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IFAD
INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

Executive Board – Eighty-Fourth Session

Rome, 18-20 April 2005

REPORT OF THE AUDIT COMMITTEE

1. Further to its Eighty-Ninth Meeting on 31 March 2005, 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 2004

2. The Committee reviewed the draft audited financial statements of IFAD for the year ending 31 December 2004. It noted with satisfaction the opinion of the external auditor, PricewaterhouseCoopers, that the statements gave a true and fair view of the consolidated financial position of IFAD and the results of its operations and cash flows, in accordance with International Financial Reporting Standards (IFRS) (formerly International Accounting Standards).

3. The Committee commented on the presentation format and on general issues, and the Secretariat and the external auditor responded as follows:

- (a) **Format of the financial statements and scope of the notes to the 2004 accounts.** The external auditor confirmed that the format of IFAD's financial statements and the notes to the accounts are in line with underlying accounting principles. In future, any financial or trend analyses and explanatory information to further assist the Committee's review of the financial statements will be provided in a separate document as an enhanced version of the current presentation of financial highlights.
- (b) **Increase in operating expenses from 2003 to 2004.** The Committee asked whether it was possible to distinguish from other factors the **increase** caused by depreciation of the United States dollar (USD) against the euro. The Secretariat replied that while the increase reflected several factors, it mainly had to do with inflation-linked salary and benefit increases and the higher USD equivalent of expenses incurred in euros (local works, goods and services). The Committee was surprised at the 16% increase in such expenditures; that was much higher than that in the exchange rate (+9.1%), which did not have an impact on all operating expenses.

- (c) **Non-convertible currency accounts.** The Eighty-Fifth Meeting of the Audit Committee in April 2004 was informed that the non-convertible currency (NCC) bank accounts with immaterial balances were being closed in line with the external auditor's recommendation. The current session of the Committee was informed that the five NCC bank accounts had been closed during the last quarter of 2004 and balances (in the range of USD 100) written off. With regard to the remaining NCC accounts, IFAD is attempting to obtain confirmation of the balances involved since they were in the range of about USD 10 000 equivalent. In the absence of confirmation or certification from the central banks involved, steps are being taken to close the accounts and to confirm IFAD's action to the respective banks.
- (d) **Link between budget and actuals.** The Committee noted that there were significant variations in administrative costs from one year to another and asked about the relationship between the budget and actuals for 2004. As requested by the Executive Board during its discussion on the Programme of Work and Budget of IFAD for 2005, an analysis of past budgets vs. actuals and a detailed analysis of human resources numbers (including consultants) will be provided during the budget review process scheduled for November 2005.
4. In its detailed discussion of the draft audited financial statements, the Committee requested the Secretariat to provide further explanation on the following:
- (a) **Average rate of return on the consolidated investment portfolio (AC 2005/89/R.5, paragraph 2).** Financial markets continued to be favourable to the investment portfolio in 2004, especially for global government bonds and equities. However, IFAD's decision to be fully hedged against currency risk and to reduce the duration of its investments in global government bonds and inflation-indexed bonds to three years and six years, respectively, lowered its volatility but limited opportunities for enhancing returns on its investment portfolio.
- (b) **Increase in direct charges against investment income from 2003 to 2004 (AC 2005/89/R.5, paragraph 4).** The Committee asked the reason for the sharp, 29% increase in direct charges against investment income from 2003 to 2004 and the increasing ratio against the value of the total portfolio from 0.22% to 0.26%. The Committee was particularly surprised at the 72% increase in advisory fees, from USD 365 000 to USD 629 000, and at the 35% increase in total management fees, from USD 4.014 million to USD 5.422 million (see Table 1 in the annex to this report). As mentioned during its review of the proposed budget for 2005, the Committee recommends that investments should be managed in a more economical manner and stressed that the revised investment policy should decrease, rather than increase, such fees.
- (c) **Increase in the loan disbursements (AC 2005/89/R.5, paragraph 9).** There was an increase of 8.8% (+USD 25.3 million) in loan disbursements in 2004 due to factors such as active work of the Loans Unit, excellent partnerships with cooperating institutions and an increase in the average SDR/USD exchange rate of 5.8% from 2003 to 2004.
- (d) **Increase in loan principal repayments (AC 2005/89/R.5, paragraph 10).** Loan principal repayments increased by USD 31.6 million from 2003 to 2004 as a result of the accumulation effect of the reflows pattern, increased receipts directly related to the Debt Initiative for Heavily Indebted Poor Countries (HIPC) and positive exchange rate effects.

- (e) **Allowance for loan impairment losses: movement from 2003 to 2004 (AC 2005/89/R.4, Appendix A).** This allowance is based on the difference between expected cash flows derived from those calculated on the estimated or renegotiated repayment schedule and the nominal value. The entire loan – and not just the overdue instalment – is subject to impairment. An allowance is made on loan instalments overdue by more than 24 months for all cases where a settlement plan is not being actively followed. In cases where more than 48 months have elapsed, an allowance is made for all outstanding principal amounts of the loan concerned. The point in time from which it is necessary to determine whether or not the given period has elapsed is the balance-sheet date. In 2004, the increase in loan provision of some USD 49.0 million was due principally to two borrowers (Togo and the Solomon Islands), which reached 48 months of repayments overdue, as well as three countries not fully covered by the Debt Initiative for HIPCs. Instead, the 2003 net release to income of some USD 17.5 million was mainly due to the transfer of one country's provision (the Democratic Republic of the Congo) under the Debt Initiative. The cut-off date for the calculation of provisioning for loan reflows is at the balance-sheet date, in accordance with international financial reporting standards.
- (f) **Consultancy trust fund (AC 2005/89/R.4, Appendix E1).** This information is shown under Programmatic Supplementary Funds in Table 7 of Appendix E.1 of the financial statements. Once the audited financial statements have been endorsed by the Executive Board, a donor statement containing detailed information as at 31 December 2004 will be provided to each relevant Member State.
- (g) **Movement in the account for foreign exchange rates: line loans and grants outstanding (AC 2005/89/R.4, Appendix H, Note 2(c)).** The foreign exchange movement for loans and grants outstanding stood at USD 2.991 million in 2003 and at USD 1.559 million in 2004. This is linked directly with the movement of the special drawing right (SDR) against the United States dollar as IFAD loans are denominated in SDR but reported in USD; in 2004, the SDR strengthened against the USD by some 4.3% compared with 9.3% in 2003.
- (h) **Restatement of contributions income relating to the Debt Initiative for Heavily Indebted Poor Countries (AC 2005/89/R.4, Appendix H, Note 2(i)).** Contributions income for the Debt Initiative for HIPCs was previously recorded directly into the relevant trust fund. However, with the change in the accounting principle in 2004, this income was reclassified within IFAD resources to reflect its impact more transparently and fairly so as to directly offset the related liability borne by IFAD.
- (i) **Derivative instruments (AC 2005/89/R.4, Appendix H, Note 4(d)(iii)).** In reply to a question as to why the unrealized market loss was accounted for only at the end of the year, the Committee was informed that the unrealized market gain/loss was accounted for on a monthly basis and that IFAD used derivative instruments to hedge against market risk rather than with the scope of speculative gains.
- (j) **Increase in staff salaries and benefits from 2003 to 2004 (AC 2005/89/R.4, Appendix H, Note 7).** Table 2 in the annex to this report gives the number of staff on the payroll by staff category for the years 2001 to 2004, with movement from 2003 to 2004. Tables 3-5 in the annex to this report show the movement in the staff costs by headcount, staff cost component and increase component.
- (k) **Expenses related to the Debt Initiative for Heavily Indebted Poor Countries (AC 2005/89/R.4, Appendix H, Note 11).** The cost of the Debt Initiative for HIPCs for

the year is based on the difference between the cumulative cost of debt relief committed at each year-end following the annual interest cost charge and taking out the impact of exchange-rate movements, which are reflected in a separate cost line. The Debt Initiative cost analysis is shown in Table 6 in the annex to this report. The Committee was informed that most Debt Initiative contributions were received through the World Bank HIPC Trust Fund.

- (l) **Impact of the Debt Initiative for Heavily Indebted Poor Countries (AC 2005/89/R.4 Appendixes G and H, Note 11).** The Committee took note of the amount shown by IFAD management in relation to the financial impact of the Debt Initiative for HIPC: at 31 December 2004, eligibility for funding under the Initiative was approved for 27 countries for a total of USD 304.8 million, plus USD 156 million for countries that were nearing decision points for which the IFAD Executive Board is expected to authorize debt relief in 2005. The Committee was informed that, as at 31 December 2004, the net accumulated Debt Initiative allowance of USD 240 million represents the best estimate of the debt relief currently approved by the Executive Board. However, IFAD will continue to participate in the Debt Initiative as and when decided by the International Monetary Fund following approval by the Executive Board. IFAD will continue to seek support from its donor countries/World Bank Trust Fund in order to alleviate its share of the total liability in this regard.
- (m) **Provisions (AC 2005/89/R.4, Appendix H, Note 14(a)).** As to whether a country that is in contributions provision is still eligible for new loans, the Committee was informed that, legally, there was no link between contributions arrears and loan disbursement eligibility.
- (n) **Contingent assets (AC 2005/89/R.4, Appendix H, Note 21(b)).** The Italian authorities have been requested to refund outstanding taxes on IFAD's holdings of Italian Government bonds, which currently stand at USD 1.319 million. Tax claims have been filed with the Italian authorities, and approval for the refund is pending with the Ministry of Finance. IFAD will continue to follow up on the matter until the refund has been received in its entirety. For that reason, the amount is not included in the assets but is recorded as contingent assets.

Reappointment of the External Auditor

5. As a result of the tender launched in 2002, PricewaterhouseCoopers was reappointed as 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 2005 audit and related fee, and confirmed the reappointment of the external auditor.

Review of the 2004 Proposal from PricewaterhouseCoopers and Related Fee

6. Having revised the fee of the external auditor, the Committee approved its request, as follows:

Audit fees for recurring work	Euro
IFAD	81 000
Combined supplementary funds	5 500
Belgian Survival Fund Joint Programme (BSF.JP)	5 000
Global Mechanism of the United Nations Convention to Combat Desertification	7 500
International Land Coalition	6 000
	<u>105 000</u>
Non-recurring audit work	
Decentralization/loans-contributions	<u>10 000</u>
Total fees	115 000

7. **Recurring work.** The external auditor's fees for recurring work have increased on a yearly basis to reflect inflation: EUR 100 000 in 2003; EUR 103 000 in 2004; and EUR 105 000 in 2005.

8. **Non-recurring work.** The fees for non-recurring work amounted to EUR 30 000 in 2003 and EUR 15 000 in 2004. The work involved verifying data migration and correct transition from the old to the new accounting system as well as process changes that took place under the Strategic Change Programme. In reviewing the external auditor's proposal of 2003, the Committee stressed that "should this non-recurring work last until [the following] year, ... that the extra EUR 30 000 would cover the work done [in the following] year" on the "accounting transitions and new systems, procedures and controls related to implementation of the Strategic Change Programme (SCP), the transfer of investment accounting to the new custodian bank and initial consolidation process of funds under IFAD's administration."¹ For the audit of the 2004 accounts, the external auditor included EUR 5 000 for additional tests related to consolidation of the accounts. For 2005, the non-recurring work will cover controls on budget decentralization and finalization of enhancements to the loans and grants system and implementation of the new payroll system.

Preventing and combating fraud and corruption in IFAD's activities and operations

9. The Secretariat presented a policy paper (AC 2005/89/R.7) on this subject to the Committee, the objectives being to:

- affirm and communicate IFAD's resolve to prevent and combat fraud and corruption in its activities and operations;
- describe IFAD's ongoing efforts in this area; and
- outline IFAD's short- and medium-term plan of action.

10. The policy paper describes the present experience with control processes in IFAD's activities and operations in terms of staff and individuals representing the Fund as well as field-level experience in the context of trends followed by major international financial organizations and United Nations organizations.

11. The IFAD policies presented for approval cover the following levels at which corruption and fraud should be prevented:

¹ AC 2003/82/R.3, paragraph 14

- IFAD staff and individuals representing the Fund;
- country programming, lending, technical assistance and policy dialogue activities; and
- loans and grants activities.

12. The Fund's full adherence to these policies will require the strengthening of controls and introduction of additional tools. Some of these actions will be implemented during 2005; based on an assessment of experience gained and emerging needs, further action will be taken in the coming years.

13. As to how such policies would translate into a plan of action for IFAD and with respect to the harmonization and alignment with other international financial institutions and United Nations organizations, the Committee was informed that the paper would be amended to provide more details on further action planned and the impact of harmonization/alignment initiatives in this respect. One first action will be the issuance of a "Code of Conduct". IFAD maintains close contact with its sister agencies in Rome and with the Asian Development Bank and the African Development Bank in this regard and, where applicable, good practices applied by those organizations will be adopted by IFAD in implementing the actions outlined in the paper.

14. The Committee was informed by the General Counsel that IFAD's practice in this regard is in line with those of most United Nations organizations – if not more aligned to best practices. An ad hoc committee of 16 legal office representatives of the United Nations system for interagency elements has been set up under the chairmanship of IFAD's General Counsel. A common issue encountered by all these organizations is the difficulty of interacting with national authorities to redress corrupt practices.

15. Information on past cases of corruption, including the sanctions applied, will be presented to the Audit Committee in July 2005 as part of the Annual Report of the Oversight Committee.

16. The policy paper will be revised in the light of comments received from the Audit Committee and submitted to the Executive Board in September 2005 for approval.

Oversight and Internal Control at IFAD

17. At its Eightieth Meeting, the Committee requested the Secretariat to ensure that IFAD's internal control framework was documented and its adequacy assessed, for which the Secretariat prepared and implemented a plan of action. The Committee reviewed the report (AC 2005/89/R.8) on progress made as of December 2004 and noted the following achievements: assessment of organizational risk and internal controls based on the Committee of Sponsoring Organizations of the Treadway Commission model ("Internal Control – Integrated Framework"); and the undertaking of a business impact assessment to prioritize organizational procedures and systems for continuity and disaster-recovery planning.

18. The assessment identified a number of risks in the areas of organizational efficiency and financial soundness, but noted that mitigating efforts and initiatives were planned/under way both to address the higher risks and strengthen the corresponding control weaknesses.

19. Managing of risk and the harnessing of information to support the delivery of institutional priorities were also risk areas noted in the assessment. For this, the following main mitigating actions are already under way:

- concrete steps to build risk management into existing management process;
- an internal audit on the management of internal projects and institutional initiatives;

- implementation of the Performance-Based Allocation System, Results Impact Management System and the Field-Presence Pilot Programme so as to measure and monitor the effectiveness and impact of field projects;
- according independence to the Office of Evaluation and strengthening in the use of monitoring and evaluation; and
- annual reports on the result and impact of IFAD's operations.

20. With a view to gradually integrating risk management into the Fund's management decision-making processes, a critical step that is already under way is the incorporation of risk management tasks into the 2006 strategic planning and budget process and their active support by the Office of Internal Audit.

21. The Committee commended the Secretariat on the information presented and action taken, and made the following requests:

- Clarification of the rating "**moderately high risk**". The Committee was informed that, in order to summarize and consolidate, the items with both high and moderate risk were discussed together. Therefore, the wording could be more appropriately stated as "moderate and high" risk. Action has been taken for both high risk and moderate risk items. Risk management is an ongoing exercise that involves identifying risks and taking action upon them. This is a management tool to help the organization hedge against risk exposure.
- **External auditor opinion.** The Committee requested the external auditor to provide a written opinion on document AC 2005/89/R.8.

Recommendations

22. The Audit Committee recommended endorsement of the IFAD Financial Statements for 2004 by the Executive Board for presentation to the Twenty-Ninth Session of the Governing Council.

23. The Audit Committee recommended that the Executive Board accept PricewaterhouseCoopers' proposal and approve the audit fee of EUR 115 000.

ADDITIONAL FINANCIAL INFORMATION

Table 1. DIRECT CHARGES AGAINST INVESTMENT INCOME, 2000-2004 (USD '000)					
	2000	2001	2002	2003	2004
Global fixed income	1 960	1 700	1 700	1 953	2 211
Diversified fixed income	900	950	1 120	817	1 285
Global Treasury Inflation-Protected Bonds	-	-	-	218	686
Equities	7 000	6 500	3 300	1 026	1 240
Currency overlay	600	300	100	-	-
Total management fees	10 460	9 450	6 220	4 014	5 422
Core services ^a	1 170	1 200	1 100	332	201
Transaction ^b	1 500	2 000	1 500	164	160
Auxiliary ^c	430	560	650	324	301
Total custody fees	3 100	3 760	3 250	820	662
Financial advisor	60	150	200	-	250
Legal and tax advisors	135	100	100	105	119
Financial information provider	142	130	200	200	200
Consultants	125	30	100	60	60
Computer systems	-	-	100	-	-
Total advisors and information services	462	410	700	365	629
Total direct charges (DCII*)	14 022	13 620	10 170	5 199	6 713
Total portfolio value	2 068 191	1 917 089	2 093 993	2 356 921	2 559 975
Gross investment income	(36 441)	(32 497)	34 050	113 477	115 239
Net investment income	(47 850)	(42 982)	26 186	107 962	108 662
Ratio DCII/total portfolio value	0.68%	0.71%	0.49%	0.22%	0.26%

* DCII = Direct charges against investment income.

^a **Core services** include standing charges, assets in custody and clean payments.

^b **Transactions** include foreign exchange transactions, derivatives and fixed deposits (line items and transactions).

^c **Auxiliary** include compliance and performance.

Table 2. STAFF ON THE PAYROLL						
	2001	2002	2003	2004	Movement 2003-2004	
					Number	Percentage
Professional	168	195	192	216	+24	+12.50%
General Service (GS)	253	259	272	287	+15	+5.51%
Total^a	421	454	464	503	+39	+8.41%

^a These figures include staff charged to the IFAD administrative budget, Programme Development Financing Facility (PDFF), Belgian Survival Fund Joint Programme, Associate Professional Officer fund, programmatic funds and other supplementary funds

Budget Source as at 31 December 2004 and 31 December 2003	2004			2003			Movement	
	Prof.	GS	Total	Prof.	GS	Total	No.	%
IFAD admin. budget	169	238	407	147	244	391	+16	+4.09%
IFAD PDFF	10	22	32	9	12	21	+11	+52.38%
IFAD sources	5	21	26	4	10	14	+12	+85.71%
BSF.JP	1	4	5	2	3	5	0	0.00%
Associate professional officer	18	0	18	20	0	20	-2	-10.00%
Programmatic funds	13	2	15	10	3	13	+2	+15.38%
Total	216	287	503	192	272	464	+39	+8.41%

Breakdown	2004			2003			Movement	
	Prof.	GS	Total ^a	Prof.	GS	Total	No.	%
Salaries and post adjustment	13.1	9.7	22.8	11.7	6.6	18.3	+4.5	24.59%
Education grant and other allowances	4.4	0.6	5.0	2.2	0.4	2.6	+2.4	92.31%
Pension and medical plan contributions	5.1	2.4	7.5	4.3	2.1	6.4	+1.1	17.19%
Home leave	0.4	-	0.4	0.3	-	0.3	+0.1	33.33%
Repatriation and termination	0.6	0.7	1.3	0.5	0.9	1.4	-0.1	-7.14%
Relocation and recruitment	0.5	-	0.5	0.6	-	0.6	-0.1	-16.67%
Short-term temporary staff	1.4	2.2	3.6	2.0	2.3	4.3	-0.7	-16.28%
Overtime	-	0.3	0.3	-	0.3	0.3	0.0	0.00%
Training expenses	0.1	0.1	0.2	0.1	0.2	0.3	-0.1	-33.33%
Total	25.6	16.0	41.6	21.7	12.8	34.5	7.1	20.58%

^a Includes the carry forward of unused 2003 administrative budget allocations (2004: USD 0.4 million), one-time costs (2004: USD 0.5 million) and external evaluation (USD 0.5 million).

2003 staff costs	34.5
Increase in Professional staff costs due to base salary increase	0.3
Increase in General Service staff costs due to base salary increase	0.9
Increase in General Service staff costs due to exchange rate movements	1.4
Increase in Professional staff costs due to post adjustments	0.8
Increase due to one-time costs approved in 2004 budget	0.5
Increase in the Professional staff base salary due to promotion	0.5
Increase in Professional staff benefits (12 General Service converted to Professional)	1.8
Increase in Professional staff pension (5.2% Jan- Sep, 4.42% Oct-Dec) and medical (21%)	0.8
Increase in after-service medical insurance costs	0.1
Total increase	7.1
2004 staff costs	41.6

N.B. Figures are approximate

Table 6. ANALYSIS OF COSTS OF THE DEBT INITIATIVE FOR HIPCs		
Years ended 31 December 2004 and 31 December 2003		
(USD '000)		
	2004	2003
Cumulative cost of debt relief	293 227	260 061
Interest costs	5 610	3 875
Change in overall provision	(4 020)	10 135
Subtotal charge to income statement	1 590	14 010
Exchange rate movements	10 016	19 156
Cumulative cost of debt relief at year-end	304 833	293 227

