

North East Local Services Improvement Project -2015

The audit of financial statements of the North East Local Services Improvement Project for the year ended 31 December 2015 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 Schedule 2, Section II B of the Financing Agreement No.4728-LK dated 08 November 2009 and Grant Agreement No.TF 013787 dated 08 May 2014 entered into between the Democratic Socialist Republic of Sri Lanka and the International Development Association.

1.2 Implementation, Objectives, Funding and Duration of the Project

According to the Financing Agreement and Grant Agreement of the Project, then Ministry of Economic Development, presently the Ministry of Provincial Councils and Local Government is the Executing and Implementing Agency of the Project. The objective of the Project is to improve the delivery of local infrastructure services by Local Authorities in the Northern, Eastern, North Central, North Western and Uva Provinces in an accountable and responsive manner. As per the Agreements, the estimated total cost of the Project was US\$ 106.30 million equivalent to Rs.12,497.50 million and out of that US\$ 50 million equivalent to Rs. 6,000 million as a Loan and US\$ 20.30 million equivalent to Rs.2,537 million as a Grant was agreed to be financed by International Development Association. The Project commenced its activities on 01 May 2010 and scheduled to be completed by 31 December 2015. Subsequently, the period of the Project had been extended up to 31 December 2016.

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 Generally Accepted Accounting Principles and for such internal control as the management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or errors.

1.4 Auditor's Responsibility

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with Sri Lanka Auditing Standards. Those standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatements. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant

to the Project's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Project's internal control. An audit also include evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the management as well as evaluating the overall presentation of the financial statements. I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my opinion. The examination also included such tests 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 relating to the operations of the Project.
- (b) Whether the expenditure shown in the financial statements of the Project had been satisfactorily reconciled with the enhanced financial reports and progress reports maintained by the Project.
- (c) Whether adequate accounting records were maintained on a continuing basis to show the expenditure of 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 identifications of the purchases made out of the Credit and Grant.
- (d) Whether the opening and closing balances and 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 2015 had been satisfactorily reconciled with the accounting records of the Central Bank of Sri Lanka (CBSL) as at that date.
- (e) Whether the withdrawals under the Credit and Grant had been made in accordance with the specifications laid down in the Financing Agreement and Grant Agreement.
- (f) Whether the funds, materials and equipments supplied under the Credit and Grant 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 on the basis of 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 the financial covenants laid down in the Financing Agreement and Grant Agreement had been complied with.

1.5 Basis for Qualified Audit Opinion

My opinion is qualified based on the matters described in paragraph 2.2 of this report.

2. Financial Statements

2.1 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 2.2 of this report, I am of opinion that,

- (a) the Project had maintained proper accounting records for the year ended 31 December 2015 and the financial statements give a true and fair view of the state of affairs of the Project as at 31 December 2015 in accordance with Generally Accepted Accounting Principles,
- (b) the opening and closing balances and 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 2015 had been satisfactorily reconciled with the accounting records of the Central Bank of Sri Lanka (CBSL) as at that date.
- (c) 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 and Grant Agreement.
- (d) the funds provided had been utilized for the purposes for which they were provided.
- (e) the 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 and Grant Agreement had been complied with.

2.2 Comments on Financial Statements

2.2.1 Accounting Deficiency

Out of the proceeds of grants aggregations Rs. 359.10 million released to 80 Local Authorities in the Northern and Eastern Provinces, a sum of Rs. 29.20 million had remained unspent in the hands of respective Local Authorities as at 31 December 2015 and shown in the financial statements as the expenditure incurred by the Project.

2.2.2 Non - Compliance with Laws, Rules and Regulations

The following observations are made.

- (a) The budget for the year under review required to be prepared according to the Section 1. 3.4 of Schedule 2 of the Financing Agreement had not been prepared by the Project.
- (b) The detailed statements on Value Added Taxes on civil works and goods procured during the year under review at a cost of Rs. 32.65 million had not been furnished to the Commissioner General of Inland Revenue, as required by the Public Finance Circular No.364 (3). Eventhough the above matter was highlighted in my report for the previous year, fruitful actions had not been taken to comply with the requirement.

3. Financial and Physical Performance

3.1 Utilization of Funds

Certain significant statistics relating to the financing of funds, budgetary provision for the year under review and the utilization of funds during the year under review and up to 31 December 2015 are shown below.

Source	Amount agreed for financing in the Loan/ Grant Agreements		Allocation made in the Budget Estimate for the year under review	Fund Utilized during the year 2015 up to 31 December 2015			
	US\$ million	Rs. million		Rs. million	US\$ million	Rs. million	US\$ million
IDA							
- Loan	50.00	6,000	1,000	-	-	49.91	6,185.00
- Grant	20.30	2,537	1,200	3.11	407.58	11.19	1,575.27
GOSL	34.00	3,740	42	0.17	22.12	14.23	1,568.69
Community Contribution	2.00	220	-	0.14	18.84	4.78	529.19
Total	<u>106.30</u>	<u>12,497</u>	<u>2,242</u>	<u>3.42</u>	<u>448.54</u>	<u>80.11</u>	<u>9,858.15</u>

The following observations are made.

- (a) A comprehensive Action Plan, covering components of the Project 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 objective by using allocated funds with period of the Projects. However, such plan had not been prepared and implemented.
- (b) Out of the Grant of US\$ 20.30 million allocated for the activities of the Project, only US\$ 11.19 million had been utilized as at 31 December 2015. The possibility of utilization of balance amount of US\$ 9.11 million within the remaining period of 01 year is in doubt.

3.2 Physical Progress

The following observations are made in this connection.

- (a) According to the information made available, the infrastructure development activities at a total estimated cost of US\$ 90 million equivalent to Rs. 10,170 million had been implemented by the Project during the year under review under the Component -01 of the Project in the areas of 101 Local Authorities in the Northern, Eastern, North Central, North Western and Uva Provinces. The physical progresses of the works thereon as at 31 December 2015 are given below.

Activities	As at 31 December 2015		
-----	Works expected to be completed	Works completed	Percentage of achievement
-----	-----	-----	-----
Access Road Development			
- Tarring	865 kilometres	379 kilometres	43
- Concreting	135 kilometres	259 kilometres	191
Constructions of parks/ markets and development of small towns	405 Nos	171 Nos	42
Rehabilitations of sewerage/ Drainage systems	245 kilometres	41 kilometres	16
Rehabilitations of waste water disposal systems	66 Nos	01 Nos	1.5
Rural water supply systems	439 Nos	22 Nos	0.5
Rural Electrification systems	187 kilometres	23 kilometres	12

According to the above information, all the infrastructure development works had reported slow progress as at 31 December 2015 except the works on concreting of roads which exceed the targets remarkably. However, the doubts on achievement of targets of other infrastructure development activities during the remaining period of the Project cannot be ruled out in audit.

- (b) The contract awarded at an estimated cost of Rs. 14.15 million to construct Muthuthavely market at Pudukutivu which expected to be completed by 09 May 2013 had not been completed even as at 31 December 2015.

3.3 Contract Administration

The following observations are made.

- (a) Although variation orders required to be approved by the relevant authority on the recommendations of the Technical Evaluation Committee before commencement the works, the changes on scope of works aggregating Rs.89.40 million had been approved by the Project Director or respective Local Authority subsequently, under 38 variation orders. The instances of significant variations of scope of works of constructions included therein are described below.

Description of the work -----	Estimated cost of the works as per Bill of Quantities Rs. million -----	Variation of works approved Rs. million -----
Children park at Ninthavur	4.89	30.74
Moolaai school road	1.38	8.48

- (b) The defects such as cracks and damages on the road surfaces had been observed at the physical site visits made by the auditors on 23 May 2016 at Chilawathurai Road of Musali Pradeshiya Sabha and Achchamkulam Road of Nanaddan Pradeshiya Sabha had indicated that the failures of quality assurance mechanism adopted on compactions and road leveling purposes, during the period of rehabilitation works carried out.
- (c) It was observed that development works carried out under 132 activities had been completed with delays over 100 days. Out of that, 16 development works had been completed with delays over 01 year. Further, the reconstruction of Linga Road at Thampalagama Pradeshiya Sabha and construction of market at Muttaveli in Velanai Pradeshiya Sabha were completed with delays over 03 years. However, the extension of times ranging from 01 to 06 occasions had been approved either by the officers of the respective Local Authorities or Project Director instead of taking action against the contractor.

3.4 Idle / Under -utilized Assets

The following observations are made.

- (a) It was observed that 32 development works such as children parks, markets, bus terminals, shopping complex, training centre and cultural hall etc. constructed at a cost of Rs. 459.91 million in remote and less populated areas

in Musali, Nanaanaddan, Mannar, Manthai East and Manthai West Pradeshiya Sabhas in the Northern Province had remained idle over 2 years.

- (b) The shopping complex constructed of market at Thaimannar railway station, Iranai Illuppaikulam, Periyamadu and Andankulam and the buildings constructed for indoor stadium for children, training centre and cultural hall at Nallur Pradeshiya Sabha had been used for other purposes, since 2014 instead of utilizing for intended purposes.

3.5 Unsettled Audit Issues Highlighted in the Previous Audit Reports

The following observations are made.

- (a) According to the matters pointed out in my report for the year ended 31 December 2013, Value Added Taxes amounting to Rs.16.2 million had been paid out of the Loan proceeds to the contractors engaged in civil works carried out by a Urban Council and 09 Pradeshiya Sabhas in 19 instances without verifying the validity of the registrations for Value Added Tax payments. In this connection, meaningful actions had not been made by Project Management Unit to recover the payment from the relevant parties concerned.
- (b) At a test check made on the payments made by 03 Local Authorities on civil works, out of 34 Local Authorities in the Northern Province, it was observed that fraudulent payment of Rs. 4.42 million had been made by alteration of rate in the bid documents. The meaningful action had not been taken against the parties responsible thereon.
- (c) It was observed that the Project Engineer had functioned as the Chairman of the Technical Evaluation Committees for selection of bidders for rehabilitation works carried out by Vavuniya South Sinhala Pradeshiya Sabha and offered such contracts to his own company. The meaningful action had not been taken against the parties responsible thereon.