

EBAP/07/102

June 29, 2007

To: Members of the Executive Board

From: The Secretary

Subject: **Report of the External Audit Committee to the Executive Board**

The terms of reference for the External Audit Committee (EAC) provide that the EAC brief the Executive Board on the work of the EAC at the conclusion of the annual audit. As background for the Board briefing by the External Audit Committee on July 9, 2007, attached is the Report of the EAC to the Executive Board on the work completed in respect of the 2007 financial year.

It is not intended that this paper will be published on the Fund's external website.

Questions may be referred to Ms. Fennell (ext. 38341) and Mr. Hemus (ext. 38263), in FIN.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Attachment (1)

Other Distribution:  
Department Heads



**Report of the External Audit Committee to the Executive Board**  
**by**  
**Mr. Konar, Chair**  
**of the External Audit Committee for FY 2007**

**June 29, 2007**

**Introduction**

1. The main role and responsibilities of the Fund's External Audit Committee (EAC) are set out in the terms of reference and include the following:
  - to oversee the annual audit process (in accordance with Section 20 of the By-Laws of the Fund);
  - to monitor the integrity of the financial statements of the Fund and relating to the Fund's financial performance, to review significant financial reporting judgements contained in them;
  - to review the Fund's internal financial controls and the Fund's internal control and risk management systems;
  - to monitor and review the effectiveness of the Fund's internal audit function;
  - to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant professional and regulatory requirements; and
  - to report to the Board, identifying any matters in respect of which it considers that action or improvement is needed, and making recommendations as to the steps to be taken.

In transmitting the audited financial statements to the Board of Governors, through the Managing Director and the Executive Board, we fulfill our responsibility to ensure that the Fund's audit process is comprehensive and of high quality.

2. In addition to our general oversight responsibilities for the external audit, our terms of reference call for a review of the interim and annual financial statements, including the underlying accounting principles, and a review of the system of internal controls, including the adequate discharge by the Office of Internal Audit and Inspection (OIA) of its responsibilities. This report summarizes for the Executive Board the work that we have performed in FY 2007, our key findings on the external audit of the FY 2007 financial statements and the functioning of OIA, and our observations on other audit-related issues.

### **EAC's Work**

3. This report follows up on the most relevant issues taken up in our previous briefing of the Executive Board on January 12 of this year, when we were in Washington, D.C., inter alia, to review the audit plan for the FY 2007. As Executive Directors will recall, this year's committee comprises: Mr. Satoshi Itoh, outside corporate statutory auditor for private sector and not-for-profit organizations in Japan; Mr. Steve Anderson, the Head of Risk Assessment and Assurance of the Reserve Bank of New Zealand, and myself, Len Konar, Member of the Board of the South African Reserve Bank. I am in my third and final year on this committee, Mr. Itoh is serving his second year, and this is Mr. Anderson's first year on the committee. The committee members have recent and relevant financial experience and professional qualifications from professional accountancy bodies.
4. Formal meetings of the EAC are the heart of its work. However, we all recognize that they will rarely be sufficient. During FY 2007, in addition to our meetings in Washington, we maintained regular contact throughout the year with staff of the Finance Department (FIN), OIA, and the Ethics Office and also with the Deloitte & Touche (D&T) team, to receive updates and discuss relevant risk management, financial, reporting and audit-related developments.
5. The main purpose of our June 2007 visit was to review the external audit work conducted by D&T on the financial statements, the internal audit process, financial system controls, and all other relevant finance-, control-, and audit-related matters, against the key developments during FY 2007. We met with Fund management, FIN, OIA, the Human Resources Department (HRD), the Technology and General Services Department (TGS), the Advisory Committee on Risk Management (ACRM), and the Ethics Officer. We received and considered much valuable information that enabled us to appreciate the issues and develop our report to yourselves, taking into account all salient aspects.
6. The EAC receives information and papers in a timely manner to enable full and proper consideration to be given to the various relevant issues. The EAC is also provided with sufficient resources to undertake its duties.

### **Key Developments**

7. It is essential that the EAC obtains a good understanding of key financial and strategic developments so that we can review the Fund's financial statements and related disclosures effectively, as well as conclude on the adequacy of the work of

the internal and external auditors, and the state of internal controls organization wide.

8. The preparation of the FY 2007 financial statements took place against the backdrop of several key developments at the Fund, notably a continued decline in credit outstanding, the establishment of the Investment Account and its related financial reporting and disclosure requirements, and progress in implementing the Fund's Medium-Term Strategy (MTS). We were briefed by staff on these developments, and on the various elements of the Fund's MTS. The Investment Account was implemented in FY 2007 and the operations and the financial position were reported in the financial statements of the General Department. We have concluded that the Investment Account has been accounted for and presented appropriately in the financial statements, and that internal controls established with respect to the Investment Account are adequate.
9. We note that the report by the Committee of Eminent Persons (CEP) recommended that a new business model be developed to sustain the Fund's activities for the long term. The EAC will continue to keep abreast of developments as the Executive Board discusses the various proposals set out in the CEP report. While the Fund's reserves are available to meet income shortfalls, it is the EAC's view that it would be counter-productive to rely on reserves beyond the short term. We also note that the Fund is examining all available options to optimize its future operating costs.
10. We were briefed on the sharpened focus on surveillance, with the recent decision updating bilateral surveillance guidelines, and on progress toward quota reform, a central element of the MTS that is important for the institution's credibility and effectiveness.

### **Financial Reporting**

11. The EAC reviewed the significant financial reporting issues and judgments made in connection with the preparation of the Fund's financial statements. Overseeing the financial reporting process is one of the most important and most difficult responsibilities of an EAC member. The EAC ensures that the Fund has high-quality financial reporting, with financial statements that are transparent, readable, consistent and comparable.
  - a. As is well known, Fund management, the auditors and the EAC each have separate roles and responsibilities in the financial reporting process. However, we share a common goal: financial reporting of the highest quality.
  - b. The EAC is informed by management about significant financial reporting matters and reviews the Fund's financial statements with management on a timely basis. The EAC also discusses such matters with the external independent auditors. A solid understanding of the Fund's activities, business and risks allows EAC members to ask focused questions about the financial

statements and related disclosures, which is done in the executive sessions that the EAC holds with each of the parties it interacts with.

- c. As the EAC, we must understand why critical accounting policies were chosen, how they were applied, and have a basis for confirming the end result fairly presents the Fund's actual status.
  - d. Stakeholders expect clear, reliable, consistent, comparable and transparent reporting of events as they occur.
  - e. In fulfilling its oversight responsibilities, the EAC reviews the audited financial statements with management, including a discussion of the quality, not just the acceptability, of the accounting policies; the reasonableness of significant judgments; and the clarity of disclosures in the financial statements.
  - f. In discharging its oversight role, the EAC is empowered to investigate any matter brought to its attention with full access to all books, records, facilities, and personnel of the Fund and the power to retain outside counsel, or other experts for this purpose.
  - g. The EAC takes appropriate actions to set the overall "tone" for quality financial reporting, sound business risk practices, and ethical behavior.
12. The EAC members had a number of opportunities to discuss and provide input to the preparation of the financial statements in the period leading up to our June visit. We received the pro forma financial statements (10 separate financial statements including 50 sub-accounts) in early March 2007 and provided our detailed comments and suggestions to staff and D&T via teleconference. In subsequent rounds of bilateral contacts, we continued to work with staff to enhance the financial statements. The following EAC suggestions are reflected in the year-end financials:
- Expanded risk management disclosures to include coverage of income risk;
  - Expanded disclosures on non-usable currencies, provisions, financial instruments and contingencies;
  - On accounting policies, additional explanations on the rationale for not consolidating the financial statements of the General Department with those of the SDR Department and Trust Accounts administered by the Fund as trustee; and
  - Improved disclosures and footnotes to enhance readability and understanding.

The EAC reviews related information presented with the financial statements, including the operating and financial review, and statements relating to the audit and risk management.

13. In our view, the Fund's financial statements are in compliance with International Financial Reporting Standards.

### **Internal Control**

14. Management is responsible for creating and maintaining internal controls, and the audit committee is responsible for judging whether those controls are adequate and implemented. Specifically, our responsibility as set out in our Terms of Reference is to *“review... risk management within the IMF and the system of internal controls, including the environment in which the system operates”*. The EAC reviews with the external audit firm, management, and staff the overall system of internal controls, including the environment in which the system operates. We generally concur with the findings of the internal and external auditors that the Fund has a strong system of controls in place, including appropriate segregation of duties, a system of transparency, oversight by the internal and external auditors and the EAC, and the existence of a Control Unit in FIN. We are also encouraged by OIA efforts to document controls through its audits conducted during the year.
15. FIN has also continued to expand work on internal controls of financial and accounting systems in FY2007. Major initiatives to document controls, review the effectiveness of key controls, and implement control-related system enhancements have continued. FIN has taken a practical approach to internal control documentation and testing, giving due consideration to the costs and benefits of different frameworks and the lessons learned from other organizations.
16. We met again this year with the Control Unit, which was established by FIN about 3 years ago to focus on financial systems, risks and controls. Our reviews and discussions were designed to allow us to obtain sufficient information about internal control initiatives, including those related to design and operation of controls to address operational risks. This also extends to general computer controls and IT systems, particularly financial systems. We discussed the review and testing by FIN of controls over the newly established Investment Account, work practice reviews by FIN of administrative expenditures, enhancements and upgrades to systems, reviews of system security, assessments of key controls in financial processes, interdepartmental reviews of risk and controls over HR/administrative expenditures and initiatives. We requested a sample of internal control review and testing reports and other documents, which we reviewed. We are pleased with the interdepartmental initiatives under way over the past year to assess risks, and improve processes and controls.
17. FIN has established both the structures and principles for a strong control environment underlying financial processes and reporting. This builds on the importance placed Fund-wide on ethical behavior, staff qualifications, code of

conduct and new initiatives such as a Whistleblowing mechanism, which all contribute to setting a positive tone for the internal control environment.

### **Internal Audit**

18. As part of its oversight role, the EAC is also tasked with reviewing the adequate discharge by OIA of its responsibilities. The EAC has four central functions with respect to OIA oversight:
  - Ensure that the internal audit plan is sufficiently broad in scope and executed in a timely manner;
  - Ensure that OIA reports are actionable and implemented;
  - Enable an internal audit team that is independent, empowered and sufficiently staffed and resourced; and
  - Promote an open, transparent relationship with OIA and other control professionals.
19. To that end, we have reviewed OIA's work program, the results and quality of its audits, the follow up of outstanding recommendations, and its adherence to International Standards of Internal Auditing as promulgated by the Institute of Internal Auditors (IIA).
20. We are pleased to note that during FY 2007 the governance structure of the internal audit function was strengthened by the formal recognition of a functional reporting relationship between OIA and the EAC in the charter of the office as laid out in GAO 14, as has been already communicated to the Board. This formally ensures an objective and independent reporting line between the internal audit department and the EAC and is in line with IIA Standard 1100. The EAC is also satisfied that OIA's current staffing, while tight to achieve its work program, is adequate and that the office, in line with IIA Standard 1230, places high emphasis on the professional qualifications of its staff and the need for continuous professional development. We also support OIA's initiatives for further staff exchanges with other departments and outside institutions, such as those that took place with the BIS and Banque de France.
21. As we have previously communicated on a number of occasions, we strongly support information-sharing with the Board on audit-related matters. In this regard, we have reviewed the material presented by OIA to the Board in FY 2007 in its semi-annual briefings and found it to be very informative and appropriately supportive of an enhanced dialogue on audit- and control-related matters.
22. We have noted the continued commitment of OIA to strict adherence to all the International Standards for the Professional Practice of Internal Auditing. Adherence

to these standards was confirmed by the results of an internal OIA Quality Review conducted during FY 2007. These standards (in particular Standard 1300) require ongoing monitoring of the quality of the internal audit activity and its effectiveness, by the EAC as well as through periodic in-depth assessments. This year's review was conducted under the leadership of the former Auditor General of the World Bank. The review commended OIA for introducing numerous international best practices and accorded OIA the highest rating a department can receive in these reviews. Learning on our own experience and the results of this review, we discussed with OIA some further enhancements to their work practices to maintain operations at the forefront of professional practice.

23. Turning to the details of OIA's work program for FY 2007, we reviewed and discussed OIA's reports issued during the year under its work program. We are pleased with the depth and scope of the work program, which covers a broad area of the Fund's activities, noting that OIA appropriately focused its attention on high-risk areas, including audits in the compensation system, financial controls, and IT matters. We also are pleased that the risk-based methodology of selecting audits for inclusion in the work program was further strengthened this year by taking into account the results of the Fund's first annual risk assessment exercise following the Enterprise Risk Management methodology.
24. We have reviewed the detailed results of the internal audits and did not identify any findings that would lead us to question the overall strength of the control framework at the Fund. At the same time, we note that while no significant weaknesses were identified, the audits did point to opportunities for improvements and strengthening in a number of areas, as was also reported to the Board by OIA in its most recent briefing. It will be important that these improvements are carried through and that the recommendations be monitored in line with IIA Standard 2500. In this regard, we are pleased with the ongoing monitoring efforts of OIA in FY 2007, also noting the high rate of implementation of earlier recommendations. While there are a few recommendations that have been outstanding for more than one year, these relate mainly to IT issues and we understand that these are currently being addressed. Finally, we also reviewed OIA's FY 2008 work program and are satisfied with the direction taken and the balanced coverage of financial, technology, and operational audits.

#### **External Audit**

25. To effectively perform its responsibilities, the EAC has oversight responsibility for the external audit function. The responsibility for performing the external audit and issuing the audit opinion rests with the independent external audit firm. The EAC is responsible for evaluating whether the resources, planned scope of activities and fees and costs are appropriate and for assessing the independence of the external audit firm. It also reviews the results of audit procedures and related recommendations regarding the Fund's controls and other issues.

26. We followed up on the external auditors' observations from last year regarding IT issues. As part of their audit for FY 2007, D&T's computer audit specialists (known as Enterprise Risk Services) performed a review of the Fund's computerised information systems environment. This work did not identify any material weaknesses or significant deficiencies in internal control.
27. The EAC reviews with the independent external auditors, who are responsible for expressing an opinion on the conformity of those audited financial statements with IFRS, their judgments as to the quality of the Fund's accounting policies and such other matters as are required to be discussed with the EAC under generally accepted auditing standards. The EAC discusses recommendations raised by the auditors on various matters, including those related to internal control. In addition, the EAC discusses with the independent external auditors their independence from management and the Fund and considers the extent of any non-audit services rendered which may affect the external auditors' independence.
28. The EAC discusses with the Fund's independent external auditors the overall scope and plans for their audit. The EAC meets with the independent external auditors, with and without staff present, to discuss the results of their examinations, their evaluations of the Fund's internal controls, and the overall quality of the Fund's financial reporting. The EAC holds two onsite meetings during the fiscal year in Washington, and meets as and when circumstances require during the rest of the year (via tele or video conference).
29. The EAC considers whether the auditors' overall work plan, including planned levels of materiality, and proposed resources to execute the audit appear consistent with the scope of the audit engagement, having regard also to seniority, expertise and experience of the audit team. The EAC assesses, annually, the qualification, expertise and resources, and independence of the external auditors and the effectiveness of the audit process. The assessment covers all aspects of the audit service provided by the audit firm.
30. Turning to the adequacy of this year's external audit, we are satisfied that D&T has applied International Standards on Auditing and auditing standards generally accepted in the United States in the conduct of their audit of the Fund's reporting entities. We are pleased to report that, as you will have seen in the financial statements distributed to the Executive Board, D&T's audit findings have enabled them to express an unqualified audit opinion on the financial statements, which of course we support fully.
31. OIA and the external auditors of the Fund met on several occasions during the period under review. The purpose of these meetings was to discuss work-related matters and share information. Copies of internal audit reports issued are forwarded to the external auditors for their perusal on a regular basis.

32. In terms of International Standards on Auditing (“ISA”) D&T is obliged to inform us of the level of unadjusted differences, regardless of whether they have a material effect on the financial statements. We are pleased to note that D&T did not propose any adjustments in the course of performing their FY 2007 audit procedures, nor did they find any material weaknesses or significant deficiencies in internal control. This simply means that no weaknesses in internal controls that could potentially cause a material misstatement in the Fund’s financial statements were identified this year. The audit conclusions confirm that the Fund continues to adhere to the highest standards in control and financial reporting. In addition, no areas of disagreement between the external audit firm and staff or management were noted.
33. The EAC reviewed and agreed with the engagement letter issued by the external auditors at the start of the audit, ensuring that it had been updated to reflect changes in circumstances arising since the previous year. The scope of the external audit was reviewed by the EAC with the auditors.
34. The EAC satisfied itself that the level of fees payable in respect of the audit services provided is appropriate and that an effective audit can be conducted for such a fee. The EAC also reviewed the audit representation letters before signature by management. The EAC considered whether the information provided is complete and appropriate based on its own knowledge.
35. At the end of the annual audit cycle, the EAC assessed the effectiveness of the external audit process. In the course of doing so, the EAC:
  - reviewed whether D&T had met the agreed audit plan, and understood the reasons for any changes, including changes in perceived audit risks and the work undertaken by the external auditors to address those risks;
  - considered the robustness and perceptiveness of the external auditors in their handling of the key accounting and audit judgements identified and in responding to questions from the EAC, and in their commentary where appropriate on the systems of internal control;
  - obtained feedback about the conduct of the audit from key people involved, e.g. the finance director and the director of internal audit; and
  - followed up on the status of items noted by the external auditors in their audit of FY 2006.

The EAC is satisfied that D&T has conducted a comprehensive audit for FY 2007.

## **Risk Management**

36. FY 2007 was an important year for risk management at the Fund, with the formal establishment of the Advisory Committee on Risk Management (ACRM) in October 2006 and the first Fund-wide risk assessment exercise. The EAC reiterates its support for the scope of the risk management framework and its modalities of implementation since this mechanism complements the Fund's existing control mechanisms. We have reviewed the reports prepared for the first risk exercise (on Risk Management, Financial Risk, and Strategic and Core Mission Risk) presented to the Board in March 2007, management's statement, and the summing-up of the Board discussions. We also met with members of the ACRM to discuss the findings of the risk assessment exercise. We are encouraged by the importance that staff, management, and the Board attach to a continuous strengthening of risk management and the mitigation of existing risks.
37. We note the overall conclusion of the 2007 risk management exercise that adequate mechanisms are in place to address many of the risks that were identified, but at the same time we want to stress that the risk universe will continue to evolve and due diligence will be required to ensure that new and emerging risks are captured and properly addressed. It will also be important to successfully implement the actions that were identified to address the main residual risks that were flagged in the 2007 report. We therefore welcome the intention to periodically brief the Board on developments.
38. In our view, the steps taken thus far go a long way towards establishing an integrated risk-based mechanism at the Fund. At the same time, further refinements to the framework are being made. We concur with suggestions made during the recent Board meeting by Directors for such refinements, including firmer prioritization and integration of all types of risks, and introduction of periodic incident reporting. We look forward to receiving timely updates on progress in this area and to further discussions in future meetings.

## **Governance**

39. **Ethics Office.** The EAC received a briefing by the Fund's Ethics Officer. We were informed of the composition of the ethics office (functions of ETO and staff), ETO budget, and the ETO Annual Report for 2005/2006 (which had been distributed to all staff during May 2007, addressing heightened awareness about ethics within the IFI world, ethics advisory series and the emphasis on ethics investigations). We discussed emerging ethics risk areas, recommendations made (on policy, communication and education and training) and a status update on the informal Whistleblowing Working Group.
40. **Whistleblowing.** In June 2005, the EAC suggested that the Fund consider adoption of an independent "Whistleblowing" facility in accordance with best practices. The

EAC members have discussed the progress made by the informal working group toward implementation of a hotline for anonymous reporting. We were briefed by the Ethics Officer on the due diligence carried out to select an appropriate hotline company for the Fund, based on the experience of some of the other International Financial Institutions. We understand that management is considering the next steps, which will include rescinding the prohibition on anonymous reporting and introducing a hotline to receive allegations, on both an anonymous and identified basis.

#### **Human Resources Department**

41. The EAC was briefed on the key outcomes of the Employment, Compensation and Benefits Review and two of the major remaining issues that will be taken up this year—the reviews of the Medical Benefits Plan and the Staff Retirement Plan. We were particularly interested in issues related to staff recruitment and retention, which we note has become more challenging given the reduction in the real budget envelope and was a concern raised in the context of the enterprise risk exercise. Maintaining a motivated, highly qualified, and diverse staff will be a key element in ensuring that the Fund can continue to fulfil its mandate.
42. HRD has made further progress in implementing the recommendations arising from recent OIA reviews, including putting in place a more robust internal control process. We welcome the major effort under way to enhance HR IT systems and review work procedures, with the aim of simplifying processes and reducing the potential for errors. We also note the updating of all Fund policies and guidelines covering ethics and staff conduct, to bring them into line with best practice, and the intention to compile all such policies and guidelines into a staff manual. We were also informed of some of the challenges being addressed by HRD (diversity, discrimination and morale, etc.), which are essential in a diverse environment such as the Fund.

#### **Technical and General Services Department (TGS)**

43. In our meeting with TGS, we were informed of the various initiatives underway to support the MTS and to address the accompanying budgetary challenges. TGS shared its efforts to rationalize and streamline activities in language services, information technology and administrative services. In this context, TGS must continue to advance the capabilities of its staff to meet the changing demands of the business climate and pursue the development of performance-based management, both of which will help deliver significant real reductions in the budget. The rebidding of third-party contracts in the area of administrative services aims to further reduce costs, but could potentially lead to service level reductions. It is critical that in all of these actions, TGS is able to address cost savings in a sustainable manner.
44. Several technology initiatives figured prominently in the FY 2007 work program, including (i) the global sourcing of a majority of IT maintenance projects; (ii) system

security certifications; and (iii) business continuity improvements. Changes to the IT governance structure are welcome developments.

### **EAC Reporting to Executive Board**

45. Under our Terms of Reference, the EAC's Chairman is required to provide a briefing to the Executive Board at the conclusion of the annual financial statement audit process in July. In practice, the EAC has provided an additional briefing to the Executive Board each January.
46. As a committee, we try to provide relevant material to the Board as much in advance of the briefing as possible, with such material providing the information the Board requires while avoiding extraneous detail.
47. This year, our report has focused on the specific details of the EAC's technical work, to provide the maximum benefit from our accounting, financial and audit expertise. We hope that by providing the Executive Board with more detail about how the EAC discharges its oversight obligations, Board members will gain a more comprehensive understanding of the EAC's role, and be further reassured as to the effectiveness and reliability of the EAC's sign-off on its areas of oversight.

### **Our Appreciation**

48. The EAC has held frank and constructive exchanges with all the assurance providers and significant roleplayers of the Fund in finalising its report to the Board.
49. We would like to conclude this presentation by thanking management and staff for their assistance and cooperation in the execution of our mandate, and to Executive Directors for raising questions and providing feedback at the time of our reports to the Board. The EAC is prepared to expand on any aspect of this report, as may be required.