Executive Board
143rd Session
Rome, 11–12 December 2024

Project financial management: Annual progress report, including review of the Conceptual Framework on Financial Reporting and Auditing of IFAD-Financed Projects

Document: EB 2024/143/R.34

Agenda: 16

Date: 7 November 2024

Distribution: Public

Original: English

FOR: INFORMATION

Action: The Executive Board is invited to take note of the report on project financial management.

Technical questions:

Gulnara Yunusova
Director a.i.
Financial Management Services Division
e-mail: g.yunusova@ifad.org

Haoua Sienta
Senior Financial Management Officer
Financial Management Services Division
e-mail: h.sienta@ifad.org

Project financial management: Annual progress report, including review of the Conceptual Framework on Financial Reporting and Auditing of IFAD-Financed Projects

I. Introduction and summary

1. IFAD reports annually to the Audit Committee on:

   (i) The application of project financial management assurance policies and practices, including developments, trends and results of the most recent project audit cycle; and

   (ii) The ongoing applicability of the Conceptual Framework on Financial Reporting and Auditing on IFAD-Financed Projects.

2. The current annual review confirmed the continuing adequacy and applicability of the principles spelled out in this framework.

3. IFAD's policies and practices for managing project finances are fundamental to fulfilling its fiduciary responsibilities. This means ensuring that funds are used efficiently and economically for their intended purposes, with complete transparency in accounting. These financial management arrangements frequently depend on the public financial management systems and processes of borrowing countries, when suitable. The principal aim of these policies is to support achievement of the development goals of each funded operation, in line with IFAD's mandate.

4. Following the comprehensive reform of project financial management and disbursement in 2023, financial management is now principles-based, with integrated risk-based disbursement validation. This has improved fiduciary assurance and ensured timely funding for projects. Key assurance measures now include greater focus on external audits, field mission participation and regular financial reporting during project implementation.

5. Staff from the Financial Management Services Division (FMD) act as finance ambassadors, coordinating with ministries on financial and debt issues and with projects and programmes on fiduciary arrangements. Finance officers manage evolving financing issues such as delivery of the Twelfth Replenishment of IFAD's Resources (IFAD12), uptake of the Borrowed Resource Access Mechanism (BRAM) and the concessionality level in IFAD financing.

6. As of January 2025, financial management and project procurement functions will be unified under the Procurement and Financial Management Division. Hence, further improvements will be made in the fiduciary role to support the two complementary functions.

Project audit reports/financial management ratings

7. Project audit reports are essential for fiduciary assurance. The timeliness and quality of audit and accounting standards are generally considered adequate. At the time of writing, 97 per cent (203) of project audit reports due for financial year (FY) 2023 had been received, leaving 6 overdue; 75 per cent were received on schedule (see annex I, table 2), representing an improvement over 66 per cent in FY 2022.

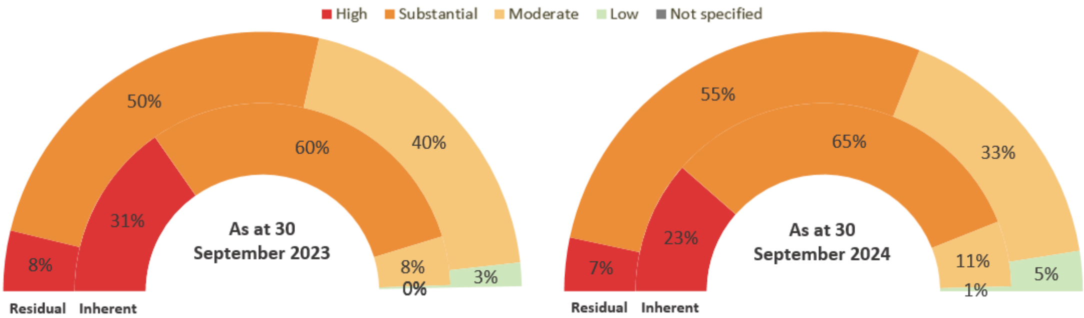
8. The proportion of quality in financial reporting rated satisfactory or highly satisfactory fell slightly from 33 per cent in FY 2022 to 26 per cent in FY 2023, while those rated either moderately unsatisfactory or unsatisfactory rose from 26 per cent in FY 2022 to 29 per cent in FY 2023. To address this development, capacity-building efforts have been strengthened.

II. Financial management practices and oversight

9. **Financial management risk profiles.** The project financial management risk-based assurance framework, which falls within IFAD's programme delivery risk domain,[1] underpins the activities of FMD. With the revised framework adopted in 2023, in keeping with corporate guidelines, a consistent distinction has been made between inherent[2] and residual risks. Residual risk[3] ratings account for mitigation benefits only post-implementation, ensuring that these efforts are prioritized during the implementation period.

10. There has been a slight change in the risk profile in 2024 compared to the previous year (2023). The percentage of projects with high or substantial inherent risk decreased slightly from 91 to 88 per cent, with high inherent risk projects falling from 31 to 23 per cent. This shift is due largely to the reclassification of some high or substantial inherent risk projects as substantial or moderate risk after supervision missions, reflecting the current country environment and project financial management arrangements without mitigation measures. In contrast, the proportion of high or substantial residual risk projects rose slightly, from 57 to 62 per cent, due mainly to new projects where mitigation strategies had not yet been executed. Financial management risk ratings continue to influence the volume and timing of checks and balances, including the frequency of missions and disbursement modalities.

Figure 1
Financial management risk profiles of investment projects and country grants before and after the enhancement of financial management risk calibration (as of September 2024)



11. **Risk-based fiduciary assurance.** The comprehensive reforms in project financial management finalized in 2023 rebalanced fiduciary oversight with a principles- and risk-based approach throughout the project disbursement, supervision and auditing stages. Mandatory submission of quarterly interim financial reports improved project financial discipline and monitoring, with 97 per cent of eligible projects submitting reports, and improved project liquidity management through 6-monthly forward planning of funding needs for timely disbursements, serving as a tool for systematically tracking financial progress and contributing to the updating and adaptation of project accounting systems. Participation in missions and validation of disbursement requests are now aligned with the corporate risk assurance frameworks, enhancing risk acceptance and proactive implementation support.

12. Further improvements, such as streamlining, greater collaboration and less duplication in the fiduciary role, are expected with the integration of the financial

[1] Risks to the ability to achieve the expected results in IFAD-supported projects, programmes or strategies and the risk of unintended consequences.
[2] Inherent risk is the risk that the project financial management system will not operate as intended due to factors related to the project implementation environment, which IFAD has a limited ability to control. It is the level of risk before/without factoring in the effect of any mitigation measures or controls applied or to be applied by the borrower.
[3] Residual risk is the level of risk remaining after recognizing the actual implementation of the mitigation measures/controls and thus reflects the actual risk identified at the time of the assessment. Residual risk is assessed at design and during implementation.

management and project procurement functions into a single Procurement and Financial Management Division, effective January 2025.

13. **Ineligible expenditures.** FMD regularly tracks and monitors potential and/or confirmed ineligible expenditures,[4] which are often identified through supervision missions and external project audits.

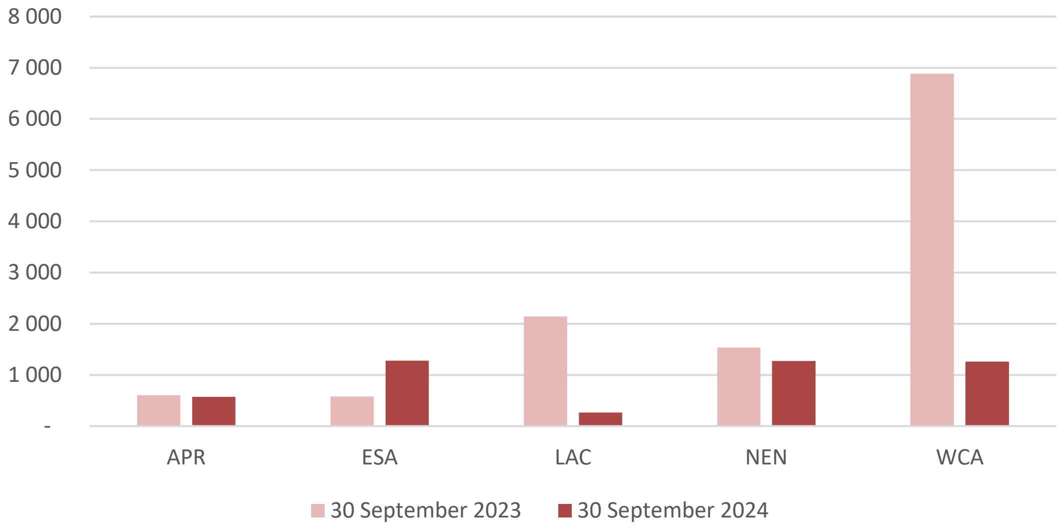
14. The total amount of ineligible expenditures fluctuates as the expenditures are reviewed and adjusted. At the time of reporting, the outstanding amount was US$4.6 million,[5] lower than the US$11.7 million reported in 2023. This decrease is primarily due to two significant cases: (i) justification was provided for the use of micro-project funds to beneficiaries of the Rural Socio-economic Opportunities Programme in Cabo Verde (US$6 million), and (ii) clarification was provided on the establishment of fiduciary funds for the Conservation and Sustainable Use of High-Andean Ecosystems of Peru through Compensation of Environmental Services for Rural Poverty Alleviation and Social Inclusion Project in Peru (US$2 million).

15. **Remedies.** IFAD takes remedial action mainly in the event of ineligible expenditure and late submission of audit reports. When non-compliance is identified, early engagement with projects and ministries is sought to encourage prompt compliance, and where possible, soft remedies considered, to avoid a more detrimental impact on project implementation.[6]

16. When delays arise in the submission of audit reports, warning notices are issued to borrowers for delays beyond 90 days, with formal suspension of the right to withdraw funds due after 180 days. As reported last year, the only country subject to suspension measures stemming from unresolved financial management issues was the Bolivarian Republic of Venezuela, due to its failure to submit project audit reports for 2017 and 2018; these measures are still in effect. Further details on compliance with the audit policy across IFAD's portfolio are presented in section III.

[4] The term "ineligible expenditures" refers to the use of financing proceeds for expenditure not compliant with the financing agreement or otherwise not in line with the General Conditions for Agricultural Development Financing, section 4.07
[5] Legacy cases from Yemen (US$1.1 million, due to a remaining unjustified outstanding balance) and Afghanistan (US$107,000, due to penalty fees not applied to the designated account and financing of taxes) are included.
[6] Soft remedies may include temporarily putting on hold the borrower's right to use an advance account and requesting substitute expenditure that meets IFAD's eligibility criteria.

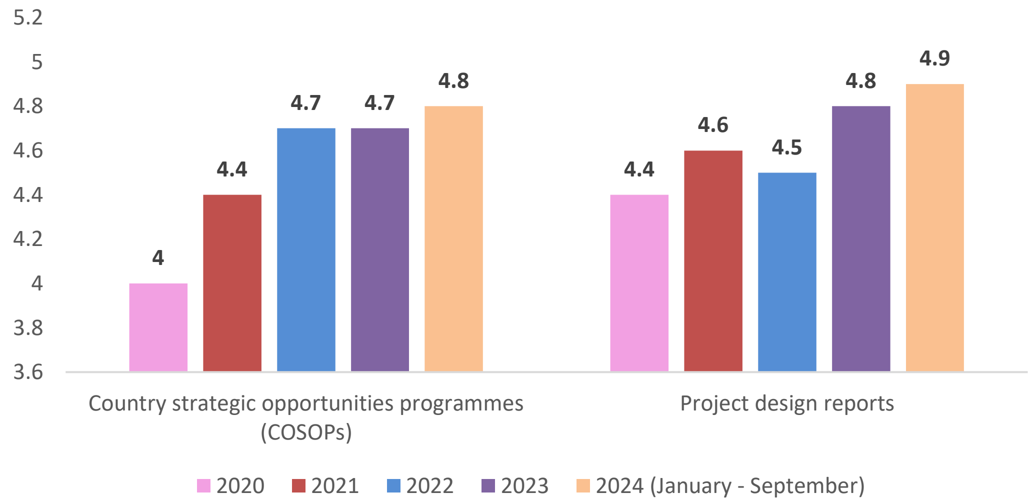
Figure 2
Unconfirmed and confirmed ineligible expenditures by region*
(Thousands of United States dollars)



* The following abbreviations are used for regions: Asia and the Pacific (APR); East and Southern Africa (ESA); Latin America and the Caribbean (LAC); Near East, North Africa and Europe (NEN); West and Central Africa (WCA).

17. **Participation in design and supervision.** The design of projects and regular supervision missions facilitate closer monitoring of financial management aspects in the field, strengthen fiduciary assurance and allow for the development of closer relationships with project finance staff, thereby identifying capacity-building needs. As part of the commitment going forward, the aim is for all design missions to be undertaken by the finance officers. As of September 2024, a total of 20 design missions had been conducted by finance officers. The risk-based assurance framework continues to be applied to supervision missions, with a target of two missions per year for projects with high or substantial residual financial management risk and one mission every two years for those with low or moderate residual financial management risk. As of September 2024, a total of 198 financial management supervision missions[7] had been conducted, with 58 per cent participation by finance officers.

Figure 3
Financial management enhanced development effectiveness matrix (DEM+) average ratings (all regions) by year



[7] These include start-up, supervision and completion missions, implementation support and midterm reviews.

18. **Quality assurance.** As part of the corporate quality assurance processes, an independent FMD unit conducts DEM+ reviews of financial management aspects for all COSOPs, concept notes and project design reports submitted to the Operational Strategy and Policy Guidance Committee for Management approval. The process enables FMD to gradually build learning into IFAD’s work. Compared to the previous year, the average rating for both the COSOPs and the quality of financial management in the designs showed a slight improvement (see figure 3).

19. The DEM+ review results are analysed to highlight good practices and areas of further improvement, which are compiled into quarterly Learning Notes for front-line teams.

20. In 2023, FMD launched regional deep dives as a channel for tailored review of practices in the decentralized teams, feedback on the results of quality assurance, knowledge and skills transfer and facilitation of harmonized approaches across the decentralized teams. In 2024, to date only one regional deep dive has been conducted (for LAC), with one more planned before end 2024.

21. As part of FMD’s quality assurance procedures, project audit reports are subject to internal peer review on a sample basis, with the object of developing a standardized approach. Further assurance was sought on the quality of project audit reports and the relevance of audit and financial reporting arrangements applied through the sixth annual independent review of project external audit reports.

Table 1
Number of DEM+ reviews conducted by document type

	Number of DEM+ reviews conducted by document type				
	2020	***2021***	***2022***	***2023***	***2024 (January – September)***
COSOPs	1	7	11	8	8
Project concept notes	17	16	20	35	18
Project design reports	19	19	20	21	32

22. **Financial management capacity-building.** Capacity-building is conducted internally for financial management consultants and at the project, country, subregional and regional levels. In-person country or regional workshops have been held for project staff, external auditors and ministry representatives, focusing on IFAD financial reporting, audit requirements and disbursement arrangements, as well as best practices and lessons learned on the application of international standards.

23. **Lending term operations.** FMD is responsible for the financial side of loan negotiations. Finance officers, supported by headquarters, assist governments in understanding and deciding on financial conditions, including those of the BRAM, and determining the level of concessionality in IFAD’s financial package. With the necessary resources, they have facilitated the successful loan negotiations leading to the delivery of IFAD12, US$1.2 billion from the performance-based allocation system (PBAS) and US$0.9 billion from the BRAM in the final IFAD12 year (2024).

24. **Transparency.** In keeping with IFAD’s commitment to increasing transparency and accountability in the use of donor funds, the Fund systematically discloses project audit reports on its website.

25. **Implementing arrangements with United Nations agencies, IFIs, MDBs, etc.** Fiduciary responsibilities issues have arisen in certain United Nations agencies where borrowers have appointed implementing partners, which has resulted in some disruption in operations. This is a decades-old issue. Funds transferred to United Nations agencies are not normally subject to audit by others (including IFAD), since each agency has its own external auditor and robust assurance

processes. The "single audit principle" of the United Nations system means that agencies rely on their own robust audit mechanism and are not required to use their own auditors to audit other sister agencies. In 2024, FMD adopted a new approach, obtaining a comfort letter from a senior official from the relevant United Nations agency headquarters attesting to the strength of internal controls and audit, and providing (upon request) the audited financial statements of the entity. FMD has subsequently modified the terms of reference of project external auditors, stipulating that such auditors are not required to audit sister United Nations agencies, IFIs, MDBs or related institutions. Separate unaudited reporting to IFAD has also been agreed upon as part of this process, and the disrupted projects have subsequently resumed.

26. **Strategic engagement.** Strategic engagement with MDBs in 2024 has continued both virtually and in person and through international forums. Five working group sessions have been held this year. In-person meetings have been held with the World Bank, the Inter-American Development Bank and the MDB financial management working groups, following up on potential developments in financial management-related areas as well.

III. Project audit reports for financial year 2023[8]

27. **Audit arrangements.** External audit of IFAD-financed projects is a key tool for fiduciary assurance, given its greater geographical coverage than supervision missions. IFAD's review of project audit reports includes:

    (i) Reliance on country systems – i.e. the use of Supreme Audit Institutions, currently at 46 per cent (see annex I, table 1);

    (ii) Adherence to international standards (financial reporting and audit); and

    (iii) Assessment of audit quality and the timeliness of audit report submission.

28. The main findings for 209 projects analysed for FY 2023 are summarized below.

29. **Timeliness.** As at 30 September 2024, 97 per cent (203) of project audit reports due for FY 2023 had been received, leaving 6 overdue; 75 per cent were received on time, thanks to the efforts of FMD and the Programme Management Department (PMD) in signing the audit contracts with private auditors before the end of the financial year (see annex I, table 2), compared with 66 per cent in 2022.

30. The timeliness of internal FMD review of audit reports is closely monitored, with 67 per cent of audit reports signed off on within the prescribed timeline of 60 days, compared with 72 per cent in 2022.

31. **Audit report findings.** The percentage of qualified audit opinions in FY 2023 was similar to that of the previous year (8 per cent), as reported in annex I, table 3; nine projects received qualified audit opinions with exceptions and four projects qualified opinions with limitation in scope.

32. Analysis shows that the main control issues are recurrent and common across all five regions. They include: (i) weak internal controls over project implementation or non-compliance with approved procedures; (ii) inadequate procurement procedures and/or poor contract management; (iii) ineffective use of accounting systems; (iv) failure to provide adequate supporting documentation; (v) limited use of or deviation from international accounting standards; and (vi) ineligible expenditures. To address these issues, IFAD will heighten its capacity-building efforts across all regions to strengthen internal controls, ensure compliance with approved procedures and aim to improve procurement practices and accounting systems. Focused reviews and targeted interventions will also be undertaken to

[8] The term "financial year 2023" covers all financial periods ending between 1 January and 31 December 2023.

ensure adherence to international accounting standards aimed at the efficient resolution of ineligible expenditures.

33. **Quality of financial reporting.** During 2023, the quality of project financial reporting slightly deteriorated overall, while the quality and timeliness of the audit reports improved. Greater complexity in the financing mix, deficiencies in project accounting systems and weak technical capacities have contributed to this trend. Challenges in fragile, conflict-affected and de facto states, which comprise over one third of IFAD's portfolio, also played a part. Further analysis of these trends is provided in annex II.

34. **Pilot for country audit strategy.** FMD conducted a pilot to set up a country audit strategy for at least two countries in each region[9] that helped to identify key lessons to mainstream and adopt a strategic approach to collaborate with auditors.

[9] It is completed for India, Indonesia, Pakistan, Eritrea, Plurinational State of Bolivia, Moldova and Djibouti, and in progress for Cuba and the WCA region.

Project audit reports – financial year 2023

Table 1
Audit arrangements for financial years 2022 and 2023
(Audit reports received and signed off on as at 30 September 2024)

	Financial year 2023			*Financial year 2022*		
Region	*Undertaken by government auditors[a]*	*Undertaken by private auditor[b]*	***Total***	*Undertaken by government auditors*	*Undertaken by private auditor*	***Total***
Asia and the Pacific	29	18	**47**	41	24	**65**
East and Southern Africa	23	16	**39**	26	28	**54**
Latin America and the Caribbean	1	12	**13**	7	20	**27**
Near East, North Africa and Europe	10	18	**28**	13	22	**35**
West and Central Africa	9	20	**29**	17	38	**55**
Total	**72**	**84**	**156**	**104**	**132**	**236**
Percentage	**46**	**54**	**100**	**44**	**56**	**100**

[a] Includes 10 audits conducted by national entities that are not the Supreme Audit Institutions (previous year: 12 audits).
[b] Two audits were outsourced by government auditors to a private firm for financial year 2022 (previous year: three).

Table 2
Timeliness of project audit report submission for financial years 2022 and 2023
(As at 30 September 2024 and 2023)

	2023		*2022*	
Audit reports	*Number*	*%*	*Number*	*%*
Received on time	157	75	158	66
Received with delay	46	22	64	27
Subtotal	**203**	**97**	**222**	**93**
Still due as at 30 September	6	3	14	7
Total reports due for year	**209**	**100**	**236**	**100**

Table 3
Audit opinion expressed on project financial statements for financial years 2022 and 2023
(Audit reports received and signed off on as at 30 September 2024)

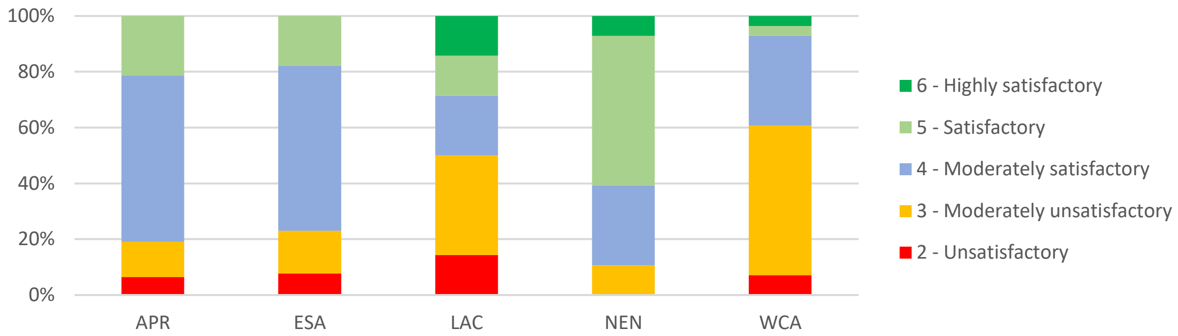
	Financial year 2023			*Financial year 2022*		
Region	*Audit reports received*	*Unqualified*	*Qualified*	*Audit reports received*	*Unqualified*	*Qualified*
Asia and the Pacific	47	46	1	66	63	3
East and Southern Africa	39	37	2	54	47	7
Latin America and the Caribbean	14	13	1	27	25	2
Near East, North Africa and Europe	28	23	5	35	32	3
West and Central Africa	28	24	4	54	50	4
Total	**156**	**143**	**13**	**236**	**217**	**19**
Percentage	**100**	**92**	**8**	**100**	**92**	**8**

Quality of financial and audit reports - 2023

1. In financial year (FY) 2023, 58 per cent of financial reports were prepared using international standards (FY 2022: 51 per cent) and 32 per cent using national or regional standards (FY 2022: 43 per cent). Other standards or "modifications/deviations from international standards" were used in 10 per cent of projects.

2. The quality of financial reporting rated satisfactory or highly satisfactory slightly deteriorated from 33 per cent in FY 2022 to 26 per cent in FY 2023. The proportion of reports rated moderately satisfactory was 46 per cent, compared to 41 per cent in FY 2022, while those rated either moderately unsatisfactory or unsatisfactory increased slightly from 26 per cent in FY 2022 to 29 per cent.[10]

Figure 1
Quality of financial reporting FY 2023[11]

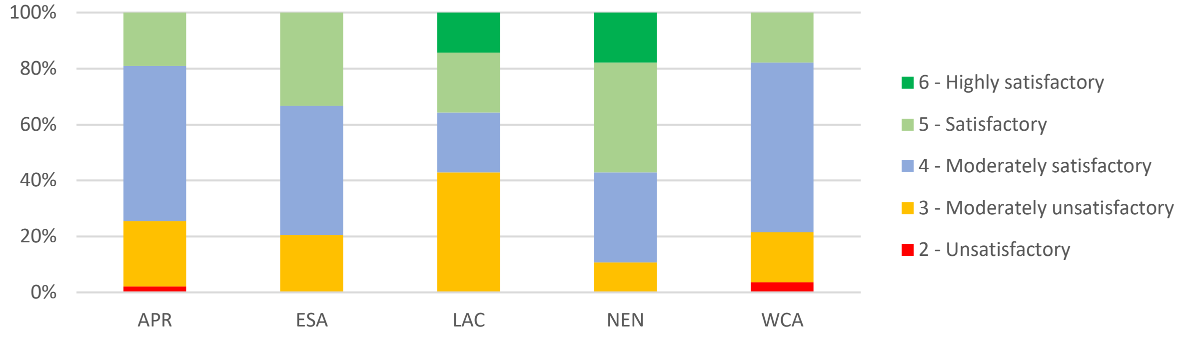


3. The quality and timeliness of audit reports are measured as part of IFAD's corporate methodology for the assessment of project performance. This indicator consists of two elements: the quality of the audit work and the timeliness of audit report submission. Even a high-quality audit report is penalized if submitted late.[12]

4. The quality and timeliness of audit reports improved in FY 2023, thanks to the efforts of FMD and PMD to sign the audit contracts with private auditors before the end of the financial year, with 31 per cent of audits rated highly satisfactory or satisfactory (30 per cent in FY 2022), 47 per cent rated moderately satisfactory (37 per cent in FY 2022) and 22 per cent rated moderately unsatisfactory or unsatisfactory (33 per cent in FY 2022). Mandatory action plans are put into place as needed to underpin minimum standards and address internal control weaknesses.

[10] See paragraph 8 for a description of IFAD actions in the case of poor performers.
[11] Ratings were based on the 156 audit reports received and signed off on as at 30 September 2024.
[12] Audit reports submitted after the due date cannot be rated higher than 3 (moderately unsatisfactory).

Figure 2
Quality and timeliness of audit, FY 2023[13]



5. In FY 2023, 58 per cent of auditors utilized international standards (2022: 83 per cent) and 31 per cent adhered to national or regional standards (2022: 16 per cent) for the audits, with 156 audit reports received and signed off on as at 30 September 2024. The final proportion may change upon completion of the review of 55 audits and the receipt of 9 overdue audits.

[13] Ratings were based on the 156 audit reports received and signed off on as at 30 September 2024.