

**Long Term Funding
Final Audit Report
Report Nr. 8/11
September 21, 2011**

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Introduction

In accordance with our FY2010 Audit Plan, EDC Internal Audit performed an audit of the Long Term Funding Process. As at December 31, 2010, long term debt was approximately \$22B CDN. This \$22B is comprised of approximately \$17.5B held for trading bonds, \$2B held to maturity bonds, and \$2.5B in commercial papers. Sources of funding include: USD Global Bonds, G-8 markets, private placements, structured notes and emerging market currency debt. Interest rate risk and foreign exchange risk associated with long term funding are managed through swap contracts which create credit exposure risk. The methodologies and processes used to measure, monitor, and manage interest rate risk, foreign exchange risk and treasury related credit risk are outlined in EDC's Risk & Capital Management Policy (RCMP). The RCMP also outlines the metrics to be used to monitor these risks and the allowable exposure limits for each metric.

Audit Objectives & Scope

The overall objective was to examine the design and operating effectiveness of the controls surrounding the issuance and recording of long term debt and related derivatives. The scope of the audit included examination of:

- ✓ Compliance with policies and guidelines;
- ✓ Controls to ensure issued debt was consistent with funding strategies;
- ✓ On-going monitoring of market and credit risks associated with funding process;
- ✓ Authorization of funding transactions; and
- ✓ Completeness and accuracy of UFS trade details.

The Board Resolution respecting the Issuance of Debt Instruments was updated in December 2010 which resulted in the issuance and approval of an operational guide outlining approval levels for both short and long term borrowings. The scope of our audit did not include detailed testing to ensure compliance with the new guide and verify UFS trade details as a sufficient population of transactions had not yet accrued.

Audit fieldwork was completed in July 2011.

Internal Audit Opinion

In our opinion, the Long Term Funding process is **Well Controlled**¹. Effective controls have been designed to ensure annual borrowing levels are approved by the Minister of Finance and that transactions executed under this approval comply with the Board Resolution respecting the Issuance of Debt Instruments. Market and credit risk exposures created through funding activities are monitored and any positions in excess of limits are closed on a timely basis. Actual funding activities and results are reviewed against strategies and adjusted based on market conditions. Two moderate issues were noted and are described in the following section.

Audit Findings & Recommendations

Market & Credit Risk Metrics

Through its funding activities EDC is exposed to market risk (interest rate risk, foreign exchange risk, and liquidity risk) and credit risk in the form of counterparty risk. The RCMP outlines the metrics to be used to monitor these risks and the allowable exposure limits for each metric. The definitions of how each risk metric is determined by Market Risk Management (MRM) in collaboration with management's Asset Liability Committee (ALCO). Positions against RCMP policy limits are calculated monthly by MRM and reviewed with ALCO. During the audit, we noted that orientation sessions are not provided for new ALCO members to ensure a consistent understanding of such items as: EDC's asset liability management principles, the related credit and market risks, the rationale for metrics used to monitor exposures including their interrelationships, and the rationale for policy limits for credit, market and liquidity exposures. In addition, although the RCMP is updated and approved by the Board on an annual basis, many of the market risk and credit risk policy metrics and limits have not been reviewed recently to ensure they continue to be appropriate in relation to EDC's operations. Finally, although positions against limits are reported to ALCO members, there is limited discussion of the operational implications of actual positions.

¹ Our standard audit opinions are as follows:

- **Strong Controls:** Key controls are effectively designed and operating as intended. Best in class internal controls exist. Objectives of the audited process are most likely to be achieved.
- **Well Controlled:** Key controls are effectively designed and operating as intended. Objectives of the audited process are likely to be achieved.
- **Opportunities Exist to Improve Controls:** One or more key controls do not exist, are not designed properly or are not operating as intended. Objectives of the process may not be achieved. The financial and/or reputation impact to the audited process is more than inconsequential. Timely action is required.
- **Not Controlled:** Multiple key controls do not exist, are not designed properly or are not operating as intended. Objectives of the process are unlikely to be achieved. The financial and/or reputation impact to the audited process is material. Action must follow immediately.

It is recommended that management develop formal training materials for new ALCO members. Consideration should be given to providing training materials to all ALCO members periodically to ensure that a common understanding exists amongst the members. Once a common understanding exists, management should review the credit and market risk metrics to ensure that they provide a balanced insight into EDC's asset liability management practices, and that the related limits are set at appropriate levels. Consideration should also be given to whether members of senior management who are not members of ALCO should also receive training on metrics and limits.

Rating of Audit Finding - Moderate²

Action Owner – Chief Financial Officer

Due Dates – All actions to be implemented by Q2 2012

Transaction Processing Controls

Treasury transactions, including funding related activities are entered into the Universal Financial Server (UFS) by members of the Treasury group. After initial input, an approval is required by another member of the Treasury group, and by Corporate Banking. Accuracy of input is important to the recording of funding activities in the general ledger. While all transactions are reviewed, errors are sometimes detected subsequent to the approval process.

It is recommended that Treasury and Corporate Banking review the roles of individuals who approve transactions in order to ensure that a complete review of the transaction is being performed. In addition, Treasury, Corporate Banking and Treasury Accounting should consider developing a working group to ensure that commonly occurring errors are resolved. Treasury Accounting should communicate through this working group the key fields in UFS which impact financial reporting.

Rating of Audit Finding - Moderate

Action Owners – Director Cash Management, Taxation & Insurance in collaboration with Deputy Treasurer & Manager Treasury Accounting

Due Date – All actions to be implemented by Q1 2012

² The ratings of our audit findings are as follows:

- **Major:** a key control does not exist, is poorly designed or is not operating as intended and the financial and/or reputation risk is more than inconsequential. The process objective to which the control relates is unlikely to be achieved. Corrective action is needed to ensure controls are cost effective and/or process objectives are achieved.
- **Moderate:** a key control does not exist, is poorly designed or is not operating as intended and the financial and/or reputation risk to the process is more than inconsequential. However, a compensating control exists. Corrective action is needed to avoid sole reliance on compensating controls and/or ensure controls are cost effective.
- **Minor:** a weakness in the design and/or operation of a non-key process control. Ability to achieve process objectives is unlikely to be impacted. Corrective action is suggested to ensure controls are cost effective.

Conclusion

The audit findings and recommendations have been communicated to and agreed by management, who has developed action plans that are scheduled for implementation no later than Q2 2012.

We would like to thank management for their support throughout the audit.

