Report of the Chairperson on the 149<sup>th</sup> Meeting of the Audit Committee

Note to Executive Board representatives

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Executive Board — 124<sup>th</sup> Session
Rome, 11-13 September 2018

For: Review
Report of the Chairperson on the 149th meeting of the Audit Committee

Executive summary

1. The Audit Committee elected Italy as Chair of the Audit Committee until the end of April 2021.

2. Various items related to the external auditor’s services were satisfactorily addressed, including the request for an increase in fees. The Committee reviewed the standard reports and memorandum; in addition, it requested the external auditor to prepare a note on International Financial Reporting Standard 9, focusing in particular on information and data quality and on credit risk, to complement the update provided by Management on this topic.

3. It was agreed that the paper on the harmonization of financing terms would be reviewed in September by the Audit Committee and the Executive Board in order to allow for additional clarifications on a number of issues to be included in the proposal. The suggestion of an informal seminar for the Board on the matter was appreciated.

4. It was also agreed that the non-concessional borrowing (NCB) policy would be reviewed at the Audit Committee meeting in November for endorsement, in order to take advantage of the forthcoming NCB policy system-wide review by the World Bank, prior to its approval by the Executive Board in December and approval of an amendment to the Policies and Criteria for IFAD Financing by the Governing Council in February 2019.

5. The Committee examined all the documents included on the agenda. A comprehensive summary of the deliberations held during the meeting is contained in the sections below.
Report of the Chairperson on the 149th meeting of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the matters examined at the 149th meeting of the Committee, held on 29 June 2018.

   Election of the Chairperson of the Audit Committee

2. Subsequent to the appointment of the Audit Committee members in April 2018, and in accordance with rule 11.1 of the Rules of Procedure of the Executive Board, Audit Committee members proceeded with the election of the Chairperson for the period ending in April 2021. Italy, from List A, was unanimously elected as Chair of the Audit Committee.

   Adoption of the agenda

3. The agenda was adopted, with the inclusion of the following topics under “other business”:
   - Update on the selection of the independent evaluator for the risk assessment;
   - Update on Management’s follow-up to recommendations arising from Audit Committee meetings;
   - Instruments to facilitate the Board’s guidance and governance of progress in implementation of Management commitments.

4. The Chairperson informed members that the Chair of the Working Group on the Transition Framework (TFWG) had proposed holding a joint meeting with the Audit Committee on 8 October 2018 to allow for discussion of items relevant to both subsidiary bodies. This would provide the opportunity to enhance dialogue and decision-making on matters directly related to IFAD’s financial sustainability. Members agreed to the proposal and requested a status update from the Chair after the third meeting of the TFWG scheduled on 23 July 2018.

   Minutes of the 148th Meeting of the Audit Committee

5. The minutes were approved without comments.

   Review of the fee related to the contract with the external auditor

6. Management introduced the agenda item, noting the external auditor’s request for fiscal year 2018 for a fee increase of 12 per cent and for fiscal years 2019 to 2021 an increase of 8.3 per cent. The requested fees included a cost-of-living adjustment for fiscal year 2018, one-off additional auditing activities to be performed during 2018 in support of the adoption of International Financial Reporting Standard (IFRS) 9 and recurring additional annual audit activities from 2019 to 2021.

7. The Committee was also informed that IFAD Management had reviewed the request and found it to be reasonable, based on the comprehensive technical justification provided by Deloitte & Touche. It was also noted that the complexity of the accounting standard required a significant investment by Management. Moody’s Analytics had been hired to support implementation of the standard and additional audit activities to assess assumptions and calculations of estimated expected credit losses related to IFAD’s financial statements.

8. Management indicated that at the time of tendering in 2016 the extent of additional effort required to implement IFRS 9 could not have been foreseen. In addition, all bidders had been requested to provide a fee quotation for the audit of fiscal year 2017 only, which would not have included costs relating to the implementation of IFRS 9 in 2018. The international financial and banking industry, which is subject to IFRS 9, had experienced an increase in audit fees specifically for IFRS 9 adoption. Benchmarking data confirmed that other international financial
institutions (IFIs) had also experienced cost increases of between 15 per cent and 17 per cent as a result of implementing IFRS 9.

9. The Committee discussed the item at great length. Members first expressed their gratitude for the analytical review and the additional efforts made by Management on this agenda item. However, they also expressed the opinion that IFRS 9 and the related additional auditing challenges should have been taken into account as a possibility at the time that the contract was being drafted. Members expressed the overall opinion that the procurement process should take into consideration to the greatest possible extent eventualities of this kind, in order to avoid a revision of fees that almost invariably took the form of an increase. In response to the Committee’s request, Management provided further clarifications on IFAD’s procurement process, specifying that the fee increases were usually exceptional and could depend on the nature of the assignment and specific terms of reference.

10. The Committee approved the fee increase.

**External auditor’s report on internal control and accounting procedures**

11. Deloitte & Touche presented the report on internal control and accounting procedures, noting that the recommendations included had arisen during the course of the audit for the year ending 31 December 2017. None of the recommendations had given rise to a qualification of either their audit opinion on the consolidated financial statements or Management’s assertion report regarding the effectiveness of internal controls over financial reporting. While noting the additional controls in place in 2017, a medium-priority recommendation was issued on the need to formalize the controls surrounding IFAD Country Office (ICO) transactions in a detailed framework, particularly IFAD’s increasing delegation of authority to ICOs. The external auditors also noted improvements in the procedures adopted for disclosure of related parties and suggested additional steps to disclose information pertaining to key management personnel. In this regard, Management assured members that the recommendation related to International Accounting Standard 24 would be implemented in time for the external auditor’s review.

12. Committee members welcomed the report and it was considered reviewed.

**External auditor’s audit strategy memorandum for the year ending 31 December 2018**

13. In presenting the strategy memorandum, the audit engagement partner informed the Committee that four key audit risks had been identified for the audit of the 2018 accounts: fair value calculation on loans for consistency with the IFRS; accuracy of the foreign currency translation calculation; revenue recognition as required under the International Standards on Auditing (ISA); and Management override, which focused on Management’s judgement or estimation as an audit risk, as required under the ISA for all audits. Moreover, the external auditor noted that during the audit exercise, activities would be undertaken for the implementation of the new accounting standard (IFRS 9) in 2018.

14. Members requested clarifications on how the external auditor viewed the exchange rate risk in terms of equity impact on the financial statements. In addition, they requested Deloitte & Touche to present at a future date information on the quality and sufficiency of data availability relating to credit risk, the assessment of which is an IFRS 9 requirement.

15. The document was considered reviewed.

**Review of harmonization of financing terms**

16. Management provided a detailed presentation on the review of harmonization of financing terms and highlighted the ambitious reform process that was under way to enhance IFAD’s business model and maximize its long-term development
contribution. Management noted that IFAD's borrowers had been increasingly requesting greater flexibility and more options in the financial products offered, and further harmonization and comparability with other IFIs.

17. The document included the following proposals:

For ordinary term loans

(i) Introduction of a fixed spread product.

(ii) Variable maturity and grace periods and related pricing to reflect the average maturity period. This aims to allow borrowers to tailor loans to the debt and exchange rate management of borrowers and their national balance sheets to allow them to tailor their debt more closely to what they need in order to manage their overall national debt. It will also provide a response to borrowers' requests for differentiation in maturity and grace periods and to match the related pricing. This will enhance the comparability with the other IFIs without aligning with them on the commitment and upfront fees.

(iii) Maturity premium differentiation linked to the spread based on the income of countries, following a change in the methodology of the International Bank for Reconstruction and Development.

For blend term loans

(iv) Matching of the pricing to the currency denomination

For highly concessional loans

(v) Change in amortization repayment terms for the small state economies to provide higher concessionality.

(vi) Matching of the pricing to the currency denomination

(vii) Slight reduction in concessionality except for small state economies in line with the changes in other IFIs that use the Debt Sustainability Framework (DSF) approach.

For all loans

(viii) Periodicity of changes to reflect market rates to change from six months to three months.

18. The impact of the changes overall is expected to be positive for IFAD in terms of accelerated cash flows, thus strengthening its financial sustainability, and resolve a fundamental mismatch in currency framework.

19. Committee members sought clarification on several points and, in light of the technical nature of the document, expressed appreciation for Management’s offer to organize a specific seminar on the topic. Some members requested additional information about the rationale for the proposals; the implications for the demand for IFAD’s products; and operational risks. Other members enquired about the timing of the exercise and underlined the need to clarify the linkages with existing strategies, frameworks and a road map. It was also noted that the proposals could have implications for the ongoing financial reform and risk management processes. Members asked for several clarifications about the broader context, i.e. how the present proposals would fit into IFAD’s overall strategy.

20. Management provided clarifications and details.

21. It was noted that this topic would then be presented at an informal seminar on 19 July. After extensive discussions, it was agreed that the document would be further reviewed at the next Committee meeting in September 2018.
Review of non-concessional borrowing policy

22. Management introduced the agenda item, highlighting the growing importance of international macroeconomic trends and IFAD’s evolving financial architecture. Developing countries were increasingly seeking non-concessional financing to partially meet their development needs. The non-concessional borrowing policy (NCBP) was introduced by the International Development Association (IDA) and used by the African Development Fund and Asian Development Bank to promote creditor coordination and disincentivize borrowers from taking on sizeable non-concessional debt. The introduction of this policy would rely on IDA’s extensive processes and resources, but an internal IFAD committee would be created to operationalize the procedures and enable IFAD to apply the IDA measures on a case-by-case basis.

23. It was noted that while the debt relief provided under the Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative enhanced a country’s borrowing space, it posed the concern that the gains could be eroded through a rapid reaccumulation of external public debt, thus undermining their debt outlook. The countries receiving concessional assistance could overspend funds or use non-concessional debt to levels that were beyond their capacity to manage through mitigation measures. The NCBP’s aim is to limit the moral hazard that borrowers access concessional resources that in turn increase their ability to take on unsustainable levels of non-concessional debt.

24. For borrowers, the NCBP helps preserve their long-term sustainable debt and for IFAD it fosters more prudent management of the scarce concessional resources, including limiting debt arrears both now and in the future should IFAD offer additional resources outside the core resources and performance-based allocation system.

25. NCBP measures would be applied by either volume cuts in resource allocation and/or through the hardening of financing terms, depending on the level of the breach and taking into account country and project factors. The countries concerned are the 40 IDA borrowers under the NCBP framework that are eligible in IFAD for highly concessional terms and are within the DSF.

26. Member States noted that in November 2018 the World Bank would present a paper on non-concessional borrowing policies across the multilateral development banks. It was suggested that before finalizing its policy, IFAD should wait for the World Bank report as this could feed into the IFAD paper. On the other hand, some members stressed the need to be mindful that IFAD should not wait too long before adopting a well-reviewed policy on this important subject.

27. It was therefore agreed that the IFAD NCBP document would be presented at the Audit Committee’s November meeting for endorsement in order to benefit from the World Bank’s experience and incorporate any emerging trends from IDA at that time, prior to submission to the Executive Board in December and the amendment of the Policies and Criteria for IFAD Financing to be approved by the Governing Council in February 2019.

28. It was also agreed that the possibility of holding an informal seminar on 19 July on the topic would be explored.

2018 external quality assessment of the IFAD internal audit function and an update on follow-up actions

29. The Office of Audit and Oversight (AUO) presented the agenda item, highlighting the main outcomes of the external quality assessment (EQA) conducted in January 2018. It was noted that, consistent with the previous two assessments, the overall conclusion was that IFAD’s internal audit function generally conforms to international standards for the professional practice of internal auditing. The assessor provided the highest possible rating.
30. It was noted that AUO had already shared the main outcome of the assessment at the previous Audit Committee meeting. The present document contained the final recommendations. In particular, AUO would introduce a revised rating scale to provide a higher degree of consistency and differentiation between audit ratings. Audit activities on ICOs would be integrated with supervisory activities and controls over adequacy and effectiveness of the supervision of the financial and procurement aspects of projects. In view of the decentralization exercise, AUO would also consider staff turnover, staffing gaps, workload distribution, and delegation of authority; usage of financial resources; budget trend analysis; and the frequency of certain types of purchases.

31. Committee members commended AUO for the positive outcome of the EQA; at the same time, they observed that AUO's audit coverage would benefit from an increased focus on IFAD's strategic risks. They requested clarification on how corporate and strategic risks were factored into AUO activities. Members also requested information about compliance auditing, especially in relation to ICOs and the growing complexity of IFAD's operations, as well as the evolving financial framework.

32. AUO clarified that risk associated with the achievement of IFAD's objectives was the first aspect considered by AUO in formulating its annual audit plan and in planning and carrying out audit exercises. Indeed, the EQA report included positive comments in this regard. The link between audit outcomes and IFAD's corporate risks could be made more explicit in reporting, especially after the current reform of the IFAD enterprise risk management (ERM) process. AUO also pointed out that the finalization of its annual audit plan involved consultation with the Audit Committee – a practice that ensured the relevance of audit choices – and that the Audit Committee had positively commented on AUO's planned audit coverage for 2018. AUO would take steps to strengthen this collaboration going forward. In relation to audit activities for ICOs, AUO noted that the main objective of an ICO was to supervise and support country programme implementation effectively. Therefore, compliance had not been the main audit objective; instead the focus had always been on the efficiency and effectiveness of the programme's supervisory and implementation support processes. Compliance was, and would continue to be, a major objective in auditing ICO office management and administration aspects because AUO considered non-compliance with rules, regulations, policies and Management decisions as a potential critical risk during a decentralization process. It was noted that six ICOs and country programme audits would be conducted in this area in 2018, and would place increased emphasis on the management of financial and human resources.

33. The document was considered as reviewed.

Review of the terms of reference for the independent assessment of IFAD's strategic and operational risks, and the gap analysis of the function and structure of IFAD's enterprise risk management

34. Management presented the agenda item, noting that the terms of reference covered the following items from the Timeline for the Review, Update and Strengthening of IFAD's Enterprise Risk Management, which was presented to the 148th meeting of the Audit Committee in March:

(a) Independent assessment of IFAD's non-financial risks (strategic and operational, and in programme delivery); and

(b) Gap analysis of the function and structure of IFAD's ERM.

35. It was noted that the overall purpose of this exercise was to: assess the risks to IFAD of not meeting its objectives during the period of the Eleventh Replenishment of IFAD's Resources and beyond; review IFAD's risk mitigation strategies and
measures; and provide recommendations on how to strengthen risk management practices, including IFAD’s institutional risk management processes and functions.

36. The terms of reference comprised four interrelated areas of analysis:
(i) assessment of IFAD’s operational risks; (ii) assessment of risks in programme delivery; (iii) assessment of IFAD’s strategic risks; and (iv) gap analysis of the function and structure of IFAD’s ERM. It was noted that operational risk assessment would be carried out in a coordinated manner with the financial risk assessment in order to ensure complementarity. It was also noted that, after the Committee’s review, Management would launch a bidding process to contract a consultancy firm to conduct the assessment, with a view to receiving findings and recommendations by the end of the year.

37. The Committee welcomed the work done in drafting the terms of reference; appreciated that the financial and non-financial assessments would to the extent possible be conducted in parallel; and proposed that the assessment process include interviews with Audit Committee members and Executive Board representatives in addition to IFAD Management.

38. The document was considered as reviewed.

Review of the principles and main areas of IFAD’s risk dashboard

39. Management presented the document, noting that the main purpose of the risk dashboard was to assist the Board in fulfilling its oversight responsibilities concerning risk management. The risk dashboard therefore covered all four of IFAD’s corporate risk areas: (i) strategic risks; (ii) financial risks; (iii) operational risks; and (iv) programme delivery risks.

40. It was also noted that the risks presented in the dashboard are linked to IFAD’s corporate objectives and that these links would be further strengthened as the dashboard evolved, before the final version was presented to the December session of the Board. It was also noted that the dashboard would be informed by the independent risk assessments being undertaken by IFAD. It was noted that targets or ranges for relevant indicators would be included in the final version of the dashboard.

41. Members welcomed the document as an important tool for the Board representatives and Committee members, and also for IFAD Management. The tool should identify risk owners and also the risk direction (escalating or decreasing). It was noted that not all risks lent themselves to having reliable indicators and that in some cases indicators could obscure the recognition of escalating risk. Members also emphasized the importance of having a living document that was updated regularly to reflect the evolving risk environment.

42. In order to properly embed the relevant outcomes of the ongoing risk review within the risk dashboard it was proposed that approval of the dashboard be deferred until after the completion of such assessments, i.e. until after the December session of the Board. The key role of the Audit Committee in the genesis and development of the risk dashboard was also highlighted.

43. The document was considered reviewed.

Strengthening the strategic role of the Audit Committee

44. Management presented an update on the discussions held on ways to enhance the role of the Audit Committee and its support to the Executive Board, including the main outcomes of the fourth retreat of the Executive Board in April 2018. At the retreat, the following priorities were noted:
(i) In consideration of the numerous meetings and the volume of associated documentation, a seminar on time management could be organized;
(ii) Audit Committee reports should focus on providing strategic guidance to the Executive Board;

(iii) Timely delivery of reports with the possibility of sharing a summary via e-mail with Committee members; it was also noted that reports should be concise, with accurate key recommendations; and

(iv) Consider the introduction of additional communication tools (e.g. creation of a WhatsApp group) to ensure timely information-sharing with subsidiary bodies and among Lists and to allow Member States to clarify issues prior to formal meetings.

45. Committee members welcomed Management’s presentation. The inclusion of an executive summary in the Chairperson’s report to the Executive Board was proposed. Further feedback would be sought at the September Board.

46. The document was considered reviewed.

Dates for meetings of the Audit Committee in 2019

47. The Committee noted the dates for the Committee’s meetings in 2019, and approved a change in the date of its 153rd meeting from 27 June to 20 June 2019.

Update on the implementation of the impairment section of International Financial Reporting Standard (IFRS) 9

48. Management provided an oral update on the progress made in implementing the impairment section of IFRS 9 (financial instruments).

49. The Committee thanked Management for the update which linked well with the earlier discussion with the external auditor.

50. The update was considered noted.

Standard financial reports presented to the Executive Board (Report on IFAD’s investment portfolio for the first quarter of 2018)

51. The Audit Committee noted the information provided in the report on IFAD’s investment portfolio for the first quarter of 2018. It was suggested that future documents include an executive summary of the portfolio’s overall performance.

52. The report was considered reviewed.

Other business

53. Three sub-items were considered by the Committee under other business:

(a) Update on the selection of the independent evaluator for the risk assessment: the Committee was updated on the selection of the independent evaluator for the risk assessment. A major consulting firm had been selected based on the technical and commercial evaluation conducted by two independent panels. The Committee thanked Management for the information;

(b) The Chairperson requested a simple means of keeping track of items for follow-up after each Audit Committee meeting and of obtaining status updates; and

(c) The Chairperson requested a quarterly dashboard showing the implementation progress of IFAD’s strategic direction.

54. No additional items were discussed under other business.