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REPORT OF THE EXTERNAL AUDITOR ON FINANCIAL REPORTING STANDARDS OF THE WORLD FOOD PROGRAMME

NOTE TO THE EXECUTIVE BOARD

This document is submitted for consideration to the Executive Board.

The Secretariat invites members of the Board who may have questions of a technical nature with regard to this document to contact the focal points indicated below, preferably well in advance of the Board's meeting.

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Should you have any questions regarding matters of dispatch of documentation for the Executive Board, please contact the Supervisor, Meeting Servicing and Distribution Unit (tel.: 066513-2328).

EXECUTIVE SUMMARY

This report reviews the basis of the World Food Programme's financial reporting standards and invites the Executive Board and management to consider the adoption of improved, independent standards to further enhance the usability, integrity and effectiveness of the organisation's financial reporting.

As the Programme's external auditors, we believe that there would be benefits to the WFP in adopting International Accounting Standards or International Public Sector Accounting Standards as the basis for its financial accounting and reporting. Compliance with independent and generally-accepted accounting practice and reporting standards would contribute to the Programme's visible demonstration of high standards of governance as an international public sector organisation and aid agency of repute.

We have carried out an analysis of the World Food Programme's financial statements against the requirements of the independent International Accounting Standards and have separately provided a detailed commentary to management. This report presents the case for considering the adoption of independent accounting and financial reporting standards; and the implications for the World Food programme if this development is pursued.

DRAFT DECISION*

The Board takes note of the "Report of the External Auditor on Financial Reporting Standards of the World Food Programme" (WFP/EB.1/2005/5-E).

* This is a draft decision. For the final decision adopted by the Board, please refer to the Decisions and Recommendations document issued at the end of the session.

INTRODUCTION — THE IMPORTANCE OF FINANCIAL REPORTING

1. The Executive Board and senior management of the World Food Programme have taken a lead in supporting the strengthening of financial management and the improvement of the Programme's corporate governance arrangements. Senior management have expressed a wish to consider moving the organisation's financial reporting towards internationally-accepted accounting standards.

2. Accurate and comprehensive financial reporting is an essential element of effective corporate governance. WFP's financial statements and related reporting provides the Executive Board, governments, donors, and the Programme's wider constituency with authoritative, independently audited information against which the organisation's financial status and performance can be assessed and decisions taken.

3. Clarity, comprehensibility and consistency in the reporting of the financial position of an organisation is integral to good governance. The World Food Programme's dependence on voluntary donations, and the absence of a regular budget funded by assessed contributions, makes it especially important that the Programme can demonstrate high standards of financial management and reporting against independent, credible and well-understood standards.

4. The presentation of this information based on the principles of currently accepted best accounting practice would encourage increased financial awareness; offer an increased level of assurance to the Board and Programme managers on the accounting records; and potentially improve the quality of decision making.

THE CASE FOR CHANGE

5. The increasing globalisation of commerce in recent years, with more companies seeking listings in foreign markets and the establishment of branches and subsidiaries in other countries, has led to a growing need for adherence to widely accepted and well-understood accounting standards. Many of the accounting abuses of recent years, particularly in the private sector, involving off-balance sheet finance, lack of clarity in the financial position, the presentation of debt as equity and the abuse of reorganisation provisions, were practised in areas of accounting where unnecessary flexibility or lack of clarity was allowed, or where appropriate standards were not followed.

6. Increasingly, improved governance requirements have been transferred over to the public sector, at both international and national levels, where stewardship, transparency and accountability for public funds is arguably of even greater importance than in the private sector. The global nature and increasing demands on international charitable and public benefit entities, and the businesslike management that is necessary for efficiency and effectiveness in an operational context of insatiable need and limited budgets, make improved standards of governance, reporting and accountability highly relevant to international aid work.

7. In June 2004, for the 2002-2003 financial statements submitted to the Executive Board, management incorporated a number of presentational changes to provide a clearer report to readers of the accounts. To further improve disclosure and presentation of the financial statements, we have now examined the benefits and impact that would result from preparing WFP's financial statements in accordance with internationally recognised

accounting standards, which could help promote comparability, consistency and transparency in the Programme's financial reporting.

GOVERNANCE AND ACCOUNTABILITY IN WFP'S FINANCIAL REPORTING

8. Under Financial Rule 13.1, the Executive Director is responsible for preparing financial statements that are in accordance with the United Nations System Accounting Standards except where the nature of WFP's operations requires different internationally accepted accounting standards. The prepared financial statements must clearly show the financial position of WFP and meet the managerial requirements of the Executive Board and the Executive Director.

9. As WFP is entirely funded by voluntary contributions, this increases the requirement for accountability over transactions and for full transparency and consistency of the financial statements in order to maintain the confidence and ongoing support of the donor and recipient community.

CHARACTERISTICS OF FINANCIAL STATEMENTS

10. Four qualitative characteristics are applicable in the reporting of financial performance, to allow users of the accounts to make informed decisions:

- Understandability – users with a reasonable knowledge of the sector, its economic activities and accounting should be able to understand the financial statements.
- Relevance – information is relevant when it influences the Executive Board and other users of the financial statements in their assessment of past, present or future events.
- Reliability – information is reliable if it is free from material error, bias and lack of clarity.
- Comparability – users of the accounts should be able to compare financial statements and results over time, in order to consider trends and performance.

11. It is important that, whichever standards are adopted by the WFP, they must reflect to the above characteristics to allow donors, recipients, governing body members and senior management to have confidence in the financial information presented to them.

ACCOUNTING STANDARDS

12. Accounting standards were typically written by national standard-setting bodies according to their own national laws and interest, which led to a lack of comparability on a worldwide basis. The development of globally accepted international accounting standards has helped to ensure that financial statements are prepared in a consistent way between different entities; and by providing detailed guidance on the presentation of information in financial statements so as to ensure that disclosures are relevant, reliable, and understandable for all users of those reports.

13. Current international standards are based on the work of the International Accounting Standards Board (IASB), responsible for setting accounting standards, now designated International Financial Reporting Standards. The IASB came into existence on 1 April 2001, replacing the International Accounting Standards Committee which had been

established 27 years previously as a result of an agreement between the accounting bodies in Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom, Ireland and the United States.

INTERNATIONAL ACCOUNTING STANDARDS

14. The IASB issues International Accounting Standards as an independent, external set of standards for accounting and financial reporting. It inherited 34 International Accounting Standards from its predecessor and has developed five new standards called International Financial Reporting Standards (IFRS) to meet the need for universally accepted standards. The two acronyms, IFRS and IAS, are therefore used interchangeably to represent the full set of international standards.

15. More than 70 countries including Australia, Canada, Hong Kong and New Zealand are currently using IASB standards worldwide, or have announced plans to do so over the next couple of years. From January 2005, companies listed on stock exchanges in European Union member states must adopt the European Commission-endorsed IASB standards in their group financial statements.

INTERNATIONAL PUBLIC SECTOR ACCOUNTING STANDARDS

16. The International Public Sector Accounting Standards Board (IPSASB, formerly the Public Sector Committee of the International Federation of Accountants, IFAC) has developed a body of International Public Sector Accounting Standards, IPSAS, based on those prepared by the IASB. The aim of the IPSAS is to set out the requirements of financial reporting by governments and others in the public sector environment, whereas IASB standards address general reporting issues of both the public and private sector.

17. The IPSAS Board, a subcommittee of IFAC responsible for maintaining the public sector standards, develops new or revised guidance to address gaps in the current coverage in addition to preparing advice on specific public sector reporting requirements. IPSAS guidance is developed after the IASB has released standards covering these areas. IPSAS currently maintain 20 accruals based standards compared to 38 standards from the IASB.

UNITED NATIONS ACCOUNTING STANDARDS

18. The United Nations System Accounting Standards (UNSAS) were developed for the United Nations system alone and are based on those IASB standards that the UN system considered relevant to its particular circumstances, with differences arising from the UN system's view of the non-commercial nature of UN organisations. The UNSAS are less prescriptive than the independent international standards used elsewhere; and were developed to allow greater flexibility (leeway) in the way the UN organisations individually wished to respond to financial reporting requirements. UNSAS allows variations in accounting treatment from one entity to another and is silent on a number of aspects of accounting disclosure compared with international public and private sector accounting standards. They represent, therefore, a less stringent set of standards with regard to the consistency and comparability of reporting within and between entities.

19. The Task Force on the United Nations Accounting Standards is addressing the continuing evolution of the UNSAS but has been unable yet to reach a consensus for the system to move to the adoption of independently-recognised international accounting

standards - not even the International Public Sector Accounting Standards, IPSAS, developed by the Public Sector Committee of the International Federation of Accountants.

THE WFP FINANCIAL STATEMENTS – COMMENTS ON EXISTING COMPLIANCE WITH INTERNATIONAL ACCOUNTING STANDARDS

20. WFP already provides an almost complete set of financial statements as required by IASB standards - an income statement (Statement I to 2002-2003 WFP Financial Statements); a balance sheet (Statement II); a cash flow statement (Statement III); and notes which include the organisation's objectives and activities (Note 1) and a summary of significant accounting policies (Note 2) with other explanatory notes. The IASB income statement allows expenditure to be reported by nature, as is the case in WFP Statement 1 which reports by commodities purchased, ocean transportation etc.

21. IASB standards require a statement of changes in equity to draw users' attention to changes in the value of the entity's reserves and equity. This allows stakeholders such as creditors and shareholders to assess the risks to their investment by showing the assets available for distribution in the event of insolvency. This is not usually a concern of a United Nations organisation. Where applicable to the WFP, statement disclosures are currently made in Statement 1 or the Notes (transfers to reserves and the financial impact of changes to accounting policy, for example). For compliance with international standards, WFP could prepare a separate statement of material changes to funds and reserves.

22. WFP's financial statements presently comply with UN Accounting Standards which require that the statements are produced on the following assumptions. These are also assumptions required under IASB and IPSASB standards:

- Going concern – that the organisation will continue to operate for the foreseeable future, with no intention to liquidate or curtail significantly its operations (paragraph 23, IAS 1);
- Accruals basis –except for the cash flow statement assets and liabilities are recognised in the financial periods when they occur rather than when for example cash payment is made or received (paragraph 25, IAS 1). In 2002, WFP introduced accruals accounting for income other than that of bilateral operations, and trust fund income which continues to be recognised on cash receipt. The recording of income for both bilateral and trust funds would require review as part of a transfer to IASB standards; and
- Consistency – the presentation and classification of items in the financial statements are usually retained from one period to the next (paragraph 27, IAS 1).

23. There are areas for review which require further consideration to ensure compliance with international accounting standards but the current principles for preparation of the WFP financial statements are broadly similar to those required under IASB standards.

24. One of the benefits of moving to full compliance with internationally accepted accounting standards is the availability of best practice guidance for the preparation of financial statements. Financial statements in accordance with one set of standards are more likely to be readily understood, assisting governance and oversight and increasing accountability by reducing the risk of introduction of inappropriate accounting treatments.

AREAS OF MAIN IMPACT IN THE ADOPTION OF IAS

25. WFP's financial operations are relatively straightforward. They do not contain any complex or risky investment mechanisms, such as derivatives, which would affect the change to compliance with international accounting standards. Nonetheless, the implementation of policies and financial recording practices to produce accounts in compliance with International Accounting Standards is a major initiative, as evidenced by the preparation inside European Union countries for implementation from January 2005.

26. A departure from IASB standards is acceptable only in the extremely rare circumstances in which compliance with the standards would conflict with the objectives of the financial statements and influence the economic decisions made by users of the financial statements. Requirements for a clear external audit opinion for financial statements prepared under IASB standards include confirmation that presentation of the financial statements complies with those standards in all material respects.

27. External audit comments on the main benefits and impediments to the successful production of financial statements compliant with international accounting standards are set out below. We have separately provided senior management with an analysis and review of the specific disclosure requirements in relation to each relevant IASB International Accounting Standard.

28. There are currently three main areas where United Nations Accounting Standards and those of the IASB or IPSAS have different accounting treatments: in relation to the capitalisation of fixed assets; the disclosure of future staff costs; and the recognition of provisions or obligations.

Changes in the Treatment of Assets

29. Historically, donors in the United Nations system who pledged funding for a financial period frequently expected that funding to be used for the purposes intended during the period concerned. Performance was usually measured by assessing financial delivery against budget, which encouraged large obligations to be set up towards the end of financial periods to bring expenditure into line with funding. In the private sector, investors wish to see profits that increase over financial periods. They are also concerned that the balance sheet (assets and liabilities statement) has sufficient assets to repay entity creditors and shareholders in the event of bankruptcy. Assets that are utilised over more than one financial period are capitalised in the balance sheet at their current value or historic cost, which is then charged to expenditure over the period of use of the asset.

30. Although UN donors are less concerned than commercial entities with the value of capitalised assets or the revenue-earning potential of assets, at WFP and other UN organisations there is a welcome move towards assessing performance through a results based approach, as opposed to simply focussing on the reporting of expenditure against budget. For effective assessment of results based performance, the extent of resources consumed remains an important consideration to ensure that the results achieved in one period are reviewed on a similar basis to that of the following periods.

31. Currently, Note 8 to WFP's financial statements discloses the historic cost of buildings, equipment, furniture and vehicles, and the total biennium purchases and inventory write offs. The records behind this disclosure would form the basis for capitalisation disclosures required by IASB standards. WFP would have to ensure that adequate management control existed over asset records to give assurance of their completeness. At present, WFP records

inventory on a separate database to the main accounting records, which does not readily provide assurance over the completeness of recording of assets valued at some $40 million.

32. By introducing integrated capitalised assets and inventory modules in its financial accounting software, WFP could improve the existing management controls over the location and condition of assets worldwide; and would have the capability to disclose capitalised asset values in accordance with IASB or IPSASB standards.

33. In the interests of transparency, where capitalised assets are to be passed to governments free of charge at the end of projects, the residual value of the assets provided to a government should be written off before project closure, and the expenditure disclosed in the financial statements. Note 8 to WFP's 2002-03 financial statements reported a value of $7 million assets written off without separate disclosure of the value of assets transferred to the recipient country or write-offs arising from obsolescence and irreparability of assets. Additional disclosure of transferred asset values would assist informed performance assessment and value judgements on WFP's activities at the end of projects.

34. Finally, the capitalisation of assets could include intangible assets, such as software developed in-house, websites, or other assets for which there might be an identified market. The Programme's new initiatives to increase private sector funding might benefit from the valuation of capitalised assets if marketing opportunities arise in the future.

The Treatment of Future Staff Costs

35. IASB standard 19 covers disclosures related to staff costs, which are currently reported by WFP in Note 10 to the financial statements. The present disclosures are broadly in line with IASB requirements, although WFP does not at present have central records to establish liabilities for all staff employed by the organisation.

36. The international standard also specifies disclosure requirements for retirement benefit plans and is applicable to situations where funds are administered by third parties, such as the United Nations Joint Staff Pension Fund, which independently manage pension funds. This would require WFP to recognise its share of the costs of actuarial gains and losses in its own financial statements in the future, should this information be available.

Changes in the Treatment of Provisions, Liabilities and Assets

37. IASB standard 37 defines the accounting treatment for liabilities, provisions, and assets, and prescribes required disclosures. A liability may be defined as a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow of resources. Provisions are liabilities of uncertain timing or amount. Assets and liabilities which depend on the outcome of uncertain future events, such as the delivery of goods to an acceptable standard, are denoted as contingent assets or liabilities.

38. Currently, contingent liabilities are not recognised as such but are disclosed in the Notes to the accounts as a commitment, until the contingency is eradicated. Contingent assets are recognised in the financial statements where management deem the benefit is likely to be obtained.

39. Compliance with international accounting standards would not require any major addition to WFP's existing accounting records. To comply with UNSAS, WFP currently records as expenditure obligations for which a written commitment such as a purchase order has been made. Under International Accounting Standard 37, obligations related to purchase orders would be recorded as expenditure on the confirmation of goods received - when there is no realistic alternative to payment. Purchase orders remain contingent liabilities until a goods received note is provided. WFP would disclose provisions, contingent liabilities and assets in accordance with IAS 37, to include provisions which are currently held and disclosed as special accounts.

EFFECTS OF THE ADOPTION OF IASB STANDARDS ON WFP SYSTEMS

40. During 2004–2005, management intend to upgrade the underlying platform of their financial accounting system, WFP Information Network and Global System (WINGS) to ensure continued support by the supplier and to introduce identified business enhancements.

41. The WINGS system, based on the SAP accounting system, has been extensively modified to meet WFP's requirements. One benefit of the adoption of IASB standards would be a reduced requirement for customisation (and therefore the avoidance of additional costs) of the SAP system's functionality, which in its basic form was designed for private sector accounting and compliance with IASB standards. An illustration of this is that SAP follows the IASB requirement for annual accounting. To facilitate the use of SAP for biennial accounting, WFP prepares separate statements for each year of operation, which are then combined into the final published financial statements to meet the organisation's requirement for biennial reporting in the financial statements.

Annual Accounting

42. Under IASB standards, financial statements have to be presented at least annually, which conflicts with WPF Financial Regulation requiring biennial financial statements. However, most member states operate annual accounting and improvement to the WFP accounting systems may provide an opportunity for the Executive Board to consider the benefits of introducing annual financial statements with an appropriate revision to the Financial Rules. The production of audited annual statements would benefit transparency, management control and oversight by virtue of more frequent reporting, although some additional costs would be involved.

Fair Presentation

43. All generally accepted accounting standards require financial statements to provide a fair presentation of the financial position, performance and cash flows of the enterprise. Compliance with standards generally can be presumed to achieve a fair presentation. At WFP, contributions in kind represent a significant income source, initially recorded at the donors' stated valuation before being verified against any supporting documentation subsequently received. To measure income at fair value, WFP should ensure that any donor's valuation of contributions in kind represents a fair value assessment, especially in the absence of supporting documentation. To provide this assurance, WFP could periodically compare donor valuation to independent market values.

Awareness of Updated Standards

44. An important management consideration in relation to the adoption of independent accounting standards is the extent of change required to existing procedures and any costs involved, such as extra training of staff.

45. The IASB updates existing standards when deemed necessary to maintain best accounting practice. An International Financial Reporting Issues Committee provides timely guidance on financial reporting issues not specifically addressed in existing standards. In November 2004, the IASB had released two exposure drafts for public review dealing with the accounting treatment for mineral resources and financial instruments. It had also proposed amendments to three current standards: financial instruments, business combinations and employee benefits. At this time, IPSASB had three outstanding exposure drafts in the public domain for comment related to revenue, accounting for social policies of governments and impairment of assets.

46. Since both sets of standards aim to express best current accounting practice to ensure accountability, ongoing development of both standard sets can be assumed. All IPSASB standards are likely to affect WFP's financial accounting, whereas amendments to a particular IASB standard may not be relevant to WFP (examples are standards in relation to mineral resources, banks or retirement plans). At the time of finalising this report, two outstanding IPSASB exposure drafts and two IASB amendments would be relevant to WFP. This indicates that it cannot be assumed that compliance with IPSAS standards would automatically result in fewer future changes impacting on WFP financial statements than those prepared under IASB requirements.

47. Amendments to relevant IASB standards are likely to result in eventual changes to the related IPSAS. Adoption of IASB standards may therefore provide earlier guidance of the latest accounting developments which should increase accountability and could assist management in its stewardship of WFP assets.

THE IMPLEMENTATION OF IASB STANDARDS

48. A decision to prepare financial statements in accordance with international accounting standards would require an amendment to Financial Regulation 13.1 in particular, which currently requires the Executive Director to prepare financial statements in accordance with the UN Common Accounting Standards except when the nature of WFP's operation requires different internationally accepted accounting standards.

49. The introduction of any fundamental new accounting arrangements is most easily achieved at the start of a financial accounting period, to reduce changes to records already prepared and to ensure the integrity of general ledger coding for new accounting items such as capitalised assets.

50. To allow for the Board and senior management to consider the benefits associated with the implementation of international accounting standards, it would seem beneficial to carry out a dry run of financial statements in relation to a single year, prepared under IASB standards. This would also provide an insight into the degree of change necessary and the level of current staff expertise. The benefits of a dry run preparation of financial statements would allow WFP to determine the need for any new guidelines for staff having responsibility for the reporting or accounting of transactions.

CONCLUSION

51. In our opinion, there should be beneficial outcomes for the World Food Programme in adoption and adherence to an independent, widely-accepted and widely-understood set of accounting and financial reporting standards. We consider that the United Nations System itself will wish to move to independent reporting standards in the future, although progress in this to date has been slow. Compliance with International Accounting Standards or International Public Sector Accounting Standards will ensure a quality and utility of financial reporting that in our view presents advantages over the United Nations Accounting Standards. We recommend that the secretariat and the Executive Board give consideration to the adoption of independent international accounting standards by the World Food Programme.