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Report of the Chairperson on the 117th meeting of the Audit Committee

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For: **Review**

Report of the Chairperson on the 117th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 117th meeting of the Committee held on 5 November 2010.

Adoption of the agenda

2. The agenda was amended to include a communication from the Chairperson on the consultation of the President with the Audit Committee on the appointment of the Director, Office of Audit and Oversight (AUO), and on changes in the Finance and Administration Department. It was suggested that this be taken up under "other business" and in a closed session of the Committee with the participation of some members of Management.

Minutes of the 116th meeting of the Audit Committee

3. The draft minutes were amended to reflect that the concern raised by the Committee with regard to the General Reserve document did not relate only to the layout, but to the need for more analytical information.
4. The Chief Finance and Administration Officer (CFAO) read a statement on behalf of the President with regard to paragraph 6 of the minutes, which related to the consultation process regarding the designation of the Director, Office of the President and Vice-President, as officer-in-charge of AUO for the period 14 September-10 October, with the task of providing administrative support to AUO. The statement affirmed that the former Director, AUO, Ms Lapointe, was informed and consulted by Management on the proposed interim plans and that she was in agreement. Reference was made to evidence of this consultation process in the statement.
5. The statement concluded by stating that, on the basis of these consultations, IFAD Management holds the statements made by the former Director, AUO, regarding the interim arrangements for AUO to be inaccurate and calls on the Audit Committee to acknowledge the substantiation as proof that such consultation indeed took place.
6. The Chairperson noted the comments and requested that the President's statement be circulated to members and be attached to the minutes of the meeting. The Chairperson further indicated that the former Director was absent and therefore unable to reply to the above comments.
7. With these amendments and additional information provided by Management, the minutes were approved.

Level of the General Reserve

8. The Director, Controller's and Financial Services Division (CFS), summarized the enhancements made to the General Reserve document after it had been agreed during the 116th Audit Committee meeting that more information and analysis should be included.
9. Analyses of empirical evidence and historical trends, with quantified results in tables and graphs, were undertaken and presented in the paper. Analysis of various risks was carried out, including exchange rate fluctuations, delinquencies in the receipt of loan service payments and in the recovery of amounts due to the Fund from the investment of liquid assets. Management believes that through operational, financial and accounting methods, it is effectively addressing the risk of potential overcommitment of resources.
10. The paper concluded that the General Reserve, at US\$95 million, is deemed prudent and at an appropriate level, and recommended ongoing monitoring

and an earlier review by the Audit Committee in 2012, instead of the three-year interval prescribed in its terms of reference.

11. Audit Committee members commented that the paper was more elaborate on the subject, but queried whether the impact of the revised investment policy on the perceived risks had been taken into consideration. It also sought clarification on the reason PricewaterhouseCoopers couldn't comment on the level of reserve and on why comparability with other international financial institutions (IFIs) could not be meaningful.
12. The CFAO clarified that the changes in the investment policy, which is also included in the agenda of this meeting, would be implemented over time and that by 2012, when the next review of the General Reserve is being proposed to take place, the Audit Committee and Management will have had a chance to review the impact of the new policy and adjust the level of the reserve as necessary.
13. The Director, CFS, clarified that the comparison with other IFIs was not considered meaningful because of substantial differences in capital and governance structures and their regulatory requirements.
14. He further confirmed that PricewaterhouseCoopers reviews the General Reserve at a higher level as part of their "going concern" review when they audit the financial statements each year.
15. The Committee expressed satisfaction with the revised paper on the General Reserve and agreed to it being presented to the next Executive Board for consideration and final approval.

IFAD's 2011 results-based programme of work and administrative and capital budgets, and the IFAD Office of Evaluation's results-based work programme and budget for 2011 and indicative plan for 2012-2013

16. This item is covered in a separate report, document EB 2010/101/R.3.

Revision of the Financial Regulations of IFAD

17. The General Counsel and the Director, Strategic Planning and Budget introduced this item. The current provisions of the Financial Regulations of IFAD stipulate that unused budget allocations at the end of a budget period shall be cancelled and any amount carried forward shall not exceed 3 per cent. The Programme Development Financing Facility (PDFF) was introduced to cater for multi-year commitments for project development disbursements. Until 2010 it was not part of the administrative budget and had no "carry forward" limit. As a consequence of the integration of the PDFF into the administrative budget, Management proposed setting the ceiling for the carry forward for cluster 1 activities (costs formerly falling within the scope of the PDFF) henceforth at 6 per cent, and this was presented to the Board and agreed by it at its December 2009 session when the 2010 programme of work and budget was approved. To enable Management to implement this, however, it is now necessary for the Governing Council to amend Financial Regulation VI to reflect this ceiling.
18. Committee members sought further justifications for the 6 per cent carry forward. The necessity of permanently codifying the carry forward proposal through an amendment to the Financial Regulations was questioned. A member recalled that the Executive Board had not considered introducing a 6% carry forward for cluster 1 on a permanent basis in December 2009. Clarifications were sought as to the need for revising the terminology applied (introduction of a definition of administrative budget to distinguish the corporate budget from the capital budget) and the non-inclusion of the 3 per cent cap in the current Financial Regulations.

19. Management stated that the Financial Regulations need to support the current mode of business and the challenges the organization faces. The General Counsel pointed out that resolution 133/XXVII of the twenty-seventh session of the Governing Council (2004) does introduce the 3 per cent carry forward into the Financial Regulations and clarified that the proposal to amend the Financial Regulations is meant to enhance coherence and logical structure in the budget and codify decisions taken in the past.
20. Management clarified the rationale behind the introduction of the PDFF and now cluster 1, which was to deal with the multi-year nature of the projects.
21. The General Counsel further advised the committee that if the draft resolution is not submitted to the Governing Council for approval, the President will not have the authority to apply a different carry forward percentage other than the 3 per cent that has been adopted in the resolution 133/XXVII (2004).
22. The Chairperson closed the agenda item and stated that the report will be presented to the Executive Board with the comments of the Audit Committee.

Revision of the Lending Policies and Criteria – Explanatory note

23. In 2010 the Governing Council instructed the Executive Board to submit to the thirty-fourth session of the Governing Council in 2011 revised Lending Policies and Criteria that take into account all developments since the last revision of the Lending Policies and Criteria in 1998 and that express concisely and clearly the broad policies and criteria applicable to financing by the Fund. A document entitled Policies and Criteria for IFAD Financing was presented by the Office of the General Counsel (LEG) as an annex to the explanatory note. This document, together with the explanatory note, will be presented to the Executive Board in December for its review and recommendation to the Governing Council for approval in February 2011. It was clarified that this paper incorporated feedback received from Board representatives during and after the informal seminar held in September.
24. Committee members expressed satisfaction with the changes to the document. Members sought clarification on: the policy on concessionality; whether specific terms would be negotiated with individual countries; the treatment of loan arrears; and the interest rate paid on loans under ordinary terms.
25. Management explained that the proposed policy on concessionality (set out in paragraph 15(a)(ii) of the proposed document) directs IFAD to generally follow the approach used by the World Bank, taking into account the Fund's special mandate. Management also explained that the proposed document allows the Executive Board to create new lending products: each product being subject to objective eligibility criteria, based on criteria generally accepted among IFIs in respect of per capita GNI and creditworthiness.
26. With respect to the treatment of arrears, Management explained that the proposed document reaffirms the existing principle that no amount of principal will be forgiven. At the same time, it will allow for greater flexibility in dealing with countries in arrears, provided that all similarly situated Member States receive equal treatment. Regarding the interest rate on ordinary-term loans, the Committee was informed that it is revised every six months and that the current rate is 1.1 per cent.
27. The Chairperson concluded that the proposed Policies and Criteria for IFAD Financing and the explanatory note were reviewed and will be submitted for the attention of the Board in December and for subsequent submission to the Governing Council for approval at its thirty-fourth session in February 2011.

Project audit reports for fiscal year 2009

28. The Director, CFS, informed the Committee that the main development in the area of project audits has been the rapid transition to direct supervision of projects by IFAD. This is subjecting project financial and audit practices to a higher level of scrutiny. Control issues reported by the auditors are acted upon promptly and followed up closely through supervision missions, leading to improved financial reporting and audit practices. The Director, CFS, further informed the Committee of the results of reviews of project audit reports submitted to IFAD:
- Approximately 25 per cent of audit reports received for the 2009 fiscal year were qualified, a percentage similar to that for 2008. These represented a smaller percentage of amounts disbursed to projects in 2009. As in prior years, qualified opinions triggered decisive actions.
 - The shift to direct supervision and the evolving IFAD approach of reliance on national systems (where they are deemed acceptable) increasingly require the Fund to assess and improve the financial management practices and audit arrangements of borrowing Member States.
29. Committee members raised queries on the timeliness of implementation completion of the recommendations made in qualified audit reports; on the reliance on national audit firms and whether these firms are international; on the contracting modality with auditors; and whether technical assistance is rendered to projects to deal with significant control weaknesses.
30. Management clarified that supervision missions include follow-up of progress in the implementation of recommendations. IFAD's approach to national audit structures is similar to its procurement approach, and reliance is placed on those systems deemed adequate after an assessment. The Fund has on occasion provided assistance to projects to build capacity and address weaknesses. The Committee was also informed that an audit recommendations tracking system (ARTS) is being developed and is expected to be in use soon.
31. There being no further comments, the Committee considered the report and the item was closed.

Changes to IFAD's investment policy and minimum liquidity requirement

32. The CFAO informed the Committee that IFAD's Management initiated the current policy review in 2009 to ensure that IFAD's investment policy remains aligned with IFAD's return and risk objectives within updated financial market assumptions. The proposed changes were being presented to the Audit Committee and to the Executive Board for review before their adoption by the President.
33. The Director, Treasury Division, presented the background of the review process, which was supported technically by an external firm, Ortec Finance, which worked closely with a Treasury-led interdepartmental working group. The review was anchored in the Financial Regulations of IFAD, and in particular focused on ensuring security, liquidity and maximization of returns. Taking into consideration economic assumptions of continuing low growth in developed markets and strong growth in emerging economies, the main recommended changes, based on the review, were as follows:
- Reduce the concentration on Organisation for Economic Co-operation and Development (OECD) government bonds and invest more in high-quality corporate bonds and emerging market government bonds.

- Manage the portfolio dynamically by establishing a market risk budget.
 - Increase the maturity of the government bonds portion of the portfolio.
 - Hire a currency overlay manager as a way to separate management of SDR currency alignment from portfolio management.
 - Exit from remaining IFAD securities lending activity in 2010.
 - Increase the minimum liquidity requirement from the current level of 60 per cent of gross disbursement to 70 per cent.
34. The proposed changes are expected to lead to an improved return at a modest increase in risk, thanks in particular to the proposal to increase diversification of the portfolio. Due to the volatile nature of the market in general, the proposed investment policy may be revisited if financial market conditions warrant it. The implementation plan would be pursued cautiously and was expected to extend to December 2011.
35. Audit Committee members commented on the potential assumption of more risk with a shift to corporate credit and longer duration instruments; on the apparent emphasis on increased return and not on increased risk; that investment policy should probably be approved by the Board even though the President has authority under financial regulation XIII; on the adequacy of information on the proposed minimum level of liquidity; and on factors taken into account in arriving at this new policy. Clarification was also sought on the proposed minimum credit rating requirement for fixed-interest instruments.
36. Management advised the Committee that the analysis was not focused on return alone. The current market situation entails risks for the IFAD investment portfolio, as interest rates are close to bottom and can only go up. This would have a negative impact on the price of global government bonds, which represent approximately 90 per cent of the IFAD portfolio. Thus, in the new strategy, part of the global investment portfolio would be diversified to mitigate this risk. The Treasurer informed the Committee that the current minimum of a double or triple A credit rating is very rare in emerging market and corporate bonds, but a minimum investment grade rating of triple B will be maintained. As regards the minimum liquidity requirement, the Treasurer clarified that while the current minimum liquidity level is set at 60 per cent of the annual gross disbursement requirement, actual liquidity is much higher – in the range of 120-150 per cent – only because of the current large allocation to OECD government bonds. With the proposed reallocation to non-OECD government and corporate bonds, the level of liquidity will be aligned to the proposed level of 70 per cent, which is not considered too high compared with the current actual level. An additional 10 per cent would be added as an outcome of the stress test in the context of the new asset allocation and the growing level of the programme of work.
37. The General Counsel clarified the role of the Executive Board in the revision of the investment policy, which is to exercise control and give direction to the President. The President would thus heed the direction given by the Executive Board before adopting the policy.
38. The Chairperson summed up the discussion by saying that simulations have been done to show relationships between risk and return. Given the nature of the institution, he further added doubts on IFAD's possibility to take more risk. It is also important to signal to the President the concern expressed as part of the oversight responsibility towards the Institution. On this basis, Management will have to submit the proposal to the Board and highlight the comments and

concerns expressed by the Audit Committee. The Committee also requested that additional information be presented to the Board on comparisons with other IFIs.

Special expenditure for the Voluntary Separation Programme for IFAD 2009-2010

39. The Committee was informed by the Acting Director, Human Resources Division, of the current status of the Voluntary Separation Programme (VSP). Only one third of the authorized funds have been used to date and US\$3.9 million remain available. Thus Management proposed to extend the VSP beyond 2010 for a second phase.
40. Comments from the Committee included requests for:
 - Confirmation of whether the rationale for the VSP remains relevant and if some elements of it can be revised to reflect the lessons learned in phase 1.
 - Detailed information on the lessons learned from the first phase.
 - Demographic statistics of people opting for VSP, such as age, and information on what happened to their posts.
41. Management reminded the Committee of the voluntary nature of the initiative and confirmed the efficiency gains, which have led to unnecessary positions being abolished and tasks and roles being redefined. The Committee was informed that Management intends to move forward and target certain people, while still maintaining the voluntary element of the programme.
42. The Chairperson stated that the report has been reviewed and the document will be submitted to the Executive Board in December for approval, for submission to the Governing Council at its thirty-fourth session.

Workplan for IFAD's Office of Audit and Oversight for 2011

43. The Interim Director of the Office of Audit and Oversight presented the workplan for 2011. The core objective of the plan was to help Management increase the organization's effectiveness and efficiency at a time when business is going through certain key changes.
44. Members raised questions on the basis of the workplan on: the audit universe and details of the risk assessment conducted; the role of the Ethics Officer and the reason for setting up the office; the ratio of staff between assurance and advisory engagements; the role of IFAD in in-country internal audit capacity-building; and clarifications of the scope of the code of conduct.
45. Management informed the Committee that their suggestion for more detailed information on risk assessment has been noted and will be included in future submissions. AUO has planned to support the process of setting up an ethics office, and recruitment of the Ethics Officer was almost concluded. This office would be a separate unit from audit and investigation.
46. All three professional audit staff in AUO are doing both advisory and assurance engagements. The Committee was also informed that the auditors are able to impart knowledge and help build capacity in the normal course of their work. The Committee was advised that the certification of the code of conduct referred to in the workplan, which until now has been signed by staff members only upon joining IFAD, is that contained in the Human Resources Procedures Manual.
47. The Chairperson wrapped up the deliberations and advised that having an Ethics Officer is in line with best practice. The workplan was considered reviewed and it will be submitted for confirmation to the Executive Board in December.

Audit Committee work programme for 2011

48. The Committee reviewed its work programme for 2011 and requested that Management provide semi-annual updates on activities by AUO and that it change references to updates on the Loan and Grant System (LGS) and the attestation from "oral update" to merely "update", as they are not to be limited to oral updates only. The Secretariat was requested to include the following items in the agenda for April 2011, which were listed as tentative in the Audit Committee work programme for 2011:
- Report on the status of contributions to the Eighth Replenishment of IFAD's resources
 - Resources available for commitment
 - Report on IFAD's investment portfolio for 2010
 - Report on IFAD's investment portfolio for the first quarter of 2011
49. The Committee also took note of its role in the selection of the external auditors and requested Management to present, at its first meeting in 2011, a proposed detailed timeline for this process, which should be concluded by December 2011, and proposed new terms of reference for the external auditor.
50. The work programme was considered and the agenda item closed.

Other business

(a) **Oral update on progress towards the introduction of a Management assertion and an external audit attestation on the effectiveness of the internal control framework for financial reporting**

51. The Committee was updated on the status of Management's initiative to implement an assertion and external attestation on financial reporting. The key objectives of these are higher stakeholder confidence in financial reporting; comparability with other IFIs; and management of overall organizational risks.
52. Envisaged benefits of the full attestation initiative were highlighted and the Committee was informed of milestones achieved and next steps to be taken.
53. There were no comments from the members on the item. The update was noted and the item closed. The meeting adjourned for a closed session – a report on which is presented separately.