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Report of the Chairperson on the 123rd meeting of the Audit Committee

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For: **Review**

Report of the Chairperson on the 123rd meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 123rd meeting of the Committee held on 22 June 2012.

Adoption of the agenda

2. Prior to adoption of the agenda, the Chairperson recalled the agreement reached at the Committee's special session on 16 April, as well as the Executive Board's special session of 3 May, regarding the housing arrangement for the Global Mechanism. She reminded the Committee that Management had agreed to provide regular updates on the status of this issue to the Audit Committee. It was thus agreed that this item would be added to the meeting's agenda under "other business". The agenda was further amended to include additional items under other business:

- A presentation entitled: "Challenges and Actions in IFAD's Treasury and Asset Liability Management";
- An update on the status of contributions to the Ninth Replenishment of IFAD's Resources (IFAD9);
- The ongoing process of preparing the budget for 2013; and
- An update on the issue of the availability of parking spaces for Executive Board representatives.

Minutes of the 122nd meeting of the Audit Committee

3. The Committee approved the minutes of its 122nd meeting and of its special session on 16 April without any comments.

External auditor's report on internal control and accounting procedures

4. The Chairperson introduced the item and informed the Committee that the report was issued subsequent to the audit of IFAD's 2011 accounts and that Management's comments had been incorporated. The engagement partner from PricewaterhouseCoopers was invited to present the report.

5. The partner informed the Committee that the report contains historical issues that are in the process of being resolved. The issues relate to: the Loan and Grant System (LGS); an automated tool supporting Heavily Indebted Poor Countries Debt Initiative (HIPC) accounting activities; enhancement of data security related to the "fair value" tool; and an information technology (IT) issue. The partner informed the Committee that he was aware of the current project to replace the LGS, which will address the risk at hand. The LGS, HIPC and fair value issues mainly refer to the risks associated with manual intervention in Microsoft Excel spreadsheets. New systems to automate these processes and make them more robust are being developed. Management had intimated that the IT item had been fully addressed. The external auditors concur with that, but with the caveat that they were not able to test and verify implementation of the recommendation at the time they were conducting their audit, as the remediation activities concluded at a time when their work had been completed.

6. Comments from members included: clarification on the auditor's position regarding the point on IT controls; clarification of the implementation time line for items regarded as needing prompt action; confirmation of the

implementation time line for the Loan and Grant System replacement project; and a request for a French translation of the document presented.

7. Management clarified that the fourth point on information technology security was fully addressed when the hosting of IT infrastructure at United Nations International Computing Centre was put in place in March. So far, tests indicate that things appear to be running smoothly. As for the fair value tool, a consultant had been hired to develop a tool that meets the recommended control criteria and work is in progress. It is expected to be completed by the end of July. The HIPC database has already been developed and tested and should be rolled out in July or August. On the LGS implementation time line, the Director and Controller, CFS, informed the Committee that the current time line indicates April 2013 for completion of phase 1, and confirmed that the risk of inflexibility referred to in the audit recommendation will be addressed with the completion of that phase.

8. On the issue of translation, the Secretary of IFAD clarified that there was no translation because the document originated from a third party. This original report had been maintained and distributed as received. The Secretary of IFAD did mention, however, that translations could potentially be provided in the future, provided that the documents from external parties were received on time.

9. The Chairperson thanked the auditors for the last report of their tenure and closed the item.

External auditor's strategy memorandum for the year ending 31 December 2012

10. The Chairperson introduced the item and welcomed the new external auditors, Deloitte LLP. Members were reminded that the item had in previous years been discussed in closed sessions. The lead audit engagement partner was invited to present the strategy.

11. The partner introduced the senior members of the audit team present, which included representatives from the United Kingdom and Italian firms, and proceeded to present the strategy. The partner informed the Committee that Deloitte's areas of focus are complex, judgemental and new. He mentioned that one of these areas is fair value on loans, due to its complexity and involvement of management estimates. Other areas of focus were identified as follows:

- Impairment of loans, contribution receivables and contribution promissory notes;
- Valuation of financial assets and derivatives;
- Change in accounting policies and estimates expected in 2012; and
- First year of audit, with the related inherent risk associated with it.

12. In all these areas, Deloitte will focus on the accuracy of calculations, appropriateness of accounting policies and compliance with International Financial Reporting Standards (IFRS).

13. Comments from members included: whether the audits will involve both compliance and performance audits; the methodology used for risk analysis; clarification of the fair value approach in the light of current market conditions; the new policy on fixed assets; and the difference between fraud and errors.

14. The partner clarified the requirements of IFRS and the mechanisms for determining fair value from discounting future cash flows. He clarified the condition for application of fair value and how it specifically applies to IFAD.

The new fixed assets policy will relate to the implementation of a new capitalization threshold, which will imply more fixed assets are capitalized than before. On the issue of fraud, the Committee was informed that International Auditing Standards require external auditors to consider this in the course of their work. It was further clarified that fair value is an area of focus because it is complex and is judgemental in nature. The Committee was reminded that IFAD has been applying fair value in its financial statements since 2006.

15. The external auditors confirmed that investment is an area of focus in their work and will also include testing of controls in the area to facilitate issuance of their attestation to the Management Assertion of internal controls over financial reporting. IFAD's particular situation in the loan valuation approach, because of highly concessional interest rates, was also clarified.

16. The Chairperson thanked the external auditors for the strategy and looks forward to their work and report for the next financial year. The item was closed.

Review of the adequacy of the General Reserve

17. The Chairperson introduced the item and informed the Committee that management had conducted a review and is proposing to maintain the same level.

18. Management presented the item and reminded the Committee of the history of the General Reserve and how it has evolved to the current level of US$95 million. The Committee was reminded that the previous review had been conducted in 2010, and it had been decided that another review be done earlier than the usual three years to test the validity of assumptions and the analyses conducted. It was stated that the main objective in maintaining a General Reserve is to counter the risk of overcommitment of IFAD's resources as a result of the following risks:

- Exchange rate fluctuations;
- Possible delinquencies in the receipt of loan service repayments;
- Possible delinquencies in the recovery of amounts due on the Fund's investments; and
- Diminution in the value of financial assets.

19. Management presented a paper that outlined the various mechanisms and strategies adopted to mitigate the above risks, quantified the potential loss under each risk category itemized above and confirmed that the aggregate amount of the potential loss is less than US$95 million. The role of external auditors in the area was stated to be that of assessing compliance with accounting standards in the disclosure and presentation of reserves in the financial statements, as opposed to reviewing the adequacy or reasonableness of the level of the General Reserve. Management concluded that the current level is adequate and recommended that another review be undertaken in two years' time to assess the impact of the sustainable cash-flow approach and the continued need for a General Reserve.

20. Comments included: the expression of satisfaction with the arguments presented to justify the level of the General Reserve, as well as urging Management to continue the reviews; clarification on the role of external auditors and why the level has remained at this level for 10 years, despite changing economic circumstances; clarification on the computation of estimated impact with risk factors covering diverse time horizons.

21. Management clarified that the level of the General Reserve has been the same for some time mainly because the Fund has established other measures to safeguard continuity, such as the advance commitment authority and now the sustainable cash-flow approach, which is intended to prevent overcommitment. Further analysis would be undertaken on establishing a mechanism to evaluate and guide decision-making in terms of the size of loans and grants in order to ensure funds committed are within the resource capacity of the organization. It was further clarified that the estimate of total loss from the crystallization of risk factors is based on considerations that are delinked and, as such, are not necessarily supposed to be based on the same time horizon.

22. The Chairperson confirmed that there are no objections to the proposal to maintain the current level of the General Reserve and that the paper would be recommended for approval at the September 2012 Executive Board session.

Review of the status of Debt Sustainability Framework grants

23. The Chairperson introduced the item and reminded the Committee that this agenda item was at the request of the Audit Committee. She informed the Committee that the paper presents the status of the Debt Sustainability Framework (DSF) and goes on to propose an approach for Member States to contribute towards principal repayments forgone.

24. Management presented the paper outlining the history of the DSF initiative from the time it was approved by the Executive Board in April 2007. The paper also provided a brief description of the underlying DSF principles and the mechanisms for implementation, including the principle of pay-as-you-go compensation for principal repayments forgone in resources given out as grants rather than as loans. Management reminded the Committee that the document was meant to trigger discussions on how Member States are going to meet their obligations towards contributions to meet that compensation cost.

25. Management had quantified the amount in principal repayments so far forgone – from the inception of DSF in 2007 to 2011 – at US$773.6 million. Extending the period to include IFAD9 up to 2015, the total amount in principal repayments forgone would amount to US$1.446 billion. The forgone repayments are expected to begin crystallizing in 2018.

26. Management presented a number of options to implement contributions by Member States and recommended that the most appropriate would be the International Development Association burden-sharing approach. Management then suggested that an ad hoc working group be formed to further consider options for burden-sharing and to present recommendations to the Executive Board for approval.

27. Comments from members included: appreciation that the issue had been brought up for discussion; expression of preference and strong support for having the entire Audit Committee involved in the review process, as opposed to forming a working group; a request for a more-elaborate presentation of options, including standard practice in other international financial institutions, especially on specific legal documentation regarding this issue; clarification on whether the Board is informed beforehand of the amounts being approved under the DSF.

28. Management informed the Committee that "planned project activities" documents are presented at every Board session for DSF projects in the pipeline. However, it was agreed that Management would provide a regular

report on the actual amounts of the DSF. The rest of the comments were noted.

29. The item was closed with the understanding that Management would prepare a revised document for the December Audit Committee meeting.

IFAD consultancy service costs

30. The Chairperson introduced the item and reminded the Committee that the Audit Committee had requested Management to provide more-detailed information on consultancy costs, clarifying that the intention had been to include analysis other than simply costs. Management was invited to present the paper.

31. Management informed the Committee that the original intention of the document had been to provide indicative insight into the distribution and factors driving these costs. The document provided an analysis of consultancy service costs for the years 2010 and 2011, including statistics on the number of consultancy contracts signed, distributed by department and division.

32. The Committee was given a brief insight into the breakdown of costs by department, and that the highest costs are incurred by the Programme Management Department (PMD), owing to the diverse nature of the skills required to handle field work in different regions.

33. Comments from members included: a request for more analysis on background and underlying information; comparison of consultant costs at institutional and project levels; clarification of the role of the hiring unit and oversight of work performed by the consultant; and clarification on the variance between the amount budgeted for 2011 and the actual amount presented in the paper.

34. Management clarified that, according to the distribution of costs in the tables, the costs incurred by PMD are mainly for consultants involved in work on IFAD-financed projects and programmes, while the other departments have institutional costs. It was further clarified that project consultancy costs are not included, only consultants hired by IFAD. The Committee was also informed that the divisions are responsible for hiring consultants, with the Human Resources Division providing a supporting role in collaboration with the hiring divisions. Management also clarified that the Office of the Secretary manages its own recruitment of translators and editors.

35. The Chairperson wrapped up the item stating that the Committee will look forward to additional information on the matter, to be presented to the September Audit Committee meeting.

Oral update on the development of the Loan and Grant System

36. Management was invited to present the oral update.

37. The Committee was informed that the project plan had been completed with the relevant stakeholders, with three main project streams: functional, data migration and interfaces. The Committee was assured that the project was progressing according to plan, with no significant delays.

38. The Committee was also informed that IFAD has explored various means to minimize customization impact and costs in general. These include certain revisions to debt-servicing procedures and the ability to backdate transactions without changing existing regulations.

39. The project is currently at a stage where subject matter experts are being trained in the standard system in preparation for the parameterization of

the system. A historical data cleaning exercise is also being undertaken on the legacy system in readiness for conversion. These steps are expected to be completed by the end of July.

40. The update was noted, with no comments from members.

Other business – Treasury and Asset Liability Management

41. The first other business item was a presentation by Management on "Treasury and Asset Liability Management".

42. Management highlighted issues that have taken place in the investments area, as well as factors at play. This mainly covered the last 12 months and was presented in the form of five challenges that have been identified over the past 12-18 months:

(a) Recognition of the policy and strategy not being in line with best practice. This was addressed by introduction of a new investment policy statement, with investment guidelines aligned accordingly, and an internal control framework.

(b) Recognition of a great deal of uncertainty in the market and the need to better manage risk. This was addressed by forming a new Asset Liability Management unit outside Treasury to monitor risk.

(c) Recognition of the difficulties in investment management. This is being addressed by switching from an asset-allocation investment framework to a risk-budgeting framework. An in-house risk-monitoring tool, Barra, has been installed.

(d) In response to downgrades of some of our in-house-managed investments, divestments were done in some European Union peripheral countries into safer havens.

(e) Lastly, eligible bank criteria were strengthened, settlement operations were streamlined and swift-sanction software is to be implemented.

43. Comments from members included a request for more information on the divestments, including amounts and countries; whether there are any additional steps expected; clarification of the rationale for selling the downgraded securities, i.e. whether sale was based on policy or simply an internal management decision. Clarification was also sought on what the maturities were for these bonds.

44. Management informed the Committee that they exited those markets due to the downgrading of their credit rating. The securities were sold from IFAD's internally managed held-to-maturity (HTM) and Spanish Trust Fund (STF) portfolios (NB: reporting on these portfolios is provided quarterly to the Executive Board [on HTM] and the Government of Spain [on STF], respectively). The liquidated amounts based on market values were:

- Spain: €223 million (€29 million in HTM, €194 million in STF);
- Italy: €48 million (€21 million in HTM, €27 million in STF);
- Portugal: €5 million in HTM.

45. A minimal loss of €1.6 million was realized with Portugal, and the others were more or less at par. The Committee was informed that the continued need to have a held-to-maturity portfolio is being reviewed, as it was created when IFAD exited from equities in 2007. The Committee was informed that Management considered whether the assets were permanently impaired in reaching the decision to sell. It was thus a management decision made to ensure preservation of capital.

46. Management further clarified that IFAD investments are to be made under IFAD Financial Regulation VIII, which prioritizes security and liquidity over return generation. The regulation governs the Investment Policy Statements adopted by the Executive Board last year, and at the operational level, the IFAD investment guidelines, which delineate eligible instruments by credit rating.

47. The Committee was informed that if security holdings are downgraded below the eligible level, while IFAD external portfolio managers are to dispose of said securities within 30 days of the date of downgrading by the rating agency, it would become a management judgement for the held-to-maturity portfolios, i.e. whether the significant deterioration in the issuer's credit worthiness would be temporary or not, and therefore impaired or not. If deemed impaired, Management would authorize Treasury to dispose of the investment. The process is necessary for held-to-maturity portfolios in order to keep the valuation basis for accounting purposes stable, while safeguarding IFAD assets for use in poverty eradication. Management clarified that the maturities for the portfolio sold varied between 2012 and 2015.

48. The Chairperson appreciated the update and stated that while the decision to disinvest was within Management's responsibilities, she had concerns about a public international financial institution selling sovereign assets with a short maturity. The update was noted.

Other business – update on contributions to the Ninth Replenishment of IFAD's Resources

49. Management presented an update on the status of IFAD9 contributions. The Committee was reminded that the target set for IFAD9 was US$1.5 billion. As of 21 June, pledges for both regular and complementary contributions amounted to US$1.058 billion, representing 70.6 per cent of the target. On 22 June, there was an announcement by the United Kingdom of a complementary contribution of about 150 million British pounds, including a conditional part, which is yet to be confirmed as a valid complementary contribution. This would in theory bring total pledges to 86.8 per cent, thus surpassing the target of 85 per cent.

50. Comments from the Committee included a request for a further update in September, with a table showing pledges by country.

51. Management reminded the Committee that the President will send an update 15 days after the expiry date on the status of pledges, in addition to the paper expected to go to the September Board as a standard document.

52. The item was noted, with the reiteration that a table with an update of confirmed pledges for the September Audit Committee meeting will be appreciated.

Other business – preparation of the 2013 budget

53. A member requested clarification on the budget preparation process, including confirmation of whether the process will be starting at 7.4 per cent lower than the previous year's.

54. Management clarified that the expected budget to be presented to the Board will be a zero nominal growth budget. There will, however, be a rebalancing of resources internally according to departmental needs. The 92.5-per-cent starting point is meant to create a space for starting the redeployment of resources.

Other business – parking

55. A member requested an update on an issue raised at the last Audit Committee meeting of providing parking spaces to Executive Board representatives.

56. Management responded that the issue has been looked into and there were only limited parking spaces available. It would like to suggest making these spaces available on request by Board representatives on a case-by-case basis, first-come, first-served.

57. The member expressed dissatisfaction with the arrangement and reminded Management that the President had indicated that this would be resolved.

58. The discussion was wrapped up on the understanding that the request will be reviewed further.

Other business – Global Mechanism

59. A member requested an update on the total costs incurred to date, in accordance with information given to the Executive Board.

60. The Committee was reminded of the response given to the May 2012 special session of the Board, to the effect that, in addition to the US$438,000 for the cost of the judgement, an additional US$192,000 has been incurred in legal costs.

61. The Committee noted that no additional costs had been incurred since the report to the Board in May.

62. The meeting was closed.