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Report of the Audit Committee 102nd Meeting

Executive Board — Ninety-fifth Session
Rome, 15-17 December 2008

For: **Approval**

Note to Executive Board Directors

This document is submitted for approval by the Executive Board.

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Report of the Audit Committee

1. The Audit Committee wishes to bring to the attention of the Executive Board the following matters, which were examined at its 102nd meeting held on 11 November 2008.
2. This report does not cover the Committee's review of the Programme of work, Programme Development Financing Facility and administrative and capital budgets of IFAD and its Office of Evaluation for 2009. This item is reported on separately to the Executive Board in document EB 2008/95/R.3 (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 2009).

Project audit report for fiscal years 2006 and 2007

3. The independent external audit of the utilization of loan proceeds is a fundamental element of IFAD's fiduciary framework. Since 2002, the secretariat has been reporting to the Audit Committee on the external audit of IFAD projects, providing information on results, timeliness of report submission and comparative trends. The report presented at the November meeting covered audits pertaining to fiscal years 2006 and 2007. The main development that occurred in this period was the significant increase in projects directly supervised by IFAD from 11 in fiscal year 2006 to 87 in fiscal year 2007.
4. The experience of the last two years, as analysed in the report, reveals an improvement both in the timeliness of submission of the project audit reports and in the quality of financial reporting provided to IFAD. The improvement can be attributable to various newly introduced activities such as the tracking, review and reporting of all audit reports received by the Loans and Grants Unit of the Financial Services Division; the creation of supervision support structures and mechanisms in the Programme Management Department; and the comprehensive training provided to most IFAD staff on all aspects of project financial management. The secretariat pointed out that several challenges remain and that the Fund's efforts must now concentrate on developing concise guidelines and tools for both IFAD and project staff by organizing specific training on audit and improving the information technology systems that support the audit process. At the same time, IFAD will also look into simplifying and rationalizing audit requirements in some areas, and explore the possibility of aligning its approach with those of other multilateral development banks.
5. The Committee noted improvements, both achieved and planned, and urged the secretariat to intensify its efforts in the following areas:
 - Communication and cooperation between IFAD and the countries' governmental institutions.
 - Training of IFAD staff to enable them to assess and manage the risks inherent to financial and audit activities.
 - Engagement by borrowers of competent and independent auditors who operate in adherence to acceptable auditing standards.
 - Completeness of audit package provided to IFAD.
6. The secretariat concurred with the Committee that these represented the most common shortcomings in the audit arrangements and commented that steps were planned or already being taken as a matter of priority to address these issues in 2009. The Committee was informed that specific audit training would start in December 2008.

Briefing on progress made with respect to the Loan and Grant System (LGS) replacement options

7. The LGS is the information technology system supporting IFAD's core business of loan and grant administration. It was developed in the early 1990s and the weaknesses of the system have been highlighted in several assessments, including in reports by internal and external auditors. This has led Management to assign top priority to replacing the system. The LGS replacement project was included in the IFAD 2008 capital budget and fully launched in mid-2008 once the detailed funding arrangements were approved. The secretariat gave a presentation on the current status of the LGS replacement project following a request made by the Committee at its September meeting.
8. During 2008, IFAD consulted with and visited other financial institutions and United Nations agencies to discuss and examine their loan and project systems. In parallel, some potentially suitable commercial applications were demonstrated to staff. In September, an inter-departmental working group produced a replacement strategy for the LGS. This was subsequently endorsed by the relevant internal committees and funds were allocated for the project under the capital budget. IFAD is now in the process of engaging an external expert to search the marketplace for a commercially available software package suitable for IFAD's business needs. At the same time, the functional specifications of the LGS will be validated and further developed with internal and external stakeholders. Following a positive outcome from the search for suitable packages, a detailed request for proposals (RFP) will be prepared for the LGS replacement and circulated in early 2009 to an appropriate set of software vendors. In response to queries, the secretariat confirmed that the process of developing the RFP document would involve all internal stakeholders and possibly project authorities and cooperating institutions. The external auditor would also be consulted in the process.
9. An appropriate project organizational structure will be set up based on best practices in project management. It will include a business owner, a steering committee, and a quality assurance function. It is expected that the project will be completed in 2010, at which time the new application will be rolled out; data will be migrated from the legacy system to the new system; guidance material will be developed; and staff will be trained. The cost of the project is tentatively estimated at US\$3.6 million (including the cost of software licences for the period 2010 to 2013); however, a more precise estimate will be obtained based on the results of the external experts' market assessment and the responses to the RFP. Of the total estimated costs, US\$710,000 was approved in the capital budget for 2008 and US\$1,050,000 is proposed for 2009.
10. In response to queries from members, the secretariat reassured the Committee that the option of using PeopleSoft – the current enterprise resource programme – was carefully examined, but it was concluded that it lacks the specific functionality to accommodate certain aspects of IFAD's loan administration processes. The decision was therefore taken to explore suitable packages available on the market. PeopleSoft and other options will be reconsidered if the market search proves unsuccessful.
11. The Committee highlighted the importance of this project and emphasized the need to work with all stakeholders, including country programme managers and borrowers, to ensure that their needs are addressed in a cost-effective way and that the new system is easy to use.

Appointment of IFAD's external auditor

12. In September 2006, the Executive Board approved the appointment of PricewaterhouseCoopers (PwC) as external auditor for the financial statements for the period 2007-2011. Following this approval, IFAD signed a contract with PwC for the audit of the 2007 financial year. This contract is subject to renewal at IFAD's

discretion for further periods of one year up to a maximum duration of five years on the same terms and conditions, once the 2007 financial year audit is complete. At its 101st meeting, the Committee considered and endorsed in principle the general strategy of PwC for the audit of the 2008 financial statements. It was also decided that PwC would be requested to provide, together with their fee proposal for 2008, an explanation as to the impact on audit work of recent developments in the financial processes and practices of the Fund. The secretariat was requested to provide the Audit Committee with its own comments on such explanations.

13. At its 102nd meeting, the Committee considered a note issued by PwC that proposed a fee of EUR 180,000 for the audit of the 2008 financial statements (equivalent to a 20 per cent increase, including an estimated inflation element of approximately 3.3 per cent) and provided details of the additional work required as compared with previous years. The proposed fee covers the audit of the IFAD consolidated financial statements, and the financial statements of the Belgian Survival Fund, the Global Mechanism and the International Land Coalition. The cover document to the note included the secretariat's assessment of the additional audit work required, based on the following elements:
 - New accounting pronouncements. These entailed the mandatory introduction, in 2007, of extensive additional disclosure in the audited financial statements on financial instruments, corresponding financial risks and mitigation measures in place.
 - Additional complexities. These included the accounting of contributions to the World Bank's Heavily Indebted Poor Countries Trust Fund (first received in 2007), the impact on financial controls of the significantly increased number of projects under direct supervision and the introduction of accounting policies and disclosures for the newly introduced capital budget.
 - Expected improvements not forthcoming. The positive impact on audit work by control improvements made to IFAD applications over the last two years was offset to some extent by the significant increase in volume of IFAD operations.
14. The secretariat recognized that the above factors have contributed to an increase in the audit effort required and considered the increase in fees requested by PwC for financial year 2008 to be reasonable.
15. The Committee had an extensive discussion on this item in a private session with PwC and afterwards in an open session with the participation of the secretariat. While acknowledging that the audit effort had increased, the Committee was concerned about the lack of detail in the justification provided by the external auditor regarding the proposed fee increase and additional hours worked. The point that the planned audit hours for 2008 were less than the actual hours worked in 2007 was raised. It was explained that the significant increase in audit hours in 2007 was primarily because, in 2007, there were several new members to the PwC audit team and that in 2008 it was expected that with the knowledge gained, the audit effort would be slightly less. Some members noted that the contract with the external auditor was not flexible enough to adjust to the increasing workload created by the changing environment and the expansion of IFAD's activities.
16. At its 101st meeting, the Committee had also requested clarification as to whether Executive Board approval was required for the re-appointment of the External Auditor, considering that, in 2006, the Executive Board had endorsed the appointment of PricewaterhouseCoopers as External Auditor for a five-year term, starting from financial year 2007. The IFAD General Counsel has confirmed that no further approval by the Executive Board regarding the appointment of PwC for financial years 2007 to 2011 is necessary unless there has been a material change in the scope, cost and contractual terms of the present arrangement.

17. After accepting the secretariat's conclusion on the reasonableness of the proposed fee due to the expanded scope, and given that the issue had been presented for its consideration at a very late stage in the year, the Committee decided to endorse the proposed EUR 180,000 audit fee. The Committee suggested that Management consider introducing appropriate clauses in the external audit contract to make it more flexible and adaptable to changing circumstances. The Committee firmly invited Management to obtain an exhaustive breakdown of the external auditor's workload at an early stage in 2009, with the aim of reaching agreement on the audit fee for the 2009 financial year during the first months of next year. The secretariat assured the Committee that this matter would be dealt with early next year.
18. **Recommendation**
The Audit Committee recommends that the Executive Board accept PricewaterhouseCoopers' proposal and approve the audit fee of EUR 180,000 for the audit of IFAD's consolidated financial statements and the financial statements of the Belgian Survival Fund, the Global Mechanism and the International Land Coalition for financial year 2008.
A voluntary separation programme for IFAD 2009-2010
19. The Director, Human Resources Division presented the proposed voluntary separation programme for IFAD 2009-2010. It was explained that this was deemed an essential step in IFAD's human resources (HR) reform programme, which aims at ensuring that the Fund meets the challenges of an expanded programme of work, delivered through an operating model where the focus is on country-led, directly supervised projects and programmes. Taking into account the ever-changing external environment and, consequently, the changing demands made on the Fund, IFAD needs a workforce that is flexible, mobile and equipped with a new set of skills and experience. At present, IFAD has a low natural turnover rate. Staff movement also needs to be increased within the organization. Member States have called for bold and concrete HR reform, identifying accelerated change as critical to overall success. A further issue to emerge from the dialogue with Member States was the importance of diversity in IFAD's workforce, while retaining a clear commitment to merit-based recruitment. To ensure the success of the HR reform, IFAD needs to: accelerate the change in skills and knowledge; raise overall staff performance; and improve its ability to deploy staff flexibly to meet changing requirements. This in turn calls for the implementation of four integrated human resource management practices: (i) source the workforce both directly through employment and indirectly through contracting against a new skills and knowledge profile; (ii) deploy people in different ways; (iii) develop the workforce to sustain IFAD's comparative advantage and deliver its mandate and mission effectively and efficiently; and (iv) release part of the workforce through outward secondment for career development and voluntary separation. An update on the HR reform will be provided to the Executive Board in December.
20. The voluntary separation programme will be funded through an authorization from the Governing Council to spend up to US\$5.5 million from IFAD's regular resources during the period 2009-2010. This represents about 0.16 per cent of the programme of work anticipated in the Eighth Replenishment period and will have a positive impact on IFAD's efficiency and effectiveness. Benchmarking has been carried out with other international financial institutions and United Nations agencies in terms of the level of the separation package to ensure what IFAD is proposing is in line with similar programmes. The programme will be monitored by the Human Resources Division in terms of the number of staff departing, their functions, their geographical background and gender, and the expenditure incurred. The financial aspects of the programme will be reported to the Executive Board annually. A final report on the financial aspects will be submitted to the Governing Council in 2011.

21. The Committee made the following comments:

- The document does not pay sufficient attention to gender mainstreaming and diversity. The secretariat explained that "diversity" as cited in the report referred to both geographic and gender considerations and reassured the Committee that issues related to diversity, with regard to recruitment, deployment, training and development, were part of the broader HR reform for which a five-point plan of action is being defined.
- The statement "Indeed, the Audit Committee has actively discouraged use of the administrative budget to finance such items" (paragraph 28) is not completely correct. The secretariat indicated that this statement was based on the comments made by the Committee when encouraging IFAD "to clean up" the presentation of the administrative budget through the exclusion of extraordinary one-off items.
- The voluntary separation programme should not be targeted at staff about to retire, consequently the statement "For staff who are approaching retirement, this may provide an opportunity to retire early" (paragraph 34) should be rephrased or deleted. The secretariat noted that the exclusion of this eventuality would undermine potential flexibility and movement since it is often the case that staff nearing retirement are less motivated to invest in a new set of skills and to continue to make an optimal contribution to the organization. After further discussion, it was agreed that this paragraph would be deleted.
- Some contradictions were noted in the document regarding eligibility criteria as outlined in paragraphs 36, 37 and 39. A suggestion was made that the programme should be restricted to staff not currently in PMD. The secretariat explained that in setting the criteria for a voluntary programme two elements are important: clarity as to who is eligible to apply and clarity as to how such applications will be assessed and approved. The possibility of excluding staff in a specific department from the programme would unnecessarily restrict the general pool of staff interested in applying. The criteria have been carefully identified in order to be equitable with respect to staff. The set of criteria presented in the paper is not yet final and the secretariat indicated that the Committee's advice would be carefully considered in finalizing the design of the scheme.
- The word "no" in paragraph 39, indicating that the scheme will not target poor performers, should be deleted to eliminate the conflict with the content of paragraph 37, which includes unsatisfactory performance as a potential criterion for identifying staff interested in the scheme.

22. Notwithstanding the number of concerns raised and the requests for modification, the Committee was generally supportive of the proposal. The majority of the members were in favour of considering this expenditure as a one-off item, but at least two members signalled the possibility of including it in the administrative budget. It was also agreed that document AC 2008/102/R.5 would be updated to ensure that the Committee's suggested changes are reflected in the document that is presented to the Executive Board.

Update on the actions taken in relation to the recommendations made on the external quality assessment of the internal audit function

23. The secretariat presented to the Committee an update on actions taken in relation to recommendations arising from the external quality assessment (EQA) of the internal audit function in IFAD. In introducing the subject, the secretariat reminded the Committee of the following EQA recommendations, which had been reported in previous meetings and had already been agreed by Management:

- Private sessions to be held between the chief audit executive and the Audit Committee.
 - The Director, Office of Audit and Oversight (OA) reports to the President and also to the Audit Committee with the purpose of ascertaining that the internal audit function is effective and efficient and that audit reports are promptly acted upon by Management. OA reports annually to the Audit Committee on all aspects of its work, including all audit activities, results of audits undertaken, audit recommendations and status of implementation, and the audit workplan.
 - The Audit Committee to review the audit work plan and if necessary make proposals for approval by the President.
 - The Audit Committee to review the OA budget in the context of its annual budgetary exercise.
 - The chairperson of the Audit Committee to give feedback on the performance of the OA Director through the annual 360-degree assessment process.
24. To support the implementation of EQA recommendations, a survey was conducted of comparative practices relating to the internal audit function in 21 international financial institutions (IFIs) and United Nations organizations. The survey covered the appointment, membership and reporting lines of audit committees; the appointment and dismissal of the chief audit executive; access to internal audit reports; and the role of the external auditor. The findings were presented to the Committee.
25. Two issues related to the EQA recommendations had been previously identified as requiring immediate action by Management. The secretariat therefore reported the following:
- With regard to the ongoing recruitment process for a new OA director, the President consulted with the chairperson of the Audit Committee immediately after the IFAD Appointments Board made its recommendation and prior to the appointment decision. The chairperson in turn consulted with the membership of the Committee. The recruitment process is nearly complete.
 - In relation to a Committee member's request for access to the internal audit report on the administration of consultancy services, the President decided to provide a hard copy of the report to the requesting member in accordance with privacy, legal, confidentiality and sensitive security requirements. Other Audit Committee members may also have access to the report if they so wish.
26. The secretariat further reported that Management had carefully reviewed outstanding EQA recommendations, reassessed its internal management principles and reflected on the results of current practices by other IFIs and United Nations organizations. Consequently, the President has decided to propose to the Audit Committee the following:
- **Appointment and dismissal of the chief audit executive.** The President's responsibility with regard to appointing and dismissing staff, set out in article 6, section 8(d) of the Agreement Establishing IFAD, also applies to the chief audit executive. The discharge of this provision, however, should not prevent the President from consulting the chairperson of the Audit Committee, as he deems appropriate, prior to making the final appointment, as was the case for the ongoing appointment of the new Director of Audit and Oversight.

- **Access to internal audit reports.** The President has decided that upon request, Management will grant access to full internal audit reports in hard copy format to the requesting Audit Committee member or members in accordance with privacy, legal, confidentiality and sensitivity security requirements. The procedure for disclosure is that members identify the reports that they may wish to access at the time of, or any time after, the submission to the Committee of the Annual Report of the Office of Audit and Oversight. This annual report sets out all internal audit reports issued during the year and summarizes significant audit findings and recommendations. Once members identify the reports, Management will provide the requesting member or members with access to the relevant report and will then inform the Audit Committee of this action at the subsequent Committee meeting. The decision to include any of these reports in the agenda for further discussion by the Committee at a future meeting will be made by the chairperson.
27. The Committee could not discuss the document under review in full because of its late distribution to members. There was, however, general agreement on the proposed approach for access to internal audit reports. On the proposed process for consultation with the Audit Committee on the appointment and dismissal of the chief audit executive, the Committee agreed to consider the issue at its next meeting on the basis of a draft text to be provided by the secretariat.
 28. The Committee felt that it was time for a clear orientation with respect to many issues, including Committee composition and the need to update its terms of reference; the participation of external experts in the Committee's meetings; access to reports; oversight; and appointment of the chief audit executive. The secretariat offered to assist the Committee in drafting the terms of reference for consideration at future meetings. The secretariat also indicated that the survey covered functional aspects of the Audit Committee that may be of relevance, such as the use of external professional experts, membership tenure and requirements for professional skills or training.
 29. It was agreed that a special meeting of the Committee would take place before the December session of the Executive Board session to discuss the Committee's terms of reference. The secretariat will provide draft updated terms of reference, reflecting the decisions taken to date with regard to the EQA recommendations.

Other business

30. At the request of some Committee members, the secretariat provided a short brief on the financial crisis.
31. During the months of September and October 2008, a number of major financial institutions either ceased to exist or required government support. Several government interventions, as well as action by central banks and the International Monetary Fund, have been required. In this environment, high-quality fixed-income instruments have proved to be the safest. IFAD's investments fall into this category.
32. Overall, IFAD's investment portfolio has benefited from its conservative investment policy and therefore from the financial markets' flight-to-quality. A significant portion of IFAD's cash is held at central banks, and IFAD's payment and disbursement operations have been entirely unaffected by the financial crisis. The projected investment income for the year-to-date, as at 31 October 2008, was US\$72.5 million. This equalled an estimated year-to-date return of 2.96 per cent, which is in line with IFAD's annual target rate of return of 3.5 per cent. As market volatility may nevertheless impact returns during the remainder of the year, IFAD is monitoring proactively. The Treasury Division (FT) and Senior Management are continuously monitoring developments in the financial market in order to protect the investment portfolio from any adverse impact. The Assistant President, Finance

and Administration Department, the General Counsel, the Director of the Financial Services Division, the Treasurer and the Senior Treasury Officer, Liquidity Management Section, FT, meet on a daily basis to monitor developments and recommend appropriate decisions by Management or other action.

33. IFAD's investment portfolio amounted to US\$2.5 billion as at 31 October 2008, 81 per cent of the portfolio was invested in government-related securities or cash held at central banks. The remaining 19 per cent was invested in high-credit quality corporate bonds; mortgage asset-backed securities; and cash held outside central banks, including commercial banks that support IFAD's day-to-day banking operations. Furthermore, a portion of the portfolio securities are loaned against collateral through the securities lending programme of IFAD's current global custodian. A very small number of the portfolio's non-government securities have been affected by credit rating downgrades resulting from rating agencies' increased rating activities as well as weakened economic conditions. In terms of credit quality as at 31 October 2008, about 90.1 per cent of IFAD's investment portfolio was invested in highest credit quality triple A securities; 9.6 per cent was invested in double A securities and only a residual 0.3 per cent was held in single A securities arising from the immediate downgrading that transpired in the previous month.
34. One Audit Committee member requested, and the secretariat agreed, that more detailed information (i.e. amounts) regarding IFAD investments be circulated to the members.

