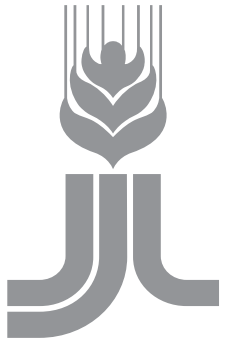


IFAD

Guidelines on

Project Audits

(for Borrowers' Use)



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▶ **Audit Committee – Eighty-Second Meeting**

Rome, 8 September 2003

Guidelines on Project Audits (for Borrowers' Use)

Approved by the Executive Board on 9 April 2003

Revised on 31 July 2003

Approved by the President of IFAD on 31 July 2003

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Abbreviations and Acronyms

CI	Cooperating Institution
FC/L	Office of the Controller, Loans and Grants Unit
IAS	International Accounting Standards
MDB	Multilateral Development Bank
PFS	Project Financial Statement
PCU	Project Coordination Unit
SA	Special Account
SAI	Supreme Audit Institution
SOE	Statements of Expenditure
TOR	Terms of Reference

Foreword

The *IFAD Guidelines on Project Audits*, approved by the Executive Board at its Seventy-Eighth Session in April 2003, outline IFAD's policy and procedures relating to annual audits of IFAD-funded projects. A large number of IFAD projects involve cofinancing with cooperating institutions (CIs), some of which have published guidelines. Where a CI has established guidelines and assumes the lead in project administration under a cooperation agreement, the CI's guidelines will be followed. The IFAD Guidelines should be followed for projects administered by CIs that do not have their own audit guidelines, and for all projects directly supervised by IFAD.

In accordance with Article 7, Section 1 (c) of the *Agreement Establishing IFAD*, and Article IX (Financial Reporting and Information), Section 9.03 (a) (Audit of Accounts) of the *General Conditions for Agricultural Development Financing*, it is essential to ensure that proceeds of any financing are used solely for the purpose intended under the loan or grant, and that all projects are audited and certified regularly.

In line with these directives, and as part of IFAD management's continuing effort to improve the quality of IFAD's portfolio, greater emphasis has been placed on the timely submission of annual project audit reports by borrowers and their effective monitoring and review by CIs and IFAD staff. These requirements have also assumed greater importance due to the increased focus by multilateral development banks (MDBs) and the global development community on good governance, transparency and reduction of corruption, particularly in donor-funded development projects.

As a partner organization in the MDB's initiative on Harmonization of Operational Policies, Procedures and Practices, IFAD places great emphasis on the need to collaborate more closely with its CIs as regards financial reporting and auditing. Hence, implementation of these Guidelines will not only enhance audit submissions and reviews, but also bring about more consistent project auditing and reporting, conforming with commonly accepted MDB and international standards.

The term 'borrower' refers to both loan beneficiaries and grant recipients covered by the *General Conditions for Agricultural Development Financing*. Similarly, the term 'loan' refers to both loans and grants. The term 'project' includes programmes.

During preparation of these Guidelines, the views of IFAD staff, borrowers and CI representatives were sought and their comments incorporated to the extent possible.

Lennart Båge
President

I. Introduction

1. Article 7, Section 1 (c) of the *Agreement Establishing IFAD* requires the Fund to ensure that the proceeds of any financing are used only for the purpose for which a loan or grant was provided, with due attention to economy, efficiency and social equity. IFAD's *General Conditions for Agricultural Development Financing*¹ require the borrower (or project party) to have the accounts relating to a project audited each fiscal year, including the statements of expenditure (SOE) and special account (SA), in accordance with appropriate auditing principles and implemented by independent auditors, as specified in the loan documents.
2. The project appraisal report will describe the assessment made at appraisal of the borrower's capacity for proper financial management, including the ability to produce periodic financial reports (generally every six months), and submit them annually for audit.² Correct and timely execution by the borrower of this fiduciary responsibility is critical to ensuring that projects achieve their intended objectives within the allocated resources. Auditor's reports should point out any problems and irregularities identified during the audit and make recommendations for improvement.

II. Audits

3. An audit is an *ex post* review of the books of accounts, records of transactions and financial and other systems maintained by a project coordination unit (PCU)³ for the purpose of executing a project, and of the financial statements prepared by a PCU reflecting project operations during a given period. Annex I describes the general principles governing project audits. An audit is carried out by professional accountants and aims to:
 - ▶ provide assurance of accountability;
 - ▶ give credibility to the financial statements and other management reports;
 - ▶ identify weaknesses in internal controls and financial systems;
 - ▶ verify compliance with loan covenants relating to financial matters; and
 - ▶ make recommendations for improvement.

1 Article IX – Financial Reporting and Information, Section 9.03 (a) Audit of Accounts.

2 The countrywide financial management capacity assessment, if any, carried out by the CI will also provide information on the borrower's capacity in this regard.

3 Also referred to as project implementation unit or project management unit.

III. Establishment of Audit Arrangements

ASSESSMENT OF THE AUDITOR'S CAPACITY

4. The groundwork for an audit, including determination of the availability and quality of auditors in the borrower's country, should be laid during the appraisal phase. Particular attention should be given to the:
 - ▶ overall status of the accounting and auditing profession;
 - ▶ competence and independence of the national supreme audit institution (SAI); and
 - ▶ selected auditors' adherence to acceptable standards of accounting and auditing.
5. Assessment of audit capacity within the borrowing country should be made during project appraisal. Agreement as to whether the project audit is to be carried out by the SAI or by a private audit firm should be reached prior to loan negotiation. A checklist for assessing an auditor's capacity, selection and appointment is given in Annex II.

APPOINTMENT OF THE AUDITOR

6. Article IX (Financial Reporting and Information), Section 9.03 (a) (Audit of Accounts) of IFAD's General Conditions stipulates the borrower's obligation with regard to annual audit of project accounts. The timing of the appointment of the auditor, as indicated in the loan agreement, and the deadlines for submission of audit reports (normally within six months from fiscal year end) are usually found in Article V (Financial Reporting and Information) of the IFAD project loan agreement.
7. Prior to loan negotiation, there will be discussion with the borrower concerning the auditor's terms of reference (TOR) and the audit arrangements, including any special audit requirements.⁴ If necessary, the appointment of the auditor will be made a condition of loan effectiveness or disbursement. Annex III contains IFAD's minimum requirements for a project audit. IFAD's audit requirements and TOR for the auditor are essential to ensure that auditors receive clear guidelines as to their task and that the scope and format of their report is established. Annex IV provides a model set of Guidelines for Auditors.
8. Auditors should not be appointed as management consultants (e.g. consultancy for design of accounting systems and controls), as such appointments could create conflict of interest and increase the risk that shortcomings in a project might not be reported.

4 In accordance with the Organisation for Economic Co-operation and Development/MDB Development Assistance Committee Reference – Good Practices Paper #5: Financial Reporting & Auditing “a single audit opinion should normally cover the auditing needs of both the government and donors, who should agree on the terms of reference for the audit” and the scope of the audit should specify the need to review disbursements made under the SOE and SA procedures.

9. Once the selection process for the auditor is concluded, it is normal for the appointed audit firm to issue an engagement letter, confirming their acceptance of the appointment and outlining the methodology, scope and responsibilities under the audit. The PCU will sign and return a copy of the letter to the auditor. A sample audit engagement letter is given in Annex V.
10. The CI approves⁵ the TOR for the auditor to be engaged by the borrower. CI or IFAD staff should not be involved in drafting audit TORs, though there is no objection to their giving advice to borrowers based on these Guidelines. Annex VI gives a sample Terms of Reference for the Audit of Project Financial Statements, including SOEs and SAs.

SUBMISSION OF THE AUDIT REPORT

11. At due date as stipulated in the loan agreement (normally six months after the end of the borrower's fiscal year), the audit report is submitted by the borrower to both the CI and IFAD.

AUDIT REPORT REVIEW AND FOLLOW-UP

12. The audit report package should include the audited financial statements, the auditor's opinion (including opinions on SOEs and SAs), a management letter, and any special reports required by IFAD. While the auditor's opinion will describe the acceptability or otherwise of the project financial statements, the management letter will detail the shortcomings, if any, in the project's internal controls, procedures and practices, together with appropriate recommendations for improvement. Annex VII gives an example of an auditor's opinion. Annex VIII provides an outline of a management letter.
13. When the auditor's report is received from the borrower, the CI will ensure that the audit has been carried out in accordance with IFAD's requirements. Particular attention should be paid to the auditor's opinion, the results of the compliance audit and the management letter.
14. The review of the audit report will be carried out by the CI within 30 days of its receipt. If the audit report is **unqualified**, i.e. has not identified any irregularities or has made no recommendations for improvement in the project, then no further action will be necessary on the part of the CI, apart from acknowledgement under copy to IFAD.
15. If the review of the audit report reveals problems or irregularities, the CI will advise the borrower of the concerns and inform IFAD. Such advice will be sent to the borrower and IFAD no later than 45 days from receipt of the audit report.
16. Audit reports containing a **qualified opinion**, an **adverse opinion** or a **disclaimer of opinion** indicate *prima facie* the existence of problems and irregularities in project implementation. The CI's advice to the borrower would in such cases refer to the auditor's opinion in the report and seek explanations in response to the issues raised.

5 In the case of IFAD directly-supervised projects, IFAD staff approve the TOR for the auditor.

17. It is essential that CI staff monitor on a regular basis the submission of financial statements by the PCU, and that IFAD update its audit report monitoring system. A sample Status of Audit Report format is provided in Annex IX to assist the CI and PCU to maintain a record of the status of project audits.

NON-COMPLIANCE WITH IFAD'S AUDIT COVENANTS

18. If a borrower does not comply with the audit covenants contained in Article V (Financial Reporting and Information), Section 5 (Audit Reports) of the IFAD loan agreement, the Fund (in consultation with the CIs as appropriate) will apply sanctions as provided for in the General Conditions, Article XII (Remedies of the Fund), Section 12.01(n) (Suspension by the Fund).⁶

19. As part of its remedial action, IFAD will apply Article VI (Remedies of the Fund) of the IFAD loan agreement, which states: "If the Borrower does not timely furnish any audit report required by Section 5.02, and the Fund, after consultation with the Borrower, determines that the Borrower is unlikely to do so within a reasonable period thereafter, the Fund . . . may engage independent auditors of its choice to audit the accounts relating to the Project. For such purpose, the Borrower and the Project Parties shall make their financial and other records available to such auditors promptly upon request, accord them full rights and privileges as agents of the Fund under Article X (Cooperation), Section 10.03 (Visits, Inspections and Enquiries) of the General Conditions and otherwise cooperate fully with such audit." Article VI of the loan agreement further states: ". . . the Fund shall make the audit report available to the Borrower promptly upon its completion. The Fund shall finance the cost of such audit by withdrawal from the Loan Account on behalf of the Borrower, and the Borrower hereby authorizes the Fund to make such withdrawals."

6 The General Conditions state: "The Fund may suspend, in whole or in part, the right of the Borrower to request withdrawals from the Loan Account, whenever the Fund has not received any audit report . . . within the time prescribed therefore in the Loan Documents" The General Conditions Applicable to Loan and Guarantee Agreements (IFAD/9), dated 13 April 1978, adopted by the Executive Board at its Second Session (10–13 April 1978), apply to all the Loan and Guarantee agreements approved by the Board after 10 April 1978 and before 13 December 1978, 1-SRI to 10-NEP. The General Conditions Applicable to Loan and Guarantee Agreements (IFAD/9 Rev.1, Rev.2 and Rev.3), dated 11 December 1978, adopted by the Executive Board at its Fourth Session (11–12 December 1978), apply to all the Loan and Guarantee agreements approved by the Board after 12 December 1978 and before 20 September 1986, as follows: 11-MG to 193-MO, SRS-1-MR, BG-1-KE to BG-4-SO. The General Conditions Applicable to Loan and Guarantee Agreements (IFAD/9 Rev.4), dated 19 September 1986, approved by the Executive Board at its Twenty-Eighth Session (16–19 September 1986), apply to all the Loan and Guarantee agreements approved by the Board after 19 September 1986 and before 28 April 1999, as follows: 194-BA to 499-TN, SRS-2-GH to SRS-48-AO, BG-5-UG to BG-30-UG. The General Conditions for Agricultural Development Financing, dated February 1999, adopted by the Executive Board at its Sixty-Fifth Session (2–3 December 1998), apply to all agreements for agricultural development projects and programmes approved by the Board from 28 April 1999, starting from Loan number 500-BI, BG-31-TD.

Annex I

GENERAL PRINCIPLES GOVERNING PROJECT AUDIT

1. Audits can vary considerably, depending on the objectives, project activities and expected reports or outcome. They can be classified into three categories:
 - ▶ financial statement audits;
 - ▶ compliance audits; and
 - ▶ operational audits.

FINANCIAL STATEMENT AUDITS

2. The objective of a financial statement audit is to determine whether the statements are presented in conformity with acceptable International Accounting Standards (IAS) or other acceptable national standards. Each audit covers a specific period, usually the project fiscal year, and the cumulative accounts over the life of the project. A financial statement audit assesses whether reported disbursements were made in accordance with the relevant loan agreement. Attention is also given to disbursements based on statements of expenditure (SOE)¹ and special accounts (SAs).² The audit ascertains whether individual expenditures, which comprise the SOE totals, are properly authorized, eligible under the loan provisions, appropriately accounted for and fully supported by documentation retained in the borrower's files.
3. The findings of the audit, in conjunction with any comments on SOE field reviews in project supervision reports, will be used by the CI and IFAD's Office of the Controller, Loans and Grants Unit (FC/L) to determine whether the borrower should continue to use the SOE procedure. If SOEs are found to include ineligible expenditures, the borrower will be required to refund the amounts in question.
4. Where SAs have been established, the annual audit will verify whether withdrawals from SAs are properly authorized and eligible in accordance with the loan agreement. The audit will ensure that the year-end balance in the SA is reconciled with IFAD's records.
5. The auditor normally examines the project's system of accounting and other internal controls, including internal audit, as part of an audit of financial statements in order to express an opinion on the reliability of project financial statements produced by the borrower.

1 Statements of expenditure refer to the certified listing of certain specified categories of eligible project expenditures and those that are below the threshold amount as agreed with IFAD and CI, and attached to the disbursement withdrawal application submitted by the borrower. The relevant supporting documents are retained by the PCU and made available for review by the CI or IFAD supervision missions and by independent auditors.

2 Special account (or revolving fund) refers to a bank account established and maintained by the PCU for depositing the agreed initial imprest advance given out of the loan funds, and the subsequent replenishments made by IFAD based on withdrawal applications submitted by the PCU. The SA is usually maintained in United States dollars, and it is the responsibility of the PCU to attach to its replenishment requests a reconciliation of the United States dollar balance in the SA with the project records.

COMPLIANCE AUDIT 6. A compliance audit involves reviewing, testing and appraising an organization's controls and operating procedures, including compliance with regulations, contracts and laws to which the organization is subject.

OPERATIONAL AUDIT 7. An operational audit is a more thorough examination of an organization's management techniques and performance. It may help to identify implementation issues for the purpose of prompt remedial actions at the project level. The primary product of an operational audit is a report recommending improvements in the efficiency and effectiveness of operations, encompassing, to the extent possible, all the major functions of the organization.

MANAGEMENT LETTER 8. Audit reports should be accompanied by a management letter,³ which is a report on an organization's internal controls and operating procedures and their effectiveness. It is based on the auditor's reviews during the normal course of an audit.

AUDIT OPINIONS 9. The audit report should contain a clear expression of opinion on the financial statements. The auditor's opinion may be unqualified, qualified, adverse, or a disclaimer of opinion.

10. An **unqualified opinion** indicates the auditor's satisfaction in all material respects with the preparation of the financial statement, its consistency, adequacy, and compliance with regulations, statutory requirements and any additional requirements stated in the corresponding audit TOR (e.g. review of SOE and SA-based disbursements).

11. A **qualified opinion** is issued when an auditor has reservations on specific areas and concludes that an unqualified opinion cannot be issued, but deems that the effect of any disagreement, uncertainty or limitation of scope of the audit does not require an adverse opinion or a disclaimer of opinion. The subject of the qualification and its financial effect must be clearly stated in the auditor's report.

12. An **adverse opinion** is issued when the effect of the disagreement is so pervasive and material to the reliability of the financial statements that the auditor concludes that a qualification of the report will be insufficient to disclose the misleading or incomplete nature of the financial statements.

13. A **disclaimer of opinion** is issued when the possible effect of an uncertainty or of a limitation on the scope of the auditor is so significant that the auditor is unable to express an opinion on the financial statements.

3 Auditors may provide an internal control memorandum instead of a management letter. A sample outline of a management letter is provided in Annex VIII to these Guidelines.

Annex II

CHECKLIST FOR CAPACITY ASSESSMENT, SELECTION AND APPOINTMENT OF AN AUDITOR

1. When the proposed auditor is the country's SAI, the CI and IFAD staff (the country portfolio manager and/or FC/L) will check the following general information about the SAI:
 - ▶ Does the SAI belong to the International Organization of Supreme Audit Institutions (INTOSAI)?
 - ▶ Is the SAI independent of the PCU and the responsible government ministry, for example, in terms of control over its budget and personnel?
 - ▶ Does the SAI report to the management of the project or to the PCU?
 - ▶ Is the SAI involved in approval of the project's transactions?
 - ▶ Is the SAI involved in the internal control or financial management systems of the project or PCU?
 - ▶ Has the SAI consented to the appointment?
2. When the country SAI is proposed as auditor, the CI and IFAD staff will also ascertain the following specific information from the records of previous project audits reports received from the country:
 - ▶ Has the SAI fulfilled satisfactorily its responsibilities in previous projects?
 - ▶ Did the SAI submit all the audit reports due?
 - ▶ Were the reports submitted on time?
 - ▶ Was the overall quality of the audit reports acceptable?
 - ▶ Was there any evidence, from the findings of CI and IFAD supervision missions, that the audit reports failed to identify irregularities and weaknesses?
 - ▶ Were the SAI recommendations appropriate to the problems and irregularities in the project?
 - ▶ Did the SAI follow up on previous audit findings during subsequent audits?
3. When the proposed auditor is a private audit firm, the CI or IFAD staff, or both, will check if the borrower's proposal is sufficiently transparent and thorough, and will, prior to consenting to the selection, seek answers to the following questions:
 - ▶ Is there evidence of a competitive selection process for the auditor, say from a list of three to six qualified firms?

1 A technical evaluation includes the firm's track record and professional reputation, audit scope and methodology, and the qualifications and experience of staff assigned to the audit. A financial evaluation assesses the quotations from bidders for cost of the audit, including all reimbursable costs.

- ▶ Was the selection based on a technical evaluation together with the financial evaluation?¹
 - ▶ Is there evidence of the auditor's past experience and acceptable performance in similar audits?
 - ▶ Did the proposed auditor submit satisfactory references and descriptive material about the firm?
4. In making a proposal for appointment of a private auditor, the borrower should provide the CI or IFAD, or both, with relevant supporting documentation and should address the following questions:
- ▶ Does the firm adhere to acceptable auditing standards? The firm's audit procedures and methods should ensure compliance with such standards.
 - ▶ Is the firm independent of the project entity to be audited and of the people appointing the auditor?
 - ▶ What is the legal status of the firm? This includes such aspects as partners' status and any limited liability provision in the firm's articles.
 - ▶ Are any of the assigned audit staff employed by or closely linked to the project entity to be audited, or to any government body or public agency?
 - ▶ Can the auditor confirm that there is no conflict of interest or lack of independence implicit in accepting the appointment?
 - ▶ Is the auditor committed to providing qualified and experienced staff who can ensure timely submission of audit reports? In particular:
 - ▶ What is the staffing plan for the audit?
 - ▶ What are the qualifications of the assigned staff?
 - ▶ Do the assigned staff belong to professional audit or accounting bodies such as the Institute of Chartered Accountants or Certified Public Accountants?
5. In assessing impartiality and independence, the borrower (project party) should find out whether the project auditor is employed by the project entity or umbrella organization, or serves as a director of it, or has any financial or business relationship with it whilst engaged as an independent professional auditor.
6. Auditors should not be appointed as management consultants responsible for designing accounting and control systems on which they would be required to comment. Such appointments would create a conflict of interest and increase the risk that auditors might not report shortcomings in the project.
7. The borrower should ensure that the auditor's fee is not established in any way that compromises independence.

Annex III

MINIMUM REQUIREMENTS FOR PROJECT AUDIT

SCOPE AND OBJECTIVES OF THE AUDIT

1. The minimum requirements for audit of IFAD-funded projects are explained to borrowers at the time of loan negotiations, with the understanding that they be conveyed to project auditors prior to audit in order to ensure satisfactory fulfilment of the requirements.
2. The borrower and the PCU must ensure that the independent auditor acceptable to the CI and IFAD is appointed in sufficient time to carry out the audit. This includes review of the financial management system at the beginning of project implementation and periodically thereafter.¹
3. The PCU will have the annual financial statements audited in accordance with acceptable auditing standards. The auditor's report should indicate the standards used, and the extent, if any, to which the examination did not conform to those standards.
4. The audit report should contain a clear expression of the **auditor's opinion** regarding the financial statements. It should include a **financial statements audit** and a **compliance audit**, and should be accompanied by a **management letter**. It should also include a section on the project's compliance with loan covenants, particularly those dealing with financial matters. A full **operational audit** may be carried out if the CI and IFAD consider it necessary.
5. The auditor will review the project accounts, including annual financial statements, SOEs and SA(s), and present an opinion covering the three elements. In addition the audit report will address:
 - ▶ the adequacy of accounting and internal controls, including the internal audit mechanism, for monitoring expenditures and other financial transactions and ensuring safe custody of project assets;
 - ▶ the adequacy of documentation maintained by the PCU for all transactions; and
 - ▶ any other matters the CI and IFAD may reasonably request.
6. 'Project accounts' refers to the financial statements of the project, usually for a fiscal year. They must show the financial status of the project and consist of:
 - ▶ yearly and cumulative statements of sources and application of funds, which should disclose separately IFAD's funds, counterpart funds (government), other donors' funds and beneficiaries' funds; and
 - ▶ the balance sheet, which should disclose bank and cash balances that agree with the statement of sources and application of funds, fixed assets and liabilities.

Where the project consists of several entities, financial statements should be consolidated.

¹ If considered necessary, the appointment of auditor will be made a condition of loan effectiveness.

7. The auditor's opinion should deal with the adequacy of the procedures used by the project for preparing SOEs and should include a statement that amounts withdrawn from the loan account on the basis of such SOEs were used for the purposes intended under the loan agreement.

AUDIT METHODOLOGY

8. In reviewing the project accounts and financial statements, the auditor will:
 - ▶ verify that acceptable accounting standards have been consistently applied and indicate any material deviation from these standards, and the effect of such deviation on the annual financial statements;
 - ▶ assess the adequacy of accounting and internal control systems (procedures and responsibilities) for monitoring expenditures and other financial transactions (commitment, review, approval, payment and accounting) and ensuring safe custody of project-financed assets, and document any instances where controls are lacking or need strengthening;
 - ▶ determine whether the PCU has maintained adequate documentation for all transactions; e.g. procurement documents, contracts, suppliers' invoices, letters of credit and evidence of payment, and ascertain that expenditures were properly authorized and in compliance with legal requirements;
 - ▶ verify the numerical accuracy of statements and accounts;
 - ▶ verify that disbursement requests for expenditures submitted to IFAD are eligible for financing under the loan agreement, and identify clearly any ineligible expenditures; and
 - ▶ carry out a physical verification of any significant assets purchased and confirm their existence and use for project purposes.
9. From the second audit onwards, the auditor will follow up on the remedial actions taken by the PCU in response to previous audit findings and recommendations, and report on progress or otherwise.

Annex IV

GUIDELINES FOR AUDITORS

TERMS OF REFERENCE (TOR) AND ENGAGEMENT LETTER

1. The CI approves the TOR for the auditor to be engaged by a borrower. The CI or IFAD staff should not be involved in drafting audit TOR, though there is no objection to their giving advice to borrowers based on these Guidelines. A borrower may wish to include in the TOR additional auditing tasks necessary to satisfy requirements of other financiers, including the borrower. These should in no way cause late delivery of the audit report.
2. These Guidelines should not be regarded as universally applicable to audits of all IFAD-financed projects or project entities. Borrowers should select the components they consider appropriate for an audit and should add to the TOR relevant aspects that are not in the Guidelines. The Guidelines are applicable only to the appointment of auditors for the audit of the financial statements of a project, an implementing agency, or a financial intermediary or credit institution. They are not intended for special audits, reviews, investigations or consultancy assignments.
3. The auditor is responsible for expressing an opinion on the financial statements; responsibility for preparing and presenting the statements to the auditor lies with project management. The form of annual financial statements and supporting documentation to be supplied to the auditor, together with the estimated time for providing them, should therefore be specified.
4. The scope of the audit should be explained by the borrower so that the auditor may determine if there are requirements beyond those of a routine audit. It is essential that the auditor becomes familiar with the project loan (or grant) agreement, and the Guidelines relating to project audit. The following are examples of routine audit requirements:
 - ▶ The audit should be carried out in accordance with acceptable auditing standards; the auditor should indicate any ways in which the examination would not conform to those standards.
 - ▶ The auditor should comment on and confirm the extent to which acceptable accounting standards have been and are being consistently applied; the auditor should indicate any material deviation from IAS and the effect on project's annual financial statements.
5. The form and content of the auditor's TOR may vary for each project; only the relevant aspects should be included in the engagement letter. The TOR and the engagement letter should include the elements set out below.

**SUMMARY OF
CONTENTS OF THE
TOR AND THE
ENGAGEMENT
LETTER**

6. The summary should include:
- ▶ description of the employing project authority or entity;
 - ▶ term of the auditor's engagement, namely whether it is for a fiscal year or some other period;
 - ▶ description and the timing of the financial statements and other material to be provided by project management for the audit;
 - ▶ terms for delivery of the audit report;
 - ▶ specification that the audit should be carried out in accordance with acceptable standards;
 - ▶ provision of a management letter;
 - ▶ statement of access to project records, documents and personnel available to the auditor; and
 - ▶ details regarding submission of a proposal and work plan by the auditor.

**DETAILS OF
CONTENTS OF
A TOR AND
AN ENGAGEMENT
LETTER**

7. The contents should include:
- ▶ a description in the TOR of the entity engaging the auditor and whether it is acting on behalf of or is a constituent part of a larger entity; and
 - ▶ legal and general descriptions of the project and the PCU, in sufficient detail to enable the auditor to understand their nature, objectives and activities.

The following additional information would be helpful:

- ▶ organizational charts;
- ▶ names and titles of senior managers;
- ▶ names and qualifications of officers responsible for financial management, accounting and internal audit;
- ▶ name and address of any existing external auditor, if a change is made;
- ▶ description of information technology facilities and computer systems in use; and
- ▶ copies of the latest financial statements, loan agreement, minutes of loan negotiations, project appraisal document, and annual work programme and budget, if it is available.

8. The auditor is required to provide an engagement letter, a sample of which is given in Annex V to these Guidelines. In countries where an auditor's obligations are provided for by law, this step may not be necessary; such a letter would still be informative, however, for the borrower, the CI and IFAD. It is in the interests of auditors and borrowers that the auditor sends the engagement letter before the audit commences in order to avoid misunderstandings.
9. In the case of recurring audits, the auditor need not be asked to issue a new engagement letter each year. The following factors may, however, call for a new engagement letter:
 - ▶ any indication that the client misunderstands the objective and scope of the audit;
 - ▶ any revised or special terms of the engagement;
 - ▶ change in project management;
 - ▶ significant change in the nature or size of the client project's activities; and
 - ▶ legal requirements.

AUDITOR'S RESPONSIBILITIES

10. The auditor should be expected to:
 - ▶ submit a proposal including the audit fees, depending on the audit assignment, for the audit of financial statements of the project, the PCU, the financial intermediary or credit institution, or a combination of these, including SOEs and SAs;
 - ▶ provide an opinion based on the scope and detail of the audit of financial statements, including SOEs, SAs, and other areas covered in the TOR, and follow up audit recommendations from previous years;
 - ▶ provide a management letter describing any weaknesses identified in the project accounting and internal control systems, including any internal audit function, and recommend improvements; and
 - ▶ provide a translation of the reports in English, French or Spanish if the originals were issued in another language.

STATEMENTS OF EXPENDITURE (SOE)

11. The auditor should be required to verify SOEs, accounting records and supporting documentation, and undertake a physical inspection of work done or goods and services acquired. The auditor should also, with reference to the disbursement letter sent from the CI to the borrower, establish that expenditures claimed for reimbursement under this procedure are eligible for financing in accordance with the provisions of the loan agreement.

SPECIAL ACCOUNT (SA)

12. The auditor should be required to verify the correctness of transactions – withdrawals and replenishments including the exchange rates used – in the SA and the use of SA funds in accordance with the loan agreement. This should include examination of the reconciliation of the SA bank balance at year end with project records and IFAD's disbursement records.

CHANGE OR ROTATION OF AUDITORS

13. Rotation of auditors after a number of years may be proposed, but frequent changes are not desirable in view of factors such as cost, the need for continuity and institutional memory, and shortage of qualified independent auditors in the borrower's country. The CI should ascertain the reasons for changing auditors. An evaluation of the auditor's performance should also be done periodically.

NON-ROUTINE AUDIT ENGAGEMENTS

14. The auditor may be asked to conduct a special review of one or more of the following:

- ▶ economy, efficiency and effectiveness in the use of project resources;
- ▶ achievement of planned project results;
- ▶ legal and financial obligations and commitments of the project and the extent of compliance or non-compliance thereof;
- ▶ systems and procedures such as improvements in accounting, information technology or computer systems, and operations that may be under development, on which the auditor's comments are necessary to ensure effective controls; and
- ▶ other activities on which an auditor may consider it appropriate to report.¹

¹ The foregoing list is not exhaustive, nor should all matters be addressed in every project. The scope and extent of an audit are likely to be unique to each project or project entity.

Annex V

SAMPLE OF AUDIT ENGAGEMENT LETTER

To the Project Management (or appropriate Project Manager):

1. You have requested that we audit [insert names of financial statements – e.g. Sources and Uses of Funds for the Year Ending (dd/mm/yyyy) and Balance Sheet as of (dd/mm/yyyy)]. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be carried out in accordance with applicable audit regulations in [name of country], with the objective of our expressing an opinion on the financial statements, including the use of the statements of expenditure and special account.
2. In forming our opinion on the financial statements, we will perform sufficient tests and reviews to obtain reasonable assurance as to whether the information contained in the underlying accounting records and other source data are reliable and sufficient as the basis for the preparation of the financial statements. We will also determine whether the information is properly communicated in the financial statements.
3. Because of the nature of the tests and other inherent limitations of an audit, and the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatements may remain undiscovered. However, we expect to provide you with a separate management letter concerning any material weaknesses in internal control that come to our notice.
4. May we remind you that project management is responsible for the preparation of financial statements, including adequate disclosure of relevant information. This includes maintenance of adequate accounting records and internal controls, selection and application of accounting policies, and safeguarding of assets. As part of our audit process, we will request from management written confirmation of representations made to us in connection with the audit.
5. We should be given access to all legal documents, correspondence, and any other information associated with the project and deemed necessary by us for the purpose of our audit.
6. We look forward to receiving the full cooperation of your staff. We trust that they will make available to us whatever records, documentation and other information we may request in connection with our audit.
7. Our fees, which will be billed as the audit work progresses, are based on the time required by the staff and other resources assigned to the audit, plus direct out-of-pocket expenses. Individual hourly rates may vary according to the degree of responsibility involved and the experience and skills of staff required for the audit.
8. Please sign and return the attached copy of this letter as confirmation that it is in agreement with your understanding of the arrangements for our audit of the financial statements.

Name of firm or company

[Chartered Accountants, Certified Public Accountants or other recognized profession]

Note: Additional items may be included in the TOR and engagement letter in accordance with the Guidelines for Auditors contained in Annex IV.

Annex VI

SAMPLE OF TERMS OF REFERENCE (TOR) FOR AUDIT OF PROJECT FINANCIAL STATEMENTS AND ACCOMPANYING STATEMENT OF EXPENDITURES (SOE) AND SPECIAL ACCOUNT (SA)

- OBJECTIVE**
1. The objective of the audit of the project financial statement (PFS) is to enable the auditor to express a professional opinion on the financial position of [insert name] project at the end of each fiscal year and of the funds received and expenditures incurred for the accounting period ended [dd/mm/yyyy], as reported in the PFS, including an opinion on the statements of expenditure (SOE) and special account (SA).
 2. The project books of accounts and records provide the basis for preparation of the PFS and have been maintained to reflect all financial transactions in respect of the project by the project-implementing agency [insert name].
 3. The audit will be carried out in accordance with [state basis] and will include such tests and reviews, as the auditor considers necessary under the circumstances. Special attention will be paid to establishing that:
 - ▶ all external funds have been used in accordance with the conditions stipulated in the financing agreements, with due attention to economy and efficiency, and solely for the purposes for which the financing was provided. The relevant financing agreements are: [insert names of loan agreements];
 - ▶ counterpart funds have been provided by [name the government ministry or the entity] and used in accordance with national or organizational financial regulations, with due attention to economy and efficiency, and solely for the purposes for which they were provided;
 - ▶ goods, consultancy and other services, and civil works financed out of project funds have been procured in accordance with stipulations in the financing agreement and/or government regulations;
 - ▶ all necessary supporting documents, records and accounts have been kept in respect of all project ventures, including expenditures reported via SOEs or SAs;¹
 - ▶ the SA has been used in accordance with the provisions of the financing agreement; and
 - ▶ the project accounts have been prepared in accordance with consistently applied [state basis] and give a true and fair view of the financial status of the project at [dd/mm/yyyy] and of resources and expenditures for the year ended on that date.

¹ It should be noted that clear linkages should exist between the project books of accounts and the reports presented to the CI and IFAD.

PROJECT FINANCIAL STATEMENTS

4. The PFS will include the following:
 - ▶ yearly and cumulative statements of sources and application of funds, which should disclose separately IFAD's funds, counterpart funds (government), other donor funds and beneficiaries' funds;
 - ▶ balance sheet, which should disclose bank and cash balances (that should agree with the statement of sources and application of funds), fixed assets and liabilities;
 - ▶ yearly and cumulative SOEs by withdrawal application and category of expenditures;
 - ▶ reconciliation of the SA; and
 - ▶ consolidated financial statements, where a project consists of more than one entity.
5. A reconciliation between the amounts shown as received by the project and those shown as being disbursed by IFAD should be attached as an annex to the PFS. As part of that reconciliation, the auditor will indicate the procedure used for disbursement – SA funds, letters of credit, special commitments, reimbursement or direct payment – and indicate whether the expenditure is fully documented or uses the SOE format.

STATEMENTS OF EXPENDITURE (SOES)

6. In addition to the audit of the PFS, the audit will include a review of SOEs used as the basis for submitting withdrawal applications. The auditor will carry out tests and reviews as necessary and relevant to the circumstances. SOE expenditures will be carefully compared for eligibility with relevant financial agreements, and the disbursement letter, and with reference to the project appraisal report² for guidance when necessary. Where ineligible expenditures are identified as having been included in withdrawal applications and reimbursed, auditors will note these separately. A schedule listing individual SOEs withdrawal applications by reference number and amount should be attached to the PFS. The total withdrawals under the SOE procedure should be part of the overall reconciliation of IFAD disbursements described above.

2 Also referred to as project appraisal document (PAD).

- SPECIAL ACCOUNTS (SAS)**
7. The auditor is also required to audit the activities of the SA(s)³ associated with the project, including the Authorized Allocation or Initial Deposit, replenishments, interest that may accrue on the outstanding balances, and the year-end balances. The auditor must form an opinion as to the degree of compliance with IFAD procedures and the balance(s) of the SA(s) at year end. The audit should examine: (i) the eligibility of withdrawals from the SA during the period under review; (ii) the operation of the SA in accordance with the relevant financing agreement(s);⁴ (iii) the adequacy of internal controls within the project appropriate for this disbursement mechanism; and (iv) the use of correct exchange rate(s) to convert local currency expenditures to United States dollars.
- AUDIT OPINION**
8. As part of the opinion on the PFS, the audit report will include an opinion on SOEs and SAs, indicating the extent to which these procedures can be relied upon as a basis for loan disbursements under the project.
- MANAGEMENT LETTER**
9. The auditor will provide a management letter⁵ (A sample outline of a management letter is given in Annex VIII.) which will identify deficiencies in the project accounting records, procedures, systems and internal controls and make appropriate recommendations for improvement. The management letter will also include any other significant matters that come to the auditor's attention and might have material impact on project implementation.

3 Separate SAs should be established and maintained for IFAD funds and other donor funds.

4 References to project SAs are provided in the relevant financing agreements.

5 The auditor's report should be addressed to the entity requesting the audit, usually the borrower or project-implementing agency, unless required otherwise by local regulations.

Annex VII

SAMPLE OF AUDITOR'S OPINION MODEL AUDIT REPORT

Unqualified Opinion for:

- I. Project Coordination Unit/Project Implementing Agency**
- II. Project Financial Statement, including SOE**
- III. Special Account**

Addressee¹

Introduction

We have audited the accompanying [name of each financial statement] of the [name of organization, name of project] under IFAD Loan No. _____ as of [dd/mm/yyyy] and for the year then ended. These financial statements are the responsibility of [insert name of borrower]; our responsibility is to express an opinion on each of these financial statements based on our audit.

Scope

We conducted our audit in accordance with [state basis – e.g. International Standards on Auditing] and IFAD's guidelines for statements of expenditure (SOEs) and special accounts (SAs). Those standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material mis-statement. Our audit included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by project management; and evaluating the overall financial statement presentation. We believe that our audit provided a reasonable basis for our opinion.

Opinion

In our opinion, the financial statements give a true and fair view of:

- I. The financial position of [name of organization] as of [dd/mm/yyyy] and of the results of its operations and its cash flows for the year then ended in accordance with [indicate International Accounting Standards (IAS) or relevant national standards].
- II. The sources and applications of funds² of [name] project for the year ended [dd/mm/yyyy] in accordance with [indicate IAS or relevant national standards]. Note: if a balance sheet is required, add "financial position" at [dd/mm/yyyy];
In addition, (a) with respect to SOEs, adequate supporting documentation has been maintained to support claims to IFAD for reimbursements of expenditures incurred; and (b) such expenditures are eligible for financing under IFAD Loan Agreement No. _____.
- III. The financial position of the SA of the [name] project as of [dd/mm/yyyy] for the year then ended in accordance with [IAS or relevant national standards] and IFAD guidelines, and of the sources and application of funds.

[Name and address of audit firm]

[Completion date of audit]

1 The auditor's report should be addressed to the entity requesting the audit, usually the borrower or project-implementing agency, unless required otherwise by local regulations.

2 A Source and Application of Funds statement is always required for each project. A Balance Sheet is also required where the project has assets and liabilities.

Annex VIII

SAMPLE OF OUTLINE OF A MANAGEMENT LETTER

Addressee:

We have audited the financial statements of [name of project or entity] for the year ending [mm/yyyy] and have issued our report dated [dd/mm/yyyy]. In planning and performing our audit of [name of project or entity], we reviewed its internal accounting control structure in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements, not to provide assurance on the internal accounting control structure. We noted no matters involving the internal accounting control structure and its operation that we consider to be material weaknesses in accordance with [international accounting standards or relevant national standards].

This report consists of three sections:

- ▶ Section I contains recommendations relating to improvements in existing systems and procedures noted in the current year.
- ▶ Section II contains recommendations from prior years that have not yet been fully implemented.
- ▶ Section III contains recommendations from prior years that have been fully implemented. (Management's comments are noted following each recommendation.)

This report is intended solely for the information and use of management and others within [name of project or entity] and should not be used for any other purpose.

During this year's audit we noted that [name of company or entity] has addressed most of the recommendations included in our prior year report. With respect to our current and carryover recommendations, we suggest that the management should continue to implement improvements based on an updated timetable.

Very truly yours,
[Name and address of Audit Firm]

Annex IX

**SAMPLE OF
STATUS OF AUDIT REPORT**

Project No: _____ Loan agreement date: _____
 IFAD loan No: _____ Effective date: _____
 Project name: _____ Project completion date: _____
 Loan closing date: _____
 First disbursement date: _____

Audit requirement in loan agreement: Section _____
 Fiscal year period: _____
 Audit report due date: _____
 Mutually agreed auditor: independent/SAI/other: _____

1	2	3	4	5
Audit report for fiscal year ending	Due date (dd/mm/yy)	Date prepared (dd/mm/yy)	Date sent to CI (dd/mm/yy)	Remarks

► July 2009



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