

DOCUMENT OF THE INTER-AMERICAN DEVELOPMENT BANK

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

1 JULY 2017 – 30 JUNE 2018

**Annual Report of the Chairperson
Audit Committee
1 July 2017 to 30 June 2018**

The Audit Committee of the Board of Executive Directors met on 16 occasions between 1 July 2017 and 30 June 2018, of which 14 formally and two informally. The Committee held five joint sessions with the Budget and Financial Policies Committee (BUFIPOL) and one joint session with the IDB Invest Committee of the Board of Executive Directors.

The workload of the Audit Committee was divided between: (i) *recurrent issues*, such as the IDB information statement and other Bank funds financial statements, the Office of the Executive Auditor (AUG) risk-based audit plan and perspectives, and Management's discussion and analysis and condensed quarterly financial statements (unaudited); and (ii) *periodic reports*, including effectiveness of internal controls over financial reporting, financial risk reports on the Ordinary Capital, external audit reports, and the annual reports presented by AUG, the Legal Department (LEG), the Office of Ethics (ETH), and the Office of Institutional Integrity (OI) and Sanctions System. In this period, the Committee also received a presentation by AUG on Cybersecurity and Digital Assurance and considered two specific audit reports suggested by the Chairperson of the Audit Committee in consultation with AUG regarding the preparation and approval of sovereign guaranteed investment loans, and the loan disbursement process. Finally, the Committee reviewed the selection process and recommendation for the Position of Chief of the Office of Institutional Integrity.

Below is a summary of the matters considered by the Audit Committee:

1. IDB Information Statement and Other Bank Funds Financial Statements, as of 31 December 2017 (FN-707-3)

The Committee met on 23 February 2018 to consider the "IDB Information Statement and Other Bank Funds Financial Statements, as of 31 December 2017". The meeting included a session with the Bank's external auditors (KPMG), who confirmed that they were in a position to issue an unqualified opinion on the financial statements. The Committee then agreed to submit the financial statements to the Board of Executive Directors recommending their transmission to the Board of Governors for approval.

On 9 March 2018, the Bank's Finance Department (FIN) and the team of external auditors conducted the workshop "Overview of IDB's Financial Statements and Information Statement (Accounting and External Audit)", with the objective of strengthening the analytical capacity of Board members regarding the Bank's financial statements. This training was part of the 2018 Board's Learning and Knowledge Plan approved by the Steering Committee. 17 Board members participated in this workshop.

2. Ordinary Capital. Management's discussion and analysis and condensed quarterly financial statements (Unaudited). Reports by 30 June 2017 (FN-707-1), 30 September 2017 (FN-707-2) and 31 March 2018 (FN-713)

The IDB Management submitted to the Audit Committee, for agreement by streamlined procedure, its discussion and analysis and condensed quarterly financial statements for subsequent filing with the US Securities & Exchange Commission. A meeting of the Committee is only called if a Director interrupts the procedure. The Committee took note of the three reports posted between 1 July 2017 and 30 June 2018 and no interruptions were necessary.

3. Effectiveness of Internal Controls over Financial Reporting (FN-586-44 and FN-586-45)

The Audit Committee held two meetings to consider the Effectiveness of Internal Controls over Financial Reporting (ICFR). The first document presented a progress report as of 31 October 2017 on Management's work to assess the effectiveness of the ICFR and the second presented the 2017 annual results. The conclusion was that as of 31 December 2017, no significant deficiencies or material weaknesses had been detected and that the ICFR system was effective.

4. Financial Risk Report on the Ordinary Capital – Second quarter 2017 (FN-708-1), Third quarter 2017 (FN-708-3), Fourth quarter 2017 (FN-708-4), and First quarter 2018 (FN-714)

The Office of Risk Management (RMG) presented quarterly reports on the financial risk of the Ordinary Capital at joint Audit Committee and BUFIPOL meetings. During the consideration of the latest reports, Management reported that all the financial risk parameters were within the limits approved by the Board and highlighted the Bank's robust capital adequacy position, as well as its capacity to absorb country downgrade shocks. Audit Committee members underscored the need to be kept abreast of market risks.

5. KPMG Integrated Audit Plan and Strategy for the year ending 31 December 2017 (XR-22), KPMG Fiscal Year 2017 Integrated Audit Results (XR-22-1), and KPMG Fiscal Year 2017 Integrated Audit Results (XR-22-2)

The KPMG team met with the Audit Committee on three occasions: first, to present the audit plan and strategy for the year ending 31 December 2017; second, to report on the plan's implementation, and third, to inform on the external audit final results.

At the first meeting, on 12 October 2017, KPMG indicated that the audit areas for FY2017 were consistent with those of FY2016, including the valuation of financial instruments, allowances for loan losses, pension and postretirement benefit obligations and audits related to the information technology environment, including new systems and processes. KPMG also reported that the IDB had decided to move from using the standards of the Public Company Accounting Oversight Board (PCAOB) to the American Institute of Certified Public Accountants (AICPA) standards, which are substantially equivalent for an integrated audit.

On 5 December 2017, KPMG reported on the status of implementation of the FY2017 audit and confirmed that no material weaknesses or significant deficiencies had been identified to that date. KPMG commented on the changes in the accounting standards "ASC 606 Revenue from Contracts with Customers" and "ASU 2016-01 Recognition and Measurement of Financial Assets and Liabilities", to be effective in January 2018. According to KPMG, the impact of the new ASC 606 on the Bank's statements was expected to be minimal. As for the ASU 2016-01, KPMG explained that the new standard would require reclassification related to the Bank's credit spread among accounts in the balance sheet and statement of operations. This matter was explained in further detail to the Board members during the training on the Bank's financial statements, held on 9 March 2018.

On 23 February 2018, KPMG presented the results of its FY2017 integrated audit of the Ordinary Capital, the Fund for Special Operations, the Intermediate Financing Facility and of the IDB Grant Facility, confirming that no significant deficiency or material weakness in internal controls over financial reporting had been identified. The external auditors also confirmed that they expected to be in a condition to express an unqualified opinion on the financial statements. In that meeting,

the Audit Committee proposed that towards the end of 2018, KPMG return to present further information to the Committee on the new credit loss standards and their implications for the IDB.

6. Office of the Executive Auditor. 2017 Semi-annual Report and Perspectives on Possible Activities for 2018-2019 (GN-2871-3), 2018 Risk-based Audit Plan and Perspectives for 2019 (GN-2907), 2017 Annual Report (GN-2871-4)

The Office of the Executive Auditor (AUG) presented its semi-annual report for 2017 and requested the Audit Committee's perspectives on possible audit activities for 2018-2019. In preparation for the discussions, AUG had distributed, prior to the meeting, a table listing the actual and possible areas for a multi-year risk-based audit plan. The Committee members expressed appreciation for the opportunity to participate in the preparation of risk-based audit plans at an earlier stage, emphasizing the importance of engaging the Board in this process. Main agreements in that meeting included: (i) the Committee's interest in being informed about the availability of new audit reports as they are completed, and in receiving reports about the status of Management's action plans before AUG's presentation of its semiannual report; (ii) as part of AUG's semi-annual reports, to receive more information about the status of the audit plan for the corresponding year as well as the indication of any issues of concern and the measures being taken to resolve such problems; (iii) to have a next discussion on audit priorities based on a framework that explains AUG's methodology to identify risks and select audit areas; and (iv) the Committee's interest in AUG exploring ways to incorporate a corporate approach to the audit plan. Finally, the Committee requested AUG to prepare a document to further explain the rationale behind the selection of possible areas for a multi-year risk-based audit plan for 2018-2019. Based on this information, the Committee agreed to continue the discussion about the perspectives on possible audit activities for 2018-2019 prior to the consideration of the audit plan proposal.

On 28 November 2017, AUG presented its proposed Risk-Based Audit Plan and work program and budget for 2018. In that occasion, the Audit Committee and BUFIPOL asked AUG to continue improving its explanation and justification of the audit engagements selected each year for inclusion in the Plan and reiterated their interest in regularly recurring audits of units reporting to the Board, following up the planned audit of OVE in 2018 with an audit of MICI in 2019. The Committees also expressed interest in AUG's offer to present a sample of its 2017 reports to the Audit Committee, to better familiarize Directors with the methods and substance of its work. Lastly, it was agreed that an external evaluation of AUG itself, to be conducted in 2018, should be presented to the Committee upon completion, with the external evaluator in attendance to answer questions.

AUG presented its 2017 Annual Report on 10 April 2018. AUG noted that 2017 ended with no overdue observations, as all action plans prepared by Management to address audit observations were implemented within the agreed upon timelines. Noting that the content of the annual report was rather descriptive, several Executive Directors expressed interest in having a more strategic discussion on the main findings and conclusions of individual audit reports, as well as on the prospective areas for AUG's work in the future. In this context, Committee members asked that AUG consider the following suggestions in the preparation of future annual reports: (i) include the main findings, conclusions and/or messages of key audit reports issued during the period; (ii) expand the commentary on emerging topics, offering perspectives on topics that have yet to materialize; and (iii) present the progress of the audit activities executed during the year against the audit plan approved by the Board, explaining any relevant changes. It was also recommended that in the oral presentation of the annual report, AUG updated the Committee on the status of overdue observations and audits completed after the distribution of the report. Moreover, Executive Directors expressed interest in continuing the practice of discussing selected individual audit reports.

7. Office of Institutional Integrity and Sanctions System. Leading Integrity Efforts for 15 Years. Annual Report 2017 (GN-2919)

The Audit Committee of the IDB and the Committee of the Board of Executive Directors of the IIC considered the 2017 Annual Report of the Office of Institutional Integrity (OII), the Sanctions Officer, and the Sanctions Committee on 17 April 2018. This comprehensive report marked the Bank's work on integrity and fraud and corruption risk management over the past 15 years. The Committees valued the Bank's focus on promoting a culture of integrity and recognized the significant progress achieved since the creation of OII and the Sanctions System. Acknowledging the increase in the number and complexity of activities and cases investigated in recent years, Directors were reassured that the offices had sufficient resources to fulfill their mandates. In this context, it was requested that indicators to measure the efficiency of OII and the Sanctions System be included in subsequent annual reports in order to provide the Board with the tools to assess the future needs of those offices.

8. Office of Ethics. Report of 2017 Activities for the IDB Group (GN-2918)

On 17 April 2018, the Office of Ethics (ETH) presented its 2017 Annual Report, whose highlights included: responding to 421 requests for guidance from IDB Group employees, administering the Declaration of Interests Program, reaching a historically high number of employees through ethics outreach and training initiatives, and handling 44 cases of alleged misconduct and closing 40 of them. The Committee thanked Management for a complete and informative report and congratulated ETH on its 10th anniversary, encouraging the team to further disseminate its important work to the IDB Group. The Committee also welcomed the newly appointed Ethics Officer, Mr. Alberto Rivera-Fournier.

9. Legal Department Report to the Audit Committee: January to December 2017 (GN-2300-17)

The Legal Department presented its 2017 annual report to the Audit Committee and provided information related to cases under consideration by the Administrative Tribunal. The General Counsel informed the Committee that, in the period 1 January to 31 December 2017, the Bank's borrowing activities had been conducted in compliance with the policies and regulations governing the institution. He also confirmed that there was no pending or threatened litigation, or other material events of which he was aware, that would have a material adverse impact on the Bank's financial statements and that had not been reported in the Bank's regular disclosure documents.

10. Preparation and Approval Process of Sovereign Guaranteed Investment Loans. Audit Report, January 2018 (GN-2916, PP-874), Disbursement Process. Audit Report, July 2017 (GN-2917) and presentation on Cybersecurity and Digital Assurance

In response to the interest expressed by the Audit Committee members to have more strategic discussions regarding the internal audit function, the Office of the Executive Auditor (AUG) presented two audit reports included in its 2017 Risk Based Audit Plan:

1. *The Preparation and Approval of Sovereign Guaranteed Investment Loans (GN-2916, PP-874)*. This audit provided reasonable assurance on the design and effectiveness of the governance, risk management, and internal controls over the sovereign guaranteed investment loans preparation and approval process, from project identification to contract signature, and

2. *The Disbursement Process (GN-2917)*. This audit provided reasonable assurance on the adequacy of segregation of duties, system access controls, and compliance with contracts and relevant policies and procedures of the process to disburse sovereign guaranteed loans. In addition, the audit aimed at providing insights on the design of internal controls in the new disbursement module to be implemented in Convergence.

Following a fruitful debate, the Committee reiterated its interest in the issues raised in both audits as well as in continuing to have the opportunity to consider selected reports in the future.

The Committee also took note of a presentation by AUG on *Cybersecurity and Digital Assurance*, which highlighted the IDBG digital landscape, AUG's digital assurance roadmap, key takeaways of AUG's work in the area of digital assurance and next steps regarding the implementation of AUG's digital assurance roadmap.

11. 2017-2018 Selection Process and Recommendation for the Position of Chief of the Office of Institutional Integrity (GA-256-7)

The Committee met in executive session on June 19, 2018 to discuss the selection process and recommendation for the position of Chief of the Office of Institutional Integrity. Management briefly described the process which was undertaken to select the number one ranked candidate, as well as the candidate's qualifications. Pursuant to its terms of reference, the Committee concurred with the recommendation of the selection panel and of the Bank's President to hire the top-ranked candidate.

Conclusion

The Audit Committee will continue to consider recurring proposals and periodic reports during the next Chairmanship. Other issues that are expected to be submitted to the Audit Committee in the next cycle include:

1. *AUG's External Quality Assurance (EQA) Review*

An external quality assurance review of the internal audit function is required by the Institute of Internal Auditors Standards to be conducted at least once every five years. External assessments require an outside qualified reviewer, or a team of independent reviewers, who are competent in the professional practice of internal auditing and in the external assessment process. The EQA results must be provided to the Executive Auditor, Senior Management, and the Audit Committee. The next EQA should be conducted in 2018.

2. *Discussion of selected individual audit reports*

Committee members had expressed interest in discussing selected individual reports issued by AUG during the year to better familiarize themselves with the methods and substance of AUG's work. AUG should present selected reports in the first semester of 2019.

3. *Other matters*

The Audit Committee proposed that towards the end of 2018, KPMG return to the Board to present further information to the Committee on the new credit loss standards and their implications for the IDB.

Finally, I would like to thank all Committee members for their active participation and insightful comments and recommendations during the Audit Committee discussions. Likewise, I wish to thank Director Martí and Director Novoa, with whom I had the pleasure of co-chairing joint

Committee meetings over the past year. I also would like to thank Management and Staff for its continuous support and collaboration in the planning and execution of the Audit Committee's work program over the past cycle.