigation into Class B fiduciary risks - specifically bribery. For a CFAA to include such investigations, both the concept note and terms of reference should specify Class B fiduciary risk detection and quantification. In addition, the CFAA team must also include fraud detectives, police, and anti-bribery experts.

8.13 A review of the experience with the WB portfolio in Nepal reveals:

- the kinds of problems that could still exist, even after standards of financial management in HMGN as a whole, has been upgraded to the standards existing in externally-funded projects (paragraph 8.5 above), and

- the potential for adopting the normal reports of an upgraded HMGN system to report on externally-funded projects, thereby promoting harmonized reporting, and reducing Nepal's project reporting costs on such projects.

B. Experience with the World Bank Portfolio

8.14 Several events and activities in the last year or two have provided a wealth of information on the financial management of the WB Portfolio. These include: a joint HMGN/ADB/WB Country Portfolio Performance Review (CPPR) in FY1999/00 and FY2000/01 (also joined by JBIC); intensive work by both FCGO and OAG; and a financial management audit by the WB's Internal Audit Department (IAD). The overall conclusion from all these activities is that, while there has been progress, a lot of work still remains to be done.

8.15 In the last two years, the single most important reason for delayed effectiveness of new projects was their failure to comply with the Action Plan designed to improve implementation agencies' Financial Management Systems.

8.16 Compliance with the WB audit-reporting requirement has fluctuated somewhat in the last four years, with promising up-turns in FY2000/01, as revealed in the following table:

Table 1

SUBMISSION OF AUDITED PROJECT FINANCIAL STATEMENT

Fiscal Year	Total No. of Audits Required	Complied within Due Date		Complied with Delay		Not complied with as of reporting FY	
		No. of Audits	%	No. of Audits	%	No. of Audits	%
1997/98	24	6	25	4	17	14	58
1998/99	25	12	48	6	24	7	29
1999/00	23	6	26	8	35	9	39
2000/01	25	8	32	11	44	6	24

8.17 It has proved extremely difficult, partly due to wholesale transfers of accounts staff in some projects, to produce even partial Project Management Reports (now called Financial Monitoring Reports and required for all WB financed projects).

8.18 A few observations made by the IAD in the course of their visit to Nepal in November 2000 to four sample WB financed projects and reported internally to the WB's management, are as follows:

- Project staff are subject to arbitrary rotation. The quality of staff varies from project to project, and the most qualified staff are not necessarily selected;

- Two projects that IAD Team visited had been without accounting staff for 4–8 months. As a result, the accounts were out of date, the bank statements were not reconciled; and financial statements, withdrawal applications and audits were delayed; and

- Since the project director does not appoint the accountant, he or she has not control over the quality of the accounts and financial statements. Consequently, the project director does not hold himself accountable if the financial statements are not prepared or audited in a timely manner, or if they are of poor quality.

The IAD report further adds, "the potential risks" associated with the above are that:

- project implementation may not be effective due to weak capacity;

- deficiencies in borrower implementing agencies in terms of organization, staffing, and FM experience will result in a weak project FM system leading to weaker overall control environment; and

- the most qualified staff are not necessarily selected for the projects."

8.19 With regard to audit, IAD reports that "Because of the vastly dispersed and poorly connected areas of Nepal, and OAG's limited managerial travel budget, it is difficult to monitor the work of the auditors. There are very few qualified accountants in the country and a huge amount of audit work to be carried out in the public sector. The potential risks are that the:

- potential irregularities might not be detected and reported; and

- lack of transparency in the public sector due to the lack of true and fair accounting picture, and limitations in the independence and quality of audits."

It further reports that in Nepal there are inadequate follow-up actions by the audited agencies, leading to the same audit comments year after year.

8.20 The CPPRs referred to above reported several issues (action plans to mitigate such issues were agreed during CPPRs), which may be summarized as follows:

- Transfer of accounts staff on a wholesale basis affecting several projects at a time was a major issue. The violation of credit agreements was noted in two projects. Staff transfers also had a major impact on timely preparation of accounts and timely submission of withdrawal applications.

- Application of internal control systems is reported to be weak in almost all projects as reported by the Auditors, and as observed by the WB's internal auditors.

- Accumulation of reimbursable expenditure is also a problem in projects working in a multi-district environment.

- Capacity building of accounts staff was a major constraint. Many projects failed to train their accounts staff, especially after the transfer of older staff.

- Untimely submission of Project Management Reports (PMRs) and audit reports was also a major issue.

- Monitoring and follow-up of expenditure statements at district level in general has been inadequate.

- Contract administration and monitoring continues to be a major problem in many projects.

- Despite efforts to raise issues on financial management following supervision missions and auditors' reports, and to help projects to rectify such issues and improve financial management, follow-up actions, in general, have been very slow.

- Budget planning and budget allocations have been crucial problems in few projects, particularly Basic and Primary Education Project (BPEP) and Road Maintenance and Development Project, which caused a major impact in accounting and auditing (BPEP is an experimental project where "Basket" approach was adopted whereby participating donor agencies and HMGN put all funds in a "basket" and all share the expenditures of the program in agreed proportion. Accounting problems and challenges were anticipated from the BPEP, because of its innovative and experimental nature.)

- Handling of special accounts by Nepal Rastra Bank has not been sufficiently effective. Bank statements are not submitted on demand, which had an effect on timely claims of expenditures from WB. Blockage of special accounts fund against special commitments was observed to be a major issue, which is in violation of the special accounts rule.

8.21 While interacting with project staff, the CFAA team noted the following issues raised consistently and loudly:

- Project managers (coordinators) and accountants are not selected on a competitive basis.

- Financial management staff in projects, seconded from FCGO, often have little or no exposure to project accounting. They do not produce statements of sources and uses of funds, cash flow, balance sheet, or fixed assets inventory.

- Project coordinators have no say in selection of their project accountants.

- Conflicts in accounting and reporting requirements between WB and HMGN regulations create problems for project accountants.

8.22 To the pre-existing issues identified above must now be added the need to ensure that all projects can regularly produce FMRs (preferably coming out of the government's system), according to the latest guidelines issued by the WB in late 2001. While there is no substitute for the financial management assessment of each project and assurance of its capacity to comply with WB guidelines, successful implementation of HMGN internal reporting regulations (Rules 21 and 25 and Schedule 2 of the FAR) will make it easier for projects implemented by HMGN to prepare FMRs for submission to WB every four months.

8.23 **It is recommended that**:

- HMGN forms used for project reporting (e.g., Schedules 2, 3, and 5 of FAR) be reviewed and improved, which can then be used as part of the FMR requirement for WB-financed projects. In fact, HMGN should move in the direction of adopting the improved version as reporting requirements for all HMGN development projects, which could be furnished to donors for the respective donor assisted projects. HMGN should move towards "one reporting system" in harmonizing the reporting system to all donors.

- HMGN, in consultation with donor partners, develop a policy on funding procedure from donor partners requiring all donors to channel funds through the MOF according to its policy.

- All project coordinators and accountants undergo financial management, procurement, and disbursement training before assuming office.

- HMGN strictly abide by its Civil Service and other related service Rules that no project staff will be transferred for at least two years, to ensure staff continuity.

- HMGN develop selection criteria and parameters for selection of project managers/coordinators on the basis of technical competence and open competition for the position, and adopt uniform standards for such selection.

- HMGN adopt and enforce a concrete policy about the placement of accounts staff in development projects. The underlying principles of such a policy are that only competent, trained and appropriately qualified staff are placed in development projects; transfers will not be made on an ad hoc basis but will follow HMGN's Civil Service and other related service Rules; and proper hand over and continuity will be assured.

- HMGN encourage promising accounting officers likely to be posted as project accountants, to enroll in training leading to the qualification of chartered accountant or other equivalent professional courses or training in financial management.

C. Implications for Programmatic Lending and Budgetary Support

8.24 Based on the evidence reviewed in preparing this CFAA, **the legislative/regulatory framework supporting programmatic or budgetary support lending in Nepal is better than average**. Furthermore, it is under the careful and constant scrutiny of a dedicated SAI which suggests improvements to the framework as it considers necessary. What needs attention is compliance. Most of the weaknesses revealed by the OAG and strongly supported by the PAC are not weaknesses of the system, but rather failure to comply therewith. The CFAA Team observed and confirmed this to be a major hindrance.

8.25 Consequently, the area of attention in minimizing fiduciary risk on programmatic lending is in compliance with the impressive framework that exists. If the joint efforts by the OAG and PAC succeed in improving compliance with the existing legal provisions, **programmatic lending should face no more than average fiduciary risks in Nepal**. It is, therefore, critically important to begin implementing the DAP designed to enforce compliance with existing laws and regulations. Failure to implement the recommendations for integrated financial management improvement suggested in the DAP may leave a "high risk environment".

8.26 As explained in paragraph 8.5 above, high fiduciary risk in most WB borrower countries (including Nepal) forced the WB to "ring-fence" most of its projects through special accounting and auditing requirements. For fiduciary risk on programmatic lending to approximate the fiduciary risk now accepted for project lending, accountability and internal control standards in the whole civil service must approximate those currently existing in the WB-financed projects. This is the objective yardstick to use. The existing legal/regulatory framework meets these standards. It remains to get compliance to attain the same level. Full implementation of the recommendations in Chapters II and III of this CFAA and OAG/PAC proposed improvements, would bring this closer to reality.

8.27 Some budgetary support or programmatic lending should be possible almost immediately through a combination of:

(a) A pragmatic program of targeted assessments and "sanitization" of sectors and institutions scheduled to benefit from such lending; and

(b) The generalized implementation of the recommendations in the public sector as a whole, likely to be completed over the medium term.

For example, to ensure that no urgently-needed budgetary support for poverty reduction and other worthwhile objectives is held up by the implementation of the above recommendations, **it is recommended** that sectors, Ministries, and institutions (such as those involved in poverty relief, for example) scheduled to benefit from budgetary support be the first to be assessed and certified by a panel of independent experts representing the accountability institutions which include, MOF, FCGO, NPC and OAG (may also include experts designated by donor partners participating in budgetary support), as complying with the accountability standards recommended above. They would be the first to be released from the "ring fence" approach. A practical implication of this recommendation is that sectors, ministries and institutions scheduled to benefit from budgetary support in FY2002/03 such as, Ministry of Education & Sports, Ministry of Agriculture & Cooperatives, Ministry of Health, Ministry of Water Resources, and Ministry of Works and Physical Planning, should, ideally already be undergoing assessment of their capacity to properly account for the funds they will receive. Delay of the assessments would delay the flow of funds. Any weak points revealed by such early assessments should be strengthened as an indispensable element and component of the budgetary support package. Implementation of such actions should be closely monitored and reported.

8.28 Following the full implementation of these improvements and the recommendations of this CFAA, a quick review would be desirable to confirm the effectiveness of the compliance system, before the WB launches into generalized programmatic lending benefiting all sectors, Ministries, and institutions. Based on current evidence, this situation may arrive sooner in central government than in local bodies. All levels of government would need to be reviewed for adequate compliance before moving forward. The guiding principle always should be that no office at central or local level should receive any funds without first demonstrating the capacity to budget and account for them in a manner which links them to outputs and outcomes and which presents such accounts for OAG audit in a timely manner.

8.29 A Task Force or a Reform Monitoring Committee (see Chapter XIII – Development Action Plan and Implementation Strategy) should continue to be in action to monitor the implementation of the recommendations of the CFAA. Continuous monitoring and follow-up are critical to ensure that agreed actions are implemented, and produce results on the ground. A high level focus on and commitment to the implementation of the DAP will accelerate the reduction of fiduciary risks. The status of implementation should be periodically reported to the Finance Committee of the Parliament, the Finance Secretary and to the development partners.

PART D:

PRIVATE SECTOR

CHAPTER IX

PRIVATE SECTOR ACCOUNTING AND AUDITING

Nepal's accounting and auditing professions, and the Institute of Chartered Accountants of Nepal (ICAN), which HMGN has mandated to regulate and monitor accounting and auditing standards are all faced with many challenges, which cannot be tackled at the same time. ICAN was created only in 1997 by the Chartered Accountants Act, 1997. It deserves a lot of credit for its achievements and value-added efforts to the country's economy within a few years of existence. A newly set-up organization with dedicated members has enabled it to position itself in a competitive environment. It is important that ICAN functions independently, for which ICAN's stakeholders, HMGN, ICAN and the Office of the Auditor General (OAG), should agree on a realistic role, functions, and program in line with its foreseeable resources. To promote its development and enhance its professional effectiveness, ICAN should establish links with IFAC, and a "twinning" relationship with one of the world's successful IFAC-member institutes.

A. Legal Framework

9.1 There are numerous laws and regulations requiring proper accounts to be maintained, and financial reports produced, by private sector organizations and institutions, and for such accounts and reports to be audited by authorized auditors. These laws include the Company Act, 1997; the Commercial Banks Act, 1974; the Development Bank Act, 1996; the Finance Companies Act, 1986; the Audit Act, 1991; the Securities Exchange Act, 1983; the Income Tax Act, 2002; the Insurance Act, 1992; and the Chartered Accountants Act, 1997. In addition, the notifications and directions issued to the banks by the Nepal Rastra Bank (Central Bank) and the Department of Inland Revenue contain further accounting and reporting requirements, with which institutions receiving them have to comply.

B. Accounting Standards and Practices

9.2 Despite the plethora of accounting-related laws listed in the preceding paragraph, there have been no nationally recognized private sector accounting standards in Nepal. While public sector accounting and reporting standards were generally proposed by the FCGO and approved by the OAG, there was no equally authoritative source of accounting standards for the private sector. The laws require compliance with some vaguely defined concept of good accounting and reporting, but the vagueness of the definition vitiates both compliance and any objective assessment thereof. The Company Act, 1997 is a typical example. It requires "accounts to be maintained…according to generally accepted accounting principles based on the Double Entry System," with no indication of the meaning of "generally accepted accounting principles." The Nepal Chartered Accountants Bill 2058 (2002) (Amendment) recently approved by the Parliament[15] has made provision for formation of Accounting and Auditing Standard Boards, which are empowered to formulate and publish Accounting and Auditing Standards to be applied in preparation of financial statements and in auditing them.

[15] Yet to receive the Royal Seal and be gazetted.

C. Auditing Standards and Practices

9.3 Auditing practices are slightly better articulated than accounting standards. At least the Company Act, 1997, lists (Section 91) six specific points which an auditor's report must mention explicitly; and the Audit Act, 1991, lists similar contents of an auditor's report as well as 15 specific items in an auditor's Code of Conduct. None of these lists, however, says anything about how to organize and conduct an audit that is technically and professionally correct (i.e., auditing standards).

D. Recent Developments Regarding Accounting and Auditing Standards

9.4 The Central Bank now requires all banks to apply International Accounting Standards (IAS) in preparing their accounts. The Institute of Chartered Accountants of Nepal (ICAN) has created an Accounting Standards Committee and an Auditing Standards Committee. Members of these committees are expected to become members of the Accounting and Auditing Standards Boards respectively after the recently passed legislation receives the royal seal (see paragraph 9.2 above). The Committees have been issuing Exposure Drafts of both Accounting Standards and Standards on Auditing.

E. The Accounting and Auditing Profession

9.5 The absence of officially recognized private sector accounting and auditing standards has a lot to do with the absence of an effective and well-established Institute of Chartered Accountants or an Accounting Standards Board, or an Auditing Standards Board. In most countries, national private sector accounting and auditing standards are usually established by an Institute of Chartered Accountants or by an Accounting Standards Board (for accounting) and an Auditing Standards Board (for auditing). In Nepal, no institution was mandated to set these standards until the passing of the Chartered Accountant Act, 1997 (CA Act), which required the Council of the ICAN "to comply or ensure compliance with the International Accounting Standards, the International Auditing Guidelines, and the guidelines received from the International Federation of Accountants".

9.6 Before the CA Act, 1997, there was no effective regulation of the accountancy profession. There was an Association of Chartered Accountants, most of whose members trained in India, and became members of the Institute of Chartered Accountants of India (ICAI). Chartered accountants (or their equivalents) are generally accepted worldwide as possessing the highest level of professional qualification in accountancy. Other Nepalese accountants achieved the same status in the United Kingdom and elsewhere. They are contributing members, admitted, through tough examinations and training, into institutes which are members of the International Federation of Accountants (IFAC) - the world governing body whose International Accounting Standards Committee (IASC) used to issue International Accounting Standards (IAS), and which still issues International Standards on Auditing (ISA). Equivalents of chartered accountants are called Certified Public Accountants (CPAs) in the United States of America, *Experts Comptables* in France, and other names in other countries. The one thing all these institutions have in common is that they are all members of IFAC - the supreme governing world body for accounting and auditing.

9.7 The fact that all Nepalese chartered accountants (CAs, ACCAs, CPAs) etc., were members of foreign institutes to which they paid annual subscriptions and from which they received membership services and professional support meant that no private sector organization in Nepal had either the mandate or the incentive to develop Nepalese accounting or auditing standards or profession.

9.8 The creation of ICAN was supposed to change all that. The hope is that all these foreign-trained chartered accountants, as well as thousands of Nepalese accountants and auditors holding qualifications short of the CA level would rally to ICAN as their professional "home," and as the focal point for the development and regulation of the accounting and auditing professions in Nepal. These and other expectations, however, face considerable challenges, which ICAN now appears to be facing with determination. One of the contributions of this CFAA will be to call for a realistic appraisal of ICAN's role and potential.

9.9 Auditing, in comparison with accounting, is slightly better controlled. Only the OAG can license auditors, and there are currently about 7,000 licensed auditors of whom about 207 are fully qualified professionals (about 180CAs, 24ACCAs and 3 CPAs). Auditors are licensed in four categories (A to D, with A as the highest) designed to match their qualifications and experience to the complexity of audits they are allowed to undertake. There are, however, no examinations or tests to prove their capacity to carry out audits. ICAN should closely work with OAG with its plan to produce more middle level technicians and work out a mutually agreeable plan to repeal the Auditors' Act, 1974 in order to ensure an adequate supply of accountants and auditors for the country. As of June 2002, ICAN and the Auditor General were discussing a plan under which ICAN would (a) absorb all Registered Auditors as members of the Institute on their existing terms, with audit mandates defined according to client size; (b) create an Institute or Association of Accounting Technicians to handle accounting responsibilities, and also audit clients in specified sectors of the economy. The Auditors' Act, 1974 will not be automatically repealed after the Nepal Chartered Accountants Bill – 2058 (2002) (Amendment) receives the Royal Seal. HMGN has to issue a separate notification in the Gazette in order to repeal the Auditors' Act.

F. Institute of Chartered Accountants of Nepal

9.10 ICAN was created by the CA Act, 1997 to:

- play the role of a regulatory body;
- enhance social recognition and faith in the accounting profession;
- develop, protect, and promote the accounting profession; and
- develop a system of registration, qualifications, and examination of accounting professionals in consonance with international norms.

The CA Act, 1997 provided for ICAN to be run by a 17-member Council, including 10 members elected from CAs, four elected from Registered Auditors and three nominated by HMGN on the recommendation of the Auditor General. The Council has established three standing committees: Executive Committee; Examination Committee; and Professional Guidance Committee. In addition, it has created five other committees dealing respectively with: Project Monitoring & Support; Income Tax; Expert Advisory; Editorial Board; and South Asian Federation of Accountants (SAFA). Within its permanent structure, there are three departments dealing with Administration, Examination, and Technical Affairs.

9.11 According to Section 45, Chapter XII of the CA Act, 1997, ICAN may be given necessary directions by HMGN on the functioning and actions of the Institute, and by OAG on development, protection and promotion of the accounting profession, which ICAN is obliged to follow. These directives are generally limited to administrative and policy directives. HMGN grants as proportion of total ICAN budget has increased in the three years ended July 2001 as follows: 14.73 percent, 25.04 percent, and 62.41 percent. The big jump in FY2000/01 was caused by an HMGN contribution to the ADB-funded capacity building project, which assisted ICAN in setting up accounting and auditing standards committees, training committee members and others, and drafting a CA examination curriculum of international standard.

9.12 ICAN is a member of the SAFA and the Confederation of South Asian and Pacific Accountants (CAPA), and has as one of the items on top of its agenda the acquisition of membership of the IFAC. It has been receiving technical assistance from the ICAI under a Memorandum of Understanding. ICAN started examining students for its own CA qualification in November 2000, adding Nepalese Economics, Nepalese Corporate Law, Nepalese Income Tax, and Value Added Tax to its CA Foundation Level and CA Intermediate examinations for its examination scheduled for December 2002 and after. About 252 students have enrolled for the CA Foundation and 102 for the CA Intermediate examinations. In examinations taken in November 2000 and May 2001, eight out of 46 students passed the CA Foundation and two out of five passed the single group of CA Intermediate.

9.13 ICAN deserves a lot of credit for its achievements within a few years of existence. Much of this progress is due to the dedication and hard work of its members giving generously of their time to serve on its council and its various committees. Despite all this progress, however, the challenges facing ICAN are many, and have been well documented. They include:

(a) The CA Act, 1997 setting up ICAN and mandating it to license and regulate accountants and auditors was predicated on the immediate repeal of the Auditors' Act 1974, under which the Auditor General (AG) was mandated to license auditors. ICAN should prepare a realistic plan to produce more trained accountants and accounting technicians. ICAN should agree with OAG a reasonable time-frame to repeal the Auditors' Act. The AG is convinced that on the implementation of such a plan within a reasonable time frame, the Auditors' Act, 1974 needs to be repealed.

(b) More Registered Auditors and accounting practitioners operate outside ICAN than within it. Thus, decisions of ICAN have no impact on, or relevance to, the vast majority of accounting and auditing practitioners in the country.

(c) Given what is stated above, the setting of accounting standards and code of conduct, and professional leadership expected from ICAN has been hard to accomplish.

(d) ICAN is, in any case, in no position to do much about the widespread culture of non-compliance with accounting/financial reporting regulations in the private sector. Many leading state-owned and private sector companies have not filed accounts with the Registrar of Companies for several years; transparency of financial statements produced by many companies is suspect; some of the largest commercial banks have not been publishing audited annual financial statements as required by law.

(e) ICAN still has to develop a convincing proposal to integrate the thousands of accountants and auditors. ICAN's Business Plan[16] explains the integration process of auditors registered with OAG and chartered accountants who are neither member of ICAN nor registered with OAG. ICAN has already developed criteria for providing membership to the chartered accountants and other accountants qualified from other professionally recognized institutes. ICAN now needs to develop a proposal to ensure that induction of registered auditors is not blocked in future.

(f) ICAN also needs to broaden its appeal, coverage, and relevance in another sense, that is, to attract and provide a congenial "home" to accountants in government and those working in industrial and commercial enterprises.

(g) The training needs that ICAN is expected to cope with are enormous. Apart from training, testing, and certifying the various classes of members discussed above, the training needs involved in the introduction of IAS (or Nepal Accounting Standards) are huge and costly even for chartered accountants. To be sure, ICAN can contract out much of this training to the two universities and the Nepal Administrative Staff College (NASC), but it still has to be involved in accrediting the colleges, approving the courses, and monitoring the maintenance of appropriate standards. There is also a need to ensure continued professional education for all ICAN members.

(h) ICAN'S financial challenges are also quite serious. Its two principal sources of revenue, member subscriptions and government grants, are inadequate to meet its ongoing operating costs, let alone the costs of new services. With most chartered accountant members continuing their contributions to foreign institutes, and the non-chartered accountant membership declining instead of growing, it is hard to see where the growth in membership subscriptions will come from. ICAN is, however, working on schemes to raise funds through charges for training courses, practicing certificates, and other member services. Even the preparation of its strategic plan, and most of the ongoing effort to establish the capacity to introduce accounting and auditing standards have had to be financed by non-Nepalese sources. This lack of funding contains the elements of a vicious circle: because it has so little money, ICAN cannot finance attractive member services; and because it cannot finance such services, a few members have left, causing revenues to decline even further, thus further eroding its functional capacity and attractiveness. Once the Auditors' Act, 1974 is repealed, it is expected that membership subscriptions will increase as all Registered Auditors will become the members of ICAN.

9.14 Given all the challenges discussed above, perhaps the most important strategic decision the principal stakeholders (accountants, government, auditors, and the OAG) have to make with regard to ICAN is: what is the realistic and sustainable role ICAN should aim to play? ICAN is in danger of drowning in an ocean of unrealistic expectations and unfunded mandates. Its current resources, human and financial, are totally inadequate to carry out the current expectations of its stakeholders - establishing and maintaining accounting and auditing standards; establishing and enforcing codes of conduct for accountants and auditors; providing the full range of member services, including advocacy and continued professional education for its members; conducting examinations and issuing certificates; issuing certificates of practice to members; providing leadership to HMGN in matters of accounting, auditing, taxation, and legislation relating thereto…the list goes on and on. Hard choices need

16 Business Plan of ICAN was developed with ADB assistance

to be made, and a realistic order of priorities established urgently, in an effort to match expectations with resources likely to be available on a reliable and sustainable basis. ICAN should not try to be all things to all people. Many of the activities listed above could be outsourced, with no serious disadvantage to ICAN members or the national interest. The possible outsourcing of training was mentioned earlier. Another possible example is that ICAN could prepare and license its members on the basis of examinations conducted by the Institute of Chartered Accountants of other countries (for example, the Institute of Chartered Accountants of India), modified by the substitution of taxation, law, liquidation, and similar papers based on Nepalese law in place of papers on law and taxation of other countries.

G. Supply and Demand for Accountants and Auditors

9.15 As is the case in many countries, the CFAA team knows of no recent scientific or convincing study designed to find out how many accountants and auditors of different categories exist in Nepal, or how many appear to be needed by the economy. There are estimated to be about 40,000 accounting staff employed in various public and private companies and HMGN. About 2,000 new private sector companies are registered every year, and the number of cooperatives, NGOs including INGOs, and educational, health and other social institutions requiring accountants is increasing the need for accountants and accounting technicians. As regards auditing, more than 72,000 organizations are required by law to be audited every year. These include public and private companies and state-owned enterprises; cooperatives and NGOs; primary and secondary schools and colleges; hospitals, DDCs, municipalities, and VDCs.

9.16 On the supply side, there are about 7,000 licensed auditors, of whom only about 207 are professionally qualified auditors (about 180 CAs, 24 ACCAs and 3 CPAs). About 10 to 12 professional auditors (CAs, ACCAs or CPAs) qualify every year. The university campuses and colleges graduate many accountants (below the CA level), but they need further training to handle practical work. Four of the world's largest accounting firms (KPMG, PriceWaterhouseCoopers, Arthur Andersen, and Deloitte Touche & Tomatsu) are represented in Nepal by associated firms.

H. Training of Accountants and Auditors

9.17 Accountancy is well provided for in business and management education. Secondary school students also can take accountancy courses. Higher Secondary education or Proficiency Certificate in business/management and, the university education such as, a three-year Bachelor of Business Studies (BBS or BCom); and a three/four-year Bachelor of Business Administration (BBA) degree -- all produce accounting technicians. A two-year Master of Business Studies (MBS), a two-year Master of Public Administration (MPA), and the Master of Business Administration (MBA) courses of the Nepalese universities course also produce accountants who, with additional practical training and experience, can occupy fairly senior accounting positions in companies and in government. The Association of Chartered Certified Accountants (ACCA) has a representative office in Nepal since 1996. ACCA examinations in Nepal are supervised by the British Council. Similarly, the ICAI with the assistance of the Indian Embassy in Nepal conducts CA examinations. ICAN is now training and certifying accountants at the CA level with the hope of producing the first ICAN CA in 2003.

9.18 In pursuit of its statutory mandate to train Nepalese accountants, ICAN has developed a few training courses and materials with the assistance of ADB financing and is gearing up to provide training for Registered Auditors and Continued Professional Education (CPE) for its members. ICAN's policy is to use private training institutions, of which it has already accredited four, and plans to accredit more for this purpose. ICAN has also conducted training programs in Self-assessment Income Tax Audit, Value Added Tax, and NGO Audit. It has also prepared guidelines on NGO Audit, Government School Audit, and Local Government Audit.

I. Recommendations

9.19 Nepal's accounting and auditing professions and ICAN, which HMGN has mandated to establish accounting and auditing standards and enforce them, are all faced with many challenges, which cannot all be tackled at the same time. **The CFAA team recommends** the following actions to deal with the most urgent of these challenges:

(a) ICAN's stakeholders (HMGN, ICAN members, and OAG) should agree on a realistic role, functions, and program for ICAN in line with its realistically foreseeable resources.

(b) HMGN should:

(i) Decide on and commit itself to an appropriate level of guaranteed budgetary support on a grant basis to ICAN, in view of the national interest role it wants ICAN to play, including, for example, the regulating and monitoring of accounting and auditing standards. Such grant support has been needed to establish national accounting bodies in most developing countries, and typically continues for several decades, until the Institute can generate enough subscription and other income to become financially self sufficient. ICAN and HMGN should agree on a reasonable time-frame for such support from HMGN, after which ICAN should be financially independent

(ii) Agree with ICAN and OAG on a realistic plan to move towards the repeal of the Auditors' Act 1974, and pass and gazette the CA Amendment Act, with whatever amendments are necessary to ensure that ICAN fulfills the role chosen for it by its stakeholders (including HMGN), as discussed in (a) above. In the meantime, no auditor should be licensed without such an auditor first passing an appropriate test of competence.

(iii) Organize and finance (with grant aid, if necessary) a study designed to establish, as a basis for future national planning, the numbers of accountants and auditors of various categories currently in Nepal, and the numbers likely to be required during, say, the next five years.

(iv) Amend the Company Act, 1997 to require all companies to prepare their accounts in accordance with Nepal Accounting Standards (based on International Accounting Standards), and have them audited according to Nepal Standards on Auditing (based on International Standards on Auditing).

(c) ICAN should:

(i) Establish links with IFAC, to promote early accession to IFAC membership and IFAC assistance for the development of Nepal accounting and auditing standards based on international accounting standards (IAS) and international standards on auditing (ISA).

(ii) Establish a “twinning” relationship with one of the world’s successful IFAC-member institutes so that ICAN can benefit from its experience and support.

(iii) Prepare and implement a plan to upgrade accounting and auditing skills of Registered Auditors.

(iv) Prepare the Human Resource Development Plan which should include training for the sustainable growth of ICAN.

(v) Finalize and enforce the Code of Ethics and establish a Disciplinary Committee to monitor and regulate members’ ethical practices and standards.

(vi) Introduce a system of peer review among member firms.

(vii) Classify Registered Auditors for the audit of various sizes and complexity of companies/organizations on the basis of criteria, including qualifications and experience, agreed with OAG.

CHAPTER X

ACCOUNTABILITY IN THE FINANCIAL SECTOR

Banking reform in Nepal, including upgrading of banking accountability and transparency, is a long-term process. Under the current initiative of the government in financial sector reform, it is important to address issues related to accounting and auditing in which respect, the Nepal Rastra Bank (Central Bank) should provide directives to all financial institutions to prepare accounts according to IAS, and have them audited according to ISA. The proposed Accounting and Auditing Standards Boards should formulate accounting and auditing standards based on IAS and ISA to apply to all companies, including financial institutions.

A. Banks and Finance Companies

Legal framework

Nepal Rastra Bank

10.1 Nepal Rastra Bank (NRB) is the central bank of Nepal and the banker to HMGN. It was established in 1955 by the NRB Act, 1955 (which was repealed in 2002 by the new NRB Act, 2002), as an autonomous corporate body with perpetual succession. It is fully owned by HMGN, and managed by a seven-member Board of Directors, all appointed by HMGN. The NRB Act authorizes NRB to issue mandatory directives to commercial banks and financial institutions on banking operations, currency, and credit. So far, NRB has issued 10 directives dealing respectively with: maintenance of minimum capital fund by commercial banks; loan classification and loan loss provision; limit on credit exposure and facilities to a single borrower, group, or sector; accounting policies and format of financial statements; minimization of inherent commercial bank risks; good corporate governance; timeframe for implementation of regulatory directives; investment in shares and securities; statistics and information to be furnished to NRB; and transfer or sale of shares of the promoters.

10.2 The NRB directives have prescribed principal accounting policies for commercial banks dealing with: disclosure of accounting policies; consistency in accounting policies; explanations of accounting head; notes on accounts; and contingent liabilities. Commercial banks are required to publish their annual financial statements in public newspapers, and to create Audit Committees and carry out internal audits.

10.3 NRB has similarly issued to Finance Companies 13 directives dealing with a broad range of credit and accounting-related issues. They are to have their financial statements audited within five months following the year end. They are also required to create Audit Committees, conduct an internal audit every six months, and submit their report thereon to the Audit Committee.

10.4 Nepal has 16 commercial banks including the Agricultural Development Bank of Nepal (ADBN), which functions as both a commercial and a development bank. The other development bank is the Nepal Industrial Development Corporation (NIDC). The two largest banks - Rastriya Banijya Bank (RBB - 100 percent state-owned) and Nepal Bank Limited (NBL – 40.49 percent state-owned) - account for 65 percent of total banking system assets. In addition, the country has more than 100 other financial institutions including finance companies, insurance companies, numerous micro-finance institutions, Grameen Replicator Banks, financial cooperatives, financial NGOs, and a Stock Exchange. HMGN and IDA have, for the last two years at least, been discussing a possible Financial Sector Technical Assistance Project (FSTAP).

10.5 The following five Acts govern most banks and finance companies: the Commercial Banks Act, 1974; the Agriculture Development Bank Act, 1967; the Finance Companies Act, 1986; the NIDC Act, 1990; and the Development Bank Act, 1996. All these Acts have remarkably similar provisions governing operations and financial management of banks and finance companies. All are required to be set up as limited liability companies except those prescribed by the Law, and only with the authorization of NRB. All have to prepare accounts according to directives issued by NRB; provide statistical and other information periodically as required by NRB; have their annual financial statements prepared in a format approved by NRB, and audited within five months following the end of the fiscal year; lay the audited accounts before the Annual General Meeting, which also appoints their auditors from a list approved by NRB, and only for three successive terms. In addition to the matters auditors are required to specify by the Company Act, 1997, auditors of all these three types of banking institutions also have to specify eight to 10 matters, including, for example, whether transactions conducted by the bank are within the scope of its authority, and whether or not work has been done in accordance with directives of NRB.

10.6 Although the latest directives require commercial banks to prepare their accounts in accordance with International Accounting Standards (IAS), there is no similar requirement for development banks or finance companies. No auditing standards are prescribed for any of the three types of financial institution.

10.7 Legal reforms in the banking sector are being articulated around two themes:

(a) A new NRB Act 2002 was recently enacted and is already enforced effective January 30, 2002. A single unified Act to govern Commercial Banks, Development Banks, and Finance Companies is in the process of drafting.

(b) Establishing an appropriate body of lending legislation with laws covering, in particular, collateral, credit activity, and bankruptcy.

10.8 The accounting and auditing environment is weak, with weak timeliness and reliability of financial data particularly from the two largest commercial banks. Weak accounting in the corporate sector (i.e., among the banks' clients) also makes lending decisions difficult. International and joint venture banks with foreign management have tended to produce more informative, reliable, and timely financial data than these two banks. Some are required by their foreign principals to apply International Accounting Standards. Given the relative weight of the Nepalese banks, however, the joint venture banks' impact on the accountability standards of the financial sector as a whole is insignificant.

10.9 There have been numerous projects and efforts to develop and improve certain aspects or institutions of the financial sector. Four technical assistance grants have been financed by the WB, 21 by the ADB (8 loans and 13 technical assistance grants), while the International Monetary Fund (IMF) and three German development institutions (KFW, DEG and GTZ) have financed one project each. The latest is the FSTAP, currently under discussion between HMGN and IDA. ADB's assistance with the Corporate and Financial Governance Project, TA to support ICAN and draft commercial laws have been acknowledged to be among the most comprehensive packages of assistance in the financial sector. Reviews carried out in the course of preparing this project revealed that NRB:

- prepares its accounts on an accrual basis, even though certain incomes (e.g., interest on loans to commercial banks) are recognized on a cash basis;

- has a relatively ineffective internal audit department, which does not have any qualified accountant on the staff;

- does not record its accounting policies in its financial statements;

- has been unable to produce its annual financial statement within the four months specified by law. The shortest period has been ten months; and

- has not had a clean audit report for many years, but has had several audit criticisms (reports were "qualified") repeated year after year.

10.10 With regard to the RBB and the NBL, which together account for 65 percent of total banking assets in the country, a KPMG/Barents study in FY2000 found that:

- Bank management is basically dysfunctional;

- There are no reliable data available on the loan portfolio;

- Financial accounting is primitive and not according to international standards (perhaps this will change under the new NRB directive);

- Business strategies are not in place;

- Human resource policy is weak;

- Management information systems and record-keeping are very basic; and

- RBB's governance and management are highly politically driven and lacking a commercial focus."

In addition, both RBB and NBL have been unable for many years to produce timely audited financial statements.

10.11 The conclusion of the above analysis is that, for the major part of the banking system, both the regulator and the regulated are weak, with poor financial management and accountability systems in urgent need of improvement. Under the impetus of the proposed WB-funded project under preparation, the NRB has revised its accounting manuals to meet the requirements of IAS. These are now being implemented. In addition, the project under preparation contains substantial financial management capacity building involving considerable use of information technology expected to make a strong positive impact on NRB's accounting systems. This capacity building, however, will only start after the effectiveness of the IDA Credit, which still has to be negotiated and agreed between WB and HMGN.

10.12 In the legal area, a recent NRB Act, 2002 involves:

- maintenance of accounts in compliance with internationally accepted accounting principles and convention;

- ensuring that three Board members have expertise in finance, accounting or banking;

- constituting an Audit Committee headed by one of the board members; and

- strengthening the internal audit function, and bringing it up to international standards either by using departmental staff or by hiring a professional audit firm.

10.13 As regards the RBB and the NBL, HMGN has decided to employ international management firms to go in and strengthen the management of both banks and prepare RBB for eventual privatization.

Recommendations

10.14 Banking reform in Nepal, including upgrading of banking accountability and transparency, is a long-term process. A lot of good sector and institutional analysis has gone into the preparation of the FSTAP, and several good recommendations, some of which are already being implemented, have resulted from that process. Therefore, although the project represents only a first step in a long and complex journey, to try to short circuit the process would only create confusion and unnecessary duplication. It is recommended, therefore, that efforts to improve banking accountability and transparency in Nepal should be exercised within the context, and through the effective implementation, of the FSTAP, and the Financial Sector Reform Program, of which that project is the first step. Meanwhile:

- NRB should:

  (i) Give directives to all financial institutions to prepare accounts according to IAS (or Nepal Accounting Standards based thereon), and have them audited according to International Standards on Auditing (or Nepal Standards on Auditing based thereon).

  (ii) Direct all financial institutions to adopt online software compatible with NRB, to facilitate and speed up data exchange between them and NRB.

- The proposed Accounting and Auditing Standards Boards should formulate accounting and auditing standards based on IAS and ISA to apply to all companies, including financial institutions.

B. Insurance Companies

<u>Insurance Board</u>

10.15 The 17 insurance companies in Nepal are regulated by the Insurance Board created under the Insurance Act, 1992, and the Insurance Regulation, 1993. The five-member Board consists of one representative each from the Ministries of Law, Justice and Parliamentary Affairs, and Finance, and two HMGN nominees - one from insurance experts, the other from the insured. The Board regulates insurance business by providing suggestions to HMGN, setting out guidelines for insurers; registering and renewing licenses of insurers, insurance agents, brokers and surveyors; arbitrating in disputes; settling complaints filed by insured; and issuing directives designed to regulate the insurance business. The Board may cancel an insurer's license for any of a number of infringements.

Accounting and Reporting of Insurance Companies

10.16 The insurance companies are required to maintain proper books of accounts. An insurance company engaged in other business along with insurance, or engaged in several types of business, has to maintain separate books and accounts for each type of business. The Insurance Regulation, 1993 has prescribed the amount of net profit to be set aside in the reserve fund for the liability of insurance business, and the format of balance sheet and the profit and loss account. There is no special format or method of accounting. Insurance companies are expected to maintain accounts according to norms of the industry and generally accepted accounting principles. As there are no accounting standards in Nepal, there are none in insurance, beyond an indication of types of financial statements to be filed each year.

10.17 Insurance companies are required to submit 12 financial statements including a balance sheet, notes on accounts, and profit and loss account at the end of each fiscal year. The audited balance sheet and profit and loss account of insurance business are required to be published and filed with the Insurance Board within six months following the end of the company's fiscal year.

Audit of Insurance Companies

10.18 External audit is governed by the Company Act, 1997. The Insurance Board provides for no specific auditing standards or requirements, other than that the audit report and certain information certified by the auditor must be submitted to the Board, along with irregularities reported by the auditor, and management's explanations thereof.

10.19 **Recommendations:**

- The Board needs to strengthen its new Inspection and Supervision Unit, to enable it to independently monitor insurance company activities.
- The necessary amendments to the Insurance Act, 1992 and Regulations 1997 should be initiated to provide for:
  - (i) application of appropriate accounting and auditing standards; and
  - (ii) process of settlement of claims.

C. Cooperative Societies and Unions

10.20 Cooperatives are governed by the Cooperative Act, 1991, and the Cooperative Regulations. All cooperative societies and unions are autonomous corporate entities with limited liability. There are 6,484 registered cooperative societies (of which 1,971 are saving and credit societies), 105 district level unions, three central cooperative unions, and one national cooperative federation. Saving and credit cooperative societies are supposed to obtain NRB permission to accept member deposits and grant loans.

Accounting and Auditing

10.21 Accounts have to be maintained as legally prescribed. Although the Act and Regulations are silent on accounting standards and practices, the Cooperative Training Center has written a manual for accounting transactions of cooperatives. The auditor is appointed and his remuneration fixed by the General Meeting. The auditor must be approved by the Registrar of the Department of Cooperatives, and his/her report is presented to the General Meeting. No auditing standards are prescribed. A three-member audit/accounts board conducts internal audit and presents its report to the General Meeting.

System Breakdown and Issues

10.22 In the last two years, directors of some cooperative saving and credit societies have disappeared with their capital and deposits. The Cooperative Department of HMGN has been unable to find them. In one district, district directors of 13 saving and credit societies have fled. According to the OAG 2001 Report, directors of 11 of the 13 societies embezzled Rs. 59.43 million of share capital and deposits. Most district societies are conducting banking activities without the required NRB authorization. In six districts, only 12 out of 358 societies obtained NRB permission.

10.23 **Recommendations:**

- Legal provision to be enacted to impose penalties (in the form of fines or even to the extent of imprisonment) on cooperative societies (and their directors) conducting saving and credit business without NRB approval.

- NRB to regularly inspect such societies.

- Such societies to submit to NRB and Cooperative Department monthly financial statements in prescribed form.

- The Cooperative Department to carry out and report on regular inspections of saving and credit cooperative societies according to the Inspection Guide, 2001.

- The roles of NRB and the Cooperative Department in supervising cooperative societies and unions to be clarified and streamlined. In principle, it would seem logical for NRB to regulate the banking, deposit taking, and credit operations, while the Cooperative Department supervises all other aspects. It is imperative to have a clear demarcation of regulatory authority between the NRB and the Cooperative Department.

CHAPTER XI

CORPORATE GOVERNANCE

Corporate Governance culture in Nepal needs to be improved. Various Acts viz., Company Act, Commercial Bank Act, Development Bank Act, Finance Companies Act, Securities Exchange Act, Income Tax Act, should be amended to provide uniform reporting requirements in respect of report timing, accounting standards to be applied for preparation of financial statements, and standards on auditing to be applied to conduct an audit, and to delete contradictory provisions of the respective Acts. The Registrar of Companies should be strengthened to enforce compliance with the Company Act. The Nepal Stock Exchange should be privatized to allow it to function independently, efficiently, and effectively. Securities Exchange Board should be strengthened to regulate and monitor listed companies and be empowered to initiate legal action for non-compliance with requirements of the Board.

A. Legal Framework

Company Act, 1997

11.1 Private and public limited liability companies can be established under the Company Act, 1997. The number of shareholders of a private limited company cannot exceed 50. Public companies must have at least seven shareholders, with no upper limit on numbers. A company established under this Act should be an autonomous corporate body with perpetual succession, managed, supervised, and controlled by the Board of Directors appointed by the company's annual general meeting.

11.2 The Company Act, 1997 has made the following provisions for maintenance of accounts:

- Companies have to maintain accounts, showing the actual state of business of the company, according to generally accepted accounting principles based on the double entry system.

- A public company has to prepare the following annual financial statements at least 30 days before its annual general meeting (AGM) and a private company within 60 days from the expiry of its financial year:

  (a) A balance sheet as of the last day of the financial year;

  (b) A profit and loss account of the financial year; and

  (c) A cash flow statement (introduced in this Act) of the financial year.

- The company must prepare its balance sheet and profit and loss account in such a manner as to reflect the true and fair view of its income and expenditure and business. Such balance sheet and profit and loss account must be prepared in the prescribed form (Section 84). The format of the financial statements has been prescribed by the Company Rules, 2001 promulgated under the Company Act, 1997.

11.3 All the companies established under the Company Act, 1997 have to appoint auditors in accordance with its legal provisions. The Board of Directors appoints the auditor before the first AGM. Thereafter, the AGM appoints the auditor. The Registrar of Companies (ROC) may appoint the auditor at the request of the company, if the AGM fails to meet, or to make the appointment, or the post falls vacant for any reason before its expiry. The auditor has to be licensed by the Office of the Auditor General (OAG).

11.4 The following persons or the firm or companies in which they are partners, may not be appointed as auditors, or remain in office if they have already been appointed in that capacity:

(a) A director, employee or worker of the company;

(b) A partner of a director or employee of the company;

(c) A debtor of the company;

(d) Any person who:

  (i) is a close relative of any director of the company, or of his partner;

  (ii) has been punished on charges pertaining to audit;

  (iii) is insolvent;

  (iv) has been punished on the charges of a criminal offence involving moral turpitude;

(e) Any person or firm, which has subscribed to one percent or more shares of the company.

11.5 The auditor has to express an opinion on the financial statements (balance sheet, profit and loss account, and cash flow statement) audited by him. The audit report addressed to the shareholders is submitted to the company and the ROC and copied to the shareholders, and to the official trade union functioning in the establishment if it so requests in writing. The audit report has to explicitly mention suggestions in addition to whether or not:

(a) The information and explanations needed for the purpose of audit were given to the auditor;

(b) The balance sheet, the profit and loss account, and cash flow statement that have been prepared according to the Company Act, 1997 tally with the accounts maintained by the company;

(c) The company has accurately maintained the accounts and records according to Law;

(d) In his/her opinion based on the explanations and information supplied to him/her in the course of audit, the balance sheet properly reflects the financial condition of the company and the profit and loss account and the cash flow statement for the year ending on the same date properly reflect the profit or loss and the cash flow respectively of the company;

(e) The Board of Directors or the representative or any employee of the company has acted contrary to the Law or committed misappropriation or caused losses or damages to the company.

11.6 There are certain legal provisions relating to the imposition of fines on, or imprisonment of, a director or the auditor or any other person for committing various offences. In the case of the following conditions relating to maintenance of accounts and audit, the directors or auditor would be liable to a fine of Rs 20,000 or imprisonment for two years, or both:

(a) Any director, managing director, manager, company secretary or employee of the company, who fails to maintain or cause to be maintained, accounts, records, or registers as required under the Company Act, 1997, or suppresses, conceals or damages such accounts, registers or records deliberately or through negligence or with malaise motives, so as to cause loss to the company or any person;

(b) The auditor of a company who inserts false particulars in his/her report while discharging his/her duty or omits necessary comments while auditing the accounts deliberately or through negligence or with malaise motives; and

(c) Any director who fails to maintain the accounts and records or documents required to be maintained under the Company Act, 1997.

11.7 A fine not exceeding Rs 10,000 may be imposed on the following persons for the offences committed as mentioned below:

(a) Any person who fails to produce, hand over, or furnish accounts or record when sought by the auditor;

(b) The auditor who fails to submit the report specified in the Company Act, 1997; and

(c) Any director or employee, who fails to furnish information to the ROC, which he/she is required to furnish under the Company Act, 1997.

Other Prevailing Laws

11.8 The Nepal Rastra Bank Act, 2002, the Commercial Bank Act, 1974, the Development Bank Act, 1996, the Finance Companies Act, 1986, the Insurance Act, 1992 and the Income Tax Act, 2002, require the respective companies to adhere to the provisions of the respective Acts in respect of reporting, accounting and auditing as explained in Chapter X.

B. Registrar of Companies

11.9 The Registrar of Companies (ROC) is referred to as Office in the Company Act, 1997. The ROC is empowered to issue orders to a company demanding explanations on any unclear points within an appropriate time-limit prescribed by it (Section 95). The management of the company is required to comply with such orders within the specified time limit, and to comply with ROC directives to rectify any irregularity.

11.10 The ROC may depute inspectors to conduct investigations if shareholders of at least ten percent of the paid-up capital of the company, or at least one-fourth of the total number of the shareholders, submit an application along with appropriate reasons and evidence claiming that the company has acted in contravention of the Company Act, 1997, or the Memorandum, or Articles of Association, prospectus or unanimous agreement of the company and other existing Laws. The ROC may also appoint and depute an inspector to investigate the business or transactions of the company if it is satisfied that the business or transactions of the company are being run with the intention of cheating its creditors or shareholders, or otherwise committing fraud, or realizing any illegal objective, or a public company has not furnished any information required to be furnished under the Company Act, 1997.

11.11 If any director, managing director, manager, employee, or any other official of the company is found to have caused any loss or damage to the company intentionally, or cheated its shareholders or creditors, or committed a fraud or any illegal act, the ROC shall issue an order to the company to file suits or claims against such offenders. The ROC may issue directives to the company to suspend such person if the company may be put to loss if the business of the company continues to be in the hands of such offenders.

11.12 In case the ROC receives information that a director or any employee or office bearer of a company has not followed the legal provisions and the Memorandum or the Article of the Association of a public company, or the unanimous agreement in the case of a private company, or that any action has been taken in contravention of the Company Law or the Memorandum or the Article of Association, it can institute inquiries into the matter or make arrangements for doing so and issue necessary directives to the concerned director employee or office bearer to do anything which he/she should do, or arrange to have this done, or refrain from doing anything which he should not do under the Company Law. It shall be the duty of the person who receives such directives to comply with them.

Company Law Board

11.13 HMGN has formed a three-member Company Law Board from among persons who have worked for a minimum of 10 years and thereby acquired expertise in the fields of law, commerce, or business administration, at the rate of one member from each field for the purpose of hearing and disposing of law suits and offer advice to HMGN in matters relating to company administration.

11.14 The ROC is mostly engaged in registration of new companies and approval of amendment to Memorandum of Association and Articles of Association and other company-related matters. Due to its heavy work load and lack of professional manpower, the ROC is unable to monitor the companies with respect to the legal compliance. However, it compels companies to fulfill all legal requirements before giving approval on company matters. It does not have the power to take legal action directly against any company for non-compliance. It can only recommend legal action to the Company Law Board, which lacks staffing network to function efficiently and effectively. One post for a chartered accountant had been created in ROC but this post has been cancelled as no one applied for the job when it was advertised.

11.15 The Company Act, 1997 does not have any provision relating to the regulation and development of a capital market. It should be updated in the same way as securities legislation is being updated. Similarly, there is no uniform reporting requirement with regard to timing of reports in various laws which govern the companies.

C. Securities Exchange Board

11.16 The Securities Board (SEBO) was established in 1993 with the objective of promoting and protecting the interest of the investors in listed companies by developing and regulating the capital market in a systematic manner under the Stock Exchange Act, 1993. The Board, consisting of seven directors, is an autonomous corporate body with perpetual succession. Its functions are to:

- Develop the securities exchange market for the benefit of the investors, formulate necessary policies, and provide advice to HMGN;
- Make necessary arrangements in order to regularize the securities exchange;
- Grant permission to corporate bodies to operate the Securities Exchange; and
- Operate the securities exchange systematically and provide directives.

11.17 The objectives of the SEBO are: (i) to promote and protect the interest of the investors by regulating the issuance, sale, purchase, exchange, and distribution of securities; (ii) to supervise and monitor the activities of the stock exchange and of other related firms carrying on securities business; and (iii) to contribute to the development of the capital market by making securities transactions fair, healthy, efficient, and responsible.

11.18 Listed companies are required to submit their annual reports along with financial statements to SEBO and to the Nepal Stock Exchange (see below) within four months after the expiry of the fiscal year and semi-annual report within 60 days after the expiry of each six-month period. Market intermediaries are required to be registered with SEBO before doing securities business and to report their financial and trading activities to SEBO. Securities business persons such as brokers, issue managers, market makers, and securities dealers have to be licensed by SEBO, and to renew their licenses from SEBO before the end of each fiscal year.

11.19 SEBO, in the year 1998, formulated a four-year "Strategic Plan," (1998-2002), to address the need of market reform. The plan strives to attain four major policy development objectives, viz. (i) improvement in the statutory and regulatory framework of the capital market; (ii) development of market standards and information system; (iii) development of widely participatory capital market; and (iv) improvement in the SEBO'S institutional capacity. The Plan also envisages improvements required in the areas of enforcement, market surveillance and compliance; education and training; and research and development. A committee consisting of the Director as a coordinator and departmental as well as divisional heads as members was formed for the purpose of monitoring the implementation of the Strategic Plan and its work plan activities. It continuously monitors them and SEBO has been integrating different activities of the plan and its annual program.

11.20 A new Securities Bill is being drafted to place emphasis on corporate governance, uniform reporting system, standard accounting and auditing practices, market transparency, and development of necessary infrastructure such as credit rating system and the central depository system of securities. SEBO has published guidelines on issue management, securities allotment and securities registration, and issue approval.

11.21 In the last seven years, SEBO approved 72 public issues amounting to Rs 2,481.97 million. The total public issues include 66 issues of ordinary shares (including 12 rights issues), three issues of preference shares, and one issue of debentures. SEBO also approved two indirect investment vehicles, viz. NCM First Mutual Fund and Citizen Unit Scheme.

11.22 SEBO is regularly monitoring the issues related to the status of corporate disclosure, holding AGM, dividend declaration of listed companies, and reporting the status of market intermediaries along with their trading activities. It is continuously informing the listed companies, through correspondence and public notices of the provisions related to information disclosure. It has also published and distributed an information booklet to all listed companies.

11.23 As another example of this proactive role, SEBO issued a public notice mentioning the names of 23 listed companies that were not in contact with SEBO and that had not been providing any information to SEBO for a long time. SEBO also requested Nepal Rastra Bank and the Insurance Board to cooperate in the disclosure issues of some of the banks, finance companies, and insurance companies. Out of 110 listed companies, 68 companies submitted their financial statements and annual reports for fiscal year 1998/99 to SEBO.

11.24 The new Securities and Exchange Bill was drafted in 1999 taking into consideration the suggestions of stakeholders and it was submitted to the Government on May 13, 1999 for initiating the process of enacting as the Law by the Parliament. The international experts appointed under ADB assistance reviewed this draft. SEBO prepared a new draft of the Securities Bill based on the suggestions of ADB and it is to be submitted to the Government. The proposed Bill envisages the strengthening of SEBO and incorporates some important provisions related to the central depository system of securities (CDS), transfer agent and full range brokerage firm. The proposed law intends to accord investors the right to demand compensation if any loss or damage occurs due to misinformation of corporate bodies at the time of public notice. Provisions have also been made to discourage insider trading of securities and to make it mandatory for listed companies to have their books and accounts audited only by those auditors who are recognized by SEBO.

11.25 SEBO is planning to amend the Securities Registration, Share Allotment Guidelines, and Issue Approval Guidelines. SEBO has also issued Stock Dividend Issue Guidelines (effective from March 14, 2002) with the objective of making Stock Dividend issuance more systematic and transparent. Also, in an effort to further improve corporate governance, SEBO is conducting a study to develop necessary codes of conduct.

D. Stock Exchange

11.26 The Nepal Stock Exchange (NEPSE) was established under the Securities Exchange Act, 1983. It is the only stock exchange in the country. It is owned by the Government, Nepal Rastra Bank (NRB), Nepal Industrial Development Corporation (NIDC), and NEPSE members. Issue managers, stock brokers, market makers, and securities dealers registered by SEBO have to be authorized members of the stock exchange to conduct securities business. The Securities Exchange Act, 1983 empowers NEPSE to issue various by-laws for the purpose of ensuring orderly and fair transactions of securities. Companies issuing shares to the public should have their securities listed in the stock exchange within three months of the closure of offering. The NEPSE has issued Securities Listing By-Laws, 1996, prescribing the terms and conditions for listing and disclosure requirements for listed companies as well as the Membership of Stock Exchange and Transactions By-Laws, 1998. There are 119 listed companies, out of which 60 companies are actively trading. The NEPSE has already recommended de-listing of 25 companies to their Board. It is also analyzing the status of 25 additional companies for their possible de-listing.

11.27 As a stock exchange, NEPSE should be a private sector institution which should deal with private sector trading. It should be owned and managed by private sector (e.g., dealers and brokers operating therein), while SEBO is the government agency that regulates the whole process. It, therefore, makes sense to privatize the NEPSE, and retain the SEBO as the regulatory agency for the capital market.

E. Recommendations

11.28. **It is recommended that**[17]:

- The laws particularly the Company Act, the Bank and Financial Institutions Acts, and the Securities Exchange Act be amended, and any new Act replacing any of these Acts be drafted, to provide uniform reporting requirements in respect of report timing, accounting standards to be applied for preparation of financial statements and standards on auditing to be applied to conduct an audit, and to delete contradictory provisions of the respective laws.

- The ROC be strengthened to make it capable of enforcing compliance with the Company Laws. Professional expertise should be employed to analyze financial statements submitted by the companies and follow-up for non-compliance of the legal provisions. A secretariat with adequate human resources be set up at the Company Law Board to make it practically competent to deal with all legal cases forwarded by the ROC, assume the statutory functional responsibilities and work as an advisory body of HMGN on company-related issues.

- The NEPSE be privatized to function independently, efficiently, and effectively. SEBO be strengthened to regulate and monitor listed companies and be empowered to initiate action for non-compliance with its requirements.

- A central depository system be implemented for quick and easy transfer of shares and to develop the stock exchange market.

- A realistic plan be prepared for establishing a credit rating agency to assess creditworthiness of the listed companies and thus provide information facilitating rational investment decisions, and the development of a corporate bond market.

[17] HMGN is said to be already working towards the implementation of some of the recommendations proposed here under the ADB assisted TA, Corporate and Financial Governance Project

PART E:

NON-GOVERNMENTAL ORGANIZATIONS

CHAPTER XII

ACCOUNTABILITY IN THE NON-GOVERNMENTAL ORGANIZATIONS

Financial reporting and auditing requirements of NGOs are prescribed in the Statutes and Acts under which they are registered and affiliated. Although there appears to be massive non-compliance with the law regarding auditing, particularly among local NGOs affiliated with the Social Welfare Council, this is largely due to the fact that many NGOs are dormant. There seems to be a lack of transparency in the total fund flow from various international NGOs partly due to some INGOs choosing not to conclude agreements with Social Welfare Council, or partly due to weak capacity of the Social Welfare Council to monitor INGO compliance with relevant financial and banking regulations. It is important that HMGN formulates policies for streamlining the administrative and legal framework within which NGOs operate, in order to increase their functional and financial accountability, transparency and effectiveness.

A. Legal Framework

12.1 Freedom to organize and operate non-governmental organizations (NGOs) has historically been closely related to the evolution of democracy in Nepal. Thus, despite the Assembly-Association Act, 1949, real freedom to organize NGOs came with Nepal's second Constitution of 1951. It was strictly controlled between 1960 and 1990 through various official instruments, such as the National Guidance Act, 1962, and really blossomed in its present form when freedom to form unions and associations was granted in Nepal's present Constitution promulgated in 1990, confirmed in the Social Welfare (SW) Act, 1992.

12.2 There is no legal definition of "NGO" in Nepal: all NGOs have been established under one of a number of laws, including, for example, the Societies Registration (SR) Act, 1977; or the Cooperative Societies Act, 1992. The SR Act, 1977, is the most popular NGO instrument. Creation of an NGO under that Act requires that seven Nepalese citizens submit the proposed statute of the NGO together with other prescribed information to the designated District Administration Office (DAO) of the Ministry of Home Affairs. A Nepalese NGO may or may not register with the Social Welfare Council (SWC) -- a high level coordinating public agency created under the SW Act, 1992, and under the tutelage of the Ministry of Women, Children, and Social Welfare (MWCSW). International NGOs (INGOs) are required to obtain work permits from the SWC before starting operations in Nepal, but some of them fail to do so, even when they affiliate with a Ministry or local government body.

B. Non-Governmental Organization Numbers and Activities

12.3 The exact number of NGOs is unknown. Although some believe there are as many as 30,000 altogether in Nepal, only about 13,000 NGOs and about 106 INGOs were recorded as affiliated to the SWC as of January 2002, with another 20 INGOs working without such affiliation. NGO activities focus mainly on child welfare; health; service to the blind and handicapped; community, women, and youth development; environmental conservation; education; drug and AIDS control.

C. Financial Reporting and Auditing Requirements

12.4 Financial reporting and auditing requirements of NGOs are prescribed in the Statutes and Acts under which they are registered and affiliated. All NGOs are required to submit their annual programs and budgets to their annual general meeting (AGM) for approval. All INGOs permitted to work in Nepal are required to furnish income and expenditure statements to the SWC every four months (SW Rules, 1992: Rule 20). They are only entitled to conduct financial transactions through the fund which is compulsorily deposited in the Commercial Banks.

12.5 The accounts of the NGOs are subject to audit by the auditors registered at the Office of Auditor General (OAG). The auditors are appointed according to the NGO statutes. The audit report with the physical verification statement is required to be submitted by the SWC related NGOs to the SWC within four months from the expiry of the fiscal year (SW Rules, 1992: Rule 2). The Auditor General audits the SWC. NGOs are required to submit their audit reports as follows:

(a) NGOs registered under the SR Act, 1977, to the AGM and the concerned DAOs.

(b) SWC-affiliated NGOs to the SWC as well as the concerned DAOs.

12.6 The designated local authority (Chief District Officer - CDO of the DAO) is entitled to authorize any officer at any time to inspect the accounts of the NGOs which are required to be compulsorily handed over on demand. In case of any misappropriation or loss of assets and abuse of authority found upon investigation, legal actions or court proceedings may be initiated under the SR Act, 1977, against the alleged NGO authorities. In addition, Village Development Committees (VDCs), municipalities, and District Development Committees (DDCs) are required by the Local Self-Governance Act, 1999 (LSGA), to coordinate NGO developmental activities, use NGOs for carrying out projects, and sign agreements with NGOs regarding their activities in the local jurisdictions.

12.7 The legal provisions related to financial reporting and auditing requirements of the NGOs including INGOs seem to be adequate. A majority of the NGOs, including the INGOs, do not observe such legal provisions, however. According to the OAG Annual Report for 2001, only 215 (out of 11,306) NGOs affiliated with the SWC, and only 39 (out of 94) INGOs, had their financial statements audited in FY 1998/99. Many NGOs do not get their accounts audited because they cease to operate after they are registered, and remain dormant.

D. Transparency of Fund Flow from Donors to Non-Governmental Organizations

12.8 The SW Act, 1992, provides for the institutionalization, channeling, and control of the flow of both domestic and foreign assistance (grants and loans) to the NGOs. Only with the approval of the SWC, should the NGOs be legally entitled to obtain any money, commodity, or technical expertise and any other form of assistance from HMGN, a foreign government, or international social organization/body/person. For this purpose, NGOs need to apply to SWC with the project proposal and funding details. The foreign organizations providing assistance are required to release funds to the local NGOs through the commercial banks of Nepal.

12.9 Nepal-based INGOs are also required to operate their funds only by opening central accounts in any one of such commercial banks (SW Rules, 1992: Rule 20). They are required to conclude agreements with the SWC before commencing work in the country (SW Act, 1992, Section 12 – 1, 2, & 3, and SW Rules, 1992: Rule 12). Such legal provisions aim to achieve transparency of funds flow from donors to NGOs. But, there seems to have been no transparency of the total fund flow for various reasons such as:

- Some INGOs conclude such agreements directly with HMGN Ministries, but not with the SWC.
- According to the OAG Report for 2001, NGOs receiving foreign assistance without SWC prior approval increased from 57 in FY1988/99 to 113 in FY1999/00.
- The SWC does not monitor INGO compliance with relevant financial and banking regulations.
- Most of the NGOs did not submit audit reports.

The CIAA had also called for the updated recording of the financial and technical assistance so far obtained by the NGOs.

E. Effectiveness of Monitoring Mechanism

12.10 Section 9(10) of the SW Act, 1992, has entrusted the SWC with the overall responsibility of monitoring, coordination, supervision, and evaluation of NGO activities. Although it claims to have put in place a scientific monitoring and evaluation system, the figures suggest that the SWC is experiencing some difficulty in coping adequately with this responsibility. In FY1999/00, it was able to monitor only 13 out of 11,036 NGOs and only 17 out of 94 INGOs. The SWC lacks the requisite resources to monitor the vast number of NGOs and INGOs. The SWC is headed by the Minister for Women, Children and Social Welfare. The Council Secretariat is composed of 164 personnel including 40 officers, and has 20 computers. The Ministry, the SWC, and the DAOs are all too weak to monitor NGOs effectively.

F. Current Initiatives for Development

12.11 Since the inception of the Ninth Plan (1997-2002), HMGN aims to develop NGOs as partners in development in a coordinated manner, and to involve NGOs in poverty alleviation and socio-economic development. NGOs and INGOs have also been regarded as instrumental in internal and external resource mobilization.

12.12 The LSGA directs the local bodies viz. VDCs, Municipalities, and DDCs to encourage the NGOs. Programs included in the Ninth Plan include: reform of NGO-related laws; capacity enhancement of SWC and NGOs; institution of a one-window system for resource mobilization from INGOs; institutional development of the monitoring and evaluation system for NGOs; and institutional arrangements to mobilize NGOs in remote areas. Programs envisaged in the forthcoming Tenth Plan include: income generating and employment programs; formulation of rule for the accountability and transparency of NGOs making the audit system performance oriented; effective implementation of national database to monitor and evaluate NGOs and INGOs; and services to NGOs and INGOs to be provided under one umbrella for which the SWC should be strengthened.

12.13 The objective of a one-window system has not been achieved. As stated in paragraph 12.9 above, all INGOs are required by the Section 12 of the SW Act, 1992, to conclude agreements with the SWC before commencing work in the country. Any INGO that fails to do so is, therefore, in breach of the law, and is contributing to the failure to achieve a one-window system for resource mobilization through INGOs. Furthermore, conclusion with the SWC should not prevent an INGO from concluding specific working arrangements or agreements with sector ministries, local authorities, or any other development partners in the country.

G. Legal Reform Initiative

12.14 With a view to overcoming or reducing NGO and INGO-related legal deficiencies and complexities, the SWC has recently prepared a Draft Bill[18] on the Non-governmental Social Development Organizations (NGSDO), for consideration of HMGN. Some of its key features/provisions are as follows:

(a) The proposed NGSDO Bill 2002:

- Replaces the SWC Act, 1992;
- Adopts a concept of "Social Development" (SD) in a comprehensive manner in lieu of "Social Welfare Concept";
- Renames the NGO as the Non-Governmental Social Development Organization (NGSDO);
- Constitutes the SD Council under the chairpersonship of the Prime Minister with the inclusion of the Social Welfare Minister as one of about 40 members. The SD Council shall have an Executive Committee of eight members to perform its management and administrative functions;
- Empowers the SD Council to designate any officer as the Registrar for the legal registration of NGOs, and the Secretary of the District Development Committee (DDC) as the Registrar, in case the SD Council does not designate any Registrar at the local level;
- Allows the establishment or registration of Associations or Federation of the NGSDO for networking and act as the functional unit of the Social Development Organization; and
- Contains adequate provisions for reporting and auditing requirements for NGOs and INGOs.

(b) The proposed NGSDO Bill, 2002, contains the regulatory provisions for foreign assistance to or from the NGOs and INGOs. The SD's approval shall be mandatory before obtaining any kind of foreign assistance including cash or commodity aid by the NGSDO from a foreign government, foreign or international organization, or foreign-national.

(c) INGOs shall strictly fall under the proposed NGSDO Bill, 2002, which stipulates that an INGO desirous of working with its office in Nepal shall obtain a work permit from the SD Council. The work permit recipient INGOs:

[18] Based on 9th version of the draft prepared on June 3, 2002.

- Shall conclude agreements with the SD Council for the project operations in the country;

- May function by way of the conclusion of the agreement with HMGN or the local self government bodies;

- Shall include SD Council while concluding the agreement (tripartite) with HMGN or the local self-government.

(d) The proposed NGSDO Bill, 2002:

- Stipulates that the exchange of foreign assistance in the form of commodity, technical, financial, or any other aid between the social development organizations and foreign government, foreign mission, INGO, or foreign national shall be subject to the approval of, or agreements with, the SD Council;

- Empowers the SD Council to seize or freeze the SD Council's unapproved foreign assistance;

- Empowers the SD Council to repeal the SWC work permit granted to the INGO;

- Provides that the INGO shall operate with the Nepalese NGOs as partners in respect of the programs other than the prescribed SD activities;

- Provides that the INGOs working in Nepal shall mobilize financial resources from the international level.

12.15 The SWC-initiated legal reform in the form of a Draft Bill is a positive and commendable step for more facilitation, regulation and promotion of Nepal-based INGOs and NGOs. The proposed Bill intends to bring all NGOs, including INGOs, under a single legal framework and under the umbrella of the proposed SD Council. But such legal provisions in some form or other exist even in the prevailing legal instruments including the SW Act, 1992. Their efficient and effective implementation is the basic problem due to weaknesses in the institutional mechanism and the human, financial, and other resource constraints.

12.16 The Draft NGSDO Bill, 2002, lacks provisions that relate to implications and complications of the existing NGOs registered under the different laws including the SR Act, 1977. It inappropriately replaces the term "NGO" by the term "NGSDO". Such a legal provision may lead to confusion among people/national or international community or legal issues.

12.17 The proposal in the draft legislation to have the Social Development Council headed by the Prime Minister, may avoid ministerial conflict on the one hand but may prove ineffective, judging by the Prime Minister's busy schedule on the other hand. The proposal appears to stem from a desire to avoid ministerial conflicts and interference. It is also expected to increase SWC authority over the INGOs.

H. Recommendations

12.18 **It is recommended that HMGN**:

(a) Formulate policies for streamlining the administrative and legal framework within which NGOs operate, in order to increase their functional and financial accountability, transparency and effectiveness.

(b) Enact a comprehensive legislation exclusively for registration and governance of NGOs including INGOs. Possible matters to be covered should include:

(i) Prescribe the accounting and auditing systems (and provide guidelines to implement them) on the basis of the nature and size of the NGOs and INGOs. Provision should be made for simplified reporting for small or dormant NGOs. Further, arrangements should also be made by SWC to prescribe fiscal framework guidelines. Auditors used by NGOs and INGOs should have qualifications and experience acceptable to SWC. The preparation of accounting and auditing standards should be included in the work of the proposed Accounting and Auditing Standards Boards.

(ii) File with the SWC (or SDC if created) the agreements, funding arrangements, and balance sheet of each INGO and its associated NGOs to ensure their accountability and transparency.

(iii) Make arrangements for all INGOs to have agreement with the SWC; have them work directly with the executing line ministries/agencies; have them produce periodic implementation reports to be shared with concerned authorities; and have the SWC monitor the implementation.

(iv) Provide for the audit of accounts of INGOs whose headquarters are in Nepal to be conducted by a suitably qualified and independent auditor registered at the OAG, and arrange to provide a copy of the audit report to the OAG.

(v) Implement a one-window policy strictly for the INGOs under strict legal provisions.

(vi) Seek inputs from the SWC as the focal point for NGOs and INGOs before concluding any agreement in favor of foreign assistance to such organizations.

(vii) Ensure transparency in fund transfer through NGOs and INGOs.

(c) Strengthen SWC or SDC (if created) by restructuring its internal organizational structure appropriately on the basis of the organizational analysis which is recommended to be carried out separately.

(d) Establish and enforce service standards by SWC, including time limits for processing agreements and responding to enquiries.

(e) Require all NGOs and INGOs to register, and file annual audited accounts, with the SWC (or the SDC, if created).

(f) Take whatever legislative and capacity building measures are necessary to facilitate the implementation of the above measures.

PART F:

DEVELOPMENT ACTION PLAN AND IMPLEMENTATION STRATEGY

CHAPTER XIII

DEVELOPMENT ACTION PLAN AND IMPLEMENTATION STRATEGY

This CFAA has covered the assessment of financial accountability in the public sector, private sector, and NGO sector. Recommendations made in each chapter are relevant to improvements in the concerned sector or sub-sector. These could serve as input to both government and donors to formulate their policies and country assistance strategies. There are actions related to enforcement of rules or amendment of some rules or capacity building of various agencies. But, there are some critical areas where immediate actions are required, and they are translated into the Development Action Plan which present the top priority actions. HMGN has agreed to implement these time-bound actions in order to bring about reforms in financial management in an integrated approach covering planning, budgeting, accounting, internal control, internal audit, external audit and oversight. Reform in only one area of financial management will not result in the same degree of expected benefits. A permanent Reform Monitoring Committee to monitor the implementation of recommended actions, will be formed. Implementation of actions will be periodically monitored by the Committee, and reports thereof will be shared with the Finance Committee of the Parliament and the development partners.

A. Realism and Priorities

13.1 The Development Action Plan (DAP) recommended as a result of this CFAA is in a matrix attached to the Executive Summary. There are close to 100 individual recommendations in the preceding 12 chapters of this report. To present them as they are to HMGN would almost certainly invite inaction. HMGN and the World Bank have therefore agreed on distilling from all the recommendations the **eight** major actions likely to have the strongest impact on financial accountability in Nepal in the short to medium term (implementation of the DAP is the **ninth** action). Each action is, of course, broken down into several supporting sub-actions.

13.2 The actions and supporting sub-actions included in the DAP represent the top priority actions to be pursued at the national level. Other recommendations in this CFAA, which are not listed in the DAP matrix should be taken on board by those responsible for their implementation in developing more detailed sectoral, departmental, or institutional action plans.

B. Implementation Strategy

13.3 Responsibility and timeframe for implementing each action in the DAP is indicated in the matrix. Following the CFAA workshop organized by the government-appointed multi-sectoral National Steering Committee (NSC) in Kathmandu in June 2002, HMGN has designated the **Reform Monitoring Committee (RMC)** as the organ responsible for monitoring the implementation of the DAP. The RMC is an inter-agency committee inheriting the monitoring ideas floated during the Nepal Development Forum (NDF) of February 2002, to follow up issues of budgetary support. It also includes representatives of donors and the private sector.

13.4 The RMC is expected to nominate specific individuals (or groups of individuals) within the committee as sub-committees to monitor specific actions in the DAP. They are to liaise with HMGN or other agencies responsible for taking actions, and report back to the full RMC every quarter. The RMC will meet periodically to discuss progress in implementing the DAP and will report thereon once every quarter to the Finance Committee of the Parliament, the Finance Secretary and all the development partners who participated in the NDF in February 2002. The first of these quarterly reports will be issued by December 2002. The WB is also expected to include the DAP and its latest stage of implementation in each Country Assistance Strategy (CAS) until all the DAP actions and sub-actions are fully implemented.

C. Possible Risks and Plans to Overcome Them

13.5 The greatest single risk to the implementation of the DAP is that old habits die hard. The DAP represents, above all, an effort to change human behavior -- to move from a culture of non-compliance with existing legislation to one of compliance. This is infinitely more difficult than enacting new legal instruments. Two "watchdog" and "oversight" institutions the CFAA team found reporting fearlessly on non-compliance, and calling for remedial action are the OAG and the PAC. The CFAA team recommends strengthening these two institutions (see DAP matrix), so that the OAG can report on non-implementation of the DAP to the PAC and the PAC can demand punitive sanctions from HMGN against officials who fail to comply.

13.6 In addition, the MOF will report on progress of implementation of the DAP to each meeting of the NDF.

D. Suggested Next Steps

13.7 HMGN will formally constitute the RMC (with representation from private sector as well), name its members, and issue it with terms of reference (TOR) incorporating the work and operating procedures outlined in this Chapter by **August 31, 2002**. The RMC will hold its first quarterly meeting and nominate its sub-committees by no later than **September 30, 2002**. It will issue its first DAP Implementation Progress Report by **December 31, 2002** and issue its first report to the next NDF.

ANNEXES

NEPAL
COUNTRY FINANCIAL ACCOUNTABILITY ASSESSMENT (CFAA)

CONCEPT NOTE

BACKGROUND

(i) Country Background

1. Nepal remains one of the world's poorest countries. In the rural areas, where 85% of Nepalese live, population increase has outpaced agricultural growth in recent years. More rapid progress in the fight against poverty has been hampered by ineffective and increasingly unstable governments. Corruption is perceived to be widespread, contributing to misallocation of government resources, delays in project implementation, difficulties in obtaining approval for private investments, and rapid turnover and perverse incentives for civil servants. While macroeconomic management has generally been acceptable, the economy has suffered from the lack of proper management of public expenditures, stagnant real revenues, large and inefficient parastatals, and a weak financial sector. As a result, Nepal has not been able to adequately exploit its assets – fertile land in the Terai, access to generous donor aid, strong tourism appeal, and enormous, if partly seasonal, water resources and hydropower export potential. This discouraging picture may be a factor in the recent emergence of a low-intensity, but violent Maoist insurgency. The Public sector contribution to the national economy, for the FY 2001, is 7.7 percentage of GDP compared to period average of 7.1 percent of GDP (FY1996-2000). With stable macro economic fundamentals, the present growth rate is expected to increase as more capital intensive projects are being implemented in the power and drinking water sectors. Compared to public sector, private investment as percentage of GDP for FY 2001 is 18 percentage with period average of 17.4 percent of GDP (FY 1996 – 2000). This slow growth rate of private sector investment has been a result of political instability and inability to undertake far reaching second round of policy changes to create a conducive environment for growth of private sector after 1991.

2. The Government's priority is to reduce poverty by strengthening the liberal and market oriented economic policies pursued earlier for building a healthy and strong economy. The FY2002 budget represents the continuation and consolidation of the reform measures that were initiated in FY2001. To achieve the goal, the budget highlighted the following five measures: (a) improve the environment for investment, (b) bring dynamism in the financial sector, (c) keep public sector expenditures to affordable limits, (d) enhance the access of the deprived class to productive resources, and (e) strengthen good governance and decentralization. The Government is highly committed to improve financial accountability and corruption control. A Country Financial Accountability Assessment (CFAA) is an important effort towards achieving this objective.

3. There have been numerous studies of Nepal's financial accountability and management systems in the last two years. Some of these studies have been executed or directed by the Bank. Others have been carried out by the Asian Development Bank (ADB) and by the United Kingdom's Department for International Development (DFID). Bank led studies include a Country Profile of Financial Accountability (CPFA) completed in 1999, a Country Procurement Assessment Report (CPAR) completed in 2001, a 2000 Public Expenditure Review (PER), and an April 2000 report on accounting and auditing in Nepal. ADB reports include sector as well as project related reports dealing with governance in the private sector, DFID reports deal with the government budgeting and accounting systems. The role of the CFAA will be to bring together all the relevant key lessons from these reports,

up-date the information, taking into account financial accountability capacity building initiatives underway in both the public and the private sectors, and assess fiduciary risk, as a pre-requisite for proposed programmatic lending, and decentralized implementation of development programs. The CFAA will also examine and recommend the ways to develop linkage between expenditures and outputs and ultimate outcomes.

(ii) Objective of the CFAA

4. A CFAA, **in general,** assesses whether a country has the necessary controls and systems to ensure that resources are used efficiently for their intended purposes, and lay the base for a nationally owned financial management improvement program that might be suitable for donor funding.

5. **Specific Objectives of the Nepal CFAA** are to:

(a) assess the risk that public financial resources in Nepal may be used illegitimately, inefficiently, or ineffectively, by comparing with the good practices of public financial management;

(b) assess status of actions taken or in progress, with regard to institutional changes in public sector financial management, designed to provide better comfort to His Majesty's Government of Nepal (HMGN), IDA and other agencies planning programmatic and adjustment lending in Nepal;

(c) examine financial management risks associated with decentralized project/program implementation, and how such risks can be mitigated through strengthening local government financial accountability; or project/program implemented through non-governmental organizations (NGOs);

(d) assess how the expenditures can be linked closely with the outputs and the ultimate envisaged outcomes by addressing the issues as relevant to this area, since the ultimate goal of financial control is to achieve good outcomes at the least cost;

(e) assess status of capacity building work on developing framework for accounting and auditing in the private sector aimed at bringing standards to international levels; and

(f) identify any needs for training and other capacity building measures, both in the public and private sector, designed to improve financial accountability standards and practices among users, custodians of public funds and other oversight agencies.

(iii) Relationship to CAS, Lending Program, Policy Dialogue

6. The **Country Assistance Strategy (CAS)** has two new prongs:

(a) bringing resources closer to the beneficiaries, to improve their productive use, and

(b) fostering the strong governance needed to reduce waste and mismanagement.

7. The CFAA will directly support the achievement of these two objectives. In the case of (a) above, the CFAA will assess central and local government financial management capacity and recommend measures to mitigate fiduciary risk at the central and local level. With regard to (b) financial accountability, which is the principal focus of the CFAA, is essential for good governance. In addition, IDA is discussing with HMG/N the possibility of a Poverty Reduction Strategy Credit (PRSC) and other programmatic lending, relying heavily on the reporting and auditing capabilities of the government. The CFAA will assess the financial risk to which such funds will be exposed.

SCOPE

(i) **Areas to be Reviewed**

8. The CFAA will cover:

- financial architecture for public sector accountability including, inter-alia, aspects of planning, budgeting, treasury operations, disbursement, accounting systems, internal control, inventory management, and related practices at the national and local levels;

- role of the Parliamentary Committees in their monitoring of public expenditures;

- financial management arrangements for donor-funded investments, and identification of key financial risk areas in disbursement mechanisms and channels currently in place, including funds flow to community and participatory organizations;

- methods of linking budgeting and planning systems to the accounting system, and how an improved financial management system can help to link the actual expenditures to measurable outputs;

- support by other development partners in strengthening financial management improvement program and other governance related programs;

- recommendations made by the Government's Public Expenditure Review Commission and their implementation status with regard to financial accountability and governance;

- review of the internal audit and its effectiveness;

- the audit capacity in the country, including the independence and the role of the Office of the Auditor General (OAG) in Nepal, and private audit firms, and scope for strengthening the institutional capacity of OAG; also, review the progress of OAG in the field of Performance Auditing initiative that has been instituted which serve the basic link to measure the measurable outputs and outcomes in relation to the expenditures incurred;

- previous assessments carried out in April 2000 of the private sector accounting, auditing and related legal frameworks to determine their compatibility with the current needs of the country as well as with International Accounting Standards (IAS) and International Standards of Auditing (ISA);

- the capacity of the Institute of Chartered Accountants of Nepal (ICAN) and the review of ICAN's work program including its training program;

- the financial sector's accepted accounting, reporting (disclosure), and auditing practices;

- the financial transparency and accountability framework for funds passed through the non-governmental organizations (NGOs) for project/program implementation; and

- the financial management/transparency dimensions of anti-corruption initiatives in Nepal, including the role of the Commission of Investigation of Abuse of Authority (CIAA) and the Public Accounts Committee (PAC) in this respect.

(ii) Specific issues deserving attention

9. In addition to specific objectives described in paragraph 5 above, the CFAA will examine a new dimension of financial control in developing linkages between expenditures and measurable outputs and outcomes. In this respect, it will focus on the suitability of the government's budgeting and accounting systems for producing financial management reports (FMR) linking physical and financial progress, as a basis for promoting FMR based disbursement on IDA financed projects.

(iii) Methodology of the Nepal CFAA

10. The CFAA will start with a desk review of previous analytical work and the latest relevant laws and regulations. Position papers will be requested from the National Steering Committee (NSC) formed by HMGN to coordinate the CFAA exercise. Local consultants will also be engaged to look into specific areas of CFAA for more focused groundwork. Based on this review, the CFAA team will prepare checklist to further probe for any missing information. Position papers and field assessment will be used to prepare a draft CFAA report, whose contents will be confirmed in the field with various stakeholders. Thereafter, a workshop of stakeholders in Nepal will discuss and refine the CFAA report and Action Plan. These latter will then be circulated for final comments, final changes, and formal adoption by HMG/N.

11. Areas of emphasis and special focus in the CFAA might be changed based on the continued Government/Bank dialogue and the perceived needs of the Government. Although attempts will be made to cover most areas that relate to financial accountability, these will remain flexible as we move forward with our dialogue with our partners in government agencies and with other development donor partners. A major adjustment in the objectives and issues is, however, not expected.

PROCESS

12. The World Bank will coordinate the CFAA exercise in close collaboration with HMG/N and other development partners active in this sector, particularly the ADB, DFID, and the Netherlands Government. Within the Bank, the CFAA team will coordinate its activities closely with teams who worked on the Public Expenditure Review (PER), Medium Term Budget Framework (MTBF) and the Country Procurement Assessment Report (CPAR).

(i) Identity and Roles of Authorities and Other In-Country Stakeholders

13. Efforts are underway to ensure Government ownership of the exercise. HMGN has formed a National Steering Committee (NSC) on December 5, 2002 headed by the Financial Comptroller General. The NSC includes representatives from the Ministry of Finance (MOF), Office of the Auditor General (OAG), Financial Comptroller General Office (FCGO), National Planning Commission (NPC), and Association of Chartered Accountants (the Bank proposed to include two more members from the Institute of Chartered Accountants and the Ministry of General Administration). The NSC is mandated to guide the CFAA exercise on behalf of the Nepalese stakeholders, working closely with the Bank CFAA team. The NSC will co-ordinate the CFAA work on behalf of the Government and work closely with the Bank CFAA Team. It will also prepare brief Position Papers on current status, emerging issues, and plans for their resolution in (a) public sector budgeting, accounting and internal control, (b) public sector auditing, (c) Parliamentary Control of public expenditures, (d) oversight agencies for ensuring good governance, as well as financial accountability in (e) local governments, (f) financial institutions, and (g) non-governmental organizations (NGOs).

(ii) Identity and Roles of Collaborating Development Partners

14. The ADB has done a lot of work in the areas of private sector governance and the development of ICAN. DFID has been equally active in supporting improvements to Government budgeting and accounting. It is anticipated that the CFAA will be able to benefit from the wealth of experience of these development partners and other local experts and professionals including other development agencies who have worked or contributed in this sector. Development partners will participate in meetings and discussions throughout the process. In addition, the ADB, DFID, Netherlands, UNDP and the IMF will be requested to provide external peer review of the CFAA.

(iii) The World Bank's Comparative Advantage

15. Much of the good analytical and capacity building work done in the past in the sector has been fragmented. The CFAA instrument developed by the Bank represents a timely opportunity to synthesize this work (much of it done by other development partners) and provide a venue for discussion with HMGN and other development partners with a view to developing a global sectoral strategy. The Bank has developed experience in this work through its CFAA program.

(iv) Relationships with other ESW and Lending Supporting Financial Accountability

16. The CFAA will review accounting and auditing systems in both the public and private sectors from the technical viewpoint aimed at assessing fiduciary risk and identifying capacity building needs. The PER has looked at many of the same public sector financial management institutions and practices as the CFAA, but through different "lenses", the objective being to assess their economic impact, including their efficiency and effectiveness in allocating resources so as to achieve the declared objectives of economic policy. The Country Procurement Assessment Report (CPAR) singles out for deeper analysis one element of internal control (i.e. of financial management), namely procurement, which also happens to be one of the biggest sources of corruption. All three sector studies -- CFAA, PER and CPAR -- represent three major tools in a tool-kit designed to promote transparency and reduce corruption. The CFAA would provide the analytical support for preparation of capacity building projects and for reform programs agreed in conjunction with adjustment lending.

(v) Appropriate Audiences for CFAA

17. Findings from CFAA will be of interest to HMGN, particularly those of its institutions involved in public sector financial management, (e.g. MOF, FCGO, and OAG). They will also be of particular interest to ICAN - a fledgling institute struggling to attain membership of the International Federation of Accountants (IFAC) - as well as the accounting and auditing professions it represents. Last, but not least, the donor community in general, and IDA in particular, will be particularly interested in the CFAA's findings regarding the state of readiness of public sector financial institutions to properly account for budgetary support as distinct from project lending. The Nepal Stock Exchange will also be interested in the CFAA findings on corporate governance and transparency.

(vi) Expected Impact

18. There will be an impact on all three groups of audiences identified in the preceding paragraph. The government agencies will apply the CFAA findings in preparing themselves not only to receive and account properly for programmatic lending and budgetary support, but also to prepare Financial Management Reports (FMRs) for IDA-financed projects. ICAN will take on board the CFAA recommendations that will strengthen its effectiveness as a self-regulatory accounting body, its usefulness to its members, and its bid for IFAC membership. IDA and the donor community will use the CFAA findings on fiduciary risk to assess Nepal's readiness for budgetary support lending and for drawing FMRs from mainstream government systems. The other expected benefit is that the government agencies will be able to apply CFAA findings to their ongoing efforts in prioritizing and addressing government financial management issues.

(vii) Reasonable Prospect of Action

19. HMGN has concluded that development expenditures have not fostered economic growth and poverty reduction that may be expected from the size of the spending that has taken place, that the quality of public expenditures in Nepal is a fundamental problem, and that improving financial accountability is a key ingredient in tackling this problem. The government has declared poverty reduction as its primary goal in its first Poverty Reduction Strategy Program (I-PRSP) and is in the process of preparing the tenth Plan as its full PRSP by the end of FY02. To give a sound fiscal framework for the PRSP and to ensure a bridge between PRSP and annual budgets, the government has announced the introduction of

Medium Term Budget Framework (MTBF) that looks beyond one year time frame to a medium term, as from the fiscal year 2003. HMGN has agreed with IDA that a CFAA at this time will help the government to improve the public accountability and transparency in the management of public funds. HMGN has given the CFAA as a priority agenda, and has demonstrated full commitment to partner with the Bank in this initiative. HMGN is also planning to organize a joint NSC and donors meeting to disseminate the CFAA initiative that HMGN is undertaking with the Bank's assistance. The CFAA will also be responsive to and take into account of the Government's Strategy Paper that has recently been prepared by the Ministry of Finance (November 2001). The examples of impact cited in the preceding paragraph virtually guarantee that some actions will be taken in response to any serious weakness or capacity building needs identified by the CFAA. Such action would be dictated by the self-interest of each stakeholder mentioned in that paragraph.

(viii) Dissemination and Other Actions to Ensure Impact

20. All the stakeholders discussed in paragraph 17 above will be involved in the CFAA from the planning stage through the submission of Position Papers, reviews of drafts of the CFAA report, participation in the CFAA workshop in Kathmandu, right through to approval of the final Action Plan. The Action Plan will also be reflected in the next Country Assistance Strategy (CAS) and, to the extent that opportunities for a Bank-financed capacity building project are identified, in IDA's future lending program. Finally, the NSC is expected to continue in existence to supervise the implementation of the Action Plan.

REPORTING ARRANGEMENTS AND TIMETABLE

21. CFAA activities, reports, and their timing will be as follows:

- Desk review of existing reports, rules, and regulations, and preparation of questionnaires (complete by January 15, 2002);
- HMGN to form a National Steering Committee (NSC) and submit position papers to the Bank (complete by January 15, 2002);
- Team of national consultants to mobilize for field work and desk review of relevant documents by January 31, 2002;
- Review position papers and other documents prepared by national consultants, complete a draft CFAA (desk review) report and prepare checklist to fill any remaining information gaps from the desk review and position papers (complete by February 7, 2002);
- Field visit to check/confirm information in draft CFAA report (complete by end February 2002);
- Preparation of full draft of CFAA report; circulation for comments (complete by end April 2002);
- Stakeholder workshop in Kathmandu (complete by end May 2002)
- Finalization of report incorporating workshop results, and issue to client as final draft report (complete by end-June 2002);

- Government/Bank agreement on time-bound Action Plan and issue of final report (complete by July 2002).

- Activity Completion Summary (complete by end September 2002)

TEAM COMPOSITION AND QUALITY ASSURANCE

22. The CFAA **core team members** and their responsibilities will be:

- Bigyan Pradhan, Senior Financial Management Specialist, Nepal Country Office: **Task Team Leader**
- Uche Mbanefo, International Consultant, (former Regional Financial Management Advisor, Africa Region, World Bank): **Lead Consultant**
- Ahmed Ahsan, Sr. Country Economist, South Asia Region, and Roshan Bajracharya, Consultant (Economist), Nepal Country Office: **PER liaison**
- Narayan Sharma, Consultant (Procurement), Nepal Country Office, and Kiran Ranjan Baral, Procurement Specialist, South Asia Procurement Regional Hub: **CPAR liaison**
- Upendra Pradhanang, Nagendra Rajbansh, Pradeep Shrestha, Chandra Bahadur Nemkul, and Harihar Regmi: **specific fact finding and interviews per specific TORs**
- Robert Saum, Acting SAR RFMA: **overall guidance and supervision**.

23. For **quality assurance**, this Concept Note, as well as the draft and final CFAA will be reviewed by:

(a) the National Steering Committee (NSC)

(b) the Country Director, the Operations Advisor, the Country Task Team Leaders of the Nepal Portfolio

(c) South Asia Regional Front Office:

Sadiq Ahmed, Chief Economist and Sector Director, Poverty Reduction and Economic Management; Eve Bosak, Regional Chief Financial Officer; Kevin Casey, Regional Procurement Advisor; Agustin Litvak, Manager, South Asia Procurement Regional Hub; Roberto Zagha, Economic Advisor, SARVP

(d) **SAR peer reviewers:**

Vinod Sahgal, Public Financial Accountability Specialist SARFM; Sanjay Pradhan, Regional Advisor for Public Sector Management and Governance, SASPR; Simon Bell, Sr. Financial Economist, SASFP.

(e) E**xternal peer reviewers:**

Ivonna Kratynski, FMS, Loan Department; Pierre Messali, OPCFM; Paul Edwin Sisk, LCOAA; John Fitzsimon (Ex-Acting RFMA of SAR); Allister Moon, ECSPE; Nominees of ADB, DFID, Netherlands, UNDP and IMF.

LIST OF PERSONS INTERVIEWED

National Steering Committee (NSC)

1. Mr. Bansidhar Ghimire, Financial Comptroller General, FCGO (Convenor) (upto April 2002)
2. Mr. Madhab Prasad Ghimire, Financial Comptroller General, FCGO (Convenor) (from May 9, 2002)
3. Mr. Rameshore Prasad Khanal, Joint Financial Comptroller General, FCGO (Member Secretary)
4. Mr. Ram Kumar Shrestha, Joint Secretary, National Planning Commission (Member)
5. Mr. Ramesh Raj Satyal, Assistant Auditor General, OAG (Member)
6. Dr. Madhav Prasad Ghimire, Joint Secretary, Budget Division (Member)
7. Mr. Ram Krishna Kharel, Under Secretary, Ministry of General Administration (Member)
8. Mr. Pramod Koushik, General Secretary, Association of Chartered Accountants (Member)
9. Mr. Purushottam Lal Shrestha, Secretary, ICAN (Member)

Ministry of Finance

10. Dr. Ram Sharan Mahat, Finance Minister*
11. Dr. Bimal Prasad Koirala, Secretary
12. Mr. Madhav Prasad Ghimire, Joint Secretary, Foreign Aid Coordination Division
13. Mr. Sundar Man Shrestha, Under Secretary, Foreign Aid Coordination Division
14. Mr. Hari Regmi, Under Secretary, Foreign Aid Coordination Division

Ministry of General Administration

15. Mr. Mukunda Prasad Arjyal, Secretary*

Ministry of Local Development

16. Mr. Uday Raj Soti, Secretary*
17. Mr. Ganga Dutta Avasthi, Joint Secretary
18. Mr. Chakra Mehar Bajracharya, Joint Secretary
19. Mr. Binod K.C., Under Secretary

Ministry of Women, Child and Social Welfare

20. Mr. Kiran Chandra Shrestha, Under Secretary

Ministry of Water Resources

21. Mr. Lok Man Singh Karki, Secretary

Office of the Auditor General

22. Mr. Bishnu Bahadur K.C., Auditor General
23. Mr. Dibakar Prasad Bhattarai, Deputy Auditor General
24. Mr. Krishna Prasad Neupane, Deputy Auditor General
25. Mr. Padma Dayal Shrestha, Deputy Auditor General

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* At the time of Fact-finding Mission in February 2002.

26. Ms. Sarita Manandhar, Director
27. Mr. Krishna Lal Shrestha, Director
28. Panel Discussion with staff of OAG (about 25 staff)

National Planning Commission

29. Mr. Prithvi Raj Ligal, Vice Chairman*
30. Dr. Shankar Sharma, Member
31. Mr. Bhagawati Kaphale, Joint Secretary
32. Mr. Narayan B. Shrestha, Under Secretary
33. Mr. Pushpa Lal Shakya, Under Secretary
34. Mr. Subas Dhar Shakya, Under Secretary
35. Mr. Miranda P. Upadhaya, Under Secretary

Office of the Attorney General

36. Mr. Badri Bahadur Karki, Attorney General*

Judicial Council

37. Mr. Kashi Raj Dahal, Secretary

Financial Comptroller General Office

38. Mr. Shiv Bhakta Sharma, Joint Financial Controller General
39. Mr. Sushil Sharma, District Treasury Controller, Kathmandu DTCO
40. Mr. Durgesh Pradhan, Accounts Officer, FCGO
41. Panel Discussion with Accounts Staff (about 25 staff)

Commission for Investigation of Abuse of Authority

42. Mr. Surya Nath Upadhya, Chief Commissioner
43. Mr. Basudev Lamichhane, Commissioner

Public Accounts Committee, House of Representatives

44. Mr. Subas Nembang, Chairman*
45. Mr. Ramesh Lekhak, Member*
46. Mr. Birodh Khatiwada, Member*
47. Mr. Surya Gurung, Secretary
48. Mr. Som Bahadur Thapa, Secretary
49. Panel Discussion with PAC (about 12 attendants)

Department of Irrigation

50. Mr. Bimal Prasad Dahal, Chief Accounts Controller

Department of Education

51. Mr. Shakti Prasad Shrestha, Chief Accounts Controller*
52. Mr. Dilip Raj Joshi, Accounts Officer

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* At the time of Fact-finding Mission in February 2002.

Department of Water Supply and Sewerage

53. Mr. Bachchu Ram Nepal, Chief Accounts Controller

Revenue Intelligence Department

54. Mr. Deep Basnet, Director General

Nepal Administrative Staff College

55. Mr. Sambhu Saran Prasad Kayastha, Executive Director
56. Mr. Gopal Jung Rayamajhi, Deputy Executive Director

Nepal Rastra Bank

57. Mr. Surendra Man Pradhan, Director, Inspection and Supervision Department
58. Mr. Rajan Singh Bhandari, Director, Operations Department
59. Mr. Tula Raj Basyal, Director

Association of District Development Committees of Nepal

60. Mr. Murari Prasad Upadhyay, Acting Executive Secretary General
61. Mr. Purusottam Nepal, Fiscal Decentralization Specialist

Revenue Administration Training Center

62. Mr. Tirtha Raj Sharma, Training Chief*

Agriculture Research and Extension Project

63. Dr. Bharat Prasad Upadhyay, Project Coordinator

Nepal Irrigation Sector Project

64. Mr. Khagendra Mani Pokharel, Accounts Controller*

Ministry of Education

65. Mr. Phanindra Regmi, Accounts Controller

Ministry of Health

66. Mr. Tanka Mani Sharma, Accounts Controller

Center for Public Policy Dialogue

67. Mr. Bishwo Nath Sapkota, Chairman*

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* At the time of Fact-finding Mission in February 2002.

Institute of Chartered Accountants of Nepal

68. Mr. Prabhu Ram Bhandari, President
69. Mr. Ratna Raj Bajracharya, Member
70. Mr. K.K. Singh, Member
71. Panel Discussion with ICAN Executive Members (about 5 present)

Transparency International of Nepal

72. Mr. Ramesh Nath Dhungel, Vice-Chairman

Social Welfare Council

73. Dr. Tika Pokharel, Member Secretary*
74. Mr. Madan Rimal, Director
75. Mr. Jeevan R. Bhattarai, Director
76. Mr. Prakash Dahal, Consultant
77. Mr. S. N. Choudhary, Director

Security Exchange Board

78. Mr. Dambar Nath Dhungel, Chairman

Insurance Board

79. Mr. Prafulla K. Kafle, Chairman

Registrar of Company

80. Mr. Ram Narayan Shrestha, Registrar

Nepal Stock Exchange

81. Mr. Mukund Prasad Dhungel, General Manager

Chartered Accountants

82. Mr. Satish Chandra Lal, S.C. Lal & Associates
83. Mr. Komal Chitracar, KB Chitracar & C0.

National Life and General Insurance

84. Mr. Bharad Bahadur Basnet, Finance Chief

Donor Agencies and Development Partners

85. Dr. Chi Nai Chong, Deputy Resident Representative, Asian Development Bank
86. Mr. Krishna Ram Pandey, Program Officer, Asian Development Bank
87. Mr. David Wood, Head of Office, DFID
88. Mr. Chris Jackson, DFID
89. Mr. Stephen Sharples, Senior Governance Adviser, DFID
90. Mr. Henning Karcher, Resident Coordinator, UNDP
91. Mr. Lawrence De Milner, Resident Representative, IMF

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* At the time of Fact-finding Mission in February 2002.

92. Mr. Jan de Witte, Country Director, SNV
93. Mr. Addie van Dalen, Manager, SNV
94. Donors Meeting Participants

ADB-financed Accounting and Auditing Project

95. Mr. Graeme Macmillan, Castanet International, Consultant

NGO Federation of Nepal

96. Mr. Gauri Pradhan, President
97. Mr. Hem Bhandari, Central Member

Action Aid, Nepal

98. Mr. Shibesh Chandra Regmi, Country Director
99. Mr. Uma Nath Sangel, Head of Finance & Administration

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