

Document: EB 2007/92/R.3
Agenda: 3
Date: 10 December 2007
Distribution: Public
Original: English

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Enabling poor rural people
to overcome poverty

**Report of the Audit Committee on the
programme of work, Programme
Development Financing Facility and
administrative and capital budgets of
IFAD and of its Office of Evaluation
for 2008**

Executive Board — Ninety-second Session
Rome, 11-13 December 2007

For: **Approval**

Note to Executive Board Directors

This document is submitted for approval by the Executive Board.

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Recommendation for approval

The Executive Board is invited to take note of this report and endorse the recommendations contained therein.

Report of the Audit Committee on the programme of work, Programme Development Financing Facility and administrative and capital budgets of IFAD and its Office of Evaluation for 2008

I. Introduction

1. In accordance with procedures adopted by the Executive Board at its eighty-first session, the proposed programme of work, Programme Development Financing Facility (PDFF) and administrative and capital budgets of IFAD and of its Office of Evaluation for 2008 (EB 2007/92/R.2) are submitted for examination by the Audit Committee prior to presentation to the Executive Board in December 2007 and subsequent submission to the Governing Council.
2. The Audit Committee's review is restricted to financial and technical matters and does not imply any changes to the policy decisions made by the Board in September 2007, nor does it make any recommendation regarding approval of the programme of work, PDFF and budget document (EB 2007/92/R.2). The Committee's mandate is limited to preparing a report for the Executive Board after reviewing the document in November.
3. The Audit Committee reviewed document EB 2007/92/R.2 at its ninety-eighth meeting on 5 November 2007.
4. This report presents the topics pertaining to proposals contained in the document that the Committee would like the Executive Board to be aware of.

II. Audit Committee's review of the programme of work and budgets of IFAD for 2008

A. Exchange rate

5. The Audit Committee noted the importance of exchange rate changes for IFAD's work, and discussed the exchange rate under two headings: the programme of work and the efficiency ratio.¹

Programme of work

6. The Committee raised the question of the erosion of the real value of the programme of work. It noted that in dollar terms the programme of work is projected to increase by 10 per cent. Nonetheless, concern was expressed that in terms of special drawing rights (SDR), taking into account the continuing realignment of the dollar, the actual benefits received by borrowers and grant recipients may actually be declining.
7. This is an important issue that could potentially affect the impact of the Fund. The Committee concluded that it is up to the membership to raise this question in the Board in order to see whether this could be addressed, particularly in view of the discussions to be held during the replenishment consultations.

Efficiency ratio

8. As has been the case at previous Committee meetings, the efficiency ratio was the subject of discussion. While the adoption of an efficiency ratio is important for directing attention to the cost aspect of the effectiveness issue, it does not precisely reflect the situation in IFAD simply because the data on which this calculation is based are not homogeneous. This is a structural problem stemming from the fact that the numerator (the administrative budget and the PDFF) is restated against

¹ The efficiency ratio (as established in December 2005) is the total of the administrative budget and the PDFF divided by the value of the programme of work.

exchange rate movements, but the value of the programme of work in United States dollars is not restated against the SDR. This structural problem is accentuated during a period of significant depreciation of the United States dollar.

9. The Secretariat recalled that during the Audit Committee seminar in June 2007, where the impact of exchange rate movements on the ratio was discussed, the Committee recognized that even if the benchmark ratio did have its inherent flaws, reviewing it over a period of time produced a trend, which was still useful for the purposes of assessing performance over a period of time.
10. Furthermore, the ratio is only one indicator of budget performance in IFAD. There are other indicators that are clearly positive, for example, a very strict definition of zero real growth (equivalent to inflation in the euro zone) which has been applied to all costs in the administrative budget and reflects real efforts to manage costs proactively. The result is that there is a real reduction of some 4.5 per cent, due to the fact that staff costs are expected to rise by an average of 8 per cent in 2008. Second, there is a significant movement within the overall budget envelope from administration towards activities that are more clearly operational. Some years ago, the Audit Committee requested management to work out what percentage of total administrative costs could be considered as operating costs. In order to be able to do this and to monitor movement of costs between operating and non-operating areas, Management devised the following categories: direct operational, indirect operational, support costs and institutional or governance costs.
11. Divisions input their budgets by activity and each activity is linked with one of the above categories. In this way, the resulting percentages for each category represent a bottom-up view of how funds will be spent and not just an estimate of what operating costs might be. Within the context of the whole envelope of US\$111.1 million, divisions have input amounts against activities that support IFAD's operations (some 54 per cent) so that projects can be better designed, better implemented and better supervised.
12. The Committee recognized that a significant effort is being made by Management to contain the dynamics of expenditure, and that costs and resources are being directed increasingly towards the operational side.
13. The Committee agreed that the efficiency ratio should be kept, but that possible modifications in the future should not be ruled out. However, the efficiency ratio should not be the sole indicator, but rather form part of a group of important indicators that reflect the dynamics of the administrative budget: zero real growth, operational versus non-operational expenditures and staff costs and numbers.

B. Capital budget

14. The Committee's main concern was the secretariat's ability to demonstrate that future benefits could be reaped from the expenditures included within the capital budget.
15. The Secretariat explained that a basic principle of its approach to capital budgeting is that the cost of the capital items be charged to the administrative budget (as depreciation) over time, reflecting the fact that the benefits are expected to be reaped over a period of time that exceeds one year. A key element is that it requires stricter discipline and greater involvement of the people managing the project because they know that the depreciation is going to be charged against their budgets in the future.
16. There are two sorts of benefits that can arise from capital expenditure; one is reduced cost, and the other is efficiency gains. Capital expenditure facilitates reduction of specific costs in some areas and, in terms of the proposal for this year a streamlining of institutional processes is in evidence, which is principally directed towards the human resource management area, the loans and grants system, and

addressing issues on country presence and on business continuity, which includes replacement of old computers.

17. The capital budgeting framework provides for various types of capital expenditure, but this year the proposed capital budget contains only basic and essential IT-related projects. IFAD's internal IT governance committee has met and discussed the proposed IT strategic programme, which includes these projects, and has decided that, in addition, it would be beneficial to address a fundamental institutional risk relating to the loans and grants system.
18. The loans and grants administration system must be reformed, and there are real opportunities for streamlining processes in a number of areas where manual interfaces exist between different systems. This is an area of corporate risk that lies at the heart of IFAD's functioning, it has been raised by the external auditor, and was discussed in the last report of the Audit Committee.
19. Another corporate risk is the lack of a robust business continuity programme insofar as our information systems are concerned. Initial steps have been taken to address this business continuity risk by having back up in Geneva at the International Computing Centre but a solid business continuity programme is needed.
20. Some Committee members enquired as to the cost benefit analysis of these investments. Management explained that in such measurements, benefits should be expressed not only in terms of reduced cost, but also in terms of the efficiency gains from being able to do more with less, including having the ability to obtain accurate and up-to-date information and to develop and produce reports that can form the basis for more timely decision-making. For example, with the introduction of the PeopleSoft budget preparation module, budget preparation time has reduced markedly, which provides more time to produce a better quality budget document for presentation to the Board.

C. Results-Based Budgeting

21. The Committee commended the Fund on its first results-based budget and requested clarification on how the budget is allocated according to the corporate management results (CMRs).
22. The Secretariat explained that the budget document is results-based at two levels: at the level of the programme of work and the level of the supporting administrative budget and the PDFF. The proposed programme of work is being allocated against the strategic objectives presented in the IFAD Strategic Framework 2007-2010. The supporting costs are however allocated to CMRs.
23. The administrative budget and PDFF are allocated to CMRs by virtue of the fact that the activities to which costs are allocated are linked with the respective CMRs. For example, the activity "design of loans and grants" is linked with CMR 2 – Better project design.
24. The Committee also asked why the projected levels of performance for 2008 for the key performance indicators were not included in section VI.B of the document. The Secretariat explained that the results-based management system is still relatively new, and became fully operational only in 2007. Although two complete quarterly performance reviews have taken place, the Secretariat deemed it appropriate to set the projections for 2008 only upon completion of the third quarter review. This will provide a more realistic baseline upon which to set feasible targets for 2008, and allow for consultation within Management on what may reasonably be expected for next year relative to that baseline. Therefore, this section was left deliberately blank so that more meaningful targets, which take into account the experience to date, could be provided to the December 2007 Executive Board session.

D. Other issues

Programme Development Financing Facility

25. The Audit Committee raised several points regarding the PDFF. Clarification was sought as to first why the PDFF nominal increase is proposed at 13.9 per cent when the programme of work increase is 10 per cent and second, how the PDFF budget is formulated.
26. The Secretariat explained that within the 13.9 per cent nominal increase there is a real increase of 8.8 per cent, which is in fact lower than the increase in the programme of work. There are three elements in the real increase of the PDFF: staff costs, cooperating institution costs, and non-staff costs. The staff costs for 2008 are expected to increase, on average, by 8 per cent. Non-staff costs (excluding cooperating institution costs) are forecast to increase by 2 per cent, which is the general inflation rate. The non-staff cost percentage increase of 2 per cent cannot be applied to the cooperating institution costs, because IFAD's biggest supplier, the United Nations Office for Project Services (UNOPS), is now adopting full cost recovery and IFAD's costs in this regard are expected to increase by more than the 2 per cent.
27. The 8.8 per cent real increase in the PDFF contains the integration of the 15 country presence initiatives that were funded from the Field Presence Pilot Programme budget in prior years. The cost of administering and staffing IFAD's country presence is budgeted at US\$2.05 million, which is part of the US\$38.8 million proposed for the PDFF. The Secretariat explained that this US\$2.05 million is contained within the US\$6.1 million for the "country programmes" activity within the PDFF as reflected in annex XII of document EB 2007/92/R.2.
28. In relation to how the PDFF budget is formulated, the Secretariat brought the Committee's attention to the shift in costs from cooperating institution supervision to costs relating to direct supervision. Direct payments to cooperating institutions will fall in 2008 and there will be a corresponding increase in the expenditure by IFAD as it directly assumes responsibilities that were previously outsourced. UNOPS is the lowest cost provider on the market, which is why IFAD has placed a high percentage of its supervision tasks in its hands. A number of studies have emerged recently indicating that the quality and volume of that supervision is inadequate for obtaining the desired results. A recent evaluation study also indicates that direct supervision is more effective in terms of achieving development impact.
29. The Fund anticipates that, in the medium term, direct supervision will cost less, reflecting the mainstreaming of field presence and greater use of national processes and national staff in supervision.

Action Plan costs

30. The Committee asked if there were costs for the Action Plan in 2008 included in the budget.
31. The Secretariat explained that the Action Plan termination report, which will include a broad overview of the financial situation, will be presented at the December 2007 Executive Board session. Some carry-over element is expected, the use of which has to be determined. However, all major Action Plan activities are now mainstreamed within IFAD and the costs are being integrated into the regular operations. For example, the Results-based Management System is completely integrated into the regular budget. Similarly, in terms of the country presence, the new processes for results-based country strategic opportunities programmes and supervision have been integrated. There may be some outstanding deliverables in terms of piloting certain activities under the Action Plan, which will absorb resources under the plan but, in principle, the expenditures involved in the change

process arising from the Action Plan are under the 2008 budget, administrative budget and PDFF.

Debt Sustainability Framework

32. The Committee requested details regarding the amount of Debt Sustainability Framework (DSF) grants expected for 2008. Loan sizes are not yet established for 2008, but the DSF grants are expected to account for about 18 per cent of the lending programme, which is in line with the expectation for 2007, as well as with the practice at the African Development Bank and the International Development Association.

Training budget

33. The Committee noted the large increase in the training budget for 2008. The Secretariat explained that this long overdue increase in the allocation to training reflects the prioritization and realignment of expenditures towards building the capacity of IFAD staff. Table 7 of document EB 2007/92/R.2 gives a broad outline of how the US\$1.1 million will be spent. The Fund commenced some middle management training in 2007, which will be continued. In addition, there will be capacity-building in relation to supervision, general communications and other specific capacity-building training identified by the divisions themselves.

III. Audit Committee's review of the work programme and budget of IFAD's Office of Evaluation for 2008

34. The Audit Committee also discussed the proposed work programme and budget for 2008 of the Office of Evaluation (OE). It expressed satisfaction with the decrease of 13 per cent in real terms in OE's proposed budget for 2008 – compared with the 2007 budget. The decrease reflected the fact that the tasks that led to a significant increase in 2007 have been fully funded. At the same time, the Committee underlined the need to ensure that the Fund's independent evaluation function is adequately resourced to ensure that it can contribute to strengthening accountability and learning within the organization.
35. Discussions took place on the possibilities of developing indicators and external benchmarks to assess the efficiency of OE's budget. One possible indicator suggested was the ratio of OE's budget to either IFAD administrative costs or the Fund's programme of work, or both. It was agreed that next year, in consultation with the Evaluation Committee, OE would come up with proposed efficiency indicators and/or benchmarks in the framework of its 2009 work programme and budget document.
36. The Audit Committee's attention was drawn to the increases related to staff costs, which are largely driven by the annual increases in standard costs for staff positions recommended by the International Civil Service Commission (ICSC). In this regard, OE clarified that – in the light of its relatively small volume of staff compared with IFAD as a whole – all increases recommended by the ICSC must be internalized by the division to ensure that staff salaries and entitlements can be paid.
37. On another issue, as requested by the Audit Committee, OE clarified that the reduction of 13 per cent proposed in its 2008 budget (of around US\$732,000) was driven by various factors. These included a reduction in 1.5 units of staff positions, the dropping of the planned Meso-America evaluation and – as agreed with the Evaluation Committee – postponement to a more appropriate date of the start of evaluations on the IFAD Policy on Sector-wide Approaches for Agriculture and Rural Development and IFAD's Private-Sector Development and Partnership Strategy. Similarly, as requested, OE clarified that the budget of around US\$183,000 allocated for evaluation outreach and partnership activities did not include a financial contribution towards the ongoing evaluation of the One United Nations Initiative, even though a small amount of the allocation reflected the OE staff time

equivalent that will be invested by the division in contributing to this specific evaluation.

38. Finally, after some discussion on the topic, the Committee agreed that the OE budget may continue to be prepared and presented independently from the IFAD administrative budget, as required by the IFAD Evaluation Policy approved by the Executive Board in April 2003.

IV. Conclusion

39. In considering the proposal for 2008, the Audit Committee wishes to draw the attention of the Board to the 10 per cent increase in the programme of work. As the continuing depreciation of the United States dollar is eroding the real value of the programme of work, the Board should discuss how that value could be expressed in more stable terms for the purpose of setting targets for the replenishment period.
40. Considering the importance attached by the Board to the efficiency ratio (a fraction in which the numerator is the administrative budget plus the PDFF and the denominator is the level of the programme of work), the Audit Committee would consider with special interest an option that would make the values included in the ratio more homogeneous. For example, these values might be restated in SDRs. However, it is correct to say that the efficiency ratio is only one indicator of budget performance in IFAD. The zero real growth in the administrative budget and the trend in the overall budget to move resources from administration to the operational area are also meaningful indicators.
41. In line with the experience of other international financial institutions, the introduction of a capital budget will bring about important benefits in terms of transparency and stricter discipline as the mechanism of depreciation connected with capital budgeting will act as a constraint on managers' budgets in the future. Efficiency gains are also expected to be seen in areas such as human resource management and the loans and grants system.
42. As regards results-based management, the main benefit derives from the connection established between corporate management results and the proposed levels of programme of work, administrative budget and PDFF. Although the system is relatively new, the third quarterly review will provide the elements required to finalize the projected indicators for 2008, which will be presented to the Board in December.
43. The Committee commended the progressive shift of supervision activity from cooperating institutions to IFAD. The Chairman concluded that the Board should expect better quality and greater effectiveness of supervision from this move and, in the medium term, lower costs.
44. Finally, with regard to OE, the decrease by 13 per cent in real terms in the proposed budget for 2008 is to be appreciated, considering in particular the high increase in staff costs recommended by the ICSC. However, the Board needs to consider two aspects. First, a more restrictive budget and the cuts and postponements in OE's activities should not imply negative effects on accountability and learning within the organization. Second, the possibility to develop indicators and benchmarks to assess the efficiency of OE's budget should be explored by OE in consultation with the Evaluation Committee in the context of preparing the 2009 work programme and budget.

