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to overcome poverty

Report of the Chairperson on the 126th meeting of the Audit Committee

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Executive Board — 108th Session
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For: Review

Report of the Chairperson on the 126th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 126th meeting of the Committee held on 28 March 2013.

Adoption of the agenda

2. The agenda was adopted with the following changes:
 - Due to the late submission of the document, consideration of the item on the update and development of an accountability framework was postponed to the next meeting. **The Committee also agreed to request that the Executive Board postpone its consideration of this item until the Committee has discussed it.**
 - Addition of an item under Other Business regarding new developments on the Global Mechanism financial implications.
 - A closed session was proposed with the Director, Office of Audit and Oversight.

Minutes of the 125th meeting of the Audit Committee

3. The Committee approved the minutes of its 125th meeting without any comments.

Review of the consolidated financial statements of IFAD as at 31 December 2012 including the Management assertion report and the external auditor's independent attestation on internal controls over financial reporting (including a closed session with the external auditors if required)

4. Management presented the consolidated financial statements for the year ended 31 December 2012. The following factors were highlighted as having impacted the financial performance and operating results of the Fund:
5. Increase in the programme of loans and grants to reach US\$ 1 billion and increased disbursements.
6. Factors affecting the composition and the overall level of expenditure such as: an increase in the programme of work directly supervised by IFAD; costs of establishing and maintaining country offices; and reduction in the number of consultants as regular staff were hired to perform tasks. The Committee was informed that staff costs at country offices were contained because of locally recruited staff and reduction in the number of consultants. As a result of the concluded Consultation and the Ninth Replenishment taking effect in November 2012, a significant amount of instruments of contributions were deposited towards the end of 2012 leading to an increase of US\$725 million in equity contributions in comparison to the prior year.
7. The Committee was informed that most government bonds and corporate yield rates decreased. The overall operating results for 2012 showed a deficit of US\$224 million, mainly attributable to the reduction in reported income and an overall increase in expenditure – especially grant expenses – Debt Sustainability Framework and accounting adjustments such as fair value and the after-service medical coverage actuarial cost.
8. The consolidated financial statements were accompanied by a Management assertion report on the effectiveness of internal controls over financial reporting with an independent external auditor's attestation thereon. The external auditor's unqualified opinion on the financial statements was also tabled.

9. Following Management's presentation, the external auditors, Deloitte, were invited to make a presentation of their report.
10. The Audit engagement partner informed the Committee that the audit was conducted as per the original plan communicated to the Audit Committee in June 2012 and that they had issued an unqualified audit opinion on IFAD's consolidated financial statements as at 31 December 2012.
11. The following were considered as the areas of main risk:
 - a) Fair value calculation. With the introduction of the new tool for computing fair value, the external auditors assessed the process against the policy and concluded that the resulting fair value was in accordance with International Financial Reporting Standards.
 - b) Loan impairment. IFAD's policy as contained in the accounting manual was reviewed and found to have been applied consistently and in accordance with International Financial Reporting Statements (IFRS).
 - c) Valuation of financial assets. Impairment indicators and valuation procedures were assessed and it was concluded that the values were appropriate, in accordance with IFRS and consistently applied.
 - d) Disclosure on new accounting standards. IFAD adopted some new accounting standards and policies in 2012 which required specific disclosure in the financial statements for 2012. The overall assessment was that the consolidated financial statements met the requirements of IFRS.
12. In other areas such as revenue recognition and possible Management override, the policies were found to be in accordance with IFRS.
13. The Committee was also informed of the assessment of the external auditors over the Management assertion on the effectiveness of internal controls over financial reporting which led to the issuance of their independent attestation report.
14. Comments from members included requests for:
 - a. clarification with regard to the increasing trend in the approved grants and Debt Sustainability Framework grants compared to loans;
 - b. clarification from the external auditors on the Management override of controls and what that risk implied;
 - c. clarification on how changes in foreign currency exchange rates affect investment market volatility and how that is reported;
 - d. clarification on why interest rates in the highly concessional category were lower than the intermediate terms category;
 - e. confirmation on the quality of staff hired at local offices at a lower cost;
 - f. an explanation as to the increase in the after-service medical coverage liability of US\$20 million; and
 - g. the amount of debt relief received by Haiti against the overall contributions by IFAD and Member States.
15. Management confirmed that there is indeed an increase in the DSF grants, mainly as a result of implementing the eligibility criteria. The issue on Management override was clarified to be part of standard procedures to be performed in accordance with International Auditing Standards to provide assurance that no Management override of controls took place. The external

auditors confirmed that foreign exchange translation process for reporting is in accordance with the requirements of IFRS. Management explained that the highly concessional lending rates are fixed at 0.75 per cent whereas the intermediate terms are market-driven and the current market rates are so low that the highly concessional rates are currently higher. The increase in the after-service medical coverage liability was clarified to be attributable mainly to the discount rates applied in valuing the future liability by actuaries. The Committee was further assured that the lower staff costs in local offices do not necessarily mean lower quality of staff as the local cost of living tends to be lower and therefore translates to lower market remuneration levels. On the Haiti debt relief, the Committee was informed that US\$3.1 million had been provided as relief in 2012, as per the amortization schedule.

16. Other comments from members included a request for:
 - a. clarification on why income from interest on loans was decreasing while the lending volumes increased and the interest rates remained constant;
 - b. the impact of reported deficits on the decreasing retained earnings balance; and
 - c. confirmation whether the reported DSF expenses should be addressed as a separate item.
17. On the issue of interest income it was clarified that because of the grace period given to borrowers and the differences in lending terms across products, there is no direct linear relationship between the volume of loans given in a year versus the reported interest earned in that year. A small portion of it is also attributable to the exchange rate impact of translating special drawing rights into United States dollars. Management explained that reported losses are mainly as a result of lower returns on investments and interest on loans that is not covering the full administrative budget and the costs of grants; however IFAD is sustainable from a resources perspective and in the long term from a cash flow stand point. It was also clarified that the treatment of DSF as expenditure as opposed to a receivable is that there is no enforceable instrument to confirm the recoverability, so in accounting terms, the related costs have to be expensed.
18. The Chairperson acknowledged all questions as having been addressed by Management and the external auditors and reminded the Committee that a closed session with the external auditors was an option they could exercise at that point, to which members responded that there would be no need. The question of the GM provision would be taken up in the separate item under any other business.
19. The Chairperson thanked the external auditors and Management and concluded that **the Committee had reviewed IFAD's 2012 consolidated financial statements and would recommend that these be transmitted to the Executive Board for endorsement of approval.**

Office of Audit and Oversight

20. The Director of Office of Audit and Oversight (AUO) presented a report of internal audit and investigation activities for 2012. Critical areas covered by audits included project design, support services for country offices including direct contribution to the review of internal controls over financial reporting to provide Management with assurance for Management assertion sign off.

21. The Committee was informed that the total number of pending recommendations was the lowest in recent years and not indicative of any specific risks in an area.
22. During 2012, IFAD underwent its second independent quality assurance review the result of which indicated that IFAD's internal audit function generally conforms to the standards for professional practice of internal auditing and the code of ethics issued by the Institute of Internal Auditors. This is the highest possible rating
23. The office also had extensive collaboration with the external auditors in their first year of audit. They also collaborated with other Rome-based agencies on a staff exchange programme.
24. The office handled a much higher level of investigations compared to prior years, relating mainly to a backlog of cases brought forward. At the end of the year, the number of pending cases was significantly lower than at the beginning of the year.
25. Comments from members included requests for:
 - a. clarification on Management's response on issues raised in the audits of the support structure for IFAD's country office and project design process; and
 - b. clarification on the role of hosting agencies.
26. The Director, Office of Audit and Oversight (AUO) confirmed that the findings were agreed with Management as per normal audit process. Management agreed with the recommendations and are working on improving the process.
27. Management confirmed that service-level agreements with hosting agencies are in the process of being reviewed and in some cases replaced. A framework agreement has been signed with the FAO and provides added flexibility and options for hosting of IFAD country offices (ICOs). Other questions involved requests for:
 - a. clarification on recommendations from the 2007 quality assessment report on communication;
 - b. further information on training for IFAD staff;
 - c. procedures with regard to unspent project funds and corruption cases involving personnel;
 - d. clarification on high-priority recommendations, their age and actions undertaken by Management to address them; and
 - e. clarification on the changed methodology in audit ratings.
28. The Director, AUO clarified how communication has been enhanced following the issuance of the 2007 external quality assessment (EQA) recommendation. He highlighted examples such as the introduction of closed sessions with the Audit Committee and the mid-term progress report on AUO's work plan implementation. The terms of reference of the Audit Committee and the Charter of Internal Audit were amended to address those recommendations.
29. The Committee was also informed of how the process of developing the training strategy was revised by the Human Resources Division to address the recommendations made by AUO. The issue of unspent project balances is now being monitored and followed up on. The Committee was informed that AUO would consider aging the recommendations and reporting on that basis from next year. The rating methodology was clarified to be a mechanism to give Management a more precise definition of the ratings of the report.

30. Management was invited to provide an update on status of the high priority recommendations and various levels of implementation were reported. Furthermore, the Committee requested that a regular mid-year review of AUO's recommendations be instituted, to include Management's comments on high-priority recommendations. This item would be discussed in conjunction with AUO's annual mid-year review of its workplan. AUO agreed with these suggestions.
31. In line with its Terms of Reference, the Committee also requested access to the individual audit reports issued by AUO in 2012 with a "needs improvement" rating; AUO agreed to post these on the Audit Committee's restricted website.
32. The reports were concluded as reviewed.

Review of the status of the Debt Sustainability Framework and financial implications

33. Management presented the document reminding the Committee that it was a follow up presentation to the one made in June 2012 after the Committee requested additional information, especially relating to the practices in use by other IFIs.
34. The Committee was reminded that the total amount of principal repayments that would need to be compensated for between 2018 and 2055 for DSF grants committed between IFAD7 and IFAD9 would be US\$1.445 billion.
35. The focus of the document was the approach to meeting the obligation to compensate IFAD for the shortfall on a pay-as-you-go basis by contributing members through additional contributions.
36. Management reported that three IFIs had been included in their research for best practice. These were International Development Association (IDA), the African Development Bank and the Asian Development Bank. Of these three options, Management recommended adoption of the African Development Bank approach because it is simpler, and more logical and adoptable for IFAD's circumstances.
37. Comments from members included requests for:
 - a. clarification for the rationale for choosing the AfDB model which is not clearly spelt out in the document;
 - b. an annex to the document to specify methodologies used by other IFIs and the basis for Management's recommendations, including the decision not to consider other options; and
 - c. the inclusion of suggested implementation procedures, especially with reference to whether members would be expected to make two pledges or one pledge to cover regular and DSF contributions.
38. Some committee members expressed concern on the proposed contribution shares which apply to all contributors to IFAD7 and IFAD8.
39. Management reminded the Committee that the process was still ahead of schedule, as the underlying mechanisms should be in place by the end of 2015.
40. The Committee reiterated their recognition of their responsibility to work on this paper before the Board's approval, as per the IFAD9 Consultation.
41. After further deliberation on the methodology options and contribution modalities, it was concluded that the Audit Committee will receive a revised document addressing clarifications sought. Once reviewed, the paper will go to the Board. It was decided that the item would be reviewed at the June

2013 session of the Committee. In the meantime, **the Audit Committee agreed to request that the Executive Board postpone its consideration of this item until the Committee has discussed and finalized it.**

Procedures and definitions for determining resources available for commitment based on the sustainable cash flow approach

42. Management presented some background to the cash flow sustainable approach, starting with the traditional commitment authority definition and usage of advance commitment authority based on future loan reflows. The IFAD9 Consultation saw a shift from this traditional outlook to an approach more directed to the long-term financial soundness of the Fund and its ability to meet future cash flow obligations. This gave rise to the sustainable cash flow approach.
43. The sustainable cash flow approach procedure was explained as focusing on the level of programmes of loans and grants being cash flow sustainable taking into account minimum liquidity requirements.
44. The Committee was informed that based on a target replenishment level of US\$1.5 billion for IFAD9, (with ASAP complementary contributions and their resulting grants), the long-term sustainable programme of loans and grants is US\$2.7 billion.
45. Management presented a graph highlighting IFAD's cash flow sustainability position as earlier clarified when the subject was initially introduced in 2011, showing inflows and outflows up to 2033 with net cash positions. The impact of IFAD's growth in operations is what affects the negative cash flows into positive and increased in positive position thereafter. The graph is based on assumptions as determined today, and which may change in future.
46. Comments from member included requests for:
 - a. clarification on whether the model factored in future replenishments and whether the trend continues to rise after 2033;
 - b. an explanation as to why Management is presenting two papers, one on resources available for commitment and the other on procedures and definitions;
 - c. clarification of the impact of the model on IFAD's liquidity policy and whether the US\$95 million General Reserve is still necessary; and
 - d. clarification on the wording of the recommendation, with particular emphasis on the responsibility for setting the level of the programme of loans and grants.
47. Management clarified the difference in the models between IFAD8 and IFAD9 and clarified that going forward, future replenishments based on the IFAD9 sustainability will have the same impact. The Committee was also informed that the cash flow rises continually after 2033. The two documents were being presented to explain the methodology and to present the resources available for commitment under the cash flow sustainable approach for the Board's approval for 2013 projects. The General Reserve was clarified to be an accounting term which describes funds set aside from retained earnings for specific purposes.
48. In closing, the Committee requested that the recommendation regarding the resources available for commitment be rephrased to clarify the issue raised on setting the programme of loans and grants. **With this amendment, the**

document was considered reviewed and will be recommended for the approval of the Board.

Standard financial reports presented to the Executive Board

49. The Chairperson introduced the item and reminded the Committee that the practice of dispensing with individual presentations by Management will continue and members may ask questions and comment on any paper under this agenda item. It was however highlighted that Management would make short presentations on three items, namely, the report on the status of IFAD9, the investment portfolio and the status report on arrears.
50. Management presented an update on the status of IFAD9 as an update on pledges, instruments of contributions and payments which have been received since the report was posted. An additional pledge had been received from Hungary bringing the overall total to 92 per cent of the target. Further instruments of contributions were received from Algeria, Brazil, Paraguay and Viet Nam brought the percentage of that to total pledges to 74 per cent. Further payments had been received from Norway, Nicaragua, Finland, Switzerland, Burkina Faso, United Arab Emirates, Denmark, Luxembourg, Botswana, Sudan, Myanmar, Canada, Austria and Pakistan.
51. Management then briefly presented some background to the 2012 annual performance of the investment portfolio. IFAD had responded to the financial markets by making a number of adjustments to the portfolio including divestments from some government bonds that fell below the minimum credit rating. On going uncertainties benefited the IFAD investment portfolio generally, as the 'flight to quality' enhanced the value of IFAD's very low risk portfolio. Newly introduced asset classes such as A-rated corporate bonds and emerging markets performed extremely well, boosting the overall investment return to 3.11 per cent.
52. Whilst the return achieved in 2012 was considered satisfactory by Management, it was noted that the outlook for 2013 is significantly lower, with depressed yields in all major allowable asset classes and potential reversal of interest rate cycles making the achievement of a similar result to 2012 very unlikely. Management is considering a thorough study on fundamentals on asset classes in order to avoid negative impact from the above conditions on investment returns and will come back to the Committee with proposals as and when they are formulated.
53. The Committee was informed of how the current level of arrears was at its historical lowest. Of the borrowers shown as being in arrears in the report, many had either cleared their arrears or, as in the case for Mali, had put in an arrears package for presentation to the April Board. A potential re-scheduling is under discussion with Zimbabwe. Democratic People's Republic of Korea has made partial payment. Only Somalia has yet to make contact.
54. The Chairperson expressed satisfaction with the updates. As the Committee did not have no further comments, the documents were considered reviewed and the item closed.

Annual confirmation of the contract of the external auditor

55. Management reminded the Committee of the process for the appointment for the external auditor: the contract awarded is an annual contract, foreseen to be annually extended for a total of up to five years, subject to satisfactory performance. Management informed the Committee that they consider that the external auditor's performance for this first financial year 2012 had been satisfactory. The auditors have requested an inflation-only increase in fees, which is entirely in accordance with the procurement contract that was signed. Management therefore recommended both the confirmation of the

contract to renew the external auditor and that the fees would be as the current year plus inflation.

- 56. The Committee took note of Management's update and agreed to recommend the external auditor's contract extension to the Executive Board for approval.**

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

57. The Committee was informed that the project has progressed as per project plan with a number of key Flexcube implementation activities completed, with the go-live expected by mid-2013.
58. The following key updates were noted:
- a) Two further amendments to the contract were required to address an increase in the number of customizations at an additional cost of US\$214,500, bringing the total amendment for customization to approximately US\$372,500, well within the contingency budget.
 - b) IFAD users have completed test cycle one, cycle two is expected in April.
 - c) As the LGS detailed design has progressed IFAD and Oracle have determined that it is possible to achieve the functionality required using fewer Oracle software modules than had originally been envisaged. As a result IFAD has paid for the licenses for two modules totalling US\$141,000 and the annual support cost of US\$31,000, which are no longer required. IFAD has requested a refund of the license costs from Oracle, however this has been rejected and Oracle have proposed a licence swap instead.
 - d) Due to unexpected significant costs, certain activities with Oracle Italia have been frozen. A subsequent estimate was provided but was not found to be acceptable to IFAD. IFAD then had an alternative solution to reduce the cost fully under its responsibility, while the data store and reporting are to be delivered by Oracle. This solution is acceptable to both IFAD and Oracle.
 - e) An initial upload to IFAD data to Flexcube has been completed.
 - f) Next and final stage of the project will be the e-disbursement and the borrower's portal; procurement, if required, and implementation is to take place to ensure go-live in 2014.
59. Comments from members included clarification on how the frozen project activities and cost increases relate to the contract.
60. Management provided clarification on the issue of contract changes and the price implications which could not lead to refunds because of the nature of the pricing in the contract.
61. The Committee enquired as to whether Internal Audit had looked at the contract execution for the project. It was clarified that an audit was conducted on the procurement process and that a further audit looking at the implementation phase in due course is a possibility.
62. The Chair concluded that the Committee notes the developments with interest but does not like to see IFAD pay for modules that will not be used without some kind of compensation. Management was requested to make further contact with Oracle to discuss this matter further. The update was noted and the Committee requested that this item stay on the agenda to inform the Committee as the project progresses.

Update on the IFAD Travel Policy and savings achieved

63. Further to the Committee's discussion of this item at its 125th meeting, Management presented an overview of changes made with regard to IFAD's Travel Policy and savings realized through these changes.
64. The following were the changes to the IFAD travel policy that have taken place in the last couple of years:
- a. Issuance of economy class tickets for training, workshops and seminars, regardless of flying time.
 - b. Abolition of the 10 per cent daily subsistence allowance uplift.
 - c. Change in the class of fare for official travel entitlements such as home leave, family visit, appointment, repatriation and change of duty station, made as economy class instead of business class as per former practice.
 - d. Discontinuance of payment of 50 per cent DSA for overnight travel.
 - e. Establishment of the preferred hotel programme with FAO. This was launched as a Rome-based United Nations initiative.
65. The Committee was informed that expected annual savings from the above measures are estimated at US\$280,000.
66. The Committee was also informed of the forward-looking steps that Management was taking related to travel, including taking the opportunity to be included in the current travel tender process being led by the World Food Programme (WFP) as the current travel agent contract expires in March 2014.
67. Comments from members included requests for:
- a. clarification on the level of Management at which the travel policy is approved;
 - b. a clarification on the meaning of alignment with other Rome-based agencies; and
 - c. information on whether travel agencies are sharing in the cost savings.
68. Management clarified that travel policies are approved by the Executive Management Committee and by the President. Alignment was clarified to mean harmonized practices across United Nations agencies. On travel savings, it was clarified that the travel savings that airlines grant to travel agencies are extended to IFAD.
69. The chairperson concluded the item, stating that the Committee encouraged additional savings and took note of the report.

Other business

70. Under other business, there was a request to discuss the financial implications of the Global Mechanism ongoing cases.
71. Management highlighted that the issue of cost has to be seen in light of recent changes in the GM staff contracts. The Audit Committee was therefore provided with the following update:
- a. All GM staff have received offer letters from the UNCCD. The objective of the exercise undertaken by the UNCCD was to implement the Conference of the Parties (COP10) decision and ensure that all the Global Mechanism staff in Rome are offered UNCCD contracts, managed by the United Nations office in Geneva. These contracts are with effect from 1 April 2013.

- b. The Committee was reminded that a year before, Management provided several financial scenarios to the Audit Committee with regards to the GM.
- 72. The Committee was further informed of a recent judgement of the ILOAT regarding the payment of further damages to a former staff member of the Global Mechanism. Further to the judgment, Management informed the Committee of the following actions it took: :
 - a. The complainant had been immediately paid the entire additional sum awarded by the judgment,
 - b. The President had ordered an independent investigation on this matter.
 - c. IFAD has written to the ILOAT to reiterate its consideration and respect of the authority of the Tribunal.
- 73. The Registrar had acknowledged receipt of this letter.
- 74. Members requested:
 - a. Clarification on the budget line to which GM costs were charged,
 - b. Information on the overall costs of litigation cases and their financial implications
 - c. Clarifications on the recent ILOAT judgment and whether Management could have foreseen this outcome.
- 75. The Audit Committee expressed concern for the delay in settling the initial judgement payment. It also expressed concern with the fact that an update on the GM issue was provided only upon request by Committee members, while management had taken the commitment to regularly update the Committee and the Board.
- 76. Management clarified that an amount had been accrued in the accounts and would be kept as is until the final cost implications of the ongoing legal cases are known. Management committed to providing the next Audit Committee meeting with updates on the investigation as well as possible cost implications of ongoing litigations.
- 77. In conjunction with request for Members of the Audit Committee, the meeting moved to closed session between Committee members and the Director, AUO and was closed at the end of that discussion.