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Report of the Audit Committee

Executive Board — Ninety-first Session
Rome, 11-12 September 2007

For: **Review**

Note to Executive Board Directors

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Report of the Audit Committee

1. At its ninety-seventh meeting, held on 26 June 2007, the Audit Committee examined the following matters, which it wishes to bring to the attention of the Executive Board.

External auditor's report on internal control and accounting procedures (AC 2007/97/R.3)

2. The Committee reviewed the PricewaterhouseCoopers report on internal control and accounting procedures. The external auditor presented the work as part of the overall audit approach. In particular, it emphasized that the main objective of the report was to provide Management with observations and suggestions for improvement. The Audit Committee members asked the external auditor and the secretariat for clarifications concerning:
 - (a) The introductory statement of the report, in particular the management assessment of the internal control system and the general opinion of the external auditor;
 - (b) Inclusion of some observations and recommendations that were already classified as high priority in previous years (Loans and Grants System [LGS], periodic review of interim financial statements, etc.) and were not yet completely implemented at the end of 2006;
 - (c) Risks relating to the recording and maintenance of critical data on fair value and the Heavily Indebted Poor Countries debt relief through spreadsheets and not integrated into the financial management system;
 - (d) Changes at senior staff level and the necessity of ensuring continuity of operations.
3. The external auditor explained that the objective of the introductory statement was to clearly define the purpose and scope of the work performed in the context of the audit of the 2006 financial statements. In this respect, the main objective was to establish the level of reliance on the organization's internal control system. It noted that assessment of the internal control system of an organization is a continuous process. With regard to recommendations coming from previous years and not yet implemented, the external auditor clarified that, although Management agrees with the recommendations, their implementation is dependent on other factors, such as their costs/benefits and the overall priorities of the organization. It further explained that in the case of the review of interim financial statements, albeit the figures are correct, further work is required to make the process more efficient. Concerning financial data managed through spreadsheets, there is a need for stronger controls to compensate for the lack of security.
4. The secretariat confirmed that the recommendations had been discussed at length and agreed with the external auditor. On the review of the internal control system, Management explained that this is an ongoing process performed in different parts of the organization, with the main objective of strengthening the system, enhancing its effectiveness and increasing efficiencies. A comprehensive internal control framework is under development. With regard to the LGS and to the use of spreadsheets for the management of critical data, Management noted that this is indeed a core business process and that a project proposal to redesign and change this home-grown system is in preparation; the proposal should be ready by the

end of October 2007 for implementation during 2008. Finally, with respect to the issue of senior officials' retirement or changes at the Senior Management level, the secretariat pointed out that measures have been put in place to ensure proper handover and business continuity.

5. Based on the above clarifications, the Committee endorsed the document.

Audit strategy memorandum for the year ending 31 December 2007 (AC 2007/97/R.4)

6. The Committee considered the audit strategy memorandum prepared and submitted by the external auditor under confidential envelope to its members. It was clarified that the secretariat was not aware of the document's contents until it was tabled at the meeting. The external auditor explained that the audit strategy was based on the experience, knowledge, and overall assessment of the level of risk of IFAD operations. It also mentioned the importance of discussing the document with the Audit Committee in order to have feedback and guidance on the strategy.
7. The Committee questioned certain aspects highlighted in the document, such as the examination of Management's assertion letter, year-end adjustments, assessment of risk management procedures and impact of budget decentralization. The external auditor clarified that reference to the various areas of activity was based mainly on potential risks that can affect the organization, independently of the measures put in place by Management to mitigate these risks.
8. The Committee enquired as to why the memorandum under discussion had not been shared with IFAD Management prior to the meeting. The external auditor explained that the audit strategy is generally not disclosed to Management beforehand, but added that its disclosure has no impact on the effectiveness of the work of the auditor. The secretariat pointed out that it is up to the members of the Committee to have a private meeting with the external auditor to discuss the document should they so decide. However, the secretariat clarified, and the external auditor agreed, that sharing the audit strategy at the meeting allows for a better appreciation of corporate risks, resulting in a more meaningful and useful audit of the organization, greater collaboration between internal and external auditors, and a more constructive relationship between Management and the external auditor.
9. The Committee took note of the document and will consider having a private meeting with the external auditor to discuss the 2008 audit strategy memorandum next year.

Presentation of a capital budgeting framework (AC 2007/97/R.5)

10. The secretariat described the rationale for having a capital budgeting framework. In particular, it clarified that the capital budget is needed to cover non-recurrent expenditure for tangible and intangible assets that contribute to the achievement of the objectives of the organization over a number of years. In defining a capital budgeting framework, the secretariat presented a comparison with other international financial institutions (IFIs). Moreover, it explained the criteria underpinning the establishment of the capital budget, in particular the monitoring of future returns to ensure that they cover the cost of investments and of the categories of expenditure involved.
11. The Committee raised the following issues:
 - (a) **Depreciation and the comparison with other IFIs.** The secretariat explained that depreciation criteria will be based on the useful life of the assets and that other IFIs use similar criteria.

- (b) **Main reasons for a capital budgeting framework.** The secretariat clarified that the objective of implementing such a framework is to answer the need for long-term investments. For example, it appears that the Fund's investment in information and communications technologies is very low compared with other IFIs, implying the need for an increase in investment in such infrastructure. This is expenditure that would be included in a capital budget.
- (c) **Analysis of the benefits of buying versus leasing.** Management explained that a light and efficient governance committee would assess the viability of investments and the operational choice of buying or leasing.

12. The Committee, after having extensively discussed the document, decided to endorse it.

Definition of operating costs and the activity tree (AC 2007/97/R.6)

13. The secretariat underlined that there was a need to classify costs better – beyond the basic antagonism between operational and non-operational expenditures – and to present them clearly, particularly when diverse activities contribute to the achievement of an objective. In this respect, four cost categories were proposed. The secretariat further explained that simplifying the activity tree of the organization would facilitate the allocation of costs to the various activities.
14. The Committee expressed appreciation for the efforts of the secretariat in establishing the cost categories. Most of the members agreed that the document constituted a first attempt to identify expenditure better, but were of the opinion that further work was needed. Some members requested that the secretariat simplify the presentation to three cost categories. The secretariat explained that the advantages of the new classification of expenditure in four categories would appear more evident in the budget document to be examined by the Committee at its next meeting. Recognizing that further work is needed in classifying the expenditures into categories, the secretariat pointed out that the main benefit of the categories will be to facilitate the work of Management in tracking costs.

Programme Development Financing Facility – streamlining budget presentation (AC 2007/97/R.7)

15. The secretariat explained that the transfer from the programme of work (POW) to the Programme Development Financing Facility (PDFF) should be eliminated to simplify budget presentation. The Committee requested that some clarifications be made regarding the origin of the PDFF transfer. The Chairperson confirmed the importance of clarifying the relationship between the level of the POW and the 10 per cent increase in the PDFF in 2008.

Impact of exchange rate movements on the administrative cost ratio (AC 2007/97/R.8)

16. The secretariat clarified that the central issue was analysis of the evolution of IFAD's real costs as a percentage of the POW, excluding the impact of exchange rates. In this respect, various approaches can be adopted. Based on different analyses, the secretariat considered that, for comparison purposes only, the administrative cost ratio (administrative budget plus PDFF as a percentage of the POW net of transfers to the PDFF) should be calculated at the historical US\$/EUR exchange rate of 0.819, prevalent when the benchmark ratio was established. In this manner, the ratio – stripped of the effect of exchange rate impact – will show the real efficiencies gained.

17. The Committee recognized the importance of tracking the efficiency ratio and the overall achievement of a zero-real-growth budget. In particular, it affirmed the necessity of looking at the ratio and budget level in the context of the overall budget submission in November 2007.
18. The secretariat explained that this issue was presented to the Committee to answer the Executive Board request for proper monitoring of the efficiency ratio. It added that zero real growth will be a critical element in the document on strategic priorities of the budget being submitted to the September Board.
19. The Committee concluded that it will further consider all budget-related aspects discussed in this meeting during its November meeting on the 2008 budget.