Report of the Chairperson of the 131st meeting of the Audit Committee

Note to Executive Board representatives

Focal points:

Technical questions:

Ruth Farrant
Director and Controller
Controller’s and Financial Services Division
Tel.: +39 06 5459 2281
e-mail: r.farrant@ifad.org

Conrad Lesa
Manager, Accounting and Financial Reporting
Tel.: +39 06 5459 2181
e-mail: c.lesa@ifad.org

Dispatch of documentation:

Deirdre McGrenra
Head, Governing Bodies Office
Tel.: +39 06 5459 2374
e-mail: gb_office@ifad.org

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For: Review
Report of the Chairperson on the 131st meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 131st meeting of the Committee held on 28 March 2014.

Adoption of the agenda

2. The agenda was adopted with three items added to other business as follows:
   - Annual confirmation of contract extension for external auditors;
   - Access to the verbatim transcripts of Audit Committee meeting; and
   - Organizational aspects of the informal meetings of the Audit Committee.

Review of the consolidated financial statements of IFAD as at 31 December 2013, including an external attestation of the Management assertion report on internal controls over financial reporting (including a closed session with the external auditors, if required)

3. The Chairperson invited Management to present the item.

4. Management began by identifying key factors affecting IFAD’s financial position and reported results. A reduction was registered in the level of new loan and grant commitments, which fell from US$699 million in 2012 to US$670 million in 2013, of which US$94 million related to ASAP grants. All administrative costs remained within budget.

5. The Committee was informed of the status of equity contributions, which showed an increase of US$329 million in 2013 with respect to the previous year. Instruments of contributions received amounted to US$1.02 billion, equivalent to 96 per cent of the total contributions pledged. Reference was made to appendix F, which presented a nominal value statement intended to simplify the picture by removing the effects of fair value and other notional adjustments.

6. Management reported that operating results for the financial year 2013 showed a net deficit of US$312 million, arising from a reduction in reported revenues and an increase in grant expenditure, especially Debt Sustainability Framework (DSF) grants. Other factors impacting reported results were the fair value adjustment of approximately US$71 million, applied to ensure compliance with International Financial Reporting Standards (IFRS). The Committee was informed that Management had issued an assertion report on the effectiveness of internal controls over financial reporting, based on a new internal control framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which had been adopted early on by IFAD. The external auditors had issued an independent attestation on the assertion report, along with their opinion on the financial statements.

7. Comments from members included clarification on: what measures Management was contemplating to address the situation of increasing deficit and depletion of returned earnings. Members requested clarification as to why the DSF continued to be treated as expenditure even after the Executive Board had approved compensation mechanisms under which donors were expected to reimburse the Fund for the forgone principal reflows. Management was requested to explain the implications in the event that the retained earnings became negative, as shown by the current trend. With regard to the consolidated cash flow statement (appendix C), clarification was requested on the cash outflow amount under the item “receipts from investments” and on whether this item should be an accounting book loss instead of an actual cash loss. Information was requested on how IFAD determines the fair value adjustment as the amount appeared to be high. Some members commented that the treatment of DSF appeared to be consistent with the practices of other IFIs. One member remarked that should the recognition of
expenditure continue under the DSF, a note may have to be included to state that these funds would be recoverable. Clarification was requested on the liquidity that is maintained to cover two years of disbursements and whether these funds could be put to more productive use. On the consultancy costs trend, one member requested clarification as to why the increase in staff being hired had not led to a reduction in consultancy costs.

8. Management reminded the Committee that IFAD’s objective was not to maximize accounting profits but rather to utilize the funds made available by the Member States by providing loans and grants in a sustainable manner. The financial projection within which the Fund was working predicted constant cash flows driven by known factors and a sustainable cash flow situation. On the DSF issue, the Committee was informed that the current treatment was based on the fact that no legal instrument was in place to warrant recognition of a receivable. The Committee was informed that once approval was granted by the Governing Council in February 2015, a receivable would be recorded in the accounts following the change in accounting policy.

9. Reference was made to appendix F, a nominal balance sheet which is presented to simplify the picture by removing all effects of exchange rate and fair value adjustments. In responding to the question on the cash flow on investments, the Committee was informed that the amount included overall realized loss plus adjustments on investment receivables and payables.

10. Management described the approach used in the determination of fair value adjustment and stated that, in addition to the accounting policy note, a detailed outline would be provided to requesting members. In response to the query on the level of consultancy costs, it was noted that there had been a modest drop as a result of staff recruitment.

11. Management reassured the Committee about the trend in the reduction of retained earnings, explaining that the main drivers of the current deficit, such as DSF expenditure, were not expected to continue.

12. With regard to the action being taken by IFAD to address the issue of investment return, Management clarified the cyclical nature of fixed income investment instruments. Management also reminded the Committee of the positive results achieved throughout the financial crisis, as demonstrated by an average yearly return of 3.58 per cent achieved over the 2007-2013 period notwithstanding the negative return in 2013. In order to limit the negative effects of the economic recovery on the portfolio, IFAD had taken action by defining and implementing a new strategy. The duration of the global government bonds had been lowered to reduce interest rate risk, and the overall portfolio had been divided into tranches, including a longer-term tranche containing liquidity not needed in the short term. This portion was invested in asset classes (emerging market hard currency and corporate bonds) which historically provided a higher return over time. The Committee was informed that the strategy was tailored to a time horizon of five to seven years, and that while a positive investment income might not necessarily materialize every year, the projected return was fully expected to be achieved over the defined time horizon.

13. The external audit engagement partner assured the Committee that they had analysed the treatment of DSF adopted by Management, including the disclosures made, and confirmed that it was satisfactory and complied with the IFRS.

14. In response to a question on the breakdown of staff costs, the Committee was directed to an additional document containing a breakdown of staff costs by component across two periods, which was prepared to supplement the high-level review of the financial statements. One member asked why the current value of IFAD8 contributions was less than in the previous year. Management clarified that this was due to the revaluation of promissory notes amounts in foreign currency that had not been encashed.
15. On the effect of retained earnings on the core contributions, Management clarified that contributions were used to finance the programme of loans and grants and not accounting losses. Management further confirmed that income from interest on loans reflected the market interest rate plus the spread in non-concessional lending. The composition of the loan portfolio was determined by the performance-based allocation system.

16. In clarifying the negative retained earnings in SDR terms, the Committee was informed that this was due to translation of a United States dollar balance sheet into special drawing rights, where the retained earnings represented the balancing figure.

17. In responding to the question as to whether the loan from KfW Development Bank had administrative cost implications, Management clarified that the existing administrative budget would cover all related administrative costs.

18. The Chairperson wrapped up the item, noting that the discussions had been detailed and constructive, and thanked Management for the clarifications provided. The consolidated financial statements were reviewed and would be presented to the 111th session of the Executive Board for endorsement for the Governing Council’s approval in February 2015.

**Review of the activities of the Office of Audit and Oversight (AUO) during 2013 and the adequacy of internal oversight mechanisms (including a closed session with the Director, AUO, if required)**

19. The Chairperson introduced the item and invited the Director, Office of Audit and Oversight (AUO) to present the report.

20. The Director, AUO, highlighted the key activities undertaken in 2013, and noted that critical areas relating to IFAD’s financial integrity and administrative effectiveness and efficiency, including support to Management reform efforts, had been covered. The Committee was informed that, overall, Management had taken action to address reported risks, thus demonstrating its strong commitment to respond to issues raised by AUO.

21. Audit reports in 2013 had generally revealed good adherence to corporate procedures in key functions.

22. The investigations section had experienced an increase in overall caseload in 2013 compared to 2012. With a fully staffed Investigations Section, AUO was generally able to conclude high-priority investigations within the targeted six months.

23. The Committee was informed that AUO had obtained additional financial resources through external support in order to complete its work and had been provided with an increased budget for 2014.

24. Members requested clarification on: the interaction between the work of AUO and the Independent Office of Evaluation of IFAD (IOE) in the review of IFAD country offices; the difference between Management “considerations” and “recommendations.” Information was requested on the audit of legal services and how legal opinion may sometimes be perceived to go beyond its remit, and on whether the issues emerging from the country office audit varied between offices.

25. The Director, AUO, stated that there would be continued focus on the audit of country offices. He confirmed that AUO collaborated with IOE not only in the country office context but also in audits with a similar or overlapping scope to IOE evaluations by sharing audit evidence and planning. The Committee was informed that although IOE had a different mandate, AUO was seeking further opportunities for cooperation.

26. In response to the comment on legal opinion, it was explained that in certain cases legal opinions went slightly beyond the legal domain in the way that their opinions were provided. This matter has been subsequently addressed and clarified with the Office of the General Counsel.
27. Management considerations differed from recommendations in that they were issued to flag matters requiring further review, but no specific implementation action was needed. Considerations did not have a formalized follow-up process.

28. The Chairperson closed the item, thanking AUO for the report and clarifications. **Revision of the IFAD approach to the cancellation of approved loans and grants**

29. The Chairperson introduced the item and reminded the Committee that in September 2013, the Board had requested Management to review IFAD’s treatment of cancelled project amounts through the Performance-Based Allocation System Working Group. The Audit Committee was requested to review the document and members of the working group attended the meeting.

30. Management presented the paper explaining that IFAD had undertaken a review of practices at three international financial institutions (IFIs). Management highlighted the practice at the International Development Association vis-à-vis reallocation of unutilized funds for cancelled loans. The current practice at IFAD was to incorporate all funds from cancelled loans back into internal resources. The majority of cancellations – 62 per cent – occurred at completion. At the other IFIs, the practice was to move funds into other projects subject to specific criteria in order to increase the potential number of beneficiaries reached, modify project scope or coverage, for example. Management stated that their recommendation to the Executive Board would be to adopt this approach subject to two considerations, namely: the management of internal resources and management of the programme portfolio. In this regard, any proposal by a country to transfer funds from one project to another would be examined on a case-by-case basis. The Committee was reminded that this practice would not be adopted for any cancellations made at loan closure. No funds cancelled at loan closure would be eligible for recommitment. These considerations should be taken into account and a review undertaken of the potential impact on the liquidity situation forecast under the sustainable cash flow approach. The existing guidelines for additional financing to expand or add components to existing projects would be the basis for the portfolio analysis.

31. Clarification was requested on how the policy on loan cancellations would impact the minimum liquidity threshold. One member requested assurance that this practice would not be used as an instrument to waive project preparation costs. In addition, clarification was sought on which stage in the project cycle the new practice would apply and to which cancelled loans; and whether it would be applicable to the entire 13 per cent of approved loan and grant amounts cancelled annually. Confirmation was sought that resources from cancelled loans on completion would not be available for reallocation and whether there would be a need to amend article 7 of the Agreement Establishing IFAD. The Committee wished to know if any follow-up mechanisms would be put in place.

32. Management clarified that funds related to loan closures would not be considered for reallocation. In addition, discussions would take place between the borrower and IFAD to ensure that every effort to improve the performance of the original project had been made before consideration of loan cancellation and reallocation. Another consideration would be cash flow sustainability. Management confirmed that the proposed approach would not be used to avoid project preparation costs. The overall objective was to improve project performance within the existing portfolio. Article 7 of the Agreement Establishing IFAD would not require amendment as all financing arrangements would be within the approved parameters and minor changes could be delegated to the President. The Board would be informed of any development to the contrary. The new practice was envisaged to be applicable to countries with large and mature portfolios. It would be used only as a last resort and would be subject to the existence of an alternative project within the country that could satisfactorily utilize additional financing.
33. The Chair closed the item, requesting that the document be clarified (see annex attached).

**IFAD After-Service Medical Coverage Scheme**

34. The Chairperson introduced the item and noted that the document provided an insight into the investment policy for IFAD's After-Service Medical Coverage Scheme (ASMCS).

35. Management presented the item, reminding the Committee that the ASMCS Trust Fund had been established to ensure that funds were set aside to provide medical benefits to staff after retirement, in compliance with accounting standards.

36. The related Governing Council resolution stipulates that IFAD will invest resources in line with IFAD's Investment Policy and that Trust Fund resources may not be invested in equities or similar instruments.

37. Until 2012, the Trust Fund's monies were managed internally through rolling time deposits. IFAD then developed a dedicated investment strategy in order to:
   (a) Reduce the probability of a resource gap between assets and liabilities; and
   (b) Minimize the size of any potential funding gap.

38. The investment strategy was finalized in mid-2012 and implemented within that year. The 2013 actuarial valuation revealed an over-funded position for the Trust Fund.

39. In 2013, Management approached the Audit Committee with the recommendation that an independent study be undertaken to review and validate the current investment strategy.

40. The outcome of this study suggested that the current asset allocation was close to optimal for the next 5-year period of expected market normalization. The study also suggested that, in the long term, the optimal portfolio should include equity (10 per cent) as well as emerging market debt local currency (EMD LC) (9 per cent). Neither of these asset classes was currently allowed in IFAD's investment universe.

41. Based on the outcome of the study and given the investment objectives, horizon and associated risk tolerance of IFAD's Investment Policy, a separate investment policy for the ASMCS should be developed to allow for a gradual build-up of the optimal portfolio. This policy would be presented first to the Audit Committee, subsequently to the Executive Board in December 2014 and to the Governing Council in February 2015.

42. Management further proposed that the Governing Council be requested to delegate the approval authority for this investment policy to the Executive Board in line with the delegation in place for the IFAD Investment Policy Statement. Future changes would thereby be approved by the Executive Board and relating implementing investment guidelines would be approved by the President.

43. Clarification was sought on the performance of the investment portfolio covering ASMCS assets; whether Management could invest IFAD regular resources in a long-term horizon portfolio considering liquidity was not a key consideration; and what the minimum return should be to maintain the portfolio at its current funding level.

44. Management confirmed that the performance for 2013 was at 4.24 per cent. The Committee was reminded of the nature of IFAD's Investment Policy which prioritized liquidity and safety, and return was sought only after the former two conditions are met.

45. In order to satisfy the liquidity requirement, IFAD regular resources portfolio needed to be invested mainly in shorter durations, whereas the ASMCS resources would not be used for a much longer time horizon. Management further informed the Committee of the two-tranche investment strategy implemented in the fourth quarter of 2013. The two-tranche strategy defined asset allocation on the basis of
duration and related liquidity needs and included a longer duration portfolio. In responding to the comment on the need for delegation of approval of the ASMCS investment policy by the Governing Council to the Executive Board, Management clarified that it would be more efficient to align the governance process for all investment policies. Management confirmed that the minimum discount rate to be met was set annually in line with the yearly actuarial valuation.

46. The document was endorsed for presentation to the Executive Board in April at the 111th session. Management was encouraged to begin development of the investment policy to be submitted to the Governing Council in February 2015.

Disclosure of Audit Committee documents

47. The Chairperson introduced the item, reminding the Committee that Management had been requested to survey practices at other IFIs with regard to the disclosure of Audit Committee documents and present a document for the consideration of the Audit Committee.

48. Clarification was sought as to whether internal audit reports were being considered for disclosure as this was the practice at some United Nations funds and programmes. Members appreciated the need to ensure transparency and the confirmation that IFAD was aligned with international best practice by providing Executive Board members with access to all Audit Committee documents.

49. Management reiterated that the Executive Board had access to all Audit Committee documents and 60 per cent of these were made available to the public.

50. The Director, AUO, clarified that AUO had conducted a survey on the practices at other organizations with regard to disclosure on internal audit reports. He confirmed that some United Nations funds and programmes disclose such reports; however almost all the specialized United Nations agencies and all IFIs choose not to disclose the reports.

51. The Chairperson wrapped up the discussion, stating that the corporate-level evaluation on IFAD’s institutional efficiency and the efficiency of IFAD’s operations had called on the Committee to review its disclosure policy and consider if there were room for greater openness. The Committee would report to the Executive Board that current practice was in line with international best practice and did not need to be changed.

Update on the development with respect to the financial implications of hosting the Global Mechanism of the United Nations Convention to Combat Desertification (UNCCD)

52. Management presented an oral update. The Committee was reminded of the decision of the Conference of Parties in September 2013 to relocate the Global Mechanism from IFAD in Rome to the UNCCD Secretariat in Bonn and establish a liaison office in Rome. Management highlighted the following developments:

- In April 2013, all the Global Mechanism (GM) staff were appointed as UNCCD staff in accordance with the United Nations Rules and Regulations.
- With regard to staff movements, the Committee was informed that most of the Professional staff would be relocated to Bonn with effect from 1 April, and that a separate liaison office would be established within FAO.
- On financial matters and costs, the Committee was reminded of the US$1.4 million transferred to the UNCCD bank account representing the balance of the funds in the GM account, less the funds that were held in an escrow account for potential liabilities.
- UNCCD had since informed IFAD of certain actions that could result in the reduction of these liabilities. Management had released about US$600,000 against evidence of the payment of a pending invoice.

53. The Committee was assured that Management would release the remaining funds on confirmation by the Administrative Tribunal of the International Labour
Organization of the withdrawal of cases by GM staff. Management further assured the Committee of the good relationship between IFAD and the UNCCD and that bilateral consultations were being held.

54. Members wished to know how long the transition would take, if updates to the Audit Committee would continue and how many staff would move to Bonn.

55. Management advised the Committee that all outstanding issues should have been resolved by the time of the next update to the Executive Board, in September 2014. Management further informed the Committee that two to three GM staff members would move to the liaison office and Professional staff would move to Bonn as required.

56. The item was closed with the understanding that further updates would be provided to the Executive Board in April and September.

Other business

Annual confirmation of contract extension for external auditors

57. Under this item, Management brought to the attention of the Committee the confirmation of the annual contract of the External Auditor for 2014-2015. It is to be recalled that the appointment of Deloitte & Touche was approved by the Executive Board for the period 2012-2016. The contract with Deloitte & Touche is confirmed on an annual basis subject to satisfactory performance. Management confirmed its satisfaction with the performance of Deloitte & Touche and noted that the only change was a cost-of-living adjustment which was foreseen in the contract. On the basis of the foregoing, and given that the change in the financial terms of the contract is not significant, the Audit Committee confirmed the contract of the External Auditor for 2014-2015.

Access to the verbatim transcripts of Audit Committee meetings

58. Management drew the Committee's attention to the IFAD Policy on the Disclosure of Documents which identifies verbatim transcripts as not eligible for disclosure in order to protect the integrity of deliberative processes and to encourage openness in exchanges.

59. Management further clarified that the verbatim transcripts are made available to staff who require access thereto in the execution of duties such as preparation of meeting minutes.

60. Reference was also made to the Rules of Procedure which stipulate that while verbatim transcripts are to be kept of meetings, the official records of governing body meetings are the minutes and/or summary records thereof. These latter documents are circulated to members for comment and final approval.

61. In conclusion, the Committee expressed its satisfaction with the current practice with regard to access to verbatim transcripts of the Audit Committee meetings, which may be made available upon request.

Organization of work on the general framework

62. The Chairperson raised the issue of the general borrowing framework to seek consensus on how to deal with informal Audit Committee meetings on this subject. The Committee was reminded of the cost and logistical implications of interpretation and document translation and that all informal meetings took place in English only.

63. One member commented that given the importance of the framework, it would be helpful to analyse documentation in their own language but would attend the meetings nonetheless.

64. The Committee agreed that the informal meetings would be conducted along the lines of other such meetings i.e. without translation. The Chairperson confirmed that the schedule of informal meetings would be distributed beforehand.
Revision of IFAD approach to use of cancellation of approved loans and/or grants

Clarification was requested on several issues raised during the Audit Committee with regard to revision of the IFAD approach to the cancellation of approved loans and/or grants.

1. Loan/grant cancellations that occur after the formal loan closing date (as specified in the relevant financing agreements) are excluded from the proposed approach to loan cancellation. This is the approach followed by IDA and African Development Bank. Similarly, loans or grants that were fully cancelled before any disbursements were made may not be considered for reallocation. The only cancellations eligible for consideration are those occurring during implementation and, as noted in paragraph 19 of the document (AC 2014/131/R.5), such cancellation must occur at least one year before loan closing. This currently accounts for 6.8 per cent of all cancellations.

2. Currently, 13 per cent of approved loan and grant amounts are cancelled annually, principally at the time of loan closure. These cancelled funds are returned in their entirety to IFAD accounts. These funds make a significant contribution to internal resources, and thereby provide an important source of financing for subsequent programmes of loans and grants. Therefore, the assumption of a 13 per cent annual cancellation rate has been included in the IFAD financial model as a key modelling parameter. While the current number of loan cancellations occurring during implementation is relatively low, it still forms a small part (6.8 per cent) of the total cancellations included in the financial model. Therefore, it would be regarded as financially prudent to examine, on a case-by-case basis, any proposal for loan cancellation and reallocation, to ascertain if there are implications for the sustainable cash flow model.

3. As is the case at the IDA and AfDB, the practice of a partial loan cancellation would only take place during implementation, in the context of improving country portfolio performance. Projects whose loan was reduced would have the amortization schedule revised (therefore reducing future repayments of loan principal) while projects receiving additional funds would have their amortization schedule adjusted to repay increased amounts. The financing agreement of the respective projects would be amended, as per normal practice, and the borrower informed. If there were changes in project scope or coverage, the financing agreement would be amended per normal procedures. If the changes could alter the project description and financing significantly with respect to that previously approved by the Executive Board, then, as per existing procedures, the Board would be asked to reapprove the project.

4. No additional charges for project preparation would be introduced, and any additional costs would be met by the existing budget for loan and grant administration.