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IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

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MANAGEMENT OF RISK AT IFAD

Introduction

1. The term “risk management” generally refers to the process of identifying potential events whose occurrence will affect the achievement of objectives and implementing actions designed to mitigate the probability or impact of such events. Critical to the management of risk is the effectiveness of an organization’s internal controls. Current conceptual thinking on internal control is largely founded on the *Internal Control – Integrated Framework* model issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992 in the United States of America (commonly referred to as the COSO model). COSO broadly defines internal control as “a process, effected by an entity’s board of directors, management and other staff, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; compliance with applicable laws and regulations”. COSO identifies the following five categories as elements of the internal control framework of an organization: control environment; control activities; risk assessment; information and communication; and monitoring. In 2004, *Enterprise Risk Management – Integrated Framework* was published by the same authors as an expansion of the COSO model. This framework recognizes the role of risk management as the driving factor in defining the internal control framework and ensuring its adequacy.

2. In the wake of several financial scandals in recent years, the role of management in ensuring the effectiveness of internal control and risk management in both the private and public sectors is increasingly emphasized. This trend is gradually becoming evident in the United Nations/international financial institution (UN/IFI) system as some organizations are developing ways of introducing more structured control and risk-management mechanisms. Structured risk management in the UN/IFI system has been traditionally focused on financial risk. However, some organizations are now expanding the scope of such processes to embrace operational, strategic and other types of risks and are linking such efforts to the effectiveness of their internal controls. The COSO model is the framework most commonly referred to by UN/IFI entities in assessing the effectiveness of their internal control systems.

3. The most significant recent development in this area was the enactment in the United States of America of the Sarbanes-Oxley Act of 2002,¹ which requires (under Section 404) the annual issuance of a management assertion that internal controls over financial reporting are effective; it also requires an organization's independent auditor to express an opinion on management's assertion on internal control and an opinion on the fair presentation of the organization's financial statements. Similar provisions on risk and control reporting have been introduced in a number of other countries. The use of the services of the United States Securities and Exchange Commission (SEC) by many non-United States-based organizations has led to widespread application of this provision even outside the country. The significant incremental costs (mainly audit fees and administrative costs) and staff time requirements associated with implementation of Section 404 of the Sarbanes-Oxley Act have been highlighted in many recent financial press articles, with the result that the SEC has been obliged to extend the original deadline for initial compliance in view of the far-reaching implications of setting up the necessary documentation and accountability structures. The multilateral development banks (MDBs),² which raise capital on financial markets and are subject to credit rating by the major rating agencies, generally follow the financial reporting practices expected by investors, and have adopted or are in the process of adopting internal control reporting practices similar to those required under Section 404. In this regard, some MDBs have established, or are in the process of setting up, small units to manage the tasks involved (in some cases with joint responsibility over institutional risk management). IFAD is not aware of any United Nations agency that has adopted a formal system of internal control reporting by management with an audit attestation thereon. A survey conducted earlier this year by another United Nations agency revealed that several agencies were considering, or were already working towards, the implementation of some form of formal internal control reporting and that resource requirements were a determining factor in the approaches under consideration.

Risk Management and Internal Control Practices at IFAD

4. The internal control structure introduced with the establishment of the various functions within the Fund has been enhanced over the years through self-improvement actions on the part of organizational units, feedback from internal and external oversight mechanisms, management improvement initiatives, occasional specialist reviews and the work of special-purpose task forces. These inputs have served to identify and address control weaknesses and mitigate risk exposures. The Office of Internal Audit and the external auditor perform a fundamental role by evaluating IFAD's internal controls and providing recommendations for their maintenance and strengthening, as documented in the many internal audit reports and memoranda and in the external auditor's annual internal control memorandum. Also prominent among IFAD's efforts in this area was the performance of a risk management survey by external experts in 1995, which covered personnel issues, treasury functions, project management, administrative services and information security, and the establishment of the Operational Risk Management Committee (ORM) charged with overseeing implementation of the risk mitigation actions identified. The ORM remained in force until 1998, when most of the mitigation actions had been implemented or superseded by other corporate improvement initiatives. The improvement initiatives undertaken in recent years include:

Financial and fiduciary soundness

- The Strategic Change Programme and implementation of the PeopleSoft integrated financial system, including further development of reporting capabilities for management information concerning all areas of the organization: this resulted in more transparent and readily accessible information on transactions; in streamlined and more effective controls; and more

¹ Applicable to publicly registered companies under the jurisdiction of the United States Securities and Exchange Commission and effective as at August 2003.

² The International Bank for Reconstruction and Development; the Inter-American Development Bank; the Asian Development Bank; the African Development Bank; the International Finance Corporation; and the European Bank for Reconstruction and Development.

efficient processes covering, inter alia, the processing of actions on procurement, payment, accounting, budget, asset management and personnel issues.

- Establishing a separate strategic planning and budgetary function; introducing activity-based budgeting; decentralizing budgetary decisions and management; and introducing standard reporting on budgetary performance combined with periodic reporting on the achievement of divisional objectives to ensure that the institution accomplishes the goals foreseen.
- Setting up the asset liability management framework to focus on identifying, understanding and managing financial risk while pursuing the institution's financial objectives; implementing a more conservative investment policy; and issuing the Treasury Manual. Linked to this was the investment security review undertaken in 2003 by the Madison Consulting Group to assess the effectiveness of operational and strategic controls pertaining to IFAD's investment practices. Implementation of the review's recommendations is closely monitored by the IFAD Audit Committee.
- Setting up the Oversight Committee to coordinate investigations into alleged irregular practices; establishing of policies and procedures to cover investigations, including provisions for protecting staff from retaliatory action and malicious accusations; and issuing an annual report on the results of investigations (including sanctions) both to staff and to the Audit Committee.
- Defining and implementing an anti-corruption policy and procedures, including a revised employee code of conduct. Further steps planned under this initiative include establishing confidential facilities for the communication of allegations, strengthening IFAD's investigation function and creating an IFAD debarment process for contractors involved in its projects.
- Strengthening the internal audit function and introducing a structured field-visit programme for staff of the Office of Internal Audit to visit loan and grant recipients.
- Restructuring IFAD's insurance coverage based on a comprehensive review of all its insurance policies and relevant internal processes and responsibilities; readjusting as appropriate some of its insurance policies; and streamlining and documenting internal processes.

Operational effectiveness

- Strengthening the loan administration function and assigning full-time duties for the monitoring/follow-up of project audits and for the administration and supervision of grants.
- Issuing the *IFAD Guidelines on Project Audits (for Borrowers' Use)* and the *IFAD Operational Procedures for Project Audits (for use by IFAD and Cooperating Institutions)*; approving revised *Guidelines for the Procurement of Goods, Works and Consulting Services under IFAD Loans and Grants* with strengthened provisions against fraud and corruption; and updating IFAD's Loans and Grants Operational Manual.
- Participating in the International Civil Service Commission's pilot programme to review pay and benefits; modernize policies and procedures; and introduce competency-based recruitment practices and a revamped performance evaluation, training, career development and promotion structure.
- Establishing the Contracts Review Committee and the Property Survey Board, and revising the Headquarters Procurement Manual to include provisions for avoiding conflicts of interest and for the blacklisting of suppliers.
- Strengthening IFAD's security function.

- Organization-wide definition of business continuity plans, including drawing up an emergency and recovery plan for critical areas of information technology and headquarters facilities, the majority of which are expected to be operational by the end of 2005.

Strategic effectiveness

- Implementing a performance-based allocation system to promote the development of national and local conditions for sustained rural poverty reduction through lending for specific development initiatives, policy dialogue and transparent implementation of the system by public disclosure of performance ratings.
- Implementing a results and impact measurement system to better measure and monitor the effectiveness and impact of field projects.
- Undertaking of the Independent External Evaluation (IEE) of IFAD and, based on its outcome, the drawing up of an action plan to address identified weaknesses and strengthen the organization's effectiveness.
- Increasing the Office of Evaluation's independence and regularly issuing the Annual Report on the Results and Impact of IFAD Operations.
- Issuing the *Guide for Project M&E* to help project managers and monitoring and evaluation (M&E) staff to improve the quality of M&E in IFAD-supported projects.
- Restructuring the internal project portfolio review process and issuing revised guidelines on the subject.
- Strengthening the communications and policy functions, defining and implementing a communications plan (in progress) and launching a policy forum process.

5. While the above list is not exhaustive, it demonstrates IFAD's serious efforts to improve its controls to ensure economy, efficiency and effectiveness in its operations.

Effectiveness of IFAD's Risk Management and Internal Control Practices

6. In recent years, this subject has generated much interest among members of the Audit Committee. IFAD has undertaken to inform the Audit Committee – and ensure that it receives up-to-date information – both on what the Fund is doing to improve its internal control framework and on industry best practices and generally applied standards. The following documents, which have been presented to the Audit Committee, provide a full account of the Fund's approach to assessing the effectiveness of its control and risk management mechanisms:

- **Oversight and Internal Control at IFAD** (document AC 2002/79/R.6, presented to the Seventy-Ninth Meeting of the Audit Committee on 9 December 2002) described emerging trends and IFAD's approach to the question of oversight in the context of standards currently under consideration by United Nations agencies and IFIs, including best practices and the potential need for annual reviews of the internal control framework.
- **Assessment of IFAD's Internal Control Framework** (document AC 2004/85/R.6, presented to the Eighty-Fifth Meeting of the Audit Committee on 19 April 2004) informed members of IFAD's approach to assessing its internal control framework.
- **Oversight and Internal Control at IFAD** (document AC 2005/89/R.8, presented to the Eighty-Ninth Meeting of the Audit Committee on 31 March 2005) provided a status report on the action plan to document and assess the adequacy of the internal control framework.

7. A summary of the main steps taken by the Fund in assessing the effectiveness of its control and risk management mechanisms, in addition to the assessments performed annually by the internal and external auditors³ for planning and implementing their work plans, is given below:

- The risk management survey of 1995 and the Operational Risk Management Committee that was active until 1998, as referred to above.
- A high-level assessment of the effectiveness of IFAD's internal control framework based on the COSO model, undertaken by the Office of Internal Audit in 2002. This assessment was used mainly for defining priority audit areas.
- Revival of the institutional risk management process through the 2004 assessment of organizational risks and internal controls by external experts based on the COSO model. The scope of the work was high-level (i.e. no substantive testing of all the controls identified), limited to aspects of financial soundness and organizational efficiency, and excluded strategic effectiveness as that area was under close review by the Independent External Evaluation of IFAD. The higher-level risks identified were, as a general rule, closely related to corresponding weaknesses in internal controls, and the external experts noted that actions to address the most critical of these risks and corresponding control weaknesses were well under way. A business impact assessment was performed at the same time to prioritize organizational procedures and systems for continuity and disaster-recovery planning. In addition to identifying and ranking critical risks, the assessment was useful with regard to identifying an appropriate control methodology to be used by IFAD and a structure for documenting the existing control framework.
- The integration of risk management into the strategic planning and budget process, which used: (i) the divisional budget submission process to gather and aggregate risks and exposures to the achievement of the institution's goals for 2006 (including "strategic effectiveness" risks); and (ii) the results of the aforementioned 2004 assessment of organizational risks and internal controls. A list of high-level institutional risks was extracted from the risks identified by the divisions (mainly linked to coordination and resource/staff time availability for the multiple initiatives that were in progress or planned for 2006) and was reviewed by senior management for the purpose of setting budgetary priorities. In addition to supporting budget allocation decisions, senior management will consider possible risk-mitigating actions in relation to the period covered by the 2006 budget and, as appropriate, assign responsibilities for their implementation. Senior management will monitor progress on such mitigating actions periodically throughout 2006.

8. The Office of Internal Audit intends to proceed with further documentation of the IFAD internal control framework in 2005, in collaboration with the Finance and Administration Department. For the immediate future, this effort will consist of the formal documentation of controls in place over external financial reporting with reference to the COSO model, evaluation of such controls and identification of issues. The results will be reported to senior management and used by the internal and external auditors as an input for audit planning. As indicated above, full adoption of the practice whereby management issues an assertion on the effectiveness of internal controls over financial reporting and the external auditor issues an opinion on management's assertion will entail significant internal and external resource needs and have a bearing on other corporate priorities to be implemented and maintained. The exercise of documenting and evaluating controls over external reporting will allow the Fund to evaluate the various alternatives for providing formal management

³ The internal control memorandum (ICM) from IFAD's external auditor reports on weaknesses noted with regard to the controls over financial reporting and includes appropriate recommendations. The Audit Committee reviews the ICM and monitors closely the implementation of the ICM recommendations, as well as the implementation of the recommendations made by the internal auditor.

reporting on the effectiveness of controls, taking into consideration the cost/benefit implications both for IFAD and for evolving best practices.

9. The IFAD approach is to insert risk management into the organization's management decision processes, both gradually and in a structured manner, without creating new permanent structures and positions but rather by building on existing resources, tools and practices. IFAD's external auditor, PricewaterhouseCoopers (PwC), assessed the approach taken by IFAD and provided written comments to the Audit Committee at its July 2005 meeting. The main comments of PwC were that the assessment of controls should be based on their substantive testing, and that the risk management process should be more formally structured. Management's response, which was also reported to the Audit Committee, stressed that further documentation of the IFAD internal control framework, coupled with cyclical audit work on business processes, would contribute towards addressing the first concern. Management is aware of the need to further structure the risk management process, but is also cognizant of the fact that this will call for additional resources and staff time at a juncture when IFAD is launching or implementing numerous improvement initiatives. IFAD has made significant progress in recent years in terms of tightening up its internal procedures and controls. Within the above-mentioned constraints, the Fund is committed to strengthening its internal control framework and to gradually expanding and refining its approach based on experience gained in striving to meet evolving best practices in the United Nations and IFI environments.

