
FAST TRACK BRIEF

September 29, 2010

The IEG report “IDA Internal Controls: Evaluation of Management’s Remediation Program” was discussed by CODE on September 29, 2010

IDA Internal Controls: Evaluation of Management’s Remediation Program

- ◆ IEG completed the last of its three reports for the review of IDA’s internal controls in December 2008. Subsequently, and in response, World Bank management prepared a Five-Point Action Plan (FPAP) designed to address and remedy the controls weaknesses uncovered by the review—one Material Weakness and six Significant Deficiencies.
- ◆ IEG evaluated the FPAP implementation against the key findings and recommendations of its earlier internal controls evaluation, assessing and taking account of the IAD review and opinion, and on that basis reassesses the materiality of the identified controls weaknesses. This follow-up activity addresses earlier findings and is not a reevaluation of the overall IDA control framework.
- ◆ IEG concurs with management and IAD that significant progress has been made and finds that the previously identified Material Weakness can now be downgraded to a Significant Deficiency and that two of the previously identified Significant Deficiencies can now be dropped.
- ◆ The effectiveness of new tools that management has now put in place will depend crucially on the extent and manner of their application and the strength of underlying staff and manager incentives to apply them effectively, and this will need to be tested over time.

Management Assessment

IEG had earlier identified five steps that were needed to address control weaknesses: improve the efficiency and effectiveness of controls for investment lending; strengthen risk management capacity, incentives, and accountability at the project and institutional levels; better integrate fraud and corruption prevention into operations; tighten fiduciary controls; and strengthen the role of information technology in risk management and improve processes for analytic and advisory

IAD Review and Opinion

IAD has closely tracked FPAP implementation progress. In its final report IAD presents findings and conclusions from a detailed database of actions underlying the 22 corrective actions in the FPAP. This provides an auditable basis to check the validity and operational content of the corrective actions. The report also compiles a detailed record of management

activities. The FPAP laid out a seven-point action plan to address these five areas.

In its assessment of the FPAP implementation, management describes progress in adopting remedies in each of the five areas. It finds that IDA internal controls have been significantly strengthened and that the control environment (at both transaction and entity levels) has been fundamentally improved. Out of 22 corrective actions, management finds that 19 have been implemented and the remaining 3 are at an advanced stage of design and testing.

testing of certain reformed fiduciary controls that had failed tests during the earlier review.

IAD’s Conclusion. “In IAD’s opinion, Management’s assertion that IDA internal controls have been significantly strengthened at both the transaction and entity levels is fairly stated. Management has substantially addressed the significant deficiencies identified in the 2008 Review through the implemen-

tation of the FPAP. The introduction of new tools and frameworks at the entity and transaction levels satisfactorily address the control weaknesses identified in the 2008 Review. Also, in the fiduciary and IT [information technology] areas, specific controls that were not operating effectively at the time of the 2008 Review have been corrected and are now operating effectively. IAD can give assurance that the design of all the new controls is robust. However, the operating effectiveness of most of these controls can be assessed only after a reasonable period of operation. IAD will cover operating effectiveness in the course of its regular assurance audits.”

IEG's Evaluation

The Scope of the FPAP. In its 2008 report IEG described the origins of each weakness, in the case of the Material Weakness also including a chart that indicated the factors involved and their interactions. Management did not organize the remedies in its FPAP to match the matrix of IEG findings, so IEG had to cross-track some remedies from the FPAP back to the earlier IEG analyses. In doing so IEG found that the FPAP directly or indirectly addressed all areas in the matrix of the Material Weakness and six Significant Deficiencies. IEG therefore concludes that the content and scope of the FPAP were broadly appropriate.

Management, in its description of the FPAP design, gave most emphasis to investment lending issues. This is understandable given the weaknesses in fiduciary and other project-level controls found by the review. Both the FPAP and the ongoing Governance and Anticorruption (GAC) implementation program also contain measures to strengthen country systems and address risk in development policy lending, but IEG finds that management could have usefully emphasized these topics more in describing its own program. This issue is important because improved country systems and institutions are needed to bolster controls and governance in Bank projects and programs under all types of lending.

Management's Implementation of the FPAP. Using the criterion that a corrective action must be in operation to be counted as implemented, IEG found that 17 of the 22 actions have been implemented. While this differs slightly from the findings of management and IAD, this difference is not material given the progress so far and does not detract from the fact that the FPAP as a whole has been substantially implemented. Management has stated that it will put all 5 remaining corrective actions into operation before the end of FY11. Further, IEG conducted a detailed examination of the 9 corrective actions that had several subcomponent actions (of which there were 49 in all) and found that virtually all subcomponents had been implemented.

Given that IEG finds the FPAP to be well designed and that the action plan has been almost fully implemented, it has reconsidered the materiality of the controls weaknesses found in its earlier evaluation.

The Material Weakness. In its earlier evaluation IEG found that no controls explicitly addressed the risks of fraud and corruption in IDA operations. Given the potential for impairment of IDA's mission if such risks were not adequately addressed, IEG deemed this a Material Weakness in the controls system. Eleven factors contributed to this finding, including entity-level (institutional) factors, project-level (transactions) factors, and a lack of integrated risk management to link the entity and transactions level controls. For each of the 11 factors this current IEG report provides a detailed account of the nature of each issue found in the 2008 report; the corrective actions that directly or indirectly addressed that issue; the implementation status of the intended remedy; and the possible impact the corrective action could have on the controls in question. The report also offers IEG's conclusion regarding the contribution of the remedies to alleviating or removing the Material Weakness.

IEG arrived at a consolidated conclusion regarding remediation of the Material Weakness by evaluating the combined impact of all remedies together. It is evident that the FPAP was designed to address the three key areas—entity-level factors, linking factors (risk management), and project level (transactions) factors that IEG identified. All have been found to be appropriately designed and substantially implemented, although greater emphasis could usefully have been given to the need to strengthen country systems.

IEG therefore concurs with management's assertion that the FPAP has significantly strengthened IDA's internal controls and improved the overall control environment. Management of institutional risk has been strengthened by a shift to a risk-based approach for investment lending operations, by new processes of quarterly and annual risk reporting to the Board that explicitly address fraud and corruption risk facing the Bank, and by providing support through tools and guidance to address fraud and corruption risk at the project level. The Country GAC has been designed *inter alia* to address fraud and corruption risks at the country level. The effectiveness of these new tools will depend on the extent and the manner of their application, and management will need to test them over time. However, their existence represents an enhancement of the controls to address fraud and corruption risk in IDA operations in a way that responds substantially to the Material Weakness finding. Based on these considerations, IEG finds that the Material Weakness can now be downgraded to a Significant Deficiency.

The three elements still to be implemented in the control environment (definition of responsibilities and accountabilities, management oversight, and human resources policies) are important, and continued attention is needed to the aspects of accountability, management oversight, and human resource policies to ensure adequate staff incentives to address fraud and corruption. Management and staff incentives and behavioral factors were important to the Material Weak-

ness finding. Behavioral factors and incentives will continue to be important in strengthening the controls and addressing the ongoing Significant Deficiency in this critical area, because the effectiveness of the new tools that have been in place will ultimately be determined by how they are applied by the operations staff.

The Significant Deficiencies. IEG employed an organizing device similar to that used for the Material Weakness, namely each corrective action relevant to addressing each of the six Significant Deficiencies has been identified, described, and evaluated. In this way IEG has now evaluated the extent to which each Significant Deficiency has been addressed by corrective actions and the extent to which the resulting improvement in controls for some of the Significant Deficiencies (management oversight, fiduciary controls, and risk management processes) may also have contributed to alleviation of the Material Weakness.

Overall Scorecard. Following its analysis of how the FPAP has addressed the Material Weakness and the six Significant Deficiencies, IEG finds that there has been substantial progress in addressing all of the Significant Deficiencies. IEG concludes on this basis that the overall scorecard of remedies has led to the results summarized in the table below: The Material Weakness should be downgraded to a Significant Deficiency, and, of the six original Significant Deficiencies, two (which relate to generic weaknesses in fiduciary controls and certain weaknesses in information technology controls) should be removed and four should remain pending implementation and testing of stated actions. Thus, the result of the FPAP so far has been to move from one Material Weakness and six Significant Deficiencies to five ongoing Significant Deficiencies: controls over fraud and corruption; currency of OP/BPs; retention and accessibility of operational documents; management oversight and staff incentives; and risk management.

Summary of IEG Findings Relating to the Material Weakness and Significant Deficiencies

Control weakness finding	IEG finding on the status of the MW/SD	Actions pending	Expected completion date
Material Weakness:			
In controls to address risk of fraud and corruption (F&C) in IDA operations	Downgraded to Significant Deficiency	Continued testing of key controls	Recommend testing by July 2012
Significant Deficiencies:			
SD 1: Currency of Bank OP/BPs	Remains Significant Deficiency	OP/PB 11.00, OP/BP on reformed investment lending controls, and compliance of analytical and advisory activities (AAA)	June 2011
SD 2: Retention and accessibility of operations documents	Remains Significant Deficiency	Rollout and testing of the Operations and Knowledge Systems Program (OKSP)	Rollout, October 2010, recommend testing by October 2012
SD 3: Generic weaknesses in fiduciary controls	Removed	Fraud and corruption aspects of fiduciary controls to be tested under the Material Weakness cluster	See F&C controls
SD 4: Management oversight and staff incentives	Remains Significant Deficiency	Completion of Matrix Leadership Team (MLT) work on sector managers; continued testing of key controls	Completion, December 2010, recommend testing by December 2012
SD 5: Risk management at Bank and project levels	Remains Significant Deficiency	Testing of operability of new fraud and corruption controls	Recommend testing by July 2012
SD 6: Lack of information technology security in certain areas	Removed	--	

Overall Summary and Recommendations

The extensive review of internal controls has been a positive experience and has strengthened IDA and the Bank. Management should periodically conduct such reviews, with modifications to fit the circumstances. IEG has noted the next steps that management described in its report—to emphasize the monitoring of key aspects of the Bank’s quality assurance, financial management, and procurement systems and to strengthen still further the Bank’s risk management systems—and makes the following recommendations:

On the five Significant Deficiencies:

- Management should continue to address the remaining five Significant Deficiencies proactively and should revisit their status when significant further improvements have been made or when there are sufficient lessons of experience.
 - **Controls to address fraud and corruption in Bank/IDA operations:** Within two years of the ongoing rollout of the new risk-based investment lending system, management should review experience under the new system. This should include selected and indicative tests of the operational effectiveness (that is, widespread usage and credible applications) of the new tools to address fraud and corruption risks in Bank operations. It should also include, as IEG rec-

ommended in its 2008 report, a parallel review of how country systems have been strengthened to address risks—including fiduciary and fraud and corruption risks—in development policy lending and investment loans that provide significant operations and management financing—both of which may require more in-depth management attention.

- **Currency of OP/BPs:** A number of OP/BPs are in various stages of revision. Management should continue or accelerate this progress to improve the currency of the OP/BPs in order to have a body of policy documents to guide staff. In particular, management has almost finalized OP/BP 11.00 on procurement, is developing a framework for new policy guidance on investment lending to conform to the new tools that are being rolled out, and is considering guidance on controls and processes for analytic and advisory activities.
- **Retention and accessibility of documentation:** In about two years, management should review experience with the operational use of the Project Portal and WBDocs, with selective and indicative testing of a few key controls to assess their effectiveness in a significant sample of projects processed under the new risk-based investment lending system.
- **Management oversight and staff incentives:** The earlier Entity-Level Controls Questionnaire (ELCQ) proved useful for assessing controls-related attitudes and problems Bank managers face. Assuming that management will periodically undertake both internal and external controls reviews, IEG recommends that the ELCQ tool also be applied periodically (every three to four years), suitably updated but with continuity in the questions so as to test the evolution of management and staff attitudes to addressing fraud and corruption risk in Bank operations.
- **Risk management:** Management has taken steps to improve risk management, including incorporation of the COSO Enterprise Risk Management into the new integrated risk management framework, adoption of the annual Integrated Risk Management Report (IRMR) and quarterly risk reports to the Board, and establishment of the risk-based approach to investment lending and the accompanying instruments and tools. Over the coming two years, and as part of testing the effectiveness of these tools, management should establish the extent to which the tools have been applied to enhance integrated risk awareness. For example, what trends emerge in the fraud and corruption risks tracked in the IRMR? What is the frequency and quality of treatment of fraud and corruption risks in Country Assistance Strategy papers for high-risk countries, and what links exist between

fraud and corruption risks expressed in the Country Assistance Strategies and those expressed in the Operational Risk Assessment Framework and Project Appraisal Document in project design?

On future internal controls reviews:

- **Monitoring of internal controls should be a continuous process.** As part of this process, management should undertake in-depth reviews when continuous monitoring highlights a problem in a particular area. High-risk areas in particular should be reviewed periodically. And when changes occur—new functions are added, reorganizations are completed, or new risks emerge, for example—those new areas should be reviewed. Risks should always be matched by explicit controls. The new Integrated Risk Report should be used to detect and report on new risks as well as on the status of existing controls based on the results of continuous monitoring efforts and any in-depth reviews of controls performed. The results of these periodic reviews should, as appropriate, be shared with the Board and other IDA stakeholders.

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