Funds Flow, Accounting, and Audit in India

This is intended as a quick reference guide to those processing and implementing projects in India. While the Government of India acts as the borrower or recipient for ADB loans and grants, the executing and implementing agencies receive funds through complex onlending arrangements involving transfer of interest rate and foreign exchange risk, and even different pricing and repayment terms. The need is emphasized to follow the budget mechanism of the central and state governments to ensure that funds flow smoothly and are subject to the effective fiduciary oversight of the government’s internal control systems and the external audit by the comptroller and auditor general of India.

About the Asian Development Bank

ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries reduce poverty and improve the quality of life of their people. Despite the region’s many successes, it remains home to two-thirds of the world’s poor: 1.7 billion people who live on less than $2 a day, with 828 million struggling on less than $1.25 a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration. Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance.
Funds Flow, Accounting, and Audit in India

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Note: In this publication, “$” refers to US dollars.
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ABSTRACT

This working paper is intended as a quick reference guide to those processing and implementing projects in India. India is a federal democracy, and there are a number of key players with responsibilities at the national and state level, whose interrelated roles need to be clearly appreciated. While the Government of India acts as the borrower or recipient for Asian Development Bank (ADB) loans and grants, the executing and implementing agencies receive ADB funds through complex onlending arrangements that involve the transfer of interest rate and foreign exchange risk, and may also involve different pricing and repayment terms. This paper describes the key players and their responsibilities. It explains the important concepts that need to be built into any fund flow, accounting, and audit arrangement. It provides details about the accounting and audit arrangements in place. The need is emphasized to follow the budget mechanism of the central and state governments to ensure that funds flow smoothly and are subject to the effective fiduciary oversight of the government's internal control systems and the external audit by the comptroller and auditor general of India. It also traces the path through which funds flow from ADB to the ultimate implementing agency, which may be up to three or four levels lower in the hierarchy. It provides a graphic illustration of the funds flow mechanisms for all four ADB disbursement procedures. The paper also highlights the major pitfalls and causes of delays in fund flow.
<table>
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<th>Abbreviation</th>
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<tr>
<td>CAAA</td>
<td>controller of aid accounts and audit</td>
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<td>CAG</td>
<td>comptroller and auditor general of India</td>
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<tr>
<td>CL</td>
<td>commitment letter</td>
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<td>CTLA</td>
<td>Loan Administration Division, Controllers’ Department</td>
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<td>DEA</td>
<td>Department of Economic Affairs</td>
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<td>EA</td>
<td>executing agency</td>
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<td>INRM</td>
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<td>LFIS</td>
<td>ADB’s Loan Financial Information System</td>
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<td>LC</td>
<td>letter of credit</td>
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<td>RBI</td>
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I. INTRODUCTION AND SCOPE

1. The objective of this working paper is to provide a handy guide to project officers processing and implementing sovereign projects in India, in the areas of funds flow, accounting, audit, and related matters.

2. For sovereign loans and grants, India follows two principal policies. For autonomous central sector entities such as the Power Grid Corporation of India Limited, or the India Infrastructure Finance Company Limited, the government has adopted a policy of disintermediation since the early 1990s. These entities directly enter into a loan or grant agreement with the lender and/or donor, and the government signs an accompanying guarantee agreement if required. For all other entities (e.g., the Ministry of Railways, National Highways Authority of India, or any state-level entity), India acts as the borrower, and funds are transferred through the budgetary channel. The discussion in this paper is confined to those transactions where India is the borrower, and excludes those transactions where the borrower is an autonomous entity, and India is a guarantor.

II. THE KEY PLAYERS

A. Ministry of Finance, Government of India

1. Department of Economic Affairs

3. The Multilateral Institutions Division of the Department of Economic Affairs (DEA), headed by the Joint Secretary, Multilateral Institutions, is the primary counterpart for ADB. This division is responsible for finalizing the ADB program of lending and nonlending products, negotiating all loans and grants, and maintaining the overall relationship with ADB.

2. Aid Accounts and Audit Division

4. The Aid Accounts and Audit Division, headed by the controller of aid accounts and audit (CAAA), is the division within DEA entrusted with the responsibility for withdrawal of loan and grant proceeds for all official development assistance where India is the recipient. This office is also responsible for loan servicing, including payment of interest, commitment charges, and principal. It should be noted that the “audit” part of this division is concerned with the audit of export promotion incentives, and is not in any way concerned with the audit of project financial accounts. This office is largely computerized, and its website, aaad.gov.in, provides complete tracking information on withdrawal applications, external debt statistics of India, etc.

3. The Chief Controller of Accounts

5. This office in the Ministry of Finance is responsible to maintain the books of accounts of the government. In particular, it is responsible for accounting for all external loan and grants transferred to state governments, and for billing and collection of interest, principal and any other charges from state governments.

4. Department of Expenditure

6. The Plan Finance I Division is the division within the Department of Expenditure (DOE) entrusted with the responsibility to transfer all incoming loan and grant receipts to beneficiary
state governments. It is also responsible for providing approval for state governments to borrow from ADB in terms of the Fiscal Responsibility and Budget Management Act.

5. The Comptroller and Auditor General of India

7. The Comptroller and Auditor General (CAG) is the supreme audit institution in India tasked with the responsibility for audit of all financial transactions of the Government of India and state governments. The CAG has a head office in New Delhi, and units in all states, called the Accountant General’s Office. It is responsible for auditing all transactions in the Consolidated Fund (see paragraph 11), and also to audit all government-owned companies.

6. The Reserve Bank of India

8. The Reserve Bank of India (RBI) acts as the banker for the Government of India and for all state governments. Thus, all payments to be made to the government for any loan are paid into the RBI for the credit of the CAAA. Any transfer from the central government to the state government is also adjusted in the books of RBI by debit and credit entries. RBI is the principal financial regulator, and exercises considerable control and influence over all foreign currency borrowings such as the rate of interest and tenor on which loans can be borrowed, the maximum amounts that can be borrowed, their end use, and more. RBI also largely regulates the entire financial sector in India, comprising commercial banks and other financial institutions. However, there are other sector-specific regulators for insurance, capital markets, etc.

B. Controllers’ Department

9. The Controllers’ Department of ADB is responsible for processing all loan, grant, and TA disbursements, accounting, billing and collection of loan service payments. The Loan Administration Division of the Controllers’ Department (CTLA) is responsible for all loan and grant disbursements, as well as for loan accounting, billing, and collection of loan service payments.

C. India Resident Mission

10. CTLA has presently delegated some portions of the disbursement function to the India Resident Mission (INRM). Acting under this delegation, INRM processes all withdrawal applications for direct payment, reimbursement, and imprest fund. However, disbursements under the commitment letter procedure, and for cofinanced loans and program loans, are handled directly by CTLA.

III. IMPORTANT CONCEPTS

11. The Consolidated Fund. As India has a federal structure, the finances of the central and state governments are independent. The central government finances are handled through the Consolidated Fund of India, and each state has its own consolidated fund. All inflows (taxes, loans, grants, and any other receipt) by the government are first credited to the respective consolidated fund. All expenditures are met out of the consolidated fund. Any withdrawal from the consolidated fund must be in accordance with the Constitution of India, and usually needs prior appropriation by the respective legislature (parliament or state) through the budget. All transactions in the consolidated fund are subject to audit by the CAG, and the reports of the CAG are submitted to the respective legislature. Significant observations in the audit reports are
scorned by the Public Accounts Committee of each legislature. This committee can summon the CAG and staff of audited entities to provide explanations on the audit observations.

12. **Accounting Concepts.** The government follows a cash-based accounting system, and follows the accounting standards laid down by the CAG. Of late, pilot efforts are going on to convert the government accounting to an accrual basis, but the predominant system is cash-based. An important consequence of this system is that any budget allocation not paid out in cash by the close of the fiscal year (31 March) lapses, and will need a fresh budget allocation in the following year before it can be spent. There is no automatic carry-over of allocations from year to year, except in extraordinary circumstances. The most common exception is the Non-Lapsable Central Pool of Resources, allocated for the development of the northeastern region of India, but there may be other exceptions. A mission should examine this issue carefully during discussions on fund flows.

13. **Central Budget.** The central budget has two portions—a receipts budget, and an expenditure budget. The budget figures act as a ceiling for all agencies, and cannot be exceeded without prior approval from the Parliament. For externally assisted projects, an external aid budget is prepared by the DEA.

14. The receipts portion is based on information received from all recipients of externally aided projects (both grant and loan). Any and all incoming receipts of grants and loans have to be accounted against this budget.

15. The expenditure portion is based on information received from executing agencies (EAs) implementing externally aided projects at both the central and state level. All transfers by the Plan Finance Division of the DOE are charged to this budget, and if the budgeted figure is exceeded, a revised estimate has to be submitted and approved by the Parliament before further transfers can be made.

16. **State Budget.** Each state prepares its own budget, which again comprises a receipts section and an expenditure section. All incoming receipts of loans and grants through the central government (called additional central assistance) are included in the receipts budget. Estimated expenditure on all externally aided projects (comprising both the share of the state government and the external agencies) is included in the expenditure budget. As with the central budget, expenditure for each project is accounted against the budget, and any excess will need prior authorization by the state legislature.

17. **The Budgetary Channel.** All external assistance is received in the first place and accounted as a receipt in the Consolidated Fund of India by CAAA. Central sector entities such as ministries can withdraw the funds through their respective budget appropriations. For state sector entities, the Plan Finance Division in the DOE authorizes a transfer to the state treasury account maintained with the RBI. It is very important to ensure that all mission leaders appreciate the importance of the budgetary channel. All fiduciary arrangements, internal control procedures, government financial rules, internal and external audit arrangements are built around this system. Bypassing of the budgetary channel may expose the project to unknown fiduciary risks that may be difficult to mitigate.
IV. ONLENDING ARRANGEMENTS

18. As regards entities at the central government level (such as the Ministry of Railways or the Ministry for the Development of the Northeastern Region), all external assistance is included in their budget approved by the Parliament. They are entitled to withdraw funds from the Consolidated Fund of India against the budget appropriation, even if the inflow of funds from ADB is delayed.

19. For state level projects, two possibilities exist. The Plan Finance Division of the DOE may provide an advance against the budgeted expenditure, which is later adjusted when the expenditure is incurred and claims are submitted for reimbursement. In the alternative, they are treated on a cash basis, and only such funds as are received from external donors are transferred to the state account. Similarly, state government ministries are entitled to incur expenditure out of the budget allocation even if receipts from ADB are delayed, provided that the state treasury has sufficient cash to accommodate them. In practice, this presents a difficulty as cash-strapped state governments may defer expenditure on externally aided projects due to insufficient cash. This provides the most common justification for use of the Imprest Fund procedure of ADB (see item IV, section D for more details).

20. It should be noted that the budgetary channel for transfer of funds works only up to the state government level. Further transfer of loans and grants from the state government to the EA (e.g., to an autonomous state-level company or to a municipal corporation) will be subject to specific arrangements, generally on a case-by-case basis. The terms of the onlending or ongranting, including transfer of interest rate and currency risk, as well as any additional premium that the state may charge, can vary from agency to agency, state to state, and project to project. Processing missions should document these terms clearly, so that the financial model for the project clearly captures the actual arrangements.

V. AUDIT ARRANGEMENTS

21. For companies incorporated under the Companies Act, or the Electricity Act (for example), the CAG appoints one or more independent firms of chartered accountants to carry out the audit. The CAG maintains a roster of firms eligible to perform such audits, and rotates auditors from time to time. This audit by the independent firm of chartered accountants is supplemented by the CAG through another audit. Both audit reports are submitted to the members of such entities.

22. For all other bodies at the central and state level, the CAG is generally the responsible agency to directly perform the audit. However, local governments (e.g. municipal bodies, village panchayats, or similar) are usually audited by the office of the local fund examiner in each state government.

23. The CAG in the central government (and the accountant general at the state level) is responsible for conducting the audit of ADB-assisted projects. Project processing missions should explicitly discuss this issue both with the EAs and DEA. It is necessary for project EAs to coordinate with their respective state finance department and DEA, to ensure that their projects are included in the audit program of the CAG. A new loan will be included in the audit program by CAG only when the Multilateral Institutions Division of the DEA makes a specific reference to the CAG’s head office at Delhi, and provides a copy of the loan and project agreements, and any other relevant documents to CAG. CAG at Delhi will then issue instructions to the
respective state unit to include the loan in the audit program. ADB, DEA, and CAG have agreed to the terms of reference for audit of project financial statements of ADB-assisted projects, and these should be referred to in future projects. The terms of reference are available with the regional financial management specialist for the South Asia Department.

24. Specific coordination is required with the responsible CAG office at the central or state level to ensure that the audits can be conducted and reports issued within the 6-month timeframe. CAG has advised that it requires a period of 3 months to conduct an audit. Accordingly, it will be necessary for executing agencies to submit their unaudited project accounts to the auditor within 3 months after the close of the fiscal year. To achieve this objective, DEA has issued a specific directive to all ADB-assisted project entities to comply with these time limits.

VI. FOREIGN EXCHANGE AND INTEREST RATE RISKS

25. States in India are divided into two categories - special category states, and others. The updated list of special category states should be verified by project teams from the list maintained by the Planning Commission from time to time. For these special category states, all external assistance, loan or grant, is received by India and transformed into rupee loans, which are repayable on rupee terms and carry a rupee rate of interest. Of the total external assistance received, 90% is converted into a grant, and the remaining 10% converted into a rupee loan repayable over 15 years. The foreign currency rate risk and interest rate risk are absorbed by the central government. They also are not liable to pay any front-end fees or commitment fees that may be charged by ADB.

26. For all other states, the loans and grants are transferred on the same terms and conditions as received. Thus, the entire loan or grant received is transferred to the states by converting the foreign currency amount into rupees by applying the spot exchange rates. They remain responsible to pay the interest, front-end fee and commitment fees as and when these amounts are billed. They are also responsible to repay the principal installments in a similar manner. In all such cases, CAAA purchases foreign currency from the open market at spot rates and remits to ADB, and recovers the equivalent Indian rupees from the states through the chief controller of accounts, Ministry of Finance. As a consequence, these states are fully exposed to the exchange rate and interest rate risks. It should be noted that states often have different terms and conditions for onlending the grants and loans received from the central government. Thus, even grants received may be onlent as loans (and loans may be passed on as part-grants), and it is possible the state charges a different rate of interest and applies a different repayment period for such transactions. Project processing missions should ensure that the specific terms on which the state will transfer funds to the EA are documented and these details captured in the project financial models. Documenting these arrangements in the project administration manual would help in proper accounting for such financial flows.

27. Because of the fact that most government-owned entities (municipal corporations, power sector utilities, water and wastewater companies) have no foreign exchange revenues, this leads to a mismatch between their foreign currency obligations and rupee revenues. As most government departments and municipalities (except for companies) follow a cash-based accounting system, accrued obligations on this account are not captured or reported. Companies (which follow accrual-based accounting as mandated by law) need to ensure that the foreign currency obligations are appropriately restated in their books as at the end of each fiscal year at their current value, and the foreign exchange differences taken to the profit and
loss account or balance sheet in accordance with the accounting standards being followed. For direct payment and commitment letter transactions, they need to reconcile the final rupee equivalent with the CAAA’s records from time to time.

VII. FUNDS FLOW ARRANGEMENTS

28. The funds flow arrangements in India range from the simple to very complex. The funds flow requirements, for each class of transaction, are described below.

A. Direct Payment

29. By order of complexity, this is the simplest method with minimal document and fund flow. The EA incurs the expenditure, and requests ADB to pay the contractor directly by withdrawal from the loan account to the extent of the ADB share of expenditure. The steps involved are:

- The contractor submits an invoice for payment to the EA.
- The EA approves the invoice for payment, and submits a request for withdrawal by way of direct payment to CAAA, for onward submission to ADB.
- CAAA prepares a withdrawal application on ADB’s prescribed format, and submits it to INRM.
- INRM reviews and verifies the withdrawal application, and encodes it into ADB’s Loan Financial Information System (LFIS).
- CTLA prepares a disbursement voucher, and authorizes the withdrawal.
- ADB Treasury directly remits funds to the contractor’s bank account.

30. To record this in the government accounts, CAAA issues instructions to the chief controller of accounts in the Ministry of Finance, who issues a zero value book entry. This book entry is used to charge the state government budget for the expenditure, and credit ADB in India’s books (necessary due to the cash-based budget systems).

31. As the direct payment arrangement leads to a direct transfer of cash from the loan account to the contractor, it has the minimum propensity for delay. It also imposes no burden on the EA to use its own resources for bridge-financing the ADB share of project expenditure.

32. The funds flow is depicted in Figure 1: Direct Payments.
B. Commitment Letter

33. This method is slightly more complex in the nature of document flows, but equally simple in terms of funds flow. The steps are described below (slightly simplified, with just one issuing and negotiating bank):

- The EA opens a letter of credit (LC) in favor of its supplier. The LC issuing bank directly issues an advice to the LC negotiating bank about the availability of the LC, referring to ADB’s commitment letter.
- The EA submits a commitment letter (CL) request to CAAA for transmission to ADB.
- CAAA submits a CL request to ADB.
- ADB issues a CL to the LC negotiating bank, stipulating that all eligible claims may be directly submitted to ADB through the Society for Worldwide Interbank Financial Telecommunication messaging system.
- Supplier submits a claim under the LC to the negotiating bank from time to time.
- The negotiating bank sends a claim through the messaging system of the Society for Worldwide Interbank Financial Telecommunication to ADB for payment. Documents go to the bank that has issued the LC.
- ADB withdraws funds from the loan account and remits to the negotiating bank through the messaging system of the Society for Worldwide Interbank Financial Telecommunication.
- As in the case of direct payment, CAAA later initiates a zero voucher to withdraw appropriate funds from the EA’s budget for accounting purpose.

34. As in the case of direct payment, this method also imposes no burden on the EA to bridge-finance the ADB share of project expenditure, which is directly withdrawn from the loan account and remitted to the contractor when due. Both the direct payment and commitment letter procedures facilitate prompt withdrawal of loan proceeds to support project expenditure.

35. The transaction flow is depicted in Figure 2: Commitment Letter below.
C. Reimbursement

36. This is a fairly complex procedure, where both documents and funds flow through several stages.

- The contractor submits an invoice to the EA for work performed.
- The EA approves the invoice, and makes a payment to the contractor.
- The EA submits a claim to CAAA for the ADB share of this expenditure for submission to ADB.
- CAAA submits a withdrawal application to INRM.
- INRM approves the application, and encodes the same in LFIS.
- CTLA authorizes the disbursement in LFIS.
- Treasury transfers funds to the credit of CAAA’s account in the RBI.
- CAAA issues a credit advice to the Plan Finance I Division of DOE.
- The Plan Finance I Division of DOE issues an authorization to RBI to credit the state government account.
- As the EA has already incurred the expenditure from its own resources, the state line department will now withdraw funds from the state Treasury to pay the EA, completing the cycle.

37. In this method, the EA is required to bridge-finance ADB’s share of project expenditure from its own resources, imposing a strain on its cash flows and also the additional carrying cost of interest on such bridge-finance. Due to the multiple layers through which the funds flow, the time between when the EA makes a payment and when it receives the ADB disbursement is not less than 1 month, and more often as long as 3 months. Due to exigencies of the ways and
means position, state governments often limit the availability of cash during the first and last weeks of every month to make room for committed payments such as interest, salaries, and pensions. This could lead to delay in payments for project expenditures.

38. This transaction is depicted in Figure 3: Reimbursement below.

![Figure 3: Reimbursement](image)

**Figure 3: Reimbursement**

ADB = Asian Development Bank; CAAA = controller of aid accounts and audit; PF-1 = Plan Finance Division of the Department of Expenditure; RBI = Reserve Bank of India

Source: Author’s assessment, for the purposes of this report.

**D. Imprest Fund**

39. This is the most complex of the procedures, where funds follow a convoluted route. The steps are given below:

- The EA submits a request for an imprest advance to ADB.
- ADB remits funds to the RBI to credit the CAAA’s account.
- CAAA issues a credit advice to the Plan Finance I division of DOE.
- Plan Finance I instructs RBI to credit the state government account.
- The state finance department provides an authorization to the state line department to withdraw the equivalent rupees from the state treasury, and pay to the EA.
- The EA deposits the imprest funds into a dedicated bank account (sub-account as defined in ADB’s Loan Disbursement Handbook).
- When eligible expenditure is incurred, the EA withdraws ADB’s share of project expenditure from the sub-account, and makes a payment to the contractor along with its own counterpart share.
- Periodically, the EA puts together a claim for simultaneous liquidation of the outstanding imprest advance and replenishment to CAAA.
- CAAA converts the EA’s claim into equivalent US dollars through the RBI, and advises RBI to make a corresponding debit entry in the RBI imprest account.
- CAAA submits a claim for liquidation and replenishment of imprest funds to INRM.
- INRM approves the application, and encodes the same in LFIS.
- CTLA creates a disbursement authorization in LFIS.
- ADB Treasury transfers funds to the credit of CAAA’s account in the RBI.
- The whole cycle is repeated from the first step above.

40. This transaction is depicted in Figure 4: Imprest Fund below.

![Figure 4: Imprest Fund](image)

ADB = Asian Development Bank; CAAA = controller of aid accounts and audit; EA = executing agency; PF -1 = Plan Finance I Division of the Department of Expenditure; RBI = Reserve Bank of India

Source: Author’s assessment, for the purposes of this report.

41. As ADB makes available a portion of the loan proceeds in advance to the EA, this procedure is intended to obviate the need for EAs to prefinance ADB’s share of project expenditure. However, in practice, it has been noted that state governments do not promptly transfer the entire ADB disbursement of imprest advance to the sub-account. As ADB’s advance is intended to cover 6 months of expenditure, state finance departments may try to negotiate with the EA to release the imprest fund in installments. EAs may also get tempted to earn some income from the idle portion of the imprest advance, which could lead to creation of time deposits that earn higher interest. However, such actions tend to limit the availability of the imprest advance for use to finance project expenditure. During project implementation, it is necessary for the project officer to closely monitor these aspects of imprest fund operation.
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