

FINAL DRAFT

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PROJECT PAPER

ON A

PROPOSED GRANT OUT OF
NEPAL PUBLIC FINANCIAL MANAGEMENT (PFM) MULTI DONOR TRUST FUND (MDTF)

IN THE AMOUNT OF US\$ 4.30 MILLION

TO

NEPAL

FOR THE

NEPAL: STRENGTHENING PUBLIC FINANCIAL MANAGEMENT SYSTEMS (TREASURY SYSTEM,
FINANCIAL REPORTING, AND PFM CAPACITY BUILDING)

AUGUST 24, 2011

Financial Management Unit
South Asia Region

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CURRENCY EQUIVALENTS
(Exchange Rate Effective June 2011)

Currency Unit = Nepalese Rupees
US\$ 1.00 = NPR 71.75

FISCAL YEAR

July 16 – July 15

ABBREVIATIONS AND ACRONYMS

ASB	Accounting Standards Board		Standards
CFAA	Country Financial Accountability Assessment	IT	Information Technology
CIDA	Canadian International Development Agency	LAN	Local Area Network
CPAR	Country Procurement Assessment Review	MDG	Millennium Development Goal
CTS	Core Treasury System	MDTF	Multi-Donor Trust Fund
DFID	Department for International Development	MOF	Ministry of Finance
DP	Development Partner	MOU	Memorandum of Understanding
DTCO	District Treasury Comptroller Office	MTBF	Medium Term Budget Framework
EU	European Union	NPC	National Planning Commission
FD	Finance Division	NPSAS	Nepal Public Sector Accounting Standards
FCGO	Financial Comptroller General Office	OAG	Office of the Auditor General
FMIS	Financial Management Information System	PAC	Public Accounts Committee
FMRP	Financial Management Reform Program	PEFA	Public Expenditure and Financial Accountability
GoN	Government of Nepal	PER	Public Expenditure Review
ICAN	Institute of Chartered Accountants of Nepal	PFM	Public Financial Management
IFMIS	Integrated Financial Management Information System	PFMRP	Public Financial Management Reform Program
IFRS	International Financial Reporting Standards	ROSC	Report on Standards and Codes
INTOSAI	International Organization of Supreme Audit Institutions	RCGP	Recurrent and Capital Expenditure on Gender and Poverty
IPSAS	International Public Sector Accounting	SOEs	State-owned Enterprises
		TA	Technical Assistance
		WBTF	World Bank Trust Fund

Regional Vice President: Country Director: Sector Director: Sector Manager: Task Team Leader:	Isabel M. Guerrero Ellen A. Goldstein Fayez Omar Jennifer K. Thomson Bigyan Pradhan/Manoj Jain
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NEPAL

STRENGTHENING PUBLIC FINANCIAL MANAGEMENT SYSTEMS (TREASURY SYSTEM,
FINANCIAL REPORTING, AND PFM CAPACITY BUILDING)

CONTENTS

	Page
A. STRATEGIC CONTEXT.....	1
1. Country Context	1
2. Sector and Institutional Context	2
3. Lessons Learned and Reflected in the Project Design	4
4. Higher level objectives to which the Project contributes	6
B. PROJECT DEVELOPMENT OBJECTIVES.....	6
1. Project Beneficiaries.....	6
2. PDO Level Results Indicator.....	6
C. PROJECT DESCRIPTION.....	7
1. Project Financing.....	7
2. Project Components	9
D. IMPLEMENTATION.....	12
1. Institutional Arrangements	12
2. Governance and Accountability	13
3. Results Monitoring and Evaluation.....	13
E. APPRAISAL SUMMARY.....	14
1. Institutional.....	14
2. Financial Management	14
3. Procurement.....	14
4. Sustainability.....	15
5. Key Risks	15
Annex 1: Results Framework and Monitoring.....	17
Annex 2: Operational Risk Assessment Framework (ORAF)	21
Annex 3: Governance Accountability Action Plan (GAAP).....	21

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NEPAL: STRENGTHENING PUBLIC FINANCIAL MANAGEMENT SYSTEMS (TREASURY SYSTEM, FINANCIAL REPORTING, AND PFM CAPACITY BUILDING)

PROJECT PAPER

SOUTH ASIA

SARFM

Date: June 3, 2011	Team Leader(s): Bigyan Pradhan and Manoj Jain
Country Director: Ellen A. Goldstein	Themes: Public Financial Management
Sector Director: Fayez Omar	
Sector Manager: Jennifer K. Thomson	
Project ID: P121853 (TF099621)	

Financing Plan (US\$ m)			
Source	Local	Foreign	Total
BORROWER/RECIPIENT	1.40	0.00	1.40
GRANT FINANCING from MDTF (recipient executed)	3.30	1.00	4.30
Total:	4.70	1.00	5.70
Borrower: Nepal			
Responsible Agency: Ministry of Finance			

Estimated RE disbursements (Bank FY/US\$ m)									
FY	2012	2013	2014	2015					
Annual	2.00	1.00	0.80	0.50					
Cumulative	2.00	3.00	3.80	4.30					
Project implementation period: Start October 1, 2011 End: December 31, 2014									
Expected effectiveness date: November 15, 2011									
Expected closing date: June 30, 2015									

Does the project depart from the CAS in content or other significant respects? <i>Ref. PP I.C.</i>	
This project forms an integral part of the World Bank's Interim Strategy Note (ISN) which was presented to the Board in June 2009. It supports Pillar One of the ISN: Promoting Capable State Structures and Systems, and Fostering Accountable Institutions. The core development agenda under the sub-pillar is to strengthen core public sector institutions and systems (that is, public financial management, procurement, accountability institutions), step by step, building on the advances to date and reinforcing the necessary underlying sound public sector management principles.	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
Does the project require any exceptions from Bank policies? <i>Ref. PP IV.G.</i>	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
Have these been approved by Bank management?	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
Is approval for any policy exception sought from the Board?	<input type="checkbox"/> Yes <input checked="" type="checkbox"/> No
Does the project include any critical risks rated "substantial" or "high"? <i>Ref. PP III.E.</i>	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
Does the project meet the Regional criteria for readiness for implementation? <i>Ref. PP IV.G.</i>	<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No

<p>Project development objective Ref. PP II.C, The Project Development Objective is to improve expenditure control and enhance government accountability of Government of Nepal by strengthening treasury system, financial reporting and other critical PFM areas.</p>
<p>Project description Ref. PAD II.D., Technical Annex 4 There are three components in this project: (i) Implementing the Treasury Single Account (TSA) System, (ii) Strengthening accounting and reporting practices in public and private sector, (iii) Supporting the Capacity Building of the PEFA Secretariat.</p>
<p>Which safeguard policies are triggered, if any? None</p>
<p>Significant, non-standard conditions, if any, for: Ref. PAD III.F. Loan/credit effectiveness: There are no effectiveness conditions. Covenants applicable to project implementation:</p> <p>Effectiveness: - Legal Opinion Disbursement Conditions: - Retroactive financing of up to US\$0.8 million, for expenditures incurred between October 1, 2010 and the Grant signing.</p>

A. STRATEGIC CONTEXT

1. Country Context

1. Nepal is a predominantly agrarian economy characterized by low productivity. Nepal is a developing country with a per capita income of \$440.¹ It is a largely agrarian economy with low labor productivity. While agriculture contributes 33% to the GDP, it employs nearly 81% of the labor force. The shares of services and industry in the GDP and labor force are respectively 50% and 16%, and 8% and 3% respectively. Civil conflict and political uncertainty have affected Nepal's economy for over a decade. Real GDP growth between 2001 and 2006 averaged about 2.7 percent per annum.

2. Nepal has recorded many impressive achievements in economic and social development in the last decade and a half. It has achieved steady economic growth of 4.0 percent annually, relatively low inflation, and stable domestic debt. More remarkable have been its achievements in reducing income poverty and improving social indicators such as life expectancy, fertility control, child mortality, literacy and enrollment rates, which in many cases exceed other countries in the region and outside as indicated by progress toward meeting the MDG goals for 2015 (See Annex II).

3. Nepal has made some progress towards establishing peace and democracy. The People's Movement (2006) marked the beginning of political negotiations for ending Nepal's decade long (1996-2006) conflict. The Comprehensive Peace Agreement (CPA) was signed in November 2006, and it paved the way for a Constituent Assembly (CA) election held in April 2008. The 601-member CA also functions as a regular parliament.²

4. Peace dividends have so far been limited. Nepal has not been able to seize fully the opportunity provided by recent political changes. The inability of the parties to negotiate a constitution has stalled the peace process, which has affected planning and implementation of development programs. The business environment remains poor and economic growth has been low (average 4 percent after 2006), despite the public spending that has reached 20 percent of GDP. A lasting political settlement among various parties and addressing the law and order situation, among others, can help attain the economic growth levels needed for meeting popular aspirations.

5. Sustained public spending in key priority areas has contributed to the impressive social outcomes observed over the years. The country has outperformed most low-income countries on a range of social indicators. Sustained expenditures on Education and Health, and the partnership with the NGO community in delivery have helped to increase gross primary enrollment from 66 percent in 2001 to 92 percent in 2009 and is on track for attaining the MDG target of 99 percent in 2015. Nepal has already attained the MDG of eliminating gender disparity in primary and secondary enrollment. With the sharp decline in infant mortality from 64 per 1,000 live births in 2001 to 41 in 2009. Nepal is set to achieve the targeted two-thirds reduction from 1990 levels by 2015. Food security has improved markedly, even for the very poor. There have been steady gains in income poverty with the share of the population in poverty which is in the declining trend.

6. Notwithstanding the achievements the country's performance falls short of income surges in India and the East Asian economies. Although per capita growth accelerated over the past three decades, the incidence of poverty remains high at percent, as calculated by the HIES data. To achieve the ambitious poverty reduction objectives and related MDG targets growth will need to increase to around percent annually. This would require (i) maintaining macroeconomic stability, (ii) reorienting the role of the state

¹ This estimate is derived using the Atlas method. The Purchasing Power Parity equivalent is \$1180 per person.

² The Interim Constitution (2007) had set May 28, 2010 as deadline for the promulgation of the new statute, failing which the deadline has been extended until May 28, 2011. This was again extended by three months to August 28, 2011.

to facilitate private sector led growth: and additional investments to the tune of [4-5] percent of GDP, especially in infrastructure -- power and transport. More importantly, the pursuit of a more equitable growth agenda, even though Nepal's growth trend is more inclusive than that of many other developing countries, requires improving the ability of poor people to participate more fully in the growth process, through access to better quality education, health, water, nutrition and local governance.

2. Sector and Institutional Context

7. Improving Governance and Accountability underpins the agenda of the Government of Nepal (GoN) for building a New Nepal that is prosperous, peaceful and just. Strengthening Public Financial Management (PFM) is a key element of the GoN's strategy for strengthening governance, optimizing outputs from public resources and for ensuring inclusive and broad-based development. Development Partners have also been expressing their concern about the increasing deterioration of the PFM systems in the country (as evidenced by the growing indiscipline in budget execution, weak and ineffective expenditure controls and lack of transparency mainly in procurement), that poses significant fiduciary risks to donor financed projects as well. Overall, there has been increasing demand for effective use of resources provided for development efforts in order to ensure value for money through a sound PFM system and for better results measured through technical reviews of performance. The GoN's intention of establishing a sound PFM system that will ensure the transparent, efficient, economical and accountable use of budgetary resources and donor funds has resulted in several initiatives to strengthen PFM in Nepal.

8. A Public Expenditure and Financial Accountability (PEFA) Assessment, to assess the performance of the country's PFM systems in comparison with internationally accepted benchmarks, was initiated by the government with the support from the World Bank to provide a basis for objectively assessing the country's Public Financial Management (PFM) systems. The PEFA methodology examined the soundness of the PFM framework by rating 31 indicators (last three related to donor practices) using criteria provided by the guidelines. The scope of the assessment covered fiscal and debt management, budget formulation, budget execution, internal controls, procurement, accounting and reporting, auditing, transparency and external scrutiny.

9. The assessment concluded that the country's PFM System was well-designed but unevenly implemented, thus posing fiscal and fiduciary risks to budgetary resources and donor funds. Following the PEFA assessment, the GoN in collaboration with Development Partners (DPs), formulated a Development Action Plan (DAP) that described the menu of actions for strengthening PFM systems and processes. In 2008, the GoN formed a PEFA Steering Committee (chaired by the Finance Secretary) and set up a PEFA Secretariat (currently located in the Financial Comptroller General Office (FCGO) premises) to drive the reform initiatives and coordinate the PFM reform efforts.

10. Following the PEFA assessment, in 2009, with the support of the World Bank and DFID, the GoN formulated a Public Financial Management Reform Program (PFMRP) Strategy, Phase I (2010-2013)³, with the objective of adopting a holistic government-wide approach to PFM reforms encompassing both the institutional and technical aspects. This is intended to be a gradual and long-term process that requires strong political will and commitment which will contribute to reducing fiduciary risks as well as improve transparency and accountability of public financial management. It provides a framework in which all related reform initiatives can be incorporated under a single 'umbrella' under which the development partners can provide their funding on a joint and 'programmatic' basis.

³ The implementation of the first phase is delayed due to resource and other constraints and is therefore the second phase is likely to begin only in 2015.

11. The PFMRP strategy has two key priorities for the short term: (1) to deliver actions that yield effective results in strengthening the PFM system, and (2) to build the capacity of the PEFA Secretariat to lead the PEFA agenda and institutionalize the reform process. This Strategy will be implemented through tactical action plans and will help make decisions on mobilizing and allocating resources and address the prioritized underlying issues. It focuses on achieving, measuring verifying the results. Over the period, it is expected to help instill "performance culture". The success of the reform program will depend on commitment and ownership by responsible agencies, strong political commitment and the sustained partnership of development partners.

12. Following priorities have been identified in the area of public expenditure and financial accountability: Sustaining technical support on basic budgeting and treasury functions; supporting outreach and consensus building on the need for PFM reforms among government and civil society stakeholders; leveraging information technologies such as Integrated Financial Management Information Systems (IFMIS); strengthening the audit function of the Auditor General; strengthening the parliamentary oversight function carried out by the Public Accounts Committee (PAC); moving from a rules-based to principles-based approach in line with international standards; supporting the institutional development of the primary institutions of accountability in Nepal; strengthening PFM monitoring by both State and non-State actors, including independent verification interventions; and supporting the design of a sound financial management system in the context of state restructuring and transition to a possible federal system.

13. The Strategy recognizes the need to first of all continue with the initiated reforms on improving budget and financial management systems within the executive (the supply side of reforms) and actions have been taken to identifying particular reform components in next three years – namely implementation of Treasury Single Accounts (TSA) system, enhancing financial reporting (IPSAS based NPSAS implementation), and strengthening of PEFA Secretariat. This project embraces this Strategy and intends to build gradually on the positive momentum for reform. Other areas will be taken up through separate projects.

14. *Rationale for Bank involvement:* This project forms an integral part of the World Bank's Interim Strategy Note (ISN) 2009 as it would support Pillar One: Promoting Capable State Structures and Systems, and Fostering Accountable Institutions. The core development agenda under this pillar is to strengthen core public sector institutions and systems (that is, public financial management, procurement, accountability institutions), step by step, building on the advances to date and reinforcing the necessary underlying sound public sector management principles. The ISN recognizes the need engage the GoN and development partners "to build consensus on the need for reforms in these areas among the public and civil society stakeholders, and for strengthening performance monitoring."

15. In response to the GoN's and DPs call for a coordinated approach to address PFM challenges, there is a wider recognition for harmonizing donor support for the GoN's PFM reform program as well as demand-led initiatives and adopting a coordinated approach to PFM reforms and fiduciary oversight of public resources (which include assistance received from development partners). As part of this coordinated strategy to support the GoN, DPs under the leadership of the World Bank have set up a programmatic Multi-Donor Trust Fund (MDTF) that will pool donor resources to provide support for strengthening PFM systems. This proposed project is the first in a series that takes up essential activities to start the PFM strengthening process.

3. Lessons Learned and Reflected in the Project Design

16. The MDTF financed projects build on lessons learned in designing and implementing projects in Nepal and elsewhere. In particular, lessons have been drawn from PFM projects supported by World Bank and other agencies, most notably, DFID and ADB. The MDTF proposes to finance three projects initially, the first of which is this project, the second will support the strengthening of the Office of the Auditor General of Nepal (OAG/N) and the third will support demand side activities to strengthen public financial management. In addition, support will be provided through technical assistance, diagnostic and research activities to provide expertise and knowledge to inform the strengthening of public financial management and governance of public resources. The specific lessons learnt and incorporated into the overall MDFT financed PFM program and specifically in this project are:

- a. **Need for a strong country led PFM reform program.** Given the experience of PFM reforms in public sector in various countries, it is essential that PFM reforms be country led and any support from external donors should build support this reform program. Nepal has set a good example leading the PFM reform program since the Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Review (CPAR) were carried out in 2002. Following the PEFA assessment completed in 2008, a PFMRP strategy Phase I has been developed by GoN with articulation of priority actions for PFM reform. The proposed program to be supported under the MDTF aligns with the strategy document.
- b. **Need for a strong coordination mechanism:** Given the essential requirement of stakeholder support during PFM reform implementation, there is a need for building up a strong coordination mechanism. A strong coordination mechanism has begun to evolve in the government on issues related to financial accountability. The PEFA Secretariat, for example, regularly meets with government and other stakeholders to discuss about various PFM challenges and to streamline the coordination mechanism. It has also initiated its regular dialogue with the Office of the Auditor General and the Public Accounts Committee. The PEFA Secretariat has mandated the creation of PEFA Units in line ministries, and the Secretariat has established a practice of regularly meeting of the units to address PFM challenges. The PEFA Secretariat, given the nature of its mandate to lead and coordinate the PFM reforms, is the main implementing agency that will coordinate all three components of the program and take timely feedback and advice from the National level PFM Steering Committee chaired by the Finance Secretary.
- c. **Sustaining technical support on basic budgeting and treasury functions as a strong base for future PFM reforms in the sector:** Experiences from across various PFM programs in other countries have stressed the need to have basic processes set right before beginning an ambitious journey of reforming the PFM systems. GoN's PFMRP strategy has rightly laid emphasis on initiating PFM reforms in the basic budget implementation and treasury management functions that will form a fulcrum for designing and implementing most of the reforms to follow on the PFM supply side. This can be achieved by leveraging information technologies which are available such as Integrated Financial Management Information Systems (IFMIS). The establishment of a TSA and setting up automated financial management information systems is a standard international practice which has yielded excellent results in many countries. For example in the ECA countries, under Bank financed Treasury projects in Ukraine, Russia, Kazakhstan, Hungary and other countries, the closure of spending unit accounts and the consolidation of all financial resources in a TSA controlled by the Treasury has led to significant reduction in idle balances and borrowing costs. In Ukraine this measure led to reduction of the fiscal deficit by some 30% in the 1990's when the TSA was first set up. In these countries, the concurrent establishment of a Treasury system has enabled the Government to ensure that all expenditures are in accordance with the

budget appropriations and timely production of fiscal reports and end of year financial statements.

- d. **Strong government ownership in the implementation of IDF Grants.** A number of IDF grants have already been implemented by the GoN in the PFM area of which, four were implemented by the Office of the Auditor General (OAG), one by the FCGO on Internal Audit, and one by the Public Procurement Monitoring Office (PPMO) on public procurement reform. Learning from the implementation of these IDFs, one strong factor which plays a critical role in ensuring success of reform programs is the ownership and demonstrated leadership by the government of the programs. At times when there was a dearth of leadership, implementation greatly suffered in some of these IDFs, and vice versa, when there was a good leadership. Developing appropriate incentive structures to motivate the staff always remained as a challenge and will continue to be a challenge. This can be mitigated if strong ownership of the program is undertaken by the government.
- e. **Experience from the roll out of TSA in 18 districts.** Although the government has already rolled out the TSA in 18 districts and recently added four more districts, the greatest challenge that is being observed is the motivation and incentives for staff. If this is not appropriately addressed, this will remain as a major challenge threatening the sustainability of the program. The government is, therefore, proposing performance based incentive program to be introduced as it was done in revenue generation. This is vital. The other challenge is the ongoing power crisis and load shedding which is a great threat to ensure continuing support of the program. Back up equipments and generators are being provisioned to address this challenge. Required capacity is another challenge which needs to be addressed. Capacity in terms of technical know-how as well as IT related capacity needs to be addressed during the implementation of the program. Similarly, internet and network connection should be regularly provided to run the online system which is very critical and integral part of the TSA.
- f. **Need to support outreach for consensus building on the need for PFM reforms among government and civil society stakeholders:** Working on the demand side of PFM in parallel is equally important to create demands for various supply side system improvements. A separate project on the demand side of PFM is being prepared and well coordinated with the supply side components to enable a holistic approach to improving PFM systems. Various awareness building and communication programs are integrated into the program. Efforts will be made to work with civil society and oversight agencies from the demand side PFM window.
- g. **Need for strong analytical and research support:** As PFM reform gathers speed, there is a need to analyze emerging issues and offer practical solutions in the context of local circumstances and at the same time embracing best international practices and principles. In addition, a robust Monitoring and Evaluation arrangements needs to be put in place to measure results and trends. The project supports an analytical and research component at the PEFA Secretariat through building up necessary skills and staffing.
- h. **Need for Institutional capacity building:** Accountability institutions often lack resources and skills required to sustain the institutional reform. The project will provide training and skill building to a range of staff working in PFM and accountability institutions to respond to rapidly changing demands and expectations. Improved management practices can help improve decision-making, planning and budgeting, treasury management to produce better outcomes.

- i. **Results-based financing leads to better results:** Results based financing can align incentives and expected outcomes. For example, the government's commitment for private sector accounting to full IFRS convergence by 2012 will be based on a results-based memorandum of understanding which will be signed between the ASB and FCGO under Component 2 of the Project.

4. Higher level objectives to which the Project contributes

17. The project will improve performance of the public financial management systems of GoN through a shift in focus to institutions and institutional building especially training and capacity building. It will also contribute to the fiscal consolidation agenda of GoN by enhancing efficiency of the public expenditures. The project is fully consistent with the Bank's Two Year Interim Strategy Note (ISN) of 2009 which identifies strengthening institutions of governance as a key plank of the World Bank's engagement in Nepal. The new ISN of 2011 which is under formulation with expected approval in August 2011 also identifies "Strengthening Governance and Accountability" as a cross cutting agenda, and the proposed intervention fits well under this agenda.

B. PROJECT DEVELOPMENT OBJECTIVES

18. The Project Development Objective is to improve expenditure control and enhance government accountability and transparency by strengthening treasury system, improving financial reporting and building up PFM Capacity. The key project indicators and end-of-project targets are detailed in Annex 1.

1. Project Beneficiaries

19. The project is expected to improve controls in public expenditure management and budget monitoring of Government of Nepal. In addition, it will strengthen the cash management procedures and practices during budget implementation leading to better fiscal controls. The direct beneficiaries of the project are approximately 7,000 of public servants who are currently engaged in budget management and execution across the entire government. These staff will get access to orientation training on new enhanced systems being rolled out across the government, short-term skills training, exposure to international best practices and opportunities for undertaking research in PFM areas. Indirectly, this project will benefit the entire government and public at large in Nepal, as it cuts across sectoral boundaries and strengthens accountability and service delivery to citizens through enhanced fiscal discipline, improved prioritization of expenditures, and increased efficiency and effectiveness.

2. PDO Level Results Indicator

20. The PDO will be measured through the following outcome indicators.

Project Development Objectives	Project Outcome Indicators	Use of Project Outcome Indicators
To improve expenditure control and enhance government accountability and transparency by strengthening treasury system, improving financial reporting and building up PFM capacity.	<p>(a) Percentage of overall budget executed through the DTCOs where the TSA system has been implemented with real time budget and expenditure control.</p> <p>(b) Budget Execution Reports and</p>	Improved Budget management and implementation.

	<p>Financial Statements produced on a real time basis by the TSA system.</p> <p>(c) Consolidated financial statements for Pilot Ministries prepared in accordance with Part 1, Cash IPSAS.</p> <p>(d) Numbers of research studies into high priority PFM areas completed and disseminated.</p>	<p>Consolidation of bank accounts ploughs back unutilized money from spending units in treasury, provides more fiscal space and leads to better cash management.</p> <p>Real time budget availability checks at DTCOs eliminate unauthorized expenditures and therefore lead to better fiscal controls.</p> <p>Real time information on budget implementation assists line managers to take informed decisions.</p> <p>Enhanced transparency and qualitative financial reporting leads to better managerial decision making and allocative efficiency.</p> <p>Local research and analysis help decision makers in taking practical actions to tackle issues and challenges related to public financial management.</p>
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C. PROJECT DESCRIPTION

1. Project Financing

21. The project will be financed from a Multi Donor Trust Fund (MDTF) which has recently been set up for PFM activities in Nepal⁴. The World Bank is taking the lead in coordinating donor support for the PFM agenda, in view of its experience in designing and supporting implementation of PFM reforms, working with key institutions of accountability, such as anti-corruption agencies and Parliamentary Committees, and engaging Civil Society Organizations (CSOs) to strengthen oversight by citizens. In the South Asia region, the World Bank is gaining experience of managing Multi-Donor Trust Funds (MDTFs) for PFM reforms in Afghanistan and Bangladesh, and in Nepal, the Bank has had a strong engagement with the GoN on PFM issues since the Country Financial Accountability Assessment (CFAA) and Country Procurement Assessment Review (CPAR) were carried out in 2002. This recipient executed grant will be supported, on a parallel basis, by Bank executed non-lending technical assistance which will provide critical expertise in support of the implementation of these reforms. **The Bank executed NLTA includes, for example, providing consulting support for enhancement of the information system (sub-component 1.2) and for technical maintenance and support for the system (sub-component 103), and related support to Component 3 (support capacity building of the PEFA Secretariat).**

⁴ Please refer to the approved PFM MDTF Concept Note dated December 3, 2010

22. The project cost and grant financing through MDTF is summarized in Table 1.

Table 1: Project Cost and Financing

Component and/or Activity	Project Cost (US\$ million)	Grant Financing through MDTF (US\$ million)	GoN Contribution
Component 1. Implementation of Treasury Single Account (TSA) System	3.80	2.80	1.00
Sub component 1.1 Providing support for up-grading the technological infrastructure to set up the Core Treasury System	2.20	1.90	0.30
Sub-component 1.2 Providing support for further enhancement of the information systems as presently configured	0.40	0.20	0.20
Sub-component 1.3 Technical Maintenance and Support for the Systems	0.10	0	0.10
Sub-component 1.4 Provide support for rolling out the TSA to the remaining districts	0.50	0.40	0.10
Sub-component 1.4 Training	0.60	0.30	0.30
Component 2. Strengthening accounting and reporting practices in public and private sector	1.00	0.75	0.25
Sub-component 2.1 Support convergence to IFRS	0.30	0.17	0.13
Sub-component 2.2 Introduce commitment accounting	0.10	0.08	0.02
Sub-component 2.3 Pilot consolidated financial reporting in accordance with International Public Sector Accounting Standards (IPSAS).	0.60	0.50	0.10
Component 3. Supporting the Capacity Building of the PEFA Secretariat	0.90	0.75	0.15
Sub-component 3.1 Provide hands on support to PEFA Secretariat	0.39	0.35	0.04
Sub-component 3.2 Support finalization and implementation of work plan to implement the PFM RP Strategy Phase I	0.19	0.15	0.04
Sub-component 3.3 Support Research and Analysis in high priority PFM areas	0.19	0.15	0.04
Sub-component 3.4 Develop and implement Communication Strategy to raise awareness of PFM	0.13	0.10	0.03
Total	5.70	4.30	1.40

2. Project Components

23. The project consists of the following three components: (i) Implementing the Treasury Single Account (TSA) System, (ii) Strengthening accounting and reporting practices in public and private sector, and (iii) Supporting the Capacity Building of the PEFA Secretariat.

Component 1: Implementation of Treasury Single Account (TSA) System (Total Costs US\$ 3.8 m)

24. The TSA component is intended to provide support for (a) implementation of a Treasury Single Account (TSA) system that enables real time budget checks across all DTCOs in the country and at the center in the FCGO, and (b) further enhancement of the modified Financial management Information System (FMIS)⁵ to include elements of the core TSA functionality requirements (including commitment accounting) that are still missing, and any additional elements that will be required as the Government moves to implement International Public Sector Accounting Standards (IPSAS cash based) standards. This component's design is based on an assessment of the current status of the implementation of the TSA⁶, of the requirements to complete full rollout of the system to the remaining districts, setting up of a Central Module of the System at the FCGO and making any additional enhancements to the software. This Component will finance the following activities:

25. **Providing support for up-grading the technological infrastructure to set up the Core Treasury System (CTS).** This activity would include the procurement and installation of hardware and associated networking equipment, network management systems, information security systems and the software. Financing will be provided for :

- Procurement and installation of additional memory and disk storage and any spare parts such as additional routers that are required to upgrade the capacity of the existing MOF/FCGO server.
- Procurement and installation of three sets of central servers and associated equipment⁷ to be installed at the FCGO and the MOF data center, on which the TSA would operate. The FCGO servers would be the main servers⁸ and the server at the MOF would be a backup server⁹ used for disaster recovery purposes.
- Workstations/computers, printers, associated equipment such as printers/scanners/fax machines and backup power generators (Inverter, Solar and Battery) and LAN/WAN equipment at DTCOs to enable them to connect to the central servers¹⁰.

26. **Providing support for further enhancement of the information systems:** Most of the functionality required by CTS has now been included in the modified District Expenditure Control System (DECS). However, some elements are still missing like commitment recording. In addition, a Central module will need to be designed and added to provide the functionality required at the FCGO

⁵ Current FMIS system in FCGO's office is known as District Expenditure Control System (DECS)

⁶ Till May 31, 2011 TSA has been rolled out in 22 districts out of 75 districts in Nepal.

⁷ Associated networking equipment and software such as routers, systems software, network management software, firewalls, disk storage, back-up power generators would also be procured and installed.

⁸ The DTCOs would connect to the central server through a telecommunications network provided by the Nepal telecom and any other possible network providers.

⁹ The location of the Disaster Recovery Center (DRC) at the MOF is an interim arrangement that needs to be implemented quickly since this is a live system. This location will need to be moved to a separate site at some distance from the FCGO eventually to further insulate it from a simultaneous breakdown

¹⁰ A provision has been made to retroactively finance the investments made by the government in this regard at the 22 DTCOs that are on line now provided the equipment installed at these DTCOs has been procured in accordance with Bank procurement procedures and required documentation is available.

office for management of overall treasury/cash operations. Also since the Government is, in parallel, also envisaging implementation of the IPSAS cash based standard, new elements for reporting will need to be added. This component will finance an international consultancy to design and implement the enhancements described above.

27. **Technical Maintenance and Support for the Systems:** The systems need continued technical maintenance support. This support is currently provided by a consulting firm which is financed by a DFID grant. This arrangement will expire on July 14, 2011 as the TA financing from DFID comes to an end. This support is critical at least for the next two years, as new TSA system is implemented across all the remaining districts. This activity will therefore provide financing for continuing the services of the same experts for a further period of two years. This will give Government enough time to ensure that the necessary technical knowledge is transferred to in-house staff/consultants.

28. **Provide support for rolling out the TSA to the remaining districts.** The component would provide financing for the hiring of up to 15 local consultants for a period of two /three years to help in the implementation and ongoing support required as the TSA is rolled out to the remaining districts in the country.

29. **Training:** The component would provide financing for the technical and functional training¹¹ of staff at the FCGO/MOF/DTCOs/OAG and line agencies as necessary to enable them to operate the system and make best use of the information provided for Government decision making. This activity could also include short visits (for seminars, workshops or training) to other countries where a similar system has been set up to enable officials to become familiar with TSA operations.

30. A detailed technical note on the current status of the TSA is available in project files.

Component 2: Strengthening accounting and reporting practices in public and private sector (Total Costs USD \$1.00 m)

31. This component will support government initiatives (i) to strengthen financial accounting and reporting of the budgetary entities and State Owned Enterprises (SOEs) of the GoN and (ii) to converge Nepalese accounting standards with International Financial Reporting Standards (IFRS). The component comprises the following main activities:

32. **Support convergence to IFRS.** SOEs in Nepal have to follow Nepal Accounting Standards (NAS), which are promulgated by the Accounting Standards Board (ASB) of the GoN. As the Nepal representative to the International Federation of Accountants (IFAC), the ASB has made a commitment for full compliance with the International Financial Reporting Standards (IFRS) by FY2013 through convergence of NAS with the IFRS in Nepal. The FCGO and ASB will sign a performance based MoU that specifies the milestones as per the agreed convergence roadmap. MDTF financing will supplement GoN resources allocated to this activity and will finance up to US\$175,000 of the associated costs¹².

33. **Introduce commitment accounting.** Current accounting procedures for government ministries, departments and agencies do not include capturing and reporting information on commitments. It is, therefore not possible to determine what portion of the unspent budget, if any, remains available to be spent under any budget head, or, if the budget is already over-committed. Introducing commitment accounting will enhance ex-ante fiscal control and provide a basis for better and informed managerial decision making by line managers. New procedures and forms will be devised to capture commitment

¹¹ This would include training courses technical operations and maintenance of the system; the end users who use the system for the performance of their day to day operational functions; and managers responsible for decision making.

¹² Associated costs include expenses related to studies, awareness program, workshops, and seminars, translation of IFRS in local language and associated trainings and procurement of office equipment as well as consulting services. Some expenditures incurred before the agreement of the project document will be retroactively financed.

information in the TSA accounting system, and provide training to spending units in implementing the new procedures. Associated consultancy, implementation and training costs will be financed.

34. **Pilot consolidated financial reporting in accordance with International Public Sector Accounting Standards (IPSAS¹³).** This activity will support FCGO in compiling consolidated financial statements for one or two government ministries – one large (e.g. Ministry of Health and Population or Ministry of Education) and one small (e.g. Ministry of Women and Social Welfare) - in accordance with Part 1 Cash basis IPSAS. The pilot will serve a number of purposes. First, the reporting entity will be established using the IPSAS definitions to determine which budgetary units, non-budgetary bodies and SOEs are “controlled” by the selected pilot government ministry. Second, the sources of the data required from each of the controlled entities will be determined. TSA will assist in collection of data related to the budgetary entities. Third, experience will be gained in refining the information contained in financial statements to comply with the IPSAS Cash basis formats. Fourth, experience will be gained in consolidating procedures, including elimination of inter-company transactions and presentation of third party payments. Finally, a basis will be gained for establishing the benefits of expanded public sector financial reporting in accordance with IPSAS. All of these experiences will be used to deliver a series of workshops with relevant stakeholders and to devise a roadmap for the GoN to implement IPSAS based NPSAS across the whole of government. This activity will finance consultancy, seminars, workshops, training and international exposure visits.

Component 3: Supporting the Capacity Building of the PEFA Secretariat (Total Costs: USD 0.90m)

35. The objective of this component is to strengthen institutional capability for initiating and sustaining reforms to improve PFM across GoN by strengthening the capacity of the recently established PEFA Secretariat which reports to the Finance Secretary. The activities under this component are:

36. **Provide hands on support to PEFA Secretariat:** As a part of implementation of PFMRP Strategy, GoN has taken the first step of setting up the PEFA Secretariat, in the Ministry of Finance (currently located in the FCGO), which will be further strengthened to fulfill the mandate envisaged. Support will be provided to the PEFA Secretariat to enable effective support to the National level PEFA Steering Committee and to effectively coordinate development and implementation of an overall PFM vision for Nepal. This will include operational, thematic and logistical support to the Steering Committee. This will require consulting support, training program, workshops, procurement of office equipment, associated training/exposure visits and other ancillary activities. This activity will also support development and implementation of a operating/procedures manual.

37. **Support finalization and implementation of work plan to implement the PFMRP Strategy Phase I:** This activity will include design of a sequenced and time bound work plan with milestones with assigned responsibilities and Monitoring and Evaluation (M&E) framework to implement the agreed PFMRP Strategy. This activity will also support the PEFA Implementation Units in line ministries and provision of requisite training to the line department staff.

38. **Support Research and Analysis in high priority PFM areas:** This activity will support in-depth research on PFM in high priority areas or sectors as may be directed by the PFM Steering Committee or requested by other stakeholders. Studies may include critical areas such as accounting for pension savings scheme, accountability of local government, impact assessments of PFM reform initiatives, research on reorganizing internal audit and accounting functions, budget classification, accountability implications of off budget items, and monitoring and evaluation of ongoing reforms.

¹³ The Government of Nepal has already developed Nepal Public Sector Accounting Standards (NPSAS) through the Accounting Standards Board in accordance with the IPSAS.

39. **Develop and implement Communication Strategy to raise awareness of PFM:** This activity will support the Secretariat in conducting surveys, raising awareness and improving coordination amongst the line ministry focal points for PFM and other important stakeholders in the PFM reform process. In addition to a series of in-country seminars and workshops that will ultimately lead to the adoption of a Phase II PFM Reform Program, the component will finance experience sharing opportunities in regional or international seminars, and training and accreditation in PFM for selected officers.

D. IMPLEMENTATION

1. Institutional Arrangements

40. Following the 2004 PEFA assessment, GoN formed a National level PEFA Steering Committee which is chaired by the Finance Secretary and comprises representatives of the Ministry of Finance (MOF), the National Planning Commission (NPC), the Office of the Auditor General (OAG), the Financial Comptroller General Office (FCGO) with a provision to invite other ministries or departments or agencies based on the themes of discussions. The overall objective of the Committee is to provide strategic direction in public financial management.

41. The PEFA Steering Committee established a PEFA Secretariat in 2009 which is currently headed by the Joint Financial Comptroller General of FCGO, who also serves as the Member Secretary of the PEFA Steering Committee. Currently, the Secretariat has only three full time staff.

42. A PEFA Working Committee has also been created to support implementation of the decisions of the Steering Committee and to support functioning of the Secretariat.. The Working Committee is chaired by the PEFA Coordinator and with representatives from the Ministry of Finance (MOF), the National Planning Commission (NPC), the Office of the Auditor General (OAG), the Department of Customs ,and the Department of Inland Revenue.

43. PEFA Implementation Units have **currently** been designated in 14 Line Ministries **which will gradually be expanded to remaining line ministries**. These Units will closely coordinate with the PEFA Secretariat to oversee the implementation of the PEFA/PFM Action Plan. However due to lack of resources and strategic direction, these units have not become fully operational.

44. The PFM stakeholders are currently debating the current structure and the Terms of Reference of the PEFA Secretariat, in order to increase its effectiveness in developing and implementing PFM reform across the GoN. The PEFA Steering Committee will review the organizational structure and prepare draft Terms of Reference for the PEFA Secretariat, and will inform the Bank of the decision of the GoN before signing of the agreement for proposed project. During the implementation of the project the finally agreed arrangements will be put in place by December 31, 2011.

45. The Coordinator of the PEFA Secretariat will serve as the primary focal point for monitoring and reporting the implementation progress of this project (three components described earlier) and the overall PFM reform program of GoN. The current staffing capacity of the Secretariat will need to be strengthened with one full time Accounting Officer and one part time Procurement Consultant who will provide support to all three components. TSA system implementation (Component 1) will continue to be carried out by the TSA Unit, separately established within FCGO, which is coordinated by a Joint Financial Comptroller General. Other stakeholders such as, the Nepal Rastra Bank and Commercial Banks will also work with the FCGO and Ministry of Finance to implement the first component. A well coordinated functional arrangement between banks/central bank and the DTCO/FCGO is a core requirement for efficient and effective cash management. The Accounts Strengthening Section of the

FCGO is responsible for implementing public sector cash based accounting standards and will implement the Component 2¹⁴. The PEFA Secretariat is responsible for implementation of PFM related capacity building programs and will implement Component 3¹⁵. It is envisaged that trainings (including study tours) will be coordinated across all three components to allow holistic exposure and overall appreciation of PFM environments rather than focusing on individual component. This will enable the government to have more number of staffs gaining international exposure on PFM and other cross-cutting areas.

46. A dedicated budget head has already been assigned for the PFM reform program in the government's budget since FY2008/09. The same budget head will be used to fund the program to be financed under this project. GoN has allocated a total budget of Rs.120 million in FY2010/11, of which Rs.15 million has been allocated for the PEFA Secretariat. It is envisaged that PEFA Secretariat will prepare a monthly update with regard to status of the work plans/actions being undertaken under the three components which will be reviewed by the PEFA Steering Committee. The PEFA Steering Committee chaired by the Finance Secretary will review the implementation progress on a quarterly basis.

47. For implementation of all three components, the government will provide counterpart funding in the form of staff time, allowances, office furniture, transportation and other basic facilities, **in addition to the counterpart funding required to meet the program costs as presented in Table 1**. For TSA implementation, the continuation of the IMF Advisor is critical to support effective implementation and roll out of TSA in the remaining districts.

2. Governance and Accountability

48. A Governance and Accountability Action Plan (GAAP) has been agreed upon with the Project. Key governance issues in the Project include coordination among relevant GoN agencies, location and role of the PEFA Secretariat, technical infrastructure, and capacity building of various organizational units, including TSA and PEFA implementation units. Transparency and access to information about project activities are other important issues. A Governance and Accountability Action Plan (GAAP) has been prepared to address these issues and other critical operational concerns related to project management (Annex...). The GAAP identifies key risks to the Project and proposes actions for each of these risks with timelines for each action and responsible agency for implementation. It also seeks to ensure stability and predictability in staff deployment in project activities. The GAAP will be a living document and will be strengthened, as necessary, based on lessons learned during the implementation of Project activities. In addition, the MOF website (www.mof.gov.np) and FCGO website (www.fcgo.gov.np) will post all development related to the implementation of the project components and will post procurement details of the project and updates on project activities including trimester Implementation Progress Reports (IPRs), and Annual Audit Reports. In order to ensure continuity of staff, as required by the Civil Service Act, the government will make arrangements to adhere with the current policy and will ensure that the concerned staffs remain in position at least for three years (although the Act specifies only two years).

3. Results Monitoring and Evaluation

49. The PEFA Secretariat will monitor all activities of the project being executed by institutions and agencies under their purview. All monitoring data and reports from across the various agencies under this

¹⁴ For IFRS convergence, the FCGO will sign the Memorandum of Understanding (MOU) with the Accounting Standards Board (ASB) on a lump sum basis with an arrangement of disbursement based on performance indicators. For IPSAS based NPSAS implementation, the FCGO will enter into twinning arrangements with ASB to seek professional inputs.

¹⁵ Under Component 3, the PEFA Secretariat proposes to establish a small grant funds program that will invite interested researchers, academicians or other professionals for undertaking research in specific PFM areas. An operational guideline will be prepared by the Secretariat to operationalize this concept.

project will be submitted to the PEFA Secretariat. The PEFA Secretariat will be responsible for : (a) routine monitoring, (b) monitoring through regular/periodic reviews, (c) mid-term review and, (d) overall project evaluation and implementation completion review at project close.

E. APPRAISAL SUMMARY

1. Institutional

50. Implementation of the project activities will be fully aligned with the existing government system. The Coordinator of the PEFA Secretariat will serve as the primary focal point for monitoring and reporting the implementation progress of this project (three components described earlier) and the overall PFM reform program of GoN. TSA system implementation (Component 1) will continued to be carried out by TSA unit, separately established within FCGO, which is coordinated by a Joint Financial Comptroller General. The Accounts Strengthening Section of the FCGO is responsible for implementing Component 2 that is, public sector cash based accounting standards in partnership with the Accounting Standards Board (ASB) and the IFRS convergence by the Accounting Standards Board.. The PEFA Secretariat is responsible for implementation of PFM related capacity building program and will implement Component 3. The PEFA Steering Committee will provide overall strategic guidance and oversight. The PEFA Steering Committee and the PFM MDTF Program Coordination Committee will closely coordinate to have an overall oversight of the PFM program.

2. Financial Management

51. On the basis of the assessment, the current FM risk is rated at “Substantial” which is expected to be “Modest” following the implementation of key actions such as, redefining the role and function of the PEFA Secretariat, and the designation of core project implementation team in the Secretariat which include a full time Accounts Officer. The Project will fully align with government financial management system. A budget head has already been created for PFM reform and the same heading will be used for the purpose of this Project. The PEFA Secretariat, as the overall coordinator of the Project, will have a team of dedicated staff overseeing the project implementation. A full time Accounts Officer will be designated for the purpose of managing and reporting on usage of the project funds. Disbursements will be report based under which two trimester equivalent of cash forecast will be provided to the Designated Accounts. The Project will submit the Implementation Progress Report which will include Financial Monitoring Report on a trimester basis. Audited Project Accounts will be required for the Project to be submitted within six months after the end of the fiscal year. A reporting format for Implementation Progress Report which will include financial monitoring report and procurement management report will be agreed upon before the signing of the Agreement. Detailed FM assessment is available in project files.

52. **Retroactive Financing:** The retroactive financing on the implementation of TSA will be provided. This will include identified local training costs, hardware (servers, computers, printers, fax, scanner, photocopier, generator, UPS, routers etc.) costs and software costs (Oracle) of all expenditures incurred from October 1, 2010, provided that the procurement was done in accordance to the Bank’s procurement guidelines or national procurement procedures acceptable to the Bank. Decision for eligibility for financing procurement of hardware will be made only after the Bank’s review of procurement procedures adopted. The retroactive financing will also include the expenses related to IFRS convergence. In order to get this activity retroactively financed, the output based Memorandum of Understanding between the PEFA Secretariat and the Accounting Standards Board will have to be reviewed and approved by IDA. The total retroactive financing is estimated not to exceed US\$ 800,000.

3. Procurement

53. Procurement for the proposed operation will be carried out in accordance with the World Bank's "Guidelines: Procurement of Goods, Works and Non-consulting Services under IBRD Loans and IDA Credits and Grants by World Bank Borrowers" published by the World Bank in January 2011 ("Procurement Guidelines"), in the case of goods and non-consulting services; and "Guidelines: Selection and Employment of Consultants under IBRD Loans and IDA Credits and Grants by World Bank Borrowers" published by the World Bank in January 2011 ("Consultant Guidelines") in the case of consultants' services, and the provisions stipulated in the Legal Agreement. For each contract to be financed under the Credit/Grant, procurement methods or consultant selection methods, the estimated costs, prior review requirements, and time frame will be agreed between the Borrower and the Bank in the Procurement Plan which needs to be prepared by the borrower and reviewed by the Bank prior to the approval of the Project. The Procurement Plan will be updated at least annually or as required to reflect the actual project implementation needs and improvements in institutional capacity.

54. A procurement capacity assessment was carried out in May 2011. On the basis of this assessment, the overall procurement risk for the project was rated "Substantial", and the residual risk "Moderate" once a procurement consultant is on board to provide procurement support. Detailed procurement assessment is available in project files. Detailed procurement assessment is available in project files.

4. Sustainability

55. The key elements for sustainability of project activities are ownership, staffing for implementation and consensus building amongst stakeholders.

56. GoN's demonstration of leading the PEFA assessment and preparing the PFMRP Strategy and kick starting the TSA implementation (which has now been rolled out to 22 districts out of 75, and planned for additional 16 districts from 16 July 2011) is the manifestation of the government's full commitment and ownership to the PFM reform agenda that needs to be supported and sustained. Support to key activities consistent with the PFMRP Strategy will have a permanent impact on the PFM sector in Nepal. Institutional, managerial, administrative and technical capacity building of Line Ministries and Departments and key agencies such as the FCGO and PEFA Secretariat will benefit both the system and the general public in the medium to long term. Retention of staff and enhancing skills in key institutions such as FCGO and PEFA Secretariat will be key to success of the project and overall PFM program. IMF's support to the TSA implementation with a placement of a Resident Advisor has been an encouraging element. The continuation of this arrangement is critical to ensure momentum to the full implementation in rest of the districts. Raising awareness about PFM issues amongst stakeholders in order to keep them interested and motivated to take up challenges and demonstrating linkage of PFM reform with development agenda will hold the key to future PFM reform in Nepal.

5. Key Risks

57. The overall project risk rating is Medium-I¹⁶. These are detailed in Annex 2, the Appraisal Stage Operational Risk Assessment Framework (ORAF). However, there are a number of important country, sector and project risks associated with the project. Even though the mitigation measures will help to lower overall project risks, they will not be able to eliminate the risks entirely. The risks that remain include:

- (a) Political uncertainty: Failure to move forward politically and consensus building with the promulgation of the Constitution of Nepal would simply delay the services that the GON should be providing to its citizens.

¹⁶ A rating of MI means that there is a low likelihood of occurrence of the risks, but should they materialize, they would have a high impact on the achievement of the PDO.

- (b) Monitoring: The security situation in Nepal is very fragile and this could affect overall implementation. The Bank team's ability to monitor and support the government on the ground will be strengthened and teams will be encouraged to: (i) continue to be vigilant with regards to security readiness; (ii) include third party consultants to provide monitoring and implementation support; and (iii) take advantage of distance communication to the extent possible.
- (c) Corruption and fraud: Corruptive practices in the project could arise in connection with the procurement of goods and services. To mitigate this risk the bank team will provide guidance to the project staff on applicable procurement procedures to enhance transparency and competition and will review procurements.

Annex 1: Results Framework and Monitoring
Strengthening the Treasury System, Financial Reporting and PFM Capacity Building

Project Development Objective	Project Outcome Indicators	Use of Project Information
<i>PDO: To improve expenditure control and enhance government accountability and transparency by strengthening treasury system, financial reporting and PFM capacity.</i>	<ul style="list-style-type: none"> • Percentage of overall budget executed through the DTCOs where the TSA system has been implemented • Budget Execution Reports and Financial Statements produced on a real time basis by the TSA system in the district and central systems. • Consolidated financial statements for Pilot Ministries prepared in accordance with Part 1, Cash IPSAS • Numbers of research studies into high priority PFM areas completed and disseminated 	Indicates along with the intermediate outcomes and output indicators whether the project is on track in the achievement of the PDO.
Intermediate Outcomes	Results Monitoring Indicators	Use of Monitoring Indicator
Component 1: Implementation of Treasury Single Account (TSA) System		
Component 1:	<ul style="list-style-type: none"> • Number of DTCOs/districts where TSA implemented; • Number of Spending Unit (SU) Bank Accounts Closed ; • Number of FCGO , line department and DTCO staff trained ; • Number of master trainers trained ; • Software redeveloped after removing bugs as reported in current software; and the full functionality systems for working out Treasury Position and Cash Management • New features added in software to meet with IPSAS Cash requirements and additional feature such as commitment accounting 	Indicates the extent to which TSA system has been implemented and real time budget controls have been strengthened for enhancing fiscal control and expenditure efficiency
Component 2: Strengthening accounting and reporting practices in public and private sector		
Component 2:	<ul style="list-style-type: none"> • Preparation of consolidated financial statements for Pilot Ministry 1 in accordance with Part 1, Cash IPSAS • Preparation of consolidated financial statements for Pilot Ministry 2 in accordance with Part 1, Cash IPSAS • Listed SOEs prepare accrual financial statements in accordance with IFRS • Implementation of commitment controls in the budgetary entities of GoN (within the piloting ministries) • Number of persons trained in application of new accounting standards based on IFRS • Number of GoN finance and accounts staff trained in application of Cash based IPSAS 	Indicates the extent to which accounting and reporting practices have been strengthened in the public and private sector ; internal controls have been improved by implementation of the commitment controls in budgetary entities of Government of Nepal

Component 3: Supporting the Capacity Building of the PEFA Secretariat		
	<ul style="list-style-type: none"> • Secretariat manual and procedures prepared and implemented • Number of National level PEFA Steering committee meetings supported during the project period • Number of research studies completed and disseminated • Carried out repeat PEFA assessment • Number of seminars & workshops conducted for raising PFM awareness • PEFA newsletter and journal published and disseminated 	Indicates the extent to which (i) PFM reforms have been initiated as per PFMRP strategy of GoN and (ii) PFM reforms have been mainstreamed in the GoN

Monitoring Arrangements (Table 1)

PDO Level Results Indicators*	Core	Unit of Measure	Base-line	Cumulative Target Values**					Frequency	Data Source/ Methodology	Responsibility for Data Collection	Description (Indicator, definition etc)
				YR 1	YR 2	YR3	YR4	YR5				
Percentage of overall budget executed through the DTCOs where the TSA system has been implemented	<input type="checkbox"/>	Percentage of expenditures	19	35	55	85	98		Annual	Data from TSA system	Project Institutions – FCGO	Indicates real time budget controls in these districts
Budget Execution Reports and Financial Statements produced by the TSA system.		Percentage of expenditures	35	50	65	80	95		Annual	Data from TSA System	Project Institutions- FCGO	Indicates mainstreaming of TSA system
Preparation of consolidated financial statements for PILOT Ministries in accordance with Part 1, Cash IPSAS ;		Number	Nil	-	1	1	2		Annual	FCGO secretariat	FCGO	Indicates improved financial reporting practices
Numbers of research studies into high priority PFM areas completed and disseminated		Number	0	1	2	4	5		Annual	Institutional records	PEFA Secretariat	Indicates research and analysis to support PFM reforms
INTERMEDIATE RESULTS												
Intermediate Result (Component One): : <i>Implementation of Treasury Single Account (TSA) System</i>												
Number of DTCOs/districts where TSA implemented	<input type="checkbox"/>	No.	18	45	65	75			Six Month	Administrative Data;	FCGO	Indicates rollout of TSA

<i>Number of Spending Unit (SU) Bank Accounts Closed</i>	<input type="checkbox"/>	No.	3500	8000	12000	14000			Six Monthly	Data;	FCGO	Indicates consolidation of bank balances
<i>Number of FCGO , line department and DTCO staff trained or oriented; and still deployed to perform the functions envisaged</i>		No.	1500	3500	5000	5500			Six Monthly	Administrative Data;	FCGO	Indicates improvement in skills
<i>Number of master trainers trained (TSA and IPSAS and working as trainers under the project</i>		No.	0	30	55	75			Six Monthly	Administrative Data; Interviews	Secretariat	Indicates improvement in TEVT instructor quality
<i>Software redeveloped after removing bugs as reported in current software;</i>		-	I	Initiated and Tested	Completed	Functional	Functional		Six Monthly	Administrative Data	FCGO ; Secretariat	Indicates improved functionality of TSA system
<i>New features added in software to meet with IPSAS Cash requirements and additional feature such as commitment accounting</i>		-	-	Initiated	Completed	Functional	Functional		Six Monthly	Administrative Data	FCGO	Indicates improved functionality of TSA system
<i>Intermediate Result (Component Two): Strengthening accounting and reporting practices in public and private sector</i>												
<i>Preparation of consolidated financial statements for PILOT Ministries in accordance with Part 1, Cash IPSAS</i>		Number	-	-	1	2	2			Administrative Data; Independent Reviewers Reports	Project Institutions, Secretariat	Indicates success of performance-based financing
<i>Listed SOEs prepare accrual financial statements in accordance with IFRS</i>		percentage	0	-	35%	50%	100%		Six Monthly	Administrative Data	FCGO ; Secretariat	
<i>Implementation of commitment controls in the budgetary entities of GoN (within pilot ministries)</i>		-	-	designed	Tested in a few entities	50% of budgetary entities	100% of budgetary		Six Monthly	Administrative Data	FCGO Secretariat	
<i>Number of persons trained in application of new accounting standards based on IFRS</i>		No.	-	225	225	225	225		Six Monthly	Administrative Data	ASB	

<i>Number of GoN finance and accounts staff trained in application of Cash based IPSAS and still deployed to perform the functions envisaged</i>		No.	0	50	125	250	500				PEFA Secretariat : FCGO	
<i>Intermediate Result (Component Three): Supporting the Capacity Building of the PEFA Secretariat</i>												
Secretariat manual and procedures prepared and implemented	<input type="checkbox"/>	-	-	Initiated	Completed	Implemented	Implemented		Six Monthly	Administrative Data	PEFA Secretariat	
Number of National level PEFA Steering committee meetings supported during the project period	<input type="checkbox"/>	No.	-	4	6	9	12		Six monthly	Administrative Data;	PEFA Secretariat	
Number of research studies completed and disseminated	<input type="checkbox"/>	No.	-	3	6	9	12		Six monthly	Administrative Data;	PEFA Secretariat	
Carried out repeat PEFA assessment			-	Completed	-	-	-		Six monthly	Administrative Data;	PEFA Secretariat	
Number of seminars & workshops conducted for raising PFM awareness		No.	-	2	4	6	7		Six monthly	Administrative Data;	PEFA Secretariat	
PEFA journal published and disseminated		No.	-						Six monthly	Administrative Data;	PEFA Secretariat	

Base-line values will be revised post the collection of base-line data; disaggregated data will be collected wherever applicable for trainees supported by gender, ethnic group and minority status and region of residence; @ base-line and target values will be determined after the selection of institutions into the project.

Strengthening the Treasury System, Financial Reporting and PFM capacity building
Negotiations version

Annex 2: Operational Risk Assessment Framework (ORAF)

Project Development Objective(s)	
Key Results Indicators:	1. Percentage of overall budget executed through the DTCOs where the TSA system has been implemented.
	2. Budget Execution Reports and Financial Statements produced on a real time basis by the TSA system.
	3. Preparation of consolidated financial statements for PILOT Ministries in accordance with Part 1, Cash IPSAS.
	4. Numbers of research studies into high priority PFM areas completed and disseminated.

ORAF Risk Levels	Risk Rating	Risk Description	Proposed Mitigation Measures
Project Stakeholder Risks			
Stakeholder Risks	Medium	<p>Resistance to TSA system due to lack of technical expertise and infrastructure.</p> <p>Frequent transfers of staffs in the FCGO, Line Ministries and Districts</p> <p>Inadequate capacity to adopt to the Cash IPSAS.</p> <p>Challenges in bringing various stakeholders together to undertake holistic PFM reform</p>	<p>GON is fully committed to implementation of TSA Project and PFM reform program. This project is centered around a well coordinated response by GoN in the shape of PFMRP Strategy, which is evidence of the ownership and commitment under the program.. Even before the donor response for support, GON has already rolled out the TSA in 22 districts, and added 16 more districts effective from July 16, 2011. PEFA secretariat has been set up. ASB has started to prepare plans to converge to IFRS. Resident Advisor from IMF has been a catalyst to support smooth implementation of TSA. Limited tenure hired IT staff to support FCGO and the 'Base Districts' and hand-hold the peripheral districts have been provided in the Project. Continued efforts to implement TSA and other reform programs, continuation of IMF Resident Advisor, partnership agreement with the Accounting Standards Board for implementation of IPSAS and convergence to IFRS, and an arrangement for international advisor for PFM Capacity Building are some of the proposed measures that will help to mitigate the current risks. To facilitate continuity in the project implementation it is also understood that endeavors will be made by GoN to allow staff to continue on projects for at least 3 years before they are transferred</p>

Implementing Agency Risks (including FM & PR Risks)			
Implementing Agency level Risks	Medium	<p>Delays in redefining the role and function of the PEFA Secretariat.</p> <p>Delays in designating a core team of staff that includes technical staff, Accounts Officer and part-time Procurement Consultant for overseeing project implementation.</p> <p>Inadequate capacity in implanting PEFA activities and frequent transfer of deputed staffs</p> <p>Misutilization of resources and fraud allegations jeopardize accountability and transparency of the project.</p>	<p>The PEFA Steering Committee will review and redefine the role and function of the PEFA Secretariat with an approved TOR. Recently in June 2011, the PEFA Secretariat held a high level workshop opened by the Finance Minister to discuss about the PFM agenda and institutionalizing the PEFA Secretariat.</p> <p>The PEFA Secretariat will take decision to depute a core team of staff that includes technical staff, full time Accounts Officer and part-time Procurement Consultant for overseeing project implementation. If required, the Bank will support with a consultant through bank execution. Series of capacity development activities will be organized and mechanism for staff transfer will be revisited by incorporating succession plan. Proposed capacity development strategy will supplement reducing the HRD gaps.</p> <p>Detailed processing information maintained by the PEFA Secretariat and close scrutiny by the PEFA Steering Committee chaired by the Finance Secretary will reduce chances of misutilization of funds and fraud allegations. Moreover the bank will support in undertaking procurement according to the Bank guidelines</p>
Project Risks			
Design Risk	Low	Implementation of priority actions envisaged by PFM Strategy Document of GON with full government ownership.	Strong GON leadership, close coordination with stakeholders, enhanced donor coordination has proven to be effective and will continue.
Social & Environmental Risk	Low	The project may have negative social and environmental impacts	The project is not financing any infrastructure or civil works, rather it is mainly financing technical assistance for reforming the PFM environs of GoN which is expected to have a positive impact on beneficiaries of the project. No negative effects on social and environmental issues are foreseen.
Delivery Quality Risk	Medium	<p>TSA system does not have the required impact;</p> <p>Actions to continue monitoring of agreed milestones in each component.</p>	<p>TSA design has been field tested and challenges faced are being tackled in the redesign of the software that will implemented going forward</p> <p>Close monitoring at the PEFA Secretariat level and periodic monitoring at the PEFA Steering Committee and at the MDTF donor level and their interface will help to ensure delivery of results.</p>

Overall Risk Rating:

Risk Rating: Preparation	Risk Rating: Implementation
Medium-I	Medium-I.

Annex 3: Governance Accountability Action Plan (GAAP)

Introduction

The project preparation team has developed this GAAP to address critical operational concerns related to project management in the Project. The GAAP seeks to ensure good governance and cost-effectiveness in the management of project activities. This is based on Nepal's existing governance and legal framework, including legislations on anti-corruption, right to information, and good governance. In addition, elements of the World Bank's access to information policy have been appropriately incorporated into it. The GAAP will be a living document and will be strengthened, as necessary, based on lessons learned during the implementation of Project activities.

Key Governance Challenges

Coordination and collaboration between stakeholders

The Project brings together a number of agencies, including FCGO, MOF, OAG, and NPC. As the main GON agency responsible for treasury operation, FCGO will be the lead on several aspects of the project. The PEFA Secretariat will have a major role in the coordination and implementation of project activities.

There are six aspects of coordination in the project:

- Coordination between GON agencies, including constitutional bodies (e.g. OAG)
- Coordination between the Project Units and the Nepal Rastra Bank; and also coordination with the Agency Commercial Banks (both NRB and Agency Banks will need to fully cooperate with Project activities)
- Coordination between TSA Units in districts (DTCOs) and Spending Units (which would be closing their bank accounts) and their line ministries
- Coordination between the Project and the ongoing IFMIS initiatives
- Coordination between the Project and the Accounting Standards Board
- Coordination between the PEFA Secretariat and line ministries implementing PFM reform activities

The PEFA Secretariat will have to put significant efforts towards achieving coordination and collaboration in all these aspects. This requires strengthening of the Secretariat itself.

PEFA Assessment

GON undertook a PEFA assessment in 2008. Its findings tend to show, among others, that while Nepal is a fiscally responsible state, the country needs to match its implementation capacity with its planning capacity. Also, Nepal is supposed to be good at collecting revenues but not equally good at spending (particularly capital expenditures). Nepal has a good audit system, but its accounting, reporting and recording systems need substantial improvements. And, the fact that every year almost half the total budget is spent during the last trimester is a sign of inadequate planning and capacity. The Project's components on PFM reform will have to tackle these shortcomings.

Interface between MOF and the banking networks

The interface between MOF, line agencies and the banking networks should be agreed by all the stakeholders and formalized through agreements. Such agreements should provide for the modalities of issuing payment orders/checks, and the arrangements for reporting and reconciliation. The ongoing IFMIS initiative can be expected to provide an electronic interface between the MOF and the banking network. But this will require investments in upgrading IT facilities across the participating banks and GON agencies.

Capacity development of the TSA users

The prospective users of the TSA system both within the MOF and line agencies will need to be trained on the new procedures and applications. Such training should be carefully coordinated with the introduction of the TSA. A user manual on receipt, payment procedures and deposits under the TSA system should also be developed and updated. The MOF should work closely with line ministries and budget execution and revenue collection entities to ensure that the latter have full information about the reforms and the necessary changes in their banking and payment arrangements.

Political support

Implementing a TSA system as planned requires firm government commitment with some hard decisions, such as closing the existing bank accounts of budget organizations (outside MOF control), that can provoke (silent) resistance. Encouragingly all relevant entities have been cooperating with the process. The TSA reform must be explicitly and consistently supported by the highest political leadership. The initiative has received political support so far. Similarly, transiting to International Public Sector Accounting Standards (IPSAS) will require lot of support and hand-holding from the accounting professionals in a very weak capacity environment of the public sector. But the risks associated with Nepal's current transition, including political instability, may not be ignored.

Objectives of GAAP

The GAAP's main objective is to contribute towards strengthening governance and accountability systems in the Project. It will achieve this objective by:

- ensuring resources allocated by GON and the Bank are spent for the intended purposes and directed to the beneficiaries of the project;
- strengthening coordination between different GON agencies; and
- improving feedback mechanisms between beneficiaries and providers of services.

Scope

Several areas for governance improvement have been identified: political environment, organizational arrangements, monitoring, and accountability arrangements. The GAAP proposes actions for each of these issues, timeline for each action, and responsible agency for implementation. There are also some 'early warning indicators' which, if monitored properly, enable timely actions for course correction.

Monitoring arrangements

The GAAP will be monitored regularly against agreed actions which will be reflected in the Project's periodical progress reports and aide-memoires. The GAAP matrix will be used widely for monitoring purposes. If any action is triggered, PEFA Secretariat will initiate enhanced supervision through specific third-party audits, reviews by sector experts, training workshops, and joint interim missions with the Bank. If the investigation confirms poor performance, appropriate sanctions will be applied by the relevant agency depending on the nature of the case. In addition, any 'early warning' indicators of governance and accountability risks will be monitored regularly so that corrective measures could take place in time. While the PEFA Steering Committee will have the overall responsibility to ensure monitoring the implementation of this GAAP, the PEFA Secretariat will be responsible for implementing program-specific actions included in the GAAP matrix and will also act as a nodal point to co-ordinate with other agencies for effective implementation of the GAAP. The GAAP will also be monitored as part of the implementation support missions.

**Nepal: Strengthening the Public Financial Management System (Treasury System, Financial Reporting and PFM Capacity Building)
Governance and Accountability Action Plan (GAAP)**

Areas of work	Issues likely to affect project performance	Actions to address the issues	Responsible agencies	Timelines	Early warning signs
1. Political and Administrative Environment					
High-level political support to PFM	Frequent changes in government with shifting policy emphasis on PFM reform, including TSA, and financial reporting	Ministers and other political leaders across the political spectrum will be briefed regularly on the importance of PFM, including TSA and implications of any policy changes, and implementation of Nepal Public Sector Accounting Standards (NPSAS) Flexibility will be allowed in project implementation arrangements to accommodate suggestions for changes that do not affect project objectives.	PEFA SC	August and March every year, and immediately after a change in Government	Political decision-makers not fully aware of PFM and TSA reform efforts
Commitment of administrative leadership to PFM reform	Poor internalization of PFM reform activities in line ministries	All GON Secretaries and other senior staff will be briefed on the findings of PEFA Assessment (2008) and the Government’s response to them. Interactions with senior staff at line ministries will be held to brief them on Project activities and seek their feedback	PEFA Sect. PEFA Sect	Sept 2011 Quarterly, starting in Jan 2012	General perception that PEFA Sect. is part of FCGO.
	No shared understanding on the role of PEFA Secretariat	The composition of PEFA Secretariat will be reviewed to bring all big spending ministries on board (e.g., Education, Health, MLD, MPPW) and review will be undertaken to examine the physical location of the PEFA Secretariat. TORs of PEFA Secretariat will be updated and disseminated widely to all stakeholders	PEFA SC	Dec 2011	
			PEFA SC	Dec 2011	
			PEFA SC/ PEFA Sect	Dec 2011	
2. Organizational Arrangements and Capacity Development					
Coordination in project implementation	Weak coordination between central-level organizations with a role in PFM (e.g., OAG, FCGO, MoF, NPC)	The PEFA Steering Committee will meet at least every quarter to achieve better communication and coordination with representation from all members at the agreed level.	PEFA Secretariat	Jul/Nov /Feb/June	Frequent absence or lower level representation of members in SC meetings
	Fragmented responsibilities for implementing project components	Heads of TSA, NPSAS and Financial Administration units and PEFA Secretariat will meet every month to review all project activities carried out during the month and agree any future course of action.	PEFA Secretariat	Monthly	Poor communication between the three component managers

Areas of work	Issues likely to affect project performance	Actions to address the issues	Responsible agencies	Timelines	Early warning signs
	Inadequate coordination with the Accounting Standards Board in the NPSAS and IFRS implementation	Output based MoU will be signed between the PEFA Secretariat and the Accounting Standards Board defining the key deliverables and roles and responsibilities of concerned agencies to ensure that results expected on IFRS implementation as well as support to NPSAS implementation are clearly articulated.	PEFA Secretariat and ASB	September 2011	Delay in signing of the MoU
Capacity building	PEFA Secretariat has inadequate capacity to handle project activities	An institutional strengthening action plan will be prepared and implemented to strengthen FCGO systems, PEFA Secretariat, TSA district units, and NPSAS pilots. Existing project supports to FCGO (e.g., IFMIS) will provide complementarities to the Project.	PEFA Sect/ PEFA SC FCGO	Sept 2011 Regular	Delays in initial project activities
	TSA units (DTCOs) in districts have inadequate capacity	TSA implemented DTCOs will be mobilized for hands-on training in new districts.	PEFA Sect	June 2012	
	Poor capacity of NPSAS pilot ministries in terms of internalizing international standards	Experience sharing events will be organized periodically to take stock of lessons learned and prepare action plan to mitigate the issues encountered User manuals will be prepared for easy access to information PFM/NEPSA processes	PEFA Sect FCGO/ NPSAS Desk PEFA Sect.	Sept 2011 onwards	
	Use of core staff is sub-optimal because of frequent staff transfer, especially in PEFA Secretariat	Core staff will remain in post for at least two years. No core staff will be transferred, if the remaining project period is less than one year.	PEFA Sect PEFA Sect.	Regular	Weak compliance to FCGO decision on staff transfer issues
	IT interface between TSA units and other agencies is weak and unreliable	IT hardware and software systems will be upgraded in all Project entities (FCGO, MOF, TSA Units)	MOF/FCGO	Feb 2012	Poor performance of IT systems
3. Monitoring and evaluation					
Inputs	There are delays in deployment and use of project staff	A staff deployment plan will be prepared to monitor staffing activities	PEFA Sect.	Sept 2011	Calendar of operations of the project becomes ineffective
	Disbursement of funds is delayed	AWPB will be prepared and submitted to relevant authorities for timely disbursement of funds	PEFA Sect.	February each year	
Processes	Poor communications between project units affect performance	Guidelines prepared and implemented for communications between project entities	PEFA Sect	Dec 2011	
	Weak observance of agreed norms	Operational manuals enforced for project activities			

Areas of work	Issues likely to affect project performance	Actions to address the issues	Respon- sible agencies	Timeli- nes	Early warning signs
Outputs	Slipping deadlines for specific outputs	Early warning indicators will be put in place for important milestones	PEFA Sect.	Dec 2011	Public complaints about poor performance
	Weak quality assurance mechanisms	Project beneficiaries will be involved in monitoring project activities	PEFA Sect.	Regular	Unfavorable reports on project activities, including in the media
		Third party (independent) monitoring will be encouraged in project activities	PEFA Sect.	Annual	
4. Transparency and accountability					
Public access to information	Lack of transparency and access to information hinders citizens' participation in policy discussions on PFM, including TSA reform and public sector accounting reform.	All project information will be available on project website Other media, including newspapers and electronic media, will also publicize information	PEFA Sect./FCGO	Dec 2011 Regular	Grievances from stakeholders about poor transparency in project activities
	There is a lack of user-friendly IEC materials	Brief, accessible brochures will be available for the public	PEFA Sect./FCGO	Feb 2012	
	Project authorities are not used to pro-active communication	RTI-consistency of project operations will be assessed every six months.	PEFA Sect./FCGO	August and March	
Participation of stakeholders	There are not enough opportunities for stakeholders (e.g., line ministry offices) to participate	GON line ministries and their district offices will be approached for feedback on Project performance FCGO will have a grievance hearing unit to receive and act on suggestions/complaints from the public.	PEFA Sect. PEFA Sect FCGO	Annual Dec 2011	Complaints about poor project performance
Achieving results	Project results and milestones are not clearly defined	Project outputs and outcomes will be defined clearly with measurable indicators to assess performance.	PEFA Sect.	Sept 2011	Poor public engagement/interest in project activities
	Inadequate dissemination of results	Project results will be publicized widely with lessons learned.		Annual	