

IMPROVING INTERNAL CONTROL

A Practical Guide for Microfinance Institutions

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LIST OF ACRONYMS

ABA	Alexandria Business Association
ACP	<i>Acción Comunitaria del Perú</i>
ASA	Association for Social Advancement
BPR	Bank Perkreditan Rakyat
BRI	Bank Rakyat Indonesia
CEO	Chief Executive Officer
CERUDEB	Centenary Rural Development Bank
CGAP	Consultative Group to Assist the Poorest
GTZ	<i>Deutsche Gesellschaft für Technische Zusammenarbeit</i>
Ksh	Kenyan shilling
MIS	Management Information System
MBP	Microenterprise Best Practices project
MFI	Microfinance Institution
NGO	Non-governmental Organization
OCC	Office of the Comptroller of the Currency
PVO	Private Voluntary Organization
ROSCA	Rotating Savings and Credit Association
Rp	Rupiah
SME	Small and Micro Enterprise

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¹ The MicroFinance Network is a global association of microfinance institutions committed to improving the quality of life of low-income individuals through the provision of credit, savings and other financial services.

public, Network members encourage other MFIs to share their information and to strive for industry standards.² By participating in this research, Network members demonstrated their willingness to expose their own challenges and issues for the common good and their commitment to ongoing self-assessment and improvement.

² The *MicroBanking Bulletin*, a bi-annual publication of microfinance performance indicators, is an output of the MicroBanking Standards project, which is funded by CGAP and managed by Calmeadow.

PREFACE

During a routine visit to delinquent loan clients by the Alexandria Business Association (ABA) in Egypt, the client in question explained that he had not renewed his loan for over two years. He had been a good client and always repaid his loans, but had since not needed a new loan. Upon investigation, ABA found that the loan officer had forged the client's signature on the loan application and corresponding documents. In order to cash the loan check the loan officer had to go to the bank and present proper identification. Further investigation revealed that the loan officer had worked in collusion with a teller of the commercial bank. The loan officer had bribed the teller to cash fraudulent loan checks. ABA audited all the loan officer's clients and discovered that the loan officer had been taking out false loans for over two years under the names of five such clients. However, the loan officer had been making timely payments on the loans. It was only when he missed a few payments that the fraud was discovered. ABA filed a suit against the bank for cashing checks without proper identification. The loan officer disappeared but is now being sought by the authorities.

Fraud, internal control, risk management. While not new to the commercial banking sector, these topics have not been widely discussed or researched within the microfinance industry. Yet as demonstrated in the ABA example above, microfinance institutions are not immune to the dangers of weak internal controls. Weak internal controls can also allow operational errors to remain uncorrected. For example, human or systems errors may result in the posting of interest to the wrong account. While most errors such as this represent only a small amount of funds, collectively they can result in significant loss to the institution over time.

Microfinance institutions are not immune to the dangers of weak internal controls.

In recognition of the dangers of weak control systems, MicroFinance Network member institutions requested the development of a technical guide to improve internal control of microfinance institutions (MFIs). In support of this initiative, the members agreed to describe their approaches to internal control and to discuss their experiences with managing risks. To conduct the research, the Network formed a working group on internal control, comprised of finance managers and internal auditors of member institutions. Many of the findings and practical examples used in this document come from the information shared by Network members.

This guide advocates a new approach to internal control that integrates control mechanisms into a larger risk management framework. Traditionally, financial institutions have left the identification of fraud and operational errors to auditors who may identify unexplained losses in the process of reconciling the accounts. Alternatively, by linking internal control to risk management, the MFI can proactively identify fraud and other risk exposures, continuously learn from its experiences, and make

To maximize efficiency, management should identify internal controls that are cost-effective, i.e. provide the maximum risk reduction for the least cost.

operational improvements as necessary. For example, by incorporating client visits into its internal control processes, a microfinance institution can verify the authenticity of its loans and identify fraudulent practices by loan officers before they are replicated on a wide scale, as illustrated by the case of ABA above.

ABA is not alone; most MFIs experience financial loss as a result of fraud at some point in their development. Exposure to fraud is a normal part of operations for any financial institution, as is exposure to credit, liquidity, interest rate, and transaction risks. The art of risk management is to determine the degree to which these risks should be controlled. The objective is not to eliminate risk or even to control all risks. MFIs conduct effective risk management by carefully analyzing their risk exposures and selecting cost-effective ways to mitigate them. By linking effective risk management to internal control, MFIs can assume more risk when doing so offers potential for increased profits. To maximize efficiency, management should identify internal controls that are cost-effective, i.e. provide the maximum risk reduction for the least cost.

Internal control plays an especially important role in microfinance institutions structured as non-governmental organizations (NGOs), which by definition lack owners (i.e. individuals with a personal financial stake). As demonstrated by MicroFinance Network members who participated in this study, microfinance NGOs can partially compensate for this structural shortcoming by developing an effective internal control system linked to sound risk management strategies.

Experience has demonstrated that microfinance institutions cannot rely on external evaluations by donors, regulators or external auditors to identify fraud or other internal problems. These evaluations are infrequent and often too shallow to assure the MFI that it is successfully controlling risks. Microfinance institutions must develop their own internal capacities to manage and monitor risk exposures. For an institution to be sustainable over the long term, it must constantly learn to reinvent itself and adjust to market changes as necessary. Internal control is a useful tool for the board and management to verify the soundness of any microfinance institution as it responds to changing external conditions over time. It is the responsibility of the board and management to encourage employee commitment to and participation in the internal control process. By emphasizing the benefits that can be achieved from applying the principles of this guide, the board and management can play an active role in overcoming employees' negative perceptions of internal control and internal audit.

1. INTRODUCTION TO INTERNAL CONTROL

Bank failures and widespread losses over the past two decades have elevated the importance of effective risk management and internal control within the formal financial sector worldwide. In the United States, bank failures rose over 200 percent in the 1980s partly due to fraud and mismanagement. Internationally, the collapse of Barings Bank and Yamaichi Securities further focused the financial sector's attention on risk management and internal control. The Basle Committee³ analyzed the problems related to these losses and concluded that they probably could have been avoided had the banks maintained effective internal control systems.⁴ In addition, a review of traditional banks asserted that the implementation of effective internal control systems played an important role in reducing bank failures throughout the 1990s.⁵

Straddling the formal and informal financial sectors, the microfinance industry also recognizes the importance of effective internal control. As microfinance institutions (MFIs) grow and more operate as regulated financial intermediaries, internal control becomes essential to long-term institutional viability. The number and types of stakeholders concerned with the MFI's financial well-being increases: donors desire to support sustainable microfinance projects; board members want to protect their reputations and fulfill their obligations; investors are interested in preserving capital; borrowers are concerned with continuous access to loans; depositors want to ensure the safety of their savings; and regulators want to protect the financial environment and depositors' interests. To remain competitive, MFIs are undertaking product and geographical expansion, which introduce new risks and challenges imposed by rapid growth. An effective system of internal control allows the MFI to assume additional risks in a calculated manner while minimizing financial surprises and protecting itself from significant financial loss. Thus, internal control is an integral component of risk management.

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³The Basle Committee is a group of supervisory authorities established by the central bank governors of the Group of Ten countries that developed a framework for the evaluation of financial institutions' internal control systems.

⁴ Basle Committee on Banking Supervision, 1998.

⁵ Williams, Clark and Clark, 1995, p.55(4).

1.1 What is Internal Control?

Definition of internal control

According to the Basle Committee on Banking Supervision,⁶ the primary objectives of the *internal control* process in a financial institution are:

1. To verify the efficiency and effectiveness of the operations;
2. To assure the reliability and completeness of financial and management information; and
3. To comply with applicable laws and regulations.

Internal audit is a component of the internal control process.

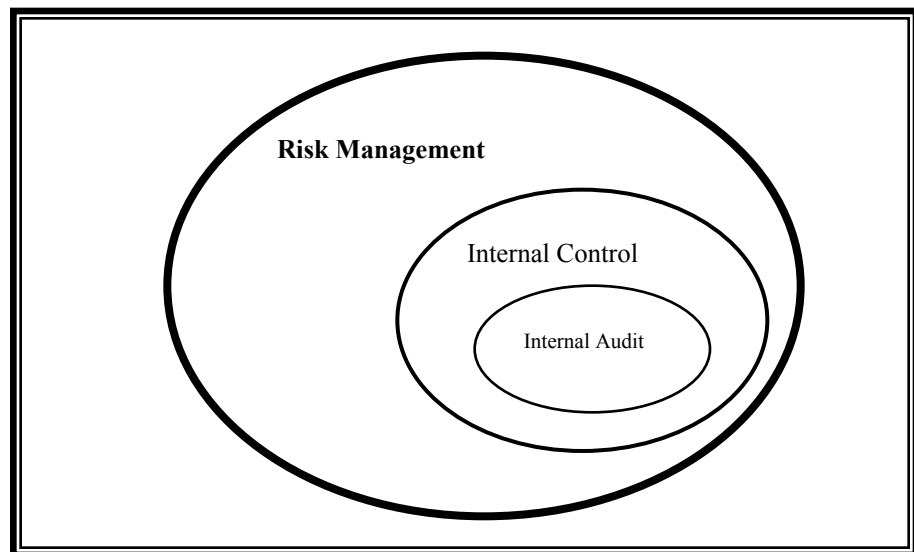
Practitioners often confuse internal control with internal audit, which is an integral part of internal control. While internal audit focuses solely on evaluating risk management “*ex-post*” (after operations), internal control comprises both the “*ex-ante*” and “*ex-post*” (before and after operations) measures to control risks. In other words, internal audit is just one component of the internal control process. This document uses the following concise definitions to discuss *risk management*, *internal control* and *internal audit* and **Figure 1** illustrates the relationship between them:

Risk management is a systematic approach to identifying, measuring, monitoring and managing business risks in an institution.

Internal control comprises the institution’s mechanisms to monitor risks before and after operations.

Internal audit is a systematic “*ex-post*” appraisal of an institution’s operations and financial reports.

Figure 1: Relationship between Risk Management and Internal Control



⁶ Basle Committee on Banking Supervision, 1998.

Microfinance institutions use internal control mechanisms to ensure that staff respects their organizational policies and procedures. However, internal control alone cannot ensure that the MFI is adequately minimizing its risk exposures. Only if the MFI's risk management strategies are effectively integrated into its policies and procedures can the internal control function support risk minimization. For example, an MFI experiencing increasing arrears might decide to reduce its exposure to credit risks, by developing stricter lending requirements or limiting increases in loan sizes for renewals. The MFI links internal control to risk management by creating mechanisms to evaluate the results of these delinquency reduction efforts, such as by requiring branches to regularly monitor portfolio quality and conduct client visits to verify loan officers' adherence to the new policies.

Only if the MFI's risk management strategies are effectively integrated into its policies and procedures can the internal control function support risk minimization.

Internal control and internal audit play important roles in the risk management feedback loop, in which the information generated in the internal control process is reported back to the board and management. Internal control mechanisms work to improve decision making by ensuring that information is accurate, complete and timely so that the board and management can respond to control issues promptly as they arise. In addition, if the MFI links its internal control mechanisms to risk management, internal control can identify remaining risk exposures and inform management. Chapter 2 discusses risk management in more detail.

Internal control mechanisms work to improve decision-making by ensuring that information is accurate, complete and timely.

1.2 Overview of Document

This publication presents a comprehensive approach to implementing internal controls at the branch level, which if linked to effective risk management strategies can reduce risks inherent in MFIs' operations. A working group comprised of finance directors and internal auditors of MicroFinance Network member institutions provided much of the content and many of the practical examples contained in this internal control guide.

Chapter 2, *The Risk Management Approach to Internal Control*, proposes the use of a risk management feedback loop to ensure that internal control is an integral part of an MFI's risk management strategies. It presents the key risks faced by microfinance institutions, and describes six elements of effective risk management commonly applied by leading microfinance institutions.

The next chapter, *The Internal Control Process*, describes how to select, implement and evaluate effective internal controls. It discusses cost-effectiveness, the initial premise of good internal controls, and provides examples of common types of internal controls that MFIs integrate into their operations *ex-ante*, i.e. prior to conducting daily operations. Based primarily on Bank Rakyat Indonesia's approach, this chapter provides a step-by-step process for assessing the effectiveness of risk management *ex-post*, i.e. after operations, at the MFI's branch or unit level. It discusses how to develop an audit plan, conduct branch and client audits, and report and follow up on findings, with an emphasis on uncovering and preventing fraud. The chapter

concludes with a brief discussion on how the internal audit can facilitate the external audit process.

Chapter 4, *Institutionalizing Internal Controls*, discusses options for creating an appropriate internal control system, depending upon the MFI's scale of operations, regulatory status and its efforts to mobilize savings. It explores the range of tools MFIs use to evaluate their risk management strategies and uses examples from MicroFinance Network member institutions to illustrate the alternatives. Finally, it addresses management's role in responding to control issues that arise in the course of the internal audit.

The publication concludes with general findings and recommendations on how to improve the effectiveness of risk management and internal control within the microfinance industry. While the publication speaks primarily to the board and management of microfinance institutions, Chapter 6, *Conclusions and Recommendations*, also addresses the responsibilities of regulators, donors, practitioner networks and technical assistance providers for improving the internal control systems of MFIs. The publication addresses internal control within autonomous microfinance institutions only; it does not attempt to address the additional control issues that can arise in microfinance projects of private voluntary organizations (PVOs) or multi-service NGOs. Nonetheless, microfinance project managers, as well as MFI managers, should find the majority of the information useful and relevant to their internal operations.

2. THE RISK MANAGEMENT APPROACH TO INTERNAL CONTROL

Traditionally, internal control systems have focused primarily on detecting and then resolving problems. A risk management approach to the development of internal controls instead emphasizes problem identification and prevention *before* a loss occurs. In the past, many MFIs have viewed internal control as a peripheral function, separate from operations. An effective system of internal control links risk identification at the branch level back to the board and management. Therefore, for internal control to play a role in mitigating risk, MFIs must institutionalize risk management into their organizational culture and at all levels of their operations.

MFIs demonstrate effective risk management by mitigating the risks that pose the greatest threat to their financial health and long-term sustainability. This chapter describes how an internal control system can play a significant role in reducing risks through the incorporation of a feedback loop that links people from all levels of the institution into the risk management process. The chapter discusses the common risk exposures found at the branch level of a microfinance institution and presents the characteristics of MFIs that effectively mitigate these risks.

MFIs demonstrate effective risk management by mitigating the risks that pose the greatest threat to their financial health and long-term sustainability.

2.1 Risk Management Feedback Loop

The risk management approach implies a shift in responsibility for internal control from the traditional back-office and support functions to the board and chief executive officer.⁷ Only by involving the board of directors and senior management can an MFI develop and integrate a strong culture of risk management into all areas of operation. To reach its fullest potential, MFIs need to recognize risk management as an important ongoing internal function rather than view it as the role of the annual external audit. Outside assessments are often too limited in scope and arrive too late to provide the depth and timeliness of feedback needed to protect the MFI from significant financial loss.

Only by involving the board of directors and senior management can an MFI develop and integrate a strong culture of risk management into all areas of operation.

Risk management is the process of controlling the likelihood and potential severity of an adverse event. While taking risks is a natural part of lending and finance, MFIs should attempt to plan for risk and avoid unnecessary surprises, i.e. unforeseen events that can threaten their viability. Risk management is a systematic approach to identifying, measuring, monitoring and managing business risks in an institution. While each of the following

⁷ Southworth and Singh, *USBanker*, November 1995, p. 92(1).

six steps of risk management involves different employees of the MFI, collectively they integrate all employees into the process.

Identify key risk exposures.

1. Identify, assess and prioritize risks. The risk management process begins with management identifying and prioritizing the key risks, which are reviewed and approved by the board of directors. This step requires the board and management to determine the degree of risk the MFI should tolerate and to conduct assessments for each risk of the potential negative impact if it is not controlled. The most significant risks faced by microfinance institutions include financial, operational and strategic risks which are discussed in the next section. Other risks include foreign exchange risk; compliance risk; and mission risk, which this publication does not discuss because they are not applicable to all institutions and typically pose a smaller threat to the MFI's financial integrity.

Prepare to measure and monitor risks.

2. Develop strategies to measure risks. The board approves policies for measuring and tracking risks and monitors the MFI's adherence to them. Management identifies key indicators and ratios that can be tracked and analyzed regularly to assess the MFI's exposure to risk in each area of operations. Management sets the acceptable range for each indicator, outside of which would indicate excessive risk exposure. Management also determines the frequency with which each indicator should be monitored and analyzed.

Develop operational policies and procedures to mitigate risks.

3. Design policies and procedures to mitigate risks. Next, management develops sound procedures and operational guidelines to mitigate each risk to the degree desired. Sound policies and procedures clearly instruct employees how to conduct transactions and incorporate effective internal control measures. Common internal control measures are discussed in Chapter 3.

Implement controls into operations and assign responsibility for oversight.

4. Implement controls into operations and assign responsibility. Management now selects cost-effective controls and seeks input from operational staff on their appropriateness. If the control measure will have an impact on clients, then management should speak with loan officers or other line staff to understand the potential repercussions. If the potential for impact is significant, the MFI can also solicit input directly from clients, such as through surveys or focus groups. The institution should assign managers to oversee implementation of the controls and to monitor them over time. **Table 1** summarizes the key roles and responsibilities for risk management within the MFI.

Test effectiveness of controls and evaluate results.

5. Test effectiveness and evaluate results. The MFI should have clearly defined indicators and parameters that determine when a risk is not adequately controlled. Then, the board and management review the operating results to assess whether the current policies and procedures are having the desired outcome and whether the MFI is adequately managing its risks. Some indicators, such as portfolio quality, require weekly or monthly monitoring while others, such as operational efficiency, require less frequent monitoring.

Table 1: Roles and Responsibilities for Risk Management

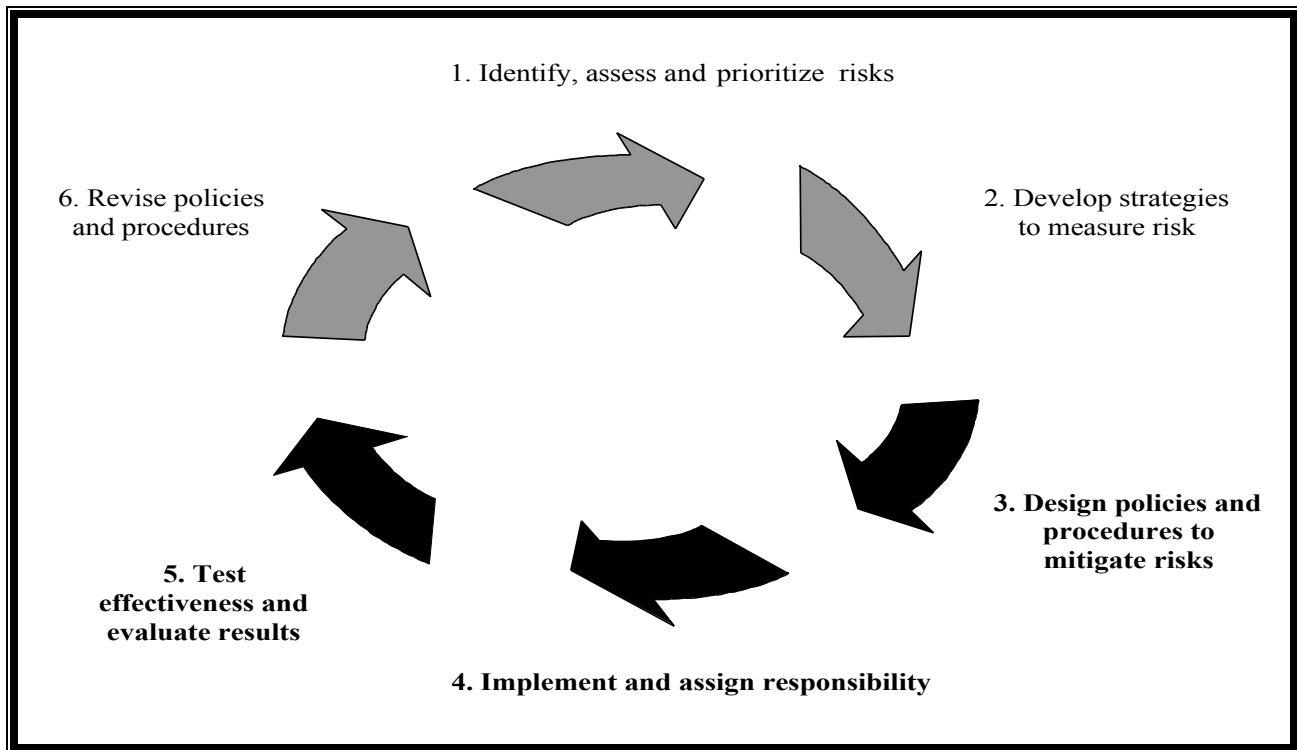
Institutional Role	Responsibilities
Board Member	Approve policies and monitor adherence to them.
Senior Management	Identify risks and develop policies, procedures, systems and guidelines to reduce risks.
Branch Management	Implement procedures and monitor adherence to policies and procedures.
Operational Staff	Offer suggestions for and provide feedback on proposed operational changes.
Internal Control Staff	Verify that policies and procedures are followed accordingly and determine extent to which risks remain uncontrolled.

6. Revise policies and procedures as necessary. In many cases, the results will suggest a need for changes to policies and procedures and possibly identify previously unidentified risk exposures. In these cases, management designs new risk control measures and oversees their implementation. Management may determine that additional staff training is needed or decide to modify existing policies or procedures or create new ones. After the new controls are implemented, the MFI tests their effectiveness and evaluates the results.

Review and revise policies and procedures regularly.

Risk management is a dynamic process, in which the MFI regularly evaluates the effectiveness of its policies and procedures in controlling risks and makes adjustments as necessary. Even if an evaluation finds that the MFI is adequately controlling its risks, the risk management process does not end; it continues with regular, ongoing evaluations. Each successive evaluation not only tests the effectiveness of new controls but also includes a review of previously tested controls. Because MFIs operate in ever-changing risk environments, the risk management process is never-ending. Creating an infrastructure and system to incorporate risk management into the MFI's culture ensures that all staff focus on identifying and anticipating potential risks. The process incorporates a continual "feedback loop" from and back to the board and senior managers to ensure they receive the information they need, that the information is accurate and that it is consistent with the risk parameters set by the MFI. **Figure 2** illustrates the cyclical and continuous nature of the risk management feedback loop.

Figure 2: Risk Management Feedback Loop⁸



An effective internal control system links risk management into the design, implementation and testing of operational procedures and policies.

Internal control is an integral component of the risk management process. Referring again to **Figure 2**, effective risk management incorporates internal control into the third through fifth steps of the feedback loop, as highlighted in bold. An effective internal control system links risk management into the design, implementation and testing of operational procedures and policies. Due to internal control’s operational focus, this publication limits its discussion to the management of those risks that are most common in MFIs at the branch level of operations. For a more detailed discussion on risk management, see GTZ’s *A Risk Management Framework for Microfinance Institutions*.

2.2 Common Risks to MFIs

MFIs face many risks that threaten their financial viability and long-term sustainability. Some of the most serious risks come from the external environment in which the MFI operates, including the risk of natural disaster, economic crisis or war. While the MFI cannot control these risks directly, there are many ways in which the MFI can prepare itself and minimize their potential for negative impact.⁹ This publication, however, focuses strictly on those risks that are inherent within the MFI’s internal operations; it does not

⁸ GTZ’s *A Risk Management Framework for Microfinance Institutions*, 2000, p. 36.

⁹ Refer to MBP publications, *Microfinance in the Wake of Natural Disaster* (Nagarajan, 1998) and *Microfinance in the Wake of Conflict* (Doyle, 1998) for information on how to address risk in the event of natural disaster and war, respectively.

address external risks. Furthermore, since the management of headquarters' level operations varies significantly from one MFI to another, the publication limits its discussion to controlling the most common risk exposures managed at the branch level. A risk management approach to internal control aims to mitigate *financial risks* (including credit, liquidity, and interest rate risks) and *operational risks* (such as transaction and fraud risks). Branch level internal control does not usually address *strategic risks*, such as governance risk, business risk and external risk.

Branch level internal control addresses the following financial risks:

Credit risk is the key risk that MFIs must manage to be sustainable. It is the risk to earnings or capital due to a client's failure to meet the terms of a lending agreement. In a microfinance institution, the credit risk in each microloan is relatively minor given that each loan is small and usually represents a minute percentage of the overall portfolio. However, due to the short-term and unsecured nature of microlending, microloan portfolios tend to be more volatile since the portfolio quality can deteriorate more rapidly than in traditional financial institutions. For this reason, it is very important that MFIs monitor portfolio quality closely and take action when necessary.

Credit risk

Liquidity risk is the risk to capital or earnings from an MFI's inability to meet its obligations when they come due, usually resulting from poor cash flow planning. Effective liquidity management requires an understanding of the impact of changing market conditions and the ability to liquidate assets quickly to meet increased demand for loans or withdrawals from savings. Liquidity management becomes more important in MFIs that act as financial intermediaries, in which the institution mobilizes client savings for use in its lending operations. In these cases, MFIs must maintain adequate cash reserves to protect against a crisis of confidence, which can result in a "run" on the bank, i.e. many clients simultaneously withdrawing all their savings from the bank. For in-depth guidance on how to manage liquidity risks, refer to GTZ's *Liquidity Management: A Toolkit for Microfinance Institutions*.

Liquidity risk

Interest rate risk is the risk of financial loss from changes in market interest rates. Interest rate risk arises from differences in the timing of rate changes and the timing of cash flows (repricing risk), from differences in yield curves (basis risk), from rate variations across the spectrum of maturities (yield curve risk) and from interest related options within financial products (options risk).¹⁰ In MFIs, the greatest interest rate risk occurs when the cost of funds goes up faster than the MFI can adjust its lending rates. Though most MFIs manage their interest rate risk at the headquarters level, there are a few MFIs, such as Fundusz Mikro in Poland and the Banks Perkreditan Rakyat (BPRs) in Indonesia, that allow branch managers to set and adjust interest rates according to their specific market needs.

Interest rate risk

Branch level internal control is primarily concerned with these two operational risks:

¹⁰ "Categories of Risk" as defined by the U.S. Office of the Comptroller of the Currency (OCC).

Transaction risk

Transaction risk is the risk of financial loss resulting from employee negligence, mismanagement, systems errors or other human errors. Reducing transaction risk is one of the primary objectives of internal control. If the MFI's risk management strategies are effective, then an MFI can mitigate transaction risk simply by ensuring that employees respect policies and follow procedures, and that all systems are functioning well.

Fraud risk

Fraud risk has been the least publicly addressed risk in microfinance to date. Also referred to as integrity risk, fraud risk is the risk of loss of earnings or capital as a result of intentional deception by an employee or client. The most common type of fraud in an MFI at the branch level is the direct theft of funds. Other forms of fraudulent activity include the creation of misleading financial statements, bribes, kickbacks, and phantom loans. Since line staff handle large amounts of client and MFI funds, branch level controls are very important. If left uncontrolled, these risks inevitably increase as fraudulent activities have a habit of spreading like a virus from one employee to another.

Once the MFI has identified its key risk exposures, it can begin to develop strategies to effectively mitigate these risks.

2.3 Elements of Effective Risk Management

MFIs with strong risk management maintain quality loan portfolios, avoid liquidity crises, reduce the risk of loss caused by fraud and human error, and minimize the effects of interest rate fluctuations over the long term. This section presents six key elements of effective risk management that are inherent in an MFI's methodology or normal business operations.

2.3.1 Risk Management within the Methodology

Most microfinance risk management strategies are integrated directly into the methodology and operations.

Most microfinance risk management strategies are those that are integrated directly into the methodology and operations, thereby systematically and proactively reducing risk. By anticipating the characteristics and motivations of its borrowers, MFIs minimize the potential for attracting high-risk borrowers, i.e. clients that would likely default on a loan. **Table 2** lists a number of practices that incorporate risk management into microlending methodologies.

In addition to risk management practices within the microfinance methodology, MFIs that effectively mitigate risk also integrate risk management strategies into their normal operations. There are five additional key elements prevalent in MFIs that can reduce risks: i) a conducive environment, ii) transparency, iii) simplicity, iv) individual accountability, and v) security.

Table 2: Risk Management within Microfinance Methodologies**Common Risk Management Practices Inherent in Microfinance Methodologies:**

- **Peer lending** – Peer or group lending reduces credit risk by spreading the risk of lending without collateral over a larger number of borrowers and transferring the burdens of encouraging repayment and collection from loan officers to clients. For example, several MFIs use a 2-2-1 disbursal mechanism, which encourages the clients in the group who have not yet received a loan to put pressure on the first two members to repay their loans, thereby ensuring their access to a loan.
- **Character assessment** – Microfinance institutions develop expertise at assessing the character of borrowers and become familiar with those characteristics that reduce the risk of future loan default due to credit risk or fraud risk. For example, MFIs consider clients who have reputations for being honest and hard-working to be lower credit and fraud risks.
- **Forced savings or co-signature requirements** – Forced savings and co-signature requirements act as collateral substitutes, which reduce the risk of default by transferring part of the risk to the borrower or third party.
- **Small loan sizes** – By making many small loans, the microfinance institution reduces its credit and liquidity risk exposure by diversifying its loan portfolio.
- **Varied loan terms** – By disbursing loans regularly or by issuing loans with different term lengths, the MFI reduces its liquidity risk exposure by having loans mature and renew frequently.
- **Limits on loan size increases** – Microfinance institutions reduce credit risk by increasing loan sizes in strict increments to ensure clients can manage gradually larger loans. In addition, MFIs manage risk by basing loan sizes on clients' demonstrated capacity to repay.
- **Loan approval processes** – Some MFIs require a credit committee to approve larger loans, which reduces the chance of making poor loan decisions (transaction or fraud risk) and increases the control for loans that pose a greater financial risk to the institution (credit risk).
- **Center collections** – Some microfinance institutions transfer the risk associated with handling cash to clients by making clients responsible for collecting loan payments and depositing them at a formal financial institution. This simultaneously reduces transaction and fraud risk.

2.3.2 Conducive Environment

Consciously or not, management sets the tone for employees' and clients' tolerance and attitude toward risk. Management can create an effective control environment by communicating the MFI's commitment to risk management through both words and actions. In a small microfinance institution, the example set by the managing director is perhaps the strongest form of communication. As the MFI grows, veteran employees communicate the MFI's attitude toward risk, as well as corresponding appropriate behavior, to new employees.

Management sets the tone for employees' and clients' tolerance and attitude toward risk.

Many employees may have negative attitudes about internal control from past experiences with internal auditors whose focus was on identifying problems and assigning blame. Management can work to overcome negative perceptions by encouraging employee participation in the internal control

system, stressing the benefits of risk mitigation, and emphasizing solutions to problems rather than placing blame.

Creating a culture of low risk tolerance is especially important for an MFI that operates in an environment with a high tolerance for fraud.

Creating a supportive atmosphere or culture that has a low risk tolerance is especially important for an MFI that operates in an environment with a high tolerance for fraud. If the MFI operates in a country that condones fraud, management must work hard to distinguish the culture of the MFI from the surrounding environment. In Kenya, a country where corruption is common, K-Rep has successfully employed this approach by screening employees and clients based on character and by strictly enforcing a policy by which employees are fired not only for stealing and other fraudulent acts, but for lying as well. **Table 3** presents a summary of methods MFIs use to screen employees and clients for character traits.

Table 3: Employee and Client Character Screening

Methods for Screening Employee’s Character:	Methods for Screening Client’s Character:
<ul style="list-style-type: none"> • Conduct personality and psychological tests that assess the potential employee’s character • Check past employment and personal references, for example: <ul style="list-style-type: none"> - ask former employers whether they would hire the person again - ask personal contacts whether they would entrust their money to this person • Interview and ask employees questions to understand their ethics • Hire for a trial period to review employee’s character and behavior 	<ul style="list-style-type: none"> • Check personal and community references to assess the potential client’s reputation • Use peer groups in which clients select other group members who they believe are honest and reliable individuals • Maintain and check blacklist of past poor performers to avoid repeat lending to bad clients • Interview client to understand his or her motivation for borrowing money • Check client history with suppliers or with credit bureau, if available

2.3.3 Transparency

Transparent operations facilitate effective risk management. Operations are transparent when information is clearly and accurately reported and readily available for all who need it to make decisions or to assess institutional performance. If an MFI’s operations are transparent, then staff and management can quickly and easily identify and control risks before they pose a significant threat to the institution. The following elements tend to increase the transparency of operations in a microfinance institution.

Rotate staff or use temporary support staff.

To uncover hidden control issues, some MFIs rotate staff or use support staff to fill in for employees during vacation or sick leave. Rotating loan production staff to other branches can help to uncover employee errors and fraud identified by the employee’s replacement, or if management notices a pattern linked to the employee’s accounts. However, few microfinance institutions like to rotate field staff because they value the close relationship

established between field officers and clients. As an alternative, ASA uses support staff to cover for employees on vacation and sick leave. ASA's unit managers act as field officers when one of their field staff is out on leave.

An effective management information system (MIS) is one that focuses on a few key indicators for each level of responsibility and produces accurate, timely and relevant information. Additionally, the MIS can incorporate early warning flags for management. For example, Mibanco branch managers receive daily reports on delinquent accounts per loan officer ranked by number of days delinquent. An aging report such as this allows the branch manager to monitor more closely the work of those loan officers whose portfolios are experiencing increasing delinquencies. Refer to CGAP's *Handbook for Management Information Systems for Microfinance Institutions* for more information on good reporting.¹¹

Effective MIS system

In general, microfinance institutions should follow standard accounting practices and make efforts to clarify non-standard practices. BRI uses a cash-based accounting system, which records income and expenses only when cash changes hands, because it considers it more transparent than the traditional accrual-based accounting. Accrual accounting records transactions when they come due as opposed to when the cash actually changes hands. MFIs that use the accrual method should be careful to record accrued interest in conjunction with delinquency to avoid reporting unrealistic income. Whether an MFI uses a cash or accrual system, or a hybrid of the two, the key is to ensure that the accounting method used is transparent and consistent.

Clear accounting systems

2.3.4 Simplicity

Microfinance institutions can reduce the chance for fraud and errors in operations if procedures are simple, clear and well communicated to employees and clients.

To increase transparency and to reduce the need for sophisticated staff or advanced training, ASA has simple products and maintains simple procedures and systems for its operational staff. For example, ASA provides its units with interest rate sheets so field officers do not have to know how to calculate interest payments. In addition, ASA offers only standardized loan sizes and interest rates, so for each loan size the field officer simply identifies the appropriate interest payment and adds it to the loan principal to calculate the amount due. Since loan payments are constant, recording is simplified. At the end of each day, field officers only have to record the loan payments that were not made on time. MFIs should weigh the benefits of using simple procedures against the potential loss of flexibility and reduced customer satisfaction.

Simple products and procedures

As in traditional financial institutions, MFIs should develop and maintain operations manuals that detail the steps required for each transaction, explain how to handle exceptions and delineate lines of authority. Operations

Clearly written operations manual

¹¹ Waterfield and Ramsing, February 1998.

manuals can reduce confusion and conflict at the branch level by ensuring standard application of policies and procedures. To be effective, the operations manual should be clearly written, regularly updated and accessible to all employees.

2.3.5 Accountability

Microfinance institutions enhance their risk management by ensuring employee accountability at all levels of authority.

Cost and profit centers

Several MFIs operate their units or branches as cost or profit centers to emphasize accountability at the operational level. Branches that operate as cost centers, such as those of ABA, have authority to make decisions on how the branch spends its budgeted allowance. Profit centers, such as the BRI units, have authority to make decisions on how they allocate revenues as well as expenses. BRI units catch 90 percent of all errors by simply requiring tellers and units to balance their transactions with account entries at the end of each day. By reconciling information in the portfolio management system with information in the accounting system, MFIs can significantly reduce the risk of financial loss by closing the window of opportunity for employees to commit fraud. Other means of increasing employee accountability include:

Clear job descriptions

Upon hiring, MFIs should give all employees a clearly written job description. Employee job descriptions should indicate where employee authority begins and ends. Managers can refer to job descriptions to assess and discuss employee performance, which reinforces individual accountability.

Incentive systems

Microfinance institutions can increase an employee's commitment to the goals of the microfinance institution by linking employee pay to performance. While some MFIs like to use team-based incentives to encourage team spirit, the use of individual incentives more strongly communicates the need for individual accountability.

2.3.6 Security

Another important element of risk management is to protect physical assets from harm. The following security measures are common in microfinance institutions.

Safes, locks, and guards

Most microfinance institutions that store cash in the branch or unit office safeguard it by storing it in a safe or strong box. In Mali, Kafo Jiginew builds a safe directly into the branch office building so that thieves cannot steal the branch's money by confiscating the entire safe. Like many institutions, BRI has a two-key system whereby the unit manager and one other unit employee each hold one of the two keys required to open the safe. Security measures should match the risk. For example, all BRI units have locks on doors and windows, security alarms and a night guard, but units that are located in cities where crime is prevalent also have bars covering the windows.

Back-up files

All microfinance institutions should have some system whereby branch information is protected from destruction or loss. MFIs that maintain a computerized database should create daily back-up files and store them off-

site. MFIs can protect non-computerized information systems by storing duplicate copies in another location. ASA learned this lesson the hard way. One ASA unit lost all its records when the unit caught on fire. The field officers had to collect all the client passbooks to recreate the accounts.

To protect from unanticipated loss, such as from fire or theft, microfinance institutions can take out insurance policies or can self-insure by making regular deposits into a reserve account that the MFI can use in case of emergency. In this way, the MFI protects itself from large unforeseen expenses by redistributing the cost of this protection over a longer period of time. MFIs that operate in environments that are prone to natural disaster, such as flooding in Bangladesh, should have some type of plan to protect themselves and their clients against excessive loss in any one year of operation. In response to the floods of 1998, ASA issued new loans to some clients and allowed others to withdraw their savings. This response facilitated ASA's clients' return to normal operations.¹² In addition, ASA has a program in which its clients make weekly life insurance payments based on 0.30 percent of the loan.¹³ In the event of death, the insurance relieves the client's family of the responsibility for repaying the remaining loan balance.

Insurance

¹² For more information on reducing risks related to natural disasters, refer to *Microfinance in the Wake of Natural Disaster: Opportunities and Challenges* by Geetha Nagarajan, April 1998.

¹³ ASA requires all borrowers of loans greater than 9,000 taka (\$180) to purchase this insurance, which entitles the beneficiary to an amount equal to the initial loan amount. ASA insures loans under 9,000 taka at no additional cost.

3. THE INTERNAL CONTROL PROCESS

Once the MFI has identified its key risk exposures and determined its overall risk management strategies, it can begin to develop internal controls that will mitigate those risks. There are two types of internal controls: a) those inherent in the methodology and normal business operations and b) follow-up mechanisms that test the effectiveness of operational policies and procedures to mitigate risk. Controls that are inherent in the MFI's methodology and operations are also referred to as *ex-ante* controls, because they are in place prior to the beginning of daily activities. Alternatively, *ex-post* controls are those that evaluate the ability of the existing systems, policies and procedures to adequately mitigate risk by reviewing transactions that have taken place.

This chapter discusses the three steps involved in the internal control process: i) selecting cost-effective internal controls, ii) integrating them into operations, and iii) testing their effectiveness. Chapter four discusses how to institutionalize the internal control process and addresses management's role in responding to control issues.

3.1 Selecting Cost-effective Controls

The initial premise of a good internal control system is cost-effectiveness. In developing a cost-effective system, the microfinance institution balances the anticipated benefits of reducing risks with the cost of controlling them. **Table 4** highlights the steps involved in selecting cost-effective controls.

The MFI balances the anticipated benefits of reducing risks with the cost of controlling them.

Table 4: Selecting Cost-effective Controls

Steps in Selecting Cost-effective Controls
1. Identify key risks to the institution.
2. For each risk, evaluate the potential loss to the MFI by factoring in the likelihood and frequency of that loss.
3. Identify potential controls to reduce or eliminate the risk.
4. Assess the direct costs and indirect costs (i.e. opportunity costs of foregone business) of implementing the various controls.
5. Compare the costs of implementing the controls with the anticipated benefits.
6. Select and implement those controls that add the most value relative to the composite costs.

For some activities, risk avoidance can be more costly to the MFI than the risk exposure.

When considering the cost of controls, in addition to the direct expenses, MFIs should also factor in the anticipated opportunity costs, i.e. lost revenue as a result of avoiding or mitigating a certain risk. For example, to reduce risk some MFIs maintain a “zero tolerance for arrears” policy, in which the MFI refuses to lend to clients who make even one late payment on a loan. However, as described in **Box 1**, the Alexandria Business Association (ABA) of Egypt found that this policy was too strict and was causing them to lose profitable clients. After testing the effects of relaxing this policy, ABA found that it was more cost-effective to give clients with payments up to 15 days late a second chance. In other words, for some activities, risk avoidance can be more costly to the MFI than the risk exposure.

Box 1: ABA’s Zero Tolerance for Arrears

ABA has built its success in managing credit risk in part on its clear communication of its “zero tolerance for arrears” policy to employees and clients. At the end of December 1998, ABA had 16,070 borrowers representing a loan portfolio of over \$12.5 million with a portfolio at risk ratio of only 1.2 percent over 90 days past due. In the past, ABA had a policy in which clients who were even one day late on a payment were considered delinquent and therefore bad credit risks and ineligible for future loans. ABA reinforced this strict policy by limiting incentives to employees who managed portfolios with at least 97 percent on-time repayment. By building a reputation of zero tolerance for delinquency, ABA developed a solid portfolio of high quality loans. In an effort to retain more clients, ABA recently began a program allowing clients up to 10 days late to pay late charges and to have a second chance. More than 35 percent of those delinquent have remained clients and continue to successfully repay their loans. Due to the success, ABA extended the program to include those who were ten to fifteen days late on repayment. By gradual implementation, ABA was able to increase client retention without increasing its portfolio at risk and has maintained its reputation of being strict on repayment.

Common internal controls

Common internal control measures inherent in policies and procedures include the segregation of duties, setting limits on cash or expenditures, signature requirements, physical controls and regular operational crosschecks. These controls are built into daily operations to minimize risk before it occurs. These controls are frequently applied to manage credit and transaction risks in MFIs.

Segregation of duties

Segregation of duties involves the separation of responsibilities for two or more tasks that could result in error or encourage dishonest behavior if only handled by one employee. For example, many MFIs assign the responsibility for procurements and check writing to two different employees. Unless the two employees collude to defraud the institution, this control reduces the risk

of purchases being made based on self-interest or for purposes outside of the organization's interests.

Limits are used to set parameters of normal behavior. A common operational limit is to put a cap on the amount of cash allowed in a branch at any point in time. For example, BRI limits cash to four percent of total savings deposits in excess of its daily, anticipated loan disbursements.

Limits

MFIs can use *signature requirements* to protect the institution from unauthorized transactions. For example, ABA now requires branch managers to sign off on all loan disbursements to avoid a repeat of fake loans being issued by a loan officer.

Signature requirements

Physical controls are measures taken to verify the existence of assets reported on the microfinance institution's books. For example, like many MFIs, Mibanco counts the cash in the vault and reconciles it with the amount recorded in the cashbook on a daily basis.

Physical controls

Microfinance institutions require *crosschecks* as an assurance that policies and procedures are respected. For example, regional managers at ASA visit clients to verify that loan officers followed proper lending procedures and adequately assessed client risk.

Crosschecks

Dual controls act as backstops to decision making by having at least one other employee check or approve a transaction. For example, some MFIs assign the authority for loan approvals to a credit committee, thereby spreading the responsibility over several individuals.

Dual controls

If its operations are computerized, the MFI exposes itself to two types of risk that require additional controls: integrity risk – the risk that non-authorized individuals will gain access to sensitive data, and management information systems risk – the risk of losing key information in the event the system crashes.

Computer-related controls

Systems fraud, involving employee manipulation of the database or the computer system, can be the most costly to MFIs. Some of the greatest computer system scandals in traditional financial institutions have involved the reprogramming of the computer to create an account into which minute amounts of money from the rounding of fractions of money are deposited. Other types of systems fraud come from the creation of false entries in the accounting system to hide the loss of funds. Systems fraud requires a highly computer literate employee and is therefore more likely to happen at the level of middle or upper management. Reconciliation of the portfolio management system with the accounting system will uncover most cases of systems fraud. However, given the potential risk of substantial loss, MFIs may want to consider contracting external computer experts to check the security of their computer systems. Once weak points in the system are identified, upgrades can be made to the system or the internal auditors can add regular checks to the computer system to prevent substantial loss.

Systems fraud, involving employee manipulation of the database or the computer system, can be the most costly to MFIs.

The lack of automated systems can also put MFIs at risk of fraud.

On the other hand, the lack of automated systems can also put MFIs at risk of fraud. In Mexico, Compartamos' village banking methodology requires that a group member go to the bank to make payments. In the past, Compartamos experienced several incidents of fraud, in which the treasurer or other group member absconded with funds from the group. It used to take Compartamos three months to discover this fraud since it received bank statements a month later and then it took time to reconcile the accounts. Now, Compartamos' computer system is directly linked with the bank, which allows immediate reconciliation. This change has greatly reduced the incidents and severity of fraud within Compartamos.

Integrity risk controls

Creating levels of access and computer access codes usually controls integrity risks. For example, the computer system can be designed so that each employee only has access to the items in the computer that are directly related to his or her scope of work. Furthermore, each employee has a secret password that allows access. The computer can then track which employee made which entries into the system. These are *integrity risk controls*.

MIS risk controls

Most MFIs mitigate the risk of losing key information from the database by creating back-up files and storing them at one or more other locations, such as at the home of one of the employees or at another branch or headquarters. These controls are known as *management information system risk controls*.

3.2 Integrating Controls into Operations

Next, the MFI should solicit employee and client feedback to understand the full effects of the internal controls selected. Once the MFI is confident of its selection of internal controls, it can begin to implement them into operations. In so doing, the MFI assigns responsibility to management to oversee their effective implementation and to monitor staff adherence to related policies and procedures.

3.2.1 Soliciting Feedback

Employees can offer valuable feedback on the potential repercussions of implementing specific internal controls.

After selecting cost-effective controls, the microfinance institution should discuss them with employees and possibly clients to ensure the proposed measures are appropriate before implementing them into operations. Employees can offer valuable feedback on the potential repercussions of implementing specific internal controls. In addition, the MFI can build employee commitment to internal control and risk management by involving staff in the development of the system. When *Acción Comunitaria del Perú* (ACP) transformed from an NGO into Mibanco, a regulated microfinance bank in Peru, management involved employees in the development of its new internal control system. In attempts to create a positive and supportive atmosphere, the Chief Internal Auditor explained the relationship between internal control and risk management to employees and encouraged their feedback on what types of controls would be most effective. Besides offering good input on proposed internal controls, employees are also often helpful in identifying policies and procedures that are no longer necessary or effective in mitigating risk.

If the internal control will have an impact on clients, then management should speak with loan officers or other line staff to understand the implications. Since line employees have the most interactions with clients, they can offer the best insight into how the clients might perceive and react to proposed operational changes. Client surveys or interviews may be necessary to fully understand the client's reaction to a new internal control measure. For example, to reduce fraud, the MFI might decide to change cash collection procedures so that all clients have to come to a branch to make payments rather than give them to the loan officer in the field. However, if client research indicates that the MFI will lose many clients as a result of this policy change, then the MFI might decide instead to improve its monitoring of the collection activity, by conducting more frequent client visits, for example.

Client surveys or interviews may be necessary to fully understand the client's reaction to a new internal control measure.

3.2.2 Assigning Responsibility

For the system to be effective, the MFI must assign clear responsibility for the implementation of the internal controls and ensure that employees respect them. For example, branch managers should be responsible for implementing procedures and monitoring adherence to policies and procedures related to branch-level internal control. In assigning responsibility, the MFI determines who collects information, compiles it and ensures that it reaches the proper levels of management for effective and timely decision making. In addition, the system should clearly indicate who is responsible for evaluating information and the extent to which it is their responsibility to respond to an identified control issue or uncontrolled risk. Chapter 4 addresses management's responsibility in responding to control issues in detail.

The MFI must assign clear responsibility for the implementation of the internal controls and ensure that employees respect them.

Once the MFI is confident that its internal controls are sufficient, it should evaluate and test their effectiveness, which is the topic of the next section.

3.3 Testing Effectiveness of Internal Controls

Besides implementing controls within the systems and operations, microfinance institutions should conduct regular checks on their effectiveness. It is the responsibility of branch managers to oversee the work of the branch employees and to monitor adherence to the MFI's policies and procedures on a daily basis. Effective internal control, however, also encompasses a systematic review of operations, most commonly referred to as the internal audit.

This section offers a detailed description of an internal audit process for a microfinance institution that offers both microsavings and microloan products, with units that operate as profit centers. It draws many of its recommendations from BRI's experience, though it incorporates other MFIs' experiences as needed. It focuses strictly on the internal audit at the operations level of an MFI, i.e. at the branch or unit level. However, an internal audit department usually evaluates the MFI's headquarters operations as well, to verify the accuracy of financial data at all levels of the institution.

To evaluate branch operations effectively, all MFIs should incorporate client visits into their review processes.

One should not confuse this type of audit with an external audit, in which a third party assesses the accuracy of the MFI's financial statements. An effective internal audit is not a simple review of the books, but is an in-depth evaluation of the MFI's ability to protect itself from excessive risk. To evaluate branch operations effectively, all MFIs should incorporate client visits into their review processes.

For the sake of consistency, this section refers to the evaluator as the auditor despite the fact that the auditor could be a manager or other employee. Furthermore, this section assumes that the microfinance institution has an Internal Audit Department, the head of which is referred to here as the Internal Audit Manager who reports directly to the board of directors. Upper management usually fulfills the role of the Internal Audit Manager in MFIs that do not have a formal internal audit function. This section describes how to develop an audit plan and presents a step-by-step approach to conduct a thorough operational audit.

3.3.1 Developing Audit Plans

If resources are limited, it is usually preferable to conduct a thorough evaluation of a few branches rather than a superficial audit of all the branches.

Each year, the microfinance institution develops a plan for its internal audit function. The scope and depth of the audit depend on previous findings and management's perception of the MFI's current risk exposure. MFIs that have recently incurred a financial loss as a result of fraud or poor branch management will likely require a more thorough internal audit than an institution that is confident of its ability to control risks. In accordance with the annual plan, the MFI determines a target number of branches to visit, which is approved by the board of directors¹⁴ and/or upper management. The number of branches audited depends on the resources available, the number of branches in the MFI, and the amount of time it takes to conduct an audit. If resources are limited, it is usually preferable to conduct a thorough review of a few branches rather than a superficial audit of all the branches.

For each branch, the internal auditor develops a separate audit plan. The audit plan is a working document that details the elements that determine the extent of the audit for that branch or unit.

The audit plan outlines how the team will accomplish its objectives and complete all tasks efficiently.

At BRI, there are two layers to the internal audit process. The internal audit department conducts an annual review of all areas of BRI's operations, including an audit of its microfinance operations at its Unit Offices. In addition, BRI has *peniliks* (internal controllers) who conduct ongoing reviews of up to four units every month. For the annual audit, the audit team leader develops the audit plan with input from the audit manager and another audit team member. The audit plan outlines how the team will accomplish its objectives and complete all tasks efficiently. The audit plan includes the following elements:

Set up audit team.

1. **Team set-up** – With information from regional offices and the central bank, the audit team leader develops the composition of the audit team, which depends on the scope of audit and risk classification of the branch office. If problems are anticipated, then additional or more experienced

¹⁴ Some boards delegate this responsibility to an Audit Committee.

members will be placed on the team. To audit a BRI branch office and its units, an audit team usually includes an audit manager, an audit team leader and four audit team members, but only two auditors go to audit each of the units. **Box 2** details BRI's organizational hierarchy, which is referred to throughout the document.

Box 2: BRI's Organizational Hierarchy

Organizational Level	Number of Offices
Headquarters	1
Regional Offices	14
Branch Offices	324
Unit Offices	3705

2. **Information gathering** – The team leader collects and compiles regional office reports, branch reports and financial statements, information from the public (e.g., customer complaints), unit reports and financial statements, and the last audit report.
3. **Risk assessment** – The team leader conducts risk analysis based on computer-generated early warning information to determine how risky this branch and its units are. For example, if a BRI unit expanded especially fast in the past year compared to its past growth rate and to others in the region, this indicates potentially higher risk. Or if a BRI unit experienced a large drop in savings, additional analysis may be necessary to determine the reason for the decrease. Extreme variation, regardless of its impact on the bottom line, is cause for potential concern and additional analysis.
4. **Scope** – The team leader determines the level of detail necessary by looking at all the information. If the branch is considered high risk, then the audit team conducts a more detailed audit; if low risk then a smaller scope is justified. The team leader also decides which tool to use, such as an internal control review (checklist) or audit program (more thorough tests).
5. **Time schedule** – Based on scope and estimated time to conduct tests, the team leader develops a time schedule for the audit. At BRI, the average time to conduct an audit is two weeks for a branch and three days for a unit. The team does not inform the branch of the audit schedule to ensure the audit is a surprise. A surprise audit is more effective in uncovering fraud or bad practices that might be hidden temporarily if the branch knows when the branch will be audited. In addition, it is important that the audit be conducted without interruption. If the audit of a unit takes three days, then they should be three consecutive days.

Gather information.

Assess risk.

Determine scope.

Set time schedule.

Estimate expenses.

6. **Expense estimate** – Finally, the team leader estimates the direct costs of the audit, including hotel, transportation expense, meals, and communication. This is the amount the team leader needs to conduct the audit. At BRI, these costs, along with the cost of the auditors’ time are prorated and charged to the auditees (the audited branch and units).

3.3.2 The Branch Audit

The internal audit of a branch or unit consists of a series of steps by which an assessment of the level of risk exposure can be determined. Most microfinance institutions that have an audit function have developed a series of checklists that can be used by managers or internal auditors to ensure a thorough review of the operations. Audit checklists range in size from a couple pages to a comprehensive manual depending on the complexity of the internal control system. The audit team should make efforts to minimize disruptions to normal operations and customer service.

3.3.2.1 Key Audit Areas

An effective internal audit should incorporate a thorough review of all areas of operation. Below is a step-by-step process to review the ten most common areas of a microfinance audit at the branch level, as summarized in **Table 5**.

Table 5: Key Audit Areas

Microfinance Audit Areas
1. Cash
2. Loans
3. Provisions
4. Write-offs
5. Savings
6. Transfers
7. Computer Systems
8. Fixed Assets
9. Interest Rate Setting
10. Financial Statements

Verify cash position.

Many MFIs minimize the risk of loss of cash by limiting the collection of loan payments and savings deposits that can occur outside of the branch.

Cash

The primary risk exposure in handling and processing cash is the risk of financial loss from theft, inaccurate accounting, and inefficiency in processing cash transactions. Many MFIs minimize the risk of loss of cash by limiting the collection of loan payments and savings deposits that can occur outside of the branch. ASA in Bangladesh is one MFI that does allow its loan officers to collect loan payments and savings deposits in the field. ASA reduces the risk of theft to its loan officers by scheduling visits to clients in a way that minimizes the amount of cash the loan officer will carry throughout the day. For example, the loan officer would first visit a group that is a net savings group and then use the excess cash to fund loan disbursements for the next group. ASA’s regional managers conduct client visits to verify the amount of cash collected, which reduces the risk of theft

by its loan officers. A later section on *Client Visits* describes this control mechanism in more detail.

The first step of the audit is to verify the cash position of a branch. Therefore, on the first day of the audit, the audit team should arrive before the branch opens to witness the opening of the safe. To audit the branch's cash position, the auditor should:

1. **Count cash and compare it to the register.** The cash amount should balance with the previous day's closing entry, to ensure the accuracy of the financial statements and protect against fraud. The audit team begins by counting unbundled currency, starting with the large notes. Some MFIs not only count the total amount but also the number of bills per currency unit to check whether money has been removed and replaced. **Table 6** presents a simplified example of a currency count register.

Table 6: Sample Register for Cash Counting

	\$1s	\$5s	\$10s	\$20s	\$50s	\$100s	Total	Signature
No. of bills								
Value								

2. **Check cash adequacy.** Most microfinance institutions have a policy that guides the range of the amount of cash held at a branch at any point in time. The MFI anticipates its future cash needs based on its expected loan renewals, new loans, and savings withdrawals and deposits. A minimum cash holding requirement reduces the branch's liquidity risk – the risk of not having adequate funds to cover savings withdrawals and loan disbursements, while a maximum cash holding requirement reduces the risk of loss from theft. To encourage the efficient use of funds, BRI sets a minimum of Rp. 500,000 and a maximum of four percent of total savings deposits in addition to its daily, anticipated loan disbursements.
3. **Check authorized access to safe.** Most MFIs restrict access to the safe or vault where cash is held. Some safes require two keys to open, one held by the branch manager and the other by another branch employee. Only together can they open the safe and access cash. This reduces the chance of theft or misplaced blame in the case of missing funds. In the absence of one of the designated staff, another staff member may receive temporary authorization to access the safe. The audit team should ensure that only authorized employees have access to the cash in the safe by checking the cash transfer register and identifying who has the keys or security code.
4. **Verify proper signatures.** Akin to the dual authorization to access cash, most MFIs require two signatures to verify the cash count. This minimizes the potential for miscounting, as well as misplaced blame in the event that cash is missing. The auditors should check to see that both

authorized employees have properly signed off on the cash count in the cash register.

After verifying the cash position, the audit team checks that all transactions were conducted according to policy and were recorded properly. For every transaction, BRI requires a signature from a *maker* (usually the client initiating the transaction), a *checker* (the employee handling the transaction), and a *signer* (a supervisory authority). For inter-office transactions, the *checker* and the *signer* could be the same employee. BRI auditors review all transactions for the past month, checking for proper authorizations and signatures. Hence, the final activity for the cash audit is to:

5. Reconcile cash transfer vouchers against the transactions register.¹⁵

Transfers of cash to and from the safe should all have supporting documentation, such as an official receipt or voucher that can be reconciled to the transactions register, which if automated is printed off the computer. Vouchers are usually numbered in order of the transaction's occurrence. This final check ensures that the cash transactions are properly recorded and that there has been no manipulating of the accounts.

Review loan portfolio.

Loans

The major risk exposure in a microfinance institution is the risk of loss of income from loans due to processing errors, inadequate information, non-compliance with loan policy, excessive concentrations of credit risk, counterfeit collateral, and employee fraud. One of the biggest control issues in MFIs comes from the fact that the loan tracking system operates separately from the accounting system. If the MFI does not reconcile the two systems, it leaves itself open to uncontrolled credit, transaction and fraud risks.

Managing credit risks

In managing the loan portfolio, MFIs reduce their credit risk by diversifying their portfolios across geographical regions and market segments.

Managing credit risk is the essence of microlending. For each loan the MFI makes, it exposes itself to credit risk associated with the client's future ability to repay the loan. Through group lending, MFIs mitigate this risk by spreading the responsibility for repayment over several individuals. To reduce this risk in individual lending, MFIs attempt to collect some collateral and as much information as possible on the client's character, asset base and productive activities. The MFI's potential exposure to credit risk increases when employees collect inadequate information on their clients or when loan decisions do not comply with stated policy. In managing the loan portfolio, MFIs reduce their credit risk by diversifying their portfolios across geographical regions and market segments.

Minimizing transaction risk

In the processing of loans, microfinance institutions expose themselves to transaction risk since its employees are human and therefore make mistakes that can result in financial loss. For example, a loan officer may accidentally register a loan payment as a deposit in the client's savings account. While computerization can reduce the risk of human error in making calculations,

¹⁵ Also known as the general ledger, the transactions register is where all transactions are recorded in order of their occurrence.

systems are limited by the data entered by the employees. MFIs can reduce the transaction risk involved in loan processing by hiring competent employees and making sure that they understand all steps involved in processing loans. The simpler the products, procedures and systems, the less likely employees will make errors that result in financial loss to the MFI. Based on interviews with several internal auditors, **Table 7** lists some of the common employee errors found in microfinance institutions.

Table 7: Common Errors Identified by Microfinance Internal Auditors

During a series of informal interviews, internal auditors of microfinance institutions cited the following as common errors by employees that expose the MFI to transaction risks:

- Transposed numbers, e.g., changing \$39 into \$93;
- Dropped zeros, e.g., changing \$1000 into \$100;
- Misplaced numbers, e.g., recording a withdrawal as a deposit or vice-versa;
- Poor business analysis by loan officers, e.g., overestimation of growth to result from loan;
- Miscalculations, e.g., incorrect calculations of interest for loan payments.

In some cases, clients or loan officers provide inadequate, false or misleading data used for making the loan decision with the intent to defraud the microfinance institution. The most common types of fraud by employees are fictitious loans, kickbacks, and misallocation of client funds.

Addressing fraud risks

Internal auditors usually identify *fictitious loans* when they try to visit the customer and they cannot find him and no one knows who he is – he simply doesn't exist. Or fictitious loans are made in the name of a former borrower as in ABA's case described in the preface. Without internal control mechanisms, fictitious loan schemes are usually identified only when the loan officer doesn't make the loan payments and the loans go into default.

Fictitious loans

Internal audits can uncover *kickbacks* by reviewing the loan files and visiting clients. In most cases, loan officers receive kickbacks for making loans to borrowers who would otherwise be ineligible. If auditors find many loans made by a loan officer that did not meet the eligibility criteria, they should suspect a possible kickback. If the auditor asks the client the original amount of the loan, the client will usually remember the amount he received rather than the amount recorded in the books. The auditor should check for other discrepancies in reported loan amounts, since fraudulent loan officers will often seek out other opportunities for kickbacks.

Kickbacks

Client visits will usually uncover *misappropriation of client funds*, the registering of a loan payment or deposit in another person's account.

Misappropriation of client funds

Fraudulent misappropriation is especially likely if clients give their money to the MFI employee for deposit in their savings account or to repay a loan outside of the branch. The internal auditor will identify the discrepancy by comparing the records in the branch with those of the client. To prove fraud in this case, the word of more than one client may be necessary. However, in most cases of fraud, the MFI will find a pattern of incidents, in which the employee committed the same act repeatedly.

The most effective way to mitigate the risk associated with fraud is for the MFI to conduct client visits to some of its loan clients.

The most effective way to mitigate the risk associated with fraud is for the MFI to conduct client visits to some of its loan clients. In traditional financial institutions, where loan sizes are larger and the number of active loan clients is fewer than in MFIs, it is often feasible to audit every client to assess exposure to credit risk. In microfinance institutions, however, the cost of auditing all clients can be prohibitively high. Therefore, MFIs rely on client sampling to assess the levels of credit and fraud risk in their portfolio. In general, MFIs must audit a larger number of loans but a smaller percentage of the overall portfolio than a traditional financial institution would. To adequately assess risk, the key is for MFIs to audit a large enough sample of loans to get a good overall picture of the true quality of the loan portfolio.

Sampling

MFIs generally employ a combination of two types of sampling: random and selective sampling. Random sampling is a process by which the auditor selects clients in a haphazard manner, with no attempt to influence the list of clients to audit. Random samples are often computer generated. MFIs use random sampling to minimize the potential for human bias to influence the sample selection. For example, auditors might consciously or unconsciously avoid selecting clients who are managed by a loan officer that they consider a friend or intuitively believe to be an honest person. Alternatively, selective sampling is a process by which the auditors attempt to create a list of clients to visit based on predetermined criteria. Selective sampling consciously focuses the majority of an MFI's efforts on higher risk clients. However, MFIs should avoid a bias within the selected sample. For example, a microfinance institution might deselect a specific geographical region simply because it is inconvenient to visit. If the MFI repeatedly avoids a specific region, the risk of fraud increases there.

In addition to the annual review by the internal audit department, BRI also has *peniliks* who conduct ongoing monthly reviews of its units. The *peniliks* attempt to review 40 percent of the loan portfolio each year and use a combination of random and selective sampling to choose which loans to review. For example, if a unit has 600 active loans, the internal controller would check a sample size of 20 for a monthly audit $((600 \text{ loans} \times 0.4)/12 \text{ months})$. The *penilik* might selectively choose a sample of 20 loans broken down by the following criteria:

- Three new loans
- Seven current loans
- Three loans in arrears (before final due date)
- Three loans in arrears (up to three months past final due date)
- Four loans in arrears (over three months past due)

This breakdown places a heavier emphasis on loans in arrears for the obvious reason – they represent a greater risk of loss to the MFI. Focusing on loans in arrears can help auditors to uncover fraud, as in the case in Nigeria described in **Box 3**. If the MFI allows loan rescheduling, rescheduled loans should be given the same level of importance in the audit as loans in arrears, since they are higher risk than other current loans. After categorizing the loans into the above categories, BRI's *peniliks* then uses random sampling to select the specific loans that will be reviewed. If there are 10 new loans in the unit, the *penilik* might select every third loan, for example.

Box 3: Uncovering Fraud in Nigeria

While visiting clients during an internal audit, a microfinance institution in Nigeria uncovered several incidents of fraud committed by its loan officers. In particular, the MFI discovered that a few loan officers had created “ghost clients,” i.e. fake loan clients, so that they could embezzle the loan funds. By giving priority to visiting clients with loans in arrears, the internal audit staff was able to quickly uncover the fraud and minimize the MFI's financial loss. To reduce the potential recurrence of this type of fraud, the MFI now requires branch managers to approve all loans. By changing the loan approval procedure, the MFI reduced the chance of fake loans being issued in the first place. In addition, the MFI believes that by simply conducting internal audits, including client visits, staff are less likely to commit fraud since their chances of being caught are high.

After selecting which loans to audit, the auditor accesses the loan files to review the following:

1. **Loan Administration.** The following questions assess the degree to which the client information was completed and processed correctly:
 - Is the loan application complete and filled out properly?
 - Is the loan file complete, e.g., does it contain identification information of the borrower?
 - Does the client meet eligibility requirements, e.g., adequate number of years in business?
 - Was the loan authority respected, e.g., if the loan amount was more than the branch is allowed to authorize, were the proper authorizing signatures collected?
 - Were the payment and interest calculated correctly?
 - Do receipts in the file match the general ledger?
2. **Credit Analysis.** The following questions assess the appropriateness of the loan decision:
 - Was the credit analysis adequate? BRI checks for the five Cs – character, capital, condition of economy, capacity, and collateral.

This verifies that the information used to approve the loan justified the decision.

- Does the loan term match the activity? For example, the first payment for an agricultural loan will usually start four months later. This question assesses whether timely repayment is likely by comparing the anticipated cash flows of the client's business with the terms of the loan.
- Are the calculations used to make the loan decision correct? For example, check the working capital calculation, including turnover of inventory and receivables.
- Is the supporting documentation adequate? It should include items such as tax payment receipts, certificate of land ownership, and proof of ownership for supporting collateral. This question determines whether the loan approval process was thorough and respected policy.

3. Repayments. The following questions assess the quality of the information on portfolio quality:

- Were loan repayments recorded correctly in terms of date and amount? This check should compare the client's records with the loan officer's records and the MFI's records to ensure that the information is consistent and accurate. If not, the auditor identifies the source of the discrepancy and assesses whether it resulted from unintentional error or intent to deceive, by speaking with employees and clients.
- If the microfinance institution accepts partial payments, does the remaining balance show as being in arrears? Many MFIs do not allow partial payments due to the complexity of managing them and maintaining integrity in the reporting system. For group loans, accepting partial payments could undermine the joint liability structure. If partial payments are allowed, the auditor verifies that portfolio quality reporting reflects the effects of partial payments, i.e. does not treat the loan payment as a normal, on-time repayment.
- Were the postdated checks used to repay loans honored and was the actual loan payment received? Some MFIs require their clients to submit postdated checks for all loan payments that can be deposited in the bank when the payment becomes due. However, MFIs should be careful to either record those payments only once the check has cleared or to ensure rapid adjustment to accounts in which the check does not clear.
- Were loans refinanced, i.e. replaced by a new loan? If so, does this show in the management information system? Many MFIs do not allow refinancing of loans because of the difficulty in tracking them appropriately. Refinanced loans should not be treated the same as other on-time loans in the management information system. The MFI should ensure that its MIS has a simple mechanism for distinguishing refinanced loans from on-time loans that avoids confusion and lack of transparency in reporting on loan quality.

- In the case of default, was collateral collected? Was the true value of that collateral recorded to pay down the loan? Often, the value of collateral used to secure a loan changes or is initially overstated by the loan officer. Upon collection, the MFI should ensure that it records the true value of the recovered collateral, and the amount the institution is likely to receive upon its sale, when paying down the loan. If the value of the recovered collateral is not sufficient to cover the loan, then the MFI should record the balance as a loss or as still owed by the client, depending on the institution's policy.
- Is it possible that employees have tampered with client records in the management information system? Most large microfinance institutions have computer systems that restrict employee access to client files to their specific areas of operation. The auditor should check that the records accurately reflect the client's history, which in an MFI is best ensured through client visits.

To complete the process of auditing the loan accounts, the auditor visits the loan clients under review. Only by visiting clients can a microfinance institution assure itself that fraud risk is adequately controlled. Left uncontrolled, fraud can cause significant financial loss and damage the MFI's reputation. The section on *Client Visits* specifically addresses this process.

Provisions

The auditors check for risk exposure due to poor provisioning of bad loans and mishandling of collections. Loan provisioning should correspond to loan maturities; loans should be risk-weighted according to a systematic process of quality assessment. In general, the short-term nature of microfinance loans implies that provisioning should be more conservative for an MFI than for traditional financial institutions.¹⁶ For example, a microloan with a three-month loan term that is 60 days delinquent is probably at greater risk of default than a five-year term loan that is 90 days past due. The audit of loan provisions includes the following:

Audit loan provisions.

- Review the process of consolidating the information contained in reports to ensure accuracy of loan classifications, i.e. according to the aging of arrears. Auditors should never take any report at face value but it is especially important to check that loan portfolio quality is accurately reported and that increasing delinquencies are transparent.
- Ensure that provisions are adequate and in compliance with policy. Auditors should check that provisions have historically supplied sufficient funds to cover actual loan losses. If not, then auditors should bring the shortage to the attention of managers who can change the MFI's provisions policy.
- Through client visits, verify authenticity of loans and validate reason for non-payment prior to write-off. Only by discussing the loans with clients will MFIs discover ghost loans and other types of fraud. In addition, the MFI can occasionally use the information collected on loan defaults by auditors to improve the loan product and procedures to reduce risk in the future.

¹⁶ Berenbach and Churchill, 1997, p.66.

Evaluate loan write-offs.

loans may still generate income to the MFI, because they do not remain on the balance sheet, they are particularly susceptible to fraud and poor management.

Write-offs

MFIs should have a schedule for writing off loans after they are a certain period of time past due and show a remaining balance. While written-off loans may still generate income to the MFI, because they do not remain on the balance sheet, they are particularly susceptible to fraud and poor management. The audit of written-off loans includes the following:

- Review general ledger postings for write-offs since the previous audit and check for proper authorization. Increasing write-offs could be a sign of fraud or uncontrolled credit risk. Auditors should identify the root of any significant change in the amount of loans written off.
- Ensure correct recording of payments on written-off assets. Any collections after a loan has been written off are especially susceptible to fraud, since loan officers can collect them in the field and never report them at the branch. Again, only by visiting clients after loans are written off can auditors verify the proper allocation of client funds.
- Check for excessive or fictitious collection expenses. As with any expense, auditors should verify money spent on collections and should ensure that the amount is reasonable.
- If applicable, assure maximum value of convertible collateral is acquired. Auditors should check the procedure used to sell off collateral and ensure that branch employees are not receiving a kickback or other benefit from selling the goods at below market rates.

Audit savings accounts.

Savings

By offering its clients savings services, the microfinance institution exposes itself to increased fiduciary, liquidity and fraud risks. The MFI must assure clients that their funds are physically secure and that their money is available for withdrawal on demand. While the average deposit held by a microenterprise client in an MFI may be small, the amount often represents a significant portion of the client's life savings. Thus, MFIs that mobilize client savings have increased responsibilities to protect their clients' assets in addition to the institution's assets, heightening the need for effective risk management and internal control. Fiduciary risks, the risk of the loss of trust in the institution, often arise from clients' changing perception of the financial soundness of the microfinance institution or a loss of confidence in management's ability to protect the MFI's assets. Clients demonstrate a loss of confidence by withdrawing their savings, and a simultaneous reaction by many clients can lead to a liquidity crisis in a financial institution. MFIs can check for indications of increasing fiduciary risk by tracking savings withdrawal trends and by monitoring customer concerns over time.

Most MFIs manage liquidity risk at the headquarters level for the entire institution. However, each branch must also ensure that it has adequate liquidity to meet its cash needs on any given day. By collecting client savings and using those funds for lending, the MFI significantly increases its exposure to liquidity risk. If the MFI is not careful in timing its cash inflows and outflows, it can result in a liquidity shortage. If the MFI fails to meet its

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cash obligations, this may cause concern among savers and result in a “run” on deposits. MFIs usually have a system of calculating anticipated cash needs by estimating incoming savings deposits and loan payments and outgoing loan disbursements and savings withdrawals. Most MFI branches retain a certain amount of cash in addition to estimated cash needs to protect against an unanticipated liquidity shortage. For example, each BRI unit maintains a minimum of Rp. 500,000 in cash in addition to its daily, anticipated loan disbursements. The internal control system should check the branch’s adherence to the MFI’s policies for managing liquidity risk.

Savings-mobilizing institutions expose themselves to a higher risk of fraud because of the greater number of cash transactions. While reviewing the savings accounts, auditors look for signs of fraud committed by employees or customers. One type of fraud that occurs in savings mobilization is when the loan officer collects savings from a client but doesn’t deposit it in the client’s account. Because of the high risk of fraud and potential danger to field officers transporting funds, many MFIs do not allow employees to accept deposits outside of the branches. Another type of savings fraud is when an individual withdraws funds from someone else’s savings account. To protect against this type of fraud, some MFIs keep a signature card or thumb print on file for each savings customer so that the client can be verified when withdrawals are made from the account. For its term savings accounts, BancoSol created a numbering system for its certificates of deposits and tracks which numbers have been issued, which greatly reduces the risk of clients cashing in fraudulent certificates.

The internal audit checks the extent to which client savings are at risk of loss and misappropriation. Misappropriation is the improper recording of a withdrawal or deposit from savings, such as in an incorrect account or as the wrong type of transaction. To audit savings accounts, the audit team must first determine the sample size for each type of savings product: liquid and term¹⁷ savings. BRI’s *peniliks* attempt to review six percent of the clients’ savings accounts over the year. Therefore, if a unit has 900 passbook savings accounts and 300 term savings accounts, then every month the *penilik* would audit 30 passbook savings accounts $((900 \times 0.06)/12 \text{ months})$ and 10 term savings accounts $((300 \times 0.06)/12 \text{ months})$ at that unit.

To audit savings accounts, the auditor conducts the following reviews:

- Is the client’s savings file complete? At BRI, the file should include a copy of the account application form, a copy of an identification card, and a signature card to be used for client verification.
- Do the receipts in the client’s file match the transactions register?
- Does the client signature match the signature card?
- Was interest correctly posted to the account?
- For term savings accounts, was the early withdrawal penalty applied consistently and calculated correctly?

Reducing fraud risk

Savings-mobilizing institutions expose themselves to a higher risk of fraud because of the greater number of cash transactions.

The internal audit checks the extent to which client savings are at risk of loss and misappropriation.

¹⁷ Also called time deposits or fixed deposit accounts.

To complete the process of auditing the savings accounts, the auditor visits the savings clients from the sample, which is addressed in the upcoming section on *Client Visits*.

Review transfers.

Transfers

To further reduce the risk of loss and misappropriation, there are two types of transfers the audit team should review: client transfers from one account to another and inter-office transfers. A few client transfers are often reconciled by reviewing the savings and loan accounts from which and to which funds are transferred. However, the audit team may wish to audit specifically money transfers from accounts owned by one client into the account of another client. To audit these transfers, the auditor should reconcile the information in the general transactions register against that in the client files and visit the client from whose account the funds were drawn. To audit inter-office transfers, the audit team brings records of funds transfers from other branches or units and reconciles those with the records at the branch or unit being audited.

Evaluate computer systems.

Computer Systems

If a microfinance institution has computerized operations, it should evaluate the system's ability to protect the institution from integrity risk and management information systems risk. The audit team checks to make sure that these risks are properly controlled.

Integrity risk checks

To verify that the computer system protects the MFI from integrity risk, the risk that non-authorized individuals will have access to sensitive data, the auditor should:

- Verify that employee passwords are kept secret and that they are regularly changed to maintain their secrecy.
- Check that employees log on and off properly and are not using a computer that was logged onto by another employee.
- Ensure that employees are not able to access information outside their scope of work.
- Check that employees ask clients to present proper identification before providing them with information on their account.

MIS risk checks

In addition, the microfinance auditors should check that there are controls to protect the information contained in the database:

- Ensure that back-up files are made frequently and that the location in which they are stored is relatively safe from physical damage.
- Verify that the computers are checked for viruses regularly and that the virus software is up-to-date.
- Check that the computer makes accurate calculations and stores the information properly. Auditors can check this manually by using a hand calculator and checking the basic calculations in the system, such as interest rate calculations, or by using audit software as discussed below.

There are computer software programs that can facilitate the identification of potential errors and/or accounts for the audit sample. Audit software checks all transactions for their adherence to the MFI's standard policies and procedures and identifies those accounts that do not comply. For example, if the MFI has a maximum loan size, the computer can quickly identify any loans that exceed that limit. The more the software conforms to the policies and practices of the MFI, the more useful it is, though such tailored products tend to be expensive. BRI hired a Canadian consultant in 1995 to develop its customized audit software, called Idea 5, which the Internal Audit Department uses at every audit visit.

Audit software

Fixed Assets

To reduce the misappropriation or theft of fixed assets, it is the audit team's responsibility to verify the physical assets reported on the balance sheet of a microfinance institution, which includes the following:

Verify fixed assets.

- Verify the existence of all major fixed assets. In an MFI, these can include furniture, air conditioning units, motorcycles, and other modes of transport. This verification protects the MFI from fraudulent recording of false expense items and the theft of fixed assets.
- Check the condition of the fixed assets and the reported level of use. Does the level of wear and tear on the asset match the level of use indicated? This checks whether fixed assets are being misused or used for purposes outside the MFI's normal activities.
- Is depreciation of fixed assets properly recorded on the balance sheet? This check protects the MFI from accounting mistakes that could affect the institution's profitability.

Interest Rate Setting

Some MFIs allow their branches to set interest rates in accordance with their specific market and client needs, such as Fundusz Mikro in Poland and the rural banks, Banks Perkreditan Rakyat (BPR), in Indonesia. To audit a branch that sets its own interest rates, internal auditors review the following:

Check interest rate setting.

- Check whether the branch determines and applies interest rates according to the MFI's policy, e.g., some MFIs determine deposit rates by simply adding on a certain percentage to the current interbank or prime lending rate in the country. Also verify that interest rates are calculated accurately and according to policy, e.g., if the MFI policy is to calculate interest rates on a declining balance, check that the interest charged on a loan declines accordingly as the loan is paid off.

Financial Statements

In the case that MFI branches operate as profit centers, auditors should also check the accuracy and reliability of the information contained in the financial statements – namely the balance sheet and income statement. The primary risk exposures that auditors identify in the review of financial statements are overstatement of expenses, lack of budgetary controls, inadequate cost accounting, double payments and fraudulent payments to vendors. Some internal auditors, such as those at BancoSol, are responsible

for comparing budgeted to actual expenses and assessing whether branches are operating within their budgets.

To conduct an audit of the financial statements, the auditors review the following:

1. Income Statement

- Check amount of revenues and expenses for the time period. Are the revenues and expenses reasonable for each item? Are the expenses within budget?
- Check receipts for purchases, verify items, amounts and dates.
- Ensure that purchases conform to policies. For example, are there proper authorizations (signatures) for large purchases?

These controls check whether the income statement is accurately reported, verify that employees adhere to policies and respect budgets, and protect against fraudulent expenditures and reporting.

2. Balance Sheet

- Check whether opening balance this period matches the closing balance from last period.
- Verify the amounts of all assets, liabilities and retained earnings recorded.

These controls check the accuracy of balance sheet reporting.

Most MFIs have additional areas for audit than those listed here. If the MFI utilizes an incentive system, for example, then the auditors may also verify the correct allocation of bonuses and whether they were paid in a timely fashion. Each MFI has aspects which make it unique and that require additional controls and checks to the system.

3.3.2.2 Client Visits

Conduct client visits.

An audit of a microfinance branch is not thorough unless the auditor visits the clients to reconcile their records with those of the branch. MFIs uncover the majority of incidents of fraud by conducting client visits. The auditor meets with the same savings and loan clients selected in the sample for review at the branch.

Client group auditing

Groups. For MFIs that use group lending and savings methodologies, the group members often fulfill many of the responsibilities that would otherwise be carried out by an employee. Therefore, the internal auditor will often visit client groups to check on their cohesiveness and ability to properly perform their roles. Depending on the nature of the group methodology, MFI internal auditors conduct the following checks:

- Verify group's existence and proper functioning by attending a group meeting. The internal auditor can usually determine whether the group has a sincere commitment to develop a long-term relationship with the MFI by observing a group meeting. A legitimate group will have clearly defined lines of authority and demonstrate an understanding of the methodology.

- Check the group's records to ensure proper calculations and accurate reporting. If records are not accurate, the internal auditor assesses whether discrepancies result from poor training, intent to deceive, or other reasons.
- Verify that groups only issue loans to group members and that the MFI's lending policies are respected. For example, many MFIs that target women-only report incidents of husbands pressuring their wives to take out loans for them.
- Check existence of and adherence to group's bylaws and determine whether the group adheres to the MFI's norms and standards of operation. For example, many MFIs that use a group lending methodology allow the groups to select their members but do not allow immediate relatives to be involved in the same group.

Borrowers. With information from the loan file, the microfinance auditor visits the loan clients for further verification that transactions have been recorded correctly. During a client visit, the auditor should ask the same questions that were asked by the loan officer to make the loan decision. The auditor checks the following information against the information contained in the client's loan file:

- Name of borrower
- Loan amount
- Loan payments – how many, how much, any payments missed?
- Loan term
- Use of the loan
- Previous loan – amount, when paid off?
- Condition of the business

Assessing the loan decision and the condition of the business is especially important for auditing clients with individual loans. For individual lending, MFIs assess business condition in a variety of ways. BRI simply looks at sales before and after the loan to identify whether the loan was used productively and is generating additional sales. Mibanco auditors conduct a more thorough analysis of the business, also considering the clients' overall assets and liabilities. Mibanco's more analytical audit includes:

- Does the client own or rent his/her home? Homeowners are considered more stable and therefore easier to find in case of default.
- Are amounts reported as assets and liabilities correct and reasonable, including inventory and collateral guaranties? An experienced auditor can estimate the value of inventory in a shop simply by viewing it.
- Does the client have other loans outstanding? How much? On what terms?

Depositors. With information from the branch, the auditor visits the savings clients to reconcile the client's transaction history. The auditor checks the following information against the information contained in the branch records:

Individual loan auditing

- Name and address of saver
- Date and amount of opening deposit
- Date and amount of subsequent deposits and withdrawals
- Reconcile all savings transactions recorded in the branch with those in the passbook or with client receipts

In theory, BRI selects savings clients to visit randomly using a statistical table. However, BRI auditors have learned that clients are distrustful of an unfamiliar person coming to their home to inquire about their personal savings. So in practice, BRI auditors primarily audit savings accounts of clients that come into the branch while they are conducting the audit. In cases where savings clients are also loan clients, MFIs can simultaneously audit the savings accounts of the loan clients under review.

Adherence to policies

While conducting client visits, the auditor should also check adherence to other policies unique to the MFI.

While conducting client visits, the auditor should also check adherence to other policies unique to the MFI. For example, in MFIs that allow clients access to more than one loan, the loan review process should ensure that the maximum combined loan amount does not exceed a safe limit. The auditor verifies that this policy was respected. In addition, many MFIs have a policy that forbids employees from collecting loan payments or savings from clients outside of the branch to protect against theft or misappropriation of client funds. To check for adherence to this policy, auditors can ask clients if they have ever given funds to an employee outside the branch. However, for this policy to be most effective, the microfinance institution should ensure that clients are aware of this policy and understand its purpose. K-Rep has an additional policy that credit officers who handle client money outside the branch are responsible for its loss and correct allocation.

As microfinance institutions evolve over time, inevitably some policies and procedures become outdated. If the auditor notices that a particular policy or procedure is repeatedly ignored, it is likely that employees do not consider it important or disagree with it entirely. Auditors should question employees about the effects of the policy to uncover reasons why employees are not following it. Often, the auditors will agree with employees once they understand the reasoning. The auditor can improve relations with employees by supporting changes to policies that have become outdated or have negative consequences.

Other uses of client visits

Microfinance institutions can also use client visits to satisfy simultaneously other institutional objectives. Since client visits are time-consuming and therefore costly to the institution, the MFI should find ways to benefit further from the opportunity to meet with clients. Microfinance institutions can take advantage of client visits to conduct market research for new product development or to solicit feedback on how to enhance customer satisfaction. During Mibanco's client visits in Peru, for example, the internal auditor initiates the conversation by explaining that the purpose of the visit is to ensure the customer's satisfaction with Mibanco's services and to make sure that staff handled all transactions properly. This approach puts the client at ease and facilitates a more frank and open discussion about the client's business and experiences with the financial institution. The auditor records

the notes from the conversation and reports key findings to management, including commonly suggested improvements to customer service or changes in product features. This approach does not undermine the auditors' relationships with branch staff because the auditors only communicate general findings to management and avoid naming staff, unless fraud is suspected.

3.3.3 Audit Reporting

For each finding, the auditors should write up an audit finding sheet, which outlines i) the conditions (what the problem is), ii) the criteria (what it should be), iii) the cause, iv) the impact (potential for loss or negative impact on the MFI) and v) the recommendation. **Table 8** presents a sample audit finding sheet. The audit team leader then compiles all the findings in the summary audit report, a sample of which is presented in **Table 9**. When possible, auditors should refer to specific bank policies and procedures to support their findings. Statements should be made in a neutral manner, making references to auditees by title or position rather than by name.

For each finding, the auditors should write up an audit finding sheet.

Table 88: Sample Audit Finding Sheet

Condition	Criteria	Cause	Impact	Recommendation
Interest calculation for loan #101 was short \$2/per month.	Interest on this loan should be \$10/per month.	The loan officer used an outdated interest rate to make the calculation.	The MFI lost \$2 per month over the past three months, for a total loss of \$6.	Remind loan officers that interest rates are updated at the beginning of each month.

Upon conclusion of the branch audit, the auditors meet with the branch manager to review the findings and clarify the information to include in the audit report. The auditors should be well prepared for the meeting, with the appropriate references to highlight their points. The presentation should begin with major issues, followed by minor exceptions, while simultaneously accentuating positive findings. Auditors should remain fair and objective and refer to specific policies and procedures that employees are not consistently following.

Meet with branch manager.

Table 9: Sample Summary Audit Report

No.	Item	Recommendation
1	Cash kept at branch should be no more than \$10,000 but found \$16,000. Excess funds should be transferred to headquarters.	Branch manager should oversee cash better and schedule more trips to deposit excess cash.
2	In visiting the business of loan client # 243, it was found that his shop has been closed for two months.	Implement supervision measures to verify that businesses are still operating at the time a new loan is granted.
3	Closing interest on passbooks has been paid but an amount still shows in the computer.	Branch manager should that ensure accounts are properly closed and recorded in the computer.
4	A large amount of bad debt is still on balance sheet as arrears.	Write off loans classified as bad debt as soon as possible in accordance with policy.

At BRI, if fraud is identified in the course of the audit, it is not usually addressed directly with the manager, nor is it written up in the summary audit report. Instead, the audit team leader creates a special report and sends it to the internal audit manager who decides with upper management how to address it depending on the severity of the allegations. A special investigation team will often be formed to conduct a thorough investigation to assess further the extent of the problem. Special investigations and fraud are covered in more detail in the next section.

Make recommendations.

Recommendations can be repressive or preventive. A repressive recommendation is one that eliminates the cause of the problem. A preventive recommendation attempts to correct the cause of the problem by other means. For example, if an employee commits fraud, a repressive recommendation would be to fire the person. When an employee is a common cause of errors, a preventive measure would be to teach the employee how to do the job correctly. Most recommendations are based on operational policies and procedures. However, the audit of a new or recently transformed institution may require recommendations for significant changes to existing policies or procedures. For example, during a client visit an auditor may discover that the income to support a solidarity loan is insufficient and that the client has also taken a second loan from another MFI. In this case, the auditor might suggest that management review the policy that allows automatic increases for repaying clients and revise it to factor in income potential and other loans held by the client.

Report to management.

Upon conclusion of an audit by BRI’s internal audit department, the audit team leader writes a letter to management that includes a letter of opinion, audit findings and recommendations. The letter of opinion states whether the findings were:

- Satisfactory – no major findings that have a negative impact on the MFI’s operations; or

- Satisfactory with qualification – one major finding of poor internal control with impact on the MFI’s operations; or
- Unsatisfactory – more than one major finding with negative impact on the MFI’s operations.

A finding that has potential to become a major issue or that relates to regulatory compliance is treated as a major finding. The letter goes to the manager of the branch that was audited and copies go to the manager’s supervisor and the internal audit manager. The audited branch manager responds with comments, including additional explanations and responses to the findings, as well as a plan of action. The branch manager sends this written response to upper management, who assesses whether the measures taken are adequate, and copies the internal audit manager.

A finding that has potential to become a major issue or that relates to regulatory compliance is treated as a major finding.

It is the responsibility of the internal audit manager to consolidate the findings of audits of all the branches and to report to upper management, the board of directors and possibly to the regulatory authorities. The frequency and content of that report depends on the reviewers’ requirements. Mibanco writes a quarterly audit report that summarizes all major findings, conclusions and recommendations, which is sent to upper management, the board and to the Peruvian Superintendency. In addition, MFIs can give audit reports to potential investors to develop their understanding of and confidence in the institution.

3.3.4 Special Investigations

The internal audit manager decides whether there is cause for a special investigation based on a variety of sources of information, including the summary reports that arise from regular audits. An MFI may conduct a special investigation if a branch experiences a sharp increase in arrears or performance (growth in loan portfolio), receives customer complaints, suspects an employee of fraud, or is robbed or burglarized. **Box 4** describes a case of fraud that K-Rep learned about through its customers, which indicated a need for increased internal control. In the case of robbery or burglary, the auditors should investigate quickly since bank assets become vulnerable when confusion prevails. To facilitate special investigations, managers may ask certain employees to take leave or to rotate to another branch while their work at the branch is investigated.

A MFI may conduct a special investigation if a branch experiences a sharp increase in arrears or performance (growth in loan portfolio), receives customer complaints, suspects an employee of fraud, or is robbed or burglarized.

Box 4: K-Rep Investigates Customer Complaints

In Kenya, one K-Rep loan officer collected membership fees from new clients but never registered them. The clients were unfamiliar with the process, and did not know that they should have been given passbooks immediately when they opened their accounts. K-Rep discovered the fraud when the clients finally complained at the branch office that they never received their passbooks. A manager investigated and found that the loan officer had stolen membership fees from approximately 20 clients for a total value of approximately \$75. K-Rep quickly fired the loan officer but was unable to recover the funds. The clients received their passbooks and an apology and K-Rep's reputation was spared from further damage.

Investigating fraud

If the MFI suspects fraud, there should be clear guidelines on how to conduct the special investigation and the institution should take immediate action to address the issue. New employees who have not been adequately screened for their moral character are the most likely to commit fraud. Fraud is most difficult to uncover when an employee commits it in collusion with a customer and/or other employees. Some MFIs regularly rotate their staff to minimize the potential for collusion. See **Box 5** for an example of collusive fraud discovered at BRI's Unit Desa.

If the special investigation verifies the existence of fraud, management should quickly act to resolve it and to prevent its future occurrence. At ASA, if the regional manager detects fraud while conducting management spot checks, he requests an immediate special investigation so that the extent of the problem can be quickly assessed. If ASA finds that an employee is guilty of stealing client funds, the employee must repay the money or face legal action. ASA retains a 5,000 taka security deposit for each of its employees. If this is insufficient to cover the loss, ASA has found that applying social pressure works to resolve fraud in the same way that it works to recover a microloan in default. If the employee does not immediately repay, ASA informs the employee's father, which is considered extremely shameful in Bangladeshi culture. The family often repays to protect the family name.

Box 5: Collusion at BRI

During its normal audits, BRI auditors discovered several incidents in which a loan officer had colluded with customers to defraud the institution. It was identified when a Rp. 5 million loan defaulted. Upon investigation, the auditors found that only Rp. 3 million of the initial loan were paid to the customer, whose name was in the files, while the other Rp. 2 million went to a friend of the customer. The original customer had been successfully repaying his loan but stopped upon discovering that his friend could not make his loan payments. The loan officer was attempting to expand his loan portfolio by going against BRI's policy not to lend to start-up enterprises or for the purpose of on-lending. Upon further investigation, the auditors discovered that this loan officer had made several such loans. BRI quickly fired the loan officer and placed the clients' names on its black list of bad borrowers, thereby punishing all parties involved in the fraud.

3.3.5 Follow-up

The audit team leader should ensure that information used to conduct an audit is compiled and archived, and that the audit file contains the following items:

- Audit plan
- Audit evidence and attachments
- Audit report
- Management letter
- Plan of action
- List of items for the follow up audit

The audit team uses the information contained in the files and conducts a follow-up audit within approximately three months to ensure that management has implemented the proposed plan of action. Section 4.3, *Responding to Control Issues*, addresses management's responsibility in following up on the findings of an internal audit.

3.4 The External Audit

Regulators and donors often require MFIs to undergo an external audit. The information and reports developed in the internal audit process can facilitate the external audit process and thereby reduce the cost of an external audit in terms of time and money. The internal audit department should contact the external auditors to understand the scope and purpose of the audit. With permission from the board or management, the internal audit manager can send the external auditors internal audit reports and financial statements a few weeks before the audit so that the external auditors can prepare their audit plan ahead of time and off-site. In addition, the internal audit department can anticipate questions and explain potential issues, as well as

Compile and archive audit information.

Conduct a follow up audit within three months.

The information and reports developed in the internal audit process can facilitate the external audit process and thereby reduce the cost of an external audit.

prepare any necessary information before the external audit team arrives. Once the external auditors arrive, the internal audit department should make itself available to help the external auditors interpret data and answer questions, especially in the case of a special investigation.

The board and management of an MFI should not rely on external audits to uncover fraud, potential problems or risk exposures that could lead to financial loss in the future.

It is important to note the difference between an external and an internal audit. An external audit is a formal, independent review of the MFI's financial statements, records, transactions and operations.¹⁸ The internal audit is a systematic process by which the MFI checks its ability to manage risks and protect itself from loss. The majority of external audits focus on assessing the degree to which the MFI's financial statements reflect reality. Internal audits, on the other hand, focus primarily on uncovering the problems in systems and operations that could lead to financial loss or to the reporting of false information. As an independent review, the external audit helps to assure third parties that the MFI's financial statements are correct. While external audit reports can sometimes be helpful in pointing out internal control issues, the board and management of an MFI should not rely on external audits to uncover fraud, potential problems or risk exposures that could lead to financial loss in the future.

The internal audit poses its own limitations. Regardless of its level in the MFI's hierarchy, the internal audit department is not very effective in uncovering and reporting on upper management discrepancies or identifying conflicts of interest within the board. These risk exposures can pose the greatest threat to an institution and are best monitored by the board and management tracking key performance indicators and through regular self-assessments. The MicroFinance Network's publication, *Guidelines for the Effective Governance of Microfinance Institutions*,¹⁹ is a tool that microfinance boards and management can use to address the risks that are not covered by the internal audit function.

¹⁸ *External Audits of Microfinance Institutions*, 1999, p.5.

¹⁹ Campion and Frankiewicz, 1999.

4. INSTITUTIONALIZING INTERNAL CONTROLS

The structure of the internal control system varies widely from one institution to another. The specific internal controls depend largely on the type and nature of the risks the institution faces, as well as the institution's structure. Nevertheless, all microfinance institutions should have some type of internal control system and a mechanism to evaluate it.

All microfinance institutions should have some type of internal control system and a mechanism to evaluate it.

The institutionalization of internal controls can take various forms depending on the MFI's risk profile and level of institutional development. This chapter identifies the key variables associated with different types of internal control systems and provides information on three methods for evaluating internal controls. It draws from numerous case studies to highlight the range of internal control systems used in the microfinance industry. The chapter concludes with a discussion of management's role in responding to control issues that arise in the course of the internal audit, such as control violations and new uncontrolled risks.

4.1 Creating an Internal Control System

Creating the appropriate internal control system depends on the MFI's scale of operations, regulatory status, whether it mobilizes client savings and whether it acts as a financial intermediary.

4.1.1 Scale of Operations

The scale of an MFI's operations determines the formality and breadth of the internal control system. In general, the smaller the MFI's operations, the simpler the internal control structure. **Table 10** highlights the primary differences in internal control systems given the MFI's operational scale. Using the *MicroBanking Bulletin*'s categories, this section classifies MFIs according to three levels of operational scale: small, medium, and large.²⁰ According to the Bulletin's definition, small MFIs have loan portfolios under \$1 million, and usually have fewer than 35 employees and under 4,000 active loan clients. Medium MFIs have portfolios that range from \$1 million to \$8 million, and have from 35 to 70 employees and under 7,000 active loan clients on average. Large MFIs manage loan portfolios in excess of \$8 million and tend to have more than 70 employees and over 7,000 active loan clients. The relationship between the number of active loan clients and size of the portfolio determines the average loan size. Using these two indicators plus the average number of employees, a microfinance institution should be

The scale of an MFI's operations determines the formality and breadth of the internal control system.

²⁰ *MicroBanking Bulletin*, No. 2, July 1998.

able to determine which category best represents the scale of its operations. These categories are geared toward lending-only MFIs. The upcoming section on *Savings Mobilization* discusses internal control systems for MFIs that also offer savings services.

Table 10: Internal Control Norms Per Operational Scale

Internal Control Factors:	Small-Scale Under \$1 million	Medium-Scale \$1-8 million portfolio	Large-Scale Over \$8 million portfolio
Control Environment	<ul style="list-style-type: none"> Managing director sets tone 	<ul style="list-style-type: none"> Guided by policies and procedures 	<ul style="list-style-type: none"> Guided by written policies and procedures
Risk Assessment	<ul style="list-style-type: none"> Less formal 	<ul style="list-style-type: none"> Formal process 	<ul style="list-style-type: none"> Documented formal process
Control Activities	<ul style="list-style-type: none"> Few controls 	<ul style="list-style-type: none"> More controls specifying who conducts what, when and how 	<ul style="list-style-type: none"> Frequently updated written and standardized internal control activities
Information and Communication	<ul style="list-style-type: none"> Informal yet often efficient and effective 	<ul style="list-style-type: none"> Defined distribution and communication channels 	<ul style="list-style-type: none"> Defined distribution and communication channels
Monitoring and Evaluation	<ul style="list-style-type: none"> Management spot checks, MFI also may contract an auditor on a short-term basis 	<ul style="list-style-type: none"> Management spot checks and involves at least one independent internal auditor 	<ul style="list-style-type: none"> Documented and standardized review process carried out by management at the branch level and reinforced by internal audit staff

Small-Scale MFIs

In a small scale MFI, the style and personality of the managing director plays a large role in setting the tone for the control environment.

Small scale microfinance institutions tend to be less developed NGOs with few employees and minimal outreach. The risk assessment process is essentially the same in all organizations, but the process is less formal in smaller institutions. In a small-scale MFI, the style and personality of the managing director plays a large role in setting the tone for the control environment. A hands-on manager that exudes personal integrity and has a reputation for being ethical often encourages employees to act with good intentions. However, small-scale MFIs should be careful to not confuse good intentions with good results. An effective internal control system is one that checks that those good intentions translate into effective risk reduction strategies.

Small microfinance institutions have fewer employees, which limits the institution’s ability to separate employee responsibilities. However, direct oversight by the managing director can compensate for this shortcoming. If the manager has a hands-off approach or is not actively involved in operations, the internal control atmosphere may be more relaxed, which can

dangerously leave employees to interpret correct and ethical behavior individually and result in control problems.

Assuming management is integrally involved in daily operations, a small-scale MFI benefits from the following inherent risk management mechanisms:

- Policies and procedures tend to be well known and implicitly understood by employees even if they are not formally documented.
- Certain control activities may not be necessary, such as the need to document management approvals for the few exceptions to normal procedures.
- Due to the smaller number of branches and staff, information and communication systems will usually be less formal than for more developed MFIs but tend to be just as efficient and effective.
- Monitoring tends to be informal and less detailed with members of senior management conducting the majority of monitoring activities as part of their managerial duties.
- Internal control personnel are uncommon, although the MFI might contract an outside auditor on a short-term basis. If conducted, external evaluations are often performed by the donor agency, as an assurance of the effective use of funds for the donor agency's internal control purposes.

Medium-Scale MFIs

Medium-scale MFIs tend to be growing institutions that are developing operations, adding branches and employees, and expanding client outreach. When a microfinance institution moves from a small to a medium-scale institution, it should begin to formalize its internal control process. In medium scale MFIs, the managing director no longer has an intimate understanding of all branch operations. Institutional policies and established norms and sanctions begin to dominate the control environment more than the managing director's personal management style. As the MFI reaches this size, it should begin to produce written policies and procedures that serve as the basis for the internal control system. Operational manuals should detail specific control activities, who conducts them, in what manner and how frequently. The MFI should standardize all systems, procedures and reporting. Risk management is easier to monitor in a medium-sized institution if it has clear policies and procedures.

Channels of communication should be well defined and clear to staff. Distribution of organizational charts to all employees is one way to clarify the proper chains of communication and authority. If policies and procedures are sound, uniform, and effectively communicated, employees are more likely to respect them, resulting in fewer discrepancies.

Monitoring the internal control system of a medium-scale MFI often involves separate internal control personnel. Separate evaluations and external audits can be helpful in revealing weaknesses in the internal control system and can

When a microfinance institution moves from a small to a medium scale institution, it should begin to formalize its internal control process.

Monitoring internal control of a medium-scale MFI often involves separate internal control personnel.

identify additional control activities necessary for management to monitor. While upper management normally oversees the work of the internal control personnel, the internal control function should report directly to the MFI's board of directors or to the board's audit committee.

As a microfinance institution develops into a large-scale institution, it should have a well-defined internal control system in place.

Large-Scale MFIs

As a microfinance institution develops into a large-scale institution, it should have a well-defined internal control system in place. To achieve this level of operational scale, MFIs often experience exponential growth, making it extremely important to have effective internal controls in place. It is also at this stage that rapid growth is likely to demand frequent adaptations and fine-tuning of the internal control system. The MFI must remember that internal control is an on-going dynamic process that continually adjusts to meet the changing needs of the institution and its external environment.

The large-scale MFI often uses a standard process for replicating its systems and procedures to create new branches. These branches sometimes operate as profit centers that conduct their own internal control. However, there is usually an internal auditor or internal audit department that also monitors the internal control of all the MFI's operations and reports directly to the board. Standardized procedures and reporting facilitate the work of internal and external auditors. Many large-scale MFIs are regulated financial institutions and regulators often determine many of the standards and reporting requirements for the institution.

Many regulators require more formal documentation of policies and procedures and insist upon the implementation of an internal audit department.

4.1.2 Regulatory Status

As more microfinance NGOs contemplate transformation into regulated financial institutions and seek equity investors, the need increases for improved internal control. While transformation to a for-profit MFI can lead to improved governance and accountability, the profit motive alone does not guarantee good governance. Yet, transformation from an NGO into a regulated financial intermediary does invariably imply increased risk exposure, which is the reason regulatory authorities often place specific internal control requirements on regulated financial institutions. Many regulators require more formal documentation of policies and procedures and insist upon the implementation of an internal audit department. For example, in the creation of the first microfinance bank in Peru, the Superintendency required Mibanco to develop operational manuals documenting all procedures and to install an internal audit department that would report regularly and directly to the Superintendency and to Mibanco's board of directors.²¹

Formal MFIs should use regulatory requirements as a starting point for improved internal controls rather than view regulatory compliance as the end objective.

Formal MFIs should use regulatory requirements as a starting point for the implementation of improved internal controls rather than view regulatory compliance as the end objective. Externally imposed laws and government supervision rarely improve the governance capacity of financial institutions.²² Regulatory intervention usually arises only after the financial institution

²¹ Campion and White, 1999, p.103.

²² Richardson, 2000, p.x.

shows external signs of distress, such as a significant loss of deposits. Furthermore, MFIs should not rely solely on input from regulatory examinations as the main source of recommendations for improvements in their internal control systems, but should have their own system of evaluating internal controls. Selecting the appropriate internal evaluation tool is discussed later in this chapter.

Both regulated and non-regulated MFIs should familiarize themselves with the regulatory requirements in their countries and conform their internal control systems to the norms of the formal financial system to the extent they are reasonable and possible. Even in cases where a microfinance NGO has no intention to join the formal financial sector, complying with country norms can help an MFI gain credibility and therefore access to funding from formal financial institutions. Internal control plays an especially important role in microfinance NGOs given their lack of real owners. In commercial MFIs, shareholders have a financial incentive to oversee the efficiency and ensure the success of the institution. NGO boards, donors and other funding providers should ensure that microfinance NGOs have adequate internal controls in place to make up for this structural difference.

Even in cases where a microfinance NGO has no intention to join the formal financial sector, complying with country norms can help an MFI gain credibility and therefore access to funding from formal financial institutions.

4.1.3 Savings Mobilization

Regulatory policies in most countries prevent unregulated non-profit organizations from collecting local, retail savings. In many countries, only by becoming registered as a formal financial institution can an MFI mobilize clients' voluntary savings deposits. However, there are a few countries in which microfinance NGOs have mobilized significant amounts of local savings without central bank supervision. For example, in Bangladesh, ASA has mobilized almost \$10 million of its clients' voluntary deposits.²³ The NGO Affairs Bureau, which oversees NGOs in Bangladesh, allows microfinance NGOs to mobilize client savings as long as their savings component is linked to their microcredit delivery. Since ASA clients' savings are usually less than their outstanding loan balances, the authorities do not consider ASA a financial intermediary, which would require greater supervision. Nonetheless, the central bank, Bangladesh Bank, is currently considering expanding its role into the regulation of microfinance NGOs.

Regardless of regulatory status, MFIs that mobilize voluntary savings expose themselves to higher levels of risk since they have a moral obligation to protect the value of their clients' savings. The MFI has increased liquidity risk exposure since it now has to ensure that adequate funds are available for savings withdrawals as well as for loan disbursements. In addition, by allowing employees to handle client savings, the MFI potentially exposes itself to fraud risk. These higher risk factors require additional internal controls. MFIs that decide to mobilize client savings have to develop new policies and procedures, enhance security and staff training, and adapt management information systems to address the additional risk exposure. MFIs that conduct financial intermediation, i.e. use client savings to make loans, should be financially self-sufficient and have formal and documented

MFIs that mobilize voluntary savings expose themselves to higher levels of risk since they have a moral obligation to protect the value of their clients' savings.

²³ December 1998 MicroBanking Bulletin statistics made publicly available by ASA.

procedures that are regularly monitored by management and evaluated by internal auditors.

4.2 Selecting Appropriate Evaluation Tools

There are three non-exclusive methods for evaluating the internal controls of a microfinance institution: 1) management spot checks, 2) the use of internal auditors, and 3) a department dedicated to internal control. All three methods test the effectiveness of internal controls as described in Chapter 3. The main difference between the three is the level of integration and involvement each has with branch operations, which depends primarily on the institution's audit objectives. Examples are used to highlight the range of application of these evaluation tools in microfinance institutions in Bangladesh, Egypt, Indonesia and Peru.

Audit Objectives

The primary objective of the internal audit is to determine the effectiveness of internal controls and the degree of compliance with policies and regulations. The internal audit includes a review of operations and in some microfinance institutions, an assessment of the MFI's progress toward institutional objectives. In these cases, the evaluator or auditor might make recommendations to improve efficiency by highlighting potential areas for cost reduction or improved earnings. For example, the review might uncover an innovation discovered at one branch that could be applied to improve the efficiency at other branches. Some MFIs go a step further and use audit findings to make improvements in customer satisfaction or to measure impact.

4.2.1 Management Spot Checks

Management spot checks are the daily reviews by supervisors of their subordinates' work.

Management spot checks are the daily reviews by supervisors of their subordinates' work. The use of management spot checks is the least costly method of evaluating the operations of a microfinance institution. Most MFIs require management to conduct some spot checks at the operational level. If spot checks are the only evaluation method used, however, the MFI should assure that they are thorough and that management has ample time to conduct them. The primary responsibility of regional managers at ASA in Bangladesh is to perform a *de facto* audit function by checking and backstopping the work of other ASA employees, as described in **Box 6**.

Box 6: Management's Role in Internal Control at ASA

The Association for Social Advancement (ASA), a Bangladeshi NGO started in 1978, is committed to empowering the landless and disadvantaged rural poor. ASA achieves this mission by lending to female villagers who pay their installments to ASA field officers in weekly group meetings. ASA is world renowned for its high level of efficiency and boasts an average cost per loan client of only \$7, according to MicroBanking Bulletin 1998 calculations.

ASA's efficiency results from its simplicity and standardization of systems and procedures. These features, combined with a commitment to transparency, simultaneously facilitate ASA's internal control. ASA's unit offices are small with only four field officers (combination savings and loan officers), one unit manager and one cook. There are no cashiers or bookkeepers at the unit offices; these duties are fulfilled by regularly rotating the field officers into these positions. ASA's reporting systems are simple and transparent. Each unit office has a blackboard where loan officers report daily on their anticipated and realized collections of loan payments, savings, life insurance and member fees. Once per month, the unit office reports a short list of key savings and loan performance indicators to the regional office, where the information is consolidated and sent to headquarters in a one-page format.

To evaluate its internal controls, ASA applies a system whereby management conducts spot checks at all layers of its hierarchy. Each of ASA's 16 division managers oversees the work of four to six regional managers, each of whom in turn oversees the work of 10 unit managers. Unit managers evaluate the work of the field officers by regularly visiting their groups and checking the members' accounts. The unit manager visits all groups every two to three months.

The regional manager has a desk in one of the unit offices, but his job takes him out of the office for the majority of his workday. The regional manager spends his time reviewing the work of approximately 10 units. The regional manager visits each unit unexpectedly with a checklist for monitoring the following four areas of operation: i) bookkeeping, ii) fund management, iii) group formation and accounts, and iv) staff quality.

Bookkeeping. ASA has a very simple manual bookkeeping system. During a visit to a unit, the regional manager checks the calculations of all the books and compares the totals to those in the unit's monthly report. The regional manager reviews the books in the order that field officers made the entries and ensures that the unit manager has calculated the totals correctly. He also verifies that the proper signature is next to each entry and total.

At the end of each day the field officers complete the daily collection sheets, reporting on all savings and loans collected by each individual in each group. The unit manager calculates the totals collected and the unit manager and field officer sign at the bottom of the sheets. The unit manager then transfers the totals from the daily collection sheets and records them in the cash book. The regional manager checks all these entries and verifies that the calculations are correct and are correctly recorded. Since the bookkeeping system is not automated, the regional manager uses a calculator to check manually for errors in summing or transferring totals.

The cash book also contains all office expenses. The regional manager will check that there are vouchers that correspond to each of the expenditures and that each expense item is also recorded in the proper ledger. The units file the vouchers by date of expense and keep them at the unit office.

(Continued on next page)

(**Box 6** continued)

Fund Management. The regional manager uses a step-by-step approach to check that the unit is properly managing its funds. He first counts the cash and checks it against the amount recorded in the cash book. Next, he reconciles the amounts recorded in the cash book as deposited in the bank against the bank statements. The regional manager then verifies that the amount held in cash at the unit adequately balances the unit's cash and security needs, and that the frequency of bank deposits is sufficient.

Group Formation and Accounts. The regional manager frequently goes into the field to meet with clients. ASA's clients receive individual loans but hold weekly meetings with the ASA field officer, and the regional manager times his visit according to the weekly meeting schedule but does not inform the unit which clients he will visit. He often stays after the field officer departs to discuss the accounts with the client members. Each client has a passbook in which all savings and loan transactions are recorded. The regional manager checks some of the passbooks against the unit's records.

Staff Quality. By reviewing the unit's operations, the regional manager assesses the quality of the staff's work. If problems or issues emerge, the regional manager attempts to isolate the cause: errors in the system can result from poor training, poor supervision, or a bad work ethic. The regional manager discusses the findings with the unit manager and makes suggestions for improvements. He then summarizes the findings and reports to headquarters. On his next visit, he checks to see if the unit has implemented the suggestions and whether improvements have been made.

In addition to the use of spot checks by management, ASA also employs 20 internal auditors who each audit 35 to 40 units once per year. These audits act as an additional check to the system, reducing the chance of widespread collusion within the operations. The use of internal auditors is covered in the next section.

4.2.2 Internal Auditors

Several of the leading microfinance institutions maintain at least one employee on staff for the sole purpose of conducting internal audits. Occasionally, small MFIs contract an external audit firm to fulfill the role of an internal audit function. Contracting out the internal audit function makes sense when the MFI does not yet have enough operations and employees to merit a full-time on-staff auditor. CGAP suggests that it is rarely cost-effective for an MFI to maintain an internal audit function in-house with fewer than 100 employees.²⁴ **Box 7** describes the use of an internal auditor at the Alexandria Business Association (ABA) in Egypt.

²⁴ *External Audits of Microfinance Institutions: A Handbook*, March 1999, p.12.

Box 7: ABA's Use of an Internal Auditor

The Alexandria Business Association (ABA) began its activities in 1983 as a committee of the Chamber of Commerce to provide support for the private sector, to promote the interests of business people and to provide networking opportunities in Alexandria, Egypt. In March 1989, ABA registered as a private non-profit organization.

ABA has one internal auditor who monitors the work of its 224 employees in 10 branches. The internal auditor works closely with the executive director, who selects the branch that the internal auditor visits each week. The primary purpose of ABA's auditor is to conduct an audit of the loan portfolio. Every week, the internal auditor requests a borrower status report from the MIS department and randomly selects three to five clients of each of the branch's loan officers. The internal auditor then visits each of these clients and completes ABA's standardized client visit questionnaire. The internal auditor visits additional borrowers if time permits or if he finds discrepancies.

While visiting the clients, the internal auditor accomplishes the following:

- verifies the existence of the business and its working operations;
- ensures that the borrower pays the loan installment at the bank branch;
- assesses the impact that this and previous loans have had on business operations;
- checks that the loan officer has made regular visits to the client; and
- obtains information from the borrower about the customer service received.

Upon returning to headquarters, the internal auditor reports to the executive director on his activities and summarizes the findings and recommendations. The executive director ensures that corrective actions are taken promptly.

The function of the internal auditor is to identify and prevent risk exposures in the MFI. The internal auditor or internal audit function requires a sufficient level of authority and administrative autonomy to execute its control activities. The responsibilities of the internal auditor include the following:

- Verify that the financial and operating information is accurate.
- Confirm that internal policies and external regulations are followed.
- Ensure that progress towards goals and objectives is satisfactory.
- Identify remaining uncontrolled risk exposures and bring them to management's attention.

Some MFIs, such as Mibanco, believe that it is also the responsibility of the internal auditor to identify areas for improved efficiency and to highlight the need for policy changes. These heightened expectations of internal auditors match Mibanco's more sophisticated hiring criteria.

Hiring an internal auditor

The skills required of an internal auditor vary across MFIs, but in general, the internal auditor is a highly competent employee who is familiar with the legal, regulatory, and operational aspects of the business. Mibanco prefers to hire only experienced auditors with financial service backgrounds. Mibanco's Chief Internal Auditor believes that experienced auditors can easily learn the business of microfinance but that not all microfinance employees can be good auditors. Mibanco looks for the following characteristics in an internal auditor:

- professional accountant;
- minimum five years in formal financial system;
- willingness to work with the poor and to go out to the market where microenterprise clients work; and
- a defined personality – does not change his or her mind easily, sees things more in black and white than gray.

BRI and ASA, on the other hand, believe that the best internal auditors are those who know the internal operations first hand. They hire internal auditors by promoting from within their existing body of employees. BRI annually recruits recent high school graduates for entry-level positions, such as a bookkeeper. Then, almost all promotions come from within the organization. Before being promoted to internal auditor, most BRI employees will have spent approximately three years in each of the following positions in this order: bookkeeper, teller, loan officer and unit manager. On the fastest track, an employee can become eligible for promotion to internal auditor after 12 years with BRI.

Training internal auditors

Regardless of their backgrounds, new internal auditors require some training to be able to perform the job. After BRI selects employees to promote from unit managers to internal auditors, they provide them job training related to their new position. Internal audit trainees receive special sessions on auditing and accounting, as well as on the policies and regulations to which BRI should comply. BRI's auditors receive one month of initial job training and one week of refresher training every year thereafter. For additional training, some MFIs send their auditors to external schools or enroll them in correspondence courses. In addition, microfinance institutions should consider training auditors on how to interact in a positive manner with employees and clients, especially if they come from a traditional internal audit background.

For MFIs with internal audit departments, most of the training is on-the-job, with new auditors learning from more senior audit staff. Internal audit manuals and quality audit checklists facilitate on-the-job training. In Uganda, Centenary Rural Development Bank (CERUDEB) promotes professional development of its auditors by allowing them access to an audit library and encouraging them to read trade magazines. CERUDEB's audit department holds in-house training meetings in which the audit manager assigns staff auditors to research and present on various topics. In addition, CERUDEB furthers the auditors' professional development through ties with professional associations, such as the Uganda Bankers Association and the Institute of Internal Auditors, which allows them to network with other audit

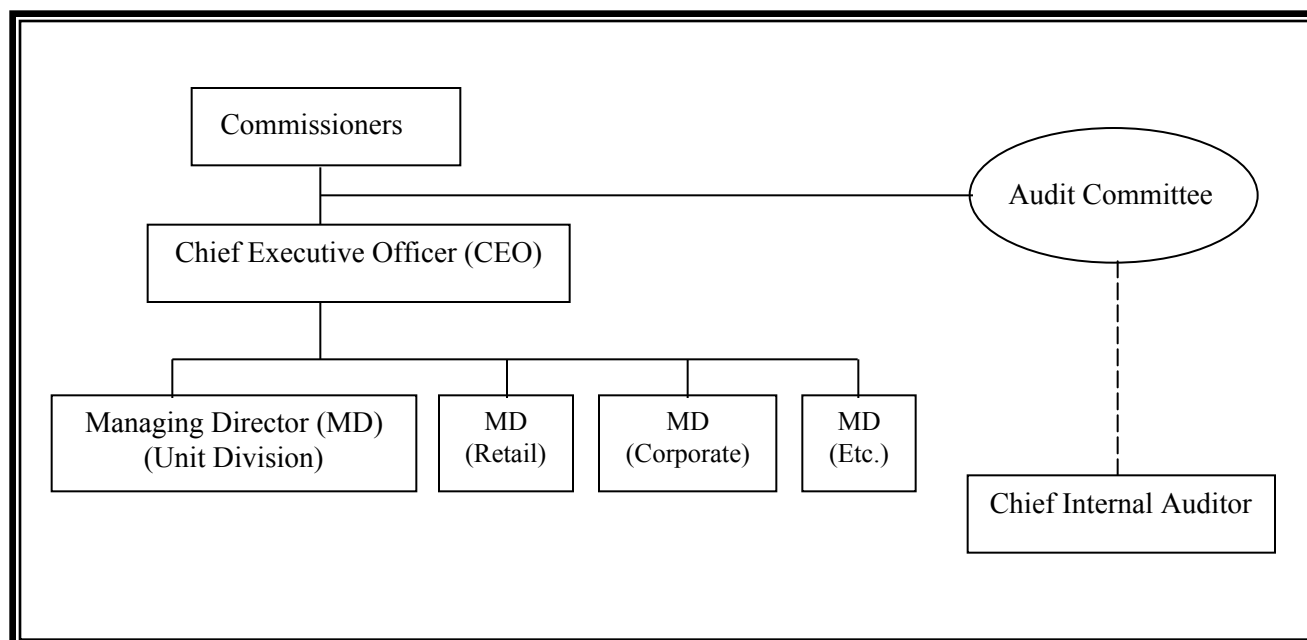
professionals. Due to rapid growth in 1998 and 1999, CERUDEB is in the process of strengthening its internal control system even further. In 2000, junior auditors will attend courses at the Uganda Institute of Bankers and senior auditors will attend classes at the Eastern and Southern Africa Management Institute. Furthermore, CERUDEB is currently in the process of revising its audit manual.

4.2.3 The Internal Audit Department

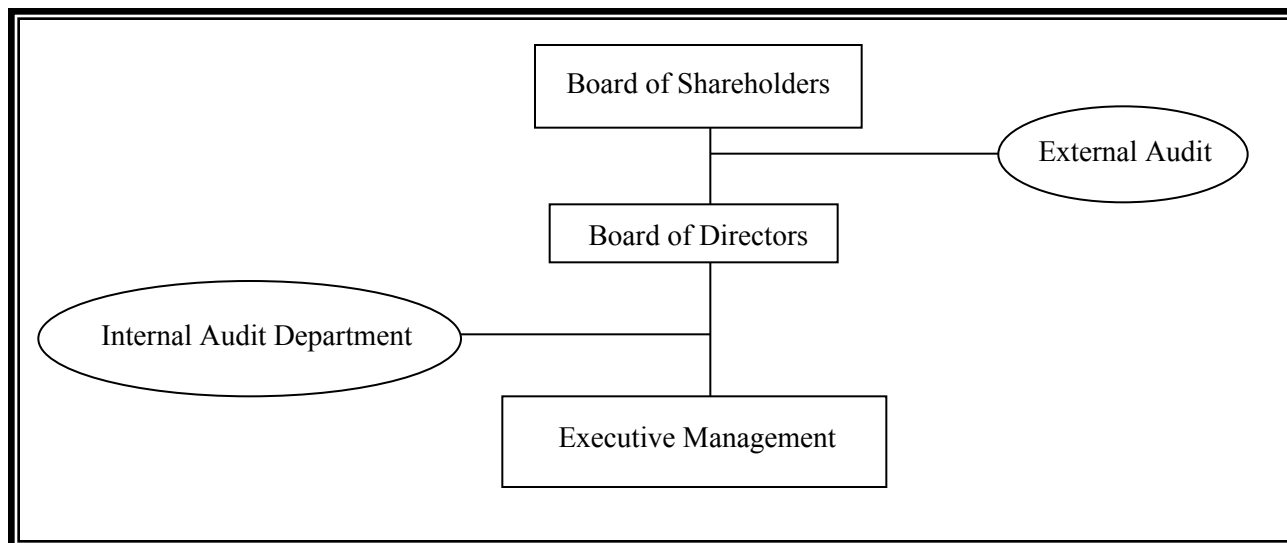
The internal audit department's responsibility is to evaluate internal controls independently, which requires that it have the authority to set the scope and choose the means of evaluation. To guarantee a sufficient level of independence to conduct an effective and objective evaluation of the MFI's operations, the internal audit function should answer directly to the board of directors. In an organizational chart, the internal audit department should link directly to the board of directors or the board's internal audit committee. While the internal audit function primarily reports to management on its daily activities, this place on the organizational chart reminds management of the internal audit department's autonomy. **Boxes 8** and **9** demonstrate how the internal audit function is represented in BRI and Mibanco respectively. These two organizational models are typical of other regulated financial institutions. The internal audit department usually reports at least quarterly to the board of directors or audit committee.

In an organizational chart, the internal audit department should link directly to the board of directors or the board's internal audit committee.

Box 8: BRI's Internal Audit Function in the Organizational Chart



Box 9: Internal and External Audit Represented in Mibanco’s Organizational Chart



Audit committee.

Some MFIs assign specific board members to an audit committee to oversee internal and external audits. The audit committee reviews internal and external audit reports and based on these findings, assesses the integrity of the financial statements and the adequacy of internal controls.²⁵ The audit committee reviews the procedures, reports and recommendations that are generated by the internal audit department and ensures that management takes corrective actions. In addition, the audit committee reviews the external audit and regulatory reports to assess the MFI’s overall control environment, and reports its findings and observations to the full board of directors.

Internal audit manager

The internal audit manager’s primary responsibility is to ensure that the MFI’s internal control system adequately evaluates the institution’s risk exposure in a cost-effective manner.

The internal audit manager, sometimes known as the chief internal auditor, is the head of the internal audit department and oversees the work of the other auditors on staff. The internal audit manager’s primary responsibility is to ensure that the MFI’s internal control system adequately evaluates the institution’s risk exposure in a cost-effective manner. The audit manager maintains open communication with management and the board of directors, tends to the professional development of the audit staff and ensures that all responsibilities of the internal audit department are fulfilled in a timely manner. The audit manager assures that audit work is properly planned and conducted, that reports meet audit standards and that audit evidence adequately supports the conclusions.

To be effective, the internal audit manager should be an experienced auditor, familiar with a variety of audit techniques, standards and computer systems. The audit manager should have excellent written and oral communication skills as well as managerial, organizational and analytical expertise.

²⁵ Campion and Frankiewicz, 1999, p.20.

Managing an internal audit department requires an independent thinker who is capable of forming sound conclusions and recommendations.²⁶ In addition to substantial experience, internal audit managers usually possess at least an undergraduate business or accounting degree.

The internal audit manager designates a senior auditor to plan and oversee the audit of each branch or unit. During a branch audit, the auditors report directly to the internal audit team leader, who compiles the findings daily and adjusts the audit scope as necessary. The audit team leader reviews key audit findings with the auditee (branch or unit manager) and submits the audit summary report to upper management and to the internal auditor manager.

Internal audit team leader

The ongoing cost of internal control varies from one microfinance institution to another. BRI spends approximately Rp. 44.7 billion (\$7.2 million) per year to evaluate its internal control system at the unit level, which represents 1.27 percent of its yearly expenditures.²⁷ Mibanco, on the other hand, estimates that it spends approximately \$128,000 per year on internal auditing, which represents approximately 3.8 percent of Mibanco's total operational costs. The amount required to maintain an effective internal control system depends in part on the scale, scope and regulatory status of the MFI, as well as on its audit objectives.

Cost of internal audit

The institution's audit objectives determine the specific role of the internal audit department and how it integrates with operations. BRI's internal audit function has a narrow focus, requiring internal auditors to simply identify areas in which employees are not adhering to pre-determined policies and procedures. Alternatively, the role of Mibanco's internal audit department role is more complex: it has the additional responsibilities of identifying potential policy changes that could lead to improved efficiencies or enhanced customer satisfaction. Mibanco's auditors not only inform management of problems identified during the internal audit process, but also make suggestions for improvements. For example, if the auditor notices that loan officers with mopeds effectively manage significantly larger portfolios than non-mobile loan officers, the audit report might suggest that management consider extending loans to loan officers for the purchase of mopeds. In addition, Mibanco's auditors treat client visits as a component of Mibanco's customer service orientation. By posing audit questions in a way that suggests that the auditors are concerned about the client's satisfaction with past products and services, clients are more likely to give honest and thorough responses. The auditors' ability to make suggestions for improvements to management further reinforces the internal audit department's link to customer satisfaction. **Boxes 10 and 11** describe BRI's and Mibanco's approach to internal audit respectively.

Role of the internal audit department

The institution's audit objectives determine the specific role of the internal audit department and how it integrates with operations.

²⁶ CERUDEB's *Internal Audit Manual*, 1994.

²⁷ September 1999 figures.

Box 10: BRI's Internal Audit Structure

Bank Rakyat Indonesia (BRI) is a century-old, state-owned bank whose traditional mission is to provide banking services to rural areas of Indonesia. BRI is Indonesia's largest bank, and its Unit Desa, or local banking system, is the leading provider of sustainable microfinance services in the world. As of December 1998, BRI's Unit Desa had a loan portfolio of over 2.4 million loans valued at \$585 million and 21.7 million savings clients with deposits in excess of \$2 billion.

BRI has a strong system of internal control for its microfinance lending operations, based on simple products, transparent and standardized systems and performance-linked incentives. The BRI units operate as small profit centers with no more than 11 employees in each unit. Employees are motivated by a strong incentive system that encourages individual accountability. The units use standardized procedures and a cash-based accounting system, and BRI's internal audit department reinforces its internal controls through regular evaluations of the system.

With over 3,700 unit offices, BRI's sheer size gives reason for its internal audit department and hierarchical structure. **Box 8** highlights BRI's organizational hierarchy in November 1999. In addition to the organizational levels listed in the table, BRI has 357 service posts that provide a limited range of customer services, but cannot accept or manage deposits.

The chief internal auditor heads BRI's internal audit department, which reports to the board's audit committee. BRI's audit committee reports to the full board and is responsible for overseeing BRI's relationship with the supervisory authorities. The chief internal auditor develops an annual plan to audit all units every 18 months, which the audit committee reviews and approves. Throughout the 18 months, teams of four to six auditors collectively audit the operations of each branch office, with two auditors from the team auditing each unit under the regional office's supervision. Each unit audit takes three to five days.

Of BRI's 35,000 employees, 496 work in the area of internal audit. The internal audit department has a written audit manual that documents policies and procedures for conducting an audit, as well as guidelines for reporting and filing. BRI's internal audit department conducts four different types of audits. BRI performs the following three audits as part of its regular audits:

- 1) compliance audit – verifies that BRI adheres to all applicable laws and regulations;
- 2) financial audit – ensures the accuracy of accounts and reports;
- 3) management audit – checks the degree to which employees follow policies and procedures correctly.

When necessary, BRI conducts a fourth type of audit:

- 4) special investigation for fraud or gross misconduct.

In addition to the work of the internal auditors, BRI has *peniliks* (internal controllers) who audit each unit for three or four days once per month. The *peniliks* report to the area manager and there is approximately one for every four units in BRI. Furthermore, unit managers spend 40 percent of their time in the field, meeting with microenterprise clients. Unit managers focus their efforts on visiting clients with large loans and loans in arrears to minimize the risk of unanticipated loss to the profit center.

Box 11: Mibanco's Customer-Oriented Internal Audit Approach

Mibanco takes a broader approach to internal control than BRI. In addition to ensuring the effectiveness of the internal control system to protect the MFI from unnecessary risk, Mibanco's internal inspection department also works to improve the efficiency and effectiveness of the MFI. This added task helps to assure that adequate and satisfactory attention is given to clients and that profits and impact are evaluated. Mibanco currently emphasizes these additional roles because it is a new MFI that is still in the process of developing its systems, products and procedures.

In May 1998, Mibanco became the first microfinance bank in Peru. In its transformation from an NGO to a regulated financial institution, the Peruvian Superintendency required Mibanco to develop operational manuals and add an internal inspections department to ensure that proper controls were in place to mitigate risk. The former NGO, *Acción Comunitaria del Perú* (ACP), retained one person who worked on internal control but who was not a professional auditor. In the first year of operations, Mibanco hired a chief internal auditor to set up an internal audit department and to supervise three employees, including ACP's former internal controller.

Mibanco has 266 employees working in 14 branches. At the end of December 1998, Mibanco had 33,858 clients, representing a loan portfolio of over \$12 million and savings deposits of over \$8 million. In its first year of operations from May to December 1998, Mibanco maintained a high-quality loan portfolio, with a portfolio at risk ratio of only 0.8 percent over 90 days past due and was profitable, with adjusted return on assets of 1.1 percent.

Mibanco's Internal Inspections Department comprises three divisions:

Internal Audit – The internal audit division is responsible for evaluating the internal control of the operating, administrative and financial entities of the bank.

Internal Control – The internal control division protects the assets of the bank against unnecessary expenses, fraud and inefficiency by ensuring adequate levels of securities and controls throughout the bank's operations.

Systems Audit – The systems audit division ensures proper control mechanisms exist within the computer and information systems so that systems function properly and without security breaches.

Mibanco's Chief Internal Auditor is responsible for supervising all control activities of these three divisions as required by regulatory authorities. Mibanco's Chief Internal Auditor treats his role as more proactive than the traditional role of internal audit manager, which has been to supervise, inspect and analyze irregular situations that arise from the result of flaws in the internal control system. Instead, the department plays an active role in the development of preventive measures that minimize risk without sacrificing operational efficiency.

Upon the implementation of the new internal inspections system, Mibanco conducted staff trainings to explain the importance of internal control and to reassure staff that the focus of the internal audits would be to identify areas for general improvement rather than to identify problems and place blame. When reporting to management, Mibanco's auditors do not identify perpetrators of problems unless they have committed fraud – they simply describe factual events and propose solutions.

(Continued on next page.)

(Box 11 continued.)

Based on traditional bank practices, the Peruvian Superintendency currently requires Mibanco to audit 100 percent of its clients each year. This is a great burden for an MFI with the majority of its portfolio made up of small short-term loans. In 1998, Mibanco's average loan balance was \$358, with most loan terms three to four months. Mibanco estimates that it spends approximately \$128,000 per year on internal auditing, which represents approximately 3.8 percent of Mibanco's total operational costs.

Mibanco's Chief Internal Auditor divides the work of the Internal Inspections Department by branches, with each auditor responsible for five branches. In addition to supervising the three internal auditors, the Chief Internal Auditor is responsible for two of the 20 branches. On average, Mibanco auditors spend 15 days per month working at the branches and meeting with clients and five days per month in the office writing reports.

When Mibanco's auditors go to meet the clients at their place of business, they treat the visit as a customer service visit. The auditor explains to the client that the purpose of the visit is to find out if the customer has received quality service and whether the current loan suits his or her situation and need. This approach puts the customer at ease and encourages open discussion about the business. The auditor asks the client a series of questions that are normally asked to make the loan decision. By seeing the business and asking questions, the auditor evaluates the inventory and assesses the general state of the business.

Each month, the Chief Internal Auditor summarizes the findings of the Internal Inspections' Department and makes recommendations to management. Out of the recommendations, management will usually implement 80 percent of the proposed changes immediately and conduct further analysis on the remaining 20 percent. The Chief Internal Auditor compiles the findings and management's responses and reports quarterly to the board of directors and the Superintendency.

In Bolivia, Caja Los Andes' internal audit department encompasses an even broader role, including monitoring client desertion and conducting market research. During client visits, internal auditors collect information on why clients fail to repay loans. For example, the audit of 11 clients who defaulted on loans in Santa Cruz revealed the following reasons for non-payment:

- Three clients moved away from the area.
- Two clients had become ill.
- Two clients' businesses failed and one client reported low sales.
- One client had lent the money to another person (a violation of the loan agreement) who had not repaid.
- No reason could be identified for two of the clients.

The internal auditors summarize findings and report them to the board and copies management, who uses the information to improve the loan product and lending methodology. In addition, Caja Los Andes' internal auditors often take advantage of the opportunity to meet with clients to conduct

market research. For example, during recent visits to active loan clients, the internal auditors conducted a survey to assess the clients' interest in housing loans and their ability to make payments.

Regardless of which evaluation tool the MFI chooses to use, it is important to remember that internal control and risk management are dynamic processes. The MFI should institutionalize the internal control process by using these tools on an ongoing basis. In evaluating the effectiveness of the internal control system, previously unidentified risks are often discovered. In these cases, management returns to the initial risk assessment step of the risk management process, and identifies and implements new internal control measures.

4.3 Responding to Control Issues

While conducting an audit, internal auditors seek and inevitably identify control issues, including violations of risk controls and remaining risk exposures. Other employees or management may also identify control issues in the course of conducting normal operations. Regardless of how a risk is exposed, management must act quickly to learn the nature and extent of the uncontrolled risk and to mitigate its potential for negative impact. If the MFI has an internal auditor or internal audit department, management employs these resources to conduct a special investigation, as described earlier in this chapter. However, it is management's responsibility to implement additional controls needed to protect against these risk exposures in the future.

Control violations are incidents in which clients or employees do not adhere to the MFI's policies and procedures. Clearly written and communicated policies and procedures assist management in responding to cases of control violations. MFIs should sanction or penalize employees who intentionally violate known policies and procedures, linking the severity of the penalty to the offense. To prevent control violations, some MFIs warn employees of the consequences of their actions by citing sanctions and penalties for each type of violation. For warnings to be effective, MFIs must be willing to impose sanctions on their employees and fire employees found guilty of fraud. However, MFIs should consider the use of positive reinforcement (carrots) as well as the threat of negative consequences (sticks) to encourage good behavior. For example, management could reward employees who identify potential problems early. Management should be careful in developing its reward and punishment mechanisms so as to ensure a supportive internal atmosphere or culture. **Box 12** describes BRI's approach to handling control violations.

Responding to control violations

MFIs should sanction or penalize employees who intentionally violate known policies and procedures, linking the severity of the penalty to the offense.

Box 12: BRI's Handling of Control Violations

BRI offers its employees a combination of carrots and sticks to encourage appropriate behavior. The bank offers its employees profit-based incentives and reinforces correct action by giving each employee a list of the 13 most common infractions committed by employees and the associated financial and disciplinary sanctions, which it applies uniformly to all employees. For example, BRI has a strict policy that forbids employees from collecting loan payments from clients unless two employees are present and the client has given written permission. BRI fires employees for violating this policy, even if the loan officer collects the loan payment and repays the full amount to BRI. BRI believes that its list of sanctions becomes more effective in preventing control issues with each employee violation.

If there are many control violations, the institution should evaluate the reasons employees are not following a particular policy or procedure.

Microfinance institutions should be careful, however, to ensure that controls make sense at the operational level. If there are many control violations, the institution should evaluate the reasons employees are not following a particular policy or procedure. It could be that employees do not understand the policy or procedure or that it was not well communicated to them. In these cases, the MFI should assume responsibility for the oversight and make efforts to clarify or better communicate expectations to employees. Another reason many employees may not follow a policy or procedure may be because of the impact the measure has on clients. For example, the microfinance institution may require borrowers to sign a loan agreement. Loan officers might issue loans to illiterate borrowers without a signed contract. Upon discovering a logical exception to a policy or procedure, such as this, the microfinance institution can make adjustments or allow the exception in the future. In this case, the MFI might suggest that illiterate borrowers have a trusted third party read them the terms of the agreement and accept an ink thumbprint in lieu of a signature.

Controlling uncontrolled risks

Occasionally MFIs discover new or previously uncontrolled risks that merit risk assessment and require new policies, procedures or controls to prevent future loss. MFIs are more likely to uncover uncontrolled risks after implementing a new product or system. Sometimes MFIs discover these risks after an incident of fraud or financial loss. Other times, insightful employees identify uncontrolled risk exposures. In either case, operational staff should bring these risks to the attention of senior management, which initiates the next cycle of the risk management feedback loop. Management assesses the risk and consults with operational staff in the area needing control to ensure that new controls effectively mitigate the risk exposure without placing undue cost or burden on the branch. New internal controls can include additional training to branch personnel or the implementation of a new policy or procedure. **Box 13** provides an example of procedural and policy changes that resulted from a microfinance NGO's identification of uncontrolled fraud risks.

Box 13: Procedural and Policy Changes to Reduce Fraud in Mali

An internal assessment of a microfinance NGO in Mali that uses a group lending methodology identified several discrepancies between the amount of funds that groups said they had deposited in the bank and the amount reported in their accounts. Further investigation indicated that the individuals who transported the funds from the village to the bank were pocketing some of the funds. To reduce the risk of financial loss to the groups, the NGO implemented new procedures requiring the transporter of the funds to record the amount of funds taken twice; first, in a register in the village prior to departure and second, by collecting a receipt from the bank where the funds were deposited. For illiterate individuals, the NGO now requires the group member who transports the funds to provide an oral report to the village authorities. In addition, the NGO added an additional policy in which it now requires the transporter of the funds to be a group member, which averted the problem of women's groups turning their funds over to the care of the men in the village.

In the process of evaluating the internal control system, the MFI identifies previously uncontrolled risks. The results of the internal control evaluation provide the circular link from the last stage of the risk management feedback loop back to the first stage, from evaluation to risk identification and assessment. Management starts a new cycle by reviewing the findings and recommendations of the internal control evaluation and responding to control issues. The risk management loop continues its second cycle when management oversees the implementation of new internal controls and ensures that they are evaluated in the next internal audit. However, the next internal control evaluation will not focus solely on the new internal controls but will incorporate management's review in the evaluation of all internal controls in future assessments.

5. CONCLUSIONS AND RECOMMENDATIONS

As more microfinance institutions grow and become formal financial institutions, the need for internal control systems increases. While each MFI has a unique risk profile and operational structure that determine which types of controls are appropriate, this chapter presents general conclusions and recommendations that apply to the microfinance industry as a whole.

5.1 Conclusions

The research that led to the development of this guide uncovered the following key findings that are applicable to the microfinance industry:

MFIs should link internal control to risk management. In the past, organizations viewed internal control as an add-on component, separate from operations, and often confused it with internal audit. Management viewed internal control as a tool for detecting errors and uncovering fraud after the fact, rather than as a tool to anticipate possible problems and proactively prevent financial loss. The risk management framework presents a new approach to internal control that is superior because it is integrated into all levels of the MFI. The risk management feedback loop involves the board and senior management in the risk identification and assessment process, as well as the creation of sound operational policies, procedures and systems. Next, internal control mechanisms test and evaluate the MFI's ability to mitigate risk. Implementation and redesign of the policies, procedures and systems integrate line staff into the internal control process, thus providing feedback on the MFI's ability to manage risk without causing operational difficulties or customer service problems. The board and senior management receive the results of the evaluation and respond accordingly, thereby continuing the ongoing risk assessment and control implementation process.

MFIs lack information on fraud. The risk management approach to internal control is holistic in that it addresses all the major risks faced by an MFI, such as credit, liquidity, interest rate, transaction and fraud risks. The microfinance industry has been highly effective in developing and documenting best practice materials geared toward the reduction of credit risk and the management of a microfinance institution. Joanna Ledgerwood's, *Microfinance Handbook: An Institutional and Financial Perspective*, and Robert Christen's *Banking Services for the Poor: Managing for Financial Success*, are particularly noted for their guiding principles of successful management for MFIs. These and other publications effectively address how to mitigate credit risk, as well as the principles of sound liquidity management and appropriate interest rate setting. Many MFIs have used these tools to build upon their own knowledge and experiences and have

The internal audit evaluates an MFI's internal control system, which is composed of policies and procedures designed to manage risk.

Although there are many microfinance best practice materials that address the management of credit, liquidity, and other risks, little has been written on fraud prevention.

developed successful microfinance strategies.²⁸ However, current best practice information lacks information on how to reduce the risk of fraud in a microfinance institution. Managing directors of MFIs have been reluctant to discuss the occurrence of fraud in their MFIs and therefore, little has been written on fraud prevention to date.

The lack of discussion of fraud has prevented MFIs from developing internal control mechanisms effective in mitigating fraud risk.

In general, MFIs have limited controls to protect against fraud. The lack of discussion on fraud in MFIs has downplayed the importance of fraud and has kept MFIs from developing internal control systems that are effective in controlling fraud risk. In addition, some people believe that the benevolent nature of those involved in providing microfinance, a social good, exempts MFIs from being exposed to fraud. Unfortunately, experience increasingly shows that this is not the case. Since fraud can occur at every level of operation, the risk of fraud increases as MFIs expand and become more decentralized. Managing directors and board members need to accept the reality of fraud and proactively address it within their institutions.

Microfinance must learn more about mitigating risks associated with mobilizing savings.

The industry needs to learn more about controls for savings operations. This publication presents many of the internal controls currently used by MFIs to reduce risk. However, the majority of MFIs today remain lending-only institutions. Once there are more MFIs that mobilize savings, their experiences will present more lessons on how to mitigate the risks associated with mobilizing and managing client savings. In addition, the microfinance industry should make efforts to draw lessons from credit unions, which have a long history of mobilizing small saving deposits. While credit unions are unique in that they are member-driven, they undoubtedly have learned lessons on risk management and internal control that would be relevant to other types of MFIs.

Regulated MFIs should view supervisory examinations and regulatory reports as the last source of risk identification and suggestions for improved controls.

5.2 Recommendations

The following recommendations highlight the role that MFIs, technical assistance agencies, donors, practitioner networks and regulators can play to improve the internal control of microfinance institutions in the future. The order of discussion of these roles reflects the relative involvement of the various stakeholders in the development of effective internal controls and their ability to detect control issues in a timely manner. Regulators play the smallest role in an MFI's internal control system. Since they traditionally examine institutions only once per year, the depth of their assessment of internal operations is limited. Therefore, regulated MFIs should view supervisory examinations and regulatory reports as the last source of risk identification and suggestions for improved controls.

MFI experiences. MFIs need to be more willing to discuss fraud, to learn from their experiences and to learn from the experiences of other MFIs. The entire field of microfinance will benefit as more MFIs implement improved internal controls and share their experiences. For example, the growth in individual lending practices in MFIs demonstrates the industry's ability to

²⁸ The *Bibliography and Suggested Reading* section at the end of this document provides a list of additional reading materials related to internal control.

find and share innovative methods to mitigate risks. In addition, the microfinance industry will attract more private investors only once MFIs demonstrate their ability to effectively mitigate all significant risk exposures. The following are specific recommendations for MFIs to improve their internal control systems:

Institutionalize a risk management process. Management of microfinance institutions has often treated internal control and internal audits as peripheral to operations, focusing only on their ability to uncover past mistakes and wrongdoing. The risk management approach suggests a more integrated approach to internal control, placing a greater emphasis on its ability to proactively prevent loss and encourage efficiency. To be effective, MFIs must institutionalize the concepts of risk management into their organizational culture and environment. The board and management should play an active role in overcoming negative perceptions of internal control and internal audit by emphasizing to employees the positive results that can be achieved from their effective application. By developing control mechanisms that act as incentives rather than disincentives, management can create a positive control environment in which all employees have a stake in improving the internal control system. The use of performance-based incentives, profit centers, and a culture that focuses on solving problems rather than on placing blame are all measures that can reinforce a positive control environment and help to overcome past negative attitudes toward internal control.

Internal control should be integrated into operations using a risk management approach.

Ensure active board involvement in internal control. Those MFIs that do address internal control often delegate this responsibility to management. For example, many MFIs have their internal audit department report solely to upper management, rather than directly to the board. Without a sufficient level of independence, internal auditors cannot conduct an objective review of the entire MFI's operations. If the internal audit department answers only to management, MFI boards may not receive a thorough assessment of internal controls beyond the branch level of operations, or they may receive information that is tailored to management's agenda. Nonetheless, not all internal audit departments have the professional expertise to report directly to the board and may require senior management to consolidate reports and present findings to the board. But for the internal control process to be effective, board members should play an active role in reviewing internal control reports and ensuring proper and timely management response to control issues.

The active participation of board members increases the effectiveness of internal audits.

Incorporate client visits into the evaluation process. In verifying the effectiveness of internal controls, all MFIs should incorporate client visits into the evaluation process. While traditional audits can effectively uncover many errors in the system, they often fail to detect fraud. By visiting the clients personally, the MFI can ensure that the records on the books reflect reality and reduce the incidents and impact of fraud, thereby protecting the MFI's reputation and financial well-being. The greater the percentage of clients the MFI visits, the less risk it will have of financial loss as a result of phantom loans, kickbacks or collusion. Ideally, MFIs should have someone other than the loan officer visit most of their clients at least once per year.

Client visits are an essential dimension of internal audits.

MFI's can benefit from outside experts to help them set up and improve their internal control systems.

Technical assistance. MFIs can benefit from outside experts to help them set up and make improvements to their internal control systems. It is often easier for an impartial third party to identify shortcomings in the internal control system than for operational staff to objectively evaluate its effectiveness. For this reason, BRI and other MFIs have contracted professional audit firms to conduct an initial assessment of the internal control system and to develop internal audit standards. An internal control assessment should determine the appropriate ongoing controls and checks to the system to be conducted by the MFI's operational or audit staff in the future.

Donors should require MFIs to have some type of internal control mechanism, appropriate to the MFI's level of development.

Donor role. Donors should require MFIs to have some type of internal control mechanism, appropriate to the MFI's level of development as discussed in Chapter 4. Donors should encourage MFIs to develop an operations manual and to conduct client visits as part of its regular operations. Donors can facilitate the development of internal control mechanisms by providing funds for the initial risk assessment and implementation of internal controls but should avoid developing dependencies for ongoing operational support. For example, donors could provide support for the initial development of operational control manuals contingent upon the MFI's commitment to adding to and updating the manuals in the future. In addition, donors can support microfinance NGOs in their efforts to test new ways to mitigate old risks through new products, such as microinsurance, or operational control tools, such as internal audit software. Furthermore, donors should discourage MFIs from relying too heavily on donor audits to identify control issues since these, like other external audits, usually are conducted infrequently and lack the depth of a thorough internal audit.

Networks can facilitate practitioner agreement on standards or principles of effective internal control and advocate for their implementation.

Practitioner networks. Microfinance practitioner networks can promote and encourage increased discussion on how to improve internal control. Networks can facilitate practitioner agreement on standards or principles of effective internal control and advocate for their implementation in MFIs throughout their area of influence, i.e. country or region of operation. Networks can oversee the implementation of improved internal controls and possibly develop a certification process, whereby MFIs would be recognized for quality risk management. These types of standards, principles, and certifications would be especially useful in building savers' and investors' confidence in countries in which the regulatory authorities do not have a good reputation for effective oversight.

It is reasonable for regulators to require that MFIs have at least one dedicated internal auditor or risk manager to oversee the effectiveness of the internal control system.

Regulatory requirements. Regulators should become familiar with microfinance and possibly adjust their requirements to suit the nature of microfinance operations. It is reasonable for regulators to require that MFIs have at least one dedicated internal auditor or risk manager to oversee the effectiveness of the internal control system. However, requiring an audit of all loan clients each year is a much greater burden for a microfinance institution than a traditional financial institution, since a microfinance portfolio is made up of many small short-term loans. Regulators should provide clear guidance on how to fulfill internal control requirements for a newly licensed microfinance institution and allow a reasonable amount of time for the MFI to implement these changes. In addition, regulators should

compile and use historical data and other tools to assess the soundness of microfinance institutions.

The ultimate tests of the effectiveness of an MFI's internal control systems will be time and investor interest. Unfortunately, some MFIs will suffer serious losses before discovering the weaknesses inherent in their internal control systems. MFIs that become complacent, assuming that what works well today will work well tomorrow, will be at the greatest risk of unforeseeable financial loss. MFIs that proactively apply the principles of risk management and implement an effective feedback loop will be able to uncover and address risk exposures and succeed the test of time. MFIs that prove their ability to manage and mitigate risk will be more likely to demonstrate consistent profits, the primary objective of private investors. In addition, MFIs that implement effective internal control systems that aid in the risk management process will be most effective in fulfilling the social mission to provide financial services to low income sectors over the long-term. Furthermore, MFIs that mobilize client savings can apply risk management strategies to ensure adequate protection of client assets, the primary concern of financial regulators. The lack of effective internal controls is one of the remaining impediments to the development of a sustainable microfinance industry; MFIs, technical assistance providers, donors, practitioner networks and regulators all have a role in overcoming this obstacle.

MFIs that prove their ability to manage and mitigate risk will be more likely to demonstrate consistent profits, the primary objective of private investors. In addition, MFIs that implement effective internal control systems that aid in the risk management process will be most effective in fulfilling the social mission to provide financial services to low-income sectors over the long-term.

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