

# FAST TRACK BRIEF

January 14, 2009

*The IEG report “Review of IDA Internal Controls: An Evaluation of Management’s Assessment and the IDA Review,” was discussed by CODE on January 14, 2009*

## Review of IDA Internal Controls: An Evaluation of Management’s Assessment and the IAD Review

- ◆ IEG’s evaluation found that IDA’s internal controls framework operates to a high standard overall, giving reasonable assurance that controls operate effectively, but it identified weaknesses in parts of the framework.
- ◆ IEG found one material weakness in the IDA controls framework, which is in the complex of controls governing IDA’s efforts to ensure against fraud and corruption in lending operations.
- ◆ The independent evaluation was based on management’s detailed self-assessment.

IDA stakeholders want to be assured that IDA complies with its Articles and policies, and that the funds it provides for development purposes are used as intended and have measurable results. A key purpose of IDA’s control system is to provide such assurance. Hence, the Board of Executive Directors requested a full evaluation of the system by the Independent Evaluation Group (IEG), through an assessment by IDA management and a review by the Internal Audit Department. The evaluation is the first of its kind not only for the Bank but also for all international financial organizations. In this sense the Bank and IDA have taken an important lead in assessment of internal controls.

In this concluding step in the exercise, IEG finds that, with some important qualifications, IDA’s internal controls framework operates to a high standard overall, giving reasonable assurance that the controls operate effectively. The weaknesses are concentrated mainly in the areas of fiduciary controls and the related lack of a specific focus on controls at the transactions level against fraud and corruption in operations supported by IDA. With regard to the management assessment, IEG finds its approach and

method as transparent, well documented, and comprehensive.

The analysis includes several recommendations. First, controls over possible fraud and corruption in IDA operations should be addressed on a broad front, starting with risk management processes and country assistance strategies, and including the development and deployment of specific additional instruments directed at fraud and corruption issues at the level of programs and projects. Second, the implementation of remedies for the other control deficiencies should be closely monitored. Management has recognized the need for such remedies, and many are contained in the Governance and Anti-corruption (GAC) program currently being implemented (including some still under preparation). These remedies appear in both scope and content to address the key issues, and they correspond well to those suggested by IEG in this report. However, they are not yet sufficiently operative to be tested and, if effective, thereby lessen the materiality of the controls weaknesses identified. IEG thus believes it would be premature to conclude that F&C risks have been successfully resolved under the current IDA controls framework.

## Approach and Method

During the IDA14 Replenishment process, in response to shareholder concerns, World Bank management committed to have carried out (by IEG) “an independent comprehensive assessment of IDA’s internal control framework, including internal controls over IDA operations and compliance with its charter and policies.” In the process agreed with the Board, management would assess the controls, the Internal Audit Department (IAD) would then review the assessment, and IEG would conduct an independent evaluation of both the management and IAD reports.

Management used the COSO (Committee of Sponsoring Organizations of the Treadway Commission) framework as the basis for its assessment. It divided its study into two parts, Part I dealing with compliance issues within business transactions, and Part II dealing with efficiency and effectiveness issues within IDA entity-level controls. Part IA of the review was completed in late 2006 and Part IB in mid 2007.

This report presents IEG’s evaluation of the effectiveness of IDA’s integrated internal controls framework. The evaluation covers both methods and findings, taking Parts I and II together.

**IEG has evaluated management’s approach and method as transparent, well documented, and comprehensive, though it would have been preferable to have examined the entity-level controls before the transactions level controls—in other words, for Part II to have preceded Part I, because this would have enabled a more prioritized, risk-based focus to the transactions level assessment.**

## Key Findings of Part II

**Evidence presented by management for both the entity- and transactions-level controls gives reasonable assurance—except for weaknesses identified in certain parts of the overall framework—that controls operate effectively.** With these exceptions, the controls framework provides Senior Management and the Board with reasonable assurance that the three COSO objectives are being achieved: Reliable financial reporting, compliance with policies and procedures, and the efficiency and effectiveness of operations. Evidence of controls effectiveness at the entity level (based on questionnaire results) includes pass rates ranging from 92 percent to 95 percent, depending on the method. The earlier evidence at the transactions level includes a pass rate of 93 percent (document-based testing of key controls).

**Management, IAD, and IEG all found that, while the overall framework is robust, there are weaknesses that are concentrated in a few key areas.** The three parties generally agree on the nature of the deficiencies uncovered, but there are somewhat different judgments as to their materiality: IEG found one *material weakness* and six *significant deficiencies*. Management found *significant deficiencies* in five areas but no material weakness. IAD found that a *material weakness* will arise if a combination of significant deficiencies in fiduciary controls, entity-level controls, controls over fraud and corruption, and information technology (IT) controls are not remedied in timely manner.

**Evaluating Controls Under COSO.** IEG evaluated the overall effectiveness of the entity-level controls framework under COSO and compared the relative strengths of controls within each of the five COSO components, using the audit standards agreed for the review. The overall rating is *satisfactory with qualifications*, and this rating was given equally to controls within all five components.

**Material Weakness.** Evidence emerged during the review—commensurate with the known prevalence of fraud and corruption (F&C) in many borrowing countries—that suggested that there are significant risks of F&C impinging on IDA’s lending operations. There has been progress in building the Bank’s governance and anti-F&C agenda. However, both the *specific* tools to address F&C issues at the transactions level in IL and heightened efforts to support the building of client country systems that can protect IDA funds from F&C in DPL/PRSC type lending (i.e. budget support) have been put in place only recently, and their overall effectiveness cannot yet be tested. These weaknesses are reinforced by significant deficiencies found in other related controls: in risk management, project financial management, and procurement. Since the risk of fraud and corruption by local beneficiaries, contractors and other stakeholders can result in diversion of funds that, in the worst case, can impair IDA’s mission, IEG considers this weakness to be a material weakness.

IEG stresses that this finding is based on the *risk* of F&C rather than any clear measure of the extent to which F&C may have *actually occurred* in operations supported by IDA financing. It should also be kept in mind that weak governance is a widespread problem and a fundamental dimension of the development challenge, and the risk of misuse of funds exists not only for IDA but also for its development partners. The challenge, which IDA is now addressing, is to bring it more into the open and match it with risk management controls.

**Significant Deficiencies.** At the conclusion of this final part of the evaluation, IEG found six significant deficiencies: (i) a need to maintain the currency of the Bank's Operational Policies and Bank Procedures (OP/BPs); (ii) a need for improved systems of document retention and accessibility; (iii) generic weaknesses in controls over financial management and procurement processes (Part I); (iv) a need for improved management oversight of project processing and supervision, coupled with improved staff incentive structures and performance accountability; (v) a need to improve risk management, including inserting specific F&C risk factors into the Risk Scan and integrating risk treatment from the entity level to the activity level; (vi) a need for greater IT security in some areas.

**Other Deficiencies.** During the two parts of the review a total of over 160 deficiencies of various kinds were identified. These are numerous but relatively minor weaknesses, which neither individually nor collectively rise above the level of minor deficiencies. Most of these have now been remedied or their remedies are in progress.

**IAD Review and Opinion.** IAD noted the significant deficiencies and other issues uncovered by the assessment in Parts I and II and, based on its review, expressed the opinion that management's assessment and qualified conclusions as to the effectiveness of IDA's internal controls review were fairly stated. However, it pointed to the identified significant deficiencies relating to fiduciary controls, entity-level controls, IT controls, and fraud and corruption controls, which in combination could create vulnerabilities which, if not remedied in a timely manner, could lead to a material weakness. IEG is unclear about the meaning of this, since if any weakness or deficiency has been identified, it should be considered to exist until mitigating measures have been introduced and proven to be effective.

**Accomplishments of the review:** This was the first review of this kind for any multilateral financial institution. It has thus broken new ground both in creating methodologies (controls mapping and testing, the ELCQ, the IEG templates) and in building strong factual knowledge about the Bank's internal controls framework. The corpus of materials emanating from the review provides a solid basis for mounting similar reviews in the future and for other analytical exercises. The review has also led to an acceleration in the developing of new controls for good governance within IDA's client countries, and specifically within IDA operations.

## Advisory Panel

IEG was assisted by a senior international Advisory Panel. It concluded that the evaluation of IDA's controls has been a comprehensive, timely and responsible initiative, and that the approaches and specific tools have been consistent with what the Panel would expect from an independent evaluation. The Panel agreed with the IEG finding of one material weakness and endorsed the reasoning underlying the finding, as it did for the six significant deficiencies. The Panel expressed the view that for an organization as significant and complex as the Bank, such findings would be common for a first review, and it concluded that the outcome of the overall Review reflects a high level of effectiveness compared to results in other organizations of similar size and complexity but with less international involvement.

## Recommendations

Based on its evaluation, IEG makes the following recommendations to IDA management:

- (a) **Address on a broad front the controls needed to ensure that F&C practices in IDA client countries and among participating stakeholders do not impinge on IDA's mission.** Actions could include:
  - **Accelerate implementation of the ongoing Governance and Anti-Corruption (GAC) program, and devote additional attention and resources to building an organizational culture and incentive structure in which the risks of F&C are explicitly and cost-effectively addressed in the management of IDA's operations.** While Management has correctly observed that such awareness has been spreading, including through the follow-up to the Volcker report, the systematic integration of this awareness into daily operations still has some way to go and needs to be given sustained emphasis going forward.
  - **Develop and deploy specific F&C related instruments into the Bank's Risk Scan processes, CASs, lending and project designs, and ISRs.** Remedies have already been initiated as part of the GAC initiative and the Volcker Report, and INT has recently become involved in helping to design toolkits to address F&C at various levels of the lending cycle, although it is too early to judge the impact of these initiatives. It is also important to link country-based risk assessments through

the Risk Scan to specific tools to address lending risks in both IL and DPL/PRSC type lending.

- **Continue the ongoing reforms of FM and PR processes (launched in response to the findings of this review) and link them closely to the F&C agenda.** These are key elements in the Bank's fiduciary and governance systems, but evidence from the review suggests that new toolkits (such as those being developed under the "GAC in Projects" program) need to be deployed, made operative and later tested for effectiveness.
- **Intensify IDA support to strengthen clients' fiduciary and governance systems, recognizing that this is a principal means to guard against F&C and to ensure the effective use of IDA resources (and the only means to do so in the case of budget support operations such as PRSCs).** In the case of DPL/PRSC operations, special emphasis needs to be given to developing tools that could attach, for example, to the Letter of Development Policy and to CFAA requirements, to raise the attention to systemic F&C issues at the country level.
- **Make arrangements for testing the operating effectiveness of these and other new controls at some appropriate time in the future,** since the material weakness and other identified deficiencies will be deemed to persist until this has been done.

(b) **Closely monitor the implementation of remedies for control deficiencies, including:**

- **The measures currently in progress to update the OP/BPs.** These also need to be extended to key areas (AAA, F&C) not yet covered or where new policies are being developed.
- **A mechanism to ensure the future currency of OP/BPs.** There has been progress in bringing the body of OP/BPs into conformity with overall Bank and IDA policies and strategic goals, and IEG has therefore downgraded the weakness uncovered in this area during Part I from a potential material weakness to a significant deficiency.
- **Improved documentation retention and accessibility and a user-friendly documentation management system.** In its Part IB report IEG had already downgraded the materiality of this issue from a potential material weakness to a significant deficiency. However, the needed IT systems are not yet in place and the Enterprise Content and Document Management (ECDM) system of which they will be a part should be developed as a matter of priority.
- **Mechanisms to correct and monitor the several IT systems deficiencies identified.** These included password management, business continuity and change management, and need for tighter control over IT access privileges for staff who rotate into new positions.
- **Measures to address the about 100 identified other as yet unresolved deficiencies.** Remedies for many of these are already in progress, but specific monitoring is needed given the wide front and many areas in which remedial actions are needed.

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