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**IFAD**

**INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT**

**Executive Board – Eighty-Fifth Session**

Rome, 6-8 September 2005

**REPORT OF THE AUDIT COMMITTEE**

1. Following its Ninetieth Meeting on 4-5 July 2005, the Audit Committee wishes to draw the attention of the Executive Board to the following matters.

**Annual Report of the IFAD Oversight Committee**

2. The Oversight Committee (OVC) is the IFAD body responsible for coordinating investigations into allegations of irregular practices. Established in May 2000, the OVC membership comprises the Vice-President of IFAD as Chair, the General Counsel and the Chief of Internal Audit. The mandate of the OVC was reinforced in July 2003 when it adopted the United Nations/International Financial Institution (UN/IFI) Uniform Guidelines for Investigation and introduced the requirement that the Committee should make annual reports to staff on important features of cases handled and the action resulting therefrom.

3. The first such report was issued to IFAD staff in June 2005 and shared with the Audit Committee at its Ninetieth Meeting for the purpose of describing the range of oversight activities undertaken by the Fund. The report covered all cases handled in the last 18 months and the main cases handled in 2000-2003. Approximately half the complaints received by the OVC were substantiated or confirmed; the majority of cases related to misconduct by staff and/or contractors, including consultants.

4. The report also made a presentation of the lessons learned, as follows:
- **Prevention.** Control weaknesses were noted by the OVC with regard to both consultants and guidance on conduct. The Committee was informed that an audit of controls over the administration of consultancy services was expected to be finished by the end of 2005. Proper ethical guidance will be provided by the Code of Conduct (Chapter 8, IFAD Human Resources Procedures Manual) issued in July 2005.
  - **Detection.** Allegations are not always passed on to the OVC. The Committee was informed that the OVC report was introduced to IFAD staff through a series of divisional presentations, which significantly raised the awareness of staff as to their obligation to report on possible irregularities encountered during the performance of their official duties.
  - **Investigation.** Proper investigation is a time-consuming activity. The Committee was informed that management was considering a proposal for strengthening IFAD's investigative capacity in order to limit the internal disruption that such investigations inevitably cause.
  - **Sanctions.** The debarment process for contractors dealing with projects will need to be properly structured. The Committee was informed that an IFAD debarment policy and process to be introduced for contractors and consultants would cover the whole spectrum of its operations.
5. The report highlights the OVC's obligation to fully protect staff from retaliation or retaliatory action (for staff members who, in good faith, report an irregularity to the OVC) and malicious accusations (for staff members accused in bad faith).
6. The Committee was informed of the main courses of action planned in this area. Apart from those outlined above, this will include the establishment of a web-based channel for communicating allegations and the revisiting of cooperating institution arrangements for reinforcing and formalizing the manner in which project-related allegations are handled.
7. Regarding sanctions, the Audit Committee Member from Japan shared information on measures currently applied by the Japanese Foreign Ministry. Japanese contractors or consultants found to have corrupt practices are debarred from bidding for Japanese official development assistance (ODA) projects for one year and their names are publicized. In the interests of greater transparency, the names of Japanese contractors that are awarded contracts for ODA projects are published on an official web site.
8. The Secretariat fully agrees as to the importance of transparency in such matters. The Committee was informed that IFAD's internal sanctions range from reprimand to summary dismissal and the withholding of monies due to the staff member(s) involved as a way of reimbursing the Fund for any losses incurred. Cases regarding staff may be handed over to the relevant national authorities for appropriate action, and the immunity afforded to IFAD officials may be suspended. In cases where a criminal action fails to result in the restitution of any monies lost by IFAD, civil action will be taken by the Fund to obtain satisfaction.
9. With respect to implementing debarment as a sanction against external parties, due consideration must be given to the laws of the territory in which IFAD has its headquarters or where its operations are conducted. Debarment also entails the right of suspected contractors to respond to allegations before sanctions are imposed.
10. For project- or grant-related cases, the OVC will need to liaise with the recipient country governments involved.

11. The Committee requested clarification on the following issues, and the Secretariat responded as follows:

- **What are the types of irregularities involved and how does the OVC distinguish between an irregularity and lack of efficiency? Is misconduct always an irregularity?** While most irregularities are financial cases, they may also involve the receipt of inappropriate gifts. The boundaries of what should be seen as misconduct on the part of staff have been partially delineated in the aforementioned Code of Conduct. However, since some cases do not fall into a distinct category, the initial investigation is dedicated to ascertaining which competency would best address the nature of the complaint raised. More reflection will be needed on this issue.
- **Which corrective measures have been undertaken to date?** That the OVC report has been presented to IFAD staff has significantly increased awareness of underlying issues and responsibilities and brought out potential improvements in current practices. Weaknesses in control measures highlighted in the OVC report are addressed in various ways: through the measures previously outlined, as also referred to in the anti-corruption policy paper; through specific internal audit work (e.g. on consultants); and through the specific awareness-raising activities now being planned, etc. The risk associated with country programme managers (CPMs) who work with the same countries over many years could be alleviated through a rotation process, although this should be measured against a possible drop in effectiveness. Another solution would be to set up country teams for missions, composed not only of CPMs and consultants but also a legal counsel, loan administration officer and procurement officer.
- **At what point is a case considered closed?** For this first report, the OVC decided to report on all current cases despite the fact that, in some cases, action was still pending. Such action, however, did not normally involve the OVC (which had concluded its work) but was being undertaken by the Office of Internal Audit (OA) in the form of a control assessment.
- **Does this document go to the Executive Board?** The first report of the OVC was distributed as an internal document and shared with the Audit Committee to assist it in assessing the effectiveness of the Fund's internal oversight mechanisms. Consideration is being given to extending distribution of the OVC report to the wider public next year, through the IFAD web site.
- **What measures are being taken when a cooperating institution (CI) fails to submit its project audit reports?** As stated in IFAD's Operational Procedures for Project Audits, "If the audit report is 90 days overdue from the stipulated due date, FC/Loans,<sup>1</sup> in consultation with the regional division and CI, will confirm non-receipt of the audit report, and will prepare a 'legal notice' to be sent informing the borrower that non-receipt of the audit report within 60 days will trigger the process of suspension of disbursements under the loan. If the audit report is overdue for 180 days from the original due date and the borrower has not satisfactorily responded to the previous communications, FC/Loans, in consultation with the regional division and CI, will prepare a President's notice for suspension, which [...] must be cleared by the Office of the General Counsel."

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<sup>1</sup> Loans and Grants Administration Unit.

12. The Committee asked how the OVC report would be linked to the draft anti-corruption policy paper presented to the Audit Committee in March 2005. It was agreed that further clarification on this link would be provided to the Audit Committee at its next meeting. Therefore, the Committee suggested that, before presenting the final version of the anti-corruption policy paper to the Executive Board for approval, it should be submitted to the next meeting of the Audit Committee together with the OVC report.

### **Consideration of the External Auditor's Memorandum on Internal Control and Accounting Procedures and the President's Reply thereto**

13. During its annual audit of IFAD's accounts, the external auditor provides observations on internal control and accounting procedures. The internal control memorandum for 2004, with the President's responses, were discussed in the presence of the external auditor.

14. The external auditor observed that much progress had been made with respect to the previous year. There was only one new recommendation relating to the accounting activities and database for the Debt Initiative for Heavily Indebted Poor Countries. Seventeen out of 22 recommendations from previous years had been closed, largely due to progress achieved under the Strategic Change Programme (SCP). The five outstanding items related to financial systems, cash and investments, loans and grants, and information technology. The Committee commended the Secretariat on the progress achieved in this area.

15. Pending recommendations from previous years were discussed in detail, as follows:

- Financial reporting had improved greatly over 2004. As of 2005, the Accounting Unit was making regular monthly closures of accounts, including reconciliations and reviews: income statements and balance sheets were being reported on a quarterly basis since June 2005. The Asset Liability Management Section had expanded its functional model and was thus in a position to project and simulate future balance sheets and income statements. With regard to budget analysis, an execution report relating to the programme of work and budget was being submitted by budget holders at the end of each quarter.
- The process for periodic evaluations of the custodian bank and financial advisor should be formalized.
- The current refactoring of the loans and grants system should address certain system difficulties identified by the external auditor in 2003.
- Significant improvements were noted in the monitoring of project audit reports. However, the external auditor recommended that a detailed analysis be made of qualifications encountered in the reports for systematic follow-up. The Secretariat replied that, with its 95% receipt rate, IFAD was well ahead compared with other international financial institutions and that the Loans and Grants Administration Unit followed up with the regional divisions, CIs and projects/programmes. Having expressed satisfaction at the huge improvements achieved in this area, the Committee stressed the necessity of acting upon lessons learned from qualified reports and of deciding on measures to take with CIs that do not comply with standard requirements for submission of project audit reports. This was suggested by the Committee in its report to the Executive Board in December 2004, after having reviewed the status of project audit reports received for 2003.
- The recommendation for more efficient and secure data management would be addressed by the new information communication technology procedure, expected to be launched in 2005.

### **Review of Internal Audit Function**

16. The Audit Committee reviews the OA work plan on a yearly basis. A report on OA activities in 2004 was submitted to the Audit Committee together with the OA work plan for 2005 and reviews of the implementation of internal audit recommendations and Madison Consulting Group's recommendations from 2003.

17. In 2004, the focus of OA's work shifted from pure audits to more advisory types of reviews. In 2005, more staff days had been assigned for investigative work and capacity-building compared with the previous year. As capacity-building consists in updating methodologies and tools, OA was revising its manual and implementing an automated tool for auditing.

18. The strategic direction for 2005 remained the same as that defined in 2002 and is linked to the Strategic Framework for IFAD 2002-2006 inasmuch as it will:

- ensure an increased flow of timely and objective feedback to management on the implementation of activities and on the effectiveness of internal processes in supporting the implementation of programme activities; and
- reinforce the accountability culture of the Fund; and assist the Fund in identifying and managing risks.

19. As far as OA recommendations are concerned, there were improvements in the areas of administrative services, loans administration, finance and the SCP. This was attributed to increased support to these activities from within the Finance and Administration Department. Further strengthening in the area of investment security was achieved by restricting asset-backed investments to those with AAA rating.

20. In response to a question regarding OA recommendations given in the "in-progress" category, OA explained that none of the recommendations in that category represented a serious degree of gravity. Recommendations were sometimes reprioritized due to changing corporate priorities and institutional undertakings. However, all recommendations remained on the list for follow-up action by OA and several initiatives were being finalized, notably the revised human resources policies and procedures that will lead to the full implementation of large blocks of recommendations.

21. With regard to the OA field-visit programme launched in 2004, the Committee remarked that such initiatives helped towards a better understanding of the type of audit work required for project/programme and grant operations. The Committee also commended the Secretariat on having taken other initiatives such as assessing the Fund's adherence to good practice guidelines in project/programme procurement and financial management, and an audit on IFAD's committees.

22. In reply to questions about cash-flow forecasting ability, the Secretariat replied that cash position reports had been developed from the financial systems but would require fine-tuning in the data flow.

### **Other Business**

23. At the request of the Chair of the Audit Committee, a number of outstanding issues were re-examined at the meeting, namely:

- management's responsibility for reviewing audit fees and submitting a recommendation to the Committee, in line with other international financial institutions;

- regarding the cost of portfolio management, detailed explanations of the increase/decrease in direct charges against investment income from 2003 to 2004 are provided in Annex I hereto;
- regarding the selection process for the financial advisor, the international competitive bidding process set forth in the IFAD procurement guidelines was followed to ensure transparency and objectivity in terms of technical specifications. The fee was negotiated directly with the selected financial advisor; and
- the contract with the financial advisor expired in February 2005, and IFAD was in the process of negotiating a new contract to obtain better services at a lower cost. The World Bank provides financial advisory services to the Food and Agriculture Organization of the United Nations and World Food Programme; IFAD is following in the same direction with a view to obtaining better services at a lower cost than with the previous financial advisor. Representatives of IFAD's Office of the Treasurer met with World Bank officials in December 2004 and May 2005. During the negotiations, management considered that the Bank's fees were still high and therefore proposed to scale back the scope of the services to reduce the overall cost. In assessing the advisory services during the initial one-year period, IFAD would consider maintaining its contract with the Bank for a further period of time.

24. At the last meeting of the Committee in March 2005, members requested the external auditor to provide written comments on the document "Oversight and Internal Control at IFAD" (document AC 2005/89/R.8). The comments were provided to the meeting, together with a response from OA (see Annex II).

ANNEX I

**DIRECT CHARGES AGAINST INVESTMENT INCOME 2002-2004**  
(USD '000)

	2002	2003	2004	Change from 2003 to 2004		
				Amount	%	Explanation
Global fixed income	1 700	1 953	2 211	258	13	Difference resulting from Manager's error in fee calculation for period 2000-2002, for which IFAD has legal liability.
Diversified fixed income	1 120	817	1 285	468	57	Increase is due to the introduction of performance fees (and to the expected out-performance).
Global TIPs	0	218	686	468	215	Increase is due to completion of the funding of this asset class, in order to align it with the asset allocation as approved by the Investment Advisory Committee.
Equities	3 300	1 026	1 240	214	21	Increase is the result of an increase in net asset value (NAV) due to market rally. The equity exposure was liquidated in March 2005.
Currency overlay	100	0	0	0	0	
<b>Total management fees</b>	<b>6 220</b>	<b>4 014</b>	<b>5 422</b>	<b>1 408</b>	<b>35</b>	
Core services <sup>a</sup>	1 100	332	201	-131	-39	Change of Custodian resulted in a reduction of fees.
Transaction <sup>b</sup>	1 500	164	160	-4	-2	Change of Custodian resulted in a reduction of fees.
Auxiliary <sup>c</sup>	650	324	301	-23	-7	Change of Custodian resulted in a reduction of fees.
<b>Total custody fees</b>	<b>3 250</b>	<b>820</b>	<b>662</b>	<b>-158</b>	<b>-19</b>	
Financial advisor	200	0	250	250	100	No financial advisor service during 2003. A new financial advisor was appointed in 2004, and this resulted in 100% increase. However, note that in 2002 the cost for financial advisor was USD 200 000
Legal and tax advisor	100	105	119	14	13	Cost sharing with the Office of the General Counsel (contract and salary renegotiations resulting in an increase approved by President).
Financial information provider	200	200	200	0	0	
Consultants	100	60	60	0	0	
Computer systems	100	0	0	0	0	
<b>Total advisors and information services</b>	<b>700</b>	<b>365</b>	<b>629</b>	<b>264</b>	<b>72</b>	
<b>Total direct charges (DCII)</b>	<b>10 170</b>	<b>5 199</b>	<b>6 713</b>	<b>1 514</b>	<b>29</b>	
<b>Total portfolio value</b>	<b>2 093 993</b>	<b>2 356 921</b>	<b>2 559 975</b>	<b>203 054</b>	<b>9</b>	
Ratio DCII/Total portfolio value	0.486%	0.221%	0.262%	0.041%	18.6	
Gross investment income	34 050	113 477	115 239	1 762	2	
Net investment income	26 186	107 962	108 662	700	1	
<b>Ratio DCII/ Gross investment income</b>	<b>30%</b>	<b>5%</b>	<b>6%</b>	<b>1%</b>	<b>20</b>	

<sup>a</sup> Includes standing charges, assets in custody and clean payments.

<sup>b</sup> Includes foreign exchange transactions, derivatives and fixed deposits/line items and transactions.

<sup>c</sup> Includes compliance and performance.

**OVERSIGHT AND INTERNAL CONTROL AT IFAD  
(DOCUMENT AC 2005/89/R.8)**

**EXTERNAL AUDITOR'S WRITTEN COMMENTS AND OA'S RESPONSE**

PricewaterhouseCoopers (PwC): As mentioned in the document, the scope of the risk assessment exercise excluded the substantive testing of controls. As a general principle, the testing phase is a key component of any risk assessment process, which enables a validation of the understanding of the underlying risks and controls gained through the task of mapping processes and controls. Drafting a complete and accurate test plan and evaluating the results of the testing activities is to be regarded as a key task in the risk assessment exercise.

OA: We are in agreement with PwC that risk assessment entails the testing of identified internal controls. As indicated in the paper, we are moving towards this following a graduated approach due to the many obligations taken on by IFAD and in particular by its Finance and Administration Department (FAD) in 2004 and 2005. A comprehensive risk management programme will be implemented gradually in a very practical manner using existing tools and resources. Our approach for 2005 is to integrate the high-level internal control assessment documentation provided by Numerica with an updated version of the 2003 OA control assessment (the updating exercise will be conducted in parallel with the IFAD strategic planning and budget process which incorporates risk management elements) to produce a more comprehensive document on the IFAD internal control framework. This step is expected to provide an adequate assessment of internal controls under the "control environment", "risk assessment", "monitoring" and "communication" COSO<sup>1</sup> categories but not of those under "control procedures", which would need to be tested through audit procedures. As is already the practice, testing of internal control procedures will continue to be the main focus of the OA audit work. The OA work plan and audit methodology is already risk-based, which ensures that the areas of highest risk and/or evaluated as having the weakest internal controls will be included in the OA work plan. That this is a risk-based approach to audit planning can be seen by the fact that an audit on the management of internal projects and large institutional initiatives has already begun.

PwC: The approach described on page 2, that is, "to gradually insert risk management into the management decision processes of the Fund in a structured manner without creating new permanent structures and positions, but by building on existing resources, tools and practices", implies a preliminary analysis aimed at understanding how the current organizational structure meets the requirements of a "best practice" risk management process and identifying potential gaps that need to be addressed. As described during our 30 June 2003 seminar on risk management, this is also a critical task in the context of implementing the critical success factors necessary for an effective risk management process: clear identification, documentation, communication and escalation procedures and full commitment by executives and the overall governance structure to the execution of the risk management process.

OA: The need to assess in a preliminary manner the extent to which "the current organizational structure meets the requirements of a 'best practice' risk management process" and to identify "potential gaps which need to be addressed" was largely dealt with by Numerica, as evidenced from their report. The validation/refinement of the relevant Numerica assessment to fully cover the "documentation, communication and escalation procedures and

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<sup>1</sup> COSO: Committee of Sponsoring Organizations of the Treadway Commission.

ANNEX II

full commitment by executives and the overall governance structure” aspects rightly noted by PwC will be a priority for this year.

PwC: The risks of not identifying and properly managing threats as well as not delivering on priorities are rated by the external advisors as very high, as described in page 3 of the document. We consider the analysis of the results of the audit on management of internal projects and large institutional initiatives launched by OA (referred to in paragraph 6) an important factor in understanding how major initiatives are managed and monitored and thus assessing the need for any actions to be implemented in order to mitigate related risks.

OA: We will keep PwC informed on the progress of this audit.

PwC: This comment by the outside advisors in our view should be given appropriate consideration in drawing the priorities of the relative action plan with respect to the overall risk assessment and control review effort.

OA: The OA plan of work for 2005 and into 2006 includes activities to support the further development of the risk management process and build on the Numerica results to document the internal control framework for further testing and auditing. OA is only coordinating the effort, however, and the risk management process will have to be implemented within the bounds of the resource and staff-time constraints of all concerned IFAD divisions.