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IFAD
INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT
Executive Board – Eighty-Second Session
Rome, 8-9 September 2004

REPORT OF THE AUDIT COMMITTEE

1. Further to discussions at its Eighty-Sixth Meeting on 6 September 2004, the Audit Committee wishes to draw the attention of the Executive Board to the following.

Implementation Status of Madison Consulting Group's Recommendations on IFAD Investment Security

2. At its Eightieth Session in December 2003, the Executive Board reviewed IFAD's investment policy as it pertains to the security of investments. The Board requested regular reports on the implementation of the recommendations made by Madison Consulting Group, the investment specialist company that had reviewed the security of IFAD's investments. To that effect the Secretariat had provided a report to the Audit Committee for submission to the Board, on implementation progress achieved through June 2004, as assessed by the Office of Internal Audit (OA).

3. The findings of the Madison report are structured around five categories: operational controls; procurement process; decision structure; staffing and organizational design; and business continuity planning. The first two categories are of an operational nature whereas the remaining categories deal with strategic controls. The implementation progress report reviewed by the Audit Committee differentiates between 'operational' and 'strategic' controls: recommendations pertaining to the former category were expected to be implemented by June 2004, while implementation of the latter is linked to actions concerning institutional structures and frameworks, some of which are of a longer-term nature.

4. The following steps have been taken to improve investment decisions:
- consolidation of the arrangement with the new Custodian (changed in April 2003);
 - formation of the Asset-Liability Management (ALM) Section (January 2004);
 - mainstreaming of procurement decisions in the Office of the Treasurer (FT);
 - upgrading to PeopleSoft 8 accounting software (April 2003);
 - launching of Phase I of PeopleSoft cash management module (June 2004); and
 - near finalization of an operational Treasury manual, the issuance of which should solve most of the operational control weaknesses identified by Madison.
5. For the recommendations related to longer-term strategic controls, action has been taken to align implementation to other institutional efforts, such as Treasury's (FT's) review of its organizational design in collaboration with the Office of Human Resources (FH) and approval thereof in March 2004. The new structure, which reflects the new ALM Section and Strategic Change Programme (SCP)-led changes, was formalized through a revised organizational chart and job descriptions. The personnel evaluation system was relaunched in 2004, whereby individual staff members have been given objectives that will be monitored throughout the year. However, a comprehensive training plan is still to be drawn up, based on an assessment of staff skills and on a broader spectrum of both technical demands and managerial requirements.
6. The continuity planning is currently under review. Management Information Systems (FM) has presented a business continuity proposal and the wider aspects are currently being covered through a risk and control framework assessment, the first phase of which is expected to be completed by end-2004.
7. The Committee commended IFAD's efforts to implement the Madison recommendations and the implementation status report presented at the meeting. However, clarification was requested on the following points:
- (a) **Decision structure.** At the next investment policy review, Management will need to decide whether to recommend the modification of asset allocation from an "absolute percentage" to a "percentage band" in order to increase operational flexibility; whether to revisit the credit rating requirement for mortgage-backed and asset-backed securities; and to compare the benefits of actively managing assets rather than investing in index funds. In response to the Committee's expressed concern regarding the potential risk associated with a "dynamic" approach to investment decisions, the Secretariat assured members that the ALM Section had been established to address the risks faced by IFAD, which reflected its prudent approach to risk management. The development of a financial model with different scenarios, which is currently being finalized, would provide a comprehensive picture of the impact of investment decisions on the balance sheet and income statements.
 - (b) **Cash level.** As per IFAD's investment policy, the allocation to cash is set at 5% of its investments and corresponds to approximately USD 100 million in cash holdings. This amount has been forecasted to cover recurring disbursements, mainly loans. The financial model will enable IFAD to make more appropriate provisions with regard to liquidity levels in order to meet its disbursement needs.
 - (c) **FT procurement and acceptance of gifts.** A clause regarding what constitutes a gift from a bidder will be added to the section entitled "Ethical Behaviour for Staff Involvement in Procurement" in the revised procurement guidelines, which are due by end-2004.

- (d) **FT procurement and technical evaluation team composition.** IFAD's small size may not always allow it to comply with the recommendation that no two members on the team should have a supervisor-subordinate relationship. However, sufficient controls are in place to ensure proper decision-making and are reviewed by an independent committee, including Senior Management.
- (e) **Treasury manual.** The manual is in its final stage of preparation and should be issued at the end of September 2004. With regard to the question of distributing the manual to its members, the Committee noted that internal rules, regulations and manuals were not generally distributed to the Board and its committees on a systemic basis, although copies may be provided upon request.
- (f) **Follow-up on pending recommendations.** Each year, OA reviews the implementation status of OA recommendations. The implementation status of pending Madison recommendations will be incorporated into the OA review and reported to the April 2005 Session of the Executive Board through the Audit Committee. IFAD concurs with most of Madison's recommendations and intends to implement them as soon as practicable, given the resource constraints caused by ongoing SCP implementation.

General Reserve

- 8. The General Reserve was established to cover four distinct risks:
 - (a) potential over-commitment as a result of exchange rate fluctuations;
 - (b) possible delinquencies in receipt of loan service payments;
 - (c) possible delinquencies in the recovery of amounts due to the Fund from the investment of its assets; and
 - (d) diminution in value of assets caused by fluctuations in the market value of investments.
- 9. The Executive Board is required to review the General Reserve through the Audit Committee every three years or earlier if necessary. The 2002 review recommended that the General Reserve be assessed again in 2004, once the new investment policy had been implemented.
- 10. To this effect, the Secretariat informed the Committee of the current situation of IFAD with respect to the above-mentioned risks and the steps taken to mitigate them.
- 11. As in previous years, the risk of over-commitment as a result of exchange rate fluctuations is reduced by the general alignment of assets to the Special Drawing Right (SDR) basket of currencies.
- 12. To minimize the risk associated with non-recovery of loan principal, loans are stated at cost, minus an allowance for impairment losses. In line with International Accounting Standard (IAS) 39, "Financial Instrument: Recognition and Measurement", IFAD reviews its loan portfolio regularly for impairment and makes an allowance in the event of any uncertainty about the receipt of the full amount.
- 13. The new investment policy has reduced both the risk of possible delinquencies in the recovery of amounts due to the Fund for its fixed interest investments and the risk associated with fluctuations in the market value of investments.
- 14. The IFAD asset and liability management review in 2003 included two specific action points with regard to financial risks: (i) to reduce market risk in the investment portfolio by holding a pre-determined amount in a held-to-maturity portfolio; and (ii) to hedge the Global Fixed Income exposure against the SDR currency weight, which has been achieved as of 1 July 2004. Policies are

expected to be implemented to address the first point during 2004, the results thereof should be assessed by the next review of the level of the General Reserve.

15. In addition, the approach to assessing IFAD's internal control framework, as presented to the Audit Committee by OA, includes an initial risk assessment exercise aimed at documenting the main risks to which the Fund is exposed in meeting its institutional objectives. The results of this exercise, which is expected to be completed by December 2004, should also be considered in the next review of the level of the General Reserve.

16. The level of risk related to exchange rate fluctuations may alter upon implementation of the revised IAS 21 on the Effects of Changes in Foreign Exchange Rates, to become effective as of 1 January 2005.

17. The Committee requested the Secretariat to provide clarification on the following points:

- (a) **History of the General Reserve.** Established in 1980 by the Governing Council with an initial amount of USD 10 million, the level of the General Reserve rose through annual transfers of funds into it until it reached USD 95 million in 1994. After that, based on the decision of the Board, no further transfers were made into it because the level was considered to be adequate.
- (b) **Reduced risks and the need for a General Reserve.** By earmarking a General Reserve of USD 95 million to cover four distinct risks, IFAD would be acting prudently compared with the concessional lending arms of other international financial institutions (IFIs). First, unlike other IFIs, IFAD does not benefit from the protection of a parent organization. Secondly, IFAD is currently looking at ways of further mitigating these risks through different areas such as ALM implementation and the strengthening of its internal control framework. However, since these initiatives have not yet been fully implemented, it would be premature to attempt a discussion on whether or not the General Reserve is needed or whether its level should be reduced. The presence of the Reserve is in line with market practice and an indicator of good financial management.
- (c) **Pilot project "held-to-maturity portfolio".** This project will be launched once the financial model has been finalized so as to assess the project's potential impact on the net investment income and on its volatility.

18. Based on the present situation regarding the four above-mentioned risks and a number of initiatives related to these risks that are currently under way, the Committee recommends that the level of the General Reserve should be maintained at USD 95 million and that it should be reviewed again in 2006 with regard to adequacy, taking into consideration the impact of the ALM action points due to be implemented in the meantime.

After-Service Medical Coverage Scheme

19. At the Eighty-Third Meeting of the Audit Committee, the Secretariat was requested to review options available to IFAD with respect to the valuation and management of the After-Service Medical Coverage Scheme (ASMCS), following the results of the 2003 valuation.

20. IFAD participates in a group plan that is administered by the Food and Agriculture Organization of the United Nations (FAO). The actuary engaged by FAO estimates the value of the staff medical benefits for the entire scheme and IFAD is allocated a share of these benefits.

21. In order to bring the methodology in line with best market practice, the basis of allocation of liability has changed, from pensionable remuneration to headcount, in addition to other improvements.

22. The actuarial valuation is carried out every two years as at year-end, with the resulting accounting gain or loss to be taken into consideration in the financial year in which the final results are known. Therefore, the accounting gain from the outcome of the 2003 valuation should be shown in the 2004 accounts in compliance with the International Financial Reporting Standards (IFRS).

23. The Committee requested clarification on the following points:

- **Increase in the current service cost.** This is linked to the increase in the premium rates and comes from the independent actuarial valuation that is reviewed by the External Auditor every year.
- **Difference** between IFAD's allocated share of the past service costs at 31 December 2001 (USD 23.3 million) and the liability and related assets in IFAD's Financial Statements at 31 December 2003, excluding the accrued retiree costs (USD 27.3 million). The difference of USD 4 million is due to the accrued current service cost.
- **Budgetary considerations** related to the increase in the current service cost will be discussed when the detailed budget figures become available in November 2004.
- **The options permitted by IFRS.** There are four options permitted by the IFRS to recognize accounting gain or loss. The recommended option immediately recognizes accounting gain or loss without the 10% corridor. This is a straightforward approach that mirrors IFAD's accounting policy for the recognition of liabilities.
- **Change in the allocation basis from pensionable remuneration to headcount.** This is best market practice and reflects liability based on medical premiums rather than on the salary level.
- **Exclusion of the Associate Professional Officers (APOs).** APO's contracts never reach the ten years of service required for them to be eligible. This technical error has been addressed in the 2003 valuation.
- **IFAD's own actuarial valuation outside the group scheme.** In 2001, World Food Programme (WFP) decided to go out of the FAO group valuation and the Fund has also considered this option. IFAD has been participating actively in operational decisions and, in the context of zero real growth budgets, it is recommended that IFAD remain in the FAO group valuation.
- **16 per cent increase in the number of active employees.** This increase is related to non-core funds, the filling of vacant posts and the extension of temporary contracts. Therefore no increase is required in IFAD administrative costs.

24. On the basis of the information provided and the discussions on the above issues, the Audit Committee makes the following recommendations to the Board:

- (a) The accounting gain arising from the 2003 actuarial valuation should be fully released through the 2004 profit-and-loss account. Under the regulations governing the IFAD's ASMCS Trust Fund, any release of funds back to IFAD requires authorization from the Executive Board. The Audit Committee therefore recommends that the Executive Board authorize the release of the 2003 accounting gain at its Eighty-Second Session.

- (b) For the present, IFAD should remain in the FAO group scheme, based on practical considerations such as the additional administrative and human-resource requirements involved in setting up an individual scheme. In addition, IFAD has provided input to the selection of certain key base assumptions for the 2003 valuation, not least the method of allocation. IFAD will continue to actively participate in operational decisions in subsequent valuations, and the Secretariat will evaluate whether or not this decision should be modified.
- (c) Any future actuarial gains and losses should be recognized immediately in IFAD's Financial Statements where required under IFRS, without having to make a formal request through the Audit Committee to the Executive Board in each relevant year for a mandatory accounting entry. It is recommended that the President of IFAD make transfers of internal resources to the Trust Fund when required. The Audit Committee and the Executive Board should be informed of any such transfers.

Liability of the Audit Committee Members

25. Having been requested to provide an opinion on the subject, the General Counsel stated that Article 3, Section 3, of the *Agreement Establishing IFAD* provides that: "No Member shall be liable, by reason of its membership, for acts or obligations of the Fund." Therefore, this and the immunity of the Fund, its staff and Member State representatives, ensures that the Members of the Committee will not be legally or financially liable for actions taken whilst serving on the Audit Committee.

Audit Committee Seminar by the External Auditor, PricewaterhouseCoopers on 18 June 2004

26. During the review of the Audited Financial Statements of IFAD for 2003 at its Eighty-Fourth Session, the Committee requested the Secretariat to undertake further analyses and comparative studies in order to facilitate interpretation of the figures when assessing financial soundness and operational efficiency and effectiveness.

27. The Committee proposed to hold a discussion before next year's review. A seminar was organized by the External Auditor on the following financial topics, details of which may be obtained on request:

- **Budgeting process and key performance indicators (KPIs).** IFAD's budgeting process is undergoing an important change from the traditional category base to activity-based budgets, which will make it possible to link operational expenses to activities that derive directly from IFAD's strategic objectives. Implementation of the new budgeting module within the integrated financial systems will provide the foundation for building the KPI structure in the next stage aimed at aligning IFAD to best practices in financial reporting.
- **Comparison with other financial institutions.** The External Auditor presented some 2003 financial data and ratios provided by the African Development Bank, Asian Development Bank, and the European Bank for Reconstruction and Development for comparison with those of IFAD. While, to a great extent, the difficulty of comparing institutions of different sizes may be overcome by comparing ratios rather than actual figures, the use of debt financing by the other three institutions constitutes an important obstacle to any meaningful comparison of, for instance, lending terms, loan income and operating expenses. However, it was noted that, overall, comparison with the three institutions points up the strength of IFAD's financial condition and performance. Given that comparison should only be made to peers with a similar mission and financial structure, it was agreed that such benchmarking and analyses would benefit IFAD. Furthermore, using a number of important ratios would be helpful, both in the preparation of budgets and in the replenishment negotiations.

- **Impact of exchange rate movements.** As an international financial institution, IFAD deals with different currencies. Its financial statements are reported in United States dollars while its unit of account for loans is the SDR. Moreover, the Fund's investments and contributions are in multi-currencies. The Financial Statements for 2003 provided information on the underlying currencies for investments and loans, and on its total assets in SDRs. In order to gain a better understanding of what the exchange rate fluctuations represent, some additional summary tables in SDR in the areas of most significant activities will be considered – albeit to the extent possible from the systems point of view. IFAD is also studying a revision to the standard from the IFRS, which will become effective on 1 January 2005, specifically concerning the issue of the exchange rate impact. IFAD's treatment of this revised standard will be communicated to the Audit Committee in due course.