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Investing in rural people

Report of the Chairperson on the 135th meeting of the Audit Committee

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Executive Board — 114th Session
Rome, 22-23 April 2015

For: Review

Report of the Chairperson on the 135th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 135th meeting of the Committee held on 7 April 2015.

Adoption of the agenda

2. The agenda was adopted with no changes.
3. The Chairperson of the Audit Committee advised that due to an apparent conflict of interest he wished to recuse himself from deliberations on items 4 and 7. Mr Erik Jonsson of Sweden took the chair for consideration of these items.

Minutes of the 134th meeting of the Audit Committee

4. The minutes were approved without comments.
Review of the consolidated financial statements of IFAD as at 31 December 2014, including an external independent attestation of the Management assertion report on internal controls over financial reporting (including a closed session with the external auditor, if required)
5. Management introduced this agenda item by identifying key factors affecting IFAD's financial position and reported results.
6. During 2014, there had been a turnaround in investment income from negative US\$17 million in 2013 to positive US\$57 million in 2014. The positive investment performance of IFAD's portfolio was mainly driven by the appetite for safe investments and the decrease in government bond and corporate yields.
7. During the latter half of 2014, there was a significant increase in the value of the United States dollar versus most other currencies, but in particular against the euro and the yen. As the majority of IFAD's assets are denominated in special drawing rights (SDR), or matched to SDR liabilities, the strengthening dollar led to a significant negative translation effect when expressing IFAD's SDR assets in United States dollars for reporting purposes. This resulted in a US\$425 million unrealized exchange loss reflected in the 2014 reported accounts. It was clarified that this book or "paper" loss did not materially impact on IFAD's operations or financial viability. The remaining US\$270 million operational loss shown in the accounts was primarily a result of Debt Sustainability Framework (DSF) and grant expenditures of US\$210 million being reflected as costs, whereas IFAD's income from Members' contributions is taken directly to equity in the balance sheet in line with generally accepted accounting principles.
8. On the operations side, in 2014, new loan and grant commitments remained stable while loan and grant disbursements increased from US\$670 million in 2013 to approximately US\$700 million in 2014 and loan repayments increased from US\$261 million to US\$271 million in 2014.
9. In 2014, IFAD implemented a change in accounting policy for qualified instruments of contributions in order to be more closely aligned with International Financial Reporting Standards and to reflect best practice as demonstrated by other international financial institutions such as the International Development Association and the European Bank for Reconstruction and Development.
10. IFAD Management confirmed the operational effectiveness of all key internal controls over financial reporting in the Management assertion report, with an independent external attestation by our external auditors. The external auditor's clean, unqualified opinion on the financial statements, together with the independent attestation report on internal controls over financial reporting had been issued and posted before this meeting.

11. Management was requested to explain the implications of the negative retained earnings on IFAD's financial sustainability, as shown by the current trend, and to clarify whether the SDR could continue to be IFAD's main denomination currency for its operations. Members requested clarification as to why the DSF continued to be treated as expenditure and not as a receivable even after the approval of the compensation for forgone principal reflows.
12. While reassuring the Committee that it was ready to further analyse the issue of the denomination currency, Management clarified that the accounting losses derived from two main components: currency translation effects and IFAD business model.
13. Material fluctuations in the SDR/US\$ exchange rate had always generated significant currency movements with repercussions for IFAD accounts, given that the vast majority of IFAD assets were denominated in or aligned to the SDR basket but reported in United States dollars. This has not affected – and would continue not to affect – IFAD's overall financial stability.
14. The underlying business model and the accounting procedures showed a trend with a future yearly loss in the range of US\$300 million. Consistent with business models and results of comparable institutions such as the International Development Association, IFAD's retained earnings would continue to be negative, all other factors remaining stable. IFAD's equity, however, would not be affected by negative retained earnings as long as changes in the replenishment level were reflected in changes in the level of the programme of loans and grants.
15. Management also clarified that the accounting treatment of the DSF was aligned with best practice at other international financial institutions (IFIs) and the effect on profit and loss accounts was similar to that recorded by other institutions.
16. The Chairperson summarized the item, noting that the discussions had been detailed and constructive. The consolidated financial statements were deemed reviewed and would be presented to the 114th session of the Executive Board for endorsement for the Governing Council's approval in February 2016.

Sovereign Borrowing Framework: Borrowing from Sovereign States and State-Supported Institutions

17. Management introduced this topic, clarifying that the IFAD borrowing framework had been developed over eight informal meetings. The document referred only to borrowing from sovereign states and state-supported institutions. It did not address borrowing from financial markets, as clarified in the preamble. The document had also benefitted from comments made by members at the first and second informal Executive Board seminars held on 11 December 2014 and 19 March 2015. During the second informal seminar, a number of Board members had made comments and raised questions on the draft document. In order to address some of these comments and questions regarding the importance of considering reputational, environmental and social risks in the framework, an addendum had been prepared by IFAD Management.
18. Some Member States expressed their preference for the deletion of all references to market borrowing from the document, specifically from the preamble, while some other Member States preferred to leave the document unchanged.
19. It was finally agreed that the two paragraphs of the preamble would be incorporated, without changes, into the main body of the document and that the preamble would be eliminated.
20. The Chairperson wrapped up the item noting that the Audit Committee had reviewed the document and that the revised version including an addendum would be submitted to the Executive Board at its 114th session for approval.

Annual Report on the Activities of the Office of Audit and Oversight during 2014 (including a closed session with the Director, Office of Audit and Oversight, if required)

21. The Office of Audit and Oversight (AUO) presented the report, highlighting that the purpose of the document was to provide details about AUO's activities in 2014. The document included a substantial summary of each audit report issued in 2014 and gave detailed information on the open recommendations. It also provided information on investigation activities.
22. In particular, it was noted that all audits on financial controls and the integrity of financial reporting had been rated by AUO as "generally satisfactory", which provided assurance of adequate compliance with rules and controls. In 2014, the three Rome-based agencies undertook for the first time a joint internal audit. In line with best practice standards applied in the United Nations system and by IFIs, the IFAD investigation and sanction processes were reviewed by an external team of experts. The report was issued in early 2015 with the general conclusion that IFAD's existing investigations/sanctions framework was adequate. The review included valuable recommendations to ensure that IFAD's practices remain aligned with best practices in the United Nations system and by IFIs. An action plan covering all recommendations had been formulated and endorsed by the President this week. The plan would be presented to the Committee at its September meeting.
23. Audit Committee members expressed appreciation for the progress made in implementing internal audit recommendations and activities, while requesting that the report be, in the future, more detailed in terms of the content, findings and recommendations of the main audit assignments, as the latter often provided useful insights regarding the efficiency and the effectiveness of the control system and related IFAD policies. This suggestion was taken on board by AUO.
24. In connection with the above, members also asked for direct access to internal audit reports. AUO reminded members that they could already access internal audit reports on request. AUO further stated that it would return to the Audit Committee with a practical solution that would allow members to access reports in a timely manner while ensuring confidentiality and compliance with the AUO charter and the terms of reference of the Audit Committee.
25. The report was deemed reviewed.

Annual confirmation of the contract for the external auditor

26. Under this item, Management brought to the attention of the Committee the confirmation of the annual contract of the external auditor for 2015-2016. Management noted that the appointment of Deloitte & Touche had been approved by the Executive Board for the period 2012-2016 and that the contract was confirmed on an annual basis, subject to satisfactory performance. Management confirmed its satisfaction with the performance of Deloitte & Touche and informed the Committee that the only change in the terms 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 was not significant, the Audit Committee confirmed the contract of the external auditor for 2015.

Standard financial reports presented to the Executive Board

27. Management presented six reports for the Audit Committee's review:
 - Report on the status of contributions to the Ninth Replenishment of IFAD's Resources
 - Report on the status of contributions to the Tenth Replenishment of IFAD's Resources
 - Report on IFAD's investment portfolio for 2014

- Status report on arrears in principal, interest and service charge payments
 - Estimated principal and net service charge payments forgone as a result of the implementation of the Debt Sustainability Framework
 - Requirements for the thirty-sixth drawdown of Member States' contributions in 2015.
28. Management provided an update on the status of the Ninth and Tenth Replenishments of IFAD's Resources (IFAD9 and IFAD10) and on the investment portfolio performance. In particular the Controller highlighted that IFAD9 payments had increased to US\$1.3 billion representing 91 per cent of pledges. IFAD10 pledges remained stable at US\$1.02 billion, corresponding to 71 per cent of the target.
29. The Treasurer informed the Audit Committee about the positive performance of the investment portfolio during the first quarter of 2015, in the region of 90 basis points. While congratulating staff on the excellent performance, the Chairperson noted some lengthening of the average duration of IFAD's portfolio, including cash, and enquired as to its drivers – i.e. whether it was strategy-motivated or driven by disbursement needs. Information was also requested on current and expected developments. In his response, the Treasurer pointed to disbursement needs as the main driver. He also updated Audit Committee members on the latest portfolio developments. On a related note, the Chairperson remarked that the current limits of the investment policy constrained the ability of Management to optimize portfolio management and hedge against interest rate risk. In this regard, the Treasurer informed the Audit Committee that a review was ongoing to assess the possible need for further portfolio optimization. The results of the process would be shared with the Committee later in the year.
30. The reports were reviewed with no further comments.
- Update on developments with respect to the financial implications of hosting the Global Mechanism of the United Nations Convention to Combat Desertification (UNCCD)
31. The Audit Committee took note of the oral update provided by the Associate Vice-President, Corporate Services Department on the hosting of the Global Mechanism of the UNCCD. The Committee was also informed that the matter would be presented to the forthcoming session of the Executive Board in April 2015.
- Other business
32. No items were discussed under this agenda item.