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Internal Control Framework

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Recommendation for approval

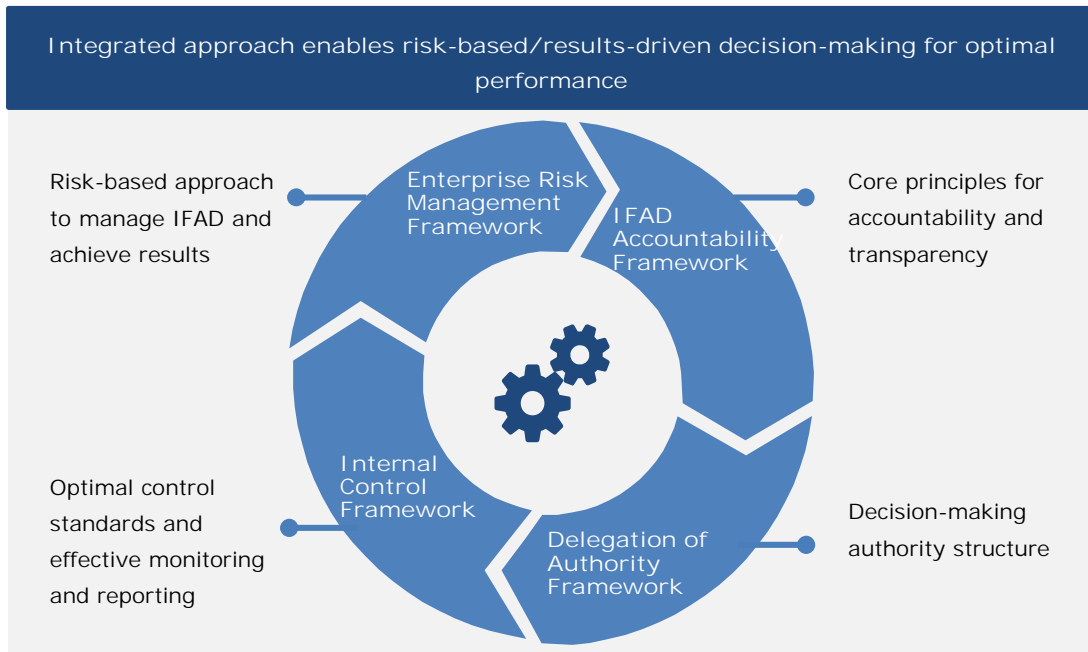
Following the Audit Committee's review, the Executive Board is invited to approve IFAD's Internal Control Framework and the principles contained therein, in order for Management to continue to implement, monitor and strengthen internal controls across IFAD, particularly in light of the enhanced decentralization efforts.

Internal Control Framework

I. Introduction

1. An effective internal control system is founded on good governance and begins with a "tone at the top" that is consistent with the accountability framework. Under the Agreement Establishing IFAD and regulation X of the Financial Regulations of IFAD, ultimate responsibility for establishing and maintaining appropriate internal financial controls rests with the President. In discharging this responsibility, the President is accountable to the governing bodies; and relies on support from the Vice-President, Associate Vice-Presidents, internal governance mechanisms, other members of senior Management and IFAD personnel.
2. A well-implemented internal control system involves the participation of all IFAD personnel – all of whom must understand their responsibilities. In fostering an effective control environment within the Fund, all personnel should proactively support and contribute to operational risk identification, assessment and – through the implementation of appropriate controls – mitigation. The Internal Control Framework (ICF) clarifies responsibilities for internal controls at IFAD.
3. The Enterprise Risk Management Framework (ERMF), IFAD Accountability Framework, Internal Control Framework (ICF) and Delegation of Authority (DoA) Framework are interrelated and work together as an integrated risk-based operational system of accountability, allowing for a holistic view of risk and control within the Fund. The Accountability Framework takes a functional view and sets out the core principles for ensuring transparency and accountability throughout the Fund, while the ICF sets out the optimal enabling standards and operationalizes IFAD's oversight and control models including DoA, as well as supporting good governance. The DoA Framework operationalizes accountability in a manner consistent with IFAD's control systems. Together, these four elements comprise the foundation of IFAD's integrated accountability and control functions.
4. The ICF is essential for effective implementation of the ERMF at IFAD. The ERMF establishes risk policy, governance, appetite and tolerance in order to monitor, report and establish risk culture within the organization. ERMF principles are applied from strategy through execution while relying on internal controls at critical junctures. The ICF seeks to establish a foundation for implementing IFAD's internal controls with an approach derived from the ERMF that is consistent with the principles of the accountability framework and implemented through the Fund's governance structure by means of DoA.

Figure 1
Four elements of the foundation of IFAD's integrated accountability and control functions



5. In addition to this framework, an ICF Implementation Guidance document has been prepared for consideration. The ICF will also be supplemented by various procedural documents to be developed and shared with IFAD personnel.

II. Objective

6. The ICF is designed to establish institutional standards and accountability for operating the internal control system by specifying: objectives and benefits; components of internal control, including the relevant policies, procedures, tools and responsible units; and the responsibilities of managers and personnel for the development, implementation, monitoring and improvement of policies and tools. The objective is to integrate several control mechanisms into one coherent and comprehensive framework. The ICF operational procedures will provide IFAD personnel with the required information and tools to implement the various requirements outlined herein.

III. Definition of internal control at IFAD

7. IFAD's definition of internal control is aligned with that of the Committee of Sponsoring Organizations of the Treadway Commission (COSO),¹ as follows:

A process effected by IFAD's governing bodies, Management and other personnel that is designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance.

IV. Scope

8. In order to protect IFAD's unqualified (clean) audit opinion, the ICF covers financial, operational, compliance and reputational risks, all of which may have a significant impact on the Fund's consolidated financial statements. This approach requires review and monitoring of all significant business processes and the operational risk related to these processes at the country and headquarters levels in order to assess key risks and related controls. Existing processes related to

¹ COSO, *Internal Control – Integrated Framework* (2013).

operations such as the Social, Environmental and Climate Assessment Procedures (SECAP) and the IFAD Policy on Preventing and Responding to Sexual Harassment, Sexual Exploitation and Abuse will continue to be monitored through existing mechanisms.

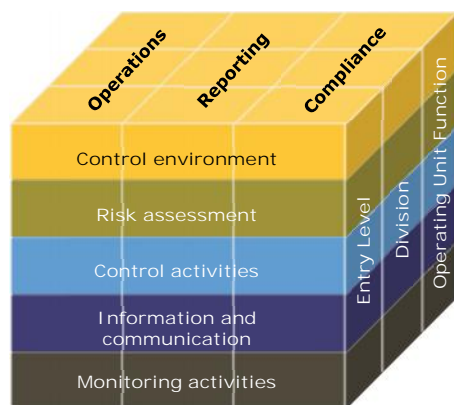
V. Benefits and underlying principles

9. The ICF establishes principles for the development, implementation and monitoring of controls with the following benefits to the Fund and its Member States:
 - (i) Provide for effective, efficient and leaner controls that address operational and other non-financial risks, including by minimizing risks associated with decentralization and the evolution of IFAD's business model;
 - (ii) Maintain and improve the completeness, accuracy, reliability, appropriateness and timeliness of financial and non-financial information;
 - (iii) Provide necessary assurance to the signatories of IFAD's consolidated financial statements and supporting an unqualified (clean) audit opinion;
 - (iv) Ensure the observance of legal, statutory and related obligations applicable to IFAD, including ethical standards and rules;
 - (v) Reduce losses and waste of assets and resources, whether through misdirected effort, avoidable errors, mismanagement, abuse or fraud; and
 - (vi) Sustain and increase confidence among Member States and other stakeholders in the reliability, resilience and efficiency of IFAD's management systems.

VI. Application of the five components of internal control

10. IFAD's ICF is based on the COSO model of internal control. This model sets out five interrelated components of internal control: control environment; risk assessment; control activities; information and communication; and monitoring activities. All are required for an integrated and effective internal control system. The five components and supporting principles are set forth below.

Figure 2
The COSO cube



* See COSO, *Internal Control – Integrated Framework* (2013).

11. Control environment includes the standards, processes and structures that provide the basis for carrying out internal control at IFAD. It also comprises the authority with which senior Management oversees the performance of control activities; recruits, develops and retains competent personnel; and holds individuals accountable for their actions.

12. Risk assessment is a dynamic and iterative process for identifying, assessing, prioritizing and managing key risks to support the achievement of IFAD's objectives.
13. Control activities are the actions carried out to ensure that the Executive Board's directions on risk management are carried out, including its stated risk appetite.
14. Information and communication from internal and external sources enables IFAD to assess how well the different elements of its control system are supporting the achievement of its objectives.
15. Monitoring activities keeps track of the operation of internal controls through ongoing and one-time evaluations to confirm that required controls are present, functioning and successfully managing risks to the achievement of IFAD's objectives.

Table 1

Internal control components and applicability at IFAD

<i>Component</i>	<i>Examples of applicability at IFAD</i>
Control environment	Procedures, standards and reporting
Risk assessment	Will be implemented with the ERMF (e.g. new risk assessments for business processes, existing risk assessments for fiduciary risk at the project level)
Control activities	Will be implemented within the Risk Appetite Framework and ICF Implementation Guidance
Information and communication	Will be implemented through reporting, risk and controls awareness-raising, and a communication plan
Monitoring activities	Will be implemented with monitoring tools and building blocks (see figure 4)

16. The COSO framework was initially applied at IFAD in 2012 through the development of IFAD's internal controls over financial reporting (ICFR) process. It includes the mapping of the significant business processes impacting financial reporting – highlighting the risks and related controls associated with each process – and is being extended through the ICF to all business processes across IFAD.

VII. Roles and responsibilities for internal control

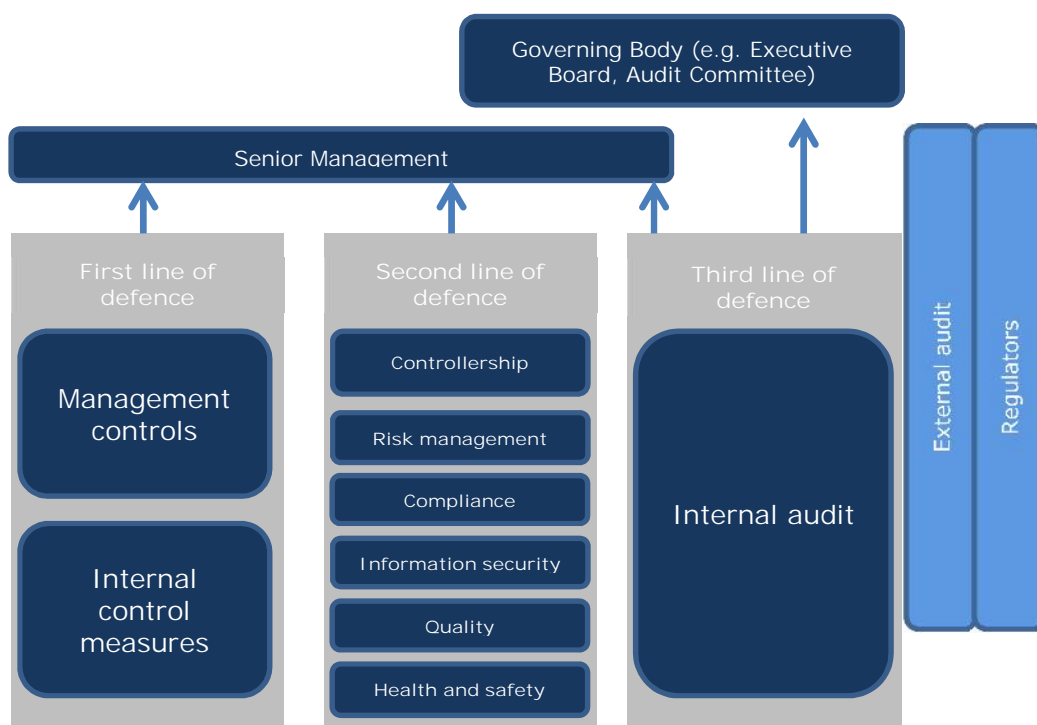
17. The creation of an effective internal control function is grounded in the Institute of Internal Auditors (IIA) three lines of defence model² (see figure 3), which is consistent with the model recommended by the Basel Committee on Banking Supervision and Bank for International Settlements³ and leading industry practice.
 - The first line of defence comprises front-line business and support units, which take on risks and are expected to manage and mitigate them. They are also expected to apply controls consistent with the ERMF and IFAD's risk appetite.
 - The second line of defence includes, among others, the safeguards and risk management functions performed by the Accounting and Controller's Division (ACD) Controllability Unit and financial and other risk management units, which: assess the risks being assumed, the controls being implemented (independent from first line of defence functions) and enable the monitoring of controls.
 - The third line of defence comprises functions such as internal audit, which provides ex post audit assessments of compliance, examines the adequacy of controls to mitigate risks, and identifies cases of non-compliance through ex

² IIA, *The Three Lines Of Defense In Effective Risk Management And Control*, IIA Position Paper (2013).

³ See Bank for International Settlements, Occasional Paper No 11, *The "Four Lines of Defence Model" for Financial Institutions* (2015).

post reviews. IFAD's application of the three lines of defence model is presented in figure 3 below.

Figure 3
Institute of Internal Auditors three lines of defence model



First line of defence functions (excluding those presented in the second and third lines of defence)

18. First line business units are the ultimate risk owners within the organization. They are accountable for operationalizing internal controls as prescribed in IFAD's regulations, rules, policies and procedures. IFAD personnel within these units must ensure that proper controls are embedded within their processes. They are responsible for identifying opportunities to improve the effectiveness and efficiency of controls, and for responding promptly to any identified gaps or weaknesses in these controls – either by remedying them or escalating them through established reporting mechanisms. IFAD personnel should escalate any control deficiency, non-compliance, risk or other operational problem that threatens the achievement of IFAD's objectives to their respective Senior Management member and engage second line of defence functions as needed.

Second line of defence functions⁴

19. As presented in figure 3, there exist multiple second lines of defence functions. The paragraphs below outline the key functions related to control and risk.
20. The ACD Controllershship Unit is a second line of defence function aimed at implementing and ensuring compliance with IFAD's ICF. It implements and conducts assessments, and monitors and reports on IFAD's internal controls, highlighting weaknesses that would expose IFAD to risks. It also provides advice, expertise and tools for risk mitigation both at headquarters and in decentralized offices to ensure that adequate internal controls and reporting processes are in

⁴ Aspects of second line of defence functions may be carried out within other units such as the Operational Policy and Results Division.

place and functioning optimally. In addition, the unit promotes a culture of internal control awareness: on the one hand, the unit aims to strike a balance between business objectives and control measures in order to protect IFAD against risks and support its unqualified (clean) audit opinion and, on the other, promote efficiency in its operations.

21. The Risk Management Unit, within the Financial Operations Department (FOD), is a second line of defence for financial risk management at IFAD.
22. The Ethics Office promotes compliance with the Fund's rules, policies and procedures, including the IFAD Code of Conduct, and fosters a culture of ethical behaviour, transparency and accountability. The Ethics Office also manages the Fund's financial disclosure and mediation programmes.
23. A second line of defence lies within the Office of the General Counsel, which aims to protect the Fund from legal risks and provide advice on the Fund's broader legal interests, including in relation to operations, policy development and dispute resolution. It provides second line legal advice and support to the President and governing bodies, ensuring that IFAD's activities are carried out in accordance with the Agreement Establishing IFAD and other rules and regulations.
24. There is a second line of defence function related to information security within the Information and Communications Technology Division (ICT), which provides a sustainable and secure digital environment; mitigates cyber security risks; and facilitates, together with business owners, a culture change to understand the value of information assets.

Third line of defence functions

25. The responsibility for auditing and evaluating controls, and for providing Management, governing bodies and other stakeholders with assurance of these controls, is delegated to the Office of Audit and Oversight. As a third line of defence, this office provides independent, objective assurance to the Audit Committee and Executive Board on the effectiveness of IFAD's internal controls in order to ensure that critical financial and operational risks are being managed appropriately, and that the internal control system is operating effectively.

Cooperation between the three lines

26. The first and second lines will have ongoing interactions and consultations with each other in particular for loss/incident reporting processes as well as over monitoring and reporting tools implementation. The second line assists the first line to establish and enhance controls within their business processes and provide monitoring support related to relevant frameworks and their respective implementation plans. Additionally, support and oversight are provided through the risk assessments.
27. The multiple second line units should interact with each other, to ensure an integrated and harmonized approach to risk and control within IFAD.
28. The second line should work closely with the third line, relying on reports by the third line to inform of risks and weaknesses identified, as well as provide the third line with the results of monitoring to enhance IFAD's overall controls.
29. There should be close interaction and consultations between first, second and third line to ensure alignment regarding common areas of control weakness and continuous communication to exchange results and outcomes following assessments.

VIII. Core control standards

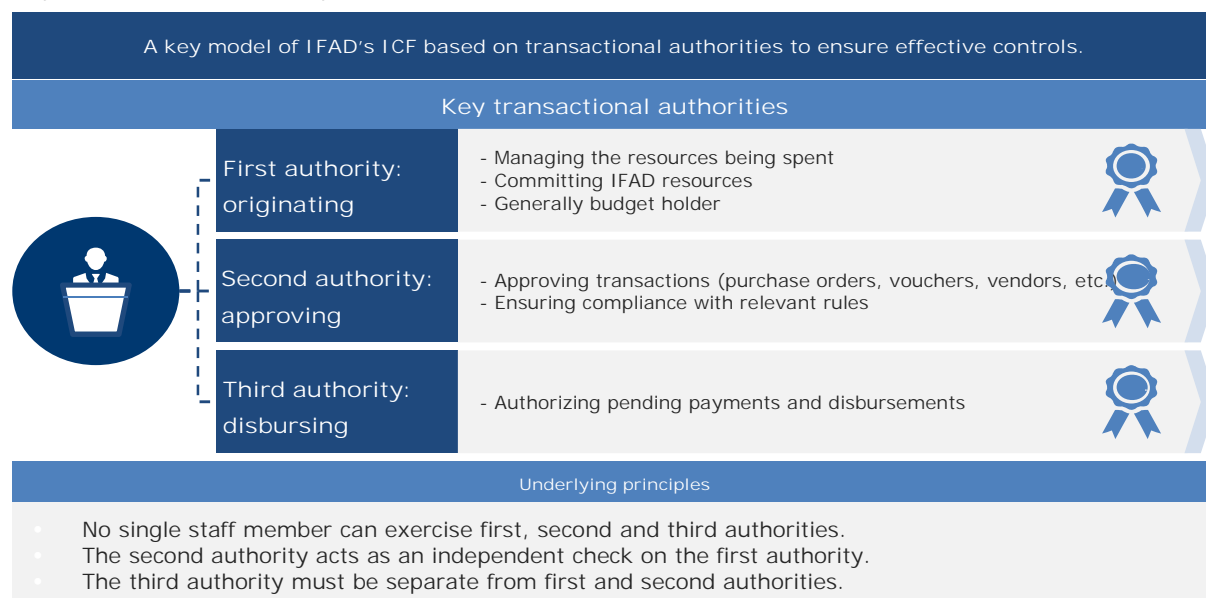
30. An effective internal control system is founded on a set of control standards. In order to establish optimal internal controls, an organization must identify and implement appropriate control standards that are based on its operations and overall exposure to risk. In light of the evolving business model and decentralization, the following section outlines the two core control standards that become increasingly important to IFAD in the decentralized environment. Additional control standards are outlined in the ICF Implementation Guidance document.

Transactional authority model

31. Each transaction or process requires three levels of transactional authority from establishment to completion. These authorities are exercised for all IFAD loans and grant disbursements, procurement, commitments, payments received and expenses (payroll, administrative, travel and consultants, etc.). They are an important element of an effective internal control system.

Figure 4

Key transactional authority model



32. First transactional authority – originating: has the primary responsibility for managing the resources being spent, ensuring the proper commitment of IFAD's resources and managing the underlying task or objectives.
33. Second transactional authority – approving: verifies and approves transactions (e.g. loan and grant disbursements, purchase orders, vendor registration, payroll), ensuring that the related requests are compliant with relevant policies, procedures and guidance.
34. Third transactional authority – disbursing: authorizes the execution of payments and disbursements.
35. No single person can exercise more than one transactional authority over any one transaction, since each transactional authority acts as an independent check on the previous one. Given the nature of these controls, they must be performed by IFAD staff members. Multiple approvals may be required within each stage of the transactional authority model.

Segregation of duties

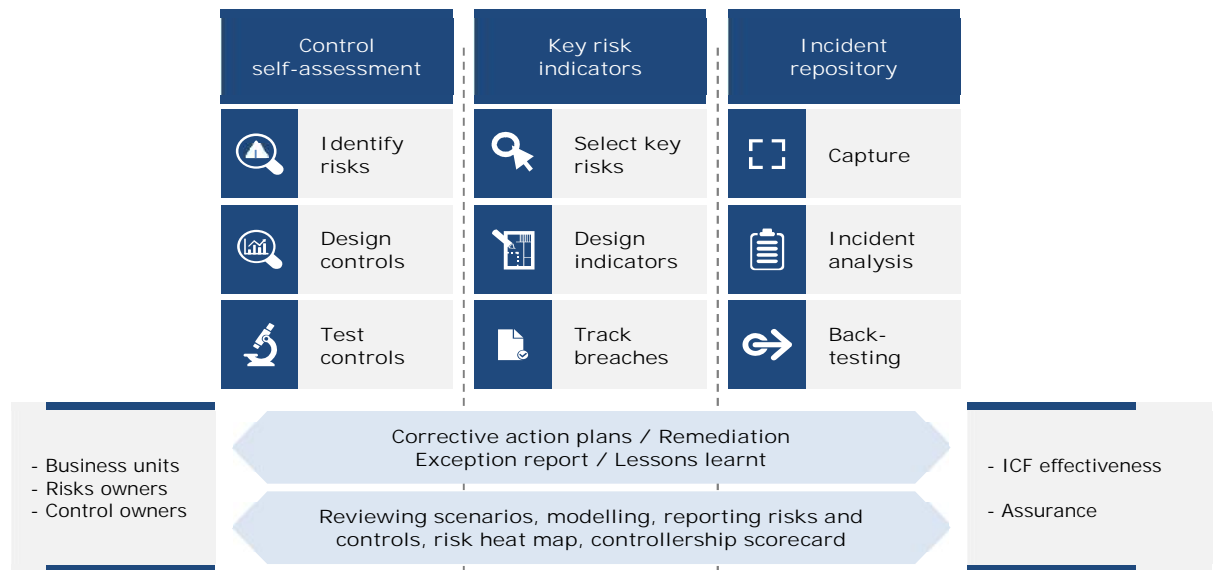
36. Segregation of duties occurs when two or more individuals are required to complete a transaction. The likelihood of error or fraud diminishes significantly when two or more individuals are involved in processing the transaction. The segregation of duties ensures an appropriate level of checks and balances by allowing one person to verify that transactions initiated by another are properly authorized, recorded and settled. When establishing standards for the segregation of duties, Management should assign responsibilities so that a single person cannot effect an entire transaction from inception to completion. For example, personnel that originate transactions should not approve the transaction.
37. Automated controls that act in a similar way to manual segregation-of-duty controls can be written into software programmes; for example in PeopleSoft. When properly designed, automated controls can be superior to manual procedures. Unique system profiles and access and rights controls within PeopleSoft (or other software) constitute fundamental system controls. IFAD's PeopleSoft and other software (e.g. FlexCube) reinforce the control of segregation of duties, ensuring that one user profile cannot perform multiple approvals on a given transactions.
38. More efficient and effective internal control automation can be achieved by adopting robotic process automation, i.e. using bots to perform controls. This further enhances the control of segregation of duties, since the bot profile is programmed to perform as one user only and there is no risk of multiple approvals.

IX. Providing oversight and monitoring internal controls

39. Figure 5 outlines the overall oversight and monitoring tools. The ACD Controllership Unit aims to institute and/or strengthen the following mechanisms for assessing the effectiveness of internal control:
 - (i) Control self-assessment process. All managers and other personnel will complete a control self-assessment exercise, as outlined in the IFAD Control Self-Assessment Manual. This manual will provide managers and other personnel with details needed to perform control self-assessments, including tools and related references. The process will include periodic self-assessments performed by the originating divisions/units and reviewed by the ACD Controllership Unit, which will help to identify control gaps and key risk indicators.
 - (ii) Incident-reporting process. All personnel will be required to report operational risk-related loss incidents and "near misses" following a defined reporting process.
 - (iii) Controller's scorecard. A monitoring tool that will be used by the ACD Controllership Unit to measure current and potential losses, and key risk indicators, and highlight the financial health of the Fund's operational risk and control environment.
 - (iv) The IFAD Corporate Risk Dashboard. The dashboard has been developed to monitor key risks, facilitate the flow of information and enable decision-making on risk management issues. It can also be used to report on the measurement and management of risks to the Audit Committee and Executive Board.
 - (v) Management assertion report on the effectiveness of ICFR. The President; Associate Vice-President, Financial Operations Department, Chief Financial Officer and Chief Controller, and the Controller and Director, ACD currently provide an annual assertion of the effectiveness of IFAD's internal controls.

- (vi) External auditors currently provide an attestation of the Fund’s internal controls over financial reporting and accounting procedures.

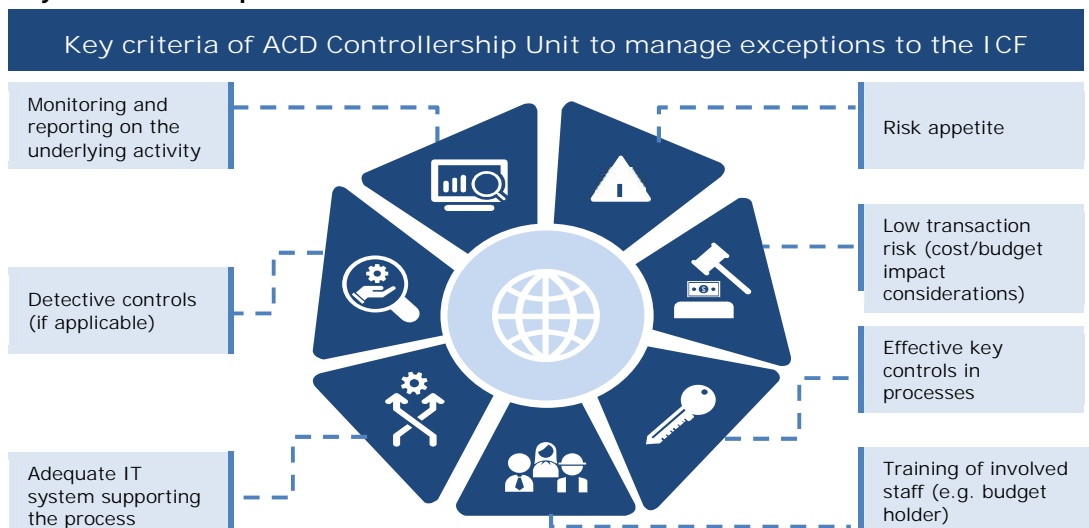
Figure 5
Oversight and monitoring of internal controls



X. Exceptions to the ICF standards

40. The ICF presents the optimal standards for internal controls such as segregation of duties and levels of transactional authority. Some smaller offices may require exceptions to the ICF standards, for example in IFAD’s decentralized model. In such cases, exceptions are to be requested from the ACD Controllership Unit, which will provide direction on compensating controls and other risk mitigation measures in order to ensure that IFAD remains compliant and within its risk appetite.
41. The ACD Controllership Unit will assess exception requests against the key criteria presented in figure 6 and detailed in paragraphs 43 and 44. Following the assessment, if an exemption can be granted, the ACD Controllership Unit will propose compensating controls or an action plan in consultation with the originating unit and may increase monitoring activities.

Figure 6
Key criteria for exceptions



42. When exemptions are requested, the ACD Controllershship Unit will conduct a risk assessment against the seven key criteria noted in figure 6 to ensure that the acceptable level of residual risk is maintained.
43. The following criteria must be met for the exemption to be considered.
 - (a) Risk appetite: Upon review of the proposed exemption to an internal control standard, the ACD Controllershship Unit will assess the residual risk that would result if an exemption is granted. In order to meet this criterion, the residual risk must be below IFAD's risk appetite limits.
 - (b) Low transaction risk: Residual risk as assessed in subparagraph 43.a must be below a set materiality threshold to minimize its potential impact on the consolidated financial statements.
 - (c) Effective key controls in processes: Existing key controls must be embedded within the process being considered for exemption. In order to meet this criterion, the process must have sufficient controls (detective or preventive) in place.
 - (d) Level of skills/training of involved staff: Affected staff must have adequate training on the process being considered, including training in assessing relevant risks and implementing adequate controls, which will help reduce risks associated with a potential exemption.
44. The following additional elements support the approval of the exemption.
 - (a) Monitoring and reporting: The activities under consideration are already subject to periodic reporting to ensure ongoing monitoring of those activities.
 - (b) Detective controls: Detective controls are to be implemented prior to approval of the exemption in order to mitigate the risks identified in the assessment.
 - (c) Adequate IT system supporting the process: Automation embedded in the process reduces the likelihood of operational risk, providing greater assurance of acceptability.

XI. Application, approval and updates

45. The ICF will be implemented within IFAD effectively and efficiently. The ICF will be presented to the Audit Committee for review and Executive Board for approval. To ensure that the ICF remains relevant, it will be updated by the ACD Controllershship Unit every three years and ad hoc reviews may be effected as deemed necessary. In addition, the ICF will be updated to ensure alignment with the revised Enterprise Risk Management Policy, which includes internal governance, accountability, risk taxonomy definitions and risk appetite. All interim revisions and amendments to the ICF outside of the three-year cycle will be approved by the President and submitted for information to the Audit Committee and Executive Board.

Glossary

Accountability

The obligation of an organization and its staff to be responsible for delivering specific results that have been determined through a clear and transparent assignment of responsibility, subject to the availability of resources and in line with applicable policies, rules and procedures. Accountability includes: achieving objectives and results in response to mandates; fair and accurate reporting on performance results; stewardship of funds; and all aspects of performance.

Compliance Risk

Monetary cost/loss (sanction), material loss or loss to reputation to which IFAD may be exposed, arising from a failure to comply with internal policies, applicable rules, regulations, laws and international standards of good practice.

Control self-assessment

The control self-assessment process is an integral element of IFAD's operational risk framework, which integrates its risk identification and management efforts. Its aim is to enhance Management's understanding, oversight and control of operational risks. It supports corporate objectives by measuring operational risk and aligning capital assessments.

Inherent risk

Inherent risk is the risk prior to controls being put in place (impact multiplied by probability factor). It is the amount of risk in the absence of any direct or focused actions by Management to mitigate its impact and likelihood.

Key controls

Key controls are interventions taken to reduce a risk to an acceptable level. Reducing risk means reducing the probability and severity of an adverse event. When well designed and operating effectively, key controls mitigate inherent risk.

Key risks

Key or important risks can be defined as internal or external events that have the potential to impact achievement of the Fund's overall objectives or those of an individual business unit.

Key risk indicators

These indicators comprise qualitative, quantitative or judgmental measures set by Management for the most important areas of risk facing the Fund. They recognize improvements or deteriorations in operational risk levels and exposures, and are monitored and assessed with the aid of escalation triggers. Assessed through control self-assessments (both first and second line), they are monitored by combining results across the Fund at both the headquarters and regional levels. They can be forward-looking indicators of shifts in risk trends.

Management

For the purposes of this framework, Management includes Senior Management, directors, heads of offices and hubs, and country directors.

Senior Management

For the purposes of this framework, senior Management includes the President, the Vice-President, the Associate Vice-Presidents, the Office of the President and the Chief of Staff.

Personnel

For the purposes of this framework, personnel includes all IFAD staff, interns, consultants and anyone else employed by IFAD.

Operational risk

Risk arising from inadequate or failed internal processes, people and systems, or from external events (e.g. fraud).

Operational risk source (or event)

The Basel Committee on Banking Supervision's categorization of events includes:

- (i) Internal fraud – the misappropriation of assets, tax evasion, intentional mismarking of positions, bribery;
- (ii) External fraud – theft of information, hacking damage, third-party theft, forgery;
- (iii) Employment practices and workplace safety – discrimination, workers' compensation, employee health and safety;
- (iv) Clients, products and business practices – market manipulation, antitrust, improper trade, product defects, fiduciary breaches, account churning;
- (v) Damage to physical assets – disasters, terrorism, vandalism;
- (vi) Business disruption and systems failures – utility disruptions, software failures, hardware failures; and
- (vii) Execution, delivery and process management – data entry errors, accounting errors, failed mandatory reporting.

Operational risk impact

The impact of operational losses can be evidenced by financial losses, penalties, compensation to clients or third parties, and increased costs from corrective actions or write offs.

Reputational risk

Risk arising from a negative perception on the part of customers, counterparties, shareholders, investors or regulators that can adversely affect an institution's ability to maintain existing or establish new business relationships and continued access to sources of funding.

Residual risk

Residual risk is the assessed risk after controls are put in place (impact after detective controls multiplied by probability factor after preventive controls). It is the amount of risk that remains after taking into consideration the controls that have been established for its mitigation.

Risk scoring matrix

The risk scoring matrix is used to assess or calculate inherent risk. It is the superimposition of the impact axis on the probability axis. Numerical values (1-5) are applied to determine the severity of the impact on the achievement of objectives should the event occur, and the probability of its occurrence.