

## **North East Local Services Improvement Project (NELSIP) - 2013**

---

The audit of financial statements of the North East Local Services Improvement Project (NELSIP) for the year ended 31 December 2013 was carried out under my direction in pursuance of provisions in Article 154(1) of the Constitution of the Democratic Socialist Republic of Sri Lanka read in conjunction with Section II B of Schedule 2 of the Financing Agreement No.4728-LK dated 08 November 2009 entered into between the Democratic Socialist Republic of Sri Lanka (GOSL) and the International Development Association (IDA).

### **1.2 Implementation, Objective, Funding and Duration of the Project**

-----

According to the Financing Agreement of the Project, the Ministry of Economic Development is the Executing and Implementing Agency of the Project. The Commissioners of Local Government of the Northern and Eastern Provincial Councils are responsible for the management and coordination of Project activities at the Provincial level. The objective of the Project is to support Local Authorities in the Northern and Eastern Provinces to deliver services and local infrastructure in a responsive and accountable manner. As per the Project Appraisal Document, the estimated total cost of the Project is US\$ 86 million and out of that US\$ 50 million or 58% was agreed to be financed by the International Development Association. The rest of the Project cost, amounting to US\$ 34 million should be provided by the Government of Sri Lanka and the balance part of US\$ 2 million to be contributed by the beneficiaries of the Project. The Project commenced its activities on 01 May 2010 and was scheduled to be completed by 31 December 2015.

### **1.3 Activities of the Project**

-----

According to the Agreement, this Project is Comprises 5 main Components. i.e. Components 1, 2, 3, 4 and 5. Activities relating to those five Components of the Project are summarized below.

- Component 1: Infrastructure Service Delivery**  
Providing grants to Local Authorities to enable them to carry out infrastructure development activities.
- Component 2: Institutionalizing Accountabilities**  
Providing technical assistance to Local Authorities to enable them to carry out transparent and independent annual financial audit, social and technical audit and deal with outstanding financial statements and audit issues. Carry out an education and communication campaign and development and implementation of systems and processes to enhance the operations of Local Authorities.
- Component 3: Capacity Building**  
Enhancing the capacity of the Local Authorities in the areas of planning, budgeting, financial management, procurement and Project management and to undertake audits in an efficient and timely manner. Strengthening the capabilities of the Project Implementation Units.
- Component 4: Assessment and Evaluation**  
Establish a comprehensive system to monitor the activities of the Local Authorities and carry out evaluations and analysis about the operations of the Local Authorities.
- Component 5: Project Management**  
Strengthening the capacity of the Project management Units.

#### **1.4 Responsibility of the Management for the Financial Statements**

---

Management is responsible for the preparation and fair presentation of these Financial Statements in accordance with Generally Accepted Accounting Principals. This responsibility includes; designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error, selecting and applying

appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

## **2. Scope of Audit and Basic of Opinion**

-----

My responsibility is to express an opinion on these financial statements based on my audit. Audit opinion, comments and findings in this report are based on review of the financial statements presented to audit and substantive tests of samples of transactions. The scope and extent of such review and tests were such as to enable as wide and audit coverage as possible within the limitations of staff, other resources and time available to me. The audit was carried out in accordance with Sri Lanka Auditing Standards to obtain reasonable assurance as to whether the financial statements are free from material misstatements. The audit includes the examination on a test basis of evidence supporting the amounts and disclosures in financial statements and assessment of accounting policies used and significant estimates made by the management in the preparation of financial statements as well as evaluating their overall presentation. I have obtained sufficient information and explanations which to the best of my knowledge and belief were necessary for the purpose of my audit. I therefore believe that my audit provides a reasonable basis for my opinion. The examination also included such test of systems and controls, transactions, assets, liabilities and accounting records as deemed necessary to assess the following.

- (a) Whether the systems and controls were adequate from the point of view of internal controls so as to ensure a satisfactory control over Project Management and the reliability of books, records etc. relating to the operations of the Project.
- (b) Whether adequate accounting records were maintained on a continuing basis to show the expenditure of the Project from the funds of the GOSL and the lending agency, the progress of the Project in financial and physical terms, the assets and liabilities arising from the operations of the Project, the identification of the purchases made out of Loan etc.
- (c) Whether withdrawals under the Loan had been made in accordance with the specifications laid down in the Financing Agreement.

- (d) Whether the funds, materials and equipment supplied under the Loan had been utilized for the purposes of the Project.
- (e) Whether the expenditure had been correctly identified according to the classification adopted for the implementation of the Project.
- (f) Whether the financial statements had been prepared on the basis of Generally Accepted Accounting Principles.
- (g) Whether the opening and closing balances withdrawals from and replenishments to the Special (Dollar) Account had been truly and fairly disclosed in the books and records maintained by the Project and the balance as at 31 December 2013 had been satisfactorily reconciled with the accounting records of the Central Bank of Sri Lanka (CBSL) as at that date.
- (h) Whether satisfactory measures had been taken by the management to rectify the issues highlighted in my previous year audit report, and
- (i) Whether financial covenants laid down in the Financing Agreement had been complied with.

### **3. Opinion**

-----

So far as appears from my examination and to the best of information and according to the explanations given to me, except for the effects of the adjustments arising from the matters referred to in paragraph 5 of this report, I am of opinion that,

- (a) the Project had maintained proper accounting records for the year ended 31 December 2013 and the financial statements give a true and fair view of the state of affairs of the Project as at 31 December 2013 in accordance with Generally Accepted Accounting Principles,

- (b) the funds provided had been utilized for the purpose for which they were provided,
- (c) the, withdrawals from and replenishments to the Special (Dollar) Account during the year ended 31 December 2013 had been truly and fairly disclosed in the books and records maintained by the Project and the balance as at 31 December 2013 had been satisfactorily reconciled with the accounting records of the Central Bank of Sri Lanka as at that date,
- (d) the Statements of Expenditure (SOEs) submitted could be fairly relied upon to support the applications for reimbursement in accordance with the requirements specified in the Financing Agreement,
- (e) satisfactory measures had been taken by the management to rectify the issues highlighted in my previous year audit report, and
- (f) the financial covenants laid down in the Financing Agreement had been complied with.

#### **4. Financial Statements**

-----

##### **4.1 Financial Performance**

-----

According to the financial statements and information made available, the expenditure of the Project for the year ended 31 December 2013 amounted to Rs.2,697,298,747 and the cumulative expenditure as at 31 December 2013 amounted to Rs.6,313,681,328. A summary of the expenditure of the Project for the year under review and the preceding year and cumulative expenditure as at 31 December 2013 are given below.

Item of Expenditure	Expenditure for the year ended		Cumulative Expenditure as at 31 December 2013
	31 December		
	2013	2012	
	Rs	Rs	Rs
<u>Component - 01</u>			
Block Grant Released to Local Authorities	2,074,525,021	1,179,150,104	5,512,060,021
<u>Component - 02</u>			
Institutionalizing Accountabilities	4,517,954	2,662,087	8,390,647
<u>Component - 03</u>			
Capacity Building	568,937,604	55,642,229	644,778,760
<u>Component - 04</u>			
Assessment and Evaluation	1,081,770	4,806,481	7,628,064
<u>Component - 05</u>			
Project Management	48,236,398	55,425,611	140,823,836
	<b><u>2,697,298,747</u></b>	<b><u>1,297,686,512</u></b>	<b><u>6,313,681,328</u></b>

#### 4.2 Special Dollar Account

According to the financial statements and information made available, the operations of the Special (Dollar) Account for the year ended 31 December 2013 and the balance therein as at that date are summarized below.

	<u>US\$</u>	<u>Rs.</u>
Opening Balance in 01 January 2013	14,280,646	1,815,938,425
Add: Replenishments	4,085,080	535,767,203
Revaluation Gain	-	<u>43,828,933</u>
	18,365,726	2,395,534,561
Less: Withdrawals	<u>14,689,406</u>	<u>1,914,844,624</u>
Balance as at 31 December 2013	<b><u>3,676,320</u></b>	<b><u>480,689,937</u></b>

## **5. Audit Observations**

-----

### **5.1 Accounting Deficiencies**

-----

The following observations are made.

- (a) The foreign exchange gain amounting to Rs 43.83 million raised during the year under review had not been disclosed in the financial statements separately.
- (b) Eventhough grants released to the local authorities had not been totally utilized by the respective authorities during the year under review, such grants amounting to Rs.27.88 million released for infrastructure development activities had been disclosed as expenditure in the financial statements.

### **5.2 Non-compliances with Laws, Rules and Regulations**

-----

The following instances of non - compliances were observed in audit.

- (a) An annual budget for the financial year that should be prepared by the Project as stipulated in Section I, B.4 of Schedule 2 of the Financing Agreement had not been prepared.
- (b) The PAYE Tax that should be deducted on the salaries and allowances paid to the officers exceeding to Rs. 50,000 per month in terms of Chapter XV of Inland Revenue Act No 10 of 2006, had not been deducted and remitted to the Commissioner General of Inland Revenue by the Project Office of the Eastern Province.
- (c) Action had not been taken to furnish the details of Value Added Tax to the Department of Inland Revenue relating to civil works and goods purchased at a cash of Rs.512.49 million during the year under review in terms of the Public Finance Circular No.364(3) of 30 September 2002.

## 6. Financial and Operating Review

### 6.1 Utilization of Funds

The details of allocation of the fund under the foreign and local components, provisions made in the Annual Estimate of the government and utilization of funds during the year under review and as at 31 December 2013 are given below.

<u>Source</u>	<u>Amount allocated in the Project agreement</u>		<u>Provisions made in the Annual Estimate for the year 2013</u> <u>Rs. Mn</u>	<u>Amount Utilized Actual Expenditure</u>			
	<u>US \$ Mn</u>	<u>Rs. Mn</u>		<u>During the year under review</u>		<u>As at 31 December 2013</u>	
	<u>US \$ Mn</u>	<u>Rs. Mn</u>		<u>US \$ Mn</u>	<u>Rs.Mn</u>	<u>US \$ Mn</u>	<u>Rs. Mn</u>
IDA	50	5,500	1,960	17.7	1,953.63	41.62	4,578.48
GOSL	34	3,740	490	4.4	484.94	13.42	1,476.46
Beneficiaries	02	220	-	0.91	100.49	1.92	211.53
<b>Total</b>	<b>86</b>	<b>9,460</b>	<b>2,450</b>	<b>23.01</b>	<b>2,539.06</b>	<b>56.96</b>	<b>6,266.47</b>

Following further observations are made.

- (i) A comprehension detail action plan, covering project components and the fund allocation with the target of financial and physical wise with fixing responsibility in monthly, quarterly and by annually covering entire project period should be prepared to ensure the achievement of project objectives by using allocated funds with Project period. However, such a plan had not been prepared and implemented.
- (ii) Eventhough as per project proposal, a sum of Rs. 2,846 million had been budgeted for the five activities for the Project period, a sum of Rs. 2,696 million only had been utilized during the period of three years under review. Although 65% of the Project period had elapsed, 5% of the budgetary allocation only for the project period had remained unutilized
- (iii) It was observed that the imprest balance as at 31 December 2013 aggregating to Rs.27.88 million had remained in Northern Province Local Authorities without utilized for intended purposes during the year under review. However,



such imprest balances had been treated as project expenditure and therefore the project cost for the year under review had been overstated.

- (iv) Further, evidence to prove the effective utilization of the construction equipment purchased at a cost of Rs 190.10 million and handed over to the Local Authorities and Office of the Asst. Commission of Local Governments during the year under review were not made available for audit.
- (v) It was observed that the computer software valued at Rs. 3,32 million procured during the under review and handed over to the Local Authorities in Eastern Province had not been used by any of Local Authorities for the intended purposes., thus indicated that the cost incurred thereon was fruitless.

## 6.2 Physical Performance

According to the information furnished, physical and financial progress of the Project under the different sectors as at 31 December 2013 are given below

<u>Sectors</u>	<u>Physical</u>			<u>Financial</u>		
	<u>Target for 2013</u>	<u>Progress as at 31 Dec 2013</u>	<u>Percentage of completion</u>	<u>Target for 2013</u>	<u>Expenditure as at 31 Dec 2013</u>	<u>Progress</u>
	<u>km / Nos</u>	<u>km / Nos</u>		<u>Rs. Mn</u>	<u>Rs. Mn</u>	
Access Roads	643.724	503.838	78%	6,221.386	4,086.772	65.7%
Markets, Parks and small Township	172	74	43%	2,134.748	810.931	38%
Sewerage / Drainage	38.454	32.664	85%	514.049	338.859	65.9%
Waste disposal systems	1	1	100%	3.019	1.449	48%
Rural water supply schemes	7	5	71%	95.870	19.745	21%
Rural Electrification	21.3	16.3	77%	28.186	16.189	57%

According to the above table, the development activities on markets, parks and township had reported progress on behind to targets. The observation made on audit visits carried out on several building, road construction sites and thereon are summarized and described below.

- (a) Buildings constructed for the purposes of fish markets at Killinochchi, Children parks at Mannar and solaughter house in Oddusudan had remained idle for over six months to eighteen months without being utilized for intended purposes.
- (b) A sum of Rs. 1.06 million had been paid to the contractor for concrete surfacing in a drainage at Brainthuraichchenai, as variation for supplying 5,540 kg TOR steel rods used for the construction of drainage without approval of the Project Director.
- (c) The bidding process of the contract for the construction of three storied building for Kattankuddy Urban Council awarded at a cost of Rs 30.80 million could not be evaluated satisfactorily due to absence of documentary evidence such as minutes of the meetings of procurement committee and tender evaluation sheets of the TEC. Further the bidding evaluation process applied for the contract awarded at Rs. 1,403,750 for the construction of office building for Manmuneipattu Pradeshiya Sabha was remained suspicious due to subsequent alteration of the bid prices quoted by selected bidder.
- (d) The works under contract for concrete surfacing at Naipaul Thottam and contract for concrete surfacing at school road at Sarukkay had not been commenced and the contract agreement had been terminated in May 2012. The mobilization advances amounting to Rs. 2.37 million and Rs 1.37 million respectively could not be recovered as the period of respective validity bond had been expired.
- (e) 107.18 Kms of Rehabilitation of road works and buildings had been constructed by the Point Pedro Urban Council and Kayts, Karainagar, Nallur, Vadamarachchi South - West, Nanaddan, Mannar, Manthai West, Musali,

Thunukkai, Maritimapatthu, Puthukkudiyiruppu, Karachi and Poonagari Pradeshiya Sabhas,

Common weakness observed in these contract works are given below.

- 100 mm and 20 mm size of the metals had not been fully utilized for the several road works.
  - Shoulder filling were done with improper compaction.
  - Width of the roads constructed less than the specification.
  - Some of the works was awarded to the community centers contrary to Section 3.9.1 of the Procurement Guidelines 2006.
  - Leveling instruments had not been utilized for road works.
  - Portion of the roads of some Pradeshiya Sabhas were badly damaged.
  - Quality testing had not been done by the contractors on some roads.
  - Culvert shoulder filling work not properly done.
  - Public participation were not done to expected value.
  - Watering was not done some of the concrete roads.
  - Cracks were observed some of the buildings.
  - Bitumen had not been properly mixed.
  - Name board of the Project had not fixed to the several road works.
  - Some of the contract works was terminated without complete the construction,
  - Channels of the roads were not properly constructed.
- (f) Contract for consultancy service to the value of Rs. 4.63 million for internal auditing in financial management, procurement and contract administration purposes had been entered into with an audit firm in private practice and out of that a sum of Rs 1.09 million had been paid as at 31 December 2013, However, the provisions for financial audit of the Local Authorities had not been included in the contract agreement. Further, 13 items, out of 31 items included in the scope of works specified in the Term of Reference were not covered by the Consultant. Further, it was observed that certain scope of works were not fully covered. Neither the activities to be carried out under financial management auditing, procurement auditing and technical auditing

made no separate reports which include the professional opinion thereon furnished.

### **6.3 Matters in Contentious Nature**

-----  
Following observations are made.

- (a) A sum of Rs. 237 million had been spent by the Project for construction of office building for Dayatakirula in the Eastern Province. However, such construction works had scheduled to be carried out other foreign funded project called Local Government Infrastructure Improvement Project (LGIIP).
- (b) It was observed that the VAT payments aggregating Rs. 12.3 million had been made by the one Urban Council and Seven Pradeshiya Sabhas in 16 instances in Northern Province to the contractors engaged in civil works without verifying the validity of VAT registration for the year under review. Further, it was observed in audit the VAT payments aggregating to Rs.3.924 million had been made by the 02 Pradeshiya Sabhas in 03 instances to the contractors who were not furnished VAT registration numbers.

### **7 Systems and Controls**

-----  
Special attention is needed in respect of the following areas of control.

- a) Accounting
- b) Contract Administration
- c) Finacial Management