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## Financial Oversight of the International Monetary Fund

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This paper reviews the IMF's accountability framework for financial audit and control and risk management,<sup>1</sup> including the Board of Governors, Executive Board, the External Audit Committee, the Office of Internal Audit and Inspection, and the Advisory Committee on Risk Management. In light of the increased complexity of the Fund since its creation, a realistic assessment of the extent to which governors can provide effective financial oversight, and the effective evolution of the Executive Board away from a "management" board to a more supervisory one, the paper finds that the structure of financial oversight established in 1946 provides inadequate shareholder oversight and is no longer adequate. The paper presents options

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<sup>1</sup>For the purposes of this paper, financial audit is defined to encompass responsibility for the integrity of the Fund's financial statements. This responsibility entails, among other things, undertaking an annual review of accounting, financial, and other controls over finance and accounting matters. Financial control refers to internal audit; the responsibility here entails reviewing and evaluating the functions performed by internal audit groups, along with the findings and recommendations of internal audits, and management follow-up. Risk management refers only to operational risk resulting from internal failures or inadequacies.

to strengthen the current framework, including by strengthening the role and capacity of the Executive Board in oversight of financial audit and control.

## **Accountability Framework for Financial Audit and Control and Risk Management of the IMF**

### **Architecture of Financial Oversight**

The Fund's governance framework gives ultimate responsibility and accountability to the Board of Governors, comprised of ministers of finance and central bank governors from all 185 member countries. The Executive Board, whose members are elected or appointed by the members of the Board of Governors, is directly accountable to the Board of Governors. According to the *IMF Articles of Agreement*, "[t]he Executive Board shall be responsible for conducting the business of the Fund, and for this purpose shall exercise all powers delegated to it by the Board of Governors" (Article XII, Section 3(a)).<sup>2</sup> This would seem to give the Board considerable management responsibilities. However, the Articles also state that "[t]he Managing Director shall be chief of the operating staff of the Fund and shall conduct, under the direction of the Executive Board, the ordinary business of the Fund" (Article XII, Section 4(b)). In other words, Management is accountable to the Executive Board for the operations of the Fund and through the Executive Board to the Board of Governors.

The Fund's main organs of financial oversight and control are (1) the Office of Internal Audit and Inspection (OIA), (2) the Finance Department, (3) the Advisory Committee on Risk Management (ACRM), all of which report directly to Management; (4) the independent audit firm that is selected by the Executive Board but reports to the External Audit Committee (EAC); and (5) the EAC, whose members are selected by the Executive Board, but which reports directly to the Board of Governors. Annex 1 provides details on the mandates and responsibilities of these organs.

### **Role and Responsibilities of the Board of Governors**

According to the By-Laws, Rules and Regulations of the IMF (Section 20(f)), "the audit committee [EAC] shall transmit the report issued by the

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<sup>2</sup>The Articles also state that "[a]ll powers . . . not conferred directly on the Board of Governors, the Executive Board, or the Managing Director shall be vested in the Board of Governors (Article XII, Section 2(a)).

audit firm to the Board of Governors for consideration by it.” An early draft of the IMF By-Laws, Section 20 assigned responsibility for the annual audit of the financial statements to the Executive Board. However, at the inaugural meeting of the IMF in 1946, governors agreed that the Executive Board should not be responsible for the annual financial audit, since the Executive Board was a “management board” and would, therefore, be auditing itself. As a result, at the annual meeting in May 1947, Section 20 of the By-Laws was amended to provide for an independent External Audit Committee (EAC). In effect, the Board of Governors withdrew responsibility for the Fund’s financial audit from the Executive Board.<sup>3</sup>

A Report on Audit is prepared by the EAC each year and transmitted through the Executive Board and the Managing Director to the Board of Governors. This report is “considered” along with the Fund’s financial statements by the Joint Procedures Committee (JPC) of the Board of Governors of the Fund and the Bank, composed of 24 Governors selected from among the membership, during the Annual Meetings of the IMF and World Bank. A resolution recommending approval of the Report on Audit, which has been proposed by the Executive Board is then forwarded by the JPC to the Board of Governors for its adoption. The resolution stipulates that the Report on Audit (including the Financial Statements) have fulfilled the requirements of Article XII, Section 7 of the Articles of Agreement<sup>4</sup> and Section 20 of the By-Laws. The JPC typically spends only 10 to 15 minutes per year considering and forwarding resolutions to the Board of Governors on around five separate items.<sup>5</sup> The Board of Governors of the Fund and the Bank, comprising around 185 members, then adopts the resolution with no discussion. This draws into serious question the extent to which the Board of Governors (or any direct representative of the Fund’s shareholders) provides any effective oversight of IMF audit arrangements. The extent of oversight by Governors or member countries is drawn further into question by the results of a recent IEO survey of member country authorities which indicated that a significant minority of member country authorities are actually unaware of current arrangements (see Box 1).

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<sup>3</sup>Interestingly, the Board of Governors of the World Bank made no similar change to the Bank’s By-Laws. Rather, responsibility for oversight of the Bank’s annual financial audit was given to the Executive Board, a practice which continues to the present. Indeed, this is the arrangement in use in most major international financial institutions (see below).

<sup>4</sup>Article XII, Section 7(a) stipulates that “The Fund shall publish an annual report containing an audited statement of its accounts. . . .”

<sup>5</sup>See the “Schedule of Meetings” in Summary Proceedings, various years.

### Box 1. Views of Executive Directors on Financial Management and Fiduciary Oversight

For the purposes of its evaluation of IMF governance, from December 2007 to February 2008, the IEO undertook three separate surveys—of past and present members of the Executive Board, of member country authorities, and of senior IMF staff.<sup>1</sup> A number of the survey questions are of interest from the standpoint of the adequacy of the IMF's system of financial oversight.

The results, which are more fully described in Annex 3, suggest that a majority of members of the Executive Board are not looking for major change in the process through which they exercise financial oversight. However, a significant minority is concerned with the adequacy of Board involvement in financial management oversight and considers the skills of executive directors in this area to be lacking.

The survey of the member country authorities revealed that more than one third of respondents did not know if existing mechanisms for internal financial audit and control were adequate.

<sup>1</sup>For a description of the surveys and presentation of main findings, see IEO, *Governance of the IMF: An Evaluation*, Background Document I.

## Role and Responsibilities of the Executive Board

According to the Fund's Articles “[t]he Fund shall publish an Annual Report containing an audited statement of its accounts....”<sup>6</sup> Responsibility for preparing the Annual Report—which contains the financial statements audited by the independent audit firm—remains with the Executive Board. The IMF's General Counsel has presented the following explanation for the current role of the Executive Board in financial audit:

The legal framework for the external audit of the Fund's accounts established by the Fund's Board of Governors in Section 20 of the By-Laws provides for an *important, but limited role for the Executive Board*. On the one hand, the Executive Board is responsible for the selection of the external audit firm, and members of the External Audit Committee, and also approves the terms of reference of the External Audit Committee. On the other hand, *it is the External Audit Committee—not the Executive Board*—that is responsible for the general oversight of the annual audit. Moreover, the External Audit Committee is required to transmit the report issued by the audit firm to the Board of Governors for its consideration. Although the report is transmitted through the

<sup>6</sup>Article XII, Section 7(a)

Managing Director and the Executive Board, neither the *Managing Director nor the Executive Board may amend or suppress it*. Finally, although the Managing Director and the Executive Board are given the opportunity to comment on the report, it is the Board of Governors that determines whether the annual audit report is acceptable and should be published. [emphasis added]<sup>7</sup>

According to the Fund's General Counsel, because the Executive Board takes "all key policy and operational decisions that affect the financial position of the Fund," it follows that "if the audit committee were to be comprised of—or under the control of—executive directors, the independence of the assessments would be called into question."<sup>8</sup> This assertion was, and still is, the basis for assigning the primary role in the Fund's annual financial audit to the External Audit Committee rather than to the Executive Board.<sup>9</sup> Nevertheless, the Executive Board approves the terms of reference for, and selects the members of, the EAC. It also selects the independent audit firm that audits the Fund's financial statements and, in consultation with the EAC, determines its compensation.

The Board selects the members of the EAC based on the recommendations of an ad hoc Audit Selection Committee (ASC). Despite the Board's long-standing responsibility for selecting members of the EAC, prior to 2004, the majority of ASC members—including the chair (usually the Director of the Finance Department)—were Fund staff. In 2004, in response to the recommendations of a task force comprising executive directors, staff, and management, Management agreed that the ASC would comprise only executive directors, with staff only providing technical and secretarial support.<sup>10</sup> Subsequently the Managing Director, after consulting with the Dean of the Board, invited seven executive directors to be members of the ASC.<sup>11</sup> Members of the ASC review résumés and interview EAC candidates.

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<sup>7</sup>Note by the General Counsel on "The Role of the Executive Board in the External Audit Process—Legal Aspects," February 16, 2006.

<sup>8</sup>Note by the General Counsel on "The Role of the Executive Board in the External Audit Process—Legal Aspects," p. 3.

<sup>9</sup>At the World Bank, the Executive Board approves all lending operations, and for most of its history formally discussed every operation before approval. Despite this active engagement, the ability of the Bank Board's Audit Committee to provide effective oversight has not been drawn into serious question.

<sup>10</sup>"Appointment of Executive Directors to the Audit Selection Committee," EBAP/04/84, July 9, 2004.

<sup>11</sup>There are no explicit criteria or lists of desirable skills and experience for membership in the EAC (or any other Board committee) nor do members receive training to address any skill deficiency. The implications of this lack for the effectiveness of Executive Board committees are discussed in Chelsky (Chapter 7 in this volume).

Other than selecting the members of the EAC and the external audit firm, the Executive Board's role in financial oversight has largely been to be briefed on, and transmit, the report of the External Audit Committee to the Board of Governors.

Over the last four years, the Board has spent very little time with the EAC discussing financial audit and control and risk management matters (Table 1). Prior to 2005, the Board spent less than two hours a year with the EAC. Starting in 2006, however, Management added a second meeting between the Board and EAC each year, in response to pressure from a number of directors who sought greater involvement for the Board in financial oversight. This increased the total time the Board spent meeting with the EAC to between two and three hours a year. In 2007, the Board spent two hours and seventeen minutes meeting with the EAC. This compares with the approximately 40 hours a year that the EAC spends dealing with IMF financial oversight issues.

Not only have the Board's audit briefings been short, but the meetings have been poorly attended by executive directors. At the last seven meetings, never more than one third of executive directors attended. The worst showing was four of 24 executive directors at both the second meeting of 2006 and first meeting of 2007. Alternate executive directors, and more frequently, advisors or senior advisors, have tended to substitute for executive directors. Executive directors representing the six largest shareholders have rarely attended.

Interviews for this paper suggested a number of possible explanations for the poor attendance and apparent lack of interest in financial oversight on the part of executive directors. Foremost is that many directors do not consider financial oversight to be their responsibility; it is the responsibility of the EAC. Other possible explanations include: lack of financial knowledge on the part of many executive directors; faith in the EAC whose members are seen as experts in audit matters; a feeling that meetings with the EAC are a "waste of time" because the information provided by the EAC to directors is inadequate; and finally, a belief among a number of directors that Management does not want them to become involved in financial oversight.

Until quite recently, the Board had little direct involvement in, or oversight of, internal audit. It did not automatically receive reports by the OIA (which is directly accountable only to Management), nor did it receive information on the OIA work program. Further, the Board did not meet with the Director of OIA to discuss issues of concern to the Board. In fact, between 2000 and 2006, only eight reports from the OIA were shared with the Board. This has changed somewhat since 2006, when Management agreed that the Director of OIA would brief the Board annually on OIA activities and emerging issues.

**Table 1. Briefings of Executive Board by External Audit Committee: Duration and Attendance**

Date	Duration (Hr/min)	Executive Directors	Alternate Executive Directors	Temporary Alternate Executive Directors	Major-Shareholder Executive Directors <sup>1</sup>
01/16/04	1/15	8	7	9	1
01/14/05	1/30	8	7	9	1
06/22/05	1/40	7	8	9	2
01/13/06	1/52	8	9	7	3
07/07/06	0/55	4	6	14	2
01/12/07	1/12	4	9	11	2
07/09/07	1/05	6	5	13	1

Source: Minutes of IMF Executive Board meetings.

<sup>1</sup>Executive directors from the six largest shareholders.

The lack of involvement by the Executive Board in financial oversight led some executive directors to express concern that the Fund was not following the practice used in other multilateral financial institutions.<sup>12</sup> They noted that most other international financial institutions have active Board audit committees and argued that the Fund should adopt a similar approach. In response, the EAC in 2006 prepared an extensive review of what constituted “audit committee best global practices.”<sup>13</sup> The Committee noted that “[t]he common theme that can be found in all the legislation that gives guidance on audit committee best practice is the requirement for the independence of its officers.”<sup>14</sup>

The Committee’s opinion echoed the view, expressed in July 2005 in an “issues note” prepared by Fund staff for an informal Board seminar, that “[t]he involvement of the Executive Board in all Fund decisions, financial as well as operational, creates a conflict of interest with the ex-post oversight role of audit committees.”<sup>15</sup> The note went on to state that “any dilution of the EAC’s existing oversight role over audit matters

<sup>12</sup>Such views were frequently expressed during the annual briefings of the Board by the EAC. See Annex 2 for a description of some of these arrangements.

<sup>13</sup>“External Audit Committee (EAC)—Communication from the EAC on Audit Committee Best Practices,” February 16, 2006.

<sup>14</sup>“Memorandum of External Audit Committee Arrangements,” February 13, 2006, p. 1.

<sup>15</sup>“The Fund’s Audit Arrangements—Issues Note,” SM/05/290, p. 5. Regrettably, staff did not propose the publication of this note. This is disappointing from the standpoint

would be considered a step backwards in terms of evolving audit best practices.”<sup>16</sup> The view of Fund staff was (and according to interviews conducted for this paper, still is) that executive directors “exercise their duty of due diligence by selecting the members of the EAC and selecting the Fund’s independent audit firm. The EAC, in turn, provides executive directors with its independent assessment of the adequacy of the Fund’s audit process which directors require for an informed judgment.”<sup>17</sup> When asked during interviews for this paper to comment on the appropriateness of a Board Audit Committee overseeing financial audit and control at the World Bank, Fund staff argued that the World Bank is different from the Fund and therefore warrants a different oversight model. However, prior to the 1990s, every single Bank lending operation was discussed by the Executive Board, which suggests that—at least in terms of independence—the Fund and Bank Boards are not so different.<sup>18</sup> That there has been no serious challenge to the appropriateness of the World Bank Board providing oversight through a Board Audit Committee suggests that the concerns of IMF staff with Board independence is probably overstated.

The Secretary’s Department arranged to have the July 2005 “issues note” discussed in an informal Board seminar, rather than a formal Board meeting, in September 2005.<sup>19</sup> The use of this informal setting to discuss an important internal governance issue like the audit framework was unfortunate, because it meant that executive directors could not formally record their views on the adequacy of the financial oversight of the Fund nor were any summary or concluding remarks prepared by the chairman at the end of the seminar to transparently summarize the “sense of the meeting.”<sup>20</sup>

Despite the lack of a formal record from the September 2005 Board seminar discussion, Fund Management concluded, in December 2005,

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of transparency and accountability, given that the note clearly articulates the prevailing framework for fiduciary oversight of the IMF and does not contain any confidential or classified information.

<sup>16</sup>SM/05/290, p. 6.

<sup>17</sup>SM/05/290, p. 7.

<sup>18</sup>Even today, all loans are approved by the Executive Board, although a number are processed under “streamlined procedures,” which means that the Board does not discuss them unless an Executive Director so requests.

<sup>19</sup>In 2004, another staff paper on the Fund’s external audit arrangements was also scheduled for discussion by the Board at an “informal seminar,” but that seminar was never held.

<sup>20</sup>While transcripts of informal seminars might be produced, these are generally destroyed after one to two years. Individual departments may produce internal memoranda to files describing their views on the outcome of a meeting, but these memoranda are not available to the executive directors or member country authorities and are not a formal record.

that “executive directors [during the September 2005 discussion] generally recognize[d] that the Fund’s audit oversight function should remain independent from management and the Executive Board.”<sup>21</sup> However, interviews undertaken in late 2007 and early 2008 for this paper revealed that a number of executive directors did not agree that the extent of their involvement in the “day to-day” operations of the Fund prevented them from providing independent financial oversight.

When it comes to audit matters, the view of Fund management has been that the Executive Board should adopt the best practice emerging for public companies (even though the IMF is not a public company and has few, if any, characteristics of a public company). The Board, for its part, remains divided on the best way forward, with a significant minority continuing to favor the establishment of a Board standing committee on audit, similar to that used in other major multilateral financial institutions. (See Annex 2 for a comparison of financial oversight arrangements in major multilateral financial institutions.)

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

The External Audit Committee (EAC) is composed of three experts “selected” by the Executive Board on the recommendation of an ad hoc committee of executive directors (ASC), and appointed by the Managing Director for staggered, renewable terms of three years. EAC members must be nationals of different member countries and one member must be from one of the largest six shareholders.<sup>22</sup>

Changes introduced as a result of the Board’s 1999 review broadened the purview of the Committee to include internal audit and risk management. The amended terms of reference expanded the responsibilities of the EAC to include: (1) risk management within the IMF and the system of internal controls, including the environment in which the system operates; (2) approval of the charter of the Office of Internal Audit; and (3) review of the OIA’s plans, the results and quality of its audits, and its adherence to standards of internal auditing.<sup>23</sup> The new terms of reference

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<sup>21</sup>“Memorandum from the Managing Director to Members of the Executive Board on Control- and Audit-Related Matters—Information Sharing with the Executive Board.” December 16, 2005, p. 1.

<sup>22</sup>See Section 20 of the By-Laws, Rules and Regulations of the International Monetary Fund, Sixtieth Issue, May 2006.

<sup>23</sup>“External Audit Committee Terms of Reference,” Sections 2.6–2.8, EBS/99/137, July 23, 1999.

also transferred the responsibility for signing the audit opinion to the independent audit firm from the EAC, which had been responsible up until then. This made it possible for the EAC to “act more like a typical board audit committee in other large institutions.”<sup>24</sup> There have been no reviews by the Board of the terms of reference for the EAC since 1999.

In 2004, given the increased scope and complexity of the EAC’s work relative to its earlier mandate, Fund Management recommended an increase in the number of EAC members to four and an increase in their term of service to four years.<sup>25</sup> But a Board discussion of the staff paper containing this proposal was never scheduled and the recommendation was therefore not approved. Subsequently, responding to an IEO questionnaire on audit arrangements in October 2007, the Chairman of the EAC argued that “. . . given the limited contact the EAC members have with the Fund and the need to build up a good level of expertise and understanding of the Fund, to get the most value from an EAC member’s contribution, a better alternative (to increasing committee size) would be to reappoint members for a second period of three years.” They also agreed that a single three-year term was too short and weakened continuity and EAC capacity, and recommended that the term be increased to five or six years.

Until 2006, the EAC was required to meet with the Executive Board only once a year. In 2006, as noted above (and further below), the frequency was raised to twice yearly.

Fund staff attempt to keep the EAC up-to-date on issues during the year through video conferencing, supported by timely briefing material on issues, problems, and developments in the Fund. Members of the EAC have expressed the view that the staff have provided them with informative briefings on the issues and problems in the Fund. According to IMF staff, the twice-yearly meetings of the EAC with Fund staff in Washington amount to about 40 hours, which is roughly equal to the practice at those publicly-traded companies that have the highest frequency and duration of audit committee meetings.<sup>26</sup>

### **Role and Responsibilities of the Advisory Committee on Risk Management**

The main types of risks faced in the Fund’s business are outlined in Box 2. In its June 2004 report, the EAC concluded that:

<sup>24</sup>“Review of the Fund’s External Audit Function,” EBS/99/23, May 1, 1999. Attachment, p. 2.

<sup>25</sup>EBS/04/71.

<sup>26</sup>EBS/04/71, p. 13.

### Box 2. Definitions of Key Risks

The 2005 IMF Task Force on Risk Management identified four types of risk that an institution like the IMF might face:

- Strategic risks are those that arise in the definition and implementation of the Fund's medium- and long-term objectives.
- Core mission risks are those adverse events that may prevent the Fund from realizing its core mission objectives, including contributing to macroeconomic and financial stability, promoting international macroeconomic cooperation, and providing capacity-building services.
- Financial risks are those that impact the Fund's financial position. As a financial institution, the Fund faces the traditional types of financial risks (interest rate risk, exchange rate risk, liquidity risk, income risk, and credit risk).
- Operational risks are those that arise in the day-to-day conduct of business and materialize because of external events or weaknesses in processes, people, or systems that underpin the delivery of an organization's outputs.

Source: "Report of the Task Force on Risk Management," EBS/06/4, January 9, 2006.

Sophisticated financial institutions globally are embracing a self-assessment of risk identification and risk management processes on an enterprise-wide basis. We recommend that the IMF consider such an assessment to determine what sort of framework can make its existing processes best coordinated and most effective and improve further knowledge and monitoring of risks faced by the Fund.<sup>27</sup>

In response, the Managing Director established a Task Force on Risk Management in June 2005. The report of the Task Force was submitted to the Executive Board for discussion in February 2006.<sup>28</sup> It recommended that "[a]n Advisory Committee on Risk Management [ACRM] should be established to assist Fund Management in analyzing and synthesizing operational risks, formulating mitigation measures, as needed, and reporting to the Board" and noted that the ACRM would prepare "a brief summary that would facilitate conduct by the Executive Board of its due diligence

<sup>27</sup>"Report of the External Audit Committee to the Executive Board," EBAP/04/71, June 16, 2004.

<sup>28</sup>"Report of the Task Force on Risk Management," EBS/06/4, January 9, 2006. The Task Force proposed a risk framework made up of four main risk elements: strategic risks, core mission risk, financial risk, and operational risk. As noted above, the present review is concerned with operational risks only, including reputation risk, resulting from internal failures or inadequacies or from external events.

function.”<sup>29</sup> A footnote stated that the report would be given to the Board during an informal meeting on control-related matters.

Discussing this report, the Executive Board expressed strong support for the work of the new Task Force and the need to put in place a more effective system to manage risk. Directors also raised questions “regarding the effectiveness, organization, scope, and lines of reporting for the Advisory Committee on Risk Management that was proposed by the Task Force.” In particular, they expressed strong agreement “that the Board should be appropriately involved in the process of risk management . . .” and noted a need “to further discuss how this can be done in the most efficient way, including as one possible option, through establishment of a Board committee.”<sup>30</sup>

A few months later, in June 2006, the Task Force on Risk Management presented a second report to the Board that focused on “specific modalities of implementation, the scope of risk management, and the governance structure supporting the framework.”<sup>31</sup> That report concluded (page 5) that the “role of the Board would be to ensure that the Fund has in place an adequate risk management framework and to review annually management’s assessments and proposals,” and that although the exact nature of Board involvement would have to be discussed by the Board, based on management’s recommendations, it would be important to consider “fully how best to exploit the synergies with the External Audit Committee,” to which the Board had given responsibility for risk management. The ACRM was required to report to Management on the outcome of annual risk assessments. Management’s responsibility would be to provide reasonable assurance to the Board that risks were being adequately monitored and mitigated.<sup>32</sup>

However, directors were not prepared to accept the same limited role for risk management that the Board had been assigned for financial audit, and in December 2006 they called “for an enhanced role of the Board in the risk management process, including with respect to timing, frequency, and process of interactions among the ACRM, management, and the Board.”<sup>33</sup>

In response to this demand for greater involvement in monitoring risk management, the staff provided the Board with three options: to meet in formal session to discuss the first annual risk assessment; to meet informally

<sup>29</sup>“Report of the Task Force on Risk Management,” p. 22.

<sup>30</sup>“The Acting Chair’s Summing Up: Report of the Task Force on Risk Management,” Executive Board Meeting 06/9, February 1, 2006. BUFF/06/24, February 6, 2006.

<sup>31</sup>“Second Report of the Task Force on Risk Management—Task Force Proposals on the Implementation of a Risk Management Framework at the Fund,” EBS/06/74, June 2, 2006.

<sup>32</sup>This would include systemic risks, core risks, financial risks, and operational risks.

<sup>33</sup>“Risk Management—Further Considerations,” SM/06/386, December 4, 2006.

to discuss the first annual assessment, and then decide to have a formal meeting if necessary; or to establish a Board Committee on risk management, to be chaired by management, along the lines of the Budget Committee.

A decision has not yet been made on any greater involvement of the Board in risk management. Most recently, in January 2008, a Working Group of Executive Directors on Executive Board Committees decided, with respect to establishing a risk management committee, to “await report on our experience with the existing risk management framework, and the report of the IEO on Fund Governance.”<sup>34</sup>

### **Recent Measures to Enhance the Role of the Executive Board in Financial Audit and Control**

In December 2005, Fund Management responded to the concerns of those executive directors who had “expressed a need for additional information on a regular basis for their due diligence responsibilities, such as status reports on OIA’s work.”<sup>35</sup> At that time, as noted above, the EAC was meeting with the Board only once a year. Its reports to the Board often contained little information and on many occasions they were not distributed to the Board before the meeting. In the case of internal audit, the OIA was not required to (nor did it, routinely) brief the Board on its activities. It reported only to the EAC, which then included a brief summary of OIA activities in its report to the Board.

Management proposed that the EAC would brief the Board twice a year (in January and June) at meetings in which members of the EAC and the external audit firm would respond to Board members’ questions. The Board would receive audited financial statements, audit reports, and a briefing by the EAC on the conduct of the audit by the external audit firm. Also, if the external audit firm issued management letters on the audit, these would be provided to the Executive Board. The EAC “would endeavor” to circulate its statement on the year-end audit in advance of the June meeting.<sup>36</sup> At its twice-a-year briefings by the EAC, the Board would also receive a report on internal audit activity, which would include, among other things, information on the implementation of the OIA work program. As well, the internal

<sup>34</sup>“Structure and Mandates of Executive Board Committees,” EBD/08/10, January 24, 2008.

<sup>35</sup>“Memorandum from the Managing Director to Members of the Executive Board on Control- and Audit-Related Matters—Information Sharing with the Executive Board,” December 16, 2005, p. 1.

<sup>36</sup>It is not clear why this change needed to be initiated by Management. Considerations of independence that led to limits on the Board’s role in external audit oversight apply equally (if not more so) to Management. The Board should therefore be able to determine the frequency with which it receives briefings from the EAC.

audit plan for the current year would be circulated for information. The report would include the main findings and issues emerging from OIA projects and the responses planned by affected departments. The Board would also be briefed on emerging topics of interest.

At the time these proposals were made, the Legal Department cautioned that increases in the flow of information from the EAC to the Board would be consistent with the existing legal framework “[p]rovided that this enhanced flow of information is not designed to give the Executive Board an oversight role in the annual external audit of the Fund’s accounts.”<sup>37</sup>

The EAC itself recognized the need to improve its relationship with the Board. And in a recent letter to members of the Executive Board proposing a meeting in January 2008, the EAC observed that:

As the members of the EAC are not ourselves Board members, we have very limited opportunity to be as well informed as it should be about the concerns of the Executive Board members with respect to the matters covered by our terms of reference. In order to reduce to some extent this disadvantage, it is proposed that the EAC meet informally with Executive Board members. . . . We believe that the EAC would be more productive and effective by having these informal meetings.<sup>38</sup>

Consequently, prior to the January 2008 meeting of the EAC with the Executive Board, members of the EAC met informally with three separate groups of executive directors to discuss the directors’ issues and concerns.

## Is the Current Framework Adequate?

Despite recent enhancements, the Executive Board of the IMF exercises minimal oversight of Management on issues related to financial audit and control and risk management. This has been the case since 1947, when the Board of Governors assigned responsibility for financial audit to an independent External Audit Committee which reports to the Board of Governors through the Executive Board. The role of the EAC was broadened in 1999 to give it a mandate over internal audit and risk management.

Several factors have reinforced the marginalization of the Executive Board. First, Management and the EAC have argued that the Fund should follow the best practice of public corporations with regard to audit committees. This

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<sup>37</sup>“Role of the Executive Board in the External Audit Process—Legal Aspects,” FO/015/06/15, p. 5.

<sup>38</sup>Letter to Members of the Executive Board from the EAC, October 26, 2007.

requires that audit committee members be independent of operations in order to avoid conflicts of interest. By this criterion, it was argued that executive directors in the Fund could not be considered fully independent, since the Board acted as a management committee in approving all Fund decisions. Management and senior staff have taken the view that the current system allows the Board to meet its fiduciary responsibility for financial oversight.

Second, there has been, and continues to be, an unfortunate tendency on the part of staff and Management to downplay executive directors' concerns about the adequacy of the financial oversight framework. This can be seen in the results of the recent IEO survey of senior Fund staff, which showed that one quarter of respondents with knowledge of the oversight framework considered that the Executive Board was excessively involved in financial management and other fiduciary oversight (Annex 3). This may explain why discussion of the oversight framework has taken place largely in informal board seminars that do not entail formal minute keeping.<sup>39</sup>

Third, for the majority of executive directors, financial oversight has not been, and is still not, a priority. The recent IEO survey of the Executive Board referred to above indicated that the majority of respondents were satisfied with the extent of their involvement (Box 1). At the same time, a significant minority of executive directors have argued that internal control mechanisms need to be strengthened. An exception to the general lack of interest displayed by the majority of board members is with respect to oversight over Management, where almost all respondents indicated that the Executive Board should exercise greater oversight. That this has not been achieved to any measurable degree may be related to another finding of the IEO survey—that many Executive Board members (67 percent of those from low-income countries and 48 from middle-income countries) fear negative repercussions if they criticize the views of IMF Management.

The justification for the current arrangement whereby the Board has no direct role in financial oversight has, from the outset, been based on the presumption that the Board functions as a “management board” and is therefore not sufficiently independent to carry out credible financial oversight. It was for this reason that the decision was taken to have the EAC report to

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<sup>39</sup>According to the Secretary's Department, “informal seminars are designed for a discussion of a subject at a preparatory stage. Possible motivations for scheduling an informal seminar may include the staff's desire to brief Executive Directors informally on the development of a policy direction or analytical framework at an early stage, and/or to provide an opportunity for Executive Directors to give preliminary and informal views, input, or guidance on possible alternative approaches to an issue under consideration.” Several Directors have expressed the view that the informal seminar framework was not appropriate for Board discussions of the adequacy of the framework for financial oversight.

the Board of Governors. But today's Executive Board acts significantly more like a supervisory board than did the Board in the early days of the Fund. Back then, executive directors were much more closely engaged in daily operations of the Fund, even to the extent of leading Fund missions. This is no longer the case and, while the Board still takes all "decisions" on every instance of the use of Fund resources by member countries as well as on the completion of all Article IV consultations, it has increasingly taken on "supervisory" functions.<sup>40</sup> Further, the issue of Board independence has not arisen as a problem in any of the other multilateral financial institutions.

Concerns with the Board's ability to undertake fully independent oversight need to be weighed against the inadequacy of the existing arrangement. While the Board of Governors is technically responsible for oversight, in practice it spends, and will continue to spend, virtually no time on this function. In fact, there is survey evidence that many Governors are unaware of their responsibilities in this area. It is probably not realistic to expect ministers and central bank governors to be as engaged on IMF issues as they were when the Fund was first created. As such, a significant gap has opened up in the Fund's accountability framework that needs to be addressed.

How can the gap be addressed in a credible and cost-effective manner? As the comparator analysis in Annex 2 shows, the big-five multilateral development banks (MDBs) all have audit committees composed of executive directors and chaired by an executive director, thus giving executive directors in those institutions greater responsibility and significantly more active roles in financial oversight, including for internal audit and operational risk management, than is the case with their IMF counterparts. Of course, there are differences between the IMF and the MDBs, but there are also many similarities, including with respect to the independence of the respective boards.

The fact that no major financial problems have come to light is obviously not an adequate defense of the status quo in which shareholders provide little or no oversight of financial audit and control. One has to be concerned about the ability of the EAC to fully appreciate the financial problems of the Fund on the basis of only twice-yearly meetings in Washington. Further, in the view of both EAC members and Fund staff, the size of the EAC is too small, and the term of its members is too short, to maintain continuity and consistency.

Recent efforts to improve the flow of information to the Executive Board from the EAC and to provide an annual briefing to the Board by the OIA are important steps in the right direction. But more should be done.

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<sup>40</sup>See IEO, *Governance of the IMF: An Evaluation*, May 2008.

## Concluding Remarks

The structure of financial oversight established in 1946 is no longer adequate given the increased complexity of the Fund and a realistic assessment of the extent to which Governors can provide effective financial oversight.

Regardless of the audit model chosen, an improvement in financial oversight, and greater accountability to the membership, will not be achieved without changes in the attitudes and practices of the Executive Board and Management. Executive Board members must become more knowledgeable of the issues involved and more active in fulfilling their fiduciary duties. For its part, Management and staff must become more transparent and open towards the Board and supportive of legitimate claims of executive directors to protect the interests of the members that elected or appointed them.

Within the existing audit model, the efforts that have been made to improve the amount, frequency, and quality of information provided to the Board are much-needed steps in the right direction. But more needs to be done to bring the Fund up to the level of oversight it needs and that is practiced at other major international financial institutions.

In particular, consideration should be given to establishing a Board audit committee that would be chaired by an executive director (not management) and have responsibility for financial audit and control and risk management.<sup>41</sup> Should this approach be taken, it would be beneficial to maintain the EAC, if not as full members of a Board audit committee (which is permissible within the Fund's legal framework<sup>42</sup>), then at least in an advisory capacity to such a committee.

## Annex 1. The Main IMF Bodies with Audit Responsibilities

### External Audit Committee

#### 1. Purpose

The EAC has general oversight responsibilities for the external audit function within the IMF. The EAC shall review the financial statements

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<sup>41</sup>See Chelsky (Chapter 7 in this volume) for shortcomings in the operation of other IMF Board committees. Also, in the recent IEO survey of current and former members of the Executive Board, only one quarter of respondents considered Board committees to be effective. Almost two thirds answered that, in order to be effective, committees would "require significant change in their structure and operations."

<sup>42</sup>Article XII, Section 2(j) of the IMF's Articles of Agreement states that "Membership of committees need not be limited to Governors or Executive Directors or their Alternates."

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

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.

2.3 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.

2.6 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.

2.9 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.

## Office of Internal Audit and Inspection<sup>43</sup>

The mission of the Office of Internal Audit and Inspection (OIA) is to:

2.01 provide independent and objective examinations and reviews of the effectiveness of the risk management, control, and governance processes of the Fund, and present analyses and advice to Fund management and staff for improvement, guided by professional standards;

2.02 provide advisory services for business processes and work practices to help ensure that they are structured and conducted in a manner that enables the Fund to fulfill its objectives effectively and efficiently;

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<sup>43</sup>Terms of Reference provided in IMF General Administrative Order No. 14, Rev. 4, November 6, 2006. In addition, OIA also functions as the Secretariat for the Advisory Committee on Risk Management (ACRM).

2.03 conduct, or assist in conducting, internal investigations requested by the Managing Director;<sup>44</sup>

2.04 assist the external audit process and support the activities of the External Audit Committee.

4.01 The Office of Internal Audit and Inspection is authorized to conduct financial, operational, and systems audits; carry out organizational reviews; support the External Audit process; and perform internal investigations at the request of the Managing Director.

### **IMF Ad Hoc Audit Selection Committee<sup>45</sup>**

To assist the Executive Board in the selection process, an Audit Selection Committee (ASC), consisting of executive directors and senior staff, is appointed to identify suitable candidates for the EAC and for evaluating proposals from external audit firms bidding for the IMF's external audit contract. Following the evaluation process, the Committee submits its recommendations to the Executive Board. The Executive Board selects the external audit firm and the three members of the EAC, prior to their appointment by the Managing Director. The external audit firm is to be selected in consultation with the EAC.

### **Advisory Committee on Risk Management<sup>46</sup>**

The initial terms of reference proposed for the Advisory Committee on Risk Management (ACRM) by the Task Force on Risk Management included identification of the key categories of the risks, evaluation of the applicability of the experience of other institutions, and for recommendations for possible modalities to carry out risk management.

Subsequently, the Task Force proposed that the Advisory Committee on Risk Management could be the mechanism to address an in-depth examination of financial risks, and it was noted that this assessment already takes place as part of the annual financial reporting process that requires the Fund to assess and report financial risks as disclosures in the notes to the annual financial statements.

The Task Force's recommendations included that all departments undertake an annual assessment of, and report to the ACRM and

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<sup>44</sup>Or a Deputy Managing Director, when delegated by the Managing Director. This authority applies to references to the Managing Director throughout this document.

<sup>45</sup>EBAP/99/102, Sup. 1, August 27, 1999.

<sup>46</sup>EBS/06/4, March 17, 2006; EBS/06/74, June 2, 2006.

management on, their residual operational and, where relevant, core mission risks; and that the ACRM, assisted by the OIA secretariat, present for Management consideration an Annual Risk Assessment report, including an assessment of key strategic, core mission, financial, and operational risks and proposed mitigation measures. Based on this Annual Risk Assessment report, Management should provide its assessment and propose mitigation measures for the Board's discussion and review.

### **Joint Procedures Committee of the Board of Governors of the Bank and the Fund (JPC)<sup>47</sup>**

. . . The Committee was established as a useful instrument available to the Chairman of the Boards of Governors in handling any problems or issues that may arise prior to and during the Annual Meetings. Members of the JPC serve for one year beginning at the close of one Annual Meetings to the close of the following Annual Meetings. . . .

The Committee is currently composed of 23 members. . . . An effort is made to ensure that members represented in the JPC command at least 50 percent of the voting power in the Bank and in the Fund.

. . . The Committee normally meets once during the Annual Meetings to deal with the items of business to be reported to the Boards of Governors. It may meet more often if additional matters arise on which the Chairman wishes to consult it. The Chairman can convene the JPC at any time to make recommendations on any subject relevant to the organizations. . . .

## **Annex 2. Financial Oversight in Major Multilateral Financial Institutions**

There is broad similarity in the responsibilities of the audit committees in all the seven major multilateral financial institutions (see Table 2). All the audit committees are responsible for the integrity of their institutions' financial statements. This requires among other things an annual review of the accounting, financial, and other internal controls that have been established regarding finance and accounting matters, including the resolution of any identified material weaknesses.

In all seven institutions, the independent auditor reports to the audit committee, which is responsible for ensuring the auditor's independence,

<sup>47</sup>FO/Dis/04/112, September 16, 2004; FO/Dis/07/131, October 12, 2007.

Table 2. Audit Committees in Major International Financial Institutions

	IMF	WB	EBRD	AsDB	AfDB	IADB	EIB
Committee of Board members	No	Yes	Yes	Yes	Yes	Yes	No
Appointed by Board	Yes	Yes	Yes	No	Yes	Yes	No
Report to Board	No	Yes	Yes	Yes	Yes	Yes	No
Size of committee	3	8	Min. 6	6	6	8	6
Term (years)	3	2	1	2	n/a	2	3
Frequency of meetings (2006)	2 times	weekly	16 times	12 times	12 times	N/A	At least 10 days
Responsible for:							
• Integrity of financial statements	Yes	Yes	Yes	Yes	Yes	Yes	Yes
• External auditor	Yes	Yes	Yes	Yes	Yes	Yes	Yes
• Internal audit	Yes	Yes	Yes	Yes	Yes	Yes	Yes
• Risk management	Yes	Yes	Yes	Yes	Yes	Yes	Yes
• Evaluation	No	No	Yes	No	No	No	No
• Fraud and corruption	No	Yes	Yes	Yes	No	Yes	Yes

Note: EBRD: European Bank for Reconstruction and Development; AsDB: Asian Development Bank; AfDB: African Development Bank; IADB: Inter-American Development Bank; EIB: European Investment Bank; and WB: World Bank.

qualifications, and performance. With respect to the appointment of independent auditors, the audit committees all play a key advisory role to their executive boards. In the IMF, the Executive Board in consultation with the External Audit Committee is responsible for selecting and compensating the independent auditor. In the EBRD, the President recommends the appointment and compensation of the independent auditor, but the Audit Committee can make recommendations to the Board before a decision is made. In the World Bank, the Audit Committee recommends to the Board the appointment, compensation, and removal of the independent auditor. A similar approach is followed at the AsDB and AfDB. In the EIB, the Audit Committee designates the independent auditor after consultation with the management committee.

The responsibilities of the audit committees are also quite similar with respect to internal audit. They include reviewing and evaluating the functions performed by the internal audit groups, including findings, recommendations, and management follow-up. There is, however, a significant difference in the roles played by audit committees in the appointment and dismissal of the head of internal audit. In the IMF, these functions rest entirely with management, whereas in the other institutions the audit committees play an advisory and consultative role in both functions.

In all seven institutions, though in some more than others, audit committees have an oversight role with respect to risk management. The External Audit Committee in the IMF seems to exercise relatively less oversight, but this may reflect the fact that, unlike the other institutions, the Fund does not have a treasury function.

The EBRD is the only one of these institutions in which the evaluation function reports directly to the audit committee. The other institutions have all assigned an independent role to evaluation, though they follow different processes for the evaluation function. For detecting fraud and corruption, only the External Audit Committee in the IMF has no responsibility.

The process for selecting audit committee members varies slightly among the institutions. In the IMF, the Executive Board selects the External Audit Committee members, who are then appointed by the Managing Director. In the EBRD, the WB, and the IADB, the committee members, and committee chairs and vice chairs, are elected by the executive boards. In the AsDB, the President appoints the audit committee, after consultation with the Executive Board. In the EIB, the Board of Governors appoints the audit committee.

Financial and accounting knowledge is a requirement for audit committee members to varying degrees. The IMF requires that all its EAC members meet rigorous professional standards, while the EBRD has no such requirements at all. In the WB Audit Committee, members are required

to have a working knowledge of finance and accounting practices, whereas in the AsDB's committee, only one member must have a background in financial and accounting practices. All the committees have the option of hiring independent expert advice if necessary.

The IMF is the only institution in which audit committee members are not members of the Executive Board, out of concern that Directors may be involved in financial decisions as is the case in most executive boards.

The other institutions have not ignored the issue of the independence of audit committee members. For example, the terms of reference of the World Bank's Audit Committee address this issue by requiring that "Audit Committee members . . . shall be free from any relationship that, in the opinion of the Board would, interfere with the exercise of their independent judgment as a member of the Audit Committee." A similar approach has been adopted by the ASDB, where the terms of reference state that "The Committee members shall inform the President of any circumstances which reasonably may be perceived to interfere with the exercise of their independent judgment as members of the Committee." The terms of reference for the EBRD Audit Committee do not contain such a requirement. The institutions other than the IMF appear to accept that executive directors will respect, and strictly adhere to, the codes of conduct of their institutions. There is no evidence that they have not done so or that the reputations of these institutions have suffered.

Except at the IMF and EIB, the full executive boards must approve all recommendations of their audit committees. In the IMF, other than in the appointment of the EAC and the independent audit firm, Executive Board approval is not required.

### **Annex 3. Views of the Board, Member Country Authorities, and Senior IMF Staff on Financial Management and Fiduciary Oversight**

Between December 2007 and February 2008, IEO undertook three separate surveys of IMF member country authorities, current and former members of the IMF Executive Board, and senior IMF staff as part of its evaluation of IMF governance. A number of the survey questions addressed issues of financial oversight and provide important insights into the adequacy of current arrangements. The response rates for the surveys of member country authorities, members of the Executive Board,

and senior staff were 50, 54, and 44 percent, respectively, with at least one response received from 64 percent of IMF member countries.

### **Board Involvement in Financial Management Oversight**

Just over half of authorities do not consider competence with financial management oversight to be an essential qualification for executive directors.

- Forty-three percent of the respondents from among member country authorities considered facility in financial management oversight to be “essential” for an IMF executive director. Fifty-three percent considered such facility “useful, but not essential.”

Board members are split on the adequacy of their involvement with financial management oversight.

- Thirty-seven percent of the Board member respondents considered the Board to be “insufficiently involved” in financial management and other fiduciary oversight; however, 51 percent considered the Board’s involvement to be “adequate.” In contrast, 81 percent of staff respondents with knowledge of the Board’s involvement in this area considered the Board to be either “adequately” or “excessively” involved.

A significant minority of Board members and a majority of staff consider Board skills and experience with financial management oversight to be “weak.”

- Just over one half of Board member respondents considered their skills and experience in this area to be “adequate.” Thirty-seven percent described them as “weak.” In contrast, only 32 percent of the senior IMF staff respondents considered Board skills and experience in this area to be adequate; 51 percent described them as “weak.”

A majority of Board respondents considered the Board to add positive, albeit modest, value in the area of financial management oversight.

- Seventy-three percent of the Executive Board respondents and 45 percent of senior staff respondents considered that the Board has “positive” value added in financial management and other fiduciary oversight. However, around three quarters of each set of respondents considered that value added to be “modest.” One quarter of the Board respondents and 35 percent of the senior staff respondents saw no, or negative, value added from the Board in this area.

## Accountability Mechanisms

Only a minority of Board and authorities consider existing system of oversight of financial audit, control, and risk management and internal financial audit and control to be adequate.

- Only 48 percent of Board respondents and 32 percent of the member country authority respondents considered existing arrangements and practices for internal financial audit and control to be adequate to ensure the IMF's fiduciary health. Fifty-five percent of the Board respondents and 39 percent of the member country authority respondents believed that the Board should exercise greater oversight of financial audit, control and risk management. One-third of the respondents from member country authorities did not know if current arrangements and practices were adequate.
- Forty-four percent of the Board and 35 percent of the member country authority respondents believed that mechanisms were either non-existent or needed to be strengthened. Just over one-third of the respondents from member country authorities did not know if current mechanisms were adequate.

A majority of low- and middle-income countries fear repercussions from criticizing the views of IMF staff or management.

- Around one-third of respondents from the Board and member country authorities were concerned with the repercussions of criticizing the views of staff or management on at least some issues. Concern was greatest among authorities from low-income countries (56 percent), recent borrowers (47 percent), and countries in the Asia-Pacific and Central Asian region (53 percent).

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