

Document: EB 2012/105/R.30
Agenda: 12(a)
Date: 30 March 2012
Distribution: Public
Original: English

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Report of the Chairperson on the 122nd meeting of the Audit Committee

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Executive Board — 105th Session
Rome, 3-4 April 2012

For: **Review**

Report of the Chairperson on the 122nd meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 122nd meeting of the Committee held on 23 March 2012.

Adoption of the agenda

2. The agenda was amended to include the following changes:
 - Removal of agenda items 8(b) Report on the Ninth Replenishment of IFAD's Resources and 8(f) Report on IFAD's investment portfolio for the first two months of 2012, due to the fact that members had not received the documents prior to the meeting. These documents would be submitted directly to the Executive Board session for information. The Committee regretted the non-availability of these documents and encouraged Management to provide all documents on time in the future.
 - Inclusion of two items under Other business namely, review of the Executive Board document on the Housing arrangement for the Global Mechanism (EB 2012/105/R.44) and possible financial implications, and the policy regarding parking spaces at the IFAD premises.

Minutes of the 121st meeting of the Audit Committee

3. The minutes were approved without any comments from the members.

Review of the consolidated financial statements of IFAD as at 31 December 2011, including a Management assertion report on internal controls over financial reporting (including closed session with external auditors, if required).

4. Management presented the financial statements to the Audit Committee highlighting key factors that affected IFAD's financial position and reported financial results for the financial year 2011.
5. The Committee was informed of the increase in loan and grant commitments in the reporting period to a record high of US\$987.2 million in approved loans and grants, a growth of 15 per cent over 2010. The increase in the programme of work affected the overall costs of the Fund, especially consultancy fees. The number of projects under implementation had also risen. The costs of increased staffing in country offices was contained due to the fact that local remuneration conditions were applicable and these were much lower than at IFAD headquarters. The Committee was also informed of the overall effect of foreign exchange fluctuations on staff costs, which increased mainly as a result of the post-adjustment element of the Professional staff category, voluntary separation payments and General Service staff separation entitlements, which in the prior year had recorded a negative balance.
6. On the financing situation, the Committee was informed of the relative reduction in overall equity contributions compared to 2010. This trend was foreseen because of the timing of Eighth Replenishment flows of instruments of contribution, the majority of which were deposited in 2009 and 2010. Contributions already received towards the Ninth Replenishment stood at US\$5.65 million as at the end of 2011.
7. A higher average interest rate compared to 2010 meant that the Fund registered an increase in interest income from both investments and the loan portfolio. The Committee's attention was also drawn to a statement within the financial statements that presented IFAD's balance sheet in nominal value terms in United States dollars as well as special drawing rights. This statement provided a more simplified picture of the Fund's financial position, without the effects of accounting adjustments.

8. The overall financial operating results, as presented by the consolidated statement of comprehensive income, showed an overall deficit of US\$157 million. This was the result of an excess of expenses over revenue before fair value adjustment of \$60.5 million as well as unrealized losses on currency exchange movements amounting to US\$64.5 million and fair value (net present value) adjustment to the loan portfolio amounting to US\$33.7 million.
9. Management also informed the Committee of a new section of the financial statements document: Management's assertion report on the effectiveness of internal controls over financial reporting. The Committee was reminded of the success of this initiative, whose milestones have been reported on since April 2010.
10. Members expressed satisfaction with the quality of the financial statements presentation and welcomed the Management assertion. In addition, members requested clarification on: the tables of loan movements; whether IFAD had government bonds in developing and emerging economies; and movements in held-to-maturity investments from previous year.
11. Members requested for the future a breakdown in staff costs to identify the impact of exchange rate movements, increase in headcount and salary adjustment. Members also requested information on the correlation between staffing levels (headcount) and staff costs; number of consultants who worked for the Fund in 2011; the presentation of the Heavily Indebted Poor Countries Debt Initiative (HIPC) accounting in the income statements; Debt Sustainability Framework (DSF) accounting and treatment in the income statement; composition of income from loans; and the recorded deficit, which had increased from the prior year's recorded deficit.
12. Management clarified that the tables for loan movements contained only loan amounts and did not include grants. The Committee was informed that IFAD had a portfolio of very high quality government bonds which yielded benefits over the course of the year. On the issue of the deficit, the Committee was reminded that IFAD was not a profit-making entity, and that its goal was to support projects funded by loans and grants channelled through countries. Initially, investment income had been intended to meet operational costs, even though lower returns had resulted in costs not being fully covered. The business model was designed to ensure available liquidity to meet disbursement commitments and needs.
13. Management clarified that income from loan repayments only included the interest component and that principal repayments were shown in the cash flow statement. IFAD monitored and actively followed up on the status of arrears of loan repayments. On HIPC, Management explained the debt relief process and its link to the accounting treatment reflected in the financial statements. The Committee was also reminded of the provisions of the Agreement Establishing IFAD, which were intended to safeguard the long-term viability of the Fund by establishing proportions of loans and grants. This process changed with the creation DSF grants.
14. In light of the financial importance of the DSF, the Committee decided to discuss this issue further at its next meeting and requested Management to prepare for such a discussion. Furthermore, the Committee would consider the financial implications of grants and their medium-term sustainability prospects.
15. Management was requested to inform the Committee of any unusual or unexpected issues that could have affected the reported financial results for the year. Management replied that the return on the investment portfolio had been higher than expected and the number of countries in non-accrual status had fallen.
16. The external auditor, PricewaterhouseCoopers, was invited to make a presentation on the outcome of the audit process for the 2011 financial statements. The auditor informed the Committee that the audit had been smooth and that an unqualified audit opinion would be issued. There had been no significant changes to either the

process or the audit approach with respect to previous years. The external auditor outlined their own responsibilities and also those of IFAD Management. The Committee was informed that part of the external auditor's role was to assist the Committee in discharging its governance and compliance responsibilities over the Fund. Furthermore, as in prior years, the external auditor would provide a letter of recommendation to improve internal controls. The auditor further outlined the nature of the work and emphasized that there were no new internal control issues this year; the two system-related items outlined in the report were outstanding from previous years. During 2011, the external auditors had not been requested to perform an audit of internal controls over financial reporting, therefore, this set of financial statements contained solely Management's assertion concerning internal controls. An audit opinion would be provided for the 2012 financial statements by the new external auditors.

17. The Committee, which had not received the external auditor's report before the meeting, requested the auditors to clarify: whether any performance audits had been conducted in addition to compliance audits; in what areas internal control issues had emerged; what was meant by audit adjustments; and the timing of audit report submission.
18. The external auditor clarified that the focus of their work was on ensuring that the financial statements complied with International Financial Reporting Standards. On the issue of internal controls, the Committee was reminded that the two issues highlighted were being addressed by Management and that performance audits were not included in their terms of reference.
19. The Committee was informed that the external auditors would be issuing a signed audit opinion by 2 April 2012, in time for its presentation to the April Executive Board session.
20. The Committee requested that documents be submitted earlier in future to allow for wider consultation. **The Committee concluded that based on the answers provided by Management and the presentation by the external auditors, the financial statements would be presented to the Executive Board and recommended for submission to the Governing Council for approval.**

Office of Audit and Oversight

21. The Chairperson introduced the item and invited the Director, Office of Audit and Oversight (AUO) to contribute.
22. Committee members were informed that the two reports before them summarized the activities and results of AUO for 2011. The past year had seen significant staff turnover, nonetheless the office had managed to achieve its planned outputs. Audits had covered high-risk areas such as consultancy services, IT network security and country programme activities, and the pace of implementation of audit recommendations had improved significantly. The creation of the new departments Financial Operations Department and Corporates Services Department, the ongoing human resources (HR) and financial management reforms and the issuance of new investment policy guidelines had set the stage for implementing high-priority recommendations in the areas of HR, direct supervision and investments. The ongoing Change and Reform agenda would support the implementation of the main high-priority recommendations pending in 2012.
23. In the investigations area, the office had been faced with the largest caseload since the function was set up. With reduced staffing in the investigation section, several investigation experts had been engaged to strengthen investigative capacity and address the backlog. Given this constraint, cases that had immediate consequences had been prioritized.
24. The internal audit capacity-building programme continued with assessments of the internal audit functions of the Ministries of Agriculture in Mozambique and Zambia

and the secondment of two auditors to AUO for six months. Continuation of this programme after June was subject to the availability of extra-budgetary funding. To date, no additional contributions had been allocated for this activity.

25. The Committee requested additional information on: the pending recommendations related to consultants, what had and had not been addressed by Management and why; grants management; and the increased investigation caseload.
26. The Director, AUO noted that some areas audited in 2011 were rated as in need of improvement or unsatisfactory. These included the area of ICT Network Security and institutional contracts. Management had taken on board the AUO recommendations and had already implemented actions to mitigate the main risks identified.
27. The audit on consultants identified the steps taken to date to improve the underlying administrative and contracting process but found that efficiency improvements were still pending, in particular regarding the automation of the intake, storage, handling and management of consultant data. This was important given IFAD's extensive use of consultants for its core activities. Members also sought clarification on the scope of AUO's audit of the grants approval process (which did not include audits of specific grants).
28. As regards investigations, the Director, AUO clarified that the increase in the investigation active caseload in 2011 was the result of unresolved cases brought forward from 2010 due to the reduction in staffing levels in 2010, coupled with a general increase in reported cases over the last three years. Management is addressing the issue of staff resource constraints.
29. In concluding, the Chairperson requested a paper on the actions being taken or planned by Management with regard to the administration of consultancy services and more generally, on costs, procedures and evaluations of consultancy services. The Chairperson further suggested that information should not to be duplicated in reports and recommended the inclusion of a table showing the main recommendations outstanding. The Committee took note of the resource constraints in the area of investigations and the actions being taken by AUO and by Management to address these.
30. Committee members and the Director, AUO agreed that there was no need for a closed session to discuss the adequacy of the internal oversight mechanisms.

Oral update on the implementation of the sustainable cash flow approach

31. Management informed the Committee of the steps taken towards this initiative since the last update at the 104th Executive Board session, most of which were organizational. These included the formation of the new Financial Planning and Risk Analysis Unit; ongoing recruitment of a specialist resource modelling officer underway; and planned creation of robust models for the institution. Management stated that a candidate with extensive experience had been identified and it was hoped would be on board in two months.
32. Members wished to know when output would be visible in this area and whether the sustainable cash flow (SCF) approach would replace the advance commitment authority (ACA).
33. Management clarified that the SCF would eventually replace the ACA but that both methods would be used for the moment. The Committee was also informed that in the third quarter of 2012, Management would be in a position to show what the model would look like.
34. The Chairperson confirmed that the Committee would like to see the model by the third quarter of 2012. The oral update was noted.

Annual Report on Enterprise Risk Management Activities in IFAD

35. Management presented an annual report, stating that the purpose of the Annual Report on Enterprise Risk Management Activities in IFAD was to provide IFAD's governing bodies with an annual overview of enterprise risk management (ERM) activities carried out by the Fund, and an update on the corporate risks it faces. The Committee was informed of the focus of the 2011 ERM activities.
36. The Committee was further informed that the reassessment of IFAD's corporate risk profile was another major ERM activity launched in January 2012 to take account of changes in the Fund's operating environment and the new targets and priorities agreed in the IFAD9 Consultation.
37. Management stated that to further underpin this effort, the corporate risk profile exercise would feed into IFAD's medium-term planning process, and be complemented by regular internal reporting on the implementation of mitigation plans.
38. Members requested clarification on: whether fraud and corruption in IFAD-funded projects were considered in this framework as part of the supervision exercises; recruitment delays mentioned in the document; and differences between financial and organizational risks.
39. Management clarified that: supervision missions were currently fielded on average one and a quarter times per year, the minimum of two supervision missions per year suggested in the mitigating measures would depend on resources available, and that IFAD intended to move towards risk-based operations and other efficiencies. As a consequence, supervision missions would not necessarily be undertaken twice yearly. The Committee was informed that the low staff morale mentioned in the report was mainly attributable to uncertainty surrounding the current job audit, hence the need to conclude the exercise and issue the report quickly. Significant progress had been made regarding recruitment for Senior Management and director-level positions. All identified corporate risks had risk champions assigned to them.

Standard financial reports presented to the Executive Board

40. The Committee was informed that, as had been decided at the 121st meeting in November 2011, individual presentations on reports would no longer be made, but comments would be invited from members. However, Management was invited to make a quick presentation on the IFAD investment portfolio for 2011, and to orally update the Committee on some aspects for 2012.
41. Management informed the Committee that the investment portfolio had declined in line with forecasts. The net decrease comprised mainly outflows for loans and grants. The return for the year of 3.82 per cent was better than expected. The main reason was the prudent investment policy, which meant that the portfolio was predominantly triple A government bonds. Management highlighted that the Investment Policy's primary objectives were to secure assets and maintain adequate liquidity. These first had to be met before considering a good investment return. Management predicted that the return on investments in 2012 would be lower than in 2011.
42. Members requested an update on the experience with the diversification approach and more information on unrealized gains and losses. Clarification was sought on the approach being taken to investment duration and the basis for determining investment managers' fees. A query was raised on the difference between the amount of total Eighth Replenishment contribution pledges appearing in the paper presented to the December Executive Board session and the amount presented to the current session of the Audit Committee.
43. Management clarified that the new diversified portfolio was not yet in place and therefore impact was unknown. The Committee was informed of a sale of

Portuguese bonds which led to a less than anticipated loss. It was also clarified the investment manager's selection was based on technical and commercial evaluations and that the process was transparent and competitive; retendering was also carried out periodically.

44. On the difference in the amounts of total pledges for the Eighth Replenishment, Management advised that they would revert to members through a response by correspondence.
45. The Committee was informed that pledges for the Ninth Replenishment Consultation stood at US\$1.035 million as at 22 March 2012.

Oral update on the progress in development of the Loans and Grants System

46. Management provided an update on the project progress since the 121st Audit Committee meeting of November 2011.
47. The Committee was informed of the progress in the procurement process, which had involved cancelling the request for proposals and subsequent direct contracting with Oracle Italia. The licence and consultancy contracts with Oracle Italia were signed on 29 December 2011. The Committee was informed of the main contractual elements of the March 2011 proposal as compared with the December 2011 proposal. Management presented the latest cost projections regarding the approved project capital costs of US\$15.7 million and informed the Committee that the new project implementation approach was expected to lead to savings of approximately 10 per cent. Ongoing recurrent costs were estimated at US\$1.1 million per annum instead of the originally envisaged US\$1.7 million.
48. The Committee was provided with an outline of the project, which would be implemented in two phases; the project implementation timeline showed the actual commencement of phase one as March 2012, with completion and final "go live" scheduled for April 2013. Phase two was expected to start prior to the end of phase one.
49. Members requested clarification on the changes in the contract with respect to the previous one; whether the timeline and costs had changed with the new contract; whether the change in scope affected the cost; and if there were any risks of cost overrun or timing issues.
50. Management responded that implementation would be quicker than originally envisaged, therefore despite the slight delay encountered in the contracting phase, the timeline remained as originally planned. On cost, Management reiterated that the project was expected to cost 10 per cent less than earlier envisaged, even with the current phased approach. Management stated that the risk of cost overrun could not be completely eliminated. The Committee was assured that there were no contractual loose ends because IFAD was legally protected under the current framework agreement.

Other business

51. The Committee discussed the issue of parking spaces under the other business item, in response to a question from a member at the beginning of the meeting.
52. Management clarified that IFAD does charge for parking spaces and that the proceeds were used to run a shuttle bus service between the office and the metro station. Proceeds were also used to support the initiative for greening IFAD.
53. The Committee expressed appreciation for the service being provided to staff. Taking note of the current practice, the Committee requested that the provision of parking spaces to Executive Board representatives be considered on a similar basis, to accommodate the Board's requirements.

54. Also included under this item, was a discussion of the Executive Board document on Housing arrangement for the Global Mechanism (EB 2012/105/R.44). **Following a brief acknowledgement of the potential financial implications contained in this document, the Committee agreed to seek the Board's referral of this item to examine the financial aspects of this issue.** This item would then be added to the agenda of the Committee's next meeting in June. **To this end, the Committee also recommended that the Executive Board postpone consideration of this item until after the Committee's deliberations.**
55. In closing the meeting, the Committee bade farewell to the representative of Austria, who would no longer be participating as a member, and thanked him for his many years of service.