

Strategic Cities Development Project - 2017

The audit of financial statements of the Strategic Cities Development Project for the year ended 31 December 2017 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) (3) of the Financing Agreement No.5428-LK dated 12 September 2014 and Additional Financing Agreement No. 5800 – LK dated 20 July 2016 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 Agreements of the Project, then Ministry of Urban Development Water Supply and Drainage presently, the Ministry of Megapolis and Western Development is the Executing and Implementing of the Project. The objective of the Project is to improve selected urban services and public urban spaces in the Participatory City Regions of Sri Lanka. Therefore, Kandy and Galle Cities had been selected as the Participatory City Regions to be developed under the Project. As per the Financing Agreement, the initial estimated total cost of the Project amounted to SDR 95 million (US\$ 192.08 million) equivalent to Rs. 25,162.48 million and out of that US\$ 147 million equivalent to Rs.19,257 million was agreed to be provided by the International Development Association. Further, according to the Financing Agreement No. 5800–LK of 20 July 2016 for additional financing, the allocation amounted to SDR 39.90 million (US\$ 65 million) equivalent to Rs.7,975 million had been for the purpose of development works in Jaffna City and out of that US\$ 55 million equivalent to Rs.8,250 million was agreed to be provided by the International Development Association.

The Project commenced its activities on 05 May 2014 and works scheduled to be carried out under the Loan is expected to be completed by 31 December 2019. The activities of the development works in Jaffna City under the additional financing arrangement scheduled to be completed by 31 December 2021.

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 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 error.

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 judgment, 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 includes 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, etc. 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 Credits etc.
- (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 2017 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 submitted could be fairly relied upon to support the application for reimbursement in accordance with requirements specified in the Financing Agreements.
- (f) Whether the withdrawals under the Credits had been made in accordance with the specifications laid down in the Financing Agreements.
- (g) Whether the funds, materials and equipment supplied under the Credits had been utilized for the purposes of the Project.
- (h) Whether the expenditure had been correctly identified according to the classification adopted for the implementation of the Project.
- (i) Whether the financial statements had been prepared on the basis of Sri Lanka Accounting Standards.
- (j) Whether the satisfactory measures had been taken by the management to rectify the issues highlighted in my previous year audit report, and

- (k) Whether the financial covenants laid down in the Financing Agreements 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 2017 and the financial statements give a true and fair view of the state of affairs of the Project as at 31 December 2017 in accordance with Sri Lanka Accounting Standards,
- (b) the funds provided had been utilized for the purpose for which they were provided,
- (c) the opening and closing balances and withdrawals from and replenishments to the Special Account had been truly and fairly disclosed in the books and records maintained by the Project and the balance as at 31 December 2017 had been satisfactorily reconciled with the accounting records of the Central Bank of Sri Lanka as at that date,
- (d) the Statements of Expenditure submitted could be fairly relied upon to support the application for reimbursement in accordance with requirements specified in the Financing Agreements,
- (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 Agreements had been complied with.

2.2 Comments on Financial Statements

2.2.1 Accounting Deficiencies

The following observations are made.

- (a) Retention money amounting to Rs.59 million remained unrecovered as at 31 December 2017 had not been brought to the financial statements.

- (b) A sum of Rs.12.8 million recoverable from the Anuradhapura Integrated Urban Development Project and a mobilization advance amounting to Rs.109 million released to a contractor who suspended the activities under a construction contract had been capitalized by the Project. Therefore, the capital expenditure of the Project had been over stated by said amounts.

2.2.2 Non-compliance with Laws, Rules and Regulations

The following observations are made.

- (a) The Statement of Intermediate Result Indicators and the Procurement Administration Manual to be prepared by the Project, as required by the Section 10 and Section 24 of the Project Appraisal Document respectively had not been prepared, as enable to evaluate the progress on procurement activities of the Project based on the Procurement Performance Indicators prepared under the Section 33 (f) of the Project Appraisal Document.
- (b) According to the Paragraph 8.1 of the Circular No. 01/2016 of 24 March 2016 of the Department of Management Services, the Consultants should be recruited following the instructions given in the Financing Agreement and the Government Procurement Guidelines. However, 11 Consultants had been recruited without being followed the above instructions and remuneration aggregating of Rs.36 million had been paid for them during the year under review.

3. Financial and Physical Performance

3.1 Utilization of Funds

Certain significant statistics relating to the financing, budgetary provision for the year under review and the utilization of funds during the year under review and up to 31 December 2017 are shown below.

Source	Amount agreed for financing in according to the Financing Agreements		Allocation made in the Budget Estimate for the year under review	<u>Funds utilized</u>			
	US\$ million	Rs. million		US\$ million	Rs. million	US\$ million	Rs. million
IDA							
- 5428 LK	147.00	19,257.00	2,614.00	11.95	1,823.49	22.87	3,387.00
- 5800 LK	55.00	8,250.00	335.00	0.29	44.72	0.29	44.72
GOSL	55.08	7,405.48	505.00	3.29	502.51	7.38	1,098.67
Total	<u>257.08</u>	<u>34,912.48</u>	<u>3,454.00</u>	<u>15.53</u>	<u>2,370.72</u>	<u>30.54</u>	<u>4,530.39</u>

The following observations are made.

- (a) According to the above information, only a sum of US\$ 23.16 million equivalent to Rs.3,431.72 million representing 11 per cent of the total allocation of US\$ 202 million equivalent to Rs.27,507 million made by the Lending Agency had been utilized as at 31 December 2017 after lapse of 3 ½ years from the commencement of the activities of the Project. Further, a comprehensive detailed action plan highlighting financial and physical targets in monthly, quarterly, biannually etc. covering entire Project period with fixing responsibilities to achieve the targets within the period of the Project had not been prepared and implemented. As a result, the progress of utilization of fund allocated was remained slow.
- (b) The detailed budget for the year under review based on the work schedule of the Project, as required by the Paragraph 11 of the Project Appraisal Document had not been prepared. Therefore, a sum of Rs.2,370 million had only been utilized, out of the allocation amounting to Rs.3,454 million made in the Budget Estimate for the year under review.
- (c) Out of the total allocation of US\$ 2.17 million equivalent to Rs.335 million made to the Jaffna City Development Project for the year under review, only US\$ 0.29 million equivalent to Rs.44.72 million had been utilized as at 31 December 2017, due to lack of a proper work plan for land acquisition and resettlement purposes.

3.2 Physical Progress

According to the information received, the Project had taken action to implement several programmes to improve selected urban services and public urban spaces in Kandy and Galle Cities since the commencement of the activities of the Project. The major development activities in Jaffna City proposed to be implemented under the additional financing arrangement had not been commenced during the year under review. According to the progress reports, as a common feature, the construction works implemented by the Project had shown slow progress due to several deficiencies on implementation of the activities of the Project such as selection of contractors without considering their financial capacities, inadequate technical staff deployed by the contractors, inaccuracies in the designs prepared by the design consultants and delays in delivering of instructions from the Project. The following observations are made.

- (a) It was observed that meetings of the Project Consultation Committee had not been held during the year under review in district basis with the participation of the representatives of respective Municipal Councils, Road Development Authority, Urban Development Authority, Department of Coastal Conservation, Department of Irrigation and National Water Supply and Drainage Board. Therefore, the fruitful decisions could not be taken at the meetings of the Committee to ensure smooth operations of the Project by delegating responsibilities among the above mentioned Agencies.

- (b) It was observed that 87 contracts scheduled to be awarded at an estimated cost of US\$ 131 million equivalent to Rs. 19,623 million for rehabilitation works in Kandy, Galle and Jaffna Cities and out of that 34 contracts valued at US\$ 55.34 million equivalent to Rs.8,289 million had been awarded as at 31 December 2017. The activities under 25 sub-projects under the contracts awarded at a cost of Rs.1,065 million had not been commenced as per the work schedule. Further, contract on the reconstruction works of Katugastota-Madawala- Digana Road had been terminated on 06 September 2017 due to poor performance of the contractor. The reconstruction works of Dharmashoka Road in Kandy had shown slow progress of 10 per cent as at 31 December 2017 even after lapse of 18 months from the date of awarding of the contract, due to inadequate capacities of the contractors. In addition, 02 contracts awarded on rehabilitation of Kandy Meda Ela at a cost of Rs.631 million had shown slow progress of 29 per cent at end of the year under review, due to changes made to the work plan. The rehabilitation works carried out at Moragoda Canal at a cost of Rs.855 million had shown slow progress of 05 per cent compared to the expected progress of 22 per cent at end of the year under review, due to the shortages of required key personnel and equipment deployed by the contractor.

3.3 Contract Administration

The following observations are made.

- (a) Eventhough the Engineering estimate of 02 contracts of Kandy Dharmashoka Mawatha and Katugastota-Madawala-Digana Road amounted to Rs.911 million and Rs.2,156 million respectively, the respective contracts had been awarded at a cost of Rs.727 million and Rs.1,615 million respectively. Thus, it indicated that there were significant variations between the estimated cost of the works and the value of contracts awarded. However, no reasons for the variation had been explained to audit. Further, the mobilization advance aggregating Rs.351 million released to the contractors had not been recovered, due to the slow progress of 30 per cent at end of the year under review.
- (b) It was observed that the mobilization advance amounting to Rs.49 million had been released under the contract for improvement of the car park of Kandy Municipal Council before signing the contract agreement and issuing the contract awarding letter. However, the construction works had not been commenced even as at 30 April 2018. Further, other mobilization advances of Rs.58.82 million had been released in 02 installments for the improvement of Kandy Tomlin Park without obtaining mobilization plans of the contract, programme for construction works and the method statements and without considering the expected performance required to release the second installment of mobilization advance.
- (c) The Project had not taken action to initiate 105 procurement activities to be completed during the year under review at an estimated cost of US\$ 44.33 million, due to the lack of a Procurement Plan of the Project.

- (d) The contract for the rehabilitation works of Gatabe water treatment plant awarded at Rs.899 million had been terminated subsequently and decided by the Procurement Appeal Committee to recall fresh bids based on a complaint received by the Committee, relating to the issues on eligibility and qualifications of the selected bidder. Hence, the Lending Agency had cut down the financing facilities allocated for this purpose.
- (e) The selection process of suitable contractor for the construction of storm water drainage system in Kandy at an estimated cost of Rs.950 million commenced in 2015 had not been finalized even as at 21 December 2017. However, the reasons for the delay had not been explained to audit.

3.4 Matters in Contentions Nature

The following observations are made.

- (a) Preparation of work plans and cost estimates for the rehabilitation activities of Kandy Meda Ela had not been carried out by the Consultants and as a result, neither a preliminary study had been done nor agreed professional standards applied. Further, the Project had to pay an additional amount of Rs.53 million as a mobilization advance based on over estimates prepared by the Consultants without preliminary studies.
- (b) Due to deficiencies in the foundation designs related to the contract on improvement of Kandy Tomlin Park, the Project had to incur an additional cost of Rs.27 million and extend the contract period by 3 ½ months.

3.5 Issues on Financial Controls

It was observed that only US\$ 12.23 million equivalent to Rs.1,869 million had been withdrawn during the year under review from the Special (Dollar) Account maintained at the Central Bank of Sri Lanka, out of the credit balance of US\$ 16.49 million equivalent to Rs.2,473.50 million remained in the respective Account including the balance of US\$ 8.84 million equivalent of Rs.1,326 million remained as at 01 January 2017 and the imprest of US\$ 7.65 million equivalent to Rs. 1,163 million made in April and June 2017. Therefore, the balance of US\$ 4.26 million equivalent to Rs.634.5 million had remained unused in the Account over six months period, due to slow progress of the activities of the Project and poor forecasting of financial needs.

3.6 Uneconomic Transactions

The following observations are made.

- (a) According to the agreements entered by the Project on hiring of motor vehicles, maximum limit of 2500 kilometres per month and additional charges is needed to be paid for excess kilometres. It was observed that a sum of Rs.7.15 million had been spent by the Project on running of 133,841 kilometres in excess while several other motor vehicles had been performed below than the maximum limit of 75,249 kilometres.

- (b) The report on rehabilitation of Galle Fort Rampart had been prepared by the Consultants without a primary investigation and environment impact assessment and as a result, a similar type of study had to be carried out subsequently. Therefore, a sum of Rs.60 million paid to the Consultant engaged in first study had become fruitless.

3.7 Underutilized Assets

The machineries and equipment procured during the year under review at a cost of Rs.195 million had been handed over to the Municipal Councils of Kandy and Galle and the Irrigation Department had remained at the said premises up to 30 April 2018 without being utilized for intended purposes, due to a lack of a plan for the utilization of respective assets. Further, a stock of pipes and accessories procured in 2016 at a cost of for Rs.120 million had not been used even up to end of April 2018 and remained idle at the premises of the Water Supply and Drainage Board.

3.8 Human Resource Management

The following observations are made.

- (a) Eventhough the approved cadre of the Project consisted with 158 of officers for 13 posts, actions had not been taken to fill the vacancies for 64 officers including officers for 07 key posts of Additional Project Director, Deputy Project Directors over 02 years. Further, the vacancies of 14 officers for the posts of Assistant Project Director had remained vacant for over 02 years as at 31 December 2017. The above mentioned shortages of staff had influenced mainly for the slow progress of implementing of the activities of the Project.
- (b) Further, the Project had deployed Deputy Project Director without having adequate experiences on handling of environment activities as required by the Management Services Circular No. 01/2016 of dated 24 March 2016 of the Department of Management Services. Further, the Project had not deployed officers with suitable qualifications for social safeguard purposes in order to solve the issues on contract management and coordination with the people affected by the activities of the Project.

3.9 Acquisition of Lands

The following observations are made.

- (a) Out of the total cost of compensation on lands acquired amounting Rs.274.8 million, only a sum of Rs.98.6 million had been paid as the statutory payments to be made under the Section 17 of Land Acquisition Act. The balance amount of Rs.176.2 million had been paid based on the recommendations of the Land Acquisition Resettlement Committee. Further, additional payments aggregating Rs.172 million had also been made to the same land owners who received compensation on concessionary basis. However, the reasons for the additional payments were not explained for audit.
- (b) The Project had scheduled to acquire 332 plots of land during the year under review for the purpose of rehabilitation of 02 roads in the urban area in Jaffna. However, none of the plots of land had been acquired.