5. REPORTING AND AUDITING

5.1 INTRODUCTION

5.1.1 This Chapter of these Guidelines addresses the financial reporting and auditing of EAs, IAs and projects. It also advises on the selection and terms of reference of auditors, particularly in relation to their qualifications and competence. Arrangements for monitoring and reviewing financial reports and auditors’ reports are explained in detail. A checklist is provided for reviewing auditors’ reports.

5.1.2 This chapter aims to: (i) provide financial analysts with detailed guidelines to enable them to advise governments, EAs, and IAs on the Bank’s financial reporting and auditing requirements; and (ii) facilitate the identification of inadequate financial reporting and auditing performance by EAs, IAs and auditors. In addition to this introduction this part has four sections:

- **5.2 – Accounting Standards and Policies:** This section describes accounting standards and their applicability to financial reports on Bank financed projects.
- **5.3 – Financial Reporting:** This section describes the Bank’s financial reporting requirements.
- **5.4 – Auditing:** This section describes auditing standards and their use in the audit of the financial reports of Bank financed projects.
- **5.5 – Reviewing Financial Statements:** This section discusses the process of reviewing financial statements, including audit reports, and outlines actions that should be taken where financial reports are overdue or are inadequate.

5.2 ACCOUNTING STANDARDS AND POLICIES

Introduction

5.2.1 The preparation and reporting of accounting information varies widely among countries and contributes to a substantial lack of transparency and consistency in financial reporting. This means that precise interpretation of financial statements can be a daunting process. At best, they may be misleading; at worst, they may be fraudulent. A serious Bank concern is the accurate interpretation of the financial position and performance of its borrowers and EAs. It is even more important for investors and those charged with the safeguarding of stock exchanges, brokerage houses and banks to have confidence in reported financial performance and position.

5.2.2 In recent years, there has been significant progress in the availability and usage of internationally-consistent accounting standards. First, the International Financial Reporting Standards/International Accounting Standards (IFRS/IASs) issued by the International Accounting Standards Board (IASB) were developed to the point where they presented a viable, and arguably preferable alternative to nationally-developed accounting standards for revenue earning or commercial entities. Second, most developed and developing countries are in the process of either harmonizing their accounting standards with IFRS/IASs or adopting IFRS/IASs directly. Third, International Public Sector Accounting Standards (IPSAS) issued by the International Public Sector
Accounting Standards Board (IPSASB) have been gaining acceptance as a source for generally accepted accounting standards for the public sector.

5.2.3 This section discusses the Bank’s approach to the application and use of accounting standards and policies by borrowers.


5.2.4 Differences in financial reporting practices and accounting standards can be significant between countries. The factors that influence the development of accounting practices and the differences between countries in terms of these practices include the nature of a country’s legal system, the prevalent providers of finance, the influence of taxation, and the strength of the accountancy profession.

5.2.5 The International Accounting Standards Board (IASB), which superseded the International Accounting Standards Committee (IASC) on 1 April 2001, promulgates IFRS/IASs. IFRS/IASs are appropriate for private sector reporting and for reporting by government business enterprises, including public utilities (e.g., electricity, gas, water and sanitation, and telecommunications). The Knowledge Management, section 7.24 of these Guidelines provides a list of IFRS/IASs with further information regarding these standards available at: www.iasb.org and at www.iasplus.com.

5.2.6 Surveys of national accounting standards show that many countries are aligning their private sector accounting standards with IFRS/IASs. Some countries have adopted IFRS/IASs completely. In particular, the G7 Group of nations has pledged to align their accounting standards with IFRS/IAS and the European Union has decreed that all member countries should adopt IFRS/IASs for listed company reporting by 2005. The status of country-adoption of IFRS/IASs can be examined at the IASB’s website (www.iasb.org).

5.2.7 In 1998, the IMF was charged with monitoring the country adoption and usage of IFRS/IASs. Consequently, countries will be under pressure to adopt some form of accounting standards in close harmony with IFRS/IAS, if not the complete IFRS/IAS package of standards. The G7 expects the IFIs, including the Bank, to contribute to advancing the use of IFRS/IAS in their member countries. These contributions may be by requiring the use of IFRS/IASs in financial reporting to the Bank by revenue earning entities, and by providing assistance in appropriate cases to modify systems and build capacity to enable RMCs to achieve this goal.

**International Public Sector Accounting Standards (IPSASs)**

5.2.8 The IPSASB which superseded the Public Sector Committee in 2004 publishes IPSASs. IPSASB focuses on the accounting and financial reporting needs of national, regional and local governments, related governmental agencies, and the constituencies they serve. It addresses these needs by issuing and promoting benchmark guidance, conducting educational and research programs, and facilitating the exchange of information among accountants and those that work in the public sector or rely on its work.

5.2.9 Accounting practices in the public sector vary considerably between countries. A limited number of countries have adopted the accrual basis of accounting for government reporting but most use the cash basis of accounting or a modified cash basis of
accounting. The modified cash basis of accounting includes a broad spectrum of deviations from the cash basis of accounting, such as the accrual of accounts payable at fiscal year end and the adoption of most but not all accrual based IPSASs.

IPSASB has issued 21 IPSASs addressing issues under the accrual basis of accounting plus an omnibus Cash Basis of Accounting IPSAS. The Rome Declaration called upon the International Federation of Accountants, through IPSASB, to issue a public sector accounting standard for development assistance. As a result, the IPSASB issued, in February 2005, the following Exposure Draft No. 24: Financial Reporting under the Cash Basis of Accounting – Disclosure Requirements for Recipients of External Assistance. Financial analysts should be conversant with the status of these developments by reviewing information in section 7.24 of the Knowledge Management Chapter of these Guidelines and at: www.ifac.org.

The Bank’s Requirements

*International Standards*

5.2.10 Financial analysts need to fully understand IFRS/IASs and IPSASs. They also need to be familiar with the accounting standards in use in the countries in which they operate. More particularly, financial analysts should become familiar with the accounting policies used by the EAs and IAs that manage Bank-financed projects. This will enable analysts to recommend approaches that will: (i) provide the Bank with adequate information to understand the efficiency of the management of borrowers’ investments; and (ii) contribute to narrowing differences between IFRS/IASs, and IPSASs and national accounting standards.

5.2.11 It is important that a clear understanding is reached with the EA during appraisal so that forecasts used in the approval process will be comparable with the financial statements submitted for reporting purposes. Therefore, the Bank will seek to agree with the borrower, and EA, not later than at loan negotiations, the acceptable accounting standards and policies governing the preparation of financial statements of the proposed project.

5.2.12 The Bank recommends that all public sector revenue-earning EAs/IAs and projects, should account and report on financial transactions on the basis of accounting policies consistent with IFRS/IASs. As for public sector non-revenue earning EAs/IAs and projects, the Bank recommends accounting standards that are consistent with IPSASs.

5.2.13 Alternatively, the Bank may accept audited annual financial statements of projects, EAs and IAs that are based on national or other defined standards, provided that the Notes to the Financial Statements include realignments and adjustments of the financial information in the audited annual financial statements to provide a report in accordance with IFRS/IASs or IPSASs. In this case, borrowers, EAs or IAs should adopt IFRS/IAS or IPSAS-compliant accounting policies by an agreed date. Until that time, financial statements should be prepared in accordance with a set of accounting policies acceptable to the Bank and noted in the Minutes of Loan Negotiations.

*Timetable to Introduce Acceptable Accounting Policies*

5.2.14 The Bank recognizes that some time will be required for borrowers, EAs and IAs to adopt IFRS/IAS-compliant accounting policies and will negotiate with new borrowers on a project-by-project basis for the timing of their introduction. In these instances, financial
analysts should coordinate with the Supreme Audit Institution (SAI) of the borrowing country, the EA and the IA, to determine required modifications of accounting policies and the required date for their introduction. The introduction date of the revised policies and practices may be included as a loan covenant.

5.2.15 Bank reports relating to project identification, preparation, appraisal and supervision should describe the current status of application and use of IFRS/IASs and IPSASs in the country concerned, and by the EA/IA. The reports should include recommendations or commentaries on, timetables and associated steps by the Bank to encourage borrowers, EAs and IAs to adopt IFRS/IAS and IPSASs-compliant accounting policies.

5.3 FINANCIAL REPORTING

Introduction

5.3.1 Subject to the obligations agreed upon by the Bank and the borrower and its EAs and IAs on the progress of a project, the Bank typically requires the submission of periodic progress reports, covering: (i) the interim, annual, and final costs of a project; (ii) where appropriate, the financial performance and financial position of an EA or IA; (iii) accountability for all funds, including the Bank’s loan(s), provided for project implementation; (iv) the bases for disbursements of the proceeds of the Bank’s loan(s); (v) the extent of compliance with financial and related covenants, and (vi) the effectiveness of project-related financial management and accounting systems as specified by the Bank and agreed to by the borrower. In cases where a TAF grant is provided by the Bank, either in parallel with a Bank loan to a borrower, or independently, the provisions for financial reporting and auditing set out in this part of the Guidelines will apply.

5.3.2 Early in the project processing cycle, preferably at project identification, the financial analyst should inform borrowers, EAs and IAs of the Bank project accounting and auditing requirements. In addition, borrowers and EAs should be reminded of the need to inform other concerned entities or persons regarding those reporting requirements, including: (i) the government agency responsible for the performance of an EA, and for assigning or appointing the auditor; (ii) the government auditor mandated by law to audit the accounts of the EAs or IAs; (iii) private or commercial auditors acting on behalf of the government auditor; and (iv) a principal or holding company having financial responsibility for the EAs or IAs. Early notification of the Bank’s requirements to the above responsible authorities is essential to enable Bank staff to assess the likely prospects for compliance prior to, and during, appraisal. This will also allow Bank staff to comment on the expected performance and quality of financial reporting and auditing in the Appraisal Report and, if necessary, in the project identification and preparation back-to-office-reports.

5.3.3 Reports on project identification, preparation, appraisal and supervision should include a reference to the accounting standards and policies adopted by the borrower’s EA and IA, and their acceptability to the Bank. Any modifications that will be, or have been, made to financial reporting requirements should be communicated to the Bank.
Content and Timing of Financial Reporting

5.3.4 The Bank recognizes that many project financial statements, particularly those prepared for non-revenue-earning projects, are of a “special purpose nature”. Consequently, the Bank requires that financial information submitted by non-revenue-earning entities adhere to an appropriately designed format acceptable to the Bank. The following fundamental principles should apply to all interim and annual financial statements on projects issued by a borrower, EA or IA: (i) disclosure of full accountability for all funds of the borrower, other donors and lenders, and the Bank; (ii) compliance with loan covenants and Bank requirements for project management; (iii) adequate disclosure of all material information; and (iv) a true and fair view, or a fair presentation in all material respects, of the financial performance and status of the project (and where applicable, of the EA/IA). In addition, the following fundamental principles apply to annual financial statements only: (i) a clear statement of the accounting policies and accounting principles adopted; and (ii) the results of an independent review of the financial accounts and financial management systems by an auditor acceptable to the Bank.

5.3.5 Audited annual financial statements of EAs/IAs or projects are required in either of the Bank’s official languages for each fiscal year of project development and implementation, including the year of final commissioning of the project.

5.3.6 Interim and annual financial statements may combine financial transactions of a project with those of the EA/IA, where the agency is established solely for purposes of developing the project. Interim and annual financial statements, also, should show sufficient information to identify separately the transactions relating to the reporting year and the cumulative transactions from the date of start-up. This applies particularly to those expense and revenue categories contained in the loan agreement and/or Appraisal Report and revisions thereto. The reporting year includes a part-year from the start-up date to the end of that fiscal year, and a part-year from the start of the fiscal year in which a project is closed, to the date of closure. “Date of start-up” means the date of the first financial transaction that is the subject of the Project Cost Table and/or the project operating costs and revenue forecasts referred to in the Appraisal Report. Therefore the date of start-up could include the date when costs that were approved for retroactive financing were incurred (e.g., design costs or mobilization expenses). There are cases where there are no expenditures incurred in the first fiscal year (or part thereof), but an Imprest Account has been established with Bank funds. Such a transaction must be reported in the annual financial statements, even though there have been no withdrawals there from. In the event that a IA or EA was established and local counterpart funds were expended (e.g., on salaries and wages) but no project implementation occurred, the first year’s annual financial statements should be provided to the Bank showing the operating costs of the EA/IA even if such costs were fully met by the borrower.

5.3.7 Where an EA is responsible for implementing defined subprojects (with or without engaging PIUs for subproject implementation) separate financial statements should be provided for each defined component together with a consolidated financial statement for the complete project. Where an EA is responsible for developing more than one project, common or joint project financial transactions of the agency may be apportioned and allocated to each project on a basis defined in the Notes to the Financial Statements. For projects where multiple EAs/IAs are required to submit separate statements, compliance details will be recorded separately indicating separate status of compliance and ratings, which will be the basis for calculating the overall rating/compliance of the project.
5.3.8 The reports on a revenue-earning project may be incorporated within EA financial statements provided that the statements explicitly describe the financial status and performance of the project for the fiscal year, the previous fiscal year and from start-up. Interim financial reporting should follow the format of the annual financial statements, but should cease on completion of Bank disbursements.

5.3.9 Borrowers are asked to provide interim and audited annual financial statements in accordance with a timetable agreed with the Bank. Interim financial reports are normally required at intervals of three, four or six months of each fiscal year. Audited annual financial statements should be provided normally within six months (or such other period as the Bank may agree) following the end of each fiscal year. Interim and annual financial statements should normally be presented in the local currency, with the basis for translation of any foreign exchange transactions or commitments explicitly stated. Where audited financial statements first submitted to a government legislature, (with the risk thereby of substantially delaying the transmission of the audited financial statements to the Bank), a draft thereof, certified by the chief financial officer and the auditor, should be submitted to the Bank within the required reporting timetable, with subsequent confirmation after they have been ratified by the legislature.

Project Financial Statements

Non-Revenue Earning Projects

5.3.10 For non-revenue earning projects, annual financial statements should be prepared by an EA in respect of a project only particularly where the project is implemented by organizations of national, provincial, state or regional and/or local governments. The statements may take the following forms and may be produced in the local budgetary and accounting formats for the project and, where applicable, for the EA concerned:

- Statement of Income and Expenses (or Cash Receipts and Payments)
- Imprest Fund Account
- Statements of Expenditure; and
- Notes to the Financial Statements

Revenue-Earning Projects

Projects and IAs/EAs

5.3.11 Borrowers are asked to provide the Bank with annual financial statements in respect of each autonomous or semi-autonomous EA that plays a substantive role in implementing and/or operating a project having revenue-earning characteristics. These financial statements should contain details sufficient to identify the financial performance and status of the project/EA. Normally these should comprise:

- A Balance Sheet showing the financial position of the entity, including the project, as at the close of each fiscal year.
- An Income (or Operating, or Income and Expenditure, or Profit and Loss) Statement.
- A Cash Flow Statement that should disclose the cash flows during each Fiscal year.
- An Imprest Account Statement.
- Record of Statements of Expenditures.
- Notes to the Financial Statements.
5.3.12 Financial statements should include comparative figures for the preceding fiscal year; with appropriate supporting schedules and explanatory notes (e.g., methods of revaluation of assets; unusual conditions that affected performance). Supplementary financial statements should be provided containing information requested by the Bank with respect to items requiring additional disclosure or explanation. Unaudited interim Cash Flow Statements and Balance Sheets may be required for specified periods of each fiscal year – for example, at the end of each quarter or semester – in addition to audited annual financial statements.

5.3.13 An Income Statement should report the results of operations for the period covered under major categories of financial information. These may embrace, but are not limited to the following: (i) operating revenue by categories of sales or service charges; (ii) operating expenses by category (e.g., labour, supplies, and administration; cost of sales, or transmission and distribution, etc.); (iii) depreciation; (iv) income from sources other than operations; (v) taxes on income; (vi) interest and financing costs charged to operations; and (vii) net income.

5.3.14 The Cash Flow Statement should show, during the period covered by the Income Statement, the origins of all cash flows and their use in financing the project, any expansion of the entity, debt service, working capital, and, where appropriate, payment of dividends on equity or other forms of surplus funds distribution. The Bank prefers that this Cash Flow Statement be designed and presented in a manner which illustrates the cash flow of the entity during the period, with separately identified information on non-cash and working capital transactions.

5.3.15 The Balance Sheet should be drawn up at the close of a reporting period and should display fixed, current and other assets, with liabilities, particularly long-term and short-term debt, paid-up equity, and accumulated earnings and surpluses. To best illustrate the nature and business of the entity, the Balance Sheet should be compiled in a manner that highlights such important characteristics as the capital structure, the liquidity position, or the reserves.

Supplementary Financial Statements

5.3.16 The Bank will normally specify the form and content of supplementary financial statements to be attached to the standard annual financial statements, but borrowers should include all information that is considered informative and appropriate to illustrate the performance of project implementation and operation. The following are examples of information that may be requested by the Bank:

- A detailed summary of the fixed assets of an entity distinguishing between assets in service and construction work in progress, and accounting for changes during the year, the basis for their valuation (and revaluation, where applied), and related accumulated depreciation, including an explanation of the methods and rates of depreciation (frequently required for public utilities).
- A summary of long-term debts, including lenders, terms, amounts outstanding showing sub-borrowers repayment history, amounts still to be disbursed showing currencies of repayment, and noting the extent to which any of the entity’s assets have been pledged (frequently required for financial intermediaries).
- A summary of accounts receivable and accounts payable in terms of their age, showing differences in accounts outstanding for government and nongovernmental parties.
(frequently required where agencies of governments do not meet their commitments to public utilities).

- A summary showing major categories of inventory and the basis of their valuation.
- For financial intermediaries, a summary of sub-borrowers’ accounts showing the short-term and long-term positions, with an explicit statement on provisions for losses (bad and doubtful debts), their methods of computation, and the adequacy of securities.
- Information on costs of sales, labour costs, and other important items in the Income Statement.
- Comparators and performance indicators showing the methods of calculation and tracking record from start-up of the project or such other date as shall be agreed with the Bank.
- An analysis of any asset and debt revaluation, method used, and the effect on the entity’s financial position.
- A statement of budget allocations and actual expenses to date.

**Examples of Model Financial Statements**

5.3.17 The Knowledge Management section 7.26 of these Guidelines provides examples of model financial statements for revenue-earning and non-revenue-earning projects. Furthermore, a set of model financial statements, which are cross-referenced to IFRS/IAS requirements, together with a disclosure checklist is provided at: www.iasplus.com.

### 5.4 AUDITING

**Introduction**

5.4.1 An audit’s overall objective is for the auditor to express an opinion as to whether the financial statements present a true and fair view of the project and, where applicable, of the EA and IA are presented fairly in all material respects in conformity with IFRS/IAS or IPSASs or other accounting standards acceptable to the Bank, and are applied on a basis consistent with that of the preceding year. Where an audit opinion is being issued on a project or EA when other MDBs or donor agencies are cofinancing the same project a single audit that satisfies the needs of all agencies financing the project should be undertaken.

5.4.2 The auditor’s opinion is necessary to establish the credibility, or otherwise, of the financial statements of an EA. The examination should be of such scope and depth to allow the auditor to give an opinion and make a report on the veracity, accuracy and fairness as regards the presentation of the financial statements of an EA or a defined part thereof (such as a project, a project unit, or a department or division). However, financial analysts should not assume that the auditor’s opinion is an assurance of the future viability of an entity or of the efficiency or effectiveness with which management has conducted the affairs of the entity.

5.4.3 During project identification and preparation, financial analysts should become familiar with the existing laws, regulations, rules and national standards of the country and the EA that govern financial reporting and auditing requirements. It is essential to identify incompatibilities between the Bank’s requirements and local legal requirements for financial reporting and auditing and to resolve gaps before appraisal.

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Audit Standards

5.4.4 The Bank recognizes International Standards of Auditing (ISAs), promulgated by IFAC, and the auditing standards of the International Organization of Supreme Audit Institutions (INTOSAI). ISAs are widely adopted by the international accounting/auditing profession and many national professions. They form the benchmark for standards on auditing acceptable to the Bank for audits.

5.4.5 Majority of RMCs Auditor-Generals and their equivalents use INTOSAI auditing standards. The Bank prefers that auditors conform to ISAs, but recognizes that in some countries auditors are expected to apply “generally accepted auditing standards”, which may not conform to ISAs. Such other standards may have been prescribed by a country’s law or may have been adopted by public accountants or associations of public accountants in the country concerned. These standards differ from country to country, but are intended by the accounting profession to imply the highest standards of auditing practice. Although ISAs are widely recognized, it should not be assumed that these have been adopted by national accounting professions or governments, and are therefore automatically applicable to audits and auditors of project entities. Local standards may not conform partially or completely with international guidelines.

5.4.6 Therefore at project identification, or during project preparation, financial analysts are required to accurately determine the auditing standards that will be applied by an auditor of annual financial statements of a borrower. If these do not correspond to ISAs, the analyst must determine the extent and impact of variances in application of the local standards. In the event that the impact of variances is sufficient to give rise to concerns for the adequacy and veracity of an audit, the analyst must request the EA to have the auditor adopt ISAs for the audit of the Bank-financed project and the project entity.

5.4.7 Failure by an EA to meet such requests must be reported in the Aide Memoire and the fact-finding BTOR. If agreement is not obtained by project appraisal, an Issues Paper should be prepared so that management can give guidance. The BTOR and the Appraisal Report should include confirmations of the acceptable auditing standards that will be used.

5.4.8 Supplementary auditing and reporting procedures may be requested by the Bank, if necessary, to confirm accountability and financial performance in cases where the Bank considers local standards need to be supplemented. In addition, the Bank would expect auditors to indicate in their report the extent of differences, and the impact on the audit, of use of local auditing standards compared to the application of ISAs.

Audit Scope

5.4.9 The audit is intended to provide an ex post review of the EA’s financial statements, financial systems, records, transactions, and operations, performed by professional accountants. It is intended to provide assurances of accountability, give credibility to the financial statements and other management reports, identify weaknesses in internal controls and financial systems, and make recommendations for improvements. The auditor should obtain an understanding of the project and the entity being audited, including the contents of the Appraisal Report, legal agreements, and these Guidelines.
5.4.10 The extent of an auditor’s review of the accounting records depends on the systems of accounts and of internal checks and controls used by the entity being examined. An auditor will need to examine, and where necessary, test:

- the organizational procedures for making financial decisions, budgeting and authorizing expenditures;
- the design, management, and operation of the accounting system;
- the effectiveness of related systems and procedures such as inventory control and data processing;
- the efficiency of the systems of internal control and of internal audit;
- all financial transactions, and verify year end balances, including an appropriate degree of physical verification;
- compliance with IFRS/IASs or IPSASs or any other applicable accounting standards, including the adequacy of disclosures;
- subsequent events and their possible effect on the financial statements;
- overall comparators of actual costs and achievements against budgets and planned indicators, obtaining and reporting adequate explanations for significant variations;
- test compliance with loan covenants and the Bank’s requirements;
- a determination as to whether the borrower and project implementing entities have maintained adequate documentation on all relevant transactions;
- a confirmation that expenditures submitted to the Bank are eligible for financing and identification of any ineligible expenditures.
- test compliance with country legal requirements on financial reporting, including auditing; and
- the adequacy and competence of accounting staff.

5.4.11 In the light of their findings, auditors should normally test the financial transactions of the organization against such documentary or other evidence as maybe necessary to enable them to be satisfied as to the authenticity and correctness of the transactions, their complete and proper entry in the books of account, and their effect on financial performance and status.

5.4.12 The timeliness and accuracy of the recording of assets and liabilities and of the methods of their valuation should be reviewed by the auditors, particularly for projects executed by government departments, for which asset recording typically is not a routine requirement. In addition they should be satisfied as to the methods of regularly determining their existence, ownership and appropriate valuation, including, where necessary, physical inspection by the auditor. Examples of items to be addressed include:

(i) land, buildings, machinery, and equipment, including methods of provision for depreciation, if such provision is applicable to the accounting procedures for the project or EA under audit; (ii) inventories, including appropriate accounting for obsolescence, spoilage, or losses; (iii) receivables, including provisions for bad and doubtful debts; (iv) cash and bank balances; (v) investments; (vi) amounts due to third parties (long-term and short-term loans and suppliers’ accounts payable); and (vii) insurance coverage, particularly of project components. Where appropriate, an auditor should examine such items as capital commitments and treatment of contingent liabilities, the effects of currency devaluation or revaluation on foreign currency transactions, and events occurring after the date of preparation of the balance sheet.

5.4.13 Circumstances beyond the control of an auditor and the EA may sometimes make it impossible to carry out all preferred auditing procedures, fully. In such cases, auditors
should satisfy themselves by alternative procedures that are practicable and reasonable in the circumstances. There are two important auditing procedures which should be carried out: (i) direct correspondence with debtors and creditors on a substantial test basis by an auditor, to confirm sums due to, and payable by the EA/IA being audited; and (ii) observation by the auditor of physical inventory taken by the client. Specific disclosure should be made of the reasons for non-compliance in cases where these procedures are not carried out, and whether satisfactory alternative procedures were employed.

5.4.14 Any significant effects on the financial performance or status of the project, as a result of not conforming to IFRS/IASs, should be disclosed. Examples of such variations and their effects on reported financial results that should be disclosed are any overstatements of assets and understatements of liabilities that may be sanctioned by local laws; accounting on a cash basis or on a basis other than historical costs; recognition and equalization of income over several accounting periods; omission of certain gains or losses in determination of net income; the use of “reserve” accounting when full details of movements in, and realized profits on, reserves may not be revealed; and the treatment of foreign exchange profits or losses in a manner that does not disclose their impact. The auditor should review the interim financial statements for each year and compare them with the annual financial statements.

5.4.15 The Bank requires the auditor to report any differences, particularly any ineligible expenditure against which the Bank may have disbursed, recommending actions necessary to avoid recurrences. The audit of the statement of expenditures should be included as a part of the overall audit of the project. However, the Bank requires that particular attention be paid to the internal control systems and the verification of documents relating to expenditures, not only to ascertain proper financial accountability, but also that expenditures are eligible for inclusion in the project.

5.4.16 The Bank requires the audit of the Imprest Accounts to be included as a part of the overall audit of the project. This audit is limited to the transactions of the Imprest Accounts, as the audit of the expenditures reimbursed or paid directly from the Imprest Accounts are to be audited as a part of the project audit, with appropriate review of the in-transit items. Where the audits of the Imprest Accounts are stand alone, a special purpose audit opinion is required. Where the audit forms a part of that of the project, a separate reference to the Imprest Account audit should be included in the auditor’s opinion.

5.4.17 Legal and professional requirements will normally determine the scope and depth of an audit examination, but these may also be supplemented by client instructions in the form of a Terms of Reference. These instructions would usually extend an audit’s scope and detail, but they may restrict an auditor’s activities rendering them unacceptable. Care should be taken when framing a request for additional work from an auditor. Borrowers should be asked to remove unacceptable restrictions on auditor’s scope of work.

**Auditor Appointment**

5.4.18 A borrower is responsible for the selection, appointment and performance of an auditor. The Bank wishes to be informed by a borrower of an ongoing or proposed appointment of an auditor, who should meet the Bank’s required standards in terms of independence, experience and competence. More specifically, the Bank should indicate the acceptability
of an auditor in the form of a “no objection” provided that the actual or proposed auditor satisfies the following criteria:

- They must be impartial and independent of the management of the entity to be audited, and of the person appointing them. In particular, the auditors should not otherwise be employed by, serve as directors for, or have any financial or close business relationship with the entity during the period covered by the audit.
- They must be well-established and reputable using procedures and methods that conform to ISAs or INTOSAI auditing standards, and employ adequate staff with the skills and competence required for their responsibilities.
- They must be able to demonstrate experience in auditing the accounts of projects or entities comparable in nature, size, and complexity to the assignments they are to undertake. However, specialized auditing experience, obtainable only from external sources, may be necessary for some projects.
- The audit work should be assigned to personnel who have the professional and technical training and proficiency required in the circumstances.

5.4.19 The Bank requires that the borrower, the EA, and the project implementing entity select and appoint an auditor acceptable to the Bank within sufficient time to carry out its responsibilities, including a review of the financial management systems at the beginning of project implementation, and periodically thereafter. The Bank does not normally advise on the selection of auditors, but prefers to review a list of several auditors submitted from whom an appointment will be made by the borrower. The Bank will advise on any auditor who may not meet the Bank’s criteria. The Bank will indicate its agreement to a proposal to engage an auditor when it is satisfied that an existing auditor, or the auditor under consideration for engagement, would be acceptable to the Bank in terms of independence and competence to carry out the audit.

5.4.20 Many prospective borrowers and EAs have ongoing audit arrangements. In other cases, borrowers initiate audit engagements at the start of a project. Whenever an auditor is to be appointed by a borrower, or the auditor is a statutory appointee, the Bank will seek information in order to be satisfied regarding the independence and experience of the proposed auditor. The required information includes: (i) the name of the auditor; (ii) the names, qualifications, and experience of the auditors’ principals and managers; (iii) the approximate number of professional staff employed; (iv) a listing of some of the main audits currently and previously carried out by the auditor; and (v) a statement of the independence of the firm of auditors vis-à-vis the entity it is proposed to audit.

**Auditor Independence**

5.4.21 The scope and detail of an audit may also depend upon laws or regulations that may constrain a government auditor from providing the independence and the depth of examination required by the Bank. The following are examples of situation that would be unacceptable to the Bank: (i) a government auditor whose staff may be required by laws or regulations to participate in the processing of financial transactions; (ii) an auditor who acts for an EA in the preparation of annual financial statements; (iii) an auditor who designs and constructs components of the EA’s financial management system. In each case, the financial analyst must thoroughly review the circumstances and have adequate support, if necessary, by seeking an independent opinion, for the exclusion of the proposed auditor from doing the auditing assignment.
5.4.22 In certain instances, staff constraints may cause the borrower and EA/IA to request an auditor to compile part or all of the annual or supplementary financial statements. Where this is necessary, to be eligible to carry out the audit, the auditor should play no part in any aspect of the decision making and/or management of the entity concerned, including maintaining and finalizing accounting and financial reporting preparation services for the current year of audit and at least the most recent preceding fiscal year of the project. The extent of the auditor’s involvement in accounting should be discussed in the Management Letter.

Timeliness of Auditor Appointment

5.4.23 It is essential that auditors are able to commence work at project start-up, and thereafter sufficiently early in each fiscal year to complete the audit expeditiously after the year-end; for example, the checking of stocks and balances at critical times in a year may require the presence of an auditor if a qualified report is to be avoided. It is important, therefore, for the borrower, before the beginning of each fiscal year, to appoint an auditor. The borrower will be expected to provide the Bank with an assurance that the initial auditor has been notified of the Bank’s requirements, including the timing of the audit and issuance of the auditor’s report. In all cases, this will not be later than the starting date of the project or the date of the Bank’s Board approval of the loan, whichever is the earlier. Financial analysts are also encouraged to meet with the auditor at the earliest opportunity following their appointment.

5.4.24 Where a government auditor is to serve during execution and operation of a revenue-earning project until the loan period expires, the borrower will be expected to provide the Bank with an assurance that the government auditor will begin and complete the audit operations within the timetable required. This timely appointment allows the auditor to carry out interim audits, therefore reducing their work at the year-end to facilitate timely reporting. Also, it allows the earlier identification of possible errors and frauds and enables quicker corrective actions where required.

Auditor Qualification

5.4.25 Auditors for public sector projects and EAs may be drawn from commercial or state audit practitioners. Government auditors will not be acceptable for revenue-earning projects and EAs within the public sector, unless confirmed by the Bank after a review of their capacity, capability, and ongoing performance has been conducted and such a review confirms that they are capable of conducting such an audit. The EA, or its controlling authority, is normally responsible for this selection and appointment of auditors, except in cases where a government auditor is required by law to provide the service. Therefore, where no auditor is currently engaged, steps should be taken during project preparation to ensure that the borrower will engage an auditor acceptable to the Bank by the date of loan signing or start up of the project.

5.4.26 Where an auditor is currently engaged, staff should ensure that they carefully review the past performance of the auditor with respect to the quality of reports and opinions, and management letters. If the appraisal mission questions the capabilities and capacity of the auditor to perform to Bank-required standards, the borrower/EA should be advised as to the possible deficiencies, and asked to convey these concerns to the auditor. In cases where the auditor fails to respond to the concerns raised or the auditor is clearly
5.4.27 When private or commercial auditors are to be used, Bank staff may, if requested, assist borrowers to review the qualifications and experience of an auditor. For this purpose, in order to form a judgment on their competence, it may be necessary to visit the local offices of the auditors and request samples of their previous or ongoing work, including typical audit reports prepared by them. Examination of data on auditors submitted to the Bank prior to their engagement by a borrower should include the ability and track record of an auditor to meet Bank requirements. In addition the MDBs have an understanding to share information and to undertake joint evaluations of private sector auditors and maintain a list of acceptable auditors in all borrowing countries.

5.4.28 An auditor’s engagement should be kept under review to ensure consistent quality of performance, including ability to adapt to changes in an entity’s accounting and general operations, and to adopt improved audit techniques. For example, development of computerized accounting would require complex and expensive auditing techniques. Auditors inexperienced in this field may not be able to provide these services, or may be constrained from appropriate expansion of services by an inadequate audit fee. In such cases, inclusion of audit costs in the project costs estimates would be appropriate. Borrowers should therefore be encouraged to restrict audit engagements to relatively short-term assignments. It is common practice in some countries to appoint the auditor each year. However, engagements should normally be long enough to enable an auditor to become familiar with the project or EA under audit and to permit efficient operation, but short enough to facilitate a change of auditor, if necessary. Engagements of three to five years are in the optimum range.

Terms of Reference for an Auditor

5.4.29 The Bank requires that a Terms of Reference (TOR) acceptable to the Bank be prepared for each audit. For different types of audits, the scope of the audit will vary according to the nature of the implementing organization and type of operation being audited. For example, the TOR for the audit of a Financial Institution will require the auditor to pay particular attention to the loan portfolio, while the area of greatest emphasis for auditing of a public utility may be the accounting of its fixed assets and its accounts receivable.

5.4.30 ISAs suggest that the auditor determine the scope of the audit of financial statements in accordance with the requirements of legislation, regulations, and generally accepted auditing standards. The TOR must not restrict the auditor’s obligations with respect to the above. However, the TOR provides the opportunity for drawing special attention to areas of concern that may not be covered or emphasized under a normal audit, such as compliance with loan covenants; or a special review of procurement documents. The TOR should always include in the scope of the audit the requirement to give an opinion on any specific items such as compliance with loan covenants. In addition, a Management Letter will always be another requirement.

5.4.31 The OECD publication on ‘Harmonising Donor Practices for Effective Aid Delivery: Good Practice Papers’ provides a ‘Specimen Terms of Reference for External Auditors of Donor-supported Projects and Sector Programme’ (see Knowledge Management, section 7.17, of these Guidelines). Bank staff should give advice to borrowers and EA on the minimum requirements of the TOR for auditors based on this model TOR. However,
although the Bank wishes to approve the TOR for auditors, it is preferable that borrowers and EAs/IAs prepares the TOR themselves and Bank staff remain independent of the drafting process.

5.4.32 The model TOR should not be regarded as universally applicable to audits of Bank projects or project entities. Staff should select those components they consider appropriate for a particular audit engagement, omit inappropriate items and add relevant matters that are not in the model to develop a working draft. This model relates only to the appointment of auditors to carry out an audit, as defined in these Guidelines. The model is not intended for the appointment of accountants for other forms of investigation, assessment, design or installation of accounting or internal auditing systems.

5.4.33 The drafting of the TOR should not restrict an auditor’s obligations with respect to legislation, regulations, and generally accepted auditing standards, nor give reasons for an auditor to claim that adherence to the TOR prevent adequate statutory, regulatory or professional performance.

**Auditors Contract or Engagement Letter**

5.4.34 The use of a Contract or Audit Engagement Letter is recommended. Where a formal contract is used, it is normally prepared by the EA or IA. A simple engagement letter is frequently used, often prepared by the auditor. The contract or letter sets out the responsibilities of the auditor and should include, but not be limited to:

- Confirmation of acceptance of the appointment including specific reference to the TOR,
- The borrowers’ responsibilities, particularly the preparation of financial statements,
- The provision of access to whatever premises, records, documentation (including legal agreements, etc.) and any other information the auditor may request in connection with the audit,
- The form of the audit report(s),
- Arrangements regarding the involvement of internal auditors and of any other external auditors (such as the government auditor),
- The expected date of issuance of the audited financial statements, and
- The basis on which fees are computed and any billing arrangements

**Government Auditors**

5.4.35 In some countries where projects are to be executed by government controlled/sponsored entities, statutory requirements may specify the use of the government auditor. Under such circumstances, the Bank will continue to require that the auditor is independent and competent; that the auditor has the capacity and professional capability to provide audit reports and opinions of the quality required by the Bank, and is generally acceptable to the Bank. Normally, the independence of a government auditor would not be questioned if the auditor’s position is established under constitutional or legal provisions designed to assure independence (e.g., by reporting directly to a legislature). In circumstances where the government auditor is acceptable, but the auditor’s report will be placed before the national assembly for approval, the borrower should provide the Bank with a draft of the report, certified by the Chief Financial Officer and the auditor, immediately on completion of the audit. As specified in the loan agreement, the approved version of the auditor’s report should be submitted to the Bank as soon as this becomes available.
5.4.36 Circumstances may exist where government auditors are involved directly or indirectly in pre-expenditure and revenue collection decision-making – a status that compromises their independence. The Bank then may seek to agree with a borrower that the Bank, will be provided with opinions and reports prepared by an independent private or commercial auditor in addition to the report of a government auditor. A government auditor who does not control, and is not under the control of the department or agency of government to be audited, and who is not involved in any aspects of its management, may in some instances be considered as independent.

5.4.37 Where the Bank has doubts with respect to the auditor’s independence and/or competence, the Bank will seek an agreement with the borrower to have the government auditor subcontract the audit to an independent and competent private auditor to carry out the audit on their behalf. In appropriate circumstance, the Bank could include this expenditure in the loan. In general, the Bank requires that private auditors, using their experience in the use of ISAs, carry out the audit of a commercial or revenue-earning entity.

5.5 REVIEWING FINANCIAL STATEMENTS

Introduction

5.5.1 The Loan Agreement sets out the Bank’s requirements for the delivery of audited annual financial statements of projects and EAs. The Loan Agreement also contains the remedial actions that the Bank will undertake in the event of non-compliance with loan covenants relating to financial reporting and auditing.

5.5.2 The examination of the annual financial statements of EAs is an important feature of project supervision and should be conducted in the same way as financial appraisal. Additional attention, however, should be given to actual performance against appraisal forecasts, compliance with financial covenants and review mission financial reports. Interim reports and unaudited annual financial statements may be the only up-to-date monitoring documents available on project progress. Consequently, their accuracy should be tested both during supervision missions and against audited annual financial statements.

The Review Process: Late or Unacceptable Financial Reports

5.5.3 The Task Manager responsible should ensure that all requirements for progress reporting are prepared in a timely manner acceptable to the Bank. The Task Manager is responsible for maintaining records on the scheduled date of submission of progress reports (and annual financial reports, auditor’s reports and completion reports), the actual date of receipt by the Bank, and date of completion of review.

5.5.4 Communications by the Bank requesting submission of audited financial statements should be addressed to the EA/IA and/or the borrower. However, in some cases, compliance with the submission of audited accounts is delayed by difficulties encountered in the government audit office. When delays are attributable thereto, it is likely that similar problems are being experienced by other divisions/departments. In such a case the issue may be better handled at country dialogue level.
5.5.5 The Financial Analyst should in all cases review the interim and annual financial reports of the project, with or without auditors’ reports. Where loan documents require submission of unaudited and audited financial statements beyond the closing date of the loan, the monitoring of submission of financial statements and compliance with financial performance covenants should continue.

5.5.6 Within four weeks of the receipt from the Project Manager of the unaudited and audited annual financial statements relating to a project and, where applicable, of an EA, the Financial Analyst should review the financial statements in consultation with the relevant task manager and other Bank staff. After the review, the Financial Analysts will have a memo sent by the Bank to the Project Manager, copied to the borrower/EA(s) on (i) the financial status of the project and, where applicable, the EA and (ii) compliance with all of the Bank’s financial and audit covenants. The memo should report declining compliance trends regarding financial or audit covenants.

5.5.7 On the basis of this review, notice should be sent to the borrower and EA acknowledging receipt of the financial statements (and, where applicable, the Audit Report) and pointing out any violation of the loan’s financial or audit covenants. A time-bound remedial plan of action will be required from the EA/IA. Receipt of a response to a request for a time-bound action plan should be closely monitored and if the response is not received within the specified time, the lack of a response must be noted as an issue to be addressed under the loan.

5.5.8 The Financial Controllers Department is informed of the review results if: (i) the audited annual financial statements are unacceptable; (ii) the auditor’s report contains significant findings that would affect loan proceeds and implementation of the overall project (or other accountability issues); or (iii) the auditor’s report highlights exceptions regarding the imprest accounts and statements of expenditures.

Compliance with Financial Covenants

5.5.9 The Bank prefers that the auditors’ report provides details on the Bank’s requirements, including among other requirements, the auditor’s view on compliance with loan covenants and on the Bank’s requirements. Borrowers and EAs enter into agreement with the Bank to provide all appropriate financial management, accounting and financial reporting information necessary to support effective management of the project. Borrowers and EAs, also, enter into financial performance covenants with the Bank. The auditor’s Terms of Reference will require an opinion on compliance with each financial covenant as well as other requirements contained in the project’s legal documents. The auditor should also indicate the extent of any non-compliance with the loan agreement, by reference to the specified (required by the loan documents) and actual performance of the borrower in respect of these requirements of the Bank for the fiscal year concerned.

5.5.10 The majority, if not all, financial performance covenants for projects include the clause “except as the Bank shall otherwise agree.” The exercise of the prerogative to “otherwise agree” rests exclusively with management. In cases where non-compliance exists with a financial performance covenant, the responsible department should analyse the adequacy of the proposed actions to be taken by the borrower and EA while assessing the probability of their being successfully implemented within the period specified. The task manager should write a memo through the responsible department head outlining the review and the conclusions reached. The memo should also specify whether the current
auditor is acceptable to the Bank or whether the Bank should ask for a replacement. Recommendations on whether management should agree to a deviation from the covenant (including minor technical deviations), retention of the auditor or such other actions as the responsible department may propose, are put forward. Once management approves the recommendations, the department should communicate its decision to the borrower and EA/IA.

**Reviewing Auditors’ Reports**

5.5.11 An examination of the annual financial statements should begin with a review of the auditor’s opinion. An audit report must include: (i) name and title of the auditor; (ii) date of the report; (iii) addressee (EA and/or borrower); (iv) identification of the financial information audited; (v) a reference to auditing standards or practices followed; (vi) an expression of an opinion, including a qualification; disclaimer or declination of an opinion, on the financial information; (vii) the auditor’s signature; (viii) auditor’s address; and (ix) date of signing of the report.

5.5.12 The auditor’s opinion for a project should refer to the reporting format agreed between the borrower and the Bank, noting the basis of accounting followed (e.g., cash basis or accrual basis). The auditor’s opinion for a revenue-earning entity, should refer to the accounting standards adopted. Significant departures from IFRS/IASs (if any), with a reference to the quantified impact of such departures on the Balance Sheet, the Income Statement or the Cash Flow Statement should be detailed in the Notes to the Financial Statements or the Auditor should disclose their impact in the Audit Report.

5.5.13 Attention should, also, be given to auditors’ comments on the accounting standards and policies used. It is common for financial statement preparers (i.e., EAs) and external auditors to use vague phrases, such as “approved standards”, “official local standards”, and “international standards”. Financial Analysts should insist on the accurate description of both accounting standards and policies used to compile the financial statements and the definition of the auditing standards applied by the auditor.

5.5.14 Three principal features should be addressed when examining an auditor’s report: (i) authenticity, form and timeliness of the report; (ii) quality or tenor of the opinion; and (iii) scope, significant accounting policies, audit practices, qualifications, and other matters addressed by the auditor. The audit report should also indicate whether any attached supplementary financial statements and Notes to the Financial Statements have been subjected to the same auditing procedures as in the case of the basic financial statements.

5.5.15 If a qualified opinion and report by an auditor is received, the materiality and extent of the qualification should be determined, particularly as regards accountability for project funds and the agency’s financial position. In the case of substantial qualifications, the financial analyst should ascertain as soon as possible what remedial measures the borrower proposes to take. If the borrower is unable or unwilling to take corrective action, staff should, after investigating the reasons, follow the course of action normally followed in cases of non-compliance with covenants.

5.5.16 Qualifications which appear not to be of a material nature (limited inadequacies in accounting sub-systems, failure by accounting staff to respond to inquiries, etc.) should be followed up with the borrower by correspondence or during review missions, to ensure
that appropriate corrective action is taken. In the same way that accounting systems need to be designed and installed over a period of time, auditing capability often also needs gradual development. In such cases, loan agreements should have referred to the form and timing of this process.

5.5.17 The analyst should participate in review work in a manner that fosters improvement of the auditor’s work. Early audit reports that lack quality and depth of performance should not be rejected at the outset. Instead, the EA and the auditor should be informed in writing of possible deficiencies and encouraged to produce either an improved audit report, or to improve presentation on the next year’s financial statements. Under such circumstances, it is important that the financial management and accounting functions of the entities involved be carefully supervised, so as to compensate as far as possible for inferior auditing ability. The foregoing does not, however, preclude the Bank from requesting the replacement of an auditor, particularly if training or other support is unlikely to achieve short-run improvements.

5.5.18 For general guidance, a checklist of matters that a reviewer of an auditor’s report should consider is provided in the Knowledge Management Section 7.17 of these Guidelines. While extensive, the checklist is not exhaustive and reviewers must exercise their own skills and common sense in deciding the adequacy of the completed audit. Similarly, reviewers should decide whether the auditor, in the manner of framing the opinion, is trying to convey a message of concern, which may be difficult to express explicitly.

5.5.19 If there are any “no” answers on the checklist, especially in areas of key concern to the project, then clarifications of the auditor’s report should be sought from the borrower and/or the EA. If the omissions are serious and/or the quality of the report is unacceptable, the matter should be discussed with the responsible department and the Office of the General Counsel. The borrower and/or the EA/IA should be advised that the audit does not conform to standards and practices acceptable to the Bank. The monitoring records should be annotated accordingly.

Types of Auditors’ Opinion

5.5.20 ISA 700 advises auditors in detail on the form and content of an auditor’s report. In particular, paragraph 39 - 41 of ISA 700 (Revised) addresses the Opinion Paragraph of an auditor’s report as follows:\(^1\): “The auditor’s report should clearly state the auditor’s opinion as to whether the financial statements give a true and fair view (or are presented fairly, in all material respects,) in accordance with the financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements”. Examples of typical auditor’s reports and opinions for (i) an unqualified opinion for a non-revenue-earning project; and (ii) an unqualified opinion for a revenue-earning project are provided in the Knowledge Management, section 7.17 of these Guidelines.

5.5.21 An unqualified opinion indicates the auditor’s satisfaction in all material respects with the following matters: (i) The financial information has been prepared in accordance with (a) for a project, the reporting format agreed; and (b) for a revenue-earning entity, consistently applied accounting standards and practices acceptable to the Bank; (ii) The financial information complies with relevant regulations and statutory requirements; (iii)

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\(^1\) ISA 700 has been amended with effect 31 December 2006. Financial Analysts should become familiar with the revisions and prepare borrowers in advance for the changes to come.
The view presented by the financial information as a whole is consistent with the auditor’s knowledge of the project/entity; (iv) There is adequate disclosure of all material matters relevant to the proper presentation of the financial information; and (v) Additional requirements that may have been requested in the TOR have been met.

5.5.22 When a qualified opinion, adverse opinion, or a disclaimer of opinion is given, the audit report should state in a clear and informative manner all of the reasons for such opinion. Explanations of these opinions follow:

- A **qualified opinion** is issued when the auditor concludes that an unqualified opinion cannot be issued, but that the effect of any disagreement, uncertainty or limitation of scope of the audit is not so material as to require an adverse opinion or a disclaimer of opinion. The subject of the qualification and its financial effect must be clearly stated in the auditor’s report.

- An **adverse opinion** is issued when the effect of a disagreement is so pervasive and material to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. The reason for the adverse opinion and its financial effect must be clearly stated in the auditor’s report.

- A **disclaimer of opinion** is issued when the effect of a limitation on the scope of the audit or of an uncertainty is so significant that the auditor is unable to express an opinion on the financial statements. The nature of the limitation or the uncertainty must be clearly stated in the auditor’s report.

5.5.23 If an audit report is received with an opinion that is qualified, is adverse or a disclaimer of opinion has been issued, the financial analyst should review the issues carefully and write a memo to Bank management to explain the matter fully and to seek further action to be taken, as appropriate.

**Materiality**

5.5.24 ISA 320 states among other things: “Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item of error judged in the particular circumstances of its omission or misstatement. Thus materiality provides a threshold or cut-off point, rather than being primarily a qualitative characteristic which information must have if it is to be useful”

5.5.25 Certain auditors (particularly government auditors) provide reports listing all mistakes, irrespective of their materiality. The Bank requires a clear opinion. Thus irregularities and instances of noncompliance with government or institutional rules and regulations that do not give rise to a qualified or disclaimed opinion should not be subjects of the report of the auditor. Where an auditor has comments that are not material to the opinion, these should be set out in the Management Letter.

**Use of Technical Experts**

5.5.26 For certain types of expenditures financed from Bank loans, the auditor may need to rely on an independent technical expert who normally would be engaged by the EA. An example would be civil works executed by the regular labour force of an entity (e.g., “force account” carried out by the Ministry of Works); or fixed-price reimbursements for measured units of work to be supervised by independent experts such as an engineering
or architectural firm. In addition to the normal responsibility of such experts to check that
the work is performed in accordance with the plans and specifications, an appropriate
certification by the expert of the value of the work executed may be acceptable to the
Bank.

5.5.27 The acceptability of the certification would depend on the independence and competence
of the firm and its staff engaged in the verification. Such a certification, where used,
should normally be attached to the related documentation supporting the expenditure.
Any dissatisfaction with the work of the expert that concerns the auditor should be stated
in the auditor’s report.

5.5.28 The content of the certificate might cover matters such as whether the goods and services
were procured, received, paid for and used in the project in conformity with the loan
agreement. In the above instances, the auditor should include a note under the scope
paragraph of the opinion, stating the extent and amount involved with respect to their
reliance on the technical expert (who should be identified and his/her expertise noted in
the Notes to the Financial Statements prepared by the EA).

Audit Management Letters

5.5.29 The scope of the engagement as set out in the TOR should require the auditor to provide
a Management Letter. This is a report on the internal controls and operating procedures
of the entity, covering all aspects included during the normal course of the audit. Because
an auditor is unlikely to cover all activities of a client during an annual audit, the
Management Letter may address only those specific matters that came to the attention of
the auditor during the review.

5.5.30 The borrower and the auditor may agree at the commencement of the audit on particular
subjects (including those at the request of the Bank) to be included in the TOR and
addressed in the Management Letter. These may include: (i) the review of compliance
with financial covenants, and actual versus planned performance indicators; (ii)
implementation of the auditor’s recommendations made in prior year’s audit reports; (iii)
efficacy of and improvements required in budgetary control; (iv) reliability of field and
financial controls; and (v) payroll, procurement, or inventory problems. However, it
should be the prerogative of the auditor to address any matter not agreed upon, but which,
in the auditor’s opinion, should be drawn to the borrower’s attention. In addition, the
auditor should comment on all significant variations between the interim financial
statements and the annual audited financial statements.

5.5.31 The Bank wishes to review all Management Letters. The task manager should ensure that
copies are forwarded to the Bank at the same time as the audited annual financial
statements are sent. The project task manager should ensure that a financial analyst
reviews each Management Letter. The Financial Analyst should advise the task manager
of any matters to which the auditor has drawn attention that may adversely affect the
operation of the EA and the implementation of project activities.