

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

**ANNUAL REPORT OF THE CHAIRPERSON OF THE
AUDIT COMMITTEE**

JULY 1, 2011 TO JUNE 30, 2012

**Annual Report of the Chairperson
Audit Committee
July 1, 2011 to June 30, 2012**

The Audit Committee of the Board of Executive Directors met on thirty-one occasions over the past year. All sessions except three were formal. I assumed the Chairmanship of the Committee in March of this year, following the departure of the previous chair, Eugenio Diaz Bonilla.

Most of the reports discussed by the Committee were recurring and detailed minutes have been prepared on each of these discussions. Recurrent reports discussed by the Committee during this period included:

- (1) the Ordinary Capital Information Statement and Other Bank Funds Financial Statements;

The Statements were discussed by the Committee in February 2012. This discussion focused on the loss of \$1.66 billion reported as “Comprehensive income loss,” which reflected changes in the fair value of the Bank’s borrowing and swaps as well as the assets/liabilities under the Bank’s retirement plans. The losses on borrowings and swaps were unrealized and were expected to reverse in the future as the Bank kept its borrowings and swaps to maturity. At the February meeting, it was agreed to forward the statements to the Board, for subsequent transmittal to the Board of Governors. The Governors approved the Statements at the annual meeting on March 24, 2012.

- (2) Effectiveness of Internal Controls over Financial Reporting;

The Committee met on the annual internal controls report in April 2012. Among the issues discussed were Directors concerns with progress in the Capital Markets Consolidation project (TMS). Management responded that the project would conclude in September, and that the Board would be updated in the next internal controls report.

- (3) Annual Report of the Office of Institutional Integrity (OII);

The Committee’s discussion of this report, which took place in February 2012, focused on OII’s new case selection protocol, the adequacy of OII staff, and the costing OII investigations. It was also agreed that, since OII’s report covers only part of the sanctions framework, there would be one comprehensive report in the future, which would include the Sanctions Committee (see 4 below).

- (4) First joint annual report on the Bank’s newly implemented Sanctions System;

As representatives of the Bank’s new sanctions system, the Case Officer and the Chairperson and Secretary of the New Sanctions Committee reported to the Audit Committee in February 2012. Among the major conclusions of the report was that, relative to this institution’s lending volume, the proportionality of the system’s caseload (16 cases in 2011) had been consistent with that of the World Bank’s anticorruption system. At this meeting, the Committee agreed that, going forward, OII and the Sanctions System would independently prepare their contributions to a

single comprehensive semiannual report on their activities, and that information on the work of these bodies would be made available to Governors at the Bank's annual meetings.

(5) First annual update of the Bank's risk taxonomy; and

This first annual update of the Bank's risk taxonomy was presented to the Committee in March 2012. No changes were made in the taxonomy in the update. Nonetheless, there were changes in content related to the inclusion of updated information on the Management Committees, and a description of how risk was communicated within the institution. It was agreed that the annual update would continue and that next year Management, among other tasks, would report on progress in training the Bank's administrative units to manage their own operational risk.

(6) Office of the Executive Auditor, 2011 Annual Report

The Executive Auditors' 2011 Annual Report was discussed at length in February 2012. The focus of the discussion was on Management's efforts to comply with the AUG's Grade I recommendations. Management noted that regarding the grade 1 systems recommendation, that Management was expected to have a data and reporting tool by the end of the year. With respect to the grade 1 recommendations on tax reimbursement, Management reported that it would soon be establishing a clean process of internal controls, with appropriate segregation of responsibilities. The process of hiring a new Executive Auditors was also discussed at the meeting, with Management noting that the process had been delayed because the person in the process of being appointed had accepted another position. Subsequently, in an Executive Session held on June 20, the Committee reconsidered the item regarding the selection of the new Executive Auditor, endorsing the process for selection, and agreed to recommend that the Board of Executive Directors proceed with recruitment of the top-ranked candidate.

In addition to regular reporting the Committee dealt with other issues which included:

(1) The selection of a new external auditor

The bidding process for the new external auditor began in August when the Board authorized Management to proceed with the procurement process for external audit services, because of the expiration of Ernst and Young's contract to take place in 2012. After a competitive process, the Board recommended that the Governors approve the selection of KPMG, LLP at the 2012 Annual Meeting in Montevideo. The selection was approved by Governors in March 2012.

(2) Changes to the Audit Committee terms of reference

The departure of the OII Chief under a mutual separation agreement led to a series of discussions (most of which were in executive session) on the role of the Audit Committee in the hiring and dismissal of the OII Chief as well as the Case Officer and the Secretary of the Sanctions Committee. Revised terms of reference clarifying the Committee's role were discussed by the Board in late June 2012, but no consensus was reached on the proposal during deliberations. The Committee agreed to continue consideration of the matter at a later time in the context of a more comprehensive review of the Committee's oversight role.