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Investing in rural people

Report of the Chairperson on the 145th meeting of the Audit Committee

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Executive Board — 121st Session
Rome, 13-14 September 2017

For: Review

Report of the Chairperson on the 145th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 145th meeting of the Committee held on 6 September 2017.

Adoption of the agenda

2. The agenda was adopted without inclusion of the review of internal audit reports under other business, as no request was received from members.

Minutes of the 144th meeting of the Audit Committee

3. The minutes of the meeting and of the closed session were approved with no comments.

High-level preview of IFAD's 2018 results-based programme of work and regular and capital budgets, and the preview of the Independent Office of Evaluation of IFAD's results-based work programme and budget for 2018 and indicative plan for 2019-2020

4. The budget proposal incorporated recurrent costs of the main elements of the programme of work, and regular and capital budgets of IFAD. The document also presented the preview of the Independent Office of Evaluation of IFAD's results-based work programme and budget for 2018 and indicative plan for 2019-2020.
5. Management presented the preview document, noting that the 2018 budget is pivotal in the context of delivery under the Eleventh Replenishment of IFAD's Resources (IFAD11). It also highlighted that assumptions and costs would be reviewed as part of the normal budgeting exercise prior to finalization.
6. Management highlighted that: for 2017, the projected IFAD programme of loans and grants (PoLG) remained at US\$1.50 billion, and for 2018, the PoLG was planned at US\$877 million; the 2018 regular budget had been proposed at US\$157.82 million compared with an approved budget of US\$149.42 million in 2017. This represented a 5.6 per cent nominal increase, comprised of a real increase of 4.6 per cent and a price increase of 1.0 per cent. The 2018 capital budget is limited to US\$2.5 million. The budget includes a combined capital and one-time budget for the Operational Excellence for Results (OpEx) exercise of US\$10 million-US\$12 million.
7. The Independent Office of Evaluation of IFAD (IOE) introduced its programme of work and budget for 2018, highlighting that it would conduct a new corporate-level evaluation of IFAD's contribution to pro-poor value-chain development. IOE will also conduct five new country strategy and programme evaluations. During 2018-2019 IFAD's evaluation function will be externally peer reviewed. The proposed IOE budget for 2018 is US\$5.91 million, which is 0.6 per cent of IFAD's expected PoLG for next year – well below the IOE budget cap of 0.9 per cent adopted by the Executive Board.
8. Committee members expressed appreciation for the first budget document based on the pillar-linked outputs approach, but highlighted that in the next version of the document more detailed quantification of the budget, more clarity and better rationale for some key expenditures are expected. Some members highlighted their uneasiness with the budget increase, and Management was encouraged to seek all possible actions to pursue cost efficiency and cost mitigation, also with reference to the anticipated expansion of decentralization and the OpEx exercise. The OpEx exercise presentation was appreciated, but given that it is still in the definition phase further details were requested. Members also noted that to a certain extent the budget presupposed the outcomes of the IFAD11 Consultation,

and therefore requested clarification on risks that could materialize if not all the anticipated scenarios came into effect.

9. Management clarified that the budget increase in real terms is related to the improvement and accelerated implementation of the decentralization plan, mainly due to IFAD's efforts towards achieving its institutional priorities and Sustainable Development Goals. In relation to OpEx, it was clarified that the purpose of the exercise is to position IFAD as an internationally recognized best-in-class performer and partner of choice across the spectrum of operations. The OpEx exercise has been divided into phases (project identification, design and implementation). The process will be fully participatory, and all internal and external stakeholders will be consulted. During the design phase, concrete actions will be defined in the form of specific deliverables to address issues and, finally, actions will be implemented. Emerging findings are consistent with IFAD11 replenishment priorities. Management also clarified that achieving a higher PoLG was only one of several cost drivers.
10. Members welcomed the information provided, looked forward to receiving more details, including on the estimated budget, and asked that Management regularly update the Committee on the progress of the OpEx exercise.
11. The budget preview document was considered reviewed.
Progress report on the workplan for IFAD's Office of Audit and Oversight for 2017
12. The Committee was provided with a summary of Office of Audit and Oversight (AUO) activities for the first six months of 2017. Field presence and decentralization remain the main audit priority. Management continues to place high importance on the implementation of audit recommendations. In the area of investigations, the intake rate of allegations remained high, cases were varied and not indicative of trends; some cases were brought to the attention of the Sanctions Committee. It was noted that AUO had requested and obtained additional financial resources to cover its human resource needs. AUO informed the Committee that an internal auditor had resigned and that AUO was taking steps to expedite the recruitment of a replacement to minimize any disruption in the delivery of planned outputs for 2017.
13. Committee members commended the good work done in implementing the programme of work and noted that the areas IFAD is seeking to address via OpEx were aligned with issues that had been continually flagged to Management by the AUO team as part of its audit work. The Committee requested details on the adequacy of resources in the light of decentralization, and AUO commented that Management had supported strengthening the staffing capacity of AUO in 2018. Management confirmed its commitment to provide AUO with adequate resources.
14. The progress report was considered reviewed.
Approach paper for revision of the IFAD Guidelines on Project Audits
15. Management presented the proposed revision to the current IFAD Guidelines on Project Audits, first issued in 2003 and subsequently reviewed in 2011. The proposed revision considers the numerous developments in international auditing and reporting standards. It embeds lessons learned since 2011, harmonization with other multilateral development banks and corporate changes at IFAD.
16. The proposed document is principles-based to create a flexible mechanism to address evolving auditing and reporting practices. The goal is to present the conceptual framework at the next Audit Committee meeting in order to seek final Executive Board approval in December 2017. It will be progressively implemented during 2018. The conceptual framework to be approved by the Executive Board will replace the current IFAD Guidelines on Project Audits. Instead, an operational Handbook on Financial Reporting and Auditing of IFAD-Financed Projects for

borrowers and recipients will be issued concurrently by Management to provide detailed guidance on required standards and a discussion of financial reporting and auditing.

17. The Committee commented on the positive work on this topic and requested some technical clarifications. These were provided to the Committee's satisfaction. The document was considered reviewed.

Second Review of IFAD's Sovereign Borrowing Framework for Borrowing from Sovereign States and State-Supported Institutions

18. Management presented the second review of the Sovereign Borrowing Framework (SBF), noting that the first agreement signed under this framework is the one concluded with Agence Française de Développement.
19. No changes are proposed to the current framework, as a new comprehensive framework related to all forms of borrowed funds will be developed soon.
20. It was also noted that entering into cross-currency swaps will expand the possibility of additional SBF agreements. Members pointed out some inconsistency between the favourable assessment of the SBF and the potential challenges that the instrument itself nevertheless poses.
21. In response to questions from Committee members, Management clarified that the SBF would continue as a valid tool to contribute to IFAD's funding in the future even after the possible implementation of Concessional Partner Loans and borrowing from capital markets.
22. The document was considered reviewed.

Review of the adequacy of the level of the General Reserve

23. Management presented the agenda item, noting that the General Reserve had been established by the Governing Council in 1980 to address four specific risks of overcommitment of IFAD's resources. Over the years, several transfers had been approved by the Executive Board, bringing the General Reserve up to its current level of US\$95 million. It was noted that strategies and mechanisms adopted over the years to mitigate overcommitment risks had strengthened the financial framework in which IFAD operates, in line with IFAD's evolving business practice.
24. It was noted that, since the introduction of the long-term sustainable cash flow approach as a mechanism to define IFAD's commitment capacity, the relevance of the General Reserve for this element had decreased. Since IFAD9, risks of overcommitment of IFAD's resources have been mitigated by ensuring availability of sufficient liquidity to meet overall disbursement needs.
25. Management also pointed out that the current document was prepared subsequent to the 2016 review of the adequacy of the General Reserve, with the result being to broaden the purpose of the General Reserve to consider it a flexible mechanism to mitigate financial risk, including emerging risks due to borrowing activities.
26. The document was considered reviewed and the recommendation was endorsed for the Board's approval at its 121st session.

Increasing Transparency for Greater Accountability

27. Management presented the agenda item, noting its commitment to improving availability, relevance, accessibility and timeliness of information to IFAD's stakeholders. The document provides an overview of IFAD's current policies and explores potential ways to ensure that the right information is provided at the right time to stakeholders. The actions listed in the paper were identified and proposed by Management after an initial assessment of peer practices, risks, resource implications and potential actions. Based on the resulting feedback, actions will be prioritized and developed further, and a final paper will be submitted to the Executive Board in December 2017. That paper will: provide an update on actions

taken by Management; present final proposals requiring approval by the Board; and, if necessary, propose revisions to relevant IFAD policies.

28. The Committee commended Management for presenting this document and expressed appreciation for the proposals on enhancing transparency. Members suggested exploring beyond the proposals in certain areas. In relation to public disclosure, the suggestion was that IFAD seek the opportunity to align its practices with those already in use by other international financial institutions (IFIs), such as the publication of the human resources policy, lending terms, classification of borrowers and the whistle-blower protection policy. It was further suggested that additional information be provided to the Audit Committee (fully respecting confidentiality) specifically about procedures that might have been circumvented or controls that might have been overridden in cases detected and analysed in the course of investigations or in cases brought to the Sanctions' Committee. Management responded that these suggestions would be considered favourably in developing further actions. The Committee also commented that its position on the access of Board representatives to confidential Audit Committee documents was one of disclosure. At the same time, the Committee clarified that it hoped that such a sensitive issue, given its implications in many areas, would be the subject of a debate at the Executive Board, as the Board was entitled to make the decision. Finally, the Committee suggested that Management consider the possibility of making certain types of information easier to manage by summarizing these in a single document. The Audit Committee referred in particular to the possibility of supplying the Board with a risk dashboard, a widely used instrument that allows several types of common organizational risks and their control methods to be easily viewed. Finally, the importance of enhancing transparency in operational matters was also underlined, including through beneficiary feedback.
29. The document was considered reviewed.
- Update on the implementation of the impairment section of International Financial Reporting Standard (IFRS) 9: Financial Instruments
30. Management presented an update on the status of implementation of IFRS 9. It was noted that the standard consists of three sections:
- (i) The section on classification and measurement, which required IFAD to classify financial assets based on their contractual cash flow characteristics and within IFAD's underlying business model, has been successfully adopted by IFAD and no further work remains on this section.
 - (ii) The section on hedge accounting, under International Accounting Standard (IAS) 39, was often criticized as complex and rules-based, and thus not reflecting the entity's risk management activities. Under IFRS 9, hedge accounting is principles-based and reflects the effect of an entity's risk management activities in the financial statements. However, it is still a highly complex standard to implement. This accounting principle is not yet mandatory, but it will be beneficial when IFAD begins entering into derivatives.
 - (iii) The section on impairment is mandatory for 2018. "Impairment" represents a significant deterioration of creditworthiness of borrowers or issuers of financial instruments. IFRS 9 was designed in response to the 2008 financial crisis. It represents an evolution from the rationale embedded in IAS 39, which was known as an "incurred loss" model, based on recognizing the deterioration of creditworthiness in an entity's books on evidence of a triggering event. Under IFRS 9, the impairment model is forward-looking, and impairment is based on the expected credit losses (ECLs) of financial instruments (such as loans) throughout their life cycle. This requires an entity to assess the probability of default at origination or purchase of the financial

instrument or loan and thereafter until the end of the maturity period of the underlying financial instrument.

31. The ECL valuation should be updated and monitored continuously, so as to reflect changes and the evolution of the credit risk of the financial instruments or loans.
32. The challenge for IFAD would be to create an internal rating system by borrower over a long time horizon, given the term or length of IFAD loans. It was noted that implementation of IFRS 9 is a challenge for the entire financial industry. Management noted the numerous steps taken towards full implementation of this standard, including benchmarking other IFIs, as well working with a consultancy firm to tailor the approach to IFAD's business model.
33. The update was considered noted.

Enterprise Risk Management at IFAD

34. Management presented the agenda item, noting the comprehensive approach adopted by IFAD in addressing risks. The Enterprise Risk Management Committee was established in 2008 and the related IFAD Policy on Enterprise Risk Management was endorsed by the Executive Board in the same year. The policy is embedded throughout management and decision-making processes at all levels. In the context of IFAD10, 18 enterprise risks have been identified and mapped to key areas (strategic, financial and operational). They are addressed through a dedicated, decentralized management system. In addition, a corporate risk register is used to identify, assess and manage IFAD's top 10 corporate risks. The register is assessed at least every three years in the light of replenishment outcomes and preparation of the medium-term plan. It was noted that the United Nations Joint Inspection Unit and AUO reviewed IFAD's enterprise risk management framework. Managing risk is a joint responsibility of Management and the Executive Board.
 35. Committee members commended the presentation and requested clarification on risk appetite and inclusion of risks related to OpEx activities. Management provided the clarifications, confirming its commitment to collaborate further with the Audit Committee on this topic.
 36. The presentation was considered noted.
- Standard financial reports presented to the Executive Board
37. Management presented the Report on IFAD's investment portfolio for the second quarter of 2017 for the Committee's review.
 38. The Treasurer updated the Committee on the latest portfolio developments, highlighting the positive performance of 1.75 basis points as at 28 August 2017. It was also noted that all risk parameters remained below the budget level defined in IFAD's Investment Policy Statement.
 39. The report was deemed reviewed.
- Other business
40. No items were discussed under other business.