EXECUTIVE BOARD MEETING

EBAP/18/58

June 27, 2018

To: Members of the Executive Board

From: The Secretary

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

Board Action:	Background for the External Audit Committee briefing to the Executive Board
Tentative Board Date:	**Tuesday, July 17, 2018**
Publication:	Not intended

International Monetary Fund

2018 Report of the External Audit Committee

to the Executive Board

June 22, 2018

Executive Summary

This report summarizes the work of the External Audit Committee (EAC) of the International Monetary Fund (the Fund) for the financial year ended April 30, 2018[1]. Our work benefited from the cooperation and support of Executive Directors (EDs), management, relevant departments, and external auditors.

The EAC oversaw the process for the external audit of the 2018 financial statements and, in the context of our oversight, commented on those financial statements. The EAC also considered the review of internal controls conducted by PricewaterhouseCoopers LLP (PwC), the external audit firm, to the extent it considers necessary to perform its audit. The EAC also reviewed the reports issued by the Office of Internal Audit (OIA) during 2018 and its 2019 Audit Plan.

Outline of the EAC Work

This report, together with our informal briefing of the Executive Board (the Board) on February 1, 2018 regarding our planning visit, covers the EAC work relating to financial year 2018.

The EAC made two visits to the Fund, and held conference calls with staff of the Finance Department (FIN) and PwC, to provide comments on the draft 2018 financial statements and obtain updates on the audit. Conference calls were held on May 15 and 30, 2018 to discuss issues arising in connection with application of IFRS 9 and other issues arising from the draft financial statements. Throughout the year we maintained contact with FIN, OIA, and the external auditors receive updates and discuss relevant developments. We will return in July for our final visit at which time we will present our report to the Board.

The main objectives of our January 2018 and June 2018 visits were to review the external audit work conducted by PwC relating to the Fund's 2018 financial statements and review the internal audit reports based on the work conducted by OIA. Our January visit focused on the external audit planning and our June visit focused on the completion of the external audit. We met with FIN, PwC, OIA, Human Resource Department (HRD), Office of Risk Management (ORM), HQ1 Task Force (HQ1), Information Technology Department (ITD), the Ethics Advisor, the Office of Internal Investigations (OII), Investment Office and the EDs in two groups. In addition, we met with the Deputy Managing Directors responsible for financial accounting and reporting, and for administration. We met the Managing Director at our June meeting.

[1] Hereafter, we refer to the financial years ended April 30, 2018, April 30, 2019 and April 30, 2020 as 2018, 2019 and 2020.

External Audit of 2018 Financial Statements

The audited financial statements subject to EAC oversight for the year ended April 30, 2018 comprise those of the Fund's General Department, Special Drawing Rights Department, Concessional Lending and Debt Relief Trusts, Administered Accounts, and the Staff Retirement Plan, Supplemental Retirement Benefit Plan, and Retired Staff Benefits Investment Account. PwC has expressed unmodified opinions on each of these financial statements confirming that the statements have been prepared in accordance with International Financial Reporting Standards (IFRS), and present fairly, in all material respects, the financial positions of each reporting entity. In 2018, FIN continued its efforts to increase the clarity of the financial statements. PwC reported no material weaknesses or significant deficiencies in internal control, nor have they made any control observations during their audit. They also confirmed that there were no significant adjustments arising from the audit.

FIN provided us with an update on a range of developments that affected the 2018 financial statements and disclosures, including those related to the General Resources Account (GRA) resources, lending arrangements and commitments, credit outstanding, GRA lending toolkit, Poverty Reduction and Growth Trust (PRGT) resources, income position and precautionary balances, and investment portfolios and strategy for trust assets.

As the Fund's financial statements are prepared in accordance with IFRS, various relevant pronouncements from the International Accounting Standards Board (IASB) were discussed. The main changes discussed were IFRS 9, IFRS 15 and IFRS 16. Further details on IFRS 9 are given below. IFRS 15 Revenue Recognition will become effective for adoption by the Fund in 2019. IFRS 15's impact on the Fund's financial statements is expected to be limited. IFRS 16 Leases will become effective for adoption by the Fund in 2020. FIN is actively working on assessing the application of the standard, and how it will affect the Fund's financial statements.

Implementation of IFRS 9

FIN provided us with an update on its progress in determining how the Fund will apply IFRS 9's requirements relating to assessing impairment of credit outstanding. That determination will not be applied in practice until IFRS 9 comes into effect for the Fund's 2019 financial statements, but it has reached a critical juncture because of the disclosures required in the Fund's 2018 financial statements of the impact on opening reserves in 2019 and the overall likely effect on the 2019 financial statements. We were pleased that not only FIN but the other departments of the Fund, as well as Area Department Country Teams were actively involved in the application of the standard.

FIN has developed a model for assessing credit impairment as required by the standard to suit the specific requirements of the Fund. We have regularly provided considerable inputs through our on-going dialogue with FIN and PwC, and have critically enquired about how the model is applied by reference to the standard. We also made detailed enquiries of PwC on the application of the standard and they reported to us that they – inclusive of their IFRS technical accounting partner - are satisfied with the application of the standard to the Fund.

We encourage FIN to give early consideration to how the application of IFRS 9 is disclosed in the 2019 financial statements.

Audit matters

We met with PwC to obtain an understanding of the audit results and findings for the audit carried out by them as at April 30, 2018. They highlighted that the Significant Audit Risks were the same as last year, being:

- Carrying amount of credit outstanding/loans receivable
- Valuation of illiquid investments
- Management override of internal controls (which applies on all audits)

Consistent with the Fund's decision last year, the audit report does not disclose Key Audit Matters (KAM), which is not mandatory for the Fund. Because practice is still evolving, PwC and FIN are monitoring the developments in the discussion of KAM in audit reports before determining whether to adopt voluntarily the KAM portion of the new auditing standard.

Fees for the 2018 external audit were $1,225,000. In addition PwC will be billing additional fees of $41,000 for incremental work related to the transitional disclosures of IFRS 9. PwC also performed non-audit services amounting to $374,800, which is below the threshold that would require Board approval. The EAC reviewed non-audit services provided by PwC during 2018 and concurs with management and PwC that these services do not compromise the independence of PwC.

Our meetings with PwC personnel were productive. PwC provided us with a report on work performed by it and the findings. We are satisfied that PwC has discharged its responsibilities in connection with the audit in a professional way. PwC's report to us revealed that the audit they have conducted is consistent with the audit plan that we had reviewed during our January 2018 planning visit. During the course of the 2018 audit, the lead audit partner was replaced by PwC on account of the divestiture of a part of the firm's business. We note that the audit partner transition was executed without incident, and FIN reported that the change did not contravene the terms and conditions of the audit engagement contract.

The EAC will brief the Executive Board at a meeting scheduled for July 17, 2018. The 2018 audited financial statements will then be submitted by the EAC to the Board of Governors through the Managing Director and the Executive Board.

Review of Internal Audit and Internal Control

We reviewed and discussed with OIA the results of the execution of its 2018 Audit Plan. Six OIA engagements were completed in 2018:

- administrative policies and procedures,
- modernization of HR processes and systems,
- systems development and maintenance processes,
- third party vendor management,
- results-based management initiative for capacity development, and
- 9th periodic monitoring report (PMR) of the status of management implementation plans (MIPs) in response to board endorsed Independent Evaluation Office (IEO) recommendations. Arising from the review of the 9th PMR, OIA has also performed an analysis of open management actions and made suggestions on possible approaches for addressing the long-standing actions.

In 2018, the OIA rolled out the Good Practice Series as best practice internal guidance. Three editions were disseminated covering the following:

1. Three lines of defense - a governance framework for risk management;

2. Ransomware - a lucrative criminal enterprise; and

3. The General Data Protection Regulation (GDPR) - strengthening privacy protection.

We commend OIA for the GPSs which are written in very simple, concise and useful language for easy understanding.

The EAC is pleased that the new Director of OIA has taken office. We reviewed and discussed OIA's proposed Programme of work for 2019 and support the ambition of the new Director of OIA. Given the volume of work proposed, the need for additional resources may reasonably arise.

The EAC applauds OIA for continuing to accept requests from various departments for advisory work to help those departments enhance their processes and controls, in addition to performing its audit work. Our meetings with other departments revealed that they welcome OIA's assistance.

In April 2018 the OIA underwent an External Quality Assessment (EQA), which was carried out by the Institute of Internal Auditors (IIA) in accordance with International Standards for the Professional Practice of Internal Auditing. OIA received the highest rating of "generally confirms with the Standards and IIA Code of Ethics". The EQA has pointed out certain gaps and opportunities for continuous improvement. We encourage OIA to work on these and note that OIA has formulated an action plan to remediate these gaps, most of which are scheduled for implementation by end 2019.

Meetings with Other Departments and Groups

HRD: The HRD team informed the EAC that the 1HR project is moving forward based on the outlined approach. This approach in summary is comprised of various phases, namely and in order: business process redesign, software selection and implementation, and benefits reviews. To date the business process redesign phase has been concluded and the project is currently on-going, hence project completion risks remain.

We note the addition of a new resource to the HRD team, whose primary objective is the enhancement of risk management and internal controls within HRD.

ITD: We are pleased that the new Director of ITD has been appointed and has taken office. We were briefed on the major areas of work being carried out by ITD. In our updates from ITD, we were informed that controls have been improved over information security, with increasingly sophisticated (red team exercise) testing being carried out to ensure there is a push for continuing improvement.

HQ1: The HQ1 Task Force informed the EAC that the project is moving forward according to the three-floors-at-a-time approach. This approach, along with continual monitoring of change orders helps to facilitate orderly completion of the project. There is cautious optimism that the project will be completed as planned and within the budget set by the Board. However, there are still challenges of the unknown and therefore project completion risks remain.

ORM: The EAC received a briefing from the ORM. We note that during the year that the Fund Risk Committee (FRC) has been meeting regularly to advance the Fund's ongoing effort to strengthen internal governance and embed its risk framework. We understand that the FRC has approved an initial list of identified "Crown Jewels" of the Fund's data, which would pave the way for ensuring the Fund's most important data assets are protected. This work is ongoing, to modify as needed, the Fund's information security policies and procedures as well as technological controls to achieve this objective.

The EAC considered risk management predominantly from the perspective of financial reporting. We commend ORM, and the Board, for the on-going progress with risk management across the Fund during this year and look forward to continued progress.

The EAC observed that the European Union's GDPR's requirement, becoming effective on May 25, 2018 was mentioned by various departments. In view of the impact of the GDPR, we note that the Fund is considering implications for data privacy.

Meetings with the Executive Directors

During the visits, we met with two groups of EDs. These meetings, conducted on an informal basis, enable us to follow up on issues raised at similar meetings and to learn of other issues of concern to the EDs. In addition to providing the EDs with an overview of the results of our oversight, the main issues discussed were as follows.

1. **IFRS 9: Financial Instruments,** especially its approach to impairment of credit outstanding in 2019 and the disclosures required in the 2018 financial statements. EDs expressed concern over the unique nature of the Fund and whether the results of the application of IFRS 9 would be understood by readers of the financial statements. Other questions arose about the possibility of impairment provisions arising and the process for dealing with these. We addressed these questions and also discussed the importance of preparing well-structured disclosures in 2018 and 2019 to explain the Fund's application of the standard.

2. **HR Strategy:** EDs asked about HR strategy generally and particularly about 1HR, the risks involved and ordering of activity, including the prospective benefits review.

3. **9th Periodic Monitoring Report (PMR):** EDs asked about the outstanding items in place after the 9th PMR, including what should be done to clear those items, in light of them potentially exposing the Fund to risks.

4. **LEG:** A question was asked about the risks associated with the General Counsel retiring and what the process should be for recruitment, including potentially seeking an external candidate. We emphasised the priority ought to be recruiting the right calibre of person, whether they come from inside or outside the Fund.

5. **OIA:** OIA's work programme was mentioned, including the nature of work and resources available to carry out the work.

EAC Recommendations

The EAC recommends two items for follow up.

1. The EAC encourages the Fund and the external auditor to to look as early as possible at the proposed disclosures in the 2019 financial statements in relation to IFRS 9, which will need to explain clearly how the standard has been implemented. FIN should also monitor the possible impact of IFRS 9 arising from events during the 2019 year, particularly any major changes in credit risk, and keep the Board informed of any potentially significant impact.

2. The EAC encourages the Fund to monitor the execution of the 1HR project and the benefits review through to completion. Further, consideration should be given to the sufficient and timely resolution of the root cause issues identified in OIA's June 2, 2017 Advisory Review of the Leave Administration Process report and its April 25, 2017 Advisory report on Identity & Access Management (IAM). As most of those issues extend beyond leave administration the effectiveness of the 1HR solution in remediating the root cause issues should remain a priority of management and the Board. Given the varying timelines for implementation of the three key components (i.e., business process redesign, software selection, benefits review), harmonisation of the Fund's HR remediation plan is vital to ensuring the end result satisfies the Fund's goals of improved service delivery and strengthened internal controls and the over-arching output of Policies and Procedures for HRD.

EAC Recommendations…*cont'd*

The EAC wishes to repeat the four items it recommended for follow up in 2016 and 2017. Although the Fund has made progress on all of them during 2018, they are ongoing and, thus, remain applicable.

i. The EAC encourages the Fund to continue to closely monitor the HQ1 renewal project. Although there is cautious optimism regarding the project, there are still risks of further delays and increased project costs.

ii. The EAC encourages the Fund and the external auditor to monitor developments in the application of the new audit report feature regarding Key Audit Matters (KAM), and consider whether the external auditor should include KAM in its audit report on the Fund's financial statements.

iii. The EAC encourages the Fund to continue to strengthen the internal risk governance framework to ensure active risk ownership, accountability, and improved risk mitigation across all departments, management, and the Board.

iv. The EAC encourages the Fund to monitor the remediation of the recommendations in OIA's Audit of the Fund's Approach to Identity and Access Management through to final dispensation. Although the EAC encourages the Fund to follow up on recommendations in all OIA reports, this is particularly important given that it affects the Fund broadly and is likely to be addressed through the 1HR project and underlying HRD strategy.

Appreciations

We take this opportunity to thank FIN, OIA, PwC, and the other departments and groups mentioned in this report for their help and cooperation in the execution of our mandate. We also thank Managing Director Madame Lagarde, Deputy Managing Directors Furusawa and Grasso, and the Executive Board members for their time and attention.

We look forward to presenting our report to the Board on July 17, 2018.

Respectfully submitted,

Kamlesh Vikamsey, Chair

Kathy David

Kathryn Cearns