

Northern Road Connectivity Project (NRCP) Original Scope and Additional Financing - 2013.

The audit of financial statements of the Northern Road Connectivity Project (NRCP) 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 4.05 of Article IV of the Loan Agreement No.2639-SRI dated 27 August 2010 entered into between the Democratic Socialist Republic of Sri Lanka (GOSL) and the Asian Development Bank (ADB).

1.2 Implementation, Objectives, Funding and Duration of the Project.

According to the Loan Agreement of the Northern Road Connectivity Project, the Ministry of Highways, Ports and Shipping is the Executing Agency and the Road Development Authority is the Implementing Agency of the Project. The Road Development Authority is responsible for the management and coordination of Project activities at the National level. The objective of the Project is to rehabilitate and improve the 170 kilometers of national roads in the Northern Region and North Central Province which were identified as urgently required for improvements. According to the Project Appraisal Document, the estimated total cost of the Project is US\$ 146 million and out of that US\$ 130 million or 89 per cent was agreed to be financed by the Asian Development Bank. Further, two Loan Agreements under Loan No.2890 SRI (SF) and No.2891 SRI for additional financing of US\$ 30 million and SDR 45,215,000 (Approximately US\$ 68 million) respectively had been signed by the Government of Sri Lanka with Asian Development Bank on 28 August 2013 to rehabilitate national roads up to 280 kilometers in Northern Province and North Central Province under the Development Framework 2010 of the Government of Sri Lanka. The Project commenced its activities on 22 October 2010 and is scheduled to be completed by 31 December 2015. The works under the additional financing arrangements were commenced on 28 August 2013 and is scheduled to be completed by 25 February 2015.

1.3 Responsibility of the Management for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Sri Lanka Accounting Standards. 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 Basis 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 an 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 tests 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 control 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 on the Project from the funds of the Government of Sri Lanka 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 Loans had been made in accordance with the specifications laid down in the Loan Agreements,
- (d) Whether the opening and closing balances, withdrawals from and replenishments to the Imprest Fund Accounts 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,
- (e) Whether 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 Loan Agreements,
- (f) Whether the funds, materials and equipment supplied under the Loan had been utilized for the purposes of the Project,
- (g) Whether the expenditure had been correctly identified according to the classification adopted for the implementation of the Project,
- (h) Whether the financial statements had been prepared in accordance with Generally Accepted Accounting Principles,
- (i) Whether satisfactory measures had been taken by the management to rectify the issues highlighted in my previous year audit report, and
- (j) Whether financial covenants laid down in the Loan Agreements 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 purposes for which they were provided,
- (c) withdrawals under the Loans had been made in accordance with the specifications laid down in the Loan Agreements,
- (d) the opening and closing balances, withdrawals from and replenishments to the Imprest Fund Accounts 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.
- (e) 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 Loan Agreements,
- (f) satisfactory measures had been taken by the management to rectify the issues highlighted in my previous year audit report, and
- (g) the financial covenants laid down in the Loan Agreements had been complied with.

4. Financial Statements

4.1 Financial Performance

According to the financial statements presented and information made available, the expenditure of the Project for the year ended 31 December 2013 amounted to Rs. 4,483,868,313 and the cumulative expenditure as at 31 December 2013 amounted to Rs. 12,719,480,889. A summary of the expenditure of the Project for the year under review, expenditure for the preceding year and the cumulative expenditure as at 31 December 2013 is given below.

Item of Expenditure	Expenditure for the year ended 31 December		Cumulative Expenditure as at 31 December
	2013 Rs.	2012 Rs.	2013 Rs.
Office Equipment	447,800	334,007	1,137,665
Mobilization Advance	1,113,942,317	-	1,113,942,317
Contract Payments	3,095,364,158	7,172,837,255	10,788,606,116
Supervision Consultancy			
-National Highways	105,021,593	184,198,978	301,691,572
-Provincial Roads	69,070,800	133,418,072	282,041,894
Survey/Testing Fees	1,413,186	300,000	2,766,562
Incremental Expenditure	38,329,921	34,412,665	97,623,710
Interest/Commitment Charges	60,278,538	47,915,286	131,671,053
	<u>4,483,868,313</u>	<u>7,573,416,263</u>	<u>12,719,480,889</u>

4.2 Imprest Fund Accounts

According to the financial statements and information made available, the operations of the Imprest Fund Accounts for the year ended 31 December 2013 and the balance available in that accounts as at that date are summarized below.

	<u>Loan No.2639</u>		<u>Loan No.2890</u>	
	<u>USD</u>	<u>Rs.</u>	<u>USD</u>	<u>Rs.</u>
Balance as at 01 January 2013	11,690.81	1,486,613	150,000.00	19,665,000
Add: Replenishments	304,565.22	39,180,500	-	-
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	316,256.03	40,667,113	150,000.00	19,665,000
Foreign Exchange Gain/ loss	-	211,078	-	(35,887)
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	316,256.03	40,878,191	150,000.00	19,629,113
Less : Withdrawals	(268,323.82)	(34,610,910)	(61,881.11)	(8,107,304)
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Balance as at 31 December 2013	<u>47,932.21</u>	<u>6,267,281</u>	<u>8,118.89</u>	<u>11,521,809</u>

5. Audit Observations

5.1 Accounting Deficiencies

The following accounting deficiencies were observed in audit.

- (a) Separate financial statements for additional financing arrangements under Loan Agreements No. 2890 SRI and Loan No. 2891 SRI (SF) had not been prepared and the transactions made under respective Loan Agreements had been amalgamated and presented in the financial statement under this Project.
- (b) The Civil work- in- progress amounting to Rs 11,599,596,673 shown in the financial statements as at 31 December 2013 had represented only the amounts paid for the contractor instead the actual value of work certified by the Engineers.
- (c) According to the Note No 2.4 of the financial statements, the assets purchased by the Contractor and Consultants during the period of contract were treated as Project expenses and accounted under work-in progress instead of being shown as Property, Plant and Equipment. Therefore, the assets valued at Rs. 137,665 only had been brought to account as at 31 December 2013
- (d) The works done under variation orders valued at Rs. 2,365,532 approved by the Engineers during the year under review had not been brought to account.

- (e) Bonus and medical allowance of Rs. 258,892 had been paid to the employees of the Road Development Authority and released for the Project even though they were not entitled for such allowances, under the Sections 8.3.9 and 8.6 of the Circular No PED/12 dated 02 June 2003 issued by the Department of Public Enterprises of the General Treasury.
- (f) Gratuity provision amounting to Rs. 409,746 had been made in the financial statements for the Road Development Authority employees who served in the Project up to 31 December 2013. This provision was overstated due to computation of provision for the entire period of service of the Road Development Authority instead of computing on period of service of the project.
- (g) Salaries of the Road Development Authority employees attached for the Project had been paid on the formula introduced by the Road Development Authority contrary to the Circular No.33 of 05 April 2007 issued by the Department of Management Services. In this connection, a sum of Rs. 19,928,802 had been paid as salaries up to 31 December 2013 without adopting the above instructions.
- (h) A sum of Rs. 1,117,149 had been remitted to the Road Development Authority as overhead and Value Added Tax, contrary to the provisions made under Section 8.3.9 of the Circular No. PED/12 dated 02 June 2003 of the Department of Public Enterprises. It was observed that the Ministry Finance and Planning had approved to grant exemption on payment of taxes for Northern Road Connectivity Project.
- (i) As specified in Section 5.4.4 of the Contract Procurement Guidelines, mobilization advance for any contract work should be paid on contract amount excluding provisional sum and contingencies. However, mobilization advances Rs. 1,659,000 had been paid with provisional sum and contingencies contrary to the above instructions.
- (j) Provisions for payables aggregating Rs. 84,766,089 as at 31 December 2013 had not been made in the financial statement. Therefore, the expenses for the year under review and the payables as at 31 December 2013 had been understated by that amount.

6. Financial and Operating Review

6.1 Utilization of Funds

According to the information made available, certain significant statistics relating to the financing of the Project and the utilization of funds for the year under review are shown below.

Source	Amounts agreed to be financed in the Loan Agreement		Amount allocated in the Annual Estimate 2013	Amount utilized during the year 2013	Fund utilized as at 31 December 2013	
	US\$ Mn	Rs. Mn	Rs. Mn	Rs. Mn	US\$ Mn	Rs. Mn
Loan 2639-SRI	130	14,950	4,505	4,505	90.3	11,743
Loan 2890 SRI(SF)	68	8,840	322	317	2.6	335
Loan 2891-SRI	30	3,900	-	233	1.8	232
GOSL	16	2,080	07	07	0.1	26
	<u>244</u>	<u>29,770</u>	<u>4,834</u>	<u>5,062</u>	<u>94.8</u>	<u>12,336</u>

According to that above information, 40 months, out of 52 months or 76 per cent of the period of the Project had elapsed as at 31 December 2013. However, 38 per cent of the total allocation only had been utilized as at 31 December 2013 thus indicating that the total utilization of the allocations during the approved project period is doubtful.

6.2 Physical Progress

Following observations are made.

- (a) According to the Loan Agreements it was expected to rehabilitate 170 kilometers of national roads in the Northern Province and the North Central Province. The contract packages comprised two stages for road rehabilitation and maintenances of roads for three subsequent years. The rehabilitation works of 10 roads under the original scope of the Loan had been completed as at 31 December 2013. However, the performance based road maintenance works could not be reliably evaluated in audit due to lack of performance indicators and the maintenance evaluation criteria determined in the contract agreements.
- (b) The progress of the road rehabilitation works carried out under the additional funding arrangements is given in the following Table.

<u>Name of Contract</u>	<u>Contract Number</u>	<u>Date of Commencement</u>	<u>Expected Date of Completion</u>	<u>Contract Value</u> Rs. millions	<u>Expenditure incurred as at 31 December 2013</u> Rs millions	<u>Physical progress as at 31 December 2013</u> percentage
Rehabilitation/ Improvement of A029-Vavuniya- Horowupathana Road	CP-11	24 August 2013	20 February 2015	990.41	242.65	11.0
Rehabilitation/ Improvement of B283- Medawachchiya- Kebithigollewa Road	CP-12	28 August 2013	25 February 2015	725.65	127.64	5.0
Rehabilitation/ Improvement of B283- Medawachchiya- Kebithigollewa Road	CP-13	28 August 2013	25 February 2015	721.61	72.16	2.7
Rehabilitation/ Improvement of B211- Kebithigollewa- Padaniya Road	CP-14	28 August 2013	25 February 2015	885.27	103.38	2.2
Rehabilitation/ Improvement of						

B211- Kebithigollewa- Padaviya Road	CP-15	28 August 2013	25 February 2015	1,020.29	102.03	3.5
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6.3 Contract Administration

The following observations relating the rehabilitation works carried out under original scope of the Project are made.

- (a) The Northern Road Connectivity Project (NRCP) had undertaken to supply and deliver of Rs. 36,054,386 UPVC and DI pipes and fittings to replace the existing water pipes located at Kekirawa and Maradankadawala Towns of A009 - Kandy-Jaffna road by utilizing funds provided by the Government of Sri Lanka and the pipe laying works had been supervised by National Water Supply and Drainage Board. The following observations were made in this connection.
 - (i) The Project had undertaken such works on behalf of National Water Supply and Drainage Board without contractual obligation. Further, the contractors engaged for the rehabilitation of Dambulla- Thonigala Road (CP-01) and Thonigala – Galkulama Road (CP-02) had been deployed to execute pipe laying work and paid them through variation orders.
 - (ii) Rehabilitation works at the Section from 92+400 km to 93+500 km at Kekirawa Town had been deleted after procuring of UPVC and DI pipes.
 - (iii) Pipes valued at Rs. 4,781,562 had not been utilized for the intended purposes and remained idle at the Provincial Director’s Office in Anuradhapura.
- (b) According to the minutes of site meetings, it was observed that the progress of the rehabilitation of works under CP12, CP17, CP15, CP13 packages which were carried out under the additional funds provided under the Project had reported that the physical progress was below the expected level due to inadequate resources of the contractors such as skilled and unskilled labour, material, plant and equipment, etc. However, no remedial action had been taken either by contractor or the Project to ensure to completion of the work according to scheduled programme. Further it was observed that the safety precautions provided and traffic control arrangements made were unsatisfactory. Although works under packages CP 13, 14, 15 had been commenced on 28 August 2013, the amended work programme, method statement and quality control plan had not been submitted by the contractor even up to 01 March 2014.

6.3.1 Transactions of Contentious Nature

The following observations are made.

- (a) It was revealed in audit that an Arbitration Committee had instructed to pay a sum of Rs 1,063,163 to the contractor engaged in rehabilitation works of Dambulla - Thonigala Road (CP-01) to resolve the dispute on backfilling of earth materials. However, it was further revealed that the respective dispute had arisen due to

unsatisfactory performance of the Consultant. No action had been taken against the Consultant for the failure to discharge his duties.

- (b) The contract for rehabilitation of Manipay to Kaithady Road (CP-5) was awarded to lay aggregate base course and wearing course. The Project Engineers and Consultants had not certified the payments due to application of track coat on primed surface. However, the Technical Evaluation Committee and the Director General of Road Development Authority had approved with subsequent concurrence of the Consultant to make the payment of Rs. 4,170,320 to the Contractor without notifying the change of the scope of works done by the Contractor without prior approval.
- (c) The contract for rehabilitation of Vallai to Araly Road (CP-06) from 0+000km to 27 + 400 km had been awarded in May 2011 and the rehabilitation works of the road section from 4 + 140 km to 9 + 200 km had been deleted subsequently due to security reasons. However, the Contractor had claimed overhead charges incurred on deleted road works and profits thereon amounting to Rs. 45,489,420 and the Project had paid that amount. It was observed that the clearance from the Ministry of Defense and Urban Development had not been obtained at the initial stages of the road works. Further payment of mobilization advances amounting to Rs. 2.22 million had been included the works which had been deleted subsequently.
- (d) According to the bid document for the rehabilitation of Vallai to Araly Road (CP-06), the soil requirement for the rehabilitation of roads should be obtained from the identified borrow pits in Jaffna. However, contractor had transported the entire soil requirements for the Project from Kilinochchi without getting prior approval. The transport cost amounting to Rs 29,831,919 had been paid by the Project to the contractor without obtaining the concurrence of the Consultant in this connection.
- (e) Rehabilitation of Vallai to Araly Road from 0 + 000 to 27 + 400 km had been substantially completed and cracks had appeared on road surface at chainages from 9 + 220 km - 15 + 820 km including major cracks in length ranging from 10 to 16.80 meters. These cracks propagated through the road surface on the surrounding ground. The review mission of Asian Development Bank visited in July 2013 and also instructed to engage independent experts for a detailed study of the cracks. However, the Project had not deployed independent experts to investigate the reasons for cracks on the road surface. Further, the laboratory and field tests indicated that the clay content of both the collected soil samples were very high. Therefore, it was proved that the proper quality assurance mechanisms had not been adopted at the time of designing and monitoring of rehabilitation work. Further, the temporary rectification had been done by the Contractor on the recommendation of the Project Director instead of taking remedial action to ensure the roadworthiness of the road.
- (f) It was observed at the physical inspection that the 80 per cent advance on materials at site amounting to Rs. 1,367,437 had been granted to the Contractor engaged in rehabilitation of Mankulam - Mullathivu Road (CP-08) without carrying out physical file measurements to determine the quantity of materials at site and confirming its value by verifying invoices etc, as required by the Sub - Clause 14.5 of the General Conditions of Contract.

- (g) According to Section 4.3.1 of the Government Procurement Guidelines, no provisions should be made to Telecom levy and Cess to the Bill of Quantity for removing and relocating of telecom cables. However a sum of Rs. 1,245,325 had been paid to the Sri Lanka Telecom as taxes for removal and relocation of existing telecom network in relation to the contracts for rehabilitation of Vallai -Arali Road (CP-6) and Dambulla - Thonigala Road (CP1).
- (h) The deficiencies were reported during the course of rehabilitation work of Mankulam - Mullathivu Road (CP-7 and 9) due to specific technical specifications not followed by the contractor. However, no proper evidence was made available to ensure whether the contractor had rectified such defects.
- (i) The contractor is expected to maintain the road for a period of three years commencing from the date of issue of taking over certificate. The payment will be based on satisfactory maintenance of the road. The performance will be assessed monthly and payment is done in full or part according to performance. Performance indicators should be used to ascertain the performance of maintenance work. Following observations are made in this connection.
 - (ii) As the contractor was allowed to carry out the outstanding work after issuing the taking over certificates, it was difficult to identify the maintenance work carried out by the Contractor.
 - (iii) A Clause had not been included in the Contract Agreements for Performance Based Road Maintenance to avoid claiming for rehabilitation works carried out during the defect liability periods.