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MFI Internal Audit and Controls Toolkit

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Mennonite Economic Development Associates

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A learning toolkit is never "final" as new techniques, tools and resources become available and are shared with one another. Participant feedback and comments will assist to continually improve this toolkit and its resources.

Table of Contents

1. SETTING THE CONTEXT: RISK AND RISK MANAGEMENT 1

What are the Key Risks in Microfinance? 2

What are the Key Issues of Operational Risks? 5

What are the Key Issues of Managing Operational Risks? 6

Risk Management: Whose Job is it? 7

2. OVERVIEW OF INTERNAL CONTROL SYSTEMS 9

What do we mean by "Internal Controls?" 9

a.Control Environment 10

b.Risk Assessment 11

c.The Control Activities: Systems, Policies and Procedures 14

d.Information and Communications 15

e.Monitoring 15

What are the Key Challenges for MFIs? 18

3. PREVENTIVE CONTROL – HUMAN RESOURCES 21

What are the Factors Contributing to Commission of Fraud by Employees? 21

How do we Limit Opportunities? Effective Staff Motivation 23

Model for Sustainable Capacity Building 28

4. PREVENTIVE CONTROL – POLICIES AND PROCEDURES 31

Accounting Controls 32

Segregation of Duties 34

Independent Checks and Verification 34

Procedures for Cash Receipts 35

Cash Receipts 35

Procedures for Cash Disbursements 36

Bank Reconciliations 37

Cash Reconciliations 38

Portfolio Reconciliations – The General Ledger and the Loan Tracking System (MIS) 38

Document Controls 38

5. PREVENTIVE CONTROL – INFORMATION SYSTEMS 41

Risks Associated with Lack of Information 41

Managing MFI Information 41

Loan Portfolio Information 42

6. ROLE OF THE INTERNAL AUDIT 47

What is an Internal Audit? 47

Role of the Internal Audit in the Internal Control System 47

Role of the Audit in the Risk Management Feedback Loop 48

Creating the Internal Audit Team 48

Reporting Function of the Internal Audit 48

7. IMPLEMENTING THE INTERNAL AUDIT FUNCTION 51

Planning the Internal Audit 51

Professionalism and Conduct 55

Reporting Audit Findings 55

Writing the Internal Audit Report and Making Recommendations 56

Follow up Previous Reports 57

Where Do We Go From Here? 57

Resource Bibliography 58

Figures

Figure 1.1 - External and Internal Risks of HIV/AIDS to an MFI 4
Figure 1.2 - The Role of Internal Controls and Internal Audits in Operating Risk Management 6
Figure 1.3 - Risk Management: Whose Job is it? 7
Figure 2.1 - COSO Internal Control Framework 10
Figure 2.2 - The Risk Management Feedback Loop 11
Figure 2.3 - The Cycle Approach 12
Figure 2.4 - Illustration of Assessing Risk Events, Drivers and Strategies 14
Figure 2.5 - Steps to Evaluate Internal Controls 17
Figure 3.1 - The Fraud Triangle 22
Figure 3.2 - Maslow's Hierarchy of Human Needs 24
Figure 3.3 - MFI Training Opportunities 26
Figure 3.4 - Model for Sustainable Capacity Building 29
Figure 4.1 - MFI Financial Management Information Systems 32
Figure 5.1 - Areas of Risk in Loan Information 45
Figure 6.1 - Differences Between Internal and External Auditors 47
Figure 6.2 – Sample Organisational Chart 49

List of Handouts

Section 1: Setting the Context: Risk and Risk Management
1.1 Workshop Agenda

Section 2: Overview of Internal Control Systems
2.1 Risk Assessment Tool
2.2 Internal Control Questionnaire
2.3 Internal Control Diagnostic – Template

Section 3: Preventive Control – Human Resources
3.1 Sample Employee Code of Conduct

Section 4: Preventive Control – Policies and Procedures
4.1 Sample Bank Reconciliation Format
4.2 Sample Cash Count and Verification
4.3 Sample Internal Control Checklist
4.4 Sample Reconciliation Problems and Tips

Section 6: Role of the Internal Audit
6.1 Sample Internal Auditor Job Description

Section 7: Implementing the Internal Audit Function
7.1 Sample Internal Audit Annual Work Plan
7.2 Internal Audit Checklist – Cash
7.3 Internal Audit Checklist – Loan
7.4 Internal Audit Checklist – Financial Reports
7.5 Internal Audit Checklist – Savings
7.6 Internal Audit Checklist – Human Resources
7.7 Internal Audit Checklist – Fixed Assets
7.8 Internal Audit Checklist – Self Help Groups
7.9 MicroSave Debriefing Note #57
7.10 Games that MFI Staff Play
7.11 Sample Internal Audit Report Format
7.12 Sample Loan Portfolio Audit Report
7.13 Sample Internal Audit Report (Branch)
7.14 Sample Internal Audit Report (Self Help Group)
7.15 Management Response to Internal Audit Report
7.16 Internal Audit Follow-up Tool

List of Exercises

Section 1: Setting the Context: Risk and Risk Management

Section 2: Overview of Internal Control Systems
2.1 Follow the Money (Parts I and II)
2.2 Risk Assessment Exercise
2.3 Internal Control Diagnostic Exercise
2.4 Policy and Procedure Compliance and Incident Worksheet

Section 3: Preventive Control – Human Resources
3.1 Human Resource Policy Discussion

Section 4: Preventive Control – Policies and Procedures
4.1 Policy and Procedure Worksheet
4.2 Segregation of Duties - Distance Management

4.3 Segregation of Duties - Loan Officers Handling Cash
4.4 Segregation of Duties - Branch Personnel Problem
4.5 Fraud Cases – Ineffective Policies and Procedures

Section 5: Preventive Control – Human Resource Policies
5.1 Case – Assessing Preventive Controls

Section 6: Role of the Internal Audit
6.1 Internal Audit Group Discussion

Section 7: Implementing the Internal Audit Function
7.1 Internal Audit Reporting and Role Play
7.2 Investigative Case Studies
7.3 MFI Internal Audit Action Planning

Setting the Context: Risk and Risk Management

Mennonite Economic Development Associates

1. Setting the Context: Risk and Risk Management

The Big Picture

Microfinance institutions exist to fulfill a dual mission – financial sustainability and positive social impact on the urban and rural poor in urban of the communities that they serve. However, too many MFIs are pre-occupied with expansion, out-smarting their competition, or reducing their operational costs to take time to look at risk management in their institutions. Others operate without proper systems that help reduce exposure to risk.

The underlying premise of both risk management and effective internal control is that the business – in our case – **the MFI, is on a path towards growth, profitability and sustainability, that it actually achieves its mission, and minimizes the risk of loss or failure in the process of conducting business.**

To fulfill their mission, MFI risks must be managed! Risk management is key to control the likelihood and severity of an adverse event.

The primary purpose of this toolkit is to look at **risk, risk management** and **internal controls** from an **operational perspective** in the MFI. It provides practical ways for MFIs to approach and implement effective **internal control systems** and **internal audit functions** within their institutions – whether large or small.

Risk is the potential that current and future events, expected or unanticipated may have an adverse or harmful impact on the institution's capital, earnings or achievement of its objectives.

Risk management is the process of balancing risk-taking and capital against a well-designed control environment. Managing risks includes identifying, prioritizing and selecting responses to risk. Managing risks effectively reduces the likelihood that a loss will occur and minimizes the scale of the loss should it occur. Risk management includes both the **prevention** of potential problems, the early **detection** of actual problems when they occur, and the **correction** of the policies and procedures that permitted the occurrence.

Simply put, both the function and activities of **"internal audits"** and **"internal controls"** are mitigation strategies for operating risks in MFIs. Internal controls are systems and procedures that seek to prevent problems and institutional loss. The internal audit function may meet external regulatory requirements for MFIs. More than that, it is a management tool to monitor the implementation of internal controls. Internal audits seek to detect problems before they become large and destructive, and they provide assurance and communication to management that its systems are in place, are functioning and are building the MFI's capacity to deliver its products and services sustainably to the community.

Risk management is an on-going process because internal and external vulnerabilities keep changing.

A publication by the Institute of Internal Auditors wrote that **"…..risk and control are virtually inseparable – like two sides of a coin – meaning that risks first must be identified and assessed; then managed and mitigated by the implementation of a strong system of internal control."**[1]

In today's business world, risk management takes a comprehensive perspective of risk, risk tolerance and risk management throughout the organisation. It looks at the role of Board governance and management in leading the risk management process, and in setting the tone for strong internal control systems.[2] The leading internal control model widely adapted and implemented throughout businesses in the world is summarized in *Executive Summary of Internal Control – Integrated Framework*[3]**.** The framework is widely used as a standard by which to measure and evaluate internal control systems.

The traditional view of internal audits has also shifted in recent years from a focus on financial transactions and past events, to a pro-active risk-based approach that not only looks at compliance to policy and procedure, but the effectiveness of risk identification and assessment, and management's risk mitigation strategy, implementation and monitoring of risks.

This toolkit is built on the key concepts of risk management and internal control from these commonly accepted frameworks and from the *MicroSave* "Institutional and Product Development Risk Management Toolkit" (Pkholz, 2005). It also references resources and samples from *MicroSave's* "Toolkit for Process Mapping for MFIs" (Champagne 2006) and the "Toolkit for Loan Portfolio Audit of Micro Finance Institutions" (Wright 2006).

Is risk management important to MFIs? Of course it is! It is critical for both growth and sustainability. But it is up to you and your MFI to address the issues. Ignore at your own risk!

What are the Key Risks in Microfinance?

All MFIs are exposed to a great number of risks, both internal and external, that threaten effective services to clients, financial stability, and future sustainability. As MFIs grow and become more complex, the need for periodic reviews of risk management systems becomes greater. The key risks for microfinance are often categorized into the following main areas. The management and Board of your microfinance institution should consider each risk as a point of vulnerability. It is your responsibility to assess the institution's level of exposure, to prioritize areas of greatest vulnerability, and to ensure that proper controls are in place to minimize your MFI's exposure.

Internal Risks

Institutional Risks:

[1] Tone at the Top Issue 18, June 2003 pg 2.
[2] The Enterprise Risk Management Framework Executive Summary is available at www.coso.org. It was produced by the Commission Committee of Sponsoring Organisations of the Treadway Commission (COSO). COSO is comprised of the American Institute of Certified Public Accountants, the American Accounting Association, Financial Executives International, The Institute of Internal Auditors, and the Institute of Management Accountants.
[3] The Internal Control – Integrated Framework Executive Summary is available at www.coso.org

Microfinance success is defined as an independent organisation providing financial services to large numbers of low-income persons over the long-term. An assessment of risks against this definition results in three categories of institutional risk.

- **Social mission risk** – the provision of appropriate financial services to the intended clientele
- **Commercial mission risk** – to manage the organisation as a business to allow it to exist for the long term
- **Dependency risk** – continuing need for strategic, financial, and operational support from an external organisation

Operational Risks:

Operational risks are the vulnerabilities that your MFI faces in its daily operations, including concerns over portfolio quality, fraud and theft, all of which can erode the institution's capital and undermine its financial position.

- **Credit risk** – lending money and not getting it back
- **Fraud risk** – intentional deception for personal gain illegal or irregular means
- **Error risk** – unintentional errors that create unreliable information and reports, or the loss of assets
- **Security risk** – risk of theft or harm to property or person

Financial Management Risks:

- **Asset and liability risk** – management of interest rate, liquidity, and foreign exchange. These risks increase and become more complex as the MFI grows, and broadens its range of financial services to include savings.
- **Inefficiency risk** – management of costs per unit of output, affected by both cost controls and level of outreach
- **System integrity risk** – the integrity of the information systems, whether computerized or manual

External Risks

Although you may have less control over them, MFI managers and Board directors must also assess the external risks to which they are exposed. Your institution can have relatively strong management and staff, and adequate systems and controls, but still experience major problems due to the environment in which it operates. It is important that these risks are recognized as challenges to be addressed rather than excuses for poor performance.

Regulatory risk – awareness of regulations in banking, labour laws, contract enforcement, and other policies that affect MFIs. Some Central Banks prohibit the collection, mobilization and use of client savings unless the MFI is registered and licensed to do so. In India, some of the partnership loans offered by a large bank to several MFIs were not renewed, severely resulted in reduced portfolio growth.

Competition risk – familiarity with the services of others to position, price, and sell your services. Competition for staff is also a huge risk. A large Indian MFI wanting to expand its operations, recently recruited 24 out of 36 field staff of a much smaller MFI who was already working in the same region.

Demographic risk – assessing characteristics of the target market. This could look at special social issues, including health, aging, and migration. The HIV/AIDS pandemic is a threat to productive middle-aged people, posing risks to the MFI's targeted market and their staff. See

Figure 1.1 for further elaboration and illustration of how HIV/AIDS risks have both internal and external effects.

Physical environment risk – natural disasters, physical infrastructure. Some rural areas (e.g. Bihar in India) may be prone to floods nearly every year. Droughts will also affect the rural poor who are dependent on agriculture or agri-businesses; these natural disasters will not only affect clients and their businesses, but the MFIs that serve them.

Macroeconomic risk – currency devaluation and inflation and the effect on both the institution and the clients. A regular interest rate increase of bank loans to MFIs will reduce the margins available to MFIs and force them to cut operating costs. The market or regulatory environment may be too competitive to increase rates, leaving them little choice to do otherwise.

Political/Governmental risk – political instability, civil unrest

Reputation risk – An MFI's image amongst clients in the community it serves is critical to strong repayment and repeat business. Image and reputation in the community does not only come from actual and factual information about the MFI. It is about client perceptions and the satisfaction they feel about the institution, about how they feel they are treated, and whether they value the services provided.

Figure 1.1 - External and Internal Risks of HIV/AIDS to an MFI

Risk Due to HIV/AIDS

MFIs that are operating in areas with high HIV/AIDS prevalence rates will face additional risks as there is a strong likelihood that a number of their clients and staff will be either infected or affected by HIV/AIDS. This has widespread effects on the local, national and regional economies, impacting MFIs, their staff, their clients and ultimately their financial performance and operational sustainability.

The HIV/AIDS pandemic poses both an external and internal risk to a microfinance institution:

External:

- First of all, the local economy may be affected in terms of market potential and business activity. Individuals and households will have less disposable income for business and consumption investment as more resources are spent on medical expenses and child care.
- There are fewer economically active people that are able to contribute to the livelihood of the household or the local economy.
- When family members are unable to generate enough income through business, their dependents are usually put under the responsibility of other family members who are able to care for them. This puts a considerable strain on the households that agree to take in these dependants and can lead to a down turn in the local economy.
- The increase in HIV/AIDS related orphans also presents long term challenges to the MFI as a younger generation that has received little skills and business training seeks credit to establish businesses.
- In the communities with a high HIV/AIDS prevalence, business growth and capitalization becomes more and more limited, threatening the MFIs long term sustainability and portfolio potential.

Internal:

The impact of HIV/AIDS on clients presents considerable internal risks to the MFI. These internal risks are greatly influenced by the external risks explained above. MFIs may find their portfolio negatively affected by the following factors:

- Client drop-out: Clients that are over-burdened financially may wish to withdraw their savings and leave the institution, causing a reduction in the MFI's client base.
- Sluggish growth: MFIs may find it difficult to meet their growth targets in regions that are severely affected by HIV/AIDS as the economy slows down and the rate of new client intake diminishes.

- Delinquency: Clients that are infected or affected by HIV/AIDS may find it increasingly difficult to meet their loan repayment deadlines. An increase in delinquency translates to poor portfolio quality, and ultimately sustainability.
- Client absenteeism from group meetings
- High staff turnover increases recruitment and training costs, triggers a decline in morale, and leads to a loss of institutional and corporate "memory" of the MFI.
- Staff absenteeism due to illness or extended leave will affect the MFI's ability to work efficiently as a team.
- Decline in staff productivity due to illness, threatening competitive advantage

What are the Key Issues of Operational Risks?

This toolkit focuses on the key issues of operating risk, and how you as MFI managers, Internal Auditors and finance managers can develop systems and procedures to prevent, detect, and correct potential problems. Operational risks are the vulnerabilities that your MFI faces in its daily operations, including concerns over portfolio quality, fraud and theft, staff capacity and development, and integrity of data and reports, all of which can erode your institution's capital and undermine its financial position or its growth projections. The following four items are usually considered when looking at operational risks

- **Credit risk** – refers lending money and not getting it back. There are many aspects of credit risk. They include the appropriateness of loan products, client demand and preference, and external environmental factors (flood, drought, etc.). However, credit risk also looks at whether credit policies and procedures are correctly followed and administered by staff and whether credit transactions are properly recorded in your MFI's loan tracking system and correctly summarized and presented in the financial and portfolio reports. *MicroSave's* "Toolkit for Loan Portfolio Audit of Micro Finance Institutions" (Wright, 2006) gives extensive and helpful tools and approaches for these key aspects of credit risks and should be referred to.

- **Fraud risk** – intentional or deliberate deception for unfair or unlawful personal gain. These are intentional actions, manipulation of data or documents, or the abuse of office, policies, procedures, or documents of your MFI's property for the purpose of personal gain. Strong internal control systems limit the opportunities and possibilities for fraudulent activity.

- **Error risk** – unintentional errors due to lack of training and capacity, rapid growth or inadequate number of staff. Errors in judgement or interpretation of policies, procedures, documents, or cash transactions can create large or small losses in your MFI. Internal control systems are designed to minimize operating risks due to either fraud or error, and this toolkit addresses practical ways to do that.

- **Security risk** – risk of theft or harm to property or person. MFIs – both large and small -- are about people, paper and money. Money, particularly the high use of cash in most MFIs, creates a high risk for security of both money and people. While the move to electronic banking and money transfers is still lagging in most parts of the world, this technology will greatly minimize security risks on the issue of money. It will of course increase new risks related to electronic transactions.

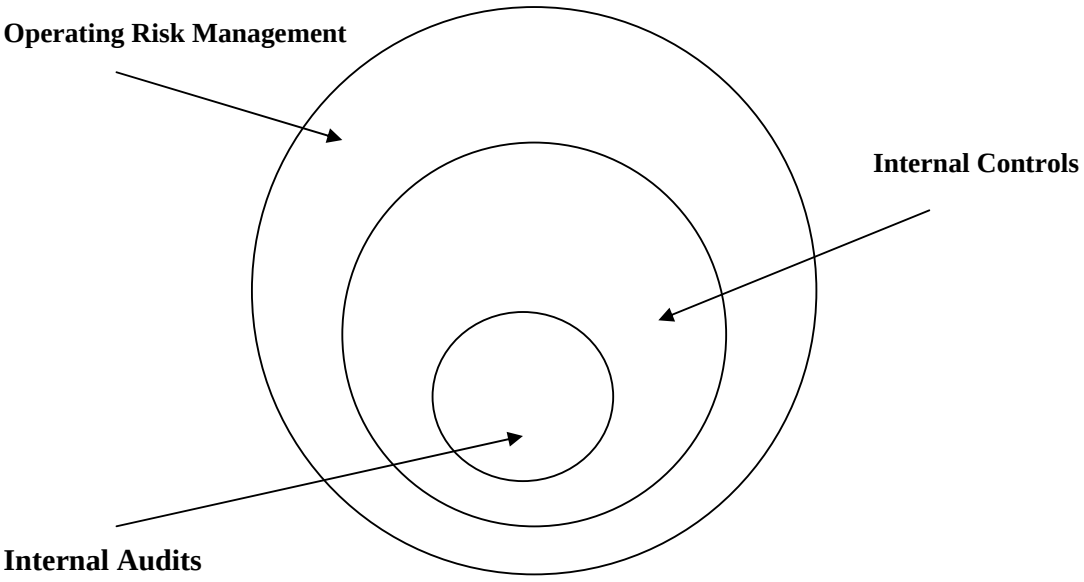
In order for your microfinance institution to realize its mission, it must identify and mitigate the risks that pose the greatest threat to its financial health and long-term survival. **Operating risks are important because they are internal to your MFI. This implies that to a large extent, they are within the influence and control of your MFI staff and management. They are also important because even the smallest of MFIs and Self Help Groups need to address operational risks**

through effective internal controls, policies and procedures. Without this foundation, they may never survive long enough to face the more complex and broader risks in their environments.

What are the Key Issues of Managing Operational Risks?

An effective system of **strong internal controls** is your MFI's primary mechanism to identify, measure and mitigate operational risks. Their role is to **prevent** problems. The **internal audit function** acts as an early warning to **detect** whether there are weaknesses or deficiencies in the system of internal controls. The internal audit is intended to find errors, problems or breaches of policy and procedure before the consequences of such incidences are severe or have a major effect on your MFI. Internal audits can also help to identify new or unrecognized risks. The following diagram illustrates the concept.

Figure 1.2 - The Role of Internal Controls and Internal Audits in Operating Risk Management[4]



In order for internal controls and internal audits to be effective, particularly for growth and expansion, the following elements must also be present in your MFI:

- Stated mission and core values
- Strong Board leadership and commitment towards the mission, and to control systems
- Honest and capable employees
- Conducive environment
- Sound methodology
- Accountability and transparency
- Security
- Performance and efficiency

[4] Adapted from Campion, Anita. Improving Internal Control: A Practical guide for Microfinance Institutions. Technical guide No. 1 (Washington D.C.: MicroFinance Network and GTZ, 2000)

- Clear delegation and segregation of duties
- Reliable management information system

A strong internal audit function will not be effective if your MFI's management information system is not dependable or reliable. If your MFI's accounting employees are not qualified, skilled or trained to do their work, they will struggle in implementing accounting policies and procedures correctly and consistently. Internal audits and internal control systems do not operate in a vacuum. They are part of a strong organisational foundation that is built on many components to ensure strength and sustainability.

Risk Management: Whose Job is it?

Each step of risk management involves different employees of the MFI. Collectively, all employees, managers, and stakeholders have a role in risk management. Risk management and internal controls must be "driven from the top." The Board and senior management set the tone and the MFI's attitude towards risk and internal controls. The following chart looks at the various steps in the risk management process, and the roles and responsibilities that various staff, management and Board members play in that process.

Figure 1.3 - Risk Management: Whose Job is it?

Process Steps	Institutional Role	Responsibilities
1. Identify risks	Senior Management	Identify major risks
	Board	Review and approve risk management
2. Develop strategies to prioritize risks	Senior Management	Develop measurement indicators. Set acceptable range for risk.
	Board	Approve indicators and range. Monitor results.
3. Design policies and procedures to mitigate risks	Senior Management	Design operational policies, systems, and guidelines to reduce risk. Provide clear instructions for procedures to implement policies.
	Board	Approve operational policies.
4. Implement controls and assign responsibility	Senior Management	Assign responsibility for implementation.
	Branch Management	Implement control procedures. Monitor compliance.
	Operating Staff	Provide input on appropriateness of policies and procedures. Offer suggestions for policies needed. Comply with established policies.
5. Test effectiveness and evaluate results	Board and Management	Review results of operations.
	Internal Audit Staff	Monitor compliance with policies. Identification of weaknesses in the risk management process
6. Revise policies and procedures as necessary	Repeat the steps above for new policies and procedures	

Risk Management is EVERYONE's job!

Overview of Internal Control Systems

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2. Overview of Internal Control Systems

What do we mean by "Internal Controls?"

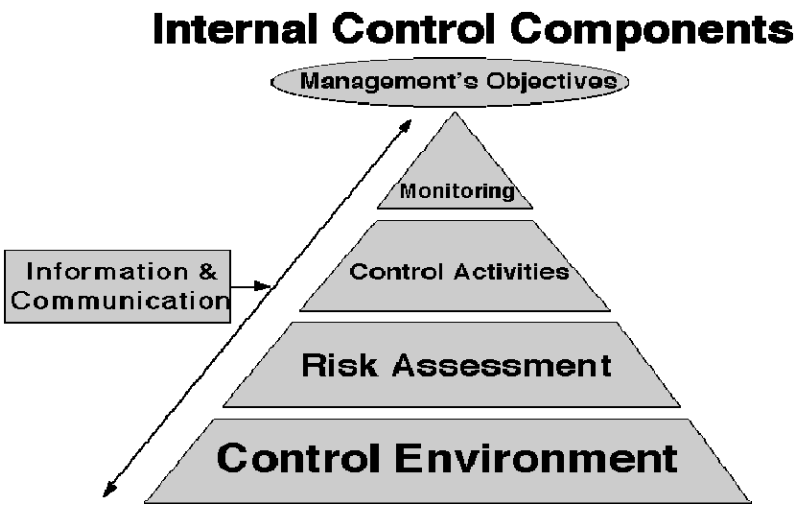
In general, **"internal controls" refers to all the policies and procedures established and maintained by the managers of an entity to help ensure, as far as is practical, the orderly, efficient and profitable conduct of its business.**

Internal controls help to promote the **basic objectives of management** and try to provide reasonable (but not absolute) assurance of the following:

- **Profitability or sustainability:** MFIs must be financially and institutionally sustainable to effectively provide financial services and products to the poor communities they serve. All the operating processes, work flows, and delivery channels are designed to provide those financial services, and to do so efficiently, according to policy, and without the loss of reputation or resources of the institution.
- **Adherence to management policies:** MFI management is responsible for the overall administration of the MFI; the Board and regulatory authorities approve policies that management implements. Management's administrative controls are internal controls designed to promote operational efficiency and encourage adherence to established management policies.
- **Safeguarding of assets:** The physical assets of an MFI can be accidentally destroyed, misused or stolen unless they are protected by adequate controls. Non-physical assets such as loans receivable, important documents (eg. Client loan contracts or receipt copies), and financial records are also vulnerable. Computer data, records and reports can also be destroyed or lost if care is not taken to protect them through reliable and safe backup procedures, clear assignment of duties, and controlled operating environments.
- **Prevention and detection of fraud and error:** Your MFI's internal control system is important in the prevention and detection of error, fraud or other irregularities. The cost of preventing a particular error, should be balanced against the likelihood of the error occurring and the amount of the error that could occur.
- **Accuracy and completeness of accounting records:** Part of the internal control system is a strong accounting system. The accounting system must produce accurate and complete accounting records.
- **Timely preparation of reliable financial information:** Financial reports and information must be reliable and timely if it is to be useful for management decision making. This is more of a function of the accounting and finance staff who use an accounting system, than the accounting system itself.
- **Discharge of statutory responsibilities:** All MFIs are accountable to external stakeholders – whether it is their Board of Directors, their shareholders, Central Bank regulators, or donors. These stakeholders have both statutory and non-statutory expectations of your MFI, and an internal control system can provide support and means to fulfill those.
- **Protection of staff members against disinformation**:

The COSO-developed model *Internal Control – Integrated Framework* can be illustrated in the figure below. The components do not act as separate, independent units in sequential steps. They interact in an integrated management process.

Figure 2.1 - COSO Internal Control Framework[5]



The internal control system extends beyond matters relating directly to the accounting system and comprises the control environment and control systems. The five components work to support the achievement of the MFI's mission, strategies and related business objectives. Each component is described in the following sections.

a. Control Environment

The control environment is the **overall attitude, awareness, and actions of the Board of directors and managers** regarding the internal control system and its importance. If top management believes control is important, others in your MFI will sense that and respond by conscientiously adhering to the policies and procedures established. However, if top management appears to only give "lip service" to internal control, or apply double standards and policies for themselves, it is almost certain that control objectives will not be as effective. A strong control environment - for example, one with tight budgetary controls and an effective internal audit function - can significantly complement specific control procedures. Factors reflected in the control environment include:

- The function of the Board of directors and its committees, particularly the Audit Committee,
- Management's philosophy and operating style, its commitment to integrity and ethical values; its commitment to competence,
- The organisational structure and methods of assigning authority and responsibility,
- Management's control system and methods, including the internal audit function, and
- Human Resource policies and procedures, and segregation of duties, and
- Management reaction to external influences.

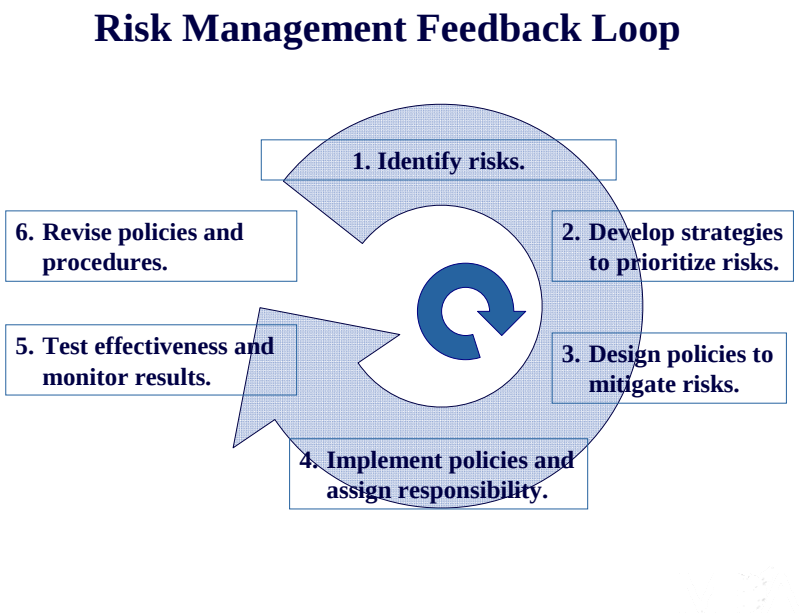
> **The essence of an effectively controlled organisation lies in the attitude of its management!**
>
> ***- Lemon, Arens, Loebbecke***

[5] www.coso.org

b. Risk Assessment

The following Risk Management Feedback Loop is a common illustration of the process of identifying, prioritizing and implementing risk management strategies, policies and procedures. Note that it is iterative in nature, in that as the environment, circumstances and organisation change, so will the events and transactions that pose risk. Systems, policies and procedures must be regularly reviewed and systematically revised in order to prevent repeating mistakes of the past, and to protect your MFI from new risks.

Figure 2.2 - The Risk Management Feedback Loop[6]



It is also worth noting that steps 2 - 4 are the **preventive** controls (Control Component of the Internal Control Framework) and 5 and 6 are the **detective** controls of the internal control system (Monitoring Component).

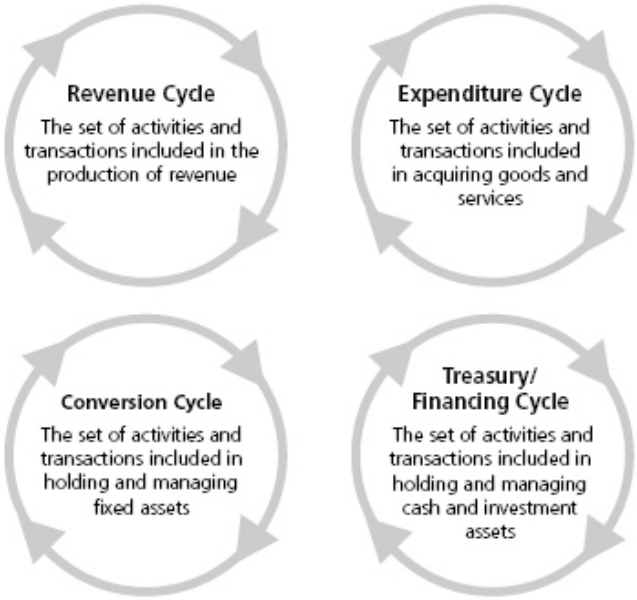
A common approach to analyzing operational risks is through "process mapping". This approach illustrates working processes through flow charts. *MicroSave's* "Toolkit For Process Mapping for MFIs" (Champagne, 2006) and "Institutional and Product Development Risk Management Toolkit" (Pikhoz, 2005) use process mapping to document work flows, identify risks in those work processes, and suggest ways in which to manage those risks. Another approach that is commonly used in the field of auditing is the Cycle Approach.

A Cycle Approach

A systematic and reliable approach for identifying points of risk within an institution is to classify operating activities and transactions into operational cycles. Although the activities within cycles vary among different types of business entities, the major cycle categories are common to all.

[6] Adapted from Campion, Anita. Improving Internal Control: A Practical guide for Microfinance Institutions. Technical guide No. 1 (Washington D.C.: MicroFinance Network and GTZ, 2000)

Figure 2.3 - The Cycle Approach



Revenue Cycle

In an MFI, the primary source of revenue is the interest and fees collected on loans made to clients. In an MFI, the revenue cycle is the credit delivery cycle and includes the entire process of disbursing and collecting loans, all of which should be clearly outlined in a credit policy manual and in the accounting policies and procedures. This is probably one of the highest risk areas for MFIs since loan disbursements and collections are usually in cash, and very often in remote communities far away from banks.

Expenditure Cycle

As in all businesses, the expenditure cycle primarily includes payment for purchases and payroll. Purchasing policies should outline procedures for initiating requests for goods or services, the tender or bid process, approval levels, preparing and signing cheques or issuing cash, and the receipt and storage of goods.

Payroll includes the range of human resource functions of hiring, training, compensating, evaluating, and terminating as well as the disbursement functions of accounting for all payroll costs, deductions, benefits, advances, and other adjustments.

Conversion Cycle

Many MFIs do not have specific policies in place for the management of fixed assets other than as part of purchases. The risks, however, are often greater because the costs are higher. Controls begin with a pre-approved capital budget and criteria for the use of the assets. In addition, there should be policies for identification/inventory of assets, depreciation, disposition, and the procedures and recording of the disposition of assets.

Treasury Cycle

The treasury cycle focuses on the management of cash within the MFI, particularly through its management of liquid or near-liquid assets and liabilities. But there are a number of additional functions included in treasury, included, but not limited to, the following:

- Funds received from investors, including client savings.
- Funds temporarily invested until needed for operations.

- Asset and liability management to mitigate liquidity or interest rate risk
- Selecting appropriate forms of financing.

To use the cycle approach to identify risks and determine the appropriate controls, apply the process and steps of the Risk Management Process:

1) List the steps for each operating process
2) Identify the points of risk in each process
3) Prioritize and assess the risks by frequency and impact
4) Design policies and procedures to mitigate risks, depending on your MFI's aversion to risk
5) Implement controls and assign responsibility
6) Test effectiveness and evaluate results
7) Revise policies and procedures as necessary

This toolkit does not go into great depth in process mapping various operating activities. However, it is worth to review the key points of risk identification, risk strategies and assessing and prioritizing risks – from the perspective of internal control. Further detail can be found in *MicroSave's* "Toolkit for Institutional and Product Development Risk Analysis".

A **"risk event"** is referred to as the undesirable outcome or incident.

The **"risk driver"** is the causal factor that results in the risk. There may be many risk drivers behind one risk event. The challenge is to identify and deal with the leading drivers.

This involves an assessment and prioritization of risk. This is challenging, but can be done by using a matrix that links the probability of risk events occurring (frequency) and their potential severity (impact). Refer to *Handout 1.2 Risk Assessment Tool*. Every MFI's tolerance and attitude towards risk will be different, and there is no correct formula or prescription for a perfect response.

	High Impact	**Medium Impact**	**Low Impact**
High Frequency			
Medium Frequency			
Low Frequency			

There are a number of alternate strategies to consider when selecting the best approach to address risk. They are:

- Avoid or eliminate the risk
- Transfer the risk to another party
- Accept or retain the risk
- Control the risk

If the MFI chooses to control the risk, there are a variety of "control tactics" – actions, processes, mechanisms – to mitigate and manage the identified risk within the institution. Selecting an efficient and effective response is usually a challenging decision. Responsibilities must be assigned to implement and to monitor the mechanism; all additional steps add to the work process and must be balanced with efficiency objectives.

Figure 2.4 - Illustration of Assessing Risk Events, Drivers and Strategies

Risk Event: Cash collections are regularly short in the field office collections sheet when compared to the client receipts issued. The MFI is loosing cash resources.

Risk Drivers:

- Client fraudulent activity
- Staff fraudulent activity
- Errors and inefficiencies in counting small coins and small bills

Prioritize Risks:

- High frequency
- Low impact per incident – high impact over time

Strategy: Control the Risk; Transfer the risk to another party (staff)

Examples:

- Buy and use counting machines – coins and bills
- Implement a policy that staff must pay for cash shortages

c. The Control Activities: Systems, Policies and Procedures

The two key components of the control activities are the accounting system and specific control policies and procedures. The accounting system has to do with the collecting, recording, processing and reporting of financial transactions. The integrity of individual transactions is critical for the reliability of the system. Specific control procedures are the policies and procedures that guide staff to process transactions, manage assets, and conduct their work. Control policies and procedures also enhance and strengthen the reliability of data and information in the accounting system.

The Accounting and Portfolio Tracking System

The accounting system is the process of data preparation, data entry, transaction processing and document and report generation. The integrity of the entire system (data entry and processing), including the financial reports, will rely on the specific controls for transactions themselves, and for data entry and processing. The overall objective is to prevent incorrect information or misstatements in the journals, records, and ultimately financial reports.

In an MFI, the accounting system and the portfolio tracking system form the basis for financial information and management (Sections 4 and 5 elaborate on these systems). The two systems are inter-connected, as the portfolio tracking system is essentially the detailed subsidiary ledger of the general ledger's control account called Client Loans Receivable. If the MFI also holds and tracks client savings, the portfolio tracking system will record all savings transactions, and will be summarized in the general ledger's control account called Client Deposits. The Client Portfolio System tracks the individual transactions for each loan – and for savings, if savings are held in the MFI. The Accounting System generally tracks summarized data for loan transactions.

Control Procedures

Control procedures are the policies and procedures that management has established to achieve the entity's specific objectives. Control procedures include things like:

- Accounting and financial policies and procedures to ensure correct and consistent treatment of transactions and operational activities

- Independent checks and review of performance
- Adequate separation of duties (Have different persons "Approve", "Record" and "Do")
- Proper authorization and approval of transactions and activities
- Design and use of adequate documents and records (Pre-numbered documents, multiple copies, Chart of Accounts, manuals and written procedures, etc.)
- Physical control over assets and records (In financial institutions, many records – like receipts, purchase orders, or payment vouchers – are records that have "near-cash" quality. They need to be well controlled)
- Security and controls over the application, change, continuity and backup of computer systems, databases and software

d. Information and Communications

The information and communications component of an internal control system is not a stand-alone component. It intersects, interacts with, and is part of each of the other 4 elements.

Strong MFI and portfolio management at all levels is highly dependent on **good information**, particularly financial information and portfolio information. **In order to be useful, it must be relevant, correct, and timely**. Loan officers who do not know the status of their portfolio at any given time cannot be held fully accountable for their performance. Branch managers need to know their branch's financial status – its revenues and costs need to be known to be managed and controlled. Sudden changes in portfolio performance may signal a variety of problems, but without portfolio reports, managers are not aware of the potential risks. Senior management and Boards must receive internal audit reports in order to act on their recommendations and assume their roles and responsibilities in risk management.

Staff and management must be fully informed and aware of the policies and procedures of the MFI. Policies that are not available to staff are not able to be implemented. The MFI's business strategies and objectives must be communicated throughout all channels in the organisation as well. Information and communication is critical to identifying risks, and to implementing risk management strategies.

Keeping an "open door policy" within the MFI sets the tone that management is approachable by staff and clients, and that they are willing to listen to both. Internal Audit reports, monitoring and evaluation reports need to be shared with staff (as appropriate) so that risk, risk management and internal controls are "everyone's responsibility."

e. Monitoring

Part of the management function involves **supervision and monitoring**. Through segregation of duties and independent checks and verification, an element of ongoing monitoring takes place in every day operations of an MFI. It is not uncommon for MFIs to undergo separate evaluations or ratings from time to time as well.

Perhaps the strongest and most effective monitoring in the internal control process takes place through the **internal audit function**. The Internal Auditor is independent of other business processes in the MFI, reports to the Board of directors (usually the Audit Committee) and is focussed on **detective controls** -- testing for compliance to policies, procedures and controls, the **reliability of financial reports** and on **risk identification**.

If the senior management and MFI Board effectively manage the internal audit function, implement recommendations for improvement, and follow up observations and signals about new risks, they are taking advantage of their greatest ally in the task of risk management.

Limitations of Internal Controls

Internal controls are tools developed and used by management to aid them in achieving the objectives of the organisation. But the controls can only be in place as far as is practical. There are always trade-offs and exceptions to consider. Increasing controls, steps and procedures in different operational processes can become cumbersome and inefficient. Adding additional staff to ensure adequate segregation of duties is expensive. Most MFIs are extremely conscious of costs and efficiencies and will find many arguments against increasing internal controls. There are a number of limitations in achieving and ensuring these objectives.

- **Cost v. Benefit.** A control must be cost effective - the cost of implementing a control relative to the probability of risk of a loss occurring and the size of the loss. Normally, the costs are easy to determine (staff, training, etc) but most benefits are difficult to determine since institutions are dealing in loss probabilities.

- **Abnormalities.** Controls are typically directed towards normal, everyday transactions - the abnormal and unusual transaction is generally not covered, primarily because of cost-benefit issues. But abnormalities do happen!

- **Human error.** This factor will always be present to some degree. Unintentional errors, mistakes, and oversights are part of the reality of working with people.

- **Staff turnover.** Staff who has worked in an area for some time are normally more efficient and familiar with processes than new staff. Rotating staff, staff turnover, or rapid expansion and adding new staff may limit the effectiveness of internal controls as well.

- **Workload volume.** Some people are more capable of handling large workloads and the associated pressures better than others. It is common for workers under pressure to take the necessary "shortcuts" in order to be efficient.

- **Collusion.** If a control is dependent on segregation of duties, internal controls can easily be circumvented when two or more of those responsible go together to purposely defraud the organisation. Therefore, no matter what segregation of duties are in place, there may still be loss of assets to the MFI.

- **Staff irresponsibility.** Persons responsible for a control may also neglect or abuse that responsibility – this limitation normally arises when employees are not satisfied or are bored with their jobs.

Because of these limitations, internal controls cannot provide absolute assurance, but only reasonable assurance, that management objectives will be met.

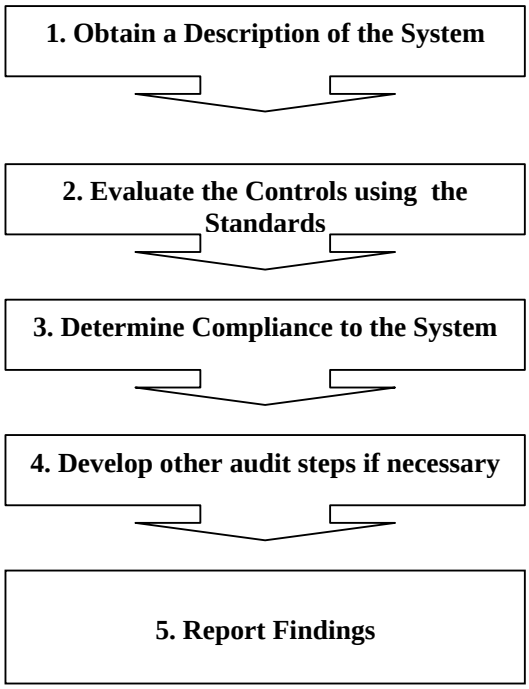
Evaluating the Effectiveness of Internal Controls

Evaluating your MFI's internal control system is not simply the role of your internal (or external) auditor. It is an overall Board and management responsibility, and must be understood and fully appreciated. In actual practice, the evaluation of the system is often contracted to an independent third party, perhaps a consultant. Why is it necessary to evaluate internal controls? And if it is necessary, how often should it be done? If systems are found in good order, how soon is it necessary to review them again? The answer lies in the human factor. Monitoring, checking

and reviewing employee performance sends the message that performance matters. On the whole, individuals are less likely to take short-cuts or deviate from standard procedures if they know that their work will be reviewed.

The overall process of evaluating internal controls encompasses the following steps:

Figure 2.5 - Steps to Evaluate Internal Controls



- **Obtain a description of the system** (eg. conduct tests of transactions, complete an internal control questionnaire, prepare a narrative description of the system or prepare a flow chart of the system). *Handout 2.2 - Internal Control Questionnaire* can help in this process. *MicroSave's* "Institutional and Product Development Risk Management Toolkit" (Pikholz, 2005) includes numerous Internal Control Questionnaires for other operating processes in Attachment 7 of the toolkit.
- **Evaluate the controls provided by the system** (often carried out concurrently with the first step – flow charts are very helpful). The COSO Internal Control Framework, and its five components, can be used as a standard or measure for an effective system. How does your MFI rate against the standard? What are the strengths and weaknesses of the accounting system? Do the written policies or procedures illustrate principles of good internal control? Do procedures demonstrate strong internal control practices? Where are potential risks?
- **Determine whether the prescribed system is being carried out** (observation, review of records, checks and verifications, interviews). Accounting policies, knowledge or written control procedures are only effective if they are relevant and if in fact they are being carried out. Where are the gaps between what **should be** taking place with what is **actually** taking place? *Handout 2.3 provides an "Internal Control Diagnostic"* tool that is broader than the Internal Control Questionnaire. It looks a little more at the actual findings of the assessment, the potential risks and recommendations to strengthen internal controls.
- Decide how the outcome of the internal control review will affect **other planned audit steps** (eg. how many transactions will be reviewed, which area warrants greater review)

- **Report findings** Refer to *Handout 2.4 Sample Internal Control Diagnostic - Report.* This Handout provides both the template for conducting such an assessment, and a sample of how findings might be reported.

If you are interested in making a quick self-assessment of your MFI, and do not have access to your policies and procedures, or do not have time to make an in depth assessment, try to think of any recent "risk events" or incidents of irregularity or fraud. *Exercise 2.2 – Policy and Procedure Compliance and Incidence Worksheet* is a tool that can help you to reflect on the incidence(s), the source of the problem(s), and what action(s) you took to correct the problem. Risk events or incidents of fraud are generally an indication that what should be taking place is not taking place, or that there is a weakness in the system.

A Weak Internal Control System

While conducting a diagnostic exercise of an MFI's Internal Control system, the External Evaluator noted that Loan Officers were responsible for marketing to new clients, processing loans, issuing loan disbursements, collecting loan repayments, updating client passbooks, and making bank deposits. There were virtually no supervisory monitoring activities conducted, the Internal Auditor never conducted client visits, and the reports of the Loan Tracking System were unreliable.

The internal control system was undoubtedly weak. The MFI's internal control systems:

- lacked segregation of duties
- lacked supervisory or internal audit monitoring
- lacked independent verification of work performed
- lacked good information systems, and
- lacked senior management commitment to good controls

What are the Key Challenges for MFIs?

- Maintaining effective control of fraud and error risk without excessive cost or burdensome procedures as the programme grows! Growth, expansion and efficiency are top priorities among MFIs. It is critical to ensure effective internal controls in periods of growth and expansion.
- Maintaining high staff morale and culture of ethics in a large, growing programme – human resources.
- Maintaining awareness of new and more complex types of fraud as the MFI develops new products and becomes more sophisticated. As MFIs decentralize, adapt new technologies and offer new products, the possibilities for error, wrong information, and yes -- fraud also has the potential to grow.

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1. lacked segregation of duties
2. lacked supervisory or internal audit monitoring
3. lacked independent verification of work performed
4. lacked good information systems, and
5. lacked senior management commitment to good controls

The next 3 sections of the toolkit address processes 2 – 4 of the Risk Management Feedback Loop. These are the preventative controls and procedures for the three most critical aspects of MFI operations:

- **Human Resources:** One of your MFI's primary resources is its staff and management. It is staff that interacts daily with clients and delivers products and services. It is staff who fulfill the accounting and financial functions of the organisation. It is staff that work with Management Information Systems. *MicroSave's* "Human Resource Management for MFIs Toolkit" (Pityn, 2005) provides helpful tools in managing this important resource in your MFI. The following section looks at the key ingredients of staff management to from a preventative perspective on internal controls.

- **Policies and Procedures:** This section will look at the control policies and procedures that your MFI needs to have in place to prevent errors, inconsistencies and abuse. They key focus will be on common issues to most MFIs – cash handling, lack of segregation of duties, decentralized operations, and decentralized branch structures.

- **Management Information Systems:** The final section on preventative controls will provide an overview of the issues around Management Information Systems, specifically related to the loan portfolio. Critical issues related to internal controls will be highlighted and references to other tools and resources made as needed. An invaluable resource is *MicroSave's* "Toolkit for Loan Portfolio Audit of Micro Finance Institutions (Wright, 2006)

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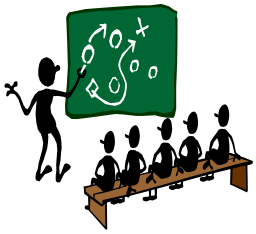
Preventive Control – Human Resources

Mennonite Economic Development Associates

3. Preventive Control – Human Resources

Setting a positive working environment to train, encourage and motivate staff is an important part of the MFI's leadership role. Atmospheres of suspicion and distrust are generally not conducive. However, the banking sector – including microfinance – is about financial intermediation. The very heart of a good banking system is the aspect of trust and trustworthiness. Banks and MFIs must be managed to build and ensure client trust in their financial institutions.



Are people basically honest? As human beings we want to believe the best in one another. However, a 1999 study conducted in Canada (and cited by KPMG Forensics) of the top 1,000 public and private companies concluded that roughly 20% of the general population is basically honest. Another 20% is basically dishonest. The remaining 60% are about as honest as the situation places them in. In other words, given the opportunity and the right situation, many people make dishonest choices!

Other findings of the study were that:

- Companies reported that 57% were defrauded in 1998
- Companies reported that employees were their greatest source of fraud
- Most fraud was discovered via:
  - Existing internal controls
  - Internal audits
  - "Whistle-blowers" ("Whistle-blowers" are employees who provide tips or inform management of the problem going on)
  - By accident!
- Over 90% of fraud goes undetected

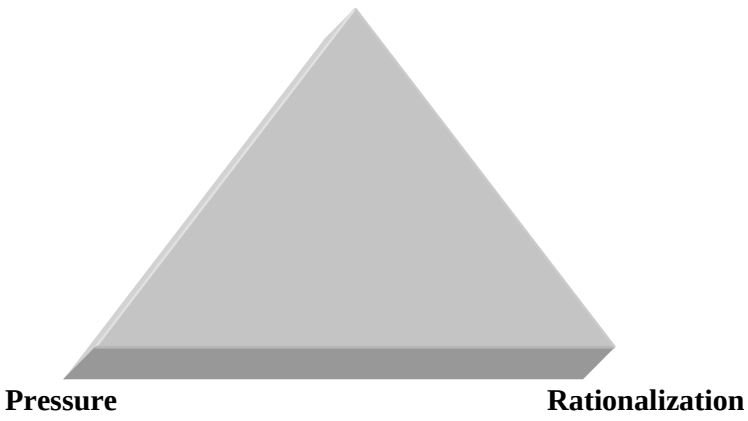
Banks and the banking industry are built on the aspect of trust. People TRUST that if they deposit their money into a bank account, they will be able to go back another day and withdraw their money. The bank's role is to be TRUSTWORTHY – and ensure that they have the skills, policies and practices that ensure a client's deposits are available when demanded.

MFI preventive controls are there to foster trust in the MFI and to demonstrate trustworthiness to clients and staff alike.

What are the Factors Contributing to Commission of Fraud by Employees?

Employees who commit fraud generally are able to do so because there is ***opportunity, pressure, and a rationalization***. A well-known criminologist, Dr. Donald Cressey researches embezzlers, people he calls "trust violators." He refers to the "Fraud Triangle" when discussing the subject.

Figure 3.1 - The Fraud Triangle



Pressure can be imposed due to a variety of factors:

- Personal financial problems
- Personal vices or addictions such as gambling, drugs, extensive debt, etc.
- Unrealistic deadlines and performance goals (e.g. our branch must break even by next year)
- Desire or pressure for status symbols e.g. a vehicle, a larger house, etc.
- Pressure from increased extended family responsibilities

> **"Knowing your employees" – their families, backgrounds, and taking time to build positive work relationships can help you to understand your employees' ambitions, dreams and pressures. And know what motivates and inspires them!**

Opportunity is generally provided through weaknesses in the internal controls. Some examples include inadequate or lack of:

- Supervision and review
- Separation of duties
- Management approval
- System controls
- Close working relationship with suppliers of goods
- Failure to enforce existing controls
- Code of ethics or rules of conduct

Incomplete or late bookkeeping and reporting and a close working relationship with suppliers of

> **Limiting opportunities for employee fraud is accomplished through strong internal controls. Policies, procedures and systems that ensure systematic record-keeping, segregation of duties and independent verification limit opportunities for fraudulent activity. Sections 4 and 5 elaborate on the ways in which to limit opportunities through internal controls.**

goods also provide staff with opportunity to manipulate data and documents for personal gain.

Rationalization occurs when the individual develops a justification for their fraudulent activities. The rationalization varies by case and individual. Some examples include:

- *"I really need this money and I'll put it back when I get my paycheque"*
- *"I am just temporarily borrowing from the petty cash, until I can repay in two days. No one will notice."*
- *"I just can't afford to lose everything – my home, car, everything"*

There is also the issue of **Personal Character**. There are people who either will deliberately make fraudulent choices at any opportunity because they lack strong moral character or personal integrity and cannot manage or control the pressures in their lives.

Rationalization to commit a fraud can also be prevented or reduced through staff motivation. In fact, it has been stated that the single most important factor in the prevention of fraud within an organisation is a well-motivated staff.

How do we Limit Opportunities? Effective Staff Motivation

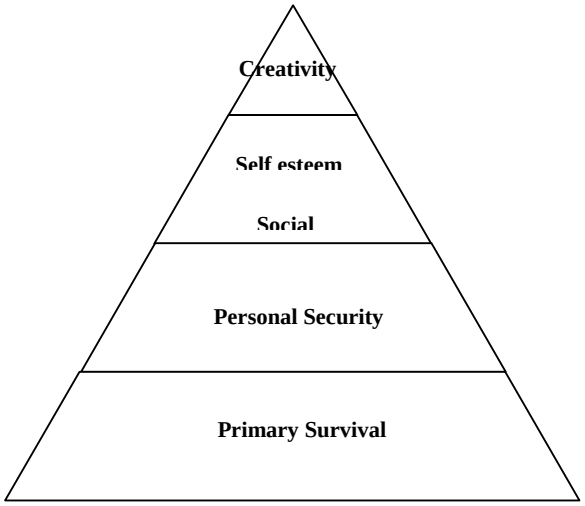
Preventive MFI internal controls – particularly with respect to human resources is about preventing opportunities for error, misstatement and abuse. The greatest preventive antidote to fraud, is to ensure your MFI provides strong and effective staff motivation.

Analysis of Human Needs

Abraham Maslow has conducted research on the various levels of human need, and most of the world is now familiar with the model that carry's his name, "Maslow's Hierarchy of Human Needs". When the lower levels of need are satisfied – primary needs of survival and personal security, he learned that people are motivated by seeking to satisfy the higher needs – social belonging and personal fulfillment.

The mission and vision of MFIs is what attracts and motivates many people to enter the sector and to an MFI's work in the community. People are drawn by a mission that seeks to provide access to the poor and disadvantaged. However, if your MFI staff themselves are not receiving adequate salary to cover their primary needs of food, clothing and shelter, and also some of their social needs for recognition, status and belonging, they may well be poorly motivated and discouraged.

Figure 3.2 - Maslow's Hierarchy of Human Needs



Analysis of Motivating Factors

Herzberg, a writer on organisational management, has identified five "motivating factors" to workplace satisfaction and positive attitudes. He also identified five "negative" factors which, if bad, cause dissatisfaction in the workplace. The table below shows the factors in the order of importance based on his research. Note that salary and benefits is only the 3rd most commonly cited de-motivating factor in a work environment. People find bad policy and administration, and incompetent supervision more difficult.

None of the motivating factors highlight the issue of salary or remuneration, although it is generally included with recognition. It is interesting to note that the motivating factors all correspond to Maslow's higher levels of human need – self-esteem and creativity.

Motivating Factors	Negative Factors
Achievement	Bad policy and administration
Recognition	Incompetent supervision
Quality of the work	Salary and benefits
Responsibility	Poor colleague relationships
Advancement	Working conditions

The Role of Human Resource Policies

It goes without say that a critical component of creating a motivating staff environment for your MFI is the administration of effective Human Resource system. The *MicroSave* toolkit "Human Resources Management for MFIs" (Pityn, 2005) provides the context, systems and tools to do that. In this toolkit, we focus on four key activities that serve as potential controls for preventing misappropriation of assets. They are part of the overall MFI human resource policies and include hiring, training, remunerating, and terminating staff members. They seek to answer these key questions:

- **Are the hiring procedures designed to attract individuals who are honest and well motivated?**

- **Are new employees oriented to the MFI culture of honesty and zero-tolerance?**
- **Are staff remuneration levels reasonable and competitive?**
- **Is there an immediate termination policy for staff fraud or dishonesty?**

> An MFI's attitude towards fraud and dishonesty will to a large extent determine staff attitudes. MFI Board and management that hold a high regard for strong internal controls and low tolerance toward fraud, will often succeed in minimizing fraud. Their policies, procedures, practices, and responses to incidents will reflect that attitude.

Hiring

Staff that work for microfinance institutions must catch the vision of the institution, or preferably already have the vision themselves. The MFI can identify sources of prospective staff members with high moral integrity, such as certain schools, faculties or religious communities, and actively recruit new staff members from these sources. Some MFIs choose to hire fresh student graduates who do not have the "baggage" of negative work experience from previous employment.

In every case, even with a "known" person, an MFI must follow solid recruitment practices and be willing to invest the time and resources to find the right people.

- Check references, both professional and personal
- Personality tests or other screening mechanisms
- Systematic and tested recruitment, interview and screening process
- Consider background checks
- Request a statement of personal ethics

> An MFI with over 14,000 clients in an urban setting works in a legal environment that discourages any type of termination. Firing staff for any reason is very difficult. The MFI has developed a Code of Ethics that outlines the grounds for termination related to fraud or dishonesty. Staff annually renews their commitment to the Code of Ethics by signing it and submitting it for their personnel records in the MFI. This signed declaration acts as a deterrent to staff who might entertain dishonest behaviour. It also allows the MFI to take appropriate action for certain misconduct, without going through great bureaucratic processes in the legal system. *Refer Handout 3.1 Sample Employee Code of Conduct*

Training and Development

A critical aspect of bringing on new recruits is to train them thoroughly in their positions, in the operational policies, procedures and internal controls, and to indoctrinate them into the institution's culture. This is the ideal opportunity to promote the organisation's core values of honesty and integrity, and demonstrate a low-tolerance toward fraud. (Some MFIs provide examples of fallen employees who succumbed to temptation and suffered the consequences. While this seems harsh, it does provoke new employees to think through their choices and the consequences).

Training staff in values, organisational culture, and practices includes both teaching and verbalizing those values, but more importantly, living those values. More is "caught" than "taught." Values need to be reinforced with all staff on an ongoing basis.

The *MicroSave* toolkit "Human Resources Management for MFIs" (Pityn, 2005) provides systems and guidance in staff training. It defines "***Training*** as the acquisition of knowledge, skills and attitudes that improve performance in the current job. ***Development*** focuses on knowledge and attitudes that may be required in the long-term achievement of an individual's career goals as well as your MFI's objectives." (Section 5 – 68). Training and development activities do not necessarily need to involve special programmes and materials. It has been estimated that 55% of development occurs through on-the-job experience and 15% through job relationships and feedback. Figure 3.2 taken from the HRM toolkit lists a number of training opportunities. Many of these are activities that can be incorporated into the orientation, probation and regular activities of the MFI.

Figure 3.3 - MFI Training Opportunities

- Special work projects
- On-site field
- Joining professional associations
- Writing articles for journals/newspapers
- One on one coaching
- Exchanges with other branches/offices
- Outside reading
- Distance learning

Unfortunately, the sad reality is that many MFIs are so focussed on operational productivity and cutting costs, that staff development and training are often sidelined or forgotten.

Remunerating

Employees should have a strong incentive to perform their job in a responsible and competent manner. Employees who do not feel sufficiently compensated will be much less likely to carry out their job with the needed thoroughness and attention to detail. Likewise, they are much more vulnerable to committing fraud, especially in economies where sums that they handle daily represent months or even years of salary. A competitive salary is a strong preventive control in deterring sloppy or fraudulent employee behaviour. Typically, MFI budgets are limited and very cost-effective. Linking financial incentives to financial performance of the MFI or the portfolio is a good way to ensure that remuneration is financially affordable.

Terminating

Employee awareness of potential negative consequences for inadequate job performance can also be a preventive control, especially for employee fraudulent activity. There should be a clear message that staff members will be immediately terminated, lose their valuable source of income and benefits, and be taken to court (if possible) if they perpetrate fraud. Swift and permanent action in response to even the least consequential fraudulent activity sends a clear message to employees that the MFI does not tolerate fraud of any type. MFIs generally include systematic disciplinary procedures as part of their human resource policies. They are applicable for general performance, and depending on the MFI's

position, may be waived for fraudulent behaviour. Final tip: Remember to check your country's labour legislation and the legal regulations for termination. They may well dictate your process!

FRAUD DETECTION SIGNALS

Danger Signals	Examples of Problems that may Result
An employee exceeds scope of responsibilities	Individual negotiates contracts and assumes responsibility for approving invoices in order to get kickbacks
An unusual reduction in, or loss of, a regular customer's business	Key employee has silent partnership in a new competitor
Absentee ownership of a small business	An MFI employee or manager may pay personal debts with company funds
A loan officer also approves a loan	Asset appraisals or financial information is inflated and loans are given in exchange for kickbacks
An employee appears to be living beyond his/her means	Employee is embezzling to support the "high life"
Open-ended contracts with clients or suppliers	The supervisor must take the loan officer's or client's word, as there are no written agreements or documents with open-ended contracts

How is fraud most often detected?

- **Increase in delinquency**
  There is a link between fraud and delinquency.
  MFIs must re-examine both lending policies and reporting procedures.

- **Accounting irregularities**
  There is a link between fraud and inadequate bookkeeping.
  MFIs must examine accounting procedures and maintain a system of independent review.

- **Employee tips**
  There is a link between fraud and unmotivated employees.
  MFIs must examine the institutional culture and create a "fraud awareness" philosophy.

Response to Fraud

If fraud is identified, the MFI needs to quickly move into damage control mode. Organisations should consider developing contingency plans that can be dusted off and put into action when the need arises. This contingency plan might include the following elements:

- What action will the MFI take against the perpetrator (i.e., termination, bringing in the police, legal proceedings, and efforts to recoup losses)?
- What approach will the organisation take with clients who were victimized?

- What approach will the organisation take with other clients who may think this is an opportunity to stop loan repayments, or become unsure of the MFI's reliability? Clients talk to one another more than they talk to the MFI, and a small incident can have much larger community effect than anticipated!
- How can the MFI turn this public relations nightmare into a coup?
- What changes to the internal control policies need to be made to prevent this from occurring again?

Suresh was a Credit Officer in a small, urban MFI in Chennai. He came from a very good, reputable family, was experienced, worked hard, and performed well. As a result, he was promoted to open a satellite office about 20 km from the Central Office and serve a small peri-urban neighbourhood. He continued to perform well, increasing his caseload to become the top performer in the entire Branch.

When he reached the highest caseload the Branch had seen, his portfolio quality began to slip, and show signs of strain. His colleagues could not help but notice his changing lifestyle. He was always buying his girlfriend gifts. His cell phone was never without credit. They did not understand.

One day, a frustrated client from his satellite area walked into the Branch Manager's central office location. He knew the MFI held high values and an "open door" policy. He held a cash receipt in his hand for a loan security deposit and demanded to know why his loan was not assessed and approved as promised. The Branch Manager immediately took the receipt and went to the Cashier's office to determine when the funds were received and banked. To her surprise, she found a deposit of 2 weeks ago with the same receipt number, carrying a different name and a different amount.

When Suresh was confronted by the Branch Manager later that afternoon, he ran from the office and went into hiding.

Staff investigations learned that Suresh had a duplicate receipt book printed by a local printing company. The receipts resembled official MFI receipts. Suresh was using these receipts to collect monies from clients and potential clients and pay for his changing lifestyle. At other times, he used official MFI receipts, and faithfully submitted these according to policy and procedure.

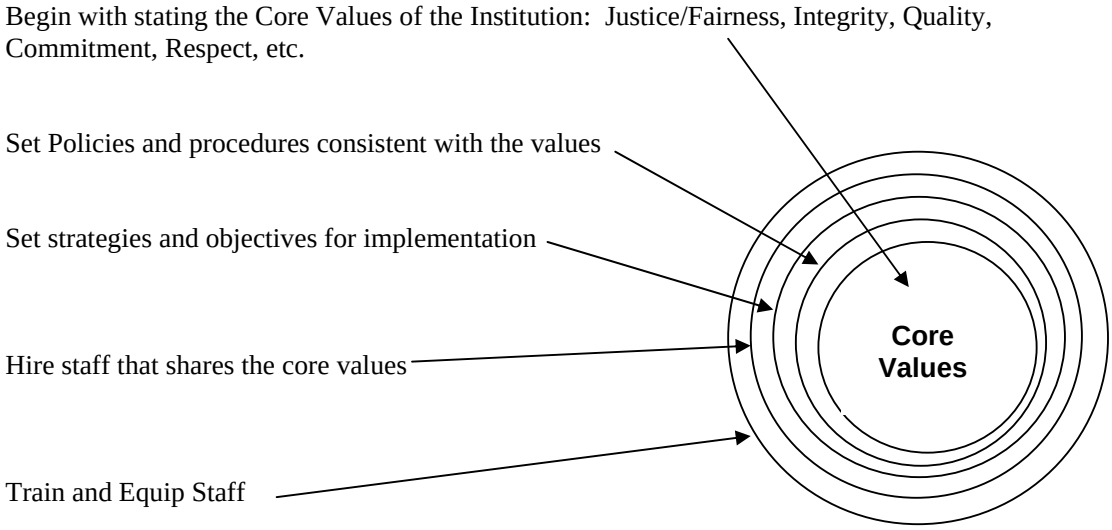
It took about 3 weeks to fully investigate the extent of damage done to his portfolio. Suresh's scheme had gone undetected for about 2 – 3 months, as he had managed to placate his clients and potential clients during that period. He was terminated from his job, but his family made full restitution of the outstanding funds.

Surprisingly, clients did not stop their repayments, and continue to demand services. They knew the MFI's policy about this type of activity and knew that Suresh was the "bad apple in the barrel". Their respect for the MFI, its remaining staff and its management increased.

Model for Sustainable Capacity Building

Each MFI must determine what values are appropriate for their institution and constantly seek to have those values internalized by every Board member, manager, and staff member. Building capacity for sustainability and growth in MFIs requires the right people, with the right skills, doing the right things. Setting policies, procedures and strategies that reflect your MFI's values and plans provide direction for your staff. However, hiring, training and developing your staff capacity is an organic process. Your approaches and strategies for staff development may evolve and be refined through experience, but they require good leadership, management and commitment.

Figure 3.4 - Model for Sustainable Capacity Building



Tips for Growth:

Exponential growth plans and projections are easily produced by good spreadsheets and planning models.

However, a quotation from Gemini Publications in the early 1990's makes the following statement: "No matter how clearly we understand the principles of sound micro-enterprise financial service delivery, building more successful institutions is going to take time. **The fundamental principle behind the successes that exist is strong leadership, which enables the development of strong programme staff. Fostering leadership and creating strong teams cannot be rushed, and attempts to put financial service targets ahead of institutional capabilities have had predictably disastrous results.** We need to build our understanding of the human capital side of micro-enterprise finance if we really want to lay the foundations to provide financial services for the masses."

Preventive Control – Policies and Procedures

Mennonite Economic Development Associates

4. Preventive Control – Policies and Procedures

Clear and comprehensive policies and procedures are an integral part of preventive control of risks in an MFI.

Policies are the written guidelines that indicate the direction of the operations. Credit policies will include guidelines on eligibility of clients, description of products offered, etc.	**Procedures** are the written instructions that tell how to implement and follow the policies.

In order to be effective, policies and procedures must be:

- **Written** – oral instructions are seldom consistent and easily misunderstood
- **Simple/Clear** – keep straight and to the point; use diagrams to show the flow of operations
- **Available** – ensure that each staff has the policies applicable to their position
- **Understood** – provide training for all staff
- **Relevant** – if a policy has been changed, be sure it is communicated and training provided
- **Implemented** – expect all staff to follow the policies and procedures as stated

Take a few minutes to assess your MFI's policy and procedure framework by referring to *Exercise 4.1 Policy and Procedure Worksheet.* This worksheet gives you the chance to reflect on your policies and procedures, whether they exist, whether they are up-to-date and whether they are available to all staff.

Tips for Growth: A rapidly growing MFI in the southern part of the country had 3 distant Branches from its Head Office in the regional capital. When conducting an internal control assessment, the Internal Auditor asked to review the existing Credit Policies and Procedures as part of the exercise. "They are unavailable" replied staff. "They are locked up in the Operations Manager's office for 3 weeks while he is on leave." No other copies of policies and procedures were available. When the Auditor asked about the latest update to the credit policies, the reply was unanimous, "Over 2 years ago."

When visiting the first Branch, the Internal Auditor again asked for a copy of the Credit Policies and Procedures. None were available. Throughout the field visit, credit staff would report that official policy dictated one approach, but an operational memo issued recently superseded the policy. It became clear that operational memos where the norm, and that new staff no longer understood the core elements of the MFI's Credit Policies and Procedures. They were no longer relevant or available.

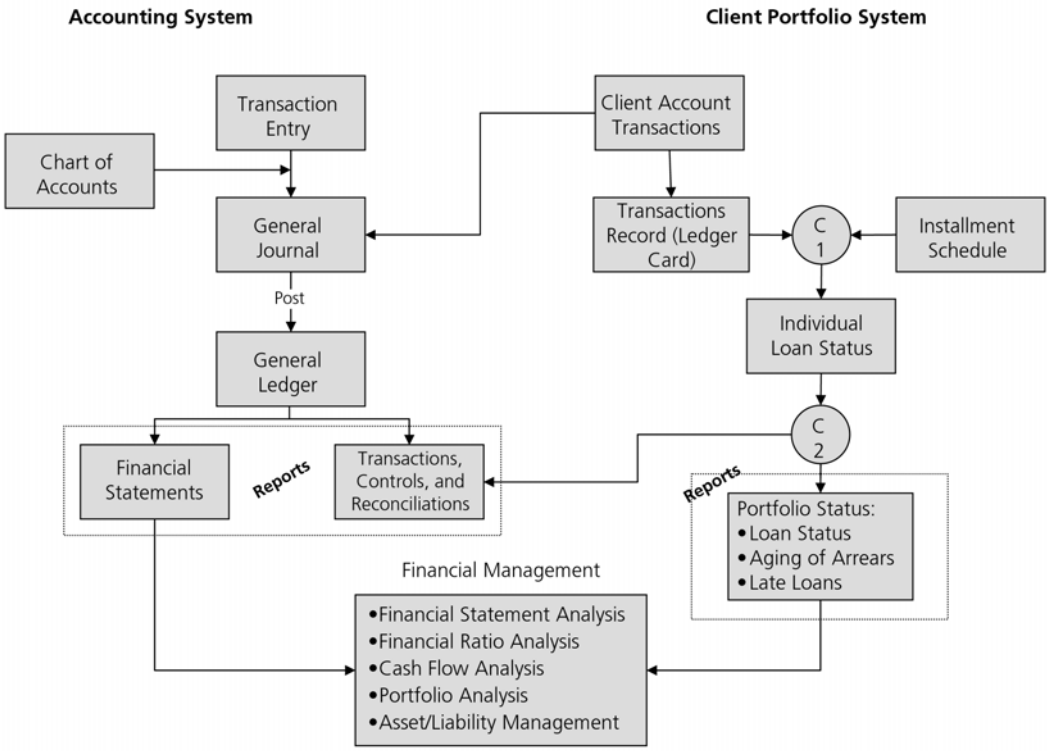
Policies and procedures need to be written for every area of operations. In a Microfinance institution, control systems for cash, reports, and loans are of primary importance. The following section of this toolkit includes general control procedures for the accounting documents, accounting transactions and the accounting system in general. Control procedures for fixed assets are included. Other areas of operations could also be included (e.g. inventory control) but are not highly relevant to an MFI's core

activities. The *MicroSave* "Toolkit for Loan Portfolio Audit of Micro Finance Institutions" (Wright, 2006) lays out many of the control procedures applicable to lending operations, and therefore are not repeated here.

Accounting Controls

The integrity of the MFI's financial reports will depend on the strength and integrity of the accounting system – whether manual or computerized. The system must operate and process transactions correctly. Individual transactions must be entered into the system correctly. The following diagram illustrates the flow of transactions through the accounting and portfolio tracking system. The two systems are connected and it is critical that transactions are entered correctly and treated correctly in both systems. The reports produced by both systems must also be reconciled at the end of each month.

Figure 4.1 - MFI Financial Management Information Systems



Characteristics of Transactions

In order to produce reliable financial statements and reports, accounting transactions must have the following characteristics. These are core elements of basic accounting and information controls.

Controls for validity, completeness, and valuation are best maintained by independent checks and segregation of duties within the accounting function. This ensures that each person performs only certain functions within the system and that each person's work is checked by another.

a. **Transactions shall be valid.** The system must not permit the inclusion of fictitious or non-existent transactions in journals or other records.

- All pre-printed forms shall be pre-numbered and kept under the control of the Head Accountant
- All transactions entered in the journals must be recorded in numerical order
- All transactions must be fully substantiated by supporting source documents
- Any changes made to entries must be made by first reversing the incorrect entry and then entering the new one. Entries that have already been posted should not be altered.

b. **Transactions shall be properly authorized.** Upon approval of the annual budget, the Manager alone authorizes expenditures. These shall remain within budget by classified categories unless approvals are received for any changes. Supporting documentation and vouchers for transactions that have been paid, shall be stamped "Paid" and dated. Your MFI assets can be wasted or destroyed by approval of incorrect or fraudulent transactions.

c. **Transaction records shall be complete.** The system must prevent the omission of transaction from the records. All pre-numbered forms must be accounted for in numerical order, including forms that have been mutilated or otherwise voided due to error.

d. **Transactions shall be properly valued.** Expense reports, invoices, receipts and other transactions shall be checked for accuracy and initialled by someone other than the person preparing the payment documentation. Values should be checked for consistency through out the recording process.

e. **Transactions shall be properly classified.** The transactions must be entered into the journals with the proper account categories according to the chart of accounts.

f. **Transactions shall be recorded at the proper time.**

- Recording transactions before or after they occur will increase the likelihood of error
- All transactions occurring in any given month must be recorded in the books during that month.
- Proper month-end cut-off procedures shall be maintained to ensure consistent reporting from month-to-month

g. **Transactions shall be properly posted to the general ledger (master files) and correctly summarized and aggregated.** Whether the accounting system is manual or automated, adequate controls must be in place to make sure that classification, posting and summarization is correct.

h. **All transactions must be supported by adequate and appropriate documents that justify and support the payment.**

Voucher preparation

Every time a transaction occurs, it must be documented on an accounting voucher or other internal source document. Preparing a voucher will record the transaction consistent with the accounting treatment. Every organisation has specific ways of preparing vouchers. The most important point to remember is that vouchers result in a paper trail for each transaction. In a computerized system, this is the basic document used for data entry. In a manual system, this is also the initial source document. Vouchers are supported by invoices and cheque stubs or cash requests and generally include the following:

- Number and nature of voucher

- Name of department
- Date prepared
- Account name and number
- Amount of money
- Source and description of the transaction
- Authorized signature(s) of person reviewing the documentation, and also authorized signature of person approving the transaction
- Attachment of original invoices and cash requests
- Proof of delivery or completion of services rendered

Segregation of Duties

The segregation of duties in the internal control system generally refers to the practice that no one person approves, handles and records financial transactions. If anyone is responsible for all three activities, the opportunity for error, abuse or fraud is created. A Loan Officer that processes a loan, disburses the loan in cash, and records the loan ledger card may falsify transactions or documents or be tempted to take some of the cash. Segregating the duties between different staff helps to avoid problems. However, it is also more costly to involve more people to processes, and does not prevent collusion of staff in misappropriation (staff work together to falsify records or steal cash).

If at all possible, three separate people should be assigned to the three activities of:

- Approve
- Record
- Do

Limits of Authority

Limits are often used to set parameters for approvals, expenditures, and other ordinary business processes. Budgets are one of the most common types of limits used in business operations. Another operational limit is to put a cap on the amount of cash allowed in a branch at any point in time. Beyond the cap, the Branch should make a bank deposit.

Dual Controls

Dual controls act as a backstop to decision making or approvals by having at least one other employee check or approve a transaction. Cheques should always be signed at least by two or more approved employees. Some MFIs use a Credit Committee to approve loans, thereby spreading the responsibility and authority of those approvals over several individuals.

Independent Checks and Verification

Independent review and checks are a common internal control feature in banking and operations generally, and are used for transactions, reconciliations, approvals and reports. It is a way of not only segregating duties, but an extra “pair of eyes” to ensure that bank reconciliations are done properly, financial reports are supported by reconciliation schedules that agree to the report, and that accounting reports agree to MIS loan tracking reports.

MFIs also need to conduct independent checks on the client loan portfolio. The authentication of clients (vouching that the client names and files in the MFI records are in fact the physical client at the

business) and the verification of their loan balances (verifying the amount of loan the client was granted, the payments made and the remaining balance) is a critical part of every MFI internal control system. If the MFI collects and holds client savings, these balances must also be verified to client records.

Procedures for Cash Receipts

The proper management of cash is very important for a Microfinance Institution for the following reasons:

- There are a large number of transactions of cash receipts and cash disbursements.
- The chance of fraud being committed regarding cash is high and strict controls are therefore required. Properly maintained cash books help to achieve this.
- Timely payments to creditors increase the reputation of the organisation.
- Timely payments from clients improve the financial position.
- Good systems foster client trust, limit opportunities for abuse, and protect staff who follow procedures as outlined.

Cash Receipts

Loan repayments

The primary source of operating cash received by a Microfinance institution is the repayment of loans from clients. In some cases, payments are made directly into a bank account. In other cases, payments are made to the teller or cashier at MFI Branch or satellite offices. Sometimes payments are made directly to loan officers.

All collection procedures should include the following elements:

- Issue pre-printed repayment schedules to each client with the loan proceeds. Include bank account numbers, if paid to a bank.
- Issue pre-numbered receipts to borrowers for bank deposit slips or cash funds received.
- List all collections, including field collections, and compare with accounting and MIS transaction journals.
- Each individual receipt is recorded in two places: the individual client ledger cards and the cash receipts journal.
- Reconcile the total receipts for each day with the daily bank deposit slip (the institution's deposit, not the client's).

In general, most MFIs discourage loan officers from handling cash payments. If there is no other option, additional control procedures need to be established. See the example below:

> In a village banking programme in the rural area, all the loan officers gather every morning and write on a blackboard the total to be collected during that day's client visits. At the end of the day, the loan officers gather again to write the total actually received. The group notes any discrepancy, and a follow-up visit is scheduled for the next day by the office coordinator. Immediate follow-up dramatically reduces the opportunity for theft.

Other receipts

There are other types of cash receipts over which the general manager must have direct control.

Donor Funds. The general manager must be responsible for the deposit of donor funds to ensure timely and proper crediting to the institution's account. No donor funds should be received and deposited without his/her knowledge.

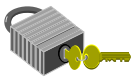
Sale of Assets. The general manager must personally approve the sale of any asset, complete with signature on the bill of sale and signature on the voucher showing the receipt of cash.
All cash receipts from whatever source must be recorded in a cash book and reconciled to the daily bank deposit slip.

> **In some institutions, all incoming mail is first reviewed by the general manager and then forwarded to the appropriate employee for further handling.**

Procedures for Cash Disbursements

Bank Account

General Control Techniques:



- Use only pre-numbered cheques for disbursements
- Have proper documentation support for cheques
- Cancel supporting documents when paid (e.g. cross them with a line and a signature, or stamp them "Paid" or "Used")
- Cheque signing by management with no access to records
- Keep voided cheques, but ensure signatures are obliterated
- Post or deliver cheques or disbursements directly to client or payee
- If hand delivered, obtain a receipt
- Record all cheques in numerical order in the cash disbursements journal and allocate each cheque to the proper operating expense account number
- Use an imprest petty cash fund system with one custodian

Petty Cash

In many institutions, supplies and expenses are often paid in cash rather than by cheque, including, in some cases, payroll. For this reason, procedures for handling the petty cash fund need to be clearly outlined and consistently followed. For example:

- Petty cash shall be maintained on an imprest basis. At any given time, the cash and receipts in the cash box shall total the imprest level. The level shall be maintained at a specific amount.

- Only the designated staff person will handle petty cash. Actual cash will be spot-checked and verified by the supervisor at least once per week. The staff person in charge of the fund shall reimburse for any discrepancies.

- All requests for petty cash must be signed by an authorized supervisor on a pre-numbered voucher. All vouchers must be supported by invoices and bills for the purchase.

- Cancel supporting documentation after payment.

- Record petty cash transactions in a cash book.

- A cheque to replenish the fund shall be issued when the fund is low, and at the end of every month. A physical cash count of the cash box will be part of the replenishment process. Compare the cash count to the cash bank when making a physical verification.

- The cash and vouchers will be kept in locked box or safe.

Other Control Procedures

Bank Reconciliations

Accurate and timely bank reconciliation is a key factor in maintaining internal control over cash in the bank account. This means monthly, immediate reconciliation of the bank statement to the general ledger. Refer to *Handout 4.1 Sample Bank Reconciliation Format* for details of the following section.

How to Prepare a Bank Reconciliation

The reconciliation must be prepared at least monthly for each bank account to reconcile the bank balances per the bank statements to the general ledger or cash book balance. The format is outlined on the next page.

Part A of the form summarizes activity in the cash book for the month. The first line is the opening balance at the beginning of the month, taken from the general ledger. This should agree to the previous month's closing balance. The monthly totals of cash receipts and disbursements from the cash book are listed.

The bank statement may list service charges or interest received on the account that have not been included in the cash book. If so, adjustments should be made to the general ledger so the final balance is current and up to date. Those adjustments are also listed in Part A.

Part B begins with the closing month end balance from the bank statement. Now the reconciling begins. The possible differences between the bank balance and the general ledger balance in Part A are in two categories:

1. Deposits that were entered in the cash book, but have not been credited to the bank account are listed as outstanding deposits.

   Deposits that are outstanding for more than one week should be followed up with the bank.

2. Cheques listed in the cash disbursements journal and included in the general ledger total, but have not cleared the bank are reported as outstanding cheques.

The ending balances of the bank statement should agree to the ending balance of the general ledger.

Cash Reconciliations

Cash reconciliations are generally part of petty cash management. However, if your MFI's primary medium of transactions happens to be cash, cash reconciliations also include the analysis and verification of cash in transit, cash in the vault, and bank deposits in transits. These must be carefully documented and monitored to ensure there are no unnecessary delays in the system. Some MFIs develop and use Cash Count sheets to document and verify cash reconciliations. Refer to *Handout 4.2 Sample Cash Count and Verification* as a sample tool for reconciling cash on hand.

Portfolio Reconciliations – The General Ledger and the Portfolio Tracking System (MIS)

Another critical control procedure is to ensure that the loan portfolio outstanding as reported in the Portfolio Tracking System (or MIS) agrees to the Loans Receivable account in your MFI's accounting general ledger. If client savings are captured and held in the MFI, the tracking system must agree to Client Deposits in the MFI's accounting general ledger (liability). These two systems are illustrated in Figure 2.1 in Section 2. Whether your two systems are integrated into one software package, or are set up as two separate systems, this reconciliation should be done monthly. Manual tracking systems or accounting systems make this very challenging, but all the more necessary. Most community and Self Help Groups use manual systems; many struggle with timely reporting and detailed accounting reconciliations. However, this reconciliation is very, very important to conduct on a regular, timely basis. All variances need to be investigated immediately.

Document Controls

Managing documents involves more than the production and printing of duplicate or triplicate copies, or ensuring they are serially pre-numbered. It also includes the proper storage, recording, issuance and tracking those documents. Normally, this is done in a Document Control Register. Staff who need to use and withdraw a receipt book for example, are required to sign them out. When they are completely filled, staff will return the receipt book with book copies intact. Receipts that are spoiled or voided remain in the book. Receipts will be spot checked and verified and then stored in safe place. These documents are generally stored and locked in a special place, since they represent the means for cash (e.g. receipts) or goods and services (e.g. a purchase order book) and can be misused.

Audit and Paper Trail

The "audit trail" represents the linking of source documents to journals, to summaries, and to monthly or cumulative financial information. For example, a receipt is issued to a client for a loan payment and should be recorded in either a collection sheet or a cash register. This entry includes the date of the receipt, the receipt number, the client name, the total amount, and the amounts allocated to principal and interest. Receipts are summarized on the collection sheet on a daily or weekly basis, and the summarized total is then posted to the general ledger at the end of the month. The general ledger posting will make reference to the date and the number of the collection sheet.

A "paper trail" refers to the system of documentation that supports accounting transactions, entries and reports. For example, source documents like invoices, payment schedules or receipts support the accounting transaction voucher. They need to be filed sequentially by month in order to be available for internal or external audits. The "paper trail" also includes the systematic filing and printing of all computer-generated reports. For example, it includes the printing of weekly or monthly transactions journal, the monthly general ledger, or the monthly financial statements. It also includes the systematic printing and filing of all Loan Tracking System reports. Auditors and managers do not rely on screen data to analyze MFI performance, or to audit financial reports, but on hard copy documents and reports.

Fixed Asset Controls

Controls over fixed assets extend beyond the physical control of those assets – which is not to be minimized. However, other fixed asset controls include the maintenance of a fixed asset ledger. It acts as a subsidiary ledger to the general ledger control accounts, and records asset serial numbers, date of purchase, location, asset identification number (visibly marked on the asset). In most cases, the fixed asset ledger also records the related accumulated depreciation. The fixed asset ledger facilitates the management of fixed assets more than many managers actually realize.

The use of fixed assets, for example vehicles and motorcycles are usually controlled through the use of a "Vehicle Log Book." This is the record kept in the vehicle that tracks use of the vehicle, the date, the kilometres driven, the places travelled, and the purpose. Most Vehicle Log Books also include sections to track fuel purchases, the number of litres purchased, the price and the odometer reading at the time of the purchase. This can help to facilitate

Refer to *Handout 4.3 Sample Internal Control Checklist* and *Handout 4.4 Sample Reconciliation Problems and Tips* for additional resources and tools to assist your MFI to strengthen its control procedures and ensure that there are independent checks and reviews of accounting work, reconciliations and reports. These tools may also be helpful in training new staff and in setting up new Branch systems.

Preventive Control – Information Systems

Mennonite Economic Development Associates

5. Preventive Control – Information Systems

Information and an information system is a vital part of effective internal control. We can't control what we don't know! MFIs need information and communication to identify and prioritize risks – not only accounting but in all facets of operations. Therefore we need a system that manages and controls information content and flow.

Operational information generally covers a wide range of administrative and management issues. **However, this section will focus on loan portfolio information. Why? The loan portfolio is the MFI's largest and most significant asset. It is the productive asset that generates revenues to cover operating costs. Loan portfolio information is critical because delinquency is one of the largest risks to the MFI.** If your MFI captures the savings of clients, it is very important to have reliable information on client deposits. Central bank regulations will no doubt require good tracking systems for this financial service.

Risks Associated with Lack of Information

- **Inability to prioritize risks.** A key part of the risk management process is the prioritization of risk. This can be done by using a matrix to rank the likelihood of the event occurring (frequency) and the potential cost (impact). Lack of good historic information will make this process more difficult, if not impossible.

- **Inability to detect fraud.** If fraud has occurred in an MFI, it most often has had an effect on the quality of the portfolio. If regular and accurate portfolio information is available, fraud related to loan disbursements and repayments can be much more easily detected.

- **Unclear employment procedures.** Each staff person should have a complete personnel file with employment agreements, remuneration decisions (with approvals), results of performance appraisals signed by both the employee and supervisor, and other documentation of issues related to the employee. To maintain a fair and transparent human resource system, the employee file information is critical.

- **Unmet statutory requirements.** Without proper and timely information, statutory reporting will be inaccurate or incomplete.

- **Inadequate control over assets.** Log books for entering or taking supplies from stores, vehicle usage log, fixed asset register.

- **Non-compliance with budget.** A financial information system should include the comparison of actual results to the budget. If a manager is not able to check the reason for variances, system manipulation is less likely to be detected.

- **Inaccurate financial statements.** Sloppy bookkeeping and accounting procedures not only create an environment for fraudulent activity, but ultimately leaves managers and stakeholders with incorrect information for managing the company.

Managing MFI Information

The management of information involves much more than installing a computer and a software system. The senior managers need to decide what reports they need in order to be able to make appropriate decisions and to provide reports to stakeholders – Board, donors, investors, regulators, etc. Information must be properly collected, recorded, and input into the system in order to enable the

delivery of these reports. Timely and accurate reporting should be a clear expectation from all staff and made part of their performance appraisal.

Each MFI should have a summary flow chart of reporting, including all forms used, persons responsible, user, due dates, etc. of all internal reports. This can help ensure that the information provided meets the following criteria. Many MFIs suffer from information overload. There is simply too much paper in many MFI offices. From time to time, it is good to ask questions about what is really important.

Is the information …

- Relevant – does it provide what is needed?
- Used – does the recipient need all the information?
- Timely – is it delivered in time to be useful?
- Accurate – is the information correct?
- Distributed to the correct people – do the reports go to the people who need the information?
- Accessed by the correct people – is access to the reports limited to the users?
- Well formatted – is it easy to read and understand?
- Retrievable – are reports filed in standard formats and locations?
- Traceable – is the information on the reports able to be audited?

Tips for Growth: A small urban-based MFI decided to open a Branch office in a location 90 km from the Head Office. Most accounting and data processing activities continued from Head Office. The satellite maintained manual ledger cards for client transactions. However, they did not produce late loan or aging reports.

Supporting documentation was sent to the Head Office by bus about 2 times a week. By the time the Head Office entered the data, produced the late loan reports, the aging reports, and sent copies of the report back to the satellite, a full week had passed.

The satellite performed fairly well, but suffered from chronic, low-grade delinquency because information was not immediate and follow-up was sluggish in the first 2 – 3 days of delinquency.

Loan Portfolio Information

It is important to distinguish three separate MFI systems that affect the loan portfolio. In practice, there may be some overlap, but in theory they perform separate functions. They are:

Loan Administration System	Loan Tracking System	Accounting System

Characteristics unique to MFIs

- MFIs grant a large number of small loans and so receive a large number of tiny payments. In addition, operations are often dispersed over a wide area. These factors make effective portfolio management more difficult.

- Decentralization is often necessary to be efficient, but can increase the opportunity for deviation from approved policies, or for fraud because:

  1. Fewer staff is involved in the total loan process: approving, disbursing, monitoring, and collecting, and
  2. There is an increased risk of error or manipulation when branches transfer information to headquarters.

- Rapid growth puts pressure on systems and can camouflage repayment problems. Rapid growth also involves new personnel that need to be trained and supervised.

- New lines, products or activities are essential for growth, but can add complicating factors to an automated loan tracking system.

- Many MFIs are non-profit NGOs with managers trained more in social sciences than in business. The importance of internal controls and financial reporting is often underestimated. It is not uncommon for an MFI to encounter fraud problems within the first few years of their existence.

- There is often great pressure to cut costs, sometimes at the expense of
  1. Adequate portfolio controls and information systems, and
  2. Insufficient supervision of clients and staff.

- MFIs dislike provisioning or write-offs of problem loans. They want to maintain a good image for donors, and the provision reduces income.

- MFIs generally do not have fully integrated management information systems. Their loan tracking system is a stand alone system from their accounting general ledger.

- Many small MFIs and Self Help Group still operate manual sets of books – both to track client savings and loans transactions, and the accounting general ledger. This adds another layer of complexity and risk, particularly as they grow, and increasingly find it cumbersome, inefficient and ineffective to track such systems manually.

Risk of Rapid Growth

A Branch manager was very concerned about the portfolio quality ratios reported at each month end. He always made sure to have high disbursements during the last week of the month. This would help to "hide" any problems with previous outstanding portfolio that was showing signs of deterioration and delinquency.

His problem was not revealed until he ran out of loan capital, and was forced to slow down new lending. His portfolio at risk began to rise noticeably.

Loan Administration

The loan administration system is not an information system, but rather it is the set of policies and procedures that govern the loan operations, including:

- Loan marketing - eligible clients and types of business
- Solidarity group formation, if applicable

- Client evaluation and training
- Loan analysis (repayment capacity)
- Loan terms and conditions
- Loan approval process
- Collateral and/or guarantors
- Loan documentation and disbursement
- Loan supervision and collection
- Follow-up loans
- Collection policies for delinquent loans
- Rescheduling for delinquent loans
- Provision for loan impairments
- Write-off of bad loans
- Savings programme
- Reporting procedures

The most important factor is to be sure that all staff is aware of and well trained with respect to the established policies and procedures, and expected to follow them.

REMEMBER
There isn't a policy or procedure worth writing – if it isn't followed!!

Loan Tracking

The purpose of the loan tracking system is information about individual loans, including:

- Identity of the client
- Credit history
- Amount disbursed
- Loan terms: interest rate, fees, maturity, etc.
- Repayment schedule: dates and amounts
- Amount and timing of payments received
- Amount and aging of delinquency
- Outstanding principal balance

The system should contain this information for both current loans and past due loans. Reports generated from loan tracking systems are a critical part of MFI portfolio management. Loan tracking systems should also be able to provide this information in a usable form on loans that have been paid off or written off.

> **One of the most dangerous information problem in MFIs is failure to provide loan officers and managers with reports that facilitate immediate follow-up on payment problems.**

How does my MFI control computer information systems?

Examples of control procedures:

- Establish controls over changes to computer programmes
- Limit access to data files
- Establish security passwords that restrict access and application of various functions, depending on the staff member's responsibilities
- Maintain and review control accounts and trial balances
- Approve and control documents
- Compare internal data with external sources of information
- Compare cash, security and inventory accounts with accounting records
- Limit direct physical access to assets and records
- Compare financial results and budgeted amounts

The credibility of the loan tracking system is crucial. If the staff does not expect accuracy, people tend to let down their guard. Situations that ought to cause alarm are ignored with the assumption they represent errors or glitches in the system rather than actual problems with portfolio quality. Where people think there are MIS problems, fraud is more tempting because it is less likely to be detected promptly.

Accounting for the Loan Portfolio

Two balance sheet accounts are very important account balances in MFIs -- the loan portfolio account and the loan loss provision account (called the Impairment Loss Allowance in International Accounting Standards). The portfolio typically accounts for most of the assets of the institution, and the potential for misstatement is great. Even without incidences of fraud, most MFI failures stem from deterioration in the quality of the loan portfolio. The risk of not collecting on some of the portfolio is accounted through the contra account, often called the loan loss provision on the balance sheet. The accounting system can receive information about individual loan transactions, but its purpose is to generate aggregate information that feeds into the financial statements.

Ideally, the loan tracking and accounting system should be seamlessly integrated (refer to Figure 4.1 MFI Financial Management Information Systems). In practice, this is often not the case. Many MFIs use a standard accounting system that can be adjusted to fit their needs, but often need to design their own loan tracking system. Loan disbursement and payment transactions are captured by both systems. But the two systems may capture the loan data at different times and from different sources, resulting in discrepancies between the two systems.

These discrepancies need to be reconciled at the end of each month!

Figure 5.1 - Areas of Risk in Loan Information

Accuracy	Does the system correctly reflect loans disbursed, payments received, and current repayment status of outstanding loans?
Security	Is the system physically secure? Is there access control? Who can enter, change, or read data?
Effectiveness	Are reports prepared in a timely manner? Is the information used?
Reconciliation Items	If there is a discrepancy with the accounting records, is it due to a fundamental inconsistency between the two systems?

Misrepresenting the Loan Payoff	Has the client proved ability to repay, or is the payoff a substitution of one type of account for another? Examples:1) Refinancing - using a new loan to pay the old.2) Payment by cheque - usually post-dated and not honoured. 3) Payoff with collateral -often of insufficient value.
Rescheduling	Are rescheduled loans tracked separately? If not, the old bad loan disappears, replaced by a new loan contract that appears to be current.
Following Established Procedures	Do the loan officers and the credit committees follow the MFI loan administration policies? Is there sufficient staff training and supervision?
Segmentation	Does the system permit segmentation, especially of delinquent loans? Examples: segment by region, branch, loan officer, loan type, etc.
Loan Write-offs	Is the policy for writing off unrecoverable balances consistently applied?
Provision Expense for Loan Impairment	Is the current method for calculating the provision expense for loan impairment reasonable in light of historical loss experience and the current delinquency situation?

MicroSave's "Toolkit for Loan Portfolio Audit of Micro Finance Institutions" (Wright, 2006) provides detailed tools and methods of conducting audits on the loan portfolio and systems and is an essential reference in conducting portfolio audits.

Automation of an MFI Loan Tracking System

An MFI with 12,000 clients operating in 6 Branches tracked all client transactions at the Branches through a manual system of ledger cards. Credit Officers worked long hours after their field work to enter loan transactions for the day on the cards.

The MFI planned to automate the system, and thought it might be a relatively simple task to do so. In preparation for the process, a Consultant was hired to train staff in the concepts of portfolio reporting and analysis, and to plan the automation process. During the assessment, the Consultant learned that the client loan ledger cards did not include repayment schedules. As a result, it was impossible for the MFI to prepare portfolio aging reports, something they had never done before.

Planning for automation took on a new dimension. The MFI realized the need for repayment schedules in order to analyze portfolio quality, and in order to implement the automation process.

Role of the Internal Audit

Mennonite Economic Development Associates

6. Role of the Internal Audit

What is an Internal Audit?

It is a systematic and independent review of the operations and controls within an organisation.

The primary goal of a financial internal audit is to determine whether the risks to the organisation are identified by checking to see if:

- financial and operating information is accurate (for internal and external purposes)
- internal policies and procedures are being followed,
- management's risk identification, prioritization and mitigation is appropriate, and
- any new risks become evident or previously identified risks remain unaddressed.

Figure 6.1 - Differences Between Internal and External Auditors

Internal Auditor	External Auditor
Can be an employee of the organisation;	Is an independent contractor;
Serves the needs of the organisation;	Also serves third parties who need reliable financial information and reports;
Focuses on future events by evaluating controls that ensure the achievement of the organisation's objectives;	Focuses on whether financial statements reflect historical events clearly and accurately;
Is directly concerned with preventing fraud;	Is incidentally concerned with fraud controls in general, but is directly concerned only when the financial statements are affected;
Audit work is continuous throughout the year.	Audit work is done annually at the end of the fiscal year.

Role of the Internal Audit in the Internal Control System

The MFI Internal Auditor contributes to the monitoring component in the internal control system. The Internal Auditor monitors compliance to policies, procedures and systems that have been put in place to prevent loss and minimize operating risks.

The Internal Auditor is also a key contributor to the **communications and information** flow that is integral to the functioning of a strong internal control system. Staff and managers contribute to the communications channel as well. However, the Internal Auditor is not part and parcel of daily

operational activities. The Internal Auditor is the objective perspective that the Board and senior management need to know what is actually happening in the field with clients, in the field offices and in branch operations.

Role of the Audit in the Risk Management Feedback Loop

Human resource measures, policies and procedures, and a strong loan tracking system are preventive controls in the Risk Management Feedback Loop. **The role and work of the Internal Auditor is the detective control in the loop.** The objective is not simply to "detect" fraud and error, but to test the effectiveness of the preventive controls and procedures put in place. The result of this assessment may lead to the adaptation and revision of current policies and procedures to minimize future risks, and to help the MFI continue its course toward sustainability and serving its clients.

Creating the Internal Audit Team

Many MFI managers ask: **When is it time to hire an Internal Auditor? There is no simple or correct answer.** The MFI should be able to afford the services of the Internal Audit department financially – but it may reach a point, where the MFI can no longer afford **not** to have the department in place. Much will depend on size, number of Branches, distance of Branches, automated systems, and centralized or decentralized management systems. It may also depend on the type of financial services offered, and the technology available. Most MFIs with 6,000 to 8,000 clients are looking for the services of an Internal Auditor. MFIs with over 12,000 clients generally begin to build their internal audit department with additional field auditors who assist and support the leadership of the Internal Audit Manager.

The **Internal Auditor should be a trained qualified accountant with a recognized designation, and auditing experience**, particularly in a banking environment. Experience in microfinance will be a definite asset. Personal characteristics of Internal Auditors are very important – honesty, integrity, discretion and objectivity, excellent verbal and written skills. As the MFI grows in size, scale and complexity, it will be necessary to add the number of auditors to the Internal Audit team. This allows for good rotation of audit work between branches, and good insights from a group of internal audit professionals, than simply 1 or 2 individuals. Refer to *Handout 6.1 for a Sample Internal Auditor Job Description.*

If a small MFI cannot afford to hire a qualified full-time Internal Auditor, the internal audit function might be contracted out, or conducted internally by managers or supervisors. If the internal audit work function is included in supervisors' duties, there is a limit to both the scope and objectivity of their work.

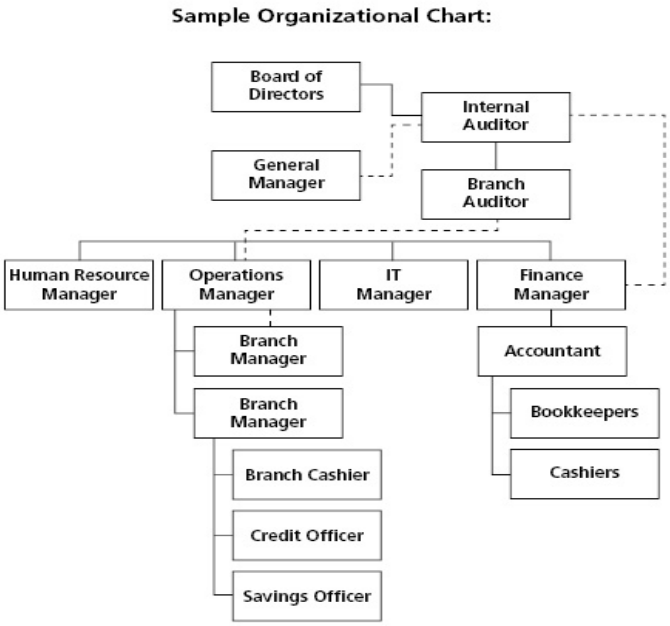
Hiring another external audit firm to conduct internal audit work is another way to add professional and credible value to the process of internal auditing. If the services of an audit firm are required, it should not be the same external audit firm that performs the annual audit. To do so would impair the independence of the annual audit. Most important is that the person performing the internal audit function is one with honesty, integrity and objectivity.

Reporting Function of the Internal Audit

- **Every MFI should have some form of internal audit.**

  When an MFI grows to the point where it can hire a full-time Internal Auditor, the ideal candidate will have had some external audit and accounting experience. At a minimum, knowledge of accounting and auditing is required. Experience is highly preferred.

Figure 6.2 – Sample Organisational Chart



- **The Internal Auditor reports directly to the Board of Directors, either through the Board Audit Committee or the Board Treasurer. There may be staff and coordinating relationships with the General Manager, and other MFI managers.** This permits the auditor to tell it like it is, and report findings on an objective and independent basis without risk of dismissal.

- **The Internal Auditor is concerned with the health and the well-being of the institution. They should be viewed as advocates, guardians and trainers of the MFI, but not as the MFI "police."**

Reporting Challenges:

MFIs may face a variety of challenges in the reporting structure of the Internal Audit Department.

- Some MFI Boards are relatively weak and uninformed; they may exist in "name" only. In this case, it may be understandable and seem appropriate for the Internal Auditor to report to the Executive Director directly.
- However, if the Internal Auditor reports directly to the Executive Director, there is no effective way to ensure that the Executive Director actually implements any audit recommendations. Further, if there are any situations that imply weak practice or controls from the Director him/herself, it may be difficult to for the Internal Auditor to report or confront the Director with the issue.
- There are a new set of challenges if the Internal Auditor does report to a weak and ineffective Board. In this case, the Board will probably also be weak in managing its Executive Director.

What are the solutions? MFI Boards need to understand their governing role, and have the skills and characteristics to fulfill their function professionally and effectively. MFI Boards should include members with banking and accounting expertise who are capable of having the Internal Auditor report to them. Getting Boards developed to this level may take time, but the process should be deliberate and take high priority. In most cases, capable, qualified Board members are available to fulfill the Audit Committee function on the Board. MFI Boards should ensure such a Board member is appointed to the Board, so that the Internal Auditor reports to this Board member(s) directly.

Implementing the Internal Audit Function

Mennonite Economic Development Associates

7. Implementing the Internal Audit Function

Planning the Internal Audit

Annual Plans and Budgets
The Internal Auditor must develop an **annual work plan and budget** for the department, whether there is 1 auditor or 5 auditors. Note that regulated MFIs may be required to comply with specific internal audit plans, tools and approaches. If your MFI falls into a category of regulation, you should consult the regulator to determine any specific requirements. In general, an MFI's annual work plan includes activities such as:

- conduct first time internal control assessments,
- review policy and procedure updates,
- conduct 2 – 4 Branch audits per year, depending on needs and capacity,
- write reports and issue recommendations to revise procedures and strengthen controls,
- meet with senior management and Board members to discuss findings, reports, and provide input into strengthening internal control systems and managing newly identified risks.

The primary budget items for the department will include staff salary and benefits, travel accommodation costs to the branches, professional publications, and possibly professional trainings or meetings. Access to transportation in the department is vital. An annual internal audit work plan and budget incorporated into the MFIs overall annual plan ensures that the function is part and parcel of the MFIs operations.

The work plan and budget will vary among MFIs, depending on their size, the number of branches, lending methodology and reporting systems. *Handout 7.1 Sample Annual Work Plan -- Internal Audit Department* provides an idea of how some MFIs develop their annual plans.

Planning a Branch Audit
The specific design and implementation of a branch audit will depend on whether this is a follow up visit, or a new visit. At the very least, the auditor should be familiar with the MFI and the branch's activities. This would include a description and understanding of the accounting system and the internal controls. If the audit is a routine visit, the auditor will select the items to review since the last audit. The scope of the Internal Auditor's work is generally confined to operational risks and compliance, but may be broader – depending on the job description and the Board's mandate. But it will always include:

1. Checklists to determine whether established procedures are being followed, and
2. A "spot-check" audit of selected financial transactions
3. Previous audit reports, management responses, external audit reports and audit management letters (as necessary and available).
4. Client visits to verify their existence and their loan and saving balances

Materiality
The term **"materiality"** refers to the relative significance or importance of a particular matter in the context of the financial statements as a whole. It is used when analyzing audit evidence and there are errors found in the course of work. The critical question usually asked is: **"Would this influence the financial statement reader's decision?"** There is an element of personal judgement that the Internal

Auditor uses in reporting and selecting findings. Materiality is assessed by considering the following three items:

- The total value of errors in the account and their effect on the overall view given by the reports,
- The nature of the item, and
- The context in which the error occurred.

Errors due to fraud or intention to manipulate financial information are deliberate breaches of policy and procedure. They are included in the audit findings, because they represent a breach of trust in the staff member, and expose the MFI to additional future risk.

Selecting the Sample Size

The greater the audit sample size, the more reliable the findings and conclusions of the audit may be. It will also be more expensive. If there are specific problems to follow up, or the Branch has previously identified internal control weaknesses, or the Branch has not been audited for a long period of time, you may wish to increase sample sizes. The following suggestion is considered a "minimum" sample size using random sampling techniques. Where samples are selected on a pure judgment basis the sample sizes must be significantly increased (e.g. a new Branch being audited, a first time audit, etc.)

Where the population is less than 1,000 items, the sample selection should be made on the basis of percentages of the population:
Poor controls: 10%
Fair Controls: 8%
Good Controls: 4%
The minimum sample to be tested is 20 items.

Gathering Evidence

There are a number of ways in which to gather information or "audit evidence" as it is referred to. This is information that the Internal Auditor gathers in the course of checking for compliance, and auditing and testing transactions. It generally includes interviews and oral verification from staff and clients, physical observation of various activities and actions, and through documentation. **Gathering the evidence requires an inquisitive mind.** The Internal Auditor is not simply inspecting documents, but **scrutinizing transactions for reasonableness and for accuracy. The Auditor must observe the circumstances in which operations are carried out and be alert for anything that appears to be unusual or out of the ordinary!**

Getting audit evidence through documentation is not simply through reading. It includes **testing** or **"vouching"** transactions and records. This means that documents, entries or the audit trail are physically checked, verified, and traced through the records by the Internal Auditor. This method has the most validity in gathering information during the audit. Information from staff or clients can be verified through this means; irregularities or fraud can be identified through physical testing as well. In general, the following general presumptions apply in most cases of gathering evidence:

- Documentary evidence is likely to be more reliable than oral evidence.

- Evidence obtained from independent sources is likely to be more reliable than the obtained from the client.

- Evidence originated by the auditor, by such means as analysis and physical inspection, is more reliable than evidence obtained from others.

Determine compliance with established policies

It is the responsibility of the Internal Auditor to review all policies established by the institution and then to design a series of questionnaires or checklists, to use in determining whether those policies are followed. *Handouts 7.2 through 7.8 Internal Audit Checklists* are sample checklists that MFIs and Self Help Groups can edit, adapt and use for their own Internal Audit department. They cover the following areas: cash, loans, financial reports, savings, human resources, fixed assets and Self Help Group management. The importance of adaptation for your specific context and situation cannot be over-emphasized. An MFI should have stated policies for every aspect of management and operations, including, but not limited to:

- Personnel – guidelines for hiring, evaluating, and terminating
- Credit Manual – eligibility, training, loan terms and conditions
- Methodology – products, collateral requirements
- Investment – cash management controls
- Accounting – authorization, segregation of duties
- Budgeting – comparing actual to budget
- Loan Loss Provision (also called Impairment Loss Allowance in International Accounting Standards) and Write-offs
- Loan supervision and collection
- Savings – withdrawals, interest payments, closing accounts
- Operating expense and asset purchase approvals (purchase orders, receiving notes, or delivery notices)
- Physical security of records and assets
- File documentation – list of documents required
- Reporting requirements – who, what, and how often

Generally, this series of checklists is kept in a loose-leaf folder. As policies are revised or updated, the checklists need to be revised as well.

The implementation of an internal audit function is an ongoing process.

What to Look For?

Internal Auditors with previous external audit or microfinance will have good experience that will instruct their planning and audit work as Internal Auditors. Over the years of microfinance experience, practitioners have seen a wide variety of challenges, errors, irregularities or fraud in operations. *Handout 7.9 MicroSave Briefing Note #57 Games Loan Clients Play* and *Handout 7.10 Games that MFI Staff Play* provide a number of examples and cases that have actually occurred. These examples can give Internal Auditors a sense of the areas to focus on, particularly in the loan portfolio audit.

Audit of Financial Transactions
This is done by reviewing the accuracy of, or auditing a random sample of financial transactions. The following procedures were used during an audit trip to an MFI branch office. The steps outlined below were followed for two different days in the current fiscal year, selected at random. One of the two days selected was a month-end day.

- **Reconcile cash receipts**
  1. Add total receipts from pre-numbered receipt books for the day
  2. Compare/reconcile with cash receipts journal
  3. Compare/reconcile with daily cash flow report to headquarters

- **Reconcile loan balances (Month-end day only)**
  1. Add principal balance on all individual client ledger cards
  2. Compare to the report of total loans outstanding
  3. Recalculate delinquency percentage

- **Cash disbursements**
  1. Look at all cheques written for the day under review
  2. Check for authorization, signatures, voucher documentation
  3. Compare total to cash disbursements journal entries
  4. Compare total to daily cash flow report to headquarters

- **Bank deposit**
  1. Review deposit slip and bank statement
  2. Compare to cash receipts journal
  3. Compare to daily cash flow report to headquarters

- **Petty cash box**
  1. Review vouchers for authorization, signatures, documentation
  2. Count cash in box
  3. Reconcile cash + vouchers = imprest amount
  4. Compare imprest amount with general ledger balance.

- **Loan file review**
  1. Select files at random for review and complete checklist (See Handouts)
  2. Review all files of delinquent accounts
  3. Visit a random sample of clients with delinquent accounts.

As the following example shows, an organisation will often institute internal control procedures **too late** to prevent an incidence of fraud.

After an incidence of fraud was discovered, an MFI instituted the following internal audit procedures:

- Verify new borrower accounts and review loan documentation
- Direct verification of all village banks and solidarity group loans
- Direct verification of random samples of individual borrowers covering all staff assignments

- Verify current and closed borrower accounts and review loan documentation
- Direct verification of random samples covering all staff assignments
- Direct verification of all Negative response account statements annually
- Verify monthly bank reconciliations and audit samples
- Verify daily posting and balancing of transactions to general and subsidiary ledger systems and audit samples
- Verify monthly balancing of trial balance of client loan and savings accounts in general and subsidiary ledger systems
- Review monthly printout of delinquent loans and verify validity of additions and removals.

Professionalism and Conduct

There is frequently a tendency for MFI staff and clients to be afraid of the Internal Auditor, and be tempted to withhold information, or be uncertain of the auditor's motives. Internal Auditors themselves may at time reinforce the "police" image and be intimidating or judgemental to those they meet. The Internal Auditor should work as a qualified professional, be approachable, careful in discretion, and use an objective perspective to their work. Internal Auditors should first of all be curious people -- curious about what they see, observe, and curious about why things appear as they do.

The Internal Auditor is there to help protect and promote the MFI, staff and client. They should only work in the best interests of all of the stakeholders, and can best do so by seeking to understand what happens, and why things happen as they do.

Reporting Audit Findings

- All audit work and evidence must be clearly documented. A "**permanent**" file is usually kept on hand to contain information that does not change frequently. It includes the MFI, branch or Self Help Group profile and key information. A **"current working file"** contains a record of actual work done, samples collected, findings, interview notes, questionnaires and conclusions. Documentation of the internal audit is critical; without a record of the audit, there will be no trace of the work that has been done. The external auditor or other internal audit team members should be able to follow the work very clearly.
- Any and all audit findings should first of all be clearly understood, clarified and explained by operational staff. Many times, a "finding" may not be a finding at all. It may be a misunderstanding, or a detail requiring clarification, or a well justified item.
- All findings should be verbally debriefed with operational staff. This is the opportunity for the Internal Auditor to explain the risks that the findings can bring to the MFI if left unchecked. It is the opportunity to build the understanding and capacity of Branch management and their supervision of Branch staff.
- The findings then are included in the written report. This would include some evidence of how many the selected samples were not in compliance with policy and procedure, an evaluation of where internal controls might be weak, and an assessment of potential risk.
- There is one exception. If the Internal Auditor discovers a case of deliberate fraud of a staff members, they should immediately report the finding to the Branch Manager confidentially so that a deliberate, careful investigation can take place without having the staff member run away, try to cover up the problem or suspect that they have been detected. This allows due

process of fraud investigation and evidence to be completed, and appropriate disciplinary action as per organisational policy.

- If the Internal Auditor discovers a case of deliberate fraud by the Branch Manager, they should take immediate steps to contact the Executive Director and the Board contact, and then together take steps for investigation and disciplinary action.

The Internal Audit Time Frame

A large rural MFI's Internal Audit department outlines the time frame for conducting, reporting, responding to and implementing audit work as follows:

a. Audit time
b. Reporting time (written report 30 days from the conclusion of field work)
c. Response time – the implementation plan (within 6 weeks from the date of the report)
d. Implementation
e. Audit Cycle
   - Each Branch will be due for an audit at least each financial year and at least 75% of all Branches will be visited each financial year.
   - New Branches should be audited within the first quarter of operations.
   - Investigations will be conducted as they arise and will be of priority from normal audits.

Writing the Internal Audit Report and Making Recommendations

Handout 7.11 Sample Internal Audit Report Format provides a clear and concise format for writing an internal audit report. The purpose of writing the report is to ensure that people read it – and the report style and format in the Handout do just that. The report outlines the time period of the audit, the areas covered, and the samples and transactions tested.

Then the report goes on to highlight key findings in the area concerned, the risks that those findings reveal, and recommended steps to correct the situation.

The report is signed off by the person writing it, and the person receiving the report also signs the report. This ensures that the communication of the audit work and recommendations is complete, and the accountability is clear.

Remember – the written report should contain no surprises or uncertainties of information. Branch and operational staff should already been verbally debriefed, and all outstanding questions and issues clarified. *Handout 7.12 Sample Loan Portfolio Audit Report* provides a sample report using the approach developed by the *MicroSave* Toolkit on the topic. It is focussed simply on the Loan Portfolio Audit.

Handouts 7.13 and 7.14 are Sample Internal Audit Reports using slightly different report formats. *7.15 refer to a Management Response to Internal Audit Report.* This is a normal process as part of the ownership and participation of management in the internal audit process. Some MFIs include this section in the Audit Report itself, as illustrated in *Handout 7.13* and is a response from the Branch management team.

Follow up Previous Reports

The follow up component of the internal audit function is important from a risk management perspective (the risk management feedback loop) and the communications channel in the overall internal control system. Both the internal audit work and the audit report include a component of follow-up on previous audits and recommendations. The auditor files their report to the Board Finance or Audit Committee, and that ensures that operational recommendations are made to correct problems and risks identified in the audit. They do that through their management and communication with the Executive Director. The Executive Director is ultimately responsible to ensure that Branch and operational staff implement the recommendations made by the Internal Auditor.

However, the Internal Auditor, in subsequent audit work, verifies the progress of implementing these changes. This is a critical part of the risk management feedback loop, and also an independent check and verification for the Board that risk management efforts are implemented in the MFI.

The final section of the audit report provides an opportunity for reporting on previous report work and recommendations. Recommendations or changes not implemented should be included in this written report, and highlighted to the Board. Many MFI Internal Audit departments provide a quarterly report to the Board and management of their activities, and the recommendations made. Recommendations not yet implemented are highlighted and followed up in that way.

Handout 7.16 provides an Internal Audit Follow-up Tool in a summarized way. It assumes a number of auditors in the department and multiple Branches being audited each year. Without a systematic and managed way, the Internal Audit function can simply be an activity. It is strong management that makes the function an effective, helpful one in your MFI.

Where Do We Go From Here?

This toolkit is designed to provide practical tools and suggestions for implementing an effective internal control system within your MFI. It is built on an integrated internal control framework that advocates a strong role of the Board and senior management in the internal control process, including the Internal Audit function. Without a strong control environment promoted from the top, the implementation and adherence to control policies and procedures within your MFI will be challenging.

The toolkit also provided key recommendations for preventive controls:

- effective human resource policies and systems that motivate staff,
- control policies and procedures designed to promote efficiency, effective service, and the prevention of loss of assets, capital or reputation of the MFI,
- reliable information systems – both accounting and client tracking systems (for loans and savings) – that provide timely, reliable and accurate information for financial reporting of the MFI. Reliable reports are essential for internal and external users.

The Internal Auditor's role in the entire process includes testing controls, systems and procedures for compliance and effectiveness, identifying any new risks, and communicating the results and findings to senior management and the MFI Board of directors.

Every MFI is at a different stage in the development of systems. Regardless of whether your MFI has an Internal Audit department, or not, there may be issues identified in this toolkit that you think can strengthen your MFI's risk management process. *Exercise 7.3 Internal Audit Action Planning* is a tool that can help you in your planning process.

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