1. Following its Eightieth and Eighty-First Meetings on 25 March and 8 April 2003, the Audit Committee wishes to draw the attention of the Executive Board to the following matters.

REVIEW OF THE AUDITED FINANCIAL STATEMENTS OF IFAD FOR 2002

2. The committee reviewed the Financial Statements of IFAD for the year ending 31 December 2002. It noted with satisfaction the opinion of the External Auditor, PricewaterhouseCoopers, that the statements gave a true and fair view of the financial position of IFAD, the results of its operations and its cash flows, in accordance with international accounting standards.

3. In its discussion of the financial statements, the committee noted the following points:

(a) **IFAD’s reporting currency.** Members commented that positive results in the revenue statement were largely due to positive exchange fluctuations. The Secretariat advised that the Strategic Change Programme (SCP) had, in consultation with the external auditor, carefully considered the issue of IFAD’s reporting currency, and had concluded that this should remain United States dollars. The new financial system will allow management to easily produce a balance sheet in Special Drawing Rights, which should show that, in the future, movements between years will be more contained.

(b) **Exchange movement.** The Treasurer explained that of the USD 369 million exchange gain, USD 138 million relates to the investment portfolio, while the remainder relates mainly to loans. Members commented that this exchange movement is purely an accounting fact.

(c) **Decreases in loan disbursements and loan repayments.** In reply to members’ questions, the Secretariat explained that the decrease in loan disbursements was mainly due to the world economic situation and the consequent slow-down in project implementation. To a lesser extent, it was also due to the decline in the number of loans approved in the last few years. The Secretariat clarified that loan repayments were reasonably flat in comparison with those of the previous year and that management closely monitors the loan repayment situation.
(d) **Investment costs.** Following a member’s query, the Treasurer pointed out that investment costs had decreased from USD 10.4 million in 2001 to USD 7.8 million in 2002, as can be seen in Note 3 to the financial statements.

(e) **Cash holdings.** Members asked why cash holdings were so large and whether the figure quoted was the same as the one quoted in the September data. The Treasurer explained that a substantial part of these were the proceeds from the sale of equities and that they were being held pending investment in inflation-protected bonds.

(f) **United States mortgages.** It was also explained that the figure of USD 316 million for investment payables relates to the fixed-income portfolio holdings of United States mortgages, which have longer-than-usual settlement periods. Members asked the external auditor for further information regarding this new product.

(g) **Receivables on investments sold.** Members asked what the USD 78 million receivable on investments sold represented. The Secretariat explained that this represented the sales proceeds of mortgage-backed securities sold by external managers.

(h) **Administrative expenses.** The statement of cash flows shows a significant decrease in payment for administrative expenses. The Secretariat explained that in 2002 IFAD had introduced Programme Development Financing Facility (PDFF) expenses, which contain expenses previously included in administrative expenses (e.g. those relating to cooperating institutions (CIs)). Moreover, there was some delay in payments in 2002.

**Recommendation**

4. The committee recommends endorsement of the IFAD financial statements for 2002 by the Executive Board for presentation to the next session of the Governing Council.

**General Reserve**

5. The General Reserve was reviewed at the end of 2002 for the first time since September 1999. Taking into consideration the four risks highlighted by the review, management considers the current reserve level of USD 95 million to be adequate.

6. Members discussed the four situations under which IFAD is authorized to use the General Reserve. They noted that although some of these situations had in fact recently occurred and had involved amounts much higher than those provided for by the Reserve, the Reserve had not been used. The Secretariat explained that management has not needed to use the Reserve because other mechanisms were in place.

7. It was noted that the General Reserve is not specifically identified against any assets, but that the Office of the Treasurer (FT) ensures that a large percentage of AAA assets held in United States banks are highly liquid. Members were surprised that a reserve for exchange risk and portfolio volatility could be held in a specific currency and in volatile products.

8. The committee agreed that a seminar be held with the External Auditor in July 2003 in which they would discuss issues relating to the General Reserve. It was also agreed that for the September 2004 Meeting, the Secretariat would update the General Reserve paper, summarizing an in-depth review of the four risk factors, considering any other relevant factors, analysing IFAD’s history with respect to the reserve, and looking at current industry standards.
9. Following the seminar and subsequent presentation of the Secretariat’s paper, the committee will reconsider the adequacy of the General Reserve.

Oversight and Internal Control

10. The Chief of the Office of Internal Audit (OA), presented a paper on oversight and internal control at IFAD. He explained that the paper does not draw any conclusions regarding the effectiveness of IFAD’s internal control system, but rather presents an overview of emerging trends with regard to internal control frameworks in the public and private sectors, in United Nations organizations and in international financial institutions. The paper also considers the role of oversight and looks at IFAD’s current activities in this regard.

11. It was noted that a proposal to reactivate the Oversight Committee had recently been submitted to the President for approval.

12. Members requested that the internal control framework be fully documented and its adequacy fully assessed.

13. The Secretariat agreed to put in place a process to assess the internal control framework and, based on this assessment, to draw up an action plan. In this plan, the Secretariat would review the implementation of internal controls within IFAD, follow up on identified weaknesses and report to the committee on its progress each April.

14. The committee requested that the external auditor be involved in IFAD’s assessment of its internal control framework.

Review of the Internal Audit Function

15. The Secretariat presented the paper on Internal Audit activities and plans, which details the activities of 2002 and the programme of work for 2003.

16. Ten audits were completed during 2002 and the results fed directly into ongoing improvement initiatives such as the SCP and human resources modernization. This effort necessitated the postponement to 2003 of one assignment (two were postponed, but one was an addition).

17. The volume of recommendations increased substantially, and OA was satisfied that significant efforts were exerted in 2002 towards their implementation. These included the establishment of cross-divisional task forces mandated to address recommendations in the areas of contracting and grants.

18. The emphasis in 2003 will be on operational processes (programme cofinancing, the use of workshops) as well as on issues linked to implementation of the SCP.

19. The committee was pleased to hear that the position of audit officer has been filled and that the Office of Internal Audit is now adequately staffed.

Review of External Auditors Proposal for 2003 Audit

20. As a result of the tender process in 2002, PricewaterhouseCoopers was reappointed External Auditor for IFAD. Under the five-year rule established in 1998 – which requires a review from first principles of the appointment of the External Auditor – the tenure is assumed to run for five years, subject to satisfactory performance. In its private session with the External Auditor, the committee reviewed the auditor’s memorandum on strategic planning for the 2003 audit and the related fee as outlined below:
21. For the audit of the 2003 accounts, the External Auditor has proposed a total fee of EUR 130 000 comprising:

<table>
<thead>
<tr>
<th>IFAD</th>
<th>81,000</th>
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<tbody>
<tr>
<td>Belgian Survival Fund</td>
<td>3,500</td>
</tr>
<tr>
<td>Global Mechanism of the United Nations Convention to Combat Desertification</td>
<td>5,000</td>
</tr>
<tr>
<td>International Land Coalition (formerly Popular Coalition to Eradicate Hunger and Poverty)</td>
<td>5,000</td>
</tr>
<tr>
<td>Combined supplementary funds</td>
<td>5,500</td>
</tr>
<tr>
<td><strong>Non-recurring audit work</strong></td>
<td><strong>100,000</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>130,000</strong></td>
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</tbody>
</table>

22. **Regular work.** For the last three years (2000 to 2002 audits), the fee for the regular work has been EUR 97 800 (or the equivalent thereof). The proposed fee for 2003 includes an increase of 2.5% for the effects of the Italian inflation index.

23. **Non-recurring work.** The 2003 audit programme will incorporate specific non-recurring audit procedures to verify the accounting transitions and new systems, procedures and controls relating to implementation of the SCP, the transfer of investment accounting to the new custodian bank and the initial consolidation process for funds under IFAD’s administration. It was agreed with the External Auditor that the fee quoted would cover their work related to the SCP until the completion of implementation.

Recommendation

24. The Audit Committee recommends that the Executive Board accept the PricewaterhouseCoopers proposal and approve the audit fee of EUR 130 000.

CONSIDERATION OF THE EXTERNAL AUDITORS MEMORANDUM ON INTERNAL CONTROL AND ACCOUNTING PROCEDURES AND THE PRESIDENT’S REPLY

25. During the annual audit of IFAD’s accounts, the External Auditor submits recommendations on internal control and accounting procedures. The auditor pointed out that those previous years’ recommendations that have been acted upon but not fully implemented are reflected in an appendix to the memorandum to enable future follow-up.

26. The committee noted the repetition of some recommendations that had appeared in previous memoranda. The Secretariat assured the committee that this was being addressed at the senior management level. The committee also insisted that the new investment policy be fully implemented.

27. The committee noted that the management responses were very general. The Secretariat agreed to circulate updated management responses to committee members within two weeks that would contain specific time frames.

28. The committee took note of the observations and recommendations of the 2002 memorandum on internal control and, pending the receipt of the specific time frames for follow-up, approved the President’s draft response.
STATUS OF PROJECT AUDIT REPORTING

29. At the 25 March 2003 Meeting, the Assistant Controller – Loans and Grants presented a paper on the status of project audit reporting. He noted that despite a significant improvement in the percentage of audit reports received – from less than 50% in 1989 to 62% in 2002 – there was still room for improvement.

30. It was noted that other methods and controls are in place to ensure that the recipient uses the funds for the agreed purposes. IFAD has been involved in discussions with other organizations with a view to harmonizing, standardizing and streamlining project auditing processes.

31. It was agreed that any qualifications should be acted upon, and that if the CIs do not follow up, then IFAD must do so. However, to do this and to monitor project audit reporting in general more closely, the Secretariat noted that additional resources would be needed.

32. The Secretariat agreed that an action plan for the improvement and follow-up of project audit reports will be submitted to the committee’s September 2003 Meeting.

REVIEW OF PROJECT AUDIT GUIDELINES

33. At the 8 April 2003 Meeting, the Assistant Controller – Loans and Grants presented the Guidelines on Project Audits (for Borrowers’ Use), for IFAD loans, which will assist in the process of project audit reporting.

34. The committee congratulated the Secretariat on the guidelines, but also proposed that the document be reduced in length and that a two-page executive summary of the guidelines be produced, noting that constraints upon beneficiaries and CIs should be kept to a minimum. In addition, the committee requested that when referring to the application of sanctions, the guidelines should specify that sanctions “will apply” rather than “may apply” and that further thought be given to sanctions in the case of non-compliance.

35. The committee requested that the Secretariat take into consideration the committee’s comments in the finalization of the Operational Procedures on Project Audit Guidelines (for IFAD and CI internal use) and that these procedures be submitted to the Audit Committee’s September 2003 meeting for information.

Recommendation

36. Subject to the phrase “may apply” being changed to “will apply” in section VI, the Audit Committee recommends that the Executive Board approve the Guidelines on Project Audits (for Borrowers’ Use) as presented in document EB 2003/78/R.15.

SUMMARY OF THE GLOBAL CUSTODIAN CONTRACT

37. IFAD’s investments, previously held by State Street, were transferred to the new global custodian, Northern Trust, on 1 April 2003.

38. A summary of the custodian contract, including a comparison between current and previous custodian fees and an estimate of the savings resulting from this tender was presented.

39. The estimated fees for State Street in 2002 were some USD 3 million, while the fee negotiated for Northern Trust for 2003 is USD 400 000.
40. IFAD has negotiated a custodian contract with a schedule of fees lower than those of State Street. The fees for basic custody services, previously three basis points (3/100ths of 1%), are now one basis point. Moreover, the cost of ancillary and compliance reporting is lower than it was with State Street in most areas.

41. The new contract represents an improvement over the old and, in conjunction with the new investment policy, will allow the Fund to save millions of dollars.

42. The Secretariat thanked the committee and the External Auditor for their initiative and guidance in this field, which has resulted in significant savings for the Secretariat.

**OTHER BUSINESS**

43. The members from China and Spain will not continue on the Audit Committee. The chairperson thanked them for their contributions, which have been greatly appreciated.