DOCUMENT OF INTERNATIONAL MONETARY FUND AND NOT FOR PUBLIC USE

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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 98/55

3:00 p.m., May 20, 1998

Contents

Decisions Taken Since Previous Board Meeting

Executive Board Attendance

M. Camdessus, Chairman

Executive Directors	**Alternate Executive Directors**
A.A. Al-Tuwaijri	C.X. O'Loghlin
	W. Szczuka
B. Esdar	A. Giustiniani, Temporary
	L.J.F. Erasmus, Temporary
K.A. Hansen	A.L. Coronel, Temporary
	J. Prader
K. Lissakers	B.S. Newman
J.-C. Milleron	
	M. Daïri
	L. Palei, Temporary
	J. Shields
	M.H. Elhage
	S.S. Farid, Temporary
	N. Jadhav, Temporary
	C.M. Gonzalez, Temporary
	T. Brizuela, Temporary
J. de Beaufort Wijnholds	A. Barro Chambrier
	H. Ogushi, Temporary
	C. Harinowo
	Han M.
A.G. Zoccali	

R.H. Munzberg, Secretary
N. Hairfield, Assistant

Independent Review of the Fund's Audit Functions—Terms of Reference

Staff representatives: Brau, OMD; Baumgartner, ADM; Gianviti, LEG

Also Present
Administration Department: U. Baumgartner, Deputy Director. Fiscal Affairs Department: G.T. Abed. Legal Department: F.P. Gianviti, General Counsel. Monetary and Exchange Affairs Department: P.T. Downes. Policy Development and Review Department: T. Leddy, Deputy Director. Secretary's Department: A.S. Linde, Deputy Secretary; A. Mountford. Treasurer's Department: G. Wittich, Deputy Treasurer; B.E. Keuppens. Office of the Managing Director: M. Russo, Special Advisor; B.V. Christensen. Office of Budget and Planning: L.A. Wolfe, Director; P.J. McPhillips. Office of Internal Audit and Inspection: E. Brau, Director; A. Coune. Advisors to Executive Directors: J.A. Costa, R.J. Heinbuecher. Assistants to Executive Directors: M. Budington, H.W. Cocker, D.A.A. Daco, J.K. Honeyfield, S.K. Keshava, K. Kpetigo, J.P. Leijdekker, D. Merino, J. Schaad.

1. INDEPENDENT REVIEW OF THE FUND'S AUDIT FUNCTIONS—TERMS OF REFERENCE

The Executive Directors considered a staff paper on the terms of reference for the ongoing review of the Fund's audit functions by independent experts (EBD/98/44, 5/18/98).

The Chairman explained that Ms. Lissakers had asked that the Executive Board be briefed on the ongoing review of the Fund's audit functions by independent experts.

The Director of the Office of Internal Audit and Inspection made the following statement:

> The origin of the review of the audit functions is the general services review, which the Office of Internal Audit and Inspection (OIA) has undertaken since October of 1996. The general services review is a review of the effectiveness and efficiency of all noneconomic functions that are being performed in the Fund, except the human resource function. The review is to be completed by OIA by summer 1998, with reports to Fund management.
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> The effectiveness and efficiency review develops an analysis of the objectives of the functions being performed, including the costs involved, the way the process of delivery of the work is performed, what the quality of the work being performed is, what the satisfaction of the users of these services is, and what the cost effectiveness of this activity is. The methodology for this review has been developed in conjunction with outside advice. Although this review is being done by OIA, when issues become very technical, outside experts are called to advise us on the work function under review.
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> We have conducted the effectiveness and efficiency review in three phases. The first phase is completed and the reports are with Fund management and the departments concerned. The first phase concerned information services: all the work by the Bureau of Computing Services, language services, telecommunications services, records management, graphics services, and documents management. The second phase, which we are about to complete, concerns the procurement function, the travel function, and the entire range of facilities services concerning the building, such as building management and maintenance. The third phase, which we are in now, covers financial services: accounting, expenditure control, budgeting, and auditing.
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> When this entire review was conceived, it was essential that all the noneconomic functions be covered, including auditing; because there is no internal expertise to assess independently how auditing functions are being done, it was decided that the assessment of the auditing function should be done by outside experts. This entire approach was explained to the external audit committee (EAC) in June 1997. You have seen in the views and suggestions of the EAC that were circulated to the Board about ten days ago that last year's EAC warmly endorsed the effectiveness and efficiency review of noneconomic services in the Fund. The EAC also warmly endorsed the audit review, and had suggestions on how the review of auditing should occur, endorsing the approach that a steering group of senior staff members could be

appointed by Fund management. This steering group would be asked by management to draft the terms of reference for the audit review, and make suggestions on the outside experts who would conduct the review.

Management did appoint a steering committee, of which the Deputy Director of the Administration Department is a member. The work of the outside experts has started.

The Deputy Director of the Administration Department made the following statement:

The Director of OIA has given you the background to the assessment of the audit functions to be performed by outside consultants. The process of this review is to be guided by a steering committee made up of senior staff of the Fund, and for this purpose, management appointed a steering committee composed of Mr. Kuhn, Senior Advisor in the Treasurer's Department as Chairman, Mr. Wolfe, Director of the Office of Budget and Planning; Mr. Abed, Senior Advisor in the Fiscal Affairs Department; and myself.

The steering committee is to select the consultants, define the terms of reference for the review, monitor its progress, and resolve issues on which the consultants request guidance. The consultants will, however, report their findings directly to management, without substantive review by the steering committee. We will, of course, ascertain whether the terms of reference have been observed.

The first task of the steering committee was to determine the structure of the review. The Fund's auditing structure is in many way sui generis. It has an internal audit department (OIA); most of its functions are standard practice in internal auditing departments. In addition, it has an external auditing structure made up an external auditor—currently Coopers & Lybrand—and the EAC, which is composed of senior officials from three member countries.

Thus, the scope of this review involves a set of interrelated issues ranging from an assessment of OIA's operational and system audits to an evaluation of the rather unique structure of the Fund's external auditing process. To make the review manageable and focused, the steering committee proposed that the review take place in two separate, but closely interlinked, parts to be carried out concomitantly and under common guidance. With this in mind, the steering committee drafted separate terms of reference: one for the review of OIA and the other for the external audit process. These two sets of terms of reference were reviewed and approved by management, and have been provided to the Board for their information.

The review of OIA is to provide an independent analysis of the quality and effectiveness of the Fund's internal audit function. The review comprises all of OIA's functions; that is, internal financial auditing, operational and system audits, institutional review, work practices reviews, and the role of OIA in support of the external audit undertaken by outside experts. The review is to include specifically OIA's compliance with the Fund's audit policies and procedures and the generally accepted professional standards for internal auditing; the effectiveness, efficiency, and state of art of OIA's review procedures, measured against generally accepted benchmarks of performance; the contribution of internal auditing to the overall system of internal controls in the Fund; the cost-effectiveness of OIA; the current responsibilities and work program of OIA; the quality, competency, and efficiency of OIA's delivery of services; the adequacy of OIA's resources measured against generally accepted benchmarks; and the relation between the internal financial audit function and the work performed by the external auditors.

The review of the external audit process, which is described in broad terms in the paper distributed to the Board, is to evaluate the current structure and effectiveness of the Fund's external financial audit process. In particular, it will focus on the adequacy of the existing framework, including legal requirements and audit standards; the functions and responsibilities of the EAC, measured against appropriate standards and generally accepted practices of EACs; the assessment of the role and reporting of the public accounting firm and its relation to the EAC; and the make up of the three members of the EAC. These, in broad terms, are the terms of reference, which are described more fully in the document distributed to the Board. Simultaneously, with drafting the terms of reference, the steering committee embarked on the search for suitable consultants. Following an extensive search, the steering committee offered the position of coordinator of the review and reviewer of the external audit function to Mr. Steven Eccles, a former Vice President and Controller of the World Bank and currently Chairman of the International Accounting Standards Advisory Council. In the view of the steering committee, Mr. Eccles met the key requirements of substantial experience with current external audit practices and financial reporting practices, and familiarity with international financial institutions. The selection of the steering committee was approved by management.

For the review of OIA, the steering committee, in consultation with Mr. Eccles, selected a team of three auditors from the Institute of Internal Auditors (IIA). The IIA is the primary international association dedicated to the promotion and development of the practice of internal auditing. The IIA is the acknowledged leader in statistics, certification, research, and education for the profession worldwide. It was established in 1941. It is an international professional association. It has 66,000 members in more than 100 countries. The team that was selected is composed of Mr. Burnham of the United States, Mr. Hodson of South Africa, and Mr. McDonald of Australia. All three are very experienced auditors with relevant international experience. The selection of these consultants was also approved by management.

The consultants will interact with former members of the EAC, the office of internal audit, Treasurer's Department, and other Fund departments as necessary. Mr. Eccles started his work in early April. As one of the first steps, he distributed a questionnaire to some 80 staff of the Fund, and responses are due in the next few days. He has also made contact with the external auditor, former members of the external audit committee, and other international organizations to help in his review. The IIA team leader and the entire team from the IIA will be here for two weeks in late June and early July.

This will allow the reviewers to evaluate OIA's interaction with the external auditors, which is part of the terms of reference. The steering committee will meet periodically with the consultants to ascertain the progress of the review. However, it will exert no influence whatsoever on the substance of the review.

The timetable established has been worked out carefully with all parties involved. The final reports of Mr. Eccles and the IIA are expected to be submitted to management in August. Finally, the total cost of the review is expected to be less than $100,000.

Ms. Lissakers thanked the staff and management for their quick response to her request to hold a meeting to review the Fund's audit functions. It was essential that the audit process be transparent, both within the institution and externally, and that it meet the highest standards.

It was also important that the Board be involved in the audit review exercise, Ms. Lissakers continued. The letter from the EAC to management, which had been distributed to the Board only after it had been requested, had addressed several central functions of the Fund. Therefore, in the future, such communications from the EAC to management should be shared with the Board. Moreover, the Board should also be apprised routinely of such functions, and should have more direct oversight of the audit functions, including the external review. To accomplish that, the terms of reference needed to be amended with regard to the oversight and reporting functions. All reports should go to the Board and be reviewed by the Board. Also, the Board—or a representative group of Directors, such as the Evaluation Group of Executive Directors—should periodically consult with the steering committee.

It was unclear in the April 30, 1998 letter by the EAC whether the management of the Fund's administered accounts would be covered by the audit, Ms. Lissakers continued. The Fund's external auditor had suggested changes to the way the Staff Retirement Plan was managed, particularly regarding the factors that limited the effectiveness of the controls over performance and market-related risk. For instance, they had recommended that credit concentration be disclosed. She wondered whether the staff could indicate how it was responding to those particular recommendations.

The Fund's financial statements and balance sheet were not presented in a transparent manner, even to professional auditors, Ms. Lissakers pointed out. That was one of the reasons for a review of the external audit function.

The Chairman stated that the review of the external audit function would be taking place soon. Concerning the Fund's balance sheet, he agreed that there was scope for presenting that information more clearly.

Management had the liberty to ask for a review of any function within the institution, the Chairman continued. The first review had been the general services review. The current review encompassed the Fund's internal and external audit functions. Certainly, in the case of the external audit review, one could not ask OIA to review that process. That was the reason for commissioning the external consultants. Upon completion of the external audit review, the report would be shared with the Board. Therefore, it was not clear why the terms of reference had to be changed.

Ms. Lissakers said that the review of the Fund's audit functions was considered a core review, and as such, the Board should be mentioned in the terms of reference. She asked that the terms of reference be changed to reflect that the final report would go to management and the Executive Board.

The Chairman reiterated that he, as head of the administration of the Fund, had the responsibility for all the functions of the Fund, including the prerogative to ask for an audit. Certainly, if the Board did not agree with the results of the report, then the Board could ask for another audit.

Ms. Lissakers disagreed with the Chairman that the functions of the Fund were not solely in the Managing Director's purview. As the Board shared the responsibility for the functions of the Fund, it should therefore be part of the review process. Also, any communication between the EAC and the Fund should go to management and the Board, which had not been the practice in the past.

The Chairman said that he would be willing to change the procedures regarding the communications between the EAC and the Board if indeed previous practices had been legally unsound. On sharing the results of the external audit review study, he remarked that he would have shared them with the Board, even if he had not been asked to. However, he expressed concern about being told that he should not have launched the audit review, or that he should have done so after seeking the approval of the Board.

Mr. Esdar made the following statement:

> I am pleased to have the first opportunity to discuss the independent external review of the Fund's audit functions which I understand is already well underway. As you can imagine, as a member of the external evaluation group, I have a particular interest in such issues. One might argue that it would have been much more preferable to have seen the suggestions for these evaluations at an earlier time, when the Board would have had the opportunity to provide some input, at least in the case of the evaluation of the external audit where the Board has clearly defined responsibilities.
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> Against this background, it is somewhat unfortunate that this external evaluation covers and intermingles two quite different subjects which in my view should be handled separately paying due regard to existing significant differences both in substance and procedure.
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> I would like to focus here particularly on the procedural aspects; i.e., the responsibilities of the Board and Management, which are different in those two areas.
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> Nobody, at least not this chair, would question the right and competence of Management to ask external evaluators to look into the internal auditing process, i.e. the functioning of the Office of Internal Audit. However, in light of the importance of such an evaluation, it would be highly appropriate, and welcomed by this chair, if Management would keep the Board informed, not only about the general intention and orientation, but in particular also about the major results of this project.

In contrast to this area, Section 20 (C) of the By-Laws clearly stipulates a direct responsibility or at least a co-responsibility of the Board when it comes to an external audit. From this provision follows that any external evaluation of the external audit procedures requires direct involvement of the Board. By the way, according to this provision, all communications of the external auditors, at least those with significant substance, should not be limited to Management but also be relayed to the Board. This is particularly true if the external auditors suggest an external evaluation as was the case last June. Insofar I welcome the recent information of the Board about the Memorandum of last June, late as it is. I would like to refer to and remind everybody of Section 20 (f) of the By-Laws, which invites the external audit committee to "formally furnish to the Managing Director and the Executive Board (I repeat and not or) the committee's views and suggestions concerning the system of accounting, internal financial control, and documentary or other procedure which may technically strengthen or improve the administration of the Fund's financial affairs." I firmly expect that this rule will be fully respected in the future.

However, at this stage of the process we have to be realistic. The external evaluation of both areas seems to be well underway. Against this background, I would suggest separating the two evaluation reports. With respect to the external evaluation of the external audit, the Board has to be fully informed about the outcome of the evaluation and should receive the complete and unedited report of the evaluators. I also would expect that additional suggestions of the Board with respect to the coverage and substance of the evaluation which will come up today will be submitted without delay to the external evaluators and be included in the respective Terms of Reference. In this regard I would like to point out that while the terms of reference more or less seem appropriate, in my view there should be a clear reference to the fact that the Fund is not a bank or another ordinary player in the financial sector, but that it has a special character justified not only by its mandate but also by its quota-based financial structure. The external evaluation must pay due regard to this special orientation and task.

Coming back to the external evaluation of the internal audit I would agree that the report of the evaluators should go directly to Management. However, I would expect that the Board receive an executive summary of the main findings.

We have to accept the fact that the evaluation is already going on. For this reason we should refrain from reopening the whole process. I do not see, therefore, the need at this relatively late stage to get the Evaluation Group involved. This is now a matter for the Board or the Committee of the Whole. However, for future cases, the Evaluation Group is certainly the appropriate body to discuss such issues and to be properly involved in the planning and execution of such external evaluation projects.

The Chairman agreed with Mr. Esdar's suggestion to have the two reports sent to the Board simultaneously.

The General Counsel explained that in the past, the external auditors had interpreted Section 20(f) of the By-Laws on their own. As Section 20(f) was ambiguous, it was not clear whether both management and the Board should receive the report. However, if the Board decided that such documents should be communicated to both management and the Board at the same time, then the practice in the future would be made consistent with that decision, and the external auditors would be informed accordingly.

Mr. Esdar believed that only substantial issues should be reported to the Board, and that the report of the external evaluators, including their procedures, was considered substantial. Therefore, he suggested that there should be a more open interpretation of Section 20(f) of the By-Laws, and that that should be made clear to the external evaluators.

Mr. Hansen pointed out that the first sentence of the second paragraph of Section 20(f) said "Managing Director and Executive Board," and wondered what was ambiguous about that.

The General Counsel explained that the ambiguity in that sentence arose from the word "may", not from the word "and." The word "may" could be understood as giving an option not only whether to communicate the report at all, but also whether the report should be communicated to both management and the Executive Board or only one of them.

Mr. Esdar commented that his interpretation of that sentence was that if a report were furnished, it had to be furnished to both management and the Board.

The General Counsel clarified that the first sentence in paragraph 2 of Section 20(f) referred to the report containing the EAC's views concerning the Fund's audit function; it did not refer to the report that would go to the Board of Governors.

Mr. Wijnholds said that he agreed with Mr. Esdar's proposal that the report should be communicated simultaneously to management and the Board.

Ms. Farid said that she also agreed with Mr. Esdar's proposal. She believed that part of the external audit process should be conducted under the auspices of the Board. Moreover, the terms of reference of the review of the external audit process should include a reference to the Board to strengthen its accountability to the Board. It should also include an interpretation of Section 20(f) of the By-Laws.

The General Counsel wondered whether Ms. Farid had suggested to amend Section 20(f) of the By-Laws.

Ms. Farid replied that if Section 20(f) was ambiguous, then it should be clarified.

The Chairman asked the Board whether they agreed with Mr. Esdar's proposal to send the report simultaneously to the Board and management.

Ms. Lissakers made a formal request to the Board asking that the last sentence in the terms of reference be changed to "Upon completion of the review, an overall report, covering all aspects of the terms of reference, would be presented directly to Fund management and to the Executive Board." Moreover, the terms of reference should mention that the EAC would be operating under the authority of both management and the Executive Board. As the Chairman did not object to that in principle, then it should be included in the text.

The Chairman said that he objected to Ms. Lissakers's proposal on the grounds that by accepting it, it would imply that management had committed an error when it launched the audit review. For practical purposes, it would be preferable to go along with Mr. Esdar's proposal.

Ms. Lissakers considered that the Board would be failing to exercise its responsibilities if it did not insist that it had authority over the audit review because the Board was as accountable as management. It should be straightforward to amend the terms of reference, and by doing so, it would serve as a precedent for future audit reviews.

The Chairman proposed that the minutes of today's discussion mention that the Board had agreed that the report from the EAC should be transmitted to the Board and management rather than changing the terms of reference.

Mrs. Brizuela supported the Chairman's proposal.

Ms. Lissakers asked that the Board vote on her proposal to amend the terms of reference.

The Chairman put forth a motion to vote on amending the terms of reference.

Mr. Esdar expressed a preference for finding an alternative solution rather than voting to amend the terms of reference. As an alternative solution, he suggested that a letter be sent to the EAC informing them that their report be sent to the Board.

The Chairman supported Mr. Esdar's new proposal.

Ms. Lissakers, however, stated that she did not support Mr. Esdar's new proposal, as it would suggest that sharing the report with the Board was simply a courtesy of management.

Mr. Shields suggested that perhaps the letter to the EAC could include Ms. Lissakers's point regarding the Board's responsibilities in the audit process, and management's intention to immediately send the report to the Board when it became available. That way, the report would come to the Board at the same time it went to management.

Ms. Lissakers disagreed with Mr. Shields's remarks, and stated that the EAC should report directly to the Board and not through management. Moreover, she considered that Section 20(f) of the By-Laws would be weakened by such an approach. It was a matter of principle to be clear that the EAC was accountable to the Board.

Mr. Esdar clarified that the letter to the EAC should indicate that the report be sent directly to the Board, but not as a courtesy.

Mr. Wijnholds pointed out that perhaps a few Directors were ill-prepared for such a discussion, and that before rushing to a formal vote, the Fund's legal experts should have an opportunity to consider the various proposals.

Mr. Prader said that if there were to be a vote, he would favor Ms. Lissakers's proposal, and added that that did not imply that management had committed an error.

Mr. Sczcuka supported Mr. Esdar's new proposal, provided that in the future the terms of reference would include the text that had been proposed by Ms. Lissakers. Certainly, when the audit review had been proposed by management, the Board had not been prevented from starting its own audit review. Therefore, as a compromise, Mr. Esdar's new proposal would ensure that the Board received the report, as well as make any future reviews more transparent.

Mr. Giustiniani pointed out that since Section 20(f) referred only to the audit committee; Mr. Esdar's new proposal was more sensible.

Mr. Al-Tuwaijri said that he was not well prepared for such an important discussion. Although it was important not to undermine the authority of the Board, at the same time, management's responsibilities needed to be respected. Therefore, if a compromise could not be reached today, he would favor Mr. Wijnholds's position to not have a formal vote today.

Mr. Milleron agreed with the Chairman that management had the responsibility to initiate reviews on the audit process. Therefore, the report should go to management first. As there was a commitment by management to share the report with the Board, he could go along with Mr. Esdar's new proposal.

Mrs. Gonzalez said the she shared Mr. Wijnholds's views. At the same time, the Board should be fully informed about the activities relating to the Fund's audit function, including the general services review, which had not been reported to the Board until March 1998. Moreover, the Board should be given the opportunity to give its views on that issue.

Ms. Lissakers suggested that the discussion be continued another day to allow Directors to reflect on all the issues.

The Chairman stressed that it was up to management to ensure that the services of the Fund worked properly. As the Managing Director of the Fund, he was in charge of the services of the institution. He also recognized that Directors would need more time before making a final decision.

Mr. Daïri asked what was the exact role of the Board in the audit process. He considered that it would be more appropriate to wait about a week before a final decision was reached, and that in the future it would be useful to have a paper by the Legal Department on the role of the Board.

The General Counsel explained that Section 20(f) of the By-Laws referred to three different documents. The first document was the report of the EAC to the Board of Governors. That report was submitted through the Managing Director and the Executive Board. The second document was the one containing the views and suggestions by the EAC, which the Committee might decide to furnish to the Managing Director and the Executive Board. As that section was ambiguous, in the past the EAC had given the report only to the Managing Director. Nevertheless, the Board could decide that that document should go simultaneously to the Managing Director and the Executive Board. The third document was the report form the external consultants—not the EAC—which would contain suggestions to improve the external audit process. That report was not covered by Section 20(f) of the By-Laws, and therefore there was no question as to whether the Managing Director should be the sole recipient of that report.

Mr. Hansen wondered whether the Chairman had suggested that Mr. Esdar's proposal could be added to the By-Laws. However, if the Board could decide how to interpret Section 20(f), then it could interpret that the report be sent to both management and the Executive Board.

The Chairman said that he was willing to send a letter to the EAC inviting them to send the report to the Board and management at the same time. Although the letter would make a reference to the By-Laws, he would leave its interpretation to them. That should satisfy Directors. He could not, however, say that the report was a joint initiative of the Board and management. As the head of management of the Fund, he retained the right to take such an initiative.

Ms. Lissakers remarked that the audit function was one of the most sensitive and important functions of the Fund, and that was why the By-Laws gave the Board of Governors and the Executive Board the responsibility and accountability in that area. The EAC has made important suggestions for improving the audit function, and those recommendations should have automatically gone to the Board. That process needed to be revisited to ensure that it did happen.

Although it had been commendable that management had taken the initiative to proceed with the audit review, the Board had not been informed about it, Ms. Lissakers continued. That should, however, not exclude the Board from having authority over that exercise. What was troubling was that the Board had not been apprised of the recommendations of the EAC. Although that had been the result of past practice, it needed to be corrected. She was not criticizing the initiative; on the contrary, management had taken an important step in commissioning a comprehensive review of the Fund's internal and external audit functions. However, the Board had to insist that it play a direct role in that exercise. She suggested that the Board take a pause to allow time for a solution.

The Executive Directors agreed to continue their discussion on May 22, 1998.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/98/54 (5/18/98) and EBM/98/55 (5/20/98).

2. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 97/102 are approved.

3. EXECUTIVE BOARD TRAVEL

Travel by an Executive Director as set forth in EBAM/98/70, Supplement 1 (5/18/98) is approved.

APPROVAL: December 10, 1999

SHAILENDRA J. ANJARIA
Secretary