Report of the Chairperson on the 136th 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

Allegra Saitto
Manager, Accounting and Financial Reporting
Controller’s and Financial Services Division
Tel.: +39 06 5459 2405
e-mail: a.saitto@ifad.org

Dispatch of documentation:

Alessandra Zusi Bergés
Officer-in-Charge
Governing Bodies Office
Tel.: +39 06 5459 2092
e-mail: gb_office@ifad.org

For: Review
Report of the Chairperson on the 136th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 136th meeting of the Committee held on 2 July 2015.

Election of the Chairperson of the Audit Committee

2. Subsequent to the appointment of the Audit Committee members in April 2015, and in accordance with rule 11.1 of the Rules of Procedures of the Executive Board, Audit Committee members proceeded with the election of their Chairperson, and elected Italy from List A unanimously as Chairperson of the Audit Committee.

Adoption of the agenda

3. The agenda was adopted. It was noted that under other business the Office of Secretary would provide an update on the disclosure of internal audit reports.

4. Prior to proceeding with the meeting, the Vice-President of IFAD took the floor to inform the Committee of the resignation of Mr Iain Kellet, with effect from 1 June 2015. The Vice-President went on to acknowledge the work done by Mr Kellet as IFAD’s first Chief Financial Officer. The Committee was informed that the Vice-President would act as officer-in-charge of the Financial Operations Department during the recruitment process for a new Chief Financial Officer, which was already under way.

Minutes of the 135th meeting of the Audit Committee

5. The minutes were approved without comments.

External auditor's report on internal control and accounting procedures

6. The external auditors, Deloitte, presented the internal control and accounting procedures report, stating that the recommendations included had arisen during the course of the audit for the year ended 31 December 2014. None of the recommendations had given rise to a qualification of either their audit opinion on the consolidated financial statements or Management's assertion over the effectiveness of internal controls over financial reporting.

7. Arising from the 2014 audit, one issue of medium priority had been identified in relation to the Treasury Services Division and in particular to the establishment of an impairment policy for investment portfolio assets held at amortized cost. Another observation, of low priority, referred to improvements with regard to the completeness and accuracy of internal information produced by the Fund. For both observations it was noted that Management was taking a proactive approach with the intention of closing these recommendations during the course of the audit on the 2015 accounts.

8. During the audit, improvements were noted in the follow up on the prior year’s recommendations. In particular, the Controller’s and Financial Services Division had implemented a new tool to conduct fair value measurement of IFAD’s loan portfolio and the Information and Communications Technology Division (ICT) had introduced adequate procedures to ensure segregation of environments for development and production.

External Auditor’s audit strategy memorandum for the year ending 31 December 2015

9. In presenting the strategy memorandum, the audit partner thanked Management for the assistance and cooperation provided during the planning exercise. He informed the Committee that four key audit risks had been identified for the audit on the 2015 accounts: fair value calculation on loans, foreign currency translation, revenue recognition and – as a matter of standard procedure – Management override with a focus on Management judgement or estimation.
10. During the meeting some members requested clarification on the methodology in preparing the audit strategy, the adoption of special drawing rights (SDR) as a denomination currency, preliminary estimates on foreign exchange impact and fair value assumptions.

11. The external auditors explained that the audit strategy was risk-based and involved a yearly review of the internal control procedures with a consequent assessment of all financial risks. The Committee was also informed that, based on current exchange rate movements, last year’s trends were continuing. The external auditors provided information about the definition of functional currency and denomination currency. The auditors explained that based on International Financial Reporting Standards (IFRS) a functional currency should be an official currency in which transactions could be made; they also stated that the possibility of changing denomination currency should be analysed by Management as appropriate. The auditors highlighted that their regular audit activities included a review the accuracy of investment portfolio information.

12. Management reassured the Committee that the Fund was already equipped to manage loans denominated in several currencies thanks to the implementation of Flexcube as the corporate loans and grants management system. Furthermore, Management informed the Committee that it was already studying the legal and operational implications associated with any change in denomination currency. It was noted that considering the number of financing agreements already denominated in SDR, a change in denomination currency could generate high transaction costs and raise a number of other significant issues.

13. The external auditor’s report and the audit strategy memorandum for the year ending 31 December 2015 were deemed reviewed.

Review of the methodological framework for determining inflation and exchange rates with respect to IFAD’s administrative budget

14. The Director, Budget and Organizational Development Unit, introduced the document, highlighting that the main purpose of the document was to address a specific request made at the 134th Audit Committee meeting held in November 2014.

15. The methodology proposed for the EUR:US$ exchange rate assumption was based on a 12-month historical average using the United Nations monthly exchange rate for computing salaries and post-adjustments. The Director and Treasurer, Treasury Services Division, elaborated on current underlying market and exchange rate dynamics that supported the use of an historical average approach.

16. With regard to price and inflation factors, the adoption of a methodology that was more reflective of actual price increase in specific line items was proposed. Specifically: staff costs would take account of any International Civil Service Commission structural increases and reflect the annual United Nations built-in salary adjustment (the within-grade step increment). Consultant costs would reflect the average fee increase for consultants based on contracts issued. Travel costs would be based on industry-wide increases in ticket and hotel costs. With respect to headquarters’ administrative and facility costs, the Italian rate of inflation would be applied, based on data provided by the Italian National Institute of Statistics (ISTAT). Contracts containing specific price escalation clauses (very common in ITC service contracts) would be adjusted accordingly. All other costs would have a price factor applied based on a weighted average of the Italian and world Consumer Price Index.

17. Some Member States requested clarification about the period to be considered as the basis of the foreign exchange rate average and on the granularity of the inflation assumptions. Management clarified that both methodologies were aligned with best practice at other international financial institutions, and were accurate
and tailored to IFAD's size. The Chairperson noted the granularity of the inflation methodology and pointed out the possible endogeneity of some of the proposed price indexes (e.g., consultant costs and contracts with price escalation clauses). It was also suggested that transparent reporting in budget documents be adopted starting from the next September preview, in order to monitor these two variables and their impact on budget implementation.

18. The document was deemed reviewed. The methodology was broadly supported by the Audit Committee and would be used for the preparation of the 2016 annual budget.

**Standard financial reports presented to the Executive Board**

19. Management presented the Report on IFAD’s investment portfolio for the first quarter of 2015, for the Audit Committee's review.

20. The Treasurer introduced the document. He highlighted that during the first quarter the portfolio had performed positively with a net rate of return of 0.91 per cent, equivalent to US$13.3 million and that all risk parameters remained within the budget levels as stated in IFAD’s Investment Policy Statement. He also informed the Committee that due to difficult market conditions and sovereign bond yield increases, the performance of the second quarter of 2015 was expected to negatively affect the year-to-date performance as at June 2015.

21. Some members requested additional information on the newly established asset and liability portfolio. The Director and Treasurer clarified that this portfolio was set up to manage KFW Development Bank funds and, in light of the different nature of this funding source, the portfolio was currently managed internally by investing in high-quality assets and with a strong focus on future debt repayment and loan disbursement needs.

22. The report was reviewed without further comment.

**Other business**

23. The Secretary of IFAD introduced a development that responded to a request by the Committee to have more direct access to internal audit reports.

24. A new disclosure procedure would be implemented starting from the Audit Committee meeting in September. Under the new procedure a list of recent internal audit reports would be made available through a fit-for-purpose document to be posted on the Member States Interactive Platform in conjunction with the dispatch of the agenda for each Audit Committee meeting (i.e. six weeks before each meeting). The document would be restricted and accessible to Audit Committee members only. Audit Committee members could request access to any report listed and, respecting privacy, legal, confidentiality, sensitivity and security requirements, the Office of the Secretary would proceed with posting the report on the restricted Audit Committee website.

25. The Director, Office of Audit and Oversight, also clarified that, as per the current provisions, the Audit Committee Chairperson could decide to include any report on the agenda for further discussion by the Committee.

26. Members had no comments on the item, and the proposal was therefore deemed reviewed.

27. Also under other business, the Audit Committee Chairperson requested clarification on the revision to IFAD’s lending terms. He noted that IFAD’s spread on its ordinary-term loans, due to the reference to the lending terms of the International Bank for Reconstruction and Development, was linked to the cost of borrowing of the latter, thus exposing IFAD’s current Libor-linked liabilities and its future liabilities under the sovereign borrowing framework to unnecessary base risk. The Audit Committee Chairperson specified that switching to Libor as the reference rate for pricing would not entail a structural increase in the ordinary terms of IFAD loans.
and would instead help ensure better hedging against interest rate and base risks. He therefore urged Management to provide the Audit Committee with further explanation on this issue, with a view to illustrating to members the nature of the problem and possible corrective measures. One member highlighted that the sovereign borrowing framework was approved under the assumption that lending terms were not subject to revision, at least in the short term. It was agreed that this matter would be discussed in the near future in the context of the scheduled review of IFAD lending terms.

28. No additional items were discussed under other business.