

# FINANCIAL MANAGEMENT IN WORLD BANK RECONSTRUCTION PROJECTS

The World Bank recognizes that financial management is an integral part of the development process. In the public sector, it ensures accountability and efficiency in the management of country resources; in the private sector, it promotes investment and growth. Therefore, the first objective of the Bank's attention to financial management is **to improve borrowing countries' financial management performance**. At the same time, if the Bank is to sustain the confidence of its shareholders, other stakeholders, and the public at large, it must be able to show that its funds are used appropriately. Thus, the second objective of the Bank's financial management work is **to provide acceptable assurance on the use of Bank loan proceeds**. While these objectives are sought even in emergency operations, including post-disaster reconstruction projects, adjustments to normal procedures are sometimes required.

For the World Bank, financial management arrangements are the budgeting, accounting, internal control, funds flow, financial reporting, and auditing arrangements of the government borrower or other agency responsible for implementing Bank-supported loan operations.<sup>1</sup> Under OP/BP 10.02, Financial Management, the Bank requires that for each Bank-funded operation the borrower maintain acceptable financial management arrangements to provide reasonable assurance that the proceeds of the loan are used for the purposes for which the loan was granted.<sup>2</sup>

This chapter provides (1) an overview of the Bank's project cycle, (2) a discussion of the elements of the Bank's financial management practices as it prepares for and oversees lending, and (3) a presentation on some of the special arrangements related to Bank financial management that may be used in emergency operations. For a full discussion of the Bank's response to emergencies, see  Chapter 20, World Bank Response to Crises and Emergencies.

## The World Bank Project Cycle

### What Is a World Bank Project?

The World Bank lends money to low- and middle-income countries to support development and change. Development projects are implemented by borrowing countries following certain rules and procedures to guarantee that the money reaches its intended target.

### What Is the World Bank's Project Cycle?

A series of activities carried out by the Bank in collaboration with government ensure that Bank support is addressing the most important development issues for the country and that loans are used for purposes for which they were intended. These activities collectively are referred to as the Bank's "project cycle." The Bank's project cycle includes the following steps.

### This Chapter Is Especially Useful For:

- Policy makers
- Lead disaster agency
- Financial specialists
- Project managers

1. The policies and procedures summarized here apply to all loans, credits, advances under the Project Preparation Facility, and grants financed from World Bank resources, including International Development Association grants and Institutional Development Fund and other Development Grant Facility grants, with the exception of Development Policy (previously known as adjustment) Loans and Guarantees. They also apply to recipient-executed grants financed from trust funds, unless the donor agreement has different terms.
2. See "Guidelines: Financial Management Aspects of Emergency Operations Processed under OP/BP 8.00" and "Financial Management in Operations Processed under New OP/BP 8.00: FM for TTLs," January 16, 2008 (PowerPoint presentations), internal Bank documents.

Stage	What it entails
Country Assistance Strategy	The World Bank project cycle begins with the elaboration of a <b>Country Assistance Strategy</b> . The Bank works with a borrowing country's government and other stakeholders periodically to determine (or to update) how financial and other Bank assistance can have the largest impact. This is followed by the preparation of strategies and priorities for reducing poverty and improving living standards. Examples of nearly all the project documents mentioned in this section, including Country Assistance Strategies, are available on the Bank's Web site. <sup>3</sup>
Project identification	Identified projects can be for infrastructure, housing, education, health, and government financial management, among others. The World Bank and government agree on an initial project concept and its beneficiaries, and the Bank's project team outlines the basic elements in a <b>Project Concept Note</b> . Also generated during this phase are the <b>Project Information Document</b> and the <b>Integrated Safeguards Data Sheet</b> , which identifies environmental and social issues that may be raised by the project.
Project preparation	The borrower government and its implementing agency or agencies conduct feasibility studies and prepare engineering and technical designs, to name only a few of the work products required. Government contracts with consultants and other public sector companies for goods, works, and services, as necessary, not only during this phase but also later in the project's implementation phase. Beneficiaries and stakeholders are consulted to obtain their feedback and enlist their support for the project. Due to the amount of time, effort, and resources involved, the full commitment of government to the project is vital.  Bank staff may determine that a proposed project could have environmental or social impacts that are included under the <b>World Bank's Safeguard Policies</b> . If so, the borrower prepares an <b>Environmental Assessment Report</b> that analyzes the planned project's likely environmental impact and describes steps to mitigate possible harm. An <b>Environmental Action Plan</b> may also be prepared. The recommendations are integrated into the project design.  Chapter 21, Safeguard Policies for World Bank Reconstruction Projects, provides a detailed description of the Bank's safeguard policies.
Project appraisal	Appraisal gives stakeholders an opportunity to review the project design in detail and resolve any outstanding questions. Government and the World Bank review the work done during the identification and preparation phases and confirm the expected project outcomes, intended beneficiaries, and the system that will be used to monitor progress. Once the Bank team confirms that all aspects of the project are consistent with World Bank operations requirements and that government has the institutional arrangements ready for implementation, the project is negotiated and is ready for approval.
Project approval	Once all project details are negotiated and accepted by both sides, the Bank prepares the <b>Project Appraisal Document</b> (for investment lending) or the <b>Program Document</b> (for development policy lending), along with other financial and legal documents, for submission to the Bank's Board of Executive Directors for consideration and approval. The <b>Project Information Document</b> is updated and publicly released when the project is approved. When funding approval is obtained, conditions for effectiveness are met, and the legal documents are accepted and signed, the implementation phase begins.
Project implementation	The borrower government implements the project with funds from the World Bank. With assistance from the Bank, the implementing agency prepares the specifications for the project and carries out the procurement of goods, works, and services, as well as any environmental and social impact mitigation agreed to during preparation. Once under way, the implementing government agency reports regularly on project activities. The project's progress, outcomes, and impact on beneficiaries are monitored by government and the Bank to obtain data to evaluate the results of the operation and the project. Government and the Bank also prepare a mid-term review of project progress. Full loan disbursement and project completion can take 1–10 years.
Project completion	As the project is completed, the World Bank and the borrower government document the results achieved, problems encountered, lessons learned, and knowledge gained from carrying out the project. The World Bank team prepares an <b>Implementation Completion and Results Report</b> , using input from the implementing government agency, co-financiers, and other partners and stakeholders. The information gained is used to determine if there is additional assistance needed to sustain the benefits derived from the project. The evaluation team also assesses how well the operation complied with the Bank's operations policies, and accounts for the financial resources.
Project evaluation	The Bank's Independent Evaluation Group (IEG) assesses the performance of a selection of projects every year, measuring outcomes against the original objectives, sustainability of results, and institutional development impact. From time to time, IEG also produces <b>Impact Evaluation Reports</b> to assess the economic worth of projects and the long-term effects on people and the environment.

3. World Bank, "Documents and Reports," <http://go.worldbank.org/H1Q3T60M80>.



# Financial Management in Bank Operations

World Bank Operating Policies (OPs) establish the parameters for the conduct of operations and describe the circumstances under which exceptions to policy can be made. They are based on the Bank's Articles of Agreement, the general conditions, and policies. Bank Procedures (BPs) explain the procedures and documentation required to carry out the policies set out in the OPs. This section summarizes OP/BP 10.02, "Financial Management," and some related financial management policy issues.

## Operational Policies

For each operation, the Bank requires the borrower to maintain financial management arrangements that are acceptable to the Bank and that provide assurance that the loan proceeds are used for the purposes for which they were lent. Where feasible, the Bank expects these arrangements to be the same ones that the institution normally uses. As mentioned above, financial management arrangements include those for budgeting, accounting, internal control, funds flow, financial reporting, and auditing. The Bank financial management operational policy requires the following:

**Assessments of financial management arrangements.** The Bank assesses the adequacy of a borrower's financial management arrangements during the preparation and implementation of each operation and requires the borrower to undertake appropriate measures to strengthen any identified weaknesses in its financial management systems and processes.

**Interim financial reporting.** The Bank normally requires a borrower to submit interim financial reports in a form agreed with the Bank.

**Audited financial statements.** The Bank requires that borrowers provide audited financial statements, within six months of the end of the reporting period, that reflect the activities of the operation supported by the Bank loan. The financial statements must be prepared using accounting standards acceptable to the Bank.<sup>5</sup> As for the audit, the auditing standards,<sup>6</sup> the scope of the audit, and the auditors who conduct it must be acceptable to the Bank as well. If the borrower fails to maintain acceptable financial management arrangements, or to submit the required financial reports by their due dates, the Bank can take action against the borrower.

## Bank Procedures

Throughout the preparation and implementation of a Bank-supported operation, qualified and experienced financial management staff are assigned to the Bank's project team. Where feasible, these staff ensure that the financial management requirements for individual projects are adapted to the country's circumstances, make use of the country's normal systems where capacity permits, and involve common arrangements with other donors, in order to simplify the borrower country's obligations.

**Project preparation.** During the preparation of each operation proposed for Bank financing, financial management staff carry out the following tasks:

- Assess the proposed financial management arrangements to identify any weaknesses and assess the risks these weaknesses pose
- Agree with the borrower on the format and content of interim and annual audited financial statements to be provided throughout the implementation of the operation
- Agree on the scope of audit work to be carried out for each operation, and the identity of the auditor or the process for selecting the auditor

Staff prepare a financial management assessment report based on the results of the assessment. A summary of their assessment is included in the **Project Appraisal Document**. The assessment also includes actions agreed with the borrower to mitigate any risks identified. If necessary, information related to financial management issues may also be recorded in the minutes of negotiations or in the legal agreements.

**Project implementation.** During project implementation, financial management staff review the continuing adequacy of a borrower's financial management arrangements. The extent, manner, and timing of these reviews is decided by the Bank on the basis of risk and actual implementation

4. World Bank, 2007, OP 10.02 "Financial Management," <http://go.worldbank.org/YHF8Y8UF30> and BP 10.02 "Financial Management," <http://go.worldbank.org/26MM8GUCU0>.
5. Accounting standards acceptable to the Bank include International Public Sector Accounting Standards issued by the Public Sector Committee of the International Federation of Accountants and the International Financial Reporting Standards/International Accounting Standards issued by the International Accounting Standards Board. The Bank may accept national accounting standards that it considers to be equivalent to international standards.
6. Auditing standards acceptable to the Bank include the Auditing Standards issued by the International Organization of Supreme Audit Institutions and the International Standards on Auditing issued by the International Federation of Accountants. The Bank may accept national auditing standards that it considers to be equivalent to international standards.



performance. In reviewing the arrangements, financial management staff undertake, as necessary, visits to project locations to meet with appropriate project staff, observe the performance of the financial management system, and check the application of controls or individual transactions. Financial management staff also (1) monitor the receipt and the timeliness of, (2) acknowledge receipt of, and (3) review the interim and annual audited financial statements that the borrower is required to provide. They pay particular attention to the quality of the auditor's performance and the substance of the audit report findings.

When financial management staff note deficiencies in the arrangements, including failure to send timely audited financial statements to the Bank, poor auditor performance, or indications in the audit of weak internal controls, they discuss these matters with the borrower and make recommendations to the Bank country director. The borrower is notified of any actions taken by the country director.

**Project completion and evaluation.** Significant financial management performance issues during implementation are recorded in the Implementation Completion and Results Report.

## Financial Management Issues That May Arise in Emergency Operations<sup>7</sup>

**Use of country systems.** The Bank believes that the use of “country systems,” that is, the use of a country's national, subnational, or sectoral institutions and applicable financial management laws, regulations, rules, and procedures for the operation being supported by the Bank, can potentially improve the impact of its operations. In fact, except where country systems are assessed by the Bank as not being adequate or for situations where the context in the country may dictate the use of a special purpose implementing entity or special implementation arrangements, the Bank tries first to use existing financial management institutional arrangements for implementing Bank-supported operations. However, the use of these arrangements may be subject to capacity-strengthening measures. Note that emergency (post-disaster and post-conflict) operations are examples of where the context may dictate the use of special implementation arrangements.

**Harmonization.** The Bank is committed to harmonizing its financial management arrangements with other donors and aligning these around a country's own systems. Accordingly, Bank staff will seek out opportunities for “delegated cooperation” (where one donor places reliance on the work of others) and ensure that, as far as possible, particularly in cases where multiple donors are involved in co-financing the same project or program, common arrangements are agreed to among all donors and government. Where a project is funded jointly by the Bank and other donors—a common situation for emergency operations—the Bank will seek to agree, to the extent practicable, on common formats, content, and reporting periods for reports to be submitted to all donors.

**Analysis of risk.** The implementation arrangements satisfactory to the Bank and the extent of Bank involvement during implementation will be a function partially of the Bank's evaluation of the risk of an operation. For various reasons, emergency operations may be evaluated as having higher risk.

The Bank's financial management risk model is qualitative and based on principles embodied in internationally recognized good practices for risk management.<sup>8</sup> The financial management risk rating is expressed as high, substantial, modest, or low, and provides a benchmark against which various aspects of project design, supervision, and other actions that may be taken by the Bank can be established. The risk model incorporates the following concepts.

7. World Bank Financial Management Sector Board, 2005, “Financial Management Practices in World Bank-Financed Investment Operations,” internal Bank report.  
8. In particular, Committee of Sponsoring Organizations (COSO), *Enterprise Risk Management – Integrated Framework*, and International Federation of Accountants, *ISA 315, Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement and ISA 330, The Auditor's Procedures in Response to Assessed Risks*. For further discussion of the COSO Framework, see Chapter 19, *Mitigating the Risk of Corruption, Annex 1, How to Do It: Conducting a Corruption Risk Assessment*.



Risk	Description
Inherent Risk	<p>Inherent risk arises from the environment in which the project is located. It is the risk that the project financial management system does not operate as intended due to such factors as country governance environment, rules, and regulations. Inherent risk comprises three elements:</p> <p>Country-level risk. This rating is determined at a portfolio level, for each fiscal year, and is the same for all projects for which a risk assessment is prepared in during the same fiscal year.</p> <p>Entity-level risk. When entities have implemented Bank-financed operations in the past, the Bank may determine this risk using internal sources, such as Implementation Completion and Results Reports and Country Portfolio Performance Reviews. If the entity is new to implementing Bank-financed operations, a risk assessment of the entity is undertaken.</p> <p>Project-level risk. This risk is project-specific and is assessed for each project.</p>
Control Risk	The risk that the project's financial management system is inadequate to ensure project funds are used economically and efficiently, and for the purpose intended. Control risk is measured for all six elements of financial management: budgeting, accounting, internal control, funds flow, financial reporting, and auditing.
Detection Risk	The risk that a material misuse of loan proceeds takes place and is not detected. Detection risk is lowered by (1) capacity-strengthening measures for the weaknesses identified as posing unacceptable levels of risk, and/or (2) increasing Bank supervision.
Residual Risk	Residual risk is the combination of the project's inherent and control risks as mitigated by borrower control frameworks and Bank supervision.

## Financial Management Aspects of OP/BP 8.00

The Bank's OP/BP 8.00, Rapid Response to Crises and Emergencies, is explained in detail in  Chapter 20, World Bank Response to Crises and Emergencies. OP/BP 8.00 addresses the need to focus Bank assistance for emergencies on its core development and economic competencies while remaining within its mandate. This section explains some of the financial management aspects of operations implemented under OP/BP 8.00.

As discussed above, OP/BP 10.02, Financial Management requires that, for each Bank-funded operation, the borrower maintain acceptable financial management arrangements that can provide reasonable assurance that the proceeds of the loan are used for the purposes for which the loan was borrowed. Consistent with this requirement, one of the guiding principles of OP/BP 8.00 is the provision of appropriate oversight arrangements, including corporate governance and fiduciary oversight, to ensure appropriate scope, design, speed, and monitoring and supervision of rapid response operations.<sup>9</sup>

For financial management staff, the main difference between preparing "normal" and rapid-response operations lies in the timing of the financial management arrangements. To respond quickly to an emergency, financial management staff streamline and simplify ex ante requirements while relying more heavily on such ex post requirements as additional fiduciary controls and reviews. They need to ensure that risk-mitigating measures suitable to available capacity are in place during implementation and, as appropriate, they may rely more heavily than usual on partner institutions. Key considerations are the following.

1. Include in project design, and agree on at negotiations, only the most critical ex ante controls; noncritical mitigating measures can be implemented during the course of the project.
2. Plan carefully for intensive supervision, particularly early in implementation, when financial management arrangements are being put in place, because it is the principal mitigating measure.
3. Appoint a seasoned senior financial management staff, along with the regional point person for the implementation of OP/BP 8.00, to work on the operation and to integrate lessons from similar regional/Bank operations.

The table below shows some examples of financial management arrangements for operations under OP/BP 8.00.

9. See "Guidelines: Financial Management Aspects of Emergency Operations Processed under OP/BP 8.00" and "Financial Management in Operations Processed under New OP/BP 8.00: FM for TTLs," 2008, World Bank PowerPoint presentations.

## Examples of Financial Management Arrangements for Operations Processed under OP/BP 8.00<sup>10</sup>

Area	Ex ante arrangements	Ex post arrangements
Budget	<ul style="list-style-type: none"> <li>Support 100% financing of activities to avoid delays in counterpart financing.</li> <li>Provide adequate funds for essential initial operations even if sound estimates are not completed.</li> <li>Reevaluate existing operations to find “excess” funds that can be quickly mobilized for the emergency operation.</li> <li>Encourage Bank and other donors to align reporting requirements with government’s cycle.</li> </ul>	Detailed budget can be prepared later.
Accounting and reporting	<ul style="list-style-type: none"> <li>Use existing reporting frameworks from government or other projects.</li> <li>Use manual systems or computer spreadsheets until on-line systems can be implemented.</li> <li>Use a commercially available off-the-shelf accounting package that is quick to install and easy to use, especially if technical support is available in-country.</li> <li>Outsource accounting functions to private sector or international firms, as needed.</li> <li>Use United Nations agencies/programs and/or local and international nongovernmental organizations with sufficient financial management capacity.</li> <li>Simplify reports, limiting them to a list of expenditures.</li> </ul>	Disseminate project reports to the lowest level beneficiary possible to help build in social accountability.
Staffing	<ul style="list-style-type: none"> <li>Outsource key operations to provide the needed staff in the short run. The Terms of Reference (TORs) could include training and capacity development of country staff and systems so that, over time, the country is gradually able to assume full responsibility for the financial management aspects of the activities.</li> <li>Use staff from other parts of the implementing entities of the same project or from other projects.</li> </ul>	Train staff, even those with a limited accounting background, on simple cash accounting to provide the minimum records to get things moving quickly.
Internal controls	<p>To compensate for weak controls in low-capacity environments, consider:</p> <ul style="list-style-type: none"> <li>internal, concurrent audits conducted by government or outsourced to private firms;</li> <li>additional controls exercised by independent persons from different parts of government, implementing entity, or community, to help ensure that duties are separated; that transactions are budgeted, authorized, executed, and recorded properly; and that services are delivered as specified; and</li> <li>using financial management agents to review implementing entity transactions and/or to process transactions in the short run to help ensure due diligence; TORs could include training and capacity development of country staff and systems so that, over time, the country is gradually able to assume full responsibility for the financial management aspects of the activities.</li> </ul>	<p>Increase reliance on interim audits and/or more frequent (3-month or shorter period) external audits, including requesting an opinion on the internal controls and on-agreed procedures.</p> <p>Conduct performance audits to track the execution of project activities and deliverables.</p>
Funds flow and disbursement arrangements	<ul style="list-style-type: none"> <li>If country financing parameters allow, finance 100% of project expenditures and limit the number of expenditure categories to one, or at most two.</li> <li>As much as possible, use retroactive financing and reimbursement of expenditures.</li> <li>Use output-based disbursements.<sup>11</sup></li> <li>Ensure that the designated account<sup>12</sup> is funded quickly and adequately.</li> <li>Use simplified report-based disbursements.</li> <li>Pool financing with other donors/government.</li> </ul>	If necessary, the Bank may disburse primarily through direct payments.
External audit	<p>The frequency, scope, and quality of audits are extremely important factors in helping ensure that funds are used for the intended purposes.</p> <ul style="list-style-type: none"> <li>In consultation with other sector and procurement colleagues, expand audit scope as needed to cover technical, institutional, and financial reviews.</li> <li>When national audit institutions have weak capacity, complement their teams with private sector auditors to help improve the quality of the audit and also build capacity gradually. (See Chapter 19, Mitigating the Risk of Corruption, Annex 2, How to Do It: Conducting a Construction Audit, for an audit methodology that can be used for a concurrent or ex post audit of a reconstruction project.)</li> <li>In the short run, use international auditors in some projects to substitute for low country capacity.</li> <li>For project preparation advances (PPAs), consider the use of annual audits.</li> <li>Subject to procurement approval, amend contracts of audit engagements for existing projects (either in the same sector or in others) to cover the work of the emergency operation.</li> </ul>	Audits should be carried out more frequently than annually, and financial management staff should follow up closely with the project implementing entity in a shorter time frame (i.e., from 6 months to 45 days).

10. World Bank, n.d., “Guidelines: Financial Management Aspects of Emergency Operations Processed under OP/BP 8.00,” internal Bank report.

11. Global Partnership for Output-Based Aid, “Checklist for Designing Output-Based Aid Schemes,” <http://www.gpoba.org/designing/index.asp>.

12. The “designated account” is the account of the borrower that is held in a financial institution acceptable to the Bank and operated on terms and conditions acceptable to the Bank, into which the Bank disburses proceeds from the loan account.

