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**IMMEDIATE  
ATTENTION**

EBS/99/137

CONFIDENTIAL

July 23, 1999

To: Members of the Executive Board

From: The Acting Secretary

Subject: **The Fund's External Audit Function—Terms of Reference for the External Audit Committee**

*Attached for consideration by the Executive Directors is a paper on the Fund's External Audit Function—Terms of Reference for the External Audit Committee.*

It is not proposed to bring this matter to the agenda of the Executive Board for discussion unless an Executive Director so requests by noon on Wednesday, July 28, 1999. In the absence of such a request, the draft decision that appears on page 5 will be deemed approved by the Executive Board and it will be so recorded in the minutes of the next meeting thereafter.

Mr. Keuppens (ext. 37813), Mr. Elizalde (ext. 37796), and Mr. Coune (ext. 38237) are available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:  
Department Heads



INTERNATIONAL MONETARY FUND

**The Fund's External Audit Function—Terms of Reference for the External Audit Committee**

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

(In consultation with Secretary's Department)

Approved by David Williams, François Gianviti, and Eduard Brau

July 22, 1999

1. The Executive Board recently approved a report to the Board of Governors proposing an amendment of Section 20 of the Fund's By-Laws in regard of the Fund's external audit process; the resolution concerning the proposed amendment will be submitted to the Board of Governors for its adoption at the next Annual Meetings.<sup>1</sup> The proposed amendment takes into account recommendations made by an external consultant to strengthen the Fund's current external audit arrangements and the Executive Board's consideration and endorsement of those recommendations.<sup>2</sup> The key changes to the external audit process endorsed by the Executive Board are as follows: (i) the external audit firm will take full responsibility for signing the audit opinion, (ii) the role of the External Audit Committee (EAC) will be one of oversight of the audit and internal control processes, and (iii) the EAC's composition will be strengthened to enable it to fulfill its expanded role.

2. The external consultant also recommended that an "initial formal set of terms of reference for the new EAC should be drafted by management and approved by the Executive Board." These terms of reference would then take effect after adoption of the amended By-Laws and upon selection of the new EAC. This paper presents proposed terms of reference (Attachment I). The proposed terms of reference are consistent with the specific recommendations in the consultant's report on the function of the new EAC and with the Directors' views expressed during the Board's discussion.

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<sup>1</sup>*Review of the Fund's External Audit Function - Draft Report to the Board of Governors and Draft Resolution* (EBS/99/77, 5/17/99).

<sup>2</sup>*Review of the Fund's External Audit Function* (EBS/99/23, 3/1/99); EBM/99/27, 3/15/99. Attached to the staff paper was the consultant's report on the *External Audit Function at the IMF*.

3. The external consultant's report suggested that the EAC should concentrate its work on the following broader audit functions: "(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" (see paragraph 15 of the external consultant's report). These functions have been included in Section 2 of the proposed terms of reference. In addition, since one of the functions of the EAC under the By-Laws is to transmit the external audit reports to the Board of Governors through the Managing Director and the Executive Board, this function has been added.

4. At the Board's discussion of the external audit process, Directors indicated their agreement with the above audit functions and noted that these should be incorporated in the terms of reference of the EAC. In response to a question during the Executive Board discussion on the relationship of the EAC to the internal audit function, the staff explained that the EAC would (i) meet with the Office of Internal Audit and Inspection (OIA) to review the internal audit plans over the medium term, (ii) receive copies of all internal audit reports that bear on the Fund's finances, and (iii) if it so wished, meet separately with OIA staff in a working session to review and discuss the internal control structure of the Fund. It was understood then that these aspects would also be reflected in the EAC's terms of reference (see paragraphs 2.7 and 2.8 in Section 2). This relationship between OIA and the EAC is also in line with the recommendations of the consultant's report (paragraph 20).

5. The consultant's report sets out in more detail a set of audit procedures the new EAC might be expected to adopt in conducting the annual audit cycle (paragraphs 16-22). This includes at least two visits to Washington, though of shorter duration than at the present time.<sup>3</sup> Based on the report, the audit procedures endorsed by the Board are as follows:

#### **Beginning of Audit Cycle**

- The three members of the EAC would meet with management and the external audit firm in, e.g., January, to review the firm's audit plans.<sup>4</sup> The visit would last two to three days during which the EAC would also get an update from TRE and OIA on recent developments in the Fund.

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<sup>3</sup> The EAC should be available, but not necessarily by additional visits, for consultation on any emerging audit matters throughout the year.

<sup>4</sup> Given the rotating membership of the Committee, the newly appointed member could arrive a few days earlier in order to get a general briefing on the Fund.

- While the EAC would not issue a formal report at the conclusion of this preliminary visit, the minutes of formal meetings with the external audit firm would be sent to the Executive Board for information.

### **Completion of Audit**

- When the audit by the external audit firm would be substantially completed, the EAC would reconvene in Washington, D.C. for 2-3 days in June. The external audit firm would submit its audit report to the EAC for review. The EAC would then discuss the audit report with the firm, Fund staff, and management, with regard to (i) any substantive points raised by the firm or the EAC, and (ii) the overall audit process, including an assessment of the internal control function.
- The EAC would meet in executive session with the external audit firm, without the presence of any Fund staff, in order to discuss audit matters.
- No formal report would be prepared at the conclusion of the second visit, but (i) minutes of the EAC's formal meetings would be sent for information to the Executive Board, and (ii) the EAC Chairman would give the Executive Board an oral briefing on the EAC's work.

The above procedures are all addressed in the proposed terms of reference.

6. To test the procedures against what is currently considered best practice, the staff has verified that the proposed audit procedures and terms of reference are consistent with the guiding principles contained in a very recently issued report in the United States on *Improving the Effectiveness of Corporate Audit Committees* (Blue Ribbon Committee).<sup>5</sup> These principles are important because they are likely to be a precursor model that will influence other standard-setting bodies such as the International Federation of Accountants (IFAC), responsible for formulating international standards for auditing, and the Institute of Internal Auditors (IIA). The fundamental guiding principles formulated as best practices for audit committees are summarized as follows<sup>6</sup>:

- the audit committee should have the key role of monitoring the audit process—it should oversee the work of those involved in the financial reporting process, including notably the internal auditor and the external audit firm

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<sup>5</sup>The Securities and Exchange Commission (SEC), the New York Stock Exchange, and the National Association of Securities Dealers appointed an 11-member panel in September 1998 to make recommendations on strengthening the role of audit committees in overseeing the corporate financial reporting process.

<sup>6</sup>The Blue Ribbon Committee also formulated 10 specific recommendations which apply more specifically to U.S. industry practices for publicly traded companies.

- there should be independent communication between the audit committee and the internal auditor, and the audit committee and the external audit firm;
- since the audit committee is largely dependent on information provided to it by staff, the internal auditor, and the external audit firm, it should cultivate a frank dialogue with each, especially regarding necessary background information on issues implicating judgement; and
- the Board of Directors should ensure that members selected to the audit committee are diligent, knowledgeable, and technically competent.

7. The draft terms of reference have been reviewed by the 1999 EAC and the external audit firm assisting the 1999 EAC as was suggested in the consultant's report. The proposed terms of reference are in line with the 1999 EAC memorandum to the Managing Director and the Executive Board dated June 24, 1999,<sup>7</sup> which included recommendations to (i) keep the terms of reference consistent with the recommendations of the external consultant, and (ii) ensure that in the future the EAC will assume the typical role and functions of audit committees in large organizations. The proposed decision and the terms of reference will only become effective in FY 2000 following adoption by the Board of Governors of the proposed amendment of the By-Laws. The proposed terms of reference provide for the new EAC—once established—to recommend changes to the terms of reference for consideration by the Executive Board. It is proposed that the Executive Board approve the attached draft terms of reference for future external audit committees by the adoption of the proposed decision below.

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<sup>7</sup>A copy of the memorandum is included in EBAP/99/81.

**Proposed Decision**

The Executive Board approves the terms of reference for the External Audit Committee appointed under Section 20 of the By-Laws, as set forth in the attachment to EBS/99/137; this decision will take effect upon approval of the proposed amendment of Section 20 of the By-Laws by the Board of Governors at its next annual meeting.

**Attachment**

**External Audit Committee  
Terms of Reference**

These Terms of Reference of the External Audit Committee (EAC) are adopted under the authority of Section 20 of the By-Laws, and are supplementary to its provisions and to Rules J-6 through J-8 of the Rules and Regulations of the International Monetary Fund.

**1. Purpose of the EAC**

The EAC has general oversight responsibilities for the external audit function within the IMF. The EAC shall review the financial statements of the IMF and the accounts administered by the IMF, including the staff retirement plans, the related financial reporting practices, and the system of internal controls, including the audit process. The responsibility for performing the external audit and issuing the audit opinion rests with the external audit firm. The EAC shall transmit the external audit reports issued by the external audit firm to the Board of Governors, through the Managing Director and the Executive Board.

**2. Responsibilities**

*Financial and Related Reporting Practices*

- 2.1 Review the interim and annual financial statements of the IMF and the accounts administered by the IMF, including the staff retirement plans, the external audit firm's opinion, and its comments on controls and other observations. The EAC shall also review the underlying accounting principles with staff of the IMF and the external audit firm.
- 2.2 Review the selection procedures for an external audit firm which shall be selected by the Executive Board, in consultation with the EAC, and appointed by the Managing Director.
- 2.3 Review and discuss with the external audit firm and staff of the IMF the scope and content of the external audit firm's examination, and the coordination with the Office of Internal Audit and Inspection. For this purpose, the EAC shall receive a written submission of the external audit firm's audit plan.
- 2.4 Review any significant operational or reporting issues affecting the financial statements which were discussed by Fund management and the external audit firm, monitor the external audit results, and review the external audit firm's performance.

- 2.5 Meet separately with the external audit firm to discuss pertinent matters, including the Fund's accounting principles as applied to its financial reporting, and any restrictions on the scope of the audit.

*System of Internal Control*

- 2.6 Review with the external audit firm, the Office of Internal Audit and Inspection, and staff of the Treasurer's Department, risk management within the IMF and the system of internal controls, including the environment in which the system operates.
- 2.7 Review the adequate discharge by the Office of Internal Audit and Inspection of its responsibilities by reviewing and approving the Office of Internal Audit and Inspection's charter and reviewing its plans, the results and quality of its audits, and its adherence to standards of internal auditing.
- 2.8 Review the Office of Internal Audit and Inspection written reports concerning the scope of reviews of compliance, any significant findings, and the resolution and follow-up on findings and recommendations; maintain direct communication with the Office of Internal Audit and Inspection Director; and meet privately with the Director at least annually.

*Reporting Responsibilities*

- 2.9 The EAC shall submit minutes of its formal meetings to the Executive Board, but need not prepare separate formal reports on its activities. Its Chairman shall brief the Executive Board on the work of the EAC at the conclusion of the annual audit.

**3. Procedures**

The EAC shall have access to information in possession of the IMF as needed to carry out its function, and will determine its own procedures to fulfill its responsibilities to the best of its professional ability. Members of the EAC undertake to protect the confidentiality of their service and the information obtained during the course of their duties.

It is expected that the EAC will meet at least twice a year. The members of the EAC shall be available for consultation on any emerging audit matters throughout the year. A preliminary two- to three-day visit shall take place in January in order for the EAC to review and discuss the audit plan with the external audit firm and IMF staff, and to get an update from the Treasurer's Department and the Office of Internal Audit and Inspection on recent developments within the IMF. Any newly appointed member of the EAC is expected to arrive a few days before returning committee members to be briefed on the IMF in general. No formal reports would be issued during this visit, but minutes of formal meetings would be sent to the Executive Board for information.

A second visit shall take place in June when the annual audit has been substantially completed by the external audit firm. At that time, the external audit firm shall submit its full audit report to the EAC for review. The EAC shall discuss the audit report with the external audit firm, the Treasurer's Department, the Office of Internal Audit and Inspection, and other departments, as necessary, with regard to substantive audit matters and the overall audit process. The EAC may decide to meet in executive sessions with the external audit firm or staff of the Office of Internal Audit and Inspection. At the conclusion of the EAC's second visit to the IMF, the Chairman of the EAC shall give the Executive Board a briefing on the EAC's work. A formal report from the EAC to the Executive Board is not required.

#### **4. Amendment of the Terms of Reference**

In accordance with the provisions of Section 20(c) of the By-Laws, the EAC shall review its terms of reference periodically and may recommend amendments for consideration by the Executive Board.