



IFAD
INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT
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PROJECT AUDIT GUIDELINES

INTRODUCTION

1. It is incumbent upon IFAD management to ensure that all projects in its portfolio are audited regularly and that the funds disbursed are used for the purposes intended; it is important that IFAD should be proactive in doing this. The issue of project audit reports has been discussed at several IFAD Audit Committee meetings. It has also been raised as an item of concern by IFAD's external and internal auditors, who have urged that procedures for receiving and reviewing audit reports of projects financed by IFAD should be formalized, because it appears that IFAD and its cooperating institutions have not received and analysed them promptly enough. IFAD's *General Conditions for Agricultural Development Financing* describe methodologies for suspending disbursements when a borrower is not in compliance with audit requirements; it was noted, however, that instances where sanctions were applied by IFAD were very rare.
2. In order to remedy the inadequacies of the present method of handling project audit reports, the Project Audit Guidelines (Guidelines) have been produced to help borrowers to carry out this critical aspect of portfolio management. If a cooperating institution entrusted with a project has published its own guidelines, they will be followed.
3. The Guidelines are intended for use by borrowers, government officials, project implementation unit managers and staff, and auditors of IFAD-funded projects – all of whom need to be fully aware of IFAD's requirements with regard to audits in order to carry out their fiduciary responsibilities effectively.
4. Operational Procedures are to be issued after Executive Board approval of this document; they will be for use by cooperating institutions without guidelines of their own and for internal use by IFAD. The Loans and Grants Unit of the Office of the Controller has been monitoring data related to project audit; the intention is to integrate this information into the corporate information technology system during the Strategic Change Programme. An investment in human resources will be required to ensure coverage of increased in-house accounting and auditing responsibilities.

RECOMMENDATION

5. The Executive Board is requested to approve the attached Guidelines on Project Audits (for Borrowers' Use), which will come into force immediately upon approval. The President will subsequently approve the Operational Procedures. The Executive Board is also requested to authorize the President to make non-substantive amendments to the Guidelines from time to time.



GUIDELINES ON PROJECT AUDITS

(FOR BORROWERS' USE)



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ABBREVIATIONS

CI	Cooperating Institution
FC/L	Office of the Controller, Loans and Grants Unit
Guidelines	Guidelines on Project Audits (for borrowers' use)
PFS	Project Financial Statement
PIU	Project Implementing Unit
SA	Special Account
SAI	Supreme Audit Institution
SOE	Statement of Expenditure
TOR	Terms of Reference



FOREWORD

The IFAD Guidelines on Project Audits outline the Fund's policy and procedures relating to annual audits of IFAD-funded projects. A large number of IFAD projects involve cofinancing with some of its cooperating institutions (CIs), some of which have published guidelines and sample audit forms. Where a CI has established guidelines and assumes the lead in project administration under a cooperation agreement, those guidelines will be followed.

The IFAD Guidelines should be followed for projects administered by CIs that do not have their own audit guidelines. CIs will inform IFAD of issues that arise regarding specific audits.

The Guidelines will be followed for all projects directly supervised by IFAD.

The Guidelines set out acceptable auditing practices such as assessment of audit capacity, timely and transparent selection of auditors, adequate preparation for audits, reliable examination of project records and financial statements, and provision of clear audit opinions and management letters. The Guidelines largely follow those developed by the major multilateral development banks to assist borrowers. The acceptable auditing standards referred to in the Guidelines are considered to be those issued by the International Organization of Supreme Audit Institutions or the International Federation of Accountants (IFAC). National auditing standards considered to be consistent in all material respects with either of the above are also acceptable. The reference to acceptable accounting standards also relates to those of the International Public Sector Accounting Standards (IPSAS) issued by IFAC.

These Guidelines are intended primarily for use by IFAD borrowers, by staff of CIs appointed by IFAD to handle loan and grant administration on its behalf and by IFAD staff and consultants working on project appraisal and supervision, particularly project financial management.

The term 'borrower' refers to both loan beneficiaries and grant recipients covered by the *General Conditions for Agricultural Development Financing*. Similarly, the term 'loan' refers to loans and grants. The term 'project' includes programmes.

During preparation of these Guidelines, the views of IFAD staff, borrowers and CI representatives have been sought; their comments are incorporated to the extent possible.

GUIDELINES ON PROJECT AUDITS

(FOR BORROWERS' USE)

I. INTRODUCTION

1. The Agreement Establishing IFAD requires the Fund to ensure that the proceeds of any financing are used only for the purposes for which a loan or grant was provided, with due attention to considerations of economy, efficiency and social equity. IFAD's *General Conditions for Agricultural Development Financing*¹ require the borrower (project party) to have the accounts relating to a project audited each fiscal year, including the special account (SA) and statements of expenditure (SOEs), in accordance with appropriate auditing principles consistently applied by independent auditors as specified in the loan documents.

2. The project appraisal report will describe the assessment made at appraisal of the borrower's (or the project party's) capacity for proper financial management, including the ability to produce periodic financial reports (generally every six months), annual financial statements for the auditor's review and the annual audit. Correct and timely execution by the borrower of this fiduciary responsibility is critical to ensuring that projects achieve their intended objectives within the allocated financial and other resources. Auditor's reports should point out any problems and irregularities identified during the audit and make recommendations for improvement.

II. AUDITS

3. An audit is an *ex post* review of the books of accounts, records of transactions and financial and other systems maintained by a project implementing unit (PIU)² for the purpose of executing a project, and of the financial statements prepared by a PIU reflecting project operations during a given period. An audit is carried out by professional accountants and aims to:

- provide assurance of accountability;
- give credibility to the financial statements and other management reports;
- identify weaknesses in internal controls and financial systems;
- verify compliance with loan covenants dealing with financial matters; and
- make recommendations for improvement.

(See Annex I for further general information on project audits.)

III. ESTABLISHMENT OF AUDIT ARRANGEMENTS

A. Assessment of the Auditor's Capacity

4. The groundwork for an audit, including determination of the availability and quality of auditors in the borrower's country, should be laid during the appraisal phase. Particular attention should be given to the:

- overall status of the accounting and auditing profession;
- competence and independence of the national supreme audit institution (SAI); and
- selected auditors' adherence to acceptable standards relating to accounting and auditing.

¹ Article IX (Financial Reporting and Information), section 9.03 (a) Audit of Accounts.

² Also referred to as the project coordinating unit or project management unit.



5. Reference to assessment of audit capacity should be made prior to loan negotiations and should ascertain whether the project audit is to be carried out by SAI or whether the borrower proposes to use a private audit firm. A Checklist for the Appointment of the Auditor is given in Annex II.

B. Appointment of the Auditor

6. Article IX (Financial Reporting and Information), section 9.03 (Audit of Accounts) of IFAD's *General Conditions* stipulates the borrower's obligation with regard to the annual audit of project accounts. The timing of the appointment of the auditor, as indicated in the loan agreement, and the deadlines for submission of audit reports, normally within six months of the end of the fiscal year, can be found in Article V (Financial Reporting and Information) of the project loan agreement.

7. Prior to loan negotiations, there will be discussion with the borrower of the auditor's terms of reference (TOR) and the audit arrangements, including any special audit requirements (see IFAD's Minimum Requirements for Project Audit in Annex III). IFAD's audit requirements and TOR for the auditor are essential to ensure that auditors receive clear guidelines as to their task and the coverage and format of their report. Annex IV gives the Guidelines for Auditors, whereas Annex V gives a Sample Terms of Reference for Audit of Project Financial Statements.

8. Auditors should not be appointed as management consultants responsible for designing accounting and control systems on which they would be required to comment. Such appointments would create a conflict of interest and increase the risk that shortcomings in a project might not be reported.

9. The cooperating institution (CI) approves the TOR for the auditor to be engaged by a borrower. CI or IFAD staff should not be involved in drafting audit TORs, though there is no objection to their giving advice to borrowers based on these Guidelines.

IV. REVIEW OF AUDIT REPORT

10. The audit report package should include the audited financial statements, the auditor's opinion – including reviews of SAs and SOEs – a management letter and any special reports required by IFAD. Examples of auditor's opinions and an outline of a management letter are given in Annex VI. A sample format is provided in Annex VII to enable the PIU and the CI to monitor preparation and submission of financial statements and the audit report.

11. When the auditor's report is received from the borrower, the CI will ensure that the audit has been carried out in accordance with IFAD's requirements. Particular attention should be paid to the auditor's opinion, the results of the compliance audit and the management letter.

12. The review of the audit report will be carried out by the CI within 30 days of its receipt. If the audit report has not identified problems or irregularities and has made no recommendations for improvement in the project, no further action will be necessary on the part of the CI apart from acknowledgement under copy to IFAD.

V. AUDIT REPORT ISSUES

13. If the review of the audit report reveals problems or irregularities, the CI will advise the borrower of the concerns and inform IFAD. Such advice will be sent to the borrower and IFAD no later than 45 days from receipt of the audit report.



14. Audit reports containing a **qualified opinion**, an **adverse opinion** or a **disclaimer of opinion** indicate the existence of problems and irregularities in project implementation. The CI's advice to the borrower would in such cases refer to the auditor's opinion in the report and address the issues raised.

VI. NON-COMPLIANCE WITH IFAD'S AUDIT COVENANTS

15. If a borrower does not comply with the audit covenants contained in Article V (Financial Reporting and Information), section 5 (Audit Reports) of the IFAD loan agreement, the Fund (in consultation with the CIs as appropriate) will apply sanctions as provided for in Article XII (Remedies of the Fund), section 12.01(n) (Suspension by the Fund), of the *General Conditions*.³

16. As part of its remedial action, IFAD will apply Article VI (Remedies of the Fund) of the IFAD loan agreement, which states: "If the Borrower does not timely furnish any audit report required by Section 5.02, and the Fund, after consultation with the Borrower, determines that the Borrower is unlikely to do so within a reasonable period thereafter, the Fund ... may engage independent auditors of its choice to audit the accounts relating to the Project. For such purpose, the Borrower and the Project Parties shall make their financial and other records available to such auditors promptly upon request, accord them full rights and privileges as agents of the Fund under Article X (Cooperation), section 10.03 (Visits, Inspections and Enquiries) of the *General Conditions* and otherwise cooperate fully with such audit." Article VI of the loan agreement further states: "... the Fund shall make the audit report available to the Borrower promptly upon its completion. The Fund shall finance the cost of such audit by withdrawal from the Loan Account on behalf of the Borrower, and the Borrower hereby authorizes the Fund to make such withdrawals."

³ "The Fund may suspend, in whole or in part, the right of the Borrower to request withdrawals from the Loan Account, whenever the Fund has not received any audit report ... within the time prescribed therefor in the Loan Documents"



GENERAL INFORMATION ON PROJECT AUDITS

1. Audits can vary considerably, depending on the objectives, project activities and expected reports or outcome. They can be classified into three categories:

- financial statement audits;
- compliance audits; and
- operational audits.

Financial Statement Audit

2. The objective of a financial statement audit is to determine whether the statements are presented in conformity with acceptable accounting standards or other acceptable national standards. Each audit covers a specified period, usually the project fiscal year, and the cumulative accounts over the life of the project. A financial statement audit assesses whether reported disbursements were made in accordance with the loan agreement. Particular attention is given to disbursements based on SOEs.¹ The audit ascertains whether individual expenditures, which comprise the SOE totals, are properly authorized, eligible under the loan provisions, appropriately accounted for and fully supported by documentation retained in the borrower's files.

3. The findings of the audit, in conjunction with any comments on SOE reviews in project supervision reports by staff, should be used by the CI and IFAD's Office of the Controller, Loans and Grants Unit (FC/L) to determine whether the borrower should continue to use the SOE procedure. If SOEs are found to include ineligible expenditures, the borrower will be expected to refund the amounts in question. Adjustments to disbursements on subsequent withdrawal claims will be made to offset disallowed claims for ineligible expenditures.

4. Where SAs have been established, the annual audit will verify that withdrawals from SAs are properly authorized and eligible in accordance with the loan agreement. The audit will ensure that the year-end balance in the SA is reconciled with IFAD's records².

5. The auditor normally examines the project's system of accounting and other internal controls, including internal audit, as part of an audit of financial statements in order to express an opinion on the reliability of project financial statements (PFSs) produced by the borrower.

¹ Under the SOE procedure, disbursements are made against a listing of relatively small eligible expenditures certified by the borrower (project party). The supporting documents are retained in the field by the borrower; IFAD reserves the right to review such supporting documents, either by its appointed CI or by IFAD staff during project supervision, or by independent auditors and consultants.

² It should be noted that while the books of accounts and the financial statements are usually prepared in the national currency of the borrowing country, the special account is generally maintained in United States dollars. It is the borrower's responsibility periodically to reconcile the national currency balance shown in the books of accounts with the United States dollar balance in the special account, usually during replenishment of the special account. The annual financial statements will include reconciliation as at the end of the project fiscal year.



Compliance Audit

6. A compliance audit involves reviewing, testing and appraising an organization's controls and operating procedures, including compliance with regulations, contracts and laws to which the organization is subject.

Operational Audit

7. An operational audit is a more thorough examination of an organization's management techniques and performance. It may help to identify implementation issues for the purpose of prompt remedial actions at the project level. The primary product of an operational audit is a report recommending improvements in the efficiency and effectiveness of operations, encompassing, to the extent possible, all the major functions of the organization. Operational audits should be considered for IFAD projects.

Management Letter

8. Audit reports should be accompanied by a management letter,³ which is a report on an organization's internal controls and operating procedures and their effectiveness. It is based on the auditor's reviews during the normal course of an audit.

Audit Opinions

9. The audit report should contain a clear expression of opinion on the financial statements. The auditor's opinion may be unqualified, qualified or adverse, or a disclaimer of opinion.

10. An **unqualified opinion** indicates the auditor's satisfaction in all material respects with the preparation of the financial statement, its consistency, adequacy, and compliance with regulations, statutory requirements and any additional requirements in the corresponding audit TOR.

11. A **qualified opinion** is issued when an auditor has reservations on specific areas and concludes that an unqualified opinion cannot be issued, but deems that the effect of any disagreement, uncertainty or limitation of scope of the audit does not require an adverse opinion or a disclaimer of opinion. The subject of the qualification and its financial effect must be clearly stated in the auditor's report.

12. An **adverse opinion** is issued when the effect of the disagreement is so pervasive and material to the reliability of the financial statements that the auditor concludes that a qualification of the report will be insufficient to disclose the misleading or incomplete nature of the financial statements.

13. A **disclaimer of opinion** is issued when the possible effect of an uncertainty or of a limitation on the scope of the auditor is so significant that the auditor is unable to express an opinion on the financial statements.

³ Auditors may provide an internal control memorandum instead of a management letter. A sample outline of a management letter is provided in Annex VI of these Guidelines.



CHECKLIST FOR THE APPOINTMENT OF AN AUDITOR

1. When the proposed auditor is the **SAI**, the CI and IFAD staff (the country portfolio manager and/or FC/L) will check the following information from CI and IFAD records of previous project audit reports from the country:

- Has the SAI fulfilled its responsibilities in previous projects satisfactorily?
- Did the SAI submit all the audit reports due?
- Were the reports submitted on time?
- What was the overall quality of the audit reports?
- Was there any evidence from the findings of CI and IFAD supervision missions that the audit reports failed to identify irregularities and weaknesses?
- Were the SAI recommendations appropriate to the problems and irregularities in the project?
- Did the SAI follow up previous audit findings during subsequent audits?

2. The following information will be ascertained during project appraisal:

- Does the SAI belong to the International Organization of Supreme Audit Institutions?
- Is the SAI independent of the PIU and the responsible government ministry in terms, for example, of control over its budget and personnel?
- Does the SAI report to the management of the project or the PIU?
- Is the SAI involved in approval of the project's transactions?
- Is the SAI involved in the internal control or financial management systems of the project or PIU?
- Has the SAI consented to the appointment?

3. When the proposed auditor is a **private audit firm**, the CI will check that the borrower's proposal is sufficiently transparent and thorough prior to consenting to selection, and will ask particularly:

- Is there evidence of a competitive selection process for the auditor, say from a list of three to six firms?
- Was selection based on a technical evaluation together with the financial evaluation? A technical evaluation includes the firm's track record and professional reputation, audit scope and methodology, and the qualifications and experience of staff assigned to the audit. A financial evaluation assesses quotations of the cost of the audit from the bidders, including all reimbursable costs.
- Is there evidence of the auditor's past experience and acceptable performance in similar audits?
- Did the proposed auditor submit satisfactory references and descriptive material about the firm?

4. In making a proposal for appointment of a private auditor, the borrower should provide the CI with relevant supporting documentation and should address the following questions:

- Does the firm adhere to acceptable auditing standards? The firm's audit procedures and methods should ensure compliance with such standards.
- Is the firm independent of the project entity to be audited and of the people appointing it?
- What is the legal status of the firm? This includes such aspects as partners' status and any limited liability provision in the firm's articles.



ANNEX II

- Are any of the assigned audit staff employed by or closely linked to the project entity to be audited, or to any government body or public agency?
- Can the auditor confirm that there is no conflict of interest or lack of independence in accepting the appointment?
- Is the auditor committed to providing qualified and experienced staff who can ensure timely submission of audit reports? In particular:
 - What is the staffing plan for the audit?
 - What are the qualifications of the assigned staff?
 - Do the assigned staff belong to professional audit or accounting bodies such as the Institute of Chartered Accountants or Certified Public Accountants?

5. In assessing impartiality and independence, the borrower (project party) should find out whether the project auditor is employed by the project entity or umbrella organization, or serves as a director of it, or has any financial or business relationship with it, when engaged as an independent professional auditor.

6. The borrower should ensure that the auditor's fee is not established in any way that compromises independence.

7. Auditors should not be appointed as management consultants responsible for designing accounting and control systems on which they would be required to comment. Such appointments would create a conflict of interest and increase the risk that auditors might not report shortcomings in the project.



MINIMUM REQUIREMENTS FOR PROJECT AUDIT

1. The minimum requirements for audit of IFAD-funded projects are explained to borrowers at the time of loan negotiations, with the request that they be passed to project auditors prior to audit in order to ensure satisfactory fulfilment of the requirements.

Scope and Objectives of the Audit

2. The borrower and the PIU must ensure that the independent auditor acceptable to the CI and IFAD is appointed in sufficient time to carry out the audit responsibilities. This includes review of the financial management system at the beginning of project implementation and periodically thereafter.

3. The borrower and the PIU will have the annual financial statements audited in accordance with acceptable auditing standards; the auditor's report should indicate the standards used. The auditor will indicate the extent to which the examination does not conform to those standards.

4. The audit report should contain a clear expression of the **auditor's opinion** regarding the financial statements. It should include the **financial statements audit** and the **compliance audit**, and should be accompanied by the **management letter**. It should also include a section on the project's compliance with loan covenants, particularly those dealing with financial matters. A full **operational audit** may be carried out if the CI and IFAD deem it necessary.

5. The management letter will summarize any shortcomings in the project and recommend improvements to the borrower's financial and administrative systems and controls. It will also contain the auditor's comments on other matters that the auditor considers pertinent, to which the management's attention should be drawn.

6. In the course of the audit, the auditor will assess the project's accounts, including annual financial statements, SOEs and the SA. In addition to project accounts, the audit report will address:

- the adequacy of accounting and internal control systems, including the internal audit mechanism, in monitoring expenditures and other financial transactions and ensuring safe custody of project assets;
- the adequacy of documentation maintained by the PIU for all transactions; and
- any other matters the CI and IFAD may reasonably request.

7. The audit report should present an audit opinion covering:

- project accounts;
- statements of expenditure; and
- special accounts (also called revolving funds).

8. 'Project accounts' refers to the financial statements for the project, usually for a fiscal year, required for all IFAD-funded projects. They must show the financial status of the project and consist of:

- yearly and cumulative statements of sources and application of funds, which should disclose separately IFAD's funds, counterpart funds (government), other donors' funds and beneficiaries' funds;
- the balance sheet, which should disclose bank and cash balances that agree with the statement of sources and application of funds, fixed assets and liabilities;
- yearly and cumulative SOEs by withdrawal application and category of expenditures; and

ANNEX III

- reconciliation of the SA.

Where the project consists of several entities, financial statements should be consolidated.

9. When the CI and IFAD have agreed with the borrower on the use of SOEs and SAs, the borrower must show a summary of SOE-based disbursements and a summary of SA activities in the annual audited financial statements.

10. 'Statements of Expenditure' refer to the certified statements attached to withdrawal applications, which list relatively small project expenditures certified and submitted by the PIU to IFAD (FC/L) for disbursement of loan funds. The SOE threshold agreed during loan negotiations is usually provided in loan agreements; the supporting documents are retained at the project site for review by CI or IFAD supervision missions and by the independent auditors. The auditor's opinion should deal with the adequacy of the procedures used by the project for preparing SOEs and should include a statement that the proceeds of the loan withdrawn from the loan account on the basis of such SOEs were used for the purposes intended under the loan agreement.

11. The 'special account' (or revolving fund) refers to the bank account established and maintained for depositing an agreed percentage of the loan or grant funds as advances or replenishments, based on project expenditure needs and replenishments made. This bank account is normally maintained in United States dollars, either at the central bank of the borrowing country or a commercial bank agreed on by IFAD and the borrower. There may be more than one SA (or advance of funds) under a loan, depending on the number of project components and implementing agencies. The audit will cover all such SAs and advances/replenishments; agencies operating the accounts will be responsible for providing supporting documents and reconciliation to the auditors.

Audit Methodology

12. In reviewing the project accounts and financial statements, the auditor will:

- verify that acceptable accounting standards have been consistently applied and indicate any material deviation from these standards and their effect on the annual financial statements;
- assess the adequacy of accounting and internal control systems (procedures and responsibilities) in monitoring expenditures and other financial transactions (commitment, review, approval, payment and accounting) and ensuring safe custody of project-financed assets, and document any instances where controls are lacking or need strengthening;
- determine whether the borrower and the PIU have maintained adequate documentation for all transactions, for example procurement documents, suppliers' invoices, letters of credit and evidence of payment, and ascertain that expenditures were properly authorized;
- verify the accuracy of statements and accounts;
- verify that disbursement requests for expenditures submitted to IFAD are eligible for financing under the loan agreement, and identify clearly any ineligible expenditures;
- carry out a physical verification, either on a test basis or where irregularities are suspected, of significant assets purchased in order to confirm their existence.

13. From the second audit period onwards, the auditor will follow up the borrower's actions based on the auditor's findings and recommendations in previous audit reports. The audit report will address the effectiveness of monitoring issues and concerns raised in the past and progress in adopting remedial actions.

GUIDELINES FOR AUDITORS

Terms of Reference and Engagement Letter

1. The CI approves the TOR for the auditor to be engaged by a borrower. CI or IFAD staff should not be involved in drafting audit TOR, though there is no objection to their giving advice to borrowers based on these Guidelines. A borrower may wish to include in the TOR additional auditing tasks necessary to satisfy requirements of other financiers, including the borrower. These should in no way cause late delivery of the audit report.

2. These Guidelines should not be regarded as universally applicable to audits of IFAD-financed projects or project entities. Borrowers should select the components they consider appropriate for an audit and should add to the TOR relevant aspects that are not in the Guidelines. The Guidelines relate only to the appointment of auditors to carry out audits of PFSs, an implementing agency's (PIU's) financial statements, financial statements of a financial intermediary or credit institution, SOEs and SAs. They are not intended for special audits, reviews, investigations or consultancy assignments.

Terms of Reference for an Auditor

3. The form and content of the auditor's TOR may vary for each project; only the relevant aspects should be included in the engagement letter. TOR/engagement letters should include the elements set out below.

Summary of contents of a TOR/engagement letter

The summary should include:

- description of the employing project authority or entity;
- description and the timing of the financial statements and other material to be provided by project management for the audit;
- terms for delivery of the audit report;
- specification that the audit should be carried out in accordance with acceptable standards;
- provision of a management letter;
- statement of access to project records, documents and personnel available to the auditor; and
- details regarding submission of a proposal and workplan by the auditor.

Details of contents of a TOR/engagement letter

The contents should include:

- description in the TOR of the entity engaging the auditor and whether it is acting on behalf of or is a constituent part of a larger entity; and
- legal and general descriptions of the project and the PIU, in sufficient detail to enable the auditor to understand their natures, objectives and activities; the following additional information would be helpful:
 - organizational charts;
 - names and titles of senior managers;



ANNEX IV

- names and qualifications of officers responsible for financial management, accounting and internal audit;
- name and address of any existing external auditor, if a change is made;
- information technology facilities and computer systems in use; and
- copies of the latest financial statements, loan agreement, minutes of loan negotiations and the annual work programme and budget, if it is available.

Auditor's Responsibilities

The auditor should be expected to:

- submit a proposal, depending on the audit assignment, for auditing financial statements – PFSs, SOEs, SAs, financial statements of the implementing unit or financial intermediary/credit institution, or a combination of these;
- provide an opinion based on the scope and detail of the audit of financial statements, including SOEs, SAs and other areas covered in the TOR, and follow up audit recommendations from previous years;
- provide a management letter describing any weaknesses identified in project accounting and internal control systems, including any internal audit function, and recommending improvements; and
- provide a translation of the reports in English, French or Spanish, if the originals were issued in another language.

4. The TOR/engagement letter should specify the term of an auditor's engagement and whether it is for a fiscal year or other period. Rotation of auditors after a number of years may be proposed, but frequent changes are not desirable in view of factors such as cost, the need for continuity and institutional memory, and shortage of qualified independent auditors in the borrower's country. The CI should ascertain the reasons for changing auditors.

5. The auditor is responsible for expressing opinions on the financial statements; responsibility for preparing and presenting them lies with project management. The form of annual financial statements and supporting documentation to be supplied to the auditor should therefore be specified. The estimated time for providing these documents to the auditor should be stated.

6. The scope of the audit should be explained by the borrower so that the auditor may determine if there are requirements beyond those of a routine audit. The following are examples of routine audit requirements:

- The audit should be carried out in accordance with acceptable auditing standards; the auditor should indicate any ways in which the examination would not conform to those standards.
- The auditor should comment on and confirm the extent to which acceptable accounting standards have been and are being consistently applied; the auditor should indicate any material deviation from international accounting standards (IAS) and the effect on a project's annual financial statements.

Statements of Expenditure

7. The auditor should be required to verify SOEs, accounting records and supporting documentation, and undertake a physical inspection of work done or goods and services acquired. The auditor should also, with reference to the disbursement letter sent from the CI to the borrower, establish that expenditures claimed for reimbursement under this procedure are eligible for financing in terms of the legal (loan) agreement between IFAD and the borrower.

Special Account

8. The auditor should be required to verify the correctness of transactions – withdrawals and replenishments – in the SA and the use of SA funds in accordance with the loan agreement. This should include examination of the reconciliation of the SA bank balance at year-end with project records and IFAD's disbursement records.

Management Letter

9. The management letter should identify shortcomings in a project and include comments and recommendations for improvements to the borrower's accounting, financial and administrative systems and controls. It should also contain remarks on other significant issues to which the project management's attention should be drawn.

10. To supplement the management letter, the auditor may be asked to conduct a special review of one or more of the following:

- economy, efficiency and effectiveness in the use of project resources;
- achievement of planned project results;
- legal and financial obligations and commitments of the project and the extent of compliance or non-compliance;
- systems and procedures such as improvements in accounting or IT and data-processing operations that may be under development, on which the auditor's comments are necessary to ensure accurate and efficient controls; and
- other activities on which an auditor may consider it appropriate to report.¹

Other Aspects Related to Audit Engagement

11. The auditor is required to prepare an engagement letter, a sample of which is given below. In countries where an auditor's obligations are provided for by law, this step may not be necessary; such a letter would still be informative, however, for the borrower, the CI and IFAD. It is in the interests of auditors and borrowers that the auditor sends the engagement letter before the audit commences in order to avoid misunderstandings. The form and content of the audit engagement letter may vary for each client but should generally include reference to the matters included in this Annex. It should also:

- state project management's responsibility for specifying the timing and nature of financial statements and disclosing all information to be provided under the audit arrangement;
- establish a timetable for providing the audit opinion and reports; and
- provide an estimate of staff time, audit fees and other reimbursable costs based on the scope of the audit and the effort and level of staff assigned to it.

12. In the case of recurring audits, the auditor should not be asked to issue a new engagement letter each year. The following factors may, however, call for a new engagement letter:

- any indication that the client misunderstands the objective and scope of the audit;
- any revised or special terms of the engagement;

¹ The foregoing list is not exhaustive, nor should all matters be addressed in every project. The scope and extent of an audit are likely to be unique to each project or project entity.



ANNEX IV

- recent change in project management;
 - significant change in the nature or size of the client project's activities; and
 - legal requirements.
13. The reporting package to be provided by the auditor would normally comprise:
- annual financial statement of the PIU or that of any financial intermediaries, including SOEs and SAs;
 - auditor's opinion, acceptable to the CI and IFAD, on the required financial statements, which must include: (i) a separate reference on withdrawals from the loan/fund account on the basis of SOEs in accordance with the loan covenants, and (ii) a separate reference on the audit of the SA in accordance with the stipulations of the loan covenants;
 - management letter; and
 - status of compliance with the legal covenants, if required in the TOR.

SAMPLE AUDIT ENGAGEMENT LETTER

To the Project Management (or appropriate Project Manager):

1. You have requested that we audit (insert names of financial statements) as of (dd/mm/yyyy) and for the year ending (dd/mm/yyyy). We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be carried out in accordance with applicable audit regulations in (name of country), with the objective of our expressing an opinion on the financial statements.
2. In forming our opinion on the financial statements, we will perform sufficient tests and reviews to obtain reasonable assurance as to whether the information contained in the underlying accounting records and other source data are reliable and sufficient as the basis for the preparation of the financial statements. We will also determine whether the information is properly communicated in the financial statements.
3. Because of the nature of the tests and other inherent limitations of an audit, and the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatements may remain undiscovered.
4. In addition to our report on the financial statements, we will provide an opinion on the use of SOEs and SA. We expect to provide you with a separate management letter concerning any material weaknesses in internal control that come to our notice.
5. May we remind you that project management is responsible for the preparation of financial statements, including adequate disclosure of relevant information. This includes maintenance of adequate accounting records and internal controls, selection and application of accounting policies, and safeguarding of assets. As part of our audit process, we will request from management written confirmation of representations made to us in connection with the audit.
6. We look forward to receiving the full cooperation of your staff. We trust that they will make available to us whatever records, documentation and other information we may request in connection with our audit.
7. Our fees, which will be billed as the audit work progresses, are based on the time required by the staff and other resources assigned to the audit, plus direct out-of-pocket expenses. Individual hourly rates may vary according to the degree of responsibility involved and the experience and skills of staff required for the audit.
8. Please sign and return the attached copy of this letter as confirmation that it is in agreement with your understanding of the arrangements for our audit of the financial statements.

Name of firm/company
(Chartered Accountants/Certified Public Accountants/other recognized profession)

Note: Additional items may be included in accordance with the Guidelines for TOR and engagement letter discussed in the body of this Annex.



SAMPLE TERMS OF REFERENCE FOR AUDIT OF PROJECT FINANCIAL STATEMENTS AND ACCOMPANYING STATEMENTS OF EXPENDITURE AND SPECIAL ACCOUNT, WHERE APPLICABLE

Objective

1. The objective of the audit of the project financial statement (PFS) is to enable the auditor to express a professional opinion on the financial position of (insert name) project at the end of each fiscal year and of the funds received and expenditures incurred for the accounting period ended (dd/mm/yyyy), as reported in the PFS, and an opinion on the statements of expenditure (SOEs) and special account (SA).
2. The project accounts (books of accounts) provide the basis for preparation of the PFS and have been maintained to reflect all financial transactions in respect of the project by the project-implementing agency (insert name).
3. The audit will be carried out in accordance with (state basis) and will include such tests and reviews as the auditor considers necessary under the circumstances. Special attention will be paid to establishing that:
 - all external funds have been used in accordance with the conditions stipulated in the financing agreements, with due attention to economy and efficiency, and solely for the purposes for which the financing was provided. The relevant financing agreements are: (insert names of loan agreements);
 - counterpart funds have been provided by (name the government ministry or the entity) and used in accordance with national or organizational financial regulations, with due attention to economy and efficiency, and solely for the purposes for which they were provided;
 - SAs, if used, have been maintained in accordance with the provisions of the financing agreement;
 - goods and services financed out of project funds have been procured in accordance with stipulations in the financing agreement and/or government regulations;
 - all necessary supporting documents, records and accounts have been kept in respect of all project ventures, including expenditures reported via SOEs or SAs; clear linkages should exist between the books of accounts and reports presented to the CI and IFAD;
 - the project accounts have been prepared in accordance with consistently applied (state basis) and give a true and fair view of the financial status of the project at (dd/mm/yyyy) and of resources and expenditures for the year ended on that date.

Project Financial Statements

4. The PFS will include the following:
 - yearly and cumulative statements of sources and application of funds, which should disclose separately IFAD's funds, counterpart funds (government), other donor funds and beneficiaries' funds;
 - balance sheet, which should disclose bank and cash balances (that should agree with the statement of sources and application of funds), fixed assets and liabilities;
 - yearly and cumulative SOEs by withdrawal application and category of expenditures;
 - reconciliation of the SA; and
 - consolidated financial statements, where a project consists of several entities.

ANNEX V

5. A reconciliation between the amounts shown as received by the project and those shown as being disbursed by IFAD should be attached as an annex to the PFS. As part of that reconciliation, auditors should indicate the procedure used for disbursement – SA/advance of funds, letters of credit, reimbursement or direct payment, and indicate whether the expenditure is fully documented or uses the SOE format.

Statements of Expenditure

6. In addition to the audit of the PFS, the auditor is required to audit all SOEs used as the basis for submitting withdrawal applications. The auditor should carry out tests and reviews necessary and relevant to the circumstances. These expenditures should be carefully compared for eligibility with relevant financial agreements, with reference to the project appraisal report¹ for guidance when necessary. Where ineligible expenditures are identified as having been included in withdrawal applications and reimbursed, auditors should note these separately. A schedule listing individual SOE withdrawal applications by reference number and amount should be attached to the PFS. The total withdrawals under the SOE procedure should be part of the overall reconciliation of IFAD disbursements described above.

Special Accounts

7. In conjunction with the audit of the PFS, the auditor is required to audit the activities of the SA(s)² associated with the project. The SA should be maintained in a reliable commercial or central bank. It usually comprises:

- authorized allocation or deposit(s) and replenishments received from IFAD;
- disbursements from the loan account substantiated by withdrawal applications submitted to the CI by the borrower and not yet authorized by IFAD;
- interest that may accrue on the balances outstanding, which belongs to the borrower; and
- the remaining balances of the SA at the end of each fiscal year or period being considered.

8. Auditors must form an opinion as to the degree of compliance with IFAD procedures and the balance(s) of the SA(s) at year-end. The audit should examine: (i) the eligibility and correctness of financial transactions relating to the SA during the period under review and the balances at the end of such period; (ii) the operation and use of the SA in accordance with the financing agreement(s); (iii) the adequacy of internal controls within the project appropriate for this type of disbursement mechanism; and (iv) review of the use of correct exchange rate to convert local currency expenditures to United States dollars.

9. References to project SAs are provided in the relevant financing agreements. SA statements and auditors' opinions regarding them should be included with the PFS.

Audit Opinion

10. Besides an opinion on the PFS, an annual audit report should include an opinion on the accuracy and eligibility of expenditures incurred under the SOE procedures and the extent to which the CI can rely on SOEs as a basis for loan disbursement under the project, and an opinion on the use of the SA. The auditor should submit the report to the borrower's designated agent rather than to any staff member of the project entity. The CI and IFAD should simultaneously receive the audited financial statements and the related audit report by the date specified in the loan agreement, generally no later than six months after the end of the accounting period or fiscal year to which the audit refers.

¹ Also referred to as staff appraisal report or project appraisal document.

² Separate SAs should normally be maintained for IFAD and other donor advances.



ANNEX V

The agent should then promptly forward two copies of the audited accounts and report to the CI and IFAD.

Management Letter

11. In addition to the audit report, the auditor will prepare a management letter, in which the auditor will:

- give comments and observations on the accounting records, systems and controls examined during the audit;
- identify deficiencies and areas of weakness in systems, procedures and controls and make recommendations for improvements in an action plan with a specified time-frame;
- report on the degree of compliance with each of the financial covenants included in the loan agreement and give any comments on internal and external matters affecting such compliance;
- communicate any significant matters that have come to the auditor's attention during the audit and that might have a material impact on project implementation; and
- bring to the borrower's attention any other matters that the auditor considers pertinent.

General

12. The auditor should be given access to all legal documents, correspondence and other information associated with the project that the auditor deems necessary for the purpose of conducting the audit. Confirmation should be obtained for amounts disbursed and outstanding in the accounting records of IFAD and/or other financiers and donors.

13. It is essential that the auditor becomes familiar with these Guidelines.

ANNEX VI

SAMPLE OF AUDITOR'S OPINION AND OUTLINE OF A MANAGEMENT LETTER

**MODEL AUDIT REPORT
Unqualified Opinion for:**

- I. A Project Implementing Agency**
- II. A Project Financial Statement including SOEs**
- III. A Special Account/Advance of Funds**

Addressee¹

Introductory Paragraph

We have audited the accompanying (name of each financial statement) of the (name of organization, name of project) under IFAD Loan No. ____ as of (dd/mm/yyyy) and for the year then ended. These financial statements are the responsibility of (insert name of borrower); our responsibility is to express an opinion on each of these financial statements based on our audit.

Scope Paragraph

We conducted our audit in accordance with (state basis) and IFAD's guidelines for special accounts and statements of expenditure. Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. Our audit included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. We believe that our audit provided a reasonable basis for our opinion.

Opinion Paragraph

In our opinion, the financial statements give a true and fair view of the financial position of:

- I. (name of organization) as of (dd/mm/yyyy) and of the results of its operations and its cash flows for the year then ended in accordance with (indicate international accounting standards (IAS) or relevant national standards);
- II. Sources and applications of funds² of (name) project for the year ended (dd/mm/yyyy) in accordance with (indicate IAS or relevant national standards). Note: if a balance sheet is required, add "financial position" at (dd/mm/yyyy);
In addition, (a) with respect to statements of expenditure (SOEs), adequate supporting documentation has been maintained to support claims to IFAD for reimbursements of expenditures incurred; and (b) such expenditures are eligible for financing under IFAD Loan Agreement no. _____.
- III. The financial position of the SA of the (name) project as of (dd/mm/yyyy) for the year then ended in accordance with (IAS or relevant national standards) and IFAD guidelines, and of the sources and application of funds.

(Name and address of audit firm)
(Completion date of audit)

¹ The auditor's report should be addressed to the entity requesting the audit, usually the borrower or project implementing agency unless required otherwise by local regulations.

² A source and application of funds statement is always required for each project. A balance sheet is also required where the project has assets and liabilities.



ANNEX VI

SAMPLE OUTLINE OF A MANAGEMENT LETTER

Dear:

We have audited the financial statements of (name of project or entity) for the year ending (mm/yyyy) and have issued our report dated (dd/mm/yyyy). In planning and performing our audit of (name of project or entity), we considered its internal accounting control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements, not to provide assurance on the internal accounting control structure. We noted no matters involving the internal accounting control structure and its operation that we consider to be material weaknesses in accordance with (international accounting standards or relevant national standards).

This report consists of three sections. Section I contains recommendations related to improvements in existing systems and procedures noted in the current year. Section II contains recommendations from prior years that have not yet been fully implemented. Section III contains recommendations from prior years that have been fully implemented. (Management's comments would be noted following each recommendation.)

This report is intended solely for the information and use of management and others within (name of project or entity) and should not be used for any other purpose.

During this year's audit we noted that (name of company or entity) has addressed most of the recommendations included in our prior year report. With respect to our current and carry-over recommendations, we suggest that the management should continue to prepare and approve an implementation timetable.

Very truly yours,



ANNEX VII

SAMPLE

STATUS OF AUDIT REPORT

Project no:
IFAD loan No:
Project name:

Loan agreement date: _____
Effective date: _____
Project completion date: _____
Loan closing date: _____
First disbursement date: _____

Audit requirement in loan agreement: section _____
Fiscal year period: _____
Audit report due date: _____
Mutually agreed auditor: independent/SAI/other: _____

1	2	3	4	5
Audit report for fiscal year ending	Due date (dd/mm/yy)	Date prepared (dd/mm/yy)	Date sent to CI (dd/mm/yy)	Remarks