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CONFIDENTIAL

March 1, 1999

To: Members of the Executive Board

From: The Secretary

Subject: **Review of the Fund's External Audit Function**

Attached for consideration by the Executive Directors is a paper on the review of the Fund's external audit function, which is tentatively scheduled for discussion on Monday, March 15, 1999.

Mr. Keuppens (ext. 37813) or Mr. Elizalde (ext. 37796) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

Other Distribution:  
Department Heads



INTERNATIONAL MONETARY FUND

**Review of the Fund's External Audit Function**

Prepared by the Treasurer's and Legal Departments  
and the Office of Internal Audit and Inspection

(In consultation with the Secretary's Department)

Approved by David Williams, François Gianviti, and Eduard Brau

March 1, 1999

**I. INTRODUCTION AND SUMMARY**

1. This paper discusses the recommendations of the recent independent review of the Fund's external audit function. The review was initiated on the recommendation of the 1997 External Audit Committee and was conducted by an outside consultant, Mr. Eccles, Chairman of the International Accounting Standards Advisory Council and former Vice President and Controller of the World Bank. His report was circulated simultaneously to the Managing Director and the Executive Board on October 30, 1998.<sup>1</sup>

2. The report concluded that the current framework for the Fund's external audit remained appropriate since it had provided "Fund members with consistent, accurate and independently audited financial statements" (paragraph 9) and that no fundamental change was warranted. Specifically, the report endorsed continuation of the current system with an external audit committee comprised of three representatives of member countries and an outside audit firm.

3. The report also identified a number of areas where the current external audit arrangements should be strengthened, and made specific recommendations for changes that would bring the Fund's external audit process more in line with standard international audit practices. The staff considers that these recommendations should be implemented, with the changes to take effect in time for the external audit of the next financial year. The key recommendations are (i) to make the external audit firm fully responsible for signing the audit opinion, (ii) to broaden the role of the External Audit Committee (EAC), and (iii) to strengthen its composition to enable it to fulfill its expanded role. Implementation of these recommendations would entail a change in the Fund's By-Laws, which requires approval by the Board of Governors, after approval by the Executive Board.

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<sup>1</sup>See Secretary's memorandum to Executive Directors and the Managing Director. The full text of the report is reproduced as an attachment.

4. The paper is structured as follows: Section II briefly describes the current audit process and the scope of the external review. Section III discusses the steps necessary to implement the recommended changes. Section IV presents proposed changes to the Fund's By-Laws. A draft resolution and draft proposed decisions will be prepared for the Executive Board's consideration in light of the outcome of the current discussion.

## **II. CURRENT AUDIT PROCESS AND SCOPE OF EXTERNAL REVIEW**

### **Current system**

5. The Fund's external audit function is based on Article XII, Section 7(a) of the Articles of Agreement, which requires the Fund to publish an annual report containing an audited statement of its accounts. The Fund's external audit is entrusted to an External Audit Committee as set out in the Fund's By-Laws, Section 20, paragraphs (b) through (g). Procedural requirements on audit matters are set out in Rules J-6 through J-8 of the Fund's Rules and Regulations. The main features of the current system are:

- The EAC is composed of three members, typically independent accountants or auditors in public service. The members of the EAC are nominated by different members of the Fund and confirmed by the Executive Board.<sup>2</sup> Each committee serves for one year, with one member normally serving for two consecutive years to provide continuity.
- The EAC elects one of its members as chairman, determines its own procedures, and is completely independent of Fund management and staff. The annual audit, conducted in accordance with generally accepted auditing standards, is comprehensive in nature to ascertain that operations and transactions have been supported by the necessary authority and that there is adequate and appropriate accounting for the assets and liabilities of the Fund. On the basis of the audit, the committee reports whether the financial statements give a true and fair view of the Fund's financial position.
- The EAC is assisted in its work by an external audit firm which each year performs a complete financial audit and reports its findings to the committee. However, the audit opinion is signed by the EAC.

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<sup>2</sup>Section 20 (c) of the By-Laws states that "The annual audit shall be made by an external audit committee consisting of either three or five persons, each of whom shall be nominated by a different member of the Fund and confirmed by the Executive Board." It has been the practice of the Fund to appoint three members to the External Audit Committee.

- The EAC submits its audit reports on the Fund's financial statements to the Board of Governors through the Managing Director and the Executive Board.

6. The EAC may also communicate views and suggestions related to the accounting system, financial controls, and other procedures which may strengthen or improve the administration of the Fund's financial affairs. In accordance with the recently amended Rule J-7, the EAC is required to communicate reports and other views and suggestions at the same time to the Managing Director and the Executive Board.

### **The independent external review**

7. The 1997 External Audit Committee suggested that the Fund undertake an independent review of its external audit arrangements. This review was seen as a desirable complement to the outside review of the Fund's internal audit process which was already planned as part of the General Services Review conducted by the Fund's Office of Internal Audit and Inspection. The terms of reference for the review of the Fund's external audit function were discussed by the Executive Board in May 1998.<sup>3</sup> The review of the external audit function was conducted by Mr. Stephen Eccles, Chairman of the International Accounting Standards Advisory Council and former Vice President and Controller of the World Bank.<sup>4</sup> His report was submitted on October 30, 1998 simultaneously to Executive Directors and the Managing Director, as required by Rule J-8. The text of the report is reproduced in the attachment.

8. The report endorsed the overall framework for the Fund's external audit and concluded that fundamental changes were not called for. It found that the audit arrangements had evolved effectively over time in response to changing conditions and had provided the Fund's members with "consistent, accurate and independently audited financial statements" (paragraph 9). In particular, the report endorsed the basic structure of the Fund's audit arrangements, and argued that the Fund should retain its institution of an External Audit Committee independent of both the Managing Director and the Executive Board and directly responsible to the Board of Governors. The report also pointed to some weaknesses in the current arrangements and developed specific recommendations for strengthening current procedures.

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<sup>3</sup>EBM 98/56. See *The Fund's External Audit Process* (SM/98/110, 5/21/98). The attached report includes the original terms of reference (Annex 1 of the report).

<sup>4</sup>Mr. Eccles also supervised the review of the Fund's internal audit function.

### III. RECOMMENDATIONS AND PROPOSED IMPLEMENTATION

9. This section discusses the recommendations of the report. It is proposed that the recommendations be implemented to take effect in the next financial year. The external audit for the current financial year is being conducted under the current arrangements.<sup>5</sup>

10. The staff supports the recommendations in the report. Implementation of the recommendations regarding the role of the EAC and the external audit firm would entail modifications to the external audit process set out in Section 20 of the Fund's By-Laws. A change in the By-Laws requires approval by the Board of Governors. The other recommendations would be implemented through appropriate changes in the Fund's internal procedures.

#### **Responsibility for audit and issuance of audit opinion**

11. The report concluded that the main weakness in the Fund's external audit arrangements stems from the fact that the responsibility for issuing the audit opinion rests with the EAC, as required by the Fund's By-Laws, although the underlying work is carried out by the external audit firm. While each EAC also performs its own audit procedures, some members of former audit committees had expressed concerns that the increasing complexity of the Fund's financial operations might make it difficult for a future committee to render an audit opinion in accordance with professional standards on the basis of the current arrangements.

12. Accordingly, the report recommends that an external audit firm be given the formal responsibility for the conduct of the audit of the Fund's financial statements, and that the audit opinion on the Fund's financial statements be issued by the external audit firm rather than the EAC.<sup>6</sup> This would bring the Fund's audit procedures in line with the prevailing practice in other international financial institutions and private industry.

13. The external audit firm would be required to follow generally accepted auditing standards to which it would be held professionally responsible by the EAC, but would no longer follow detailed instructions from the EAC. As noted above, the external audit firm currently conducts all substantive audit work. Given the already comprehensive scope of the audit work performed by the external audit firm, no significant changes to the audit process

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<sup>5</sup>See *Members and Nominees of the FY 1999 External Audit Committee* (EBAP/99/7, 1/15/99).

<sup>6</sup>In addition to issuing the audit opinion on the Fund's financial statements, the EAC also issues audit opinions on the financial statements of the Staff Retirement Plan and the Supplemental Retirement Benefit Plan.

would seem necessary. The present audit firm has indicated that it would be prepared to render an opinion based on the present scope of the audit, and it is unlikely that difficulties would arise in this area were the present audit firm changed.

14. To make this recommendation effective, Sections 20(c), (d), and (f) of the Fund's By-Laws would need to be amended. Proposed amendments are presented in Section IV.

#### **Selection of external audit firm**

15. Given the expanded responsibility of the external audit firm for the audit of the Fund, the report recommends that the external audit firm be appointed by the Executive Board, on advice of the EAC rather than by management as at present.<sup>7</sup> The current external audit firm was appointed in 1993 for a five-year period and its term was extended for one year pending the outcome of this review. The staff supports this recommendation and its implementation would need to be reflected in the By-Laws, Section 20(c).

16. The report notes that the bidding procedure used by Fund management in appointing the current audit firm was in line with best practices. The report recommends maintaining the basic procedures, though with some changes, including participation of at least one member of the Executive Board in the Selection Committee and at least one member of the EAC. These procedural changes could be implemented through appropriate changes in internal procedures.

#### **Role of the External Audit Committee**

17. Since the EAC is responsible for the audit report, each EAC reviews the work of the audit firm. Moreover, in order to obtain sufficient audit evidence and assurance on which to base its audit opinion, the EAC conducts additional procedures. This role stands in contrast to prevailing practice in other organizations where the typical responsibilities of audit committees revolve around overseeing the audit process rather than executing the actual audit. To bring the role of the EAC in line with standard international practices, the report recommends that the EAC should concentrate on broader issues and concludes that "it would be most appropriate for an independent EAC in the Fund to concentrate on audit functions" (paragraph 15).

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<sup>7</sup>The Fund's By-Laws, Section 20(c) state that "The Managing Director shall arrange for auditing services by persons outside the Fund to assist the [external] audit committee in the performance of its functions."

18. Specifically, the report suggests and the staff supports the recommendation that the EAC concentrate its work on:

- reviewing the financial statements and the underlying accounting principles;
- discussing with the external audit firm the scope and content of its examination;
- recommending the appointment of the external audit firm and regularly reviewing its performance;
- reviewing and raising any matter related to internal control and risk management;
- reporting to the Executive Board upon conclusion of the annual audit; and
- transmitting the external audit reports to the Board of Governors.

19. The report recommends that these functions be set out in an initial formal set of terms of reference and be approved by the Executive Board. The EAC, once appointed, would be free to recommend changes in those terms of reference for consideration by the Executive Board. The staff would propose to put forward for the consideration of the Executive Board such initial terms of reference, taking into account the Board discussion on the present review and after seeking input from the members of the current EAC.

20. As specified in the current By-Laws, each EAC would continue to determine its own procedures, and the EAC would continue to remain independent from management in the conduct of the audit. The report (paragraphs 16-22) sets out in more detail a set of audit procedures the new EAC might be expected to adopt in conducting the annual audit cycle. This would involve at least two visits to Washington, though of shorter duration than at present.<sup>8</sup>

### **Selection procedures for EAC membership**

21. In light of the recommended changes and enhancements to the role and responsibilities of the EAC, the report suggests that the criteria for membership of the EAC should give primary emphasis to auditors that have proven accounting and auditing skills of the highest quality, as well as experience in the oversight of the audit process, while retaining the current requirements regarding wide geographic representation. The report proposes that at least one member should have experience with the oversight of an audit firm engaged in

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<sup>8</sup>In this context, the report also recommends that logistic support for the EAC be shifted from the Fund's Office of Internal Audit and Inspection to the Secretary's Department in the future, with technical support from the Treasurer's Department and OIA.



the audit of a large institution, and that at least one member should be a respected accountant completely conversant with the different accounting standards. In this context, it is also proposed (paragraph 13) that EAC members be compensated. The staff will make a separate proposal on this matter if the Executive Board agrees with the proposal on remuneration.

22. Procedurally, the report suggests that the Executive Board itself select the three members of the EAC, and that the Managing Director would identify candidates for the Board's approval. Under the current procedures, the Executive Board selects three member countries, which nominate candidates, who in turn are confirmed by the Executive Board. There may, therefore, in practice be little difference between the current and proposed procedures, once the proposed new criteria for selection or nomination are taken into account, but the revised procedure would allow for a more in-depth search and review of the qualifications of candidates for the EAC.

23. In order to ensure continuity, the report also recommends that the period of appointment to the EAC be extended from one to three years, with each new appointment staggered by one year. The appointments could be renewed. The staff supports the implementation of this recommendation, which would be reflected in the By-Laws and would need to be phased in over the coming three years.

24. The staff proposes that the existing requirement be retained that one of the EAC members must be from one of the six member countries with the largest quotas in the Fund. Since all Fund members are participants in the SDR Department, the current requirement that one EAC member must be from a member country with such participation is no longer applicable and could be deleted.

25. These recommendations would require changes to Section 20(c) of the By-Laws, as well as a change in internal procedures in line with the recommendations.

### **Role of the Executive Board**

26. The proposed changes to the Fund's audit procedures would involve the Executive Board more directly in the audit process, although it would remain independent of the audit function. In particular, the Executive Board would:

- approve the appointment of the external audit firm;
- receive an audit report of the external audit firm (paragraph 17);
- be briefed by the Chairman of the EAC on the results of the annual audit; and
- receive the minutes of formal meetings of the EAC with the external audit firm.

In addition, the Executive Board would remain the conduit, with the Managing Director, for the transmission of the financial statements and audit opinion to the Board of Governors.

**Management letters by the external audit firm**

27. The report argues that the external audit firm should be allowed to report to management minor findings that, in the view of the external audit firm, would only be of interest to staff and management, but not the Executive Board. For example, recommendations to update certain internal administrative documents, such as the Fund's General Administrative Orders, or to delete certain unused accounts from the Fund's Chart of Accounts, or to review the retention period of accounting records, would all fall into that category. It is a standard practice for audit firms to provide management with such a "management letter". Following the recent amendment to Rule J-7, all communications to the Managing Director by the external audit committee must be communicated at the same time to the Managing Director and the Executive Board. The report (paragraph 29) views this as an unnecessarily restrictive limitation and recommends that such letters not constitute communications referred to in Rule J-7. The proposed change to Rule J-7 would not limit relevant information provided to the Executive Board since (i) audit standards require that the more significant audit and control weaknesses, if any, be communicated to Directors, and (ii) the provisions spelled out in the previous paragraph would ensure that the Executive Board is kept informed of important audit developments.

28. The staff would support the recommendation that the audit firm provide management with a "management letter", as this is the practice in all other international financial institutions. If Executive Directors agree, a draft decision to this effect would be brought to the Executive Board together with the draft resolution.

**IV. PROPOSED AMENDMENTS TO THE FUND'S BY-LAWS AND RULES AND REGULATIONS**

29. Section 24 of the By-Laws provides that "By-Laws may be amended by the Board of Governors at any meeting thereof or by vote without a meeting as provided in Section 13."

30. For the changes to take effect by financial year 2000, it is proposed that the Executive Board recommend to the Board of Governors a resolution to adopt the proposed amendments to Sections 20(c), (d), and (f) of the By-Laws at the 1999 Annual Meetings. A draft resolution will be proposed for Executive Board consideration in light of the outcome of the current discussion.

31. Under Section 16 of the By-Laws, the Executive Board is authorized to amend the Rules and Regulations as necessary, subject to review by the Board of Governors at their next regular meeting. It is proposed that the Executive Board approve the proposed amendments

to Rule J-7, to take effect upon approval of the amendments to the By-Laws by the Board of Governors. A draft Executive Board decision is included.

32. The following provisions of Section 20 of the By-Laws of the International Monetary Fund shall be amended to read as indicated below. The Board of Governors Resolution approving the amendments to Section 20 will contain transitional provisions providing for the appointment of members of the external audit committee on a rolling basis by establishing that of the first three new appointees one shall serve for one year, one for two years and one for three years, so that a new member of the committee will need to be appointed (or reappointed) every year:

“(b) An external audit of the financial statements of the Fund and of Accounts administered under Article V, Section 2(b), including the financial statements of the Staff Retirement Fund Plan, shall be made annually and such audit shall relate to the period representing the financial year.

~~(c) The annual audit shall be made by an external audit committee consisting of either three or five persons each of whom shall be nominated by a different member of the Fund and confirmed by the Executive Board. An external audit committee shall have general oversight of the annual audit. The external audit committee shall consist of three persons nominated by the Managing Director in consultation with Executive Directors and appointed by the Managing Director with the approval of the Executive Board. The persons serving on the external audit committee must be nationals of different members of the Fund at the time of their appointment; at least one of them shall be a national of one of the six members having the largest quotas. The members of the external audit committee must possess the qualifications~~

required to carry out the oversight of the annual audit. They shall be appointed for a period of three years and may be reappointed for further periods of three years. In the performance of their functions, they shall be considered as officers of the Fund for purposes of the Articles of Agreement of the Fund. At least one person serving on each audit committee shall be nominated by one of the six members of the Fund having the largest quotas, and at least one person shall be nominated by a member who is also a participant in the Special Drawing Rights Department. The Executive Board shall determine, in the case of each audit, whether the audit committee shall consist of three or five persons and which members of the Fund shall be requested to nominate persons to serve in the committee. The service of the members of each audit committee shall terminate upon completion of the annual audit and submission of the audit report.

Each audit committee shall elect one of its members as chairman, shall determine its own procedure, and shall otherwise be independent of the Management of the Fund in conducting overseeing the annual audit. The Executive Board shall approve the terms of reference of the audit committee. The audit committee may recommend changes to the terms of reference for the approval of the Executive Board.

~~The Managing Director shall arrange for auditing services by persons outside the Fund to assist the audit committee in the performance of its functions. The Managing Director, in consultation with the external audit committee and with the approval of the Executive Board, shall appoint an external audit firm to conduct the annual audit and issue an audit report.~~ The members of the audit committee and ~~any outside assistants~~ ~~the external audit firm, including its partners and personnel,~~ shall respect the confidential nature of their service and the information made available for the purposes of the audit.

(d) The annual audit shall be conducted in accordance with generally accepted auditing standards, and shall include such tests of the accounting records and such auditing procedures as are considered necessary. The audit shall be comprehensive with respect to examination of the financial records of the General Department, the Special Drawing Rights Department, and Accounts administered under Article V, Section 2(b), including the Staff Retirement ~~Fund Plan~~; shall extend, in so far as practicable, to the ascertainment that the operations and transactions conducted during the period under review are supported by the necessary authority; and shall determine that there is adequate and faithful accounting for the assets and liabilities of the General Department and Accounts administered under Article V, Section 2(b), including the Staff Retirement ~~Fund Plan~~, and for special

drawing rights. On the basis of this audit, the audit ~~committee firm~~ shall state whether the financial statements as presented give a true and fair view of the financial position at the close of the financial year of the General Department, and of Accounts administered under Article V, Section 2(b), including the Staff Retirement ~~Fund Plan~~, and, with respect to the Special Drawing Rights Department, of the allocation and holdings of special drawing rights, and of the result of operations and transactions during that year. For these purposes, the audit committee ~~and the audit firm~~ shall have access to the accounting records of the Fund and other supporting evidence of its operations and transactions, and of its administration of Accounts under Article V, Section 2(b), including the Staff Retirement ~~Fund Plan~~. The Managing Director of the Fund shall furnish the audit committee ~~and the audit firm~~ with such information and representations as may be required in connection with the audit.

(e) The Executive Board shall decide all questions of policy raised by requests of the audit committee ~~or the audit firm~~ for particular information or the inspection of particular records or documents. The refusal of any such requests for reasons of policy shall be explained in the comments of the Executive Board forwarded to the Board of Governors with the audit report.

Any question the audit committee ~~or the audit firm~~ may have concerning interpretation of the Articles of Agreement, the By-Laws, the Rules and Regulations, or the decisions of the Fund shall be discussed with the Managing Director, or officials designated by him, and if the reply is not completely satisfactory to the audit committee ~~or the audit firm~~, the matter shall be referred to the Executive Board through the Managing Director.

(f) The audit committee shall ~~submit~~ ~~transmit~~ the report ~~issued by the external audit firm~~ to the Board of Governors for consideration by it. Such ~~submission~~ ~~transmittal~~ shall be made through the Managing Director and the Executive Board which shall forward with the audit report its comments thereon. The audit ~~committee~~ ~~firm~~ shall afford the Managing Director an opportunity for explanation to it before deciding that any matter seems to require criticism in the report. The audit report shall be ~~submitted~~ ~~transmitted~~ to the Board of Governors within a reasonable time after its completion.

The audit ~~committee~~ ~~firm~~ may formally furnish to ~~the external audit committee~~, the Managing Director and the Executive Board the ~~firm's~~ ~~committee's~~ views and suggestions concerning the system of accounting, internal financial control, and documentary and other procedure which may technically strengthen or improve the administration of the Fund's financial

affairs. Such matters need not be dealt with in the audit report unless the audit committee ~~firm~~ believes they are of such moment as to warrant inclusion.”

It is proposed that Rule J-7 of the Fund’s Rules and Regulations be amended to read as follows. This proposal can be adopted by a majority of the votes cast:

“J-7. When ~~the external audit firm~~ communicates views and suggestions pursuant to Section 20(f) of the By-Laws, those views and suggestions shall be communicated at the same time to ~~the external audit committee~~, the Managing Director and the Executive Board, ~~with the exception of minor findings that, in the view of the external audit firm, are only of interest to the external audit committee and the Management of the Fund.”~~

Attachment





# *Office Memorandum*

To: Executive Directors  
The Managing Director

A handwritten signature, likely of Reinhard Munzberg, is written in the center of the page. It consists of stylized, cursive letters.

October 30, 1998

From: Reinhard Munzberg

Subject: **Report on the External Audit Function in the Fund**

The attached report on the external audit function in the Fund by the consultant, Mr. Stephen Eccles, is being transmitted simultaneously to the Executive Directors and the Managing Director.

The terms of reference under which the report was prepared are reproduced in Annex I of the report. The background material referred to in paragraph 5 of the report will be made available shortly.



# INTERNATIONAL MONETARY FUND

## REPORT ON THE EXTERNAL AUDIT FUNCTION AT THE INTERNATIONAL MONETARY FUND

By Stephen Eccles<sup>1</sup>  
OMD Consultant

October 27, 1998

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<sup>1</sup>Former Vice President and Controller at the World Bank; currently Chairman of the International Accounting Standards Advisory Council.

## EXECUTIVE SUMMARY

The Fund's external audit arrangements — as they have evolved over time — expressly provide for substantive independence from Executive Directors. The external audit is formally conducted by a three member External Audit Committee (EAC), nominated by three Fund members selected by the Executive Board, but with the substantive work carried out by an external audit firm appointed by the Managing Director. The Fund's financial statements are submitted by the EAC to the Board of Governors, through the Managing Director and the Executive Board, along with an audit opinion issued by the EAC.

The **current system provides Fund members with consistent, accurate and independently audited financial statements**. Nevertheless, there are some weaknesses, including the appearance of lacking some credibility because the audit opinion is not issued under the name of the external audit firm that actually carries out the substantive audit. These weaknesses can readily be overcome by further evolution, and fundamental changes are not necessary.

The **principal recommendations** of the report are:

- An **external audit firm** should be **appointed by the Executive Board**, on the advice of EAC, to **take full responsibility for the audit, to issue the audit opinion** and provide a full range of reports to the Board of Governors, the EAC and Executive Board, and Fund management.
- The **External Audit Committee should be strengthened** by **ensuring continuity** of its membership, by **improving the quality** of its membership and by **changing its terms of reference** so that it can act more like a typical board audit committee in other large institutions.
- The **Executive Board** should also participate directly in the selection process leading to the appointment of the external audit firm, be briefed orally by the EAC Chairman on completion of the audit, receive minutes of EAC meetings with the external audit firm, remain as the conduit (with the Managing Director) for the transmission of the financial statements and audit opinion to the Board of Governors, and permit the external audit firm to submit a standard 'management letter' to Fund management, without requiring its transmission also to the Executive Board.

These recommendations involve the Executive Board more than at present, as befits the organ responsible for management oversight, while leaving intact Fund member governments' intentions that the external audit itself be independent.

## I. INTRODUCTION

1. The Terms of Reference for this review of the external audit function at the International Monetary Fund (the Fund), issued by the Office of the Managing Director and made available to the Executive Board as an attachment to document EBD/98/44 dated May 18, 1998, are reproduced as Annex 1. One origin of the decision to undertake such a review was a recommendation to that effect by the 1997 External Audit Committee (EAC). The focus of the Terms of Reference, and therefore of this report, is on the arrangements for the external audit function. It is not part of the Terms of Reference to review the quality of the work of the external or internal auditors *per se*, nor the internal controls in place in the Fund. Nevertheless, as is usual in 'audit' reports, comments on these matters have been included whenever the review incidentally found something useful to say.
2. In arriving at the recommendations, I have relied principally on my own judgment and experience. I have discussed the issues with six Executive Directors or their Alternates — specifically, the dean of the Board and the five Directors or Alternates representing countries which nominated members of the last two EACs; four out of the five members of the last two EACs and the chairman of an earlier EAC; senior Fund staff in the Office of Internal Audit and Inspection, the Treasurer's, Secretary's and Legal Departments, and the Investment Office; and senior staff in the Fund's external audit firm, Coopers & Lybrand (now PricewaterhouseCoopers). I have looked at the external audit arrangements in other international financial institutions, namely the World Bank Group, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the European Bank for Reconstruction and Development, the European Investment Bank and the Nordic Investment Bank. And I have reviewed the documentation made available to the 1997 and 1998 EACs, as well as the Fund's own accounts, and the relevant Articles of Agreement, By-Laws, Rules and Regulations.
3. I received full cooperation from all the parties mentioned above. Fund management and staff were given an opportunity to comment on a draft of this report. Any alterations made as a result of such comments were ones in which I fully concurred.
4. The arrangement of the rest of this report is as follows:
  - Part II summarizes the history of the Fund's external audit arrangements;
  - Part III reviews the workings of the External Audit Committee and recommends some basic changes;
  - Part IV concentrates on issues affecting the external audit firm;
  - Part V brings together the various recommendations affecting the role of the Executive Board in the external audit function; and
  - Part VI deals with some transition questions.

## II. HISTORY OF THE FUND'S EXTERNAL AUDIT ARRANGEMENTS

5. The only reference to the Fund's audited accounts in the Articles of Agreement is in Article XII, Section 7(a), which states that '(t)he Fund shall publish an annual report containing an audited statement of its accounts . . . .'. The principal legislation on external audit functions in the Fund is found in the By-Laws, Section 20, paragraphs (b) through (g), reproduced as Annex 2. I am indebted to the Fund's General Counsel for providing a review of the legislative history of these By-Laws, which is summarized below, with the full history available from the Secretary's office. There are further references to audit matters in Rules J-6, J-7 and J-8, which are reproduced as Annex 3.

6. The original text of Section 20 adopted at the Inaugural Meeting of the Board of Governors in March 1946 required only that the Executive Directors should have an audit prepared each year and should submit financial statements to the Board of Governors for their consideration. There does not appear to be any record of why the financial statements needed to be considered by the Board of Governors in the case of the Fund, while this was not required in the case of the World Bank. However, when subsequently discussing the related issue of 'who' should prepare the audit, one Governor made the following statements at the first Annual Meeting in October 1946: "The Board of Governors comes together representing the countries once a year. The Executive Directors have the task of taking the day-to-day decisions. The Managing Director and his staff have the task of carrying that out . . . . The body holding the supreme power, the Board of Governors, has to satisfy itself that the financial transactions are in accordance with the Fund Agreement and with the By-Laws and with the Rules and Regulations . . . . The (auditor) should be a person appointed by the Board of Governors, who is responsible to the Board of Governors, and maintains his independence purely because he is the servant of the Board of Governors. He is not the servant of the Executive Directors. He is not the servant of the (Managing Director)". Throughout all the subsequent legislative history there does not appear to have been any questioning about the role of the Board of Governors in approving the financial statements, rather than the Executive Board. Although this role appears to be pro forma — the 'approval' takes place in the Board of Governors' Joint Procedures Committee, usually and perhaps invariably without any discussion — I presume that Fund members continue to see value in this separation of responsibilities.

7. The discussions at the first Annual Meeting also concerned 'how' the audit should be carried out. It was decided that, as an interim measure, the audit should be carried out 'by an Auditing Committee which shall consist of a small group of persons, three or four in number, chosen from the Auditing Departments of Treasuries of the same number of members'. At the second Annual Meeting, the main elements that exist today were enacted, elaborating on the interim arrangement but not changing its fundamental character. Since then only technical amendments have been made, except that in 1978 it was acknowledged that the accounts had become sufficiently complex and extensive that the Managing Director was authorized to engage an external audit firm 'to assist the audit committee in the performance of its functions'.

8. The current arrangements for the Fund's external audit can be summarized as follows. An External Audit Committee (EAC) is formed by the Executive Board asking three Fund members to each nominate one EAC member, one of whom had been asked to nominate a member in the preceding year. The member from that latter country visits the Fund early in the calendar year for a review with the external audit firm — appointed by the Managing Director — about the firm's plan for the coming audit and makes recommendations for possible changes. After that firm has substantially completed its audit, the full EAC assembles for a three-week period. With two new members — sometimes three, when the continuity arrangements break down — most of the first week is typically taken up with extensive briefing about the Fund. The second week is typically taken up with reviewing the work of the external audit firm in detail and interviewing appropriate senior staff in the Fund, with the purpose of allowing the members of the EAC to certify that they are satisfied with the financial statements and to issue the audit opinion. The third week is typically devoted to the drafting of that audit opinion (usually in standard language) and of the memorandum of observations resulting from the audit, addressed to the Managing Director and, since this year, to the Executive Board.

9. These arrangements have evolved effectively over time, responding to changing conditions. They provide the Fund's members with consistent, accurate and independently audited financial statements, at a reasonable cost. Nevertheless, this review has found some weaknesses, largely corroborated by the views of two recent EAC chairmen, and the present arrangements can give the appearance of lacking some credibility, because the audit opinion is not issued under the name of the external audit firm that actually carries out the substantive audit. However, the perceived weaknesses can readily be overcome by further evolution of the present arrangements, and fundamental changes are not necessary. The rest of this report necessarily concentrates on these perceived weaknesses, and means of remedying them.

### **III. THE EXTERNAL AUDIT COMMITTEE**

10. The Fund's external auditing services revolve around the External Audit Committee (EAC) — as per Section 20(c) of the By-Laws. Although mandated to have either three or five members, in practice it has comprised three members — which number is sufficient to provide an adequate spread of experience and country representation. It is also mandated that one of these members be from one of the six members of the Fund having the largest quotas and that one be from a participant in the SDR Department; the former requirement could remain, while the second may now be redundant. The mandate that 'each audit committee . . . shall determine its own procedure and shall otherwise be independent of the Management of the Fund in conducting the annual audit' should also be retained.

11. Members of the EAC are nominated by a set of countries selected by the Executive Board. This provision has led to uneven qualifications, as simultaneous emphasis has been given to a balanced representation by geographic area, to countries not yet represented, and to competence. An institution as important as the Fund should have its audit committee comprise three persons of stature. This could be arranged by having the Executive Board itself select the three members of the EAC. The Managing Director would be responsible for

bringing potential candidates to the Board, which candidates should meet an agreed set of criteria, for example:

- the current requirements concerning nationality, and otherwise ensuring an appropriately wide geographic spread for any one audit committee and over time could be retained, but primary emphasis should be given to quality;
- at least one of the members (and preferably two) should have experience in the oversight of an external audit firm carrying out an audit of a large institution. Lack of this experience is a major shortcoming under present arrangements. Members with this experience may well not be qualified accountants but would have served on the audit committees of other large institutions, or would have been in senior financial management positions in such institutions;
- at least one member should be a respected accountant fully conversant with the accounting standards applied by the Fund and with other accounting standards. Such member(s) should not be directly associated with any of the Big 5 international accounting firms (since the Fund would normally select its external audit firm from this universe), and might well be an academic.

In putting together a similar team for the World Bank's Board of Executive Directors some years ago, it did not prove difficult to find three such persons: an ex-CEO of a major US bank (not an accountant and originally suggested by the US Executive Director); the head of one of the most prestigious independent accounting companies in France (as suggested by the French Treasury, at the request of staff); and the recently retired Controller of the Asian Development Bank (an Asian accountant recommended by the staff).

12. The current requirement that 'the service of the members of each audit committee shall terminate upon completion of the annual audit', coupled with the custom of inviting only one country nominating a current member to nominate someone to the next audit committee, means that a major part of each EAC's time is spent in 'learning' about the Fund and its accounts. For this and other reasons — see paragraph 8 — each EAC needs to spend three weeks in Washington. Moreover, this requirement provides for little continuity, exacerbated by the fact that, in recent years, two countries relied on to provide such continuity actually nominated a different person to the follow-on EAC. Continuity in the EAC is most important to the proper oversight of the financial statements and of the external audit firm.<sup>2</sup> Each EAC member should preferably be appointed for three years, with staggered terms, so that there is normally only one new member each year. The terms of EAC members should be renewable in order to obtain as much continuity as practical, should that be acceptable to the Fund and

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<sup>2</sup>A chairman of one EAC stated that the EAC in its present composition could not work effectively and that even a four-week stay at the Fund could not overcome the fact that the EAC lacked the experience and especially the insight into the Fund to really contribute something from an external view.



to the EAC members concerned. The Chairman should be determined for each audit by the current EAC members.

13. It should be possible to find potential members of the EAC who would be prepared to stay for at least three years, because of the prestige of the Fund, provided that certain changes are made in addition to those already noted.<sup>3</sup> First, the positions should be compensated, reflecting the stature required and thus set proportionately to the remuneration of Executive Directors. Second, the terms of reference for the EAC need to be changed, as indicated directly below. Not only would such change make the position of more professional interest, it would also require attendance in Washington for much shorter periods than the current three weeks.

14. Members of the EAC currently issue the audit opinion on the financial statements that appears in the Annual Report, although the underlying work is carried out not by them but by the external audit firm. It is not therefore surprising that some members of some EACs have been quite uncomfortable with the present arrangements, however much reviewing they might be able to do.<sup>4</sup> Other members who consider that they have been able to do sufficient reviewing to enable them to issue the audit opinion have told me that, nevertheless, they see very little added value in that review.<sup>5</sup> My recommendation is that the Fund change its By-Laws to allow for the engagement of an external audit firm to carry out the audit 'according to generally accepted auditing standards' and to issue the audit opinion.<sup>7</sup>

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<sup>3</sup>A chairman of one EAC stated that when he first accepted the appointment he was not aware of the complexity of the task, of its limits and of the role of the EAC, not to talk of the (open) question of responsibility and possible liability in case of neglect or default in carrying out his duties.

<sup>4</sup>And the arrangements do not appear to be in conformity with 'generally accepted auditing standards', as stated in the typical EAC Report to the Governors, although the underlying work of the external audit firm does so conform. This problem will be corrected automatically if the arrangements now recommended for the external audit firm and the EAC are implemented.

<sup>5</sup>Similarly, the EAC Report should not describe the financial statements as having been prepared in accordance with 'generally accepted accounting principles' as this phrase, to be meaningful, needs to indicate which country's (or international) 'generally accepted accounting principles' are being used. This is a presentational issue for the EAC Report only, as the accounting methodology actually used by the Fund is described in the financial statements themselves.

<sup>6</sup>However, some EAC members of high caliber have contributed value to the Fund on non-audit matters.

<sup>7</sup>Further considerations about the external audit firm are contained in Part IV of this report.

15. Once relieved of the need to review directly the detailed work of the external audit firm, the EAC could concentrate on broader issues, as do typical audit committees in other large institutions, both commercial and multilateral. While some of these committees take on additional roles, such as financial policy and operations evaluation, it would be most appropriate for an independent EAC in the Fund to concentrate on audit functions. Typically, those audit functions include: (a) reviewing the financial statements and the accounting principles behind them; (b) discussing with the external audit firm the scope and content of its examination; (c) recommending the appointment of the external audit firm and regularly reviewing its performance; (d) raising and reviewing any matter related to internal control and risk management; and (e) reporting to the Board. An initial formal set of Terms of Reference for the new EAC should be drafted by management and approved by the Executive Board. Once appointed, the new EAC should be free to recommend changes in those Terms of Reference for consideration by the Executive Board.

16. This enhanced EAC must decide for itself what is necessary for it to carry out its function. By way of illustration, a preliminary view is as follows. Any 'new' EAC member would be appointed by the Executive Board in good time, so that member can join the two 'carry-over' members for a meeting with management and the external audit firm in about January to review the firm's audit plans.<sup>8</sup> Such a review would be based on a written submission by the auditing firm. During this visit — which would normally last 2–3 days — the EAC would also receive an update from TRE and OIA on recent developments in the Fund, whether or not deserving of special audit emphasis. This starting point of the annual audit cycle is often considered to be the most important from an audit committee perspective. There would normally be no formal report as a result of this visit, but minutes of the meeting with the external audit firm would be prepared and sent for information to the Executive Board.

17. The EAC would reassemble for a further 2–3 days when the audit was substantially completed and the external audit firm had submitted its full audit report to the EAC, with information copy to the Executive Board.<sup>9</sup> The EAC would review this audit report with the external audit firm, TRE, OIA and any other department that appears appropriate to it. The review would have two main elements: a discussion of any substantive points raised by the external audit firm or any EAC member for discussion, and a review of the audit process. There would usually be some discussion on the state of the internal control regime within the Fund (see paragraph 20). Again, the EAC would not normally submit a report, but minutes of its formal meetings would be prepared and sent for information to the Executive Board. At the end of this visit to Washington, the EAC Chairman would give the Executive Board an oral briefing on the EAC's work, accompanied when appropriate by the partner of the external audit firm, and staff from TRE and OIA.

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<sup>8</sup>This new member would arrive a few days earlier than the rest for general briefing on the Fund.

<sup>9</sup>As is customary good practice, the audit firm's full audit report would have been discussed with Fund staff in draft form, to confirm the accuracy of any findings.

18. Although not technically required, I would recommend, given the legislative history of the Fund's external audit function, that the EAC submit the audited financial statements, together with the external audit firm's audit opinion, to the Board of Governors under a signed statement normally along the following lines:

'Following our review of the financial statements with Fund management and the external audit firm, we recommend their acceptance by the Board of Governors'.

19. During its second visit to Washington, the EAC would meet in executive session with the external audit firm, without the presence of any Fund staff. Such a meeting would be a useful safeguard, allowing a full and frank discussion of the relationship between Fund staff and the external audit firm, and of the quality of Fund financial management.

20. At one of its sessions, the EAC would review with the OIA Director that Office's medium-term plans and plans for the coming year, especially those elements which might directly impact the finances of the Fund and the conduct of the external audit. While the EAC should not have any general powers to direct the OIA Director, the EAC ought to be able to have included in the internal audit work plan additional items of a financial nature, if the EAC felt that to be desirable. During the year, the EAC would receive for its information copies of all audit reports bearing substantially on the Fund's finances. These would be reviewed, if necessary, with the Director during EAC visits to Washington. Once a year, the EAC would invite the OIA Director to an executive session, to discuss the internal control environment<sup>10</sup> within the Fund, the adequacy of OIA resources and any restrictions on the scope of its work or access to Fund personnel, facilities or records.

21. The EAC should discuss with Fund management the pros and cons of having the EAC also review the Fund's quarterly and semiannual unaudited accounts, involving additional visits to Washington. The audit committee in several other international financial institutions carry out such reviews, but it is not essential. The EAC should also be available to the external audit firm throughout the year, not necessarily by additional visits to Washington, for consultation on any emerging audit matters.

22. Currently the EAC receives logistic support from OIA, which may give the appearance of a mild conflict of interest. As the EAC is appointed by the Executive Board as an instrumentality of the Board of Governors, there would be a case for having logistic support for the EAC provided by the Secretary's Department in the future, with technical support from TRE and OIA.

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<sup>10</sup>Internal control has been broadly defined by COSO (the Committee on Sponsoring Organizations of the Treadway Commission) as 'a process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations'.

23. At all other international financial institutions (except the European Investment Bank—EIB<sup>11</sup>; and the Nordic Investment Bank—NIB<sup>12</sup>), the role described above for the EAC is played by an audit committee of the board of executive directors. That arrangement would not be the most appropriate in the Fund's case, since Fund members have opted to keep the external audit functionally independent from the Executive Board, as described in Part II. Moreover, the lack of continuity typical in the audit committee of an international financial institution, and the shortage of board members with the experience suggested in paragraph 11, argue in favor of the Fund retaining its institution of an External Audit Committee.

#### IV. THE EXTERNAL AUDIT FIRM

24. As recommended in paragraph 14, an external audit firm should be given total responsibility for the independent audit of the Fund's financial statements, and for issuing the audit opinion. This change of role would raise a number of subsidiary issues.

25. Such an external audit firm should be appointed by a body representing the Board of Governors and not by management as at present. This is fundamental to the objectivity of the audit in fact and in appearance. Some of the regional multilateral development banks have the external auditor appointed by the Board of Governors itself, reflecting the practice of some commercial entities that have that selection ratified by the annual meeting of shareholders.<sup>13</sup> However, most international financial institutions have the appointment made by the equivalent of the Fund's Executive Board, reflecting another widely accepted commercial practice. As a matter of practicality, the appointment should be made by a representative body below the Board of Governors, the most obvious being the Executive Board. Another possibility is the External Audit Committee (EAC). On balance, I would recommend appointment by the Executive Board, on the advice of EAC, since the Executive Board is more representative of the members as a whole.

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<sup>11</sup>At the EIB, the Audit Committee consists of three members (with staggered terms of three years) and one observer (with one-year term), appointed directly by the Board of Governors.

<sup>12</sup>At the NIB, the Control Committee has ten members, each with a term of up to two years (renewable) — five are appointed by the five member states, with the other five appointed jointly by the Nordic Council of Ministers.

<sup>13</sup>At the African Development Bank, the external audit firm is appointed by the Board of Governors on the recommendation of the Board of Directors. At the Nordic Investment Bank, the Control Committee appoints two external audit firms, one locally based and the other rotated among the four other Nordic countries.

26. The present term of appointment of the Fund's external audit firm is for a fixed five-year term, an arrangement which is acceptable and with plenty of precedents.<sup>14</sup> However, the arrangement recently adopted by the World Bank is of interest. After 50 years with the same external audit firm, the Bank recently effected a change. The new Bank external audit firm, like their predecessors, and in line with US banking practice, are formally retained on a one-year renewable contract, which is useful for ensuring that the auditors keep up their standards, allocate suitable partners and other staff to conduct the audit and stay on top of relevant audit issues. However, in order to allow the new auditors to amortize their substantial initial investment in taking on the function, the auditors have been informed that, unless they fail to perform adequately, the Bank expects to renew its contract for at least five years. But the audit firm has also been informed that the Bank has no intention of allowing them to continue for as long as their predecessors and that, at some suitable point, the Bank will want a change — at which point the existing auditors will not be allowed to compete for the position. This arrangement avoids the difficulty posed by fixed terms — performance may drop off as the term expires (especially if there is a mandatory change in auditors, as is the custom in some countries) — and the inherent unfairness and awkwardness of allowing the current auditor to compete in any bidding for a new contract.<sup>15</sup> This model produces in my view the best balance between the needs for continuity, for sustained quality and against the emergence of complacency.<sup>16</sup> The Fund Executive Board, with the advice of management and the EAC, would determine when a change in the external audit firm should take place. Other things being equal, I would expect this to be after 15–20 years.

27. The bidding procedure used by Fund management in appointing Coopers & Lybrand in 1993 was in line with best practice. It involved a staff committee setting selection criteria and their relative weighting, analyzing bids received according to those weighted criteria and recommending appointment to Fund management. This basic procedure should be retained if it is decided to move ahead with the other changes recommended in this Report, but with some changes. First, it would be advantageous if at least one member of the Executive Board would participate in the Selection Committee; and similarly for at least one member of the new EAC, if appointed in time and if available. Second, the cost to the Fund of a change in

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<sup>14</sup>Five-year terms are in place at the Inter-American Development Bank, the African Development Bank, the European Investment Bank (with possible extension of up to a further three years), and the Nordic Investment Bank. Four-year terms are employed at the Asian Development Bank (but this is to be reviewed), and at the European Bank for Reconstruction and Development.

<sup>15</sup>For example, the Fund's existing external audit firm won renewal of its contract after bidding in 1993. The bidding process took into account the cost to the Fund itself (mainly in staff time) of making a change in the auditing firm. Two of the Big 6 auditing firms (now the Big 5) chose not to participate in the bidding process.

<sup>16</sup>Long-term continuity of the external audit firm is the practice in many countries. In such countries, it is also usual practice to rotate the audit partners every five to seven years; and this has been happening with the Fund's present audit firm.

the external audit firm (in terms of staff time) should not be taken into account.<sup>17</sup> Third, the recommendation to award the contract should be made to the Executive Board, with the advice of the new EAC (if in place).

28. The external audit firm would be required to follow generally accepted auditing standards to which they would be held professionally responsible by the EAC, but they would no longer need to follow detailed instructions from the EAC; nor would they be required to produce the voluminous printed records for the current EAC to review and check, or for the Fund's files.<sup>18</sup> The costs saved here would rather be spent on adding value by enhancing auditing and reporting. The following reports should typically be produced by the external audit firm:

- the plan of audit, referred to in paragraph 16;
- the audit opinion that is printed in the Fund's Annual Report;
- the full report on audit findings and issues, referred to in paragraph 17, distributed to the Board, EAC and management;
- a comprehensive 'management letter' made available only to management and which is discussed immediately below.

29. It is standard practice, but not in the present contract, for an external audit firm to provide management (but not the Audit Committee or the Board) with a letter detailing all the points that the auditor has found during the audit that warrant management attention. These points would range from the very important (e.g., an inadequate method of assessing risk in the asset portfolio) to the minor (e.g., a reconciliation of accounts that was no longer necessary), with everything in between. The external audit firm typically brings any of these points that it thinks could have a material impact on the finances of the institution to the attention of its audit committee, leaving the rest to the attention solely of management at an appropriate level. The external audit firm will typically request a time-bound management response to all these points and will follow-up with management that these responses are being acted upon. If the external audit firm is not satisfied with any management response, or finds that a response is acceptable but the follow-up action does not take place adequately, then the external audit firm would typically take the matter to higher levels of management or to the audit committee. Such a management letter can be a most useful instrument and

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<sup>17</sup>It is assumed that the present external audit firm (now PricewaterhouseCoopers, as a result of the merger of Coopers & Lybrand and Price Waterhouse) will be allowed to compete on this first award of the new style audit. They will have a built-in advantage, but it would be grossly unfair to exclude them, only 5-6 years after they won the 1993 competition; and this would not be the opportune time for the Fund to mandate a change in auditing firm.

<sup>18</sup>Some printed records from the external audit firm may be necessary as agreed upon between the external and internal auditors in coordinating their work.

extracts from the external audit firm better value for the funds spent on the audit than just the audit opinion and the report to the audit committee. In the case of the Fund at present, the typical EAC has picked up only some of the issues brought to its attention by the external audit firm and has sometimes added items of its own, in its report to the Managing Director. The rest of the external audit firms' points are handled less formally, without written management response and follow-up. If the Fund accepts the value of such a detailed management letter in the future, then it would be advisable for the Executive Board to rule that it would not constitute the 'external audit committee . . . views and suggestions' referred to in Rule J-7 and thus did not need to be communicated to the Board. Otherwise, the natural tendency would be to only commit to writing the most important issues, with loss of value to the Fund and its members. Such a letter is prepared for the managements of all other international financial institutions.<sup>19</sup>

30. The principal contact between the external audit firm and Fund management is currently the OIA. I recommend that the contact point be shifted to TRE, as being a more efficient arrangement. There is always the appearance of a conflict of interest wherever that contact point is placed unless it is placed with a non-financial unit, such as the Administration or Secretary's Department. Such an arrangement, however, loses the direct contact with the finance units that can be helpful in practice. In other international financial institutions, the equivalent of TRE is chosen. The potential for conflict of interest can be reduced by having the external audit firm appointed independently by the Board (as now recommended), by having the external audit firm reporting substantively to the EAC (as now), by the EAC holding an executive session solely with the external audit firm (as now recommended) and by the external audit firm having regular discussions with the Office of the Managing Director (which does not now happen but should become mandatory).

## V. THE ROLE OF THE EXECUTIVE BOARD IN THE EXTERNAL AUDIT FUNCTION

31. This part of the report contains no new recommendations, but pulls together the earlier recommendations concerning the External Audit Committee (EAC) and the external audit firm as they relate to the Executive Board. Taken together, they add up to a more substantial Board involvement than presently, as befits the organ responsible for management oversight, but leaves intact the Fund member governments' intentions that the external audit itself be independent of the Executive Board (and management).

32. The present involvement of the Executive Board in the external audit function is minimal. The Board selects only the three countries that are invited to nominate members of each annual EAC, which it usually does on the recommendation of Fund management without discussion. The Board is not involved with the appointment of the external audit firm. The Board is the conduit (along with the Managing Director) for forwarding the financial statements and audit opinion to the Board of Governors, but has not apparently ever

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<sup>19</sup>In the case of the African Development Bank, the management letter also goes to the Audit Committee and the Board of Directors.

discussed these substantively. Until this year, the Board has not received the 'views and suggestions' made by each EAC to the Managing Director.

33. If the recommendations of this report are accepted, the Executive Board would have the following involvement in the external audit function. It would:

- appoint the members of the EAC (paragraph 11);
- approve the appointment of the external audit firm, and participate in the selection process (paragraphs 25 and 27);
- be briefed on the results of the audit by the Chairman of the EAC, accompanied when appropriate by the partner of the external audit firm and TRE and OIA staff, on the basis of a report prepared by the external audit firm for the EAC and copied to the Board (paragraph 17);
- receive minutes of the formal meetings of the EAC with the external audit firm (paragraphs 16 and 17);
- remain as the conduit (with the Managing Director) for the transmission of the financial statements and audit opinion to the Board of Governors.

## **VI. SOME TRANSITION QUESTIONS**

34. If the recommendations of this report are accepted, they could not be put into immediate effect as they would need amendment of the By-Laws. It is unlikely that this could be accommodated in time for the 1999 audit, as the External Audit Committee (EAC) needs to discuss the audit plan with the external audit firm no later than early January 1999. The present five-year contract with the external audit firm expires with the 1998 audit. For this reason, the management has extended the contract of the existing external audit firm on an interim basis for one year, pending Board consideration of this report.

35. For the same reasons, the present method of appointment has been continued for the 1999 EAC.

36. If the report recommendation is accepted that future members of the EAC should each serve for three years (renewable), with not more than one terminating each year, then it would be necessary to phase this in. This will require that initially the Board should appoint one member for one year, another member for two years and the third for a full three-year term. Any of these appointments could be renewed for full three-year terms if acceptable to the Fund and the appointees at that time.

37. It would appear — without detailed estimates having been made — that the proposed new arrangements would have the same order of magnitude of cost as the present arrangements.



## **Review of the External Audit Process**

### **Terms of Reference**

#### ***Background***

The IMF is currently in the process of conducting a comprehensive review of a number of its internal support activities. As part of this review, Fund management has decided to conduct an external assessment of the Fund's internal and external audit functions. The review of the audit functions will be conducted in two parts: (i) a general review of the operations and effectiveness of the Office of Internal Audit and Inspection; (ii) a review of the financial external audit process. These terms of reference deal with the second part of the review.

The external audit of the Fund's financial statements is currently undertaken, in line with the Fund's by-laws and regulations, by an External Audit Committee (EAC), assisted by an independent external auditing firm, which relies in part on the work performed by the Office of Internal Audit and Inspection. The EAC is charged with conducting an examination of the Fund's system of accounting and financial controls and records, and with issuing an opinion with respect to the fairness of the presentation of the financial statements. The EAC is constituted annually by the Executive Board of the Fund and comprises three representatives from the Fund's member countries. The services of the EAC are terminated upon completion of the annual audit and submission of the audit report, though one member of the EAC serves for two years. The EAC convenes in Washington in late May/early June for three weeks.

#### ***Purpose***

The main objective of the review is to provide Fund management with a comprehensive evaluation of the current structure and effectiveness of the Fund's external financial audit process. As recommended by the 1997 EAC, the review will include a thorough evaluation of the responsibilities and functions of the EAC, comparisons with the external audit procedures of other international financial organizations and corporations, and identification of potential changes that could increase the effectiveness of the external financial audit process.

#### ***Scope of the review***

The review should be broad and focus in particular on the following issues, while taking into account the requirements under the Fund's Articles of Agreement and By-Laws:

- Study of the adequacy of the existing framework, including legal requirements and audit standards, for the Fund's external financial audit process.

- Evaluation of the current functions and responsibilities of the Fund's EAC in light of recent developments in audit standards, the generally accepted practices of external audit committees, and practices of similar organizations.
- Assessment of the role and reporting of the public accounting firm and its relation to the EAC. Under current procedures, the audit of the Fund's financial statements is largely executed by the accounting firm, and the EAC reviews the audit work performed by the audit firm and issues an audit opinion. Specific questions to be addressed in this context are whether the EAC should continue to have the responsibility of signing the opinion on financial statements and whether alternative arrangements would be appropriate in light of audit standards. The review should include a study of the implications of possible alternatives on the organization and conduct of the external audit process, and on the scope and division of responsibilities of the EAC, the external accounting firm, and the Fund's Office of Internal Audit and Inspection.
- Review of the current practice of constituting the three members of the EAC on an annual basis, with one member serving for two years, and development of possible alternative approaches that could bring greater continuity and thus more effective oversight while maintaining broad participation of the Fund's membership in the audit process.

### ***Procedures***

The external consultants are expected to have substantial experience with current external audit practices and financial reporting practices and be familiar with international financial institutions. The consultants will be expected to interact with former members of External Audit Committees, the OIA, the Fund's Treasurer's Department and other departments as necessary, particularly those that participate in the internal audit process.

The external consultants will be selected by a Steering Committee composed of four senior staff members in the Fund, who will monitor progress, provide internal assistance as needed, and resolve issues on which the consultants request guidance. Upon completion of the review, an overall report, covering all aspects of these terms of reference, will be presented directly to Fund management.

## **BY-LAWS OF IMF RELATING TO EXTERNAL AUDIT**

### **Section 20. Budget and Audits**

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(b) An external audit of the financial statements of the Fund and of Accounts administered under Article V, Section 2(b), including the financial statements of the Staff Retirement Fund, shall be made annually and such audit shall relate to the period representing the financial year.

(c) The annual audit shall be made by an external audit committee consisting of either three or five persons each of whom shall be nominated by a different member of the Fund and confirmed by the Executive Board. At least one person serving on each audit committee shall be nominated by one of the six members of the Fund having the largest quotas, and at least one person shall be nominated by a member that is also a participant in the Special Drawing Rights Department. The Executive Board shall determine, in the case of each audit, whether the audit committee shall consist of three or five persons and which members of the Fund shall be requested to nominate persons to serve on the committee. The service of the members of each audit committee shall terminate upon completion of the annual audit and submission of the audit report. The Managing Director shall arrange for auditing services by persons outside the Fund to assist the audit committee in the performance of its functions. The members of the audit committee and any outside assistants shall respect the confidential nature of their service and the information made available for purposes of the audit.

Each audit committee shall elect one of its members as chairman, shall determine its own procedure, and shall otherwise be independent of the Management of the Fund in conducting the annual audit.

(d) The annual audit shall be conducted in accordance with generally accepted auditing standards, and shall include such tests of the accounting records and such other auditing procedures as are considered necessary. The audit shall be comprehensive with respect to examination of the financial records of the General Department, the Special Drawing Rights Department, and Accounts administered under Article V, Section 2(b), including the Staff Retirement Fund; shall extend, insofar as practicable, to the ascertainment that operations and transactions conducted during the period under review are supported by the necessary authority; and shall determine that there is adequate and faithful accounting for the assets and liabilities of the General Department and Accounts administered under Article V, Section 2(b), including the Staff Retirement Fund, and for special drawing rights. On the basis of this audit, the audit committee shall state whether the financial statements as presented give a true and fair view of the financial position at the close of the financial year of the General Department, and of Accounts administered under Article V, Section 2(b), including the Staff Retirement Fund, and, with respect to the Special Drawing Rights

Department, of the allocations and holdings of special drawing rights, and of the results of operations and transactions during that year. For these purposes, the audit committee shall have access to the accounting records of the Fund and other supporting evidence of its operations and transactions, and of its administration of Accounts under Article V, Section 2(b), including the Staff Retirement Fund. The Managing Director of the Fund shall furnish the audit committee with such information and representations as may be required in connection with the audit.

(e) The Executive Board shall decide all questions of policy raised by requests of the audit committee for particular information or the inspection of particular records or documents. The refusal of any such requests for reasons of policy shall be explained in the comments of the Executive Board forwarded to the Board of Governors with the audit report.

Any question the audit committee may have concerning interpretation of the Articles of Agreement, the By-Laws, the Rules and Regulations, or the decisions of the Fund shall be discussed with the Managing Director, or officials designated by him, and if the reply is not completely satisfactory to the audit committee, the matter shall be referred to the Executive Board through the Managing Director.

(f) The audit committee shall submit the audit report to the Board of Governors for consideration by it. Such submission shall be made through the Managing Director and the Executive Board, which shall forward with the audit report its comments thereon. The audit committee shall afford the Managing Director an opportunity for explanation to it before deciding that any matter seems to require criticism in the report. The audit report shall be submitted to the Board of Governors within a reasonable time after its completion.

The audit committee may formally furnish to the Managing Director and the Executive Board 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. Such matters need not be dealt with in the audit report unless the audit committee believes they are of such moment as to warrant inclusion.

(g) The Managing Director shall determine what expenses are necessary and reasonable in connection with each annual audit, and the Fund shall bear such expenses.

## IMF RULES RELATING TO EXTERNAL AUDIT

### Audit

**J-6** At least two months before a regular meeting of the Board of Governors, the audited financial statements of the Fund shall be submitted to the Executive Board for its consideration. If a regular meeting of the Board of Governors is not scheduled to be held in any year, the audited financial statements shall be submitted as soon as possible after the end of the financial year of the Fund.

**J-7** When the external audit committee communicates views and suggestions pursuant to Section 20(f) of the By-Laws, those views and suggestions shall be communicated at the same time to the Managing Director and the Executive Board.

**J-8** Any review of the external audit process initiated by the Fund shall be conducted under the direction of the Executive Board and the Managing Director and any report shall be communicated upon completion, at the same time, to the Executive Board and the Managing Director.

