



THE CONSULTATIVE GROUP TO ASSIST THE POOREST  
[A MICROFINANCE PROGRAM]

# External Audits of Microfinance Institutions

*A Handbook*

Volume 1

For Audit Clients:  
Boards, Managers, Donors, Creditors, and Investors

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# Contents

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Foreword vii

Acknowledgments viii

Acronyms and Abbreviations ix

## **Chapter 1 Introduction 1**

1.1 Audiences and uses for this handbook 3

1.2 Limitations of this handbook 4

1.3 An important caution 4

## **Chapter 2 Understanding Audits 5**

2.1 Why are external audits needed? 5

2.2 External audit services 5

2.2.1 Financial statement audits 6

2.2.2 Special purpose audits 8

2.2.3 Agreed-upon procedures 9

2.2.4 Reviews 9

2.2.5 Compilations 9

2.2.6 How do audits differ from examinations? 9

## **Chapter 3 Internal Audit and Fraud Control 11**

3.1 What is internal audit, and who should perform it? 11

3.2 Fraud issues 13

## **Chapter 4 Commissioning the Audit 17**

4.1 Donor requirements and the “single-audit” approach 17

4.2 Role of an MFI’s board of directors and audit committee 19

4.3 Determining the scope of work for an external audit and related services 19

4.3.1 Annual audit of financial statements 20

4.3.2 Management letter 23

4.3.3 Special purpose audits 24

4.3.4 Agreed-upon procedures 24

4.4 Preparing the terms of reference 26

4.4.1 Introduction 26

4.4.2 Description of the MFI and its organizational structure 26

4.4.3 Prior year audits 27

4.4.4 Objective of the audit 27

4.4.5	Scope of the audit	27
4.4.6	Audit report and financial statements	27
4.4.7	Management letter	27
4.4.8	Agreed-upon procedures	27
4.4.9	General issues	27
4.4.10	Timing of the audit	28
4.4.11	Pre-proposal survey	28
4.4.12	Proposal format	28
4.4.13	Cost proposal	28
4.4.14	Submission of proposals	28
4.4.15	Oral presentation	28
4.5	Deciding whether to use competitive bidding	28
4.6	The pre-proposal survey	29
4.7	General observations on selecting the auditor	30
4.8	Evaluation of proposals	31
4.8.1	Understanding of the engagement	31
4.8.2	Audit approach	31
4.8.3	Audit team	32
4.8.4	General experience of the firm	33
4.8.5	Cost proposal	34
4.8.6	Proposal scoring	34
4.9	Contract or engagement letter	34

## **Chapter 5 Loan Portfolio Issues 35**

5.1	General portfolio review issues	35
5.1.1	Characteristics of microfinance lending	36
5.1.2	How extensive should the portfolio review be?	36
5.1.3	An overview of systems	39
5.2	Specific portfolio review areas	40
5.2.1	Accuracy of loan tracking management information systems	41
5.2.2	Security and effectiveness of portfolio-related management information systems	42
5.2.3	Significance of reconciliation items	42
5.2.4	Misrepresentation of loan payoff	43
5.2.5	Rescheduling	45
5.2.6	Interest income issues: yield gap and interest accrual policy	46
5.2.7	Consistent implementation of the loan administration system	47
5.2.8	Portfolio-related fraud controls	48
5.2.9	Adequacy of loan tracking information	48
5.2.10	Loan write-offs	50
5.2.11	Loan loss provisions	51
5.2.12	Other portfolio-related business risks	53
5.3	Defining audit procedures for the loan portfolio	54

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<b>Chapter 6 Conducting the Audit: A Brief Overview</b>	<b>57</b>
6.1 The auditor's activities	57
6.1.1 Preparation and planning	57
6.1.2 Obtaining audit evidence	58
6.1.3 Reporting	59
6.2 The client's responsibilities	59
6.3 Timing of the audit	60
<b>Chapter 7 Understanding Audit Reports</b>	<b>61</b>
7.1 The audit report	61
7.1.1 Unqualified opinion	62
7.1.2 Unqualified opinion with an emphasis of matter	63
7.1.3 Qualified opinion	64
7.1.4 Disclaimer of opinion	64
7.1.5 Adverse opinion	65
7.2 The management letter	66
7.3 Reports of agreed-upon procedures	67
<b>Boxes</b>	
2.1 Accounting standards and auditing standards	7
7.1 Example of an auditor's report expressing an unqualified opinion	62
7.2 Example of an emphasis of matter paragraph	63
7.3 Example of an emphasis of matter paragraph relating to a going concern	63
7.4 Example of a qualified opinion due to a limitation on scope	64
7.5 Example of a qualified opinion due to a disagreement on accounting policies (inappropriate accounting method)	64
7.6 Example of a disclaimer of opinion due to a limitation on scope	65
7.7 Example of an adverse opinion due to a disagreement on accounting policies (inadequate disclosure)	65
<b>Tables</b>	
3.1 Differences between internal and external auditors	12
4.1 Common external audit services for a microfinance institution	20
5.1 An illustrative loan aging schedule and corresponding loss provisions	52



# Foreword

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Microfinance is the provision of banking services for the poor. Over the past 20 years the field has been revolutionized as dozens of microfinance institutions (MFIs) have demonstrated the feasibility of delivering such services on a financially sustainable basis. Having developed services that can be run profitably with commercial sources of funds, these institutions are positioned to expand their outreach to the poor far beyond the limits of scarce donor and government funding. In this context, many MFIs are devoting increased attention to financial management and financial reporting.

The Consultative Group to Assist the Poorest (CGAP) is a multidonor consortium dedicated to the advance of sustainable microfinance worldwide. We believe that external audits can be an important tool for improving the quality and credibility of MFIs' financial reporting and management. At the same time, we have observed that MFIs, donors, and auditors often invest major effort and expense in audits without getting an appropriate return in terms of the transparency and reliability of the audited information. Audits often do a reasonable job of tracking the uses of donor funds, but far less often produce a meaningful picture of the health of an MFI's financial service business.

CGAP has produced this handbook to help audit customers—meaning the boards of directors and managers of MFIs, donors, creditors, and investors—contract for audits that are more responsive to their needs, and to help audit firms deal with some of the unique issues presented by microfinance operations. Microfinance differs in crucial respects from commercial banking and other businesses with which auditors are more familiar.

Because this handbook is breaking new ground, we are sure that experience with its use will suggest many areas for improvement. Thus we are anxious to hear from the staff of audit firms, MFIs, and donors who have put it to the test of practical use. These busy people may not find it easy to free up time to offer comments about their experience with this handbook. Still, we know that many of them share our belief in the immense human worth of microfinance efforts, and hope that they will be motivated to help improve this tool in subsequent editions.

Please communicate any comments and suggestions to Richard Rosenberg ([rosenberg@worldbank.org](mailto:rosenberg@worldbank.org)) or Jennifer Isern ([jiser@worldbank.org](mailto:jiser@worldbank.org)). CGAP's telephone number is +1 202-473-9594, its fax number is +1 202-522-3744, and its mailing address is World Bank, Room Q 4-023, 1818 H Street NW, Washington, D.C. 20433, USA.

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# Acronyms and Abbreviations

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CGAP	Consultative Group to Assist the Poorest
GAAP	generally accepted accounting principles
IAS	International Accounting Standards
ISA	International Standards on Auditing
MFI	microfinance institution
MIS	management information system
NGO	nongovernmental organization



# Introduction

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*This brief chapter discusses the need for this handbook, offers suggestions for its use, and underscores its limitations.*

Microfinance—the provision of banking services for the poor—has been a growth industry for the past 20 years. In 1997 an estimated 7,000 microfinance institutions (MFIs) around the world were offering tiny loans to microenterprises, deposit services tailored to the needs of poor households, and other financial services such as transfers. To date most of these institutions have been nonprofit, nongovernmental organizations (NGOs). But many credit unions, especially in Africa, are offering microfinance services, and a few licensed finance companies and commercial banks are beginning to enter the market.

At present most microfinance is funded by donors and governments. But stronger MFIs are realizing that the demand for their services far outstrips the limited supply of donor and government funds. At the same time, they have shown that they can provide microfinance on a financially sustainable basis: customers find MFIs so valuable that they are willing to pay the full cost of their services. When an MFI becomes financially sustainable, it can begin funding its loans with deposits and other commercial sources of capital. In doing so it escapes the limitations inherent in donor funding, while providing a safe and convenient savings service to its customers.

In this context, boards of directors and managers of MFIs, as well as the donors that fund them, are focusing more closely on MFIs' financial reports. External audits have traditionally been the principal means of assuring the accuracy and meaningfulness of those reports. But experience has shown that external audits often fail to produce an adequate review of an MFI's financial position and internal controls—especially when it comes to information on its loan portfolio. There are three main reasons external audits often fall short:

- Customers requesting external audits—boards, managers, and donors—often do not understand what audits can and cannot be expected to do. Nor do they understand what special procedures, beyond the scope of a normal statutory

*External audits often fail to produce an adequate review of an MFI's financial position—especially its loan portfolio*

*Typical financial statement audit procedures are not well-suited to detecting some common deficiencies of microfinance portfolios*

audit, may be needed to address certain issues, or how to craft terms of reference that communicate their needs to the auditor.

- Donors often provide terms of reference for external audits, but these usually focus on compliance with the donors' loan or grant agreements and on tracking the specific uses of the donors' funds, rather than on the financial health of the audited institution's microfinance business.
- Few external auditors have much experience with microfinance. Thus they seldom understand the unique features of the microfinance business, which call for different audit procedures than those used in conventional financial businesses.

A further problem with audits of MFIs is that they often absorb too much time of auditors and MFI staff with issues that are not especially material to the main risks inherent in the microfinance business. Audit firms tend to assign junior staff to MFI audits, and these staff often focus on checking compliance with detailed lists of accounting and operational prescriptions—not all of which are highly relevant to the basic soundness of the MFI's financial reporting or the security and efficiency of its operations. For this reason, this handbook emphasizes a “risk-based” audit approach: the external auditor must evaluate the relative importance of various areas of risk and focus most of the audit work on those areas that are most material to the business being audited. For example, voluminous loan documentation and multilevel approval procedures are standard in normal commercial banking but may be utterly impractical in a microcredit setting. Discriminating between important and less important issues requires an exercise of judgment that is possible only if the auditor understands the MFI's business. Most auditors will have to devote considerable time to learning this business, but this effort should be amply rewarded by saving time that would otherwise be devoted to elaborate testing of items that are in fact less material.

Reference was made above to “unique features” of the microfinance business. Most of these features have to do with an MFI's loan portfolio. And it is precisely the loan portfolio that is the most common source of serious problems that escape disclosure, or even management's attention—sometimes until it is too late to deal with them. Typical financial statement audit procedures are not well-suited to detecting some common deficiencies of microfinance portfolios. Thus the chapters in each volume dealing with procedures for reviewing loan portfolio systems are among the most important parts of this handbook. Those chapters, more than the rest of the handbook, contain material that is unlikely to be found elsewhere. Auditors and audit customers should review them especially closely.

Readers will note that the handbook devotes much more attention to MFIs' loan operations than to their savings operations. This certainly does not reflect a view that credit is more important than deposit services for poor clients. If anything, the opposite is often true. Many MFIs want to become licensed financial institutions, not only to gain access to commercial funding but also to provide

savings services to their target clients. Savings services receive only brief treatment here, however, because few MFIs are licensed to take savings and because audits of MFIs' savings operations, unlike audits of their credit operations, can be quite similar to audits of commercial banks.

Another key element of this handbook is annex A, which offers guidelines for the content and presentation of MFIs' financial statements. If these guidelines are followed, readers of audited financial statements will be much better able to judge whether an MFI has a business that can grow beyond the limited availability of subsidized donor funding.

*The handbook is divided into two volumes, for two distinct audiences*

## 1.1 Audiences and uses for this handbook

The handbook is divided into two volumes, for two distinct audiences. Volume 1 is primarily for clients of external audits—including boards, managers, and staff of MFIs, as well as outside investors, especially donors. Topics covered in volume 1 include:

- What to expect—and what not to expect—from external audits
- The relationship between internal and external audit functions
- The different products that external auditors can be asked for, including special purpose audits and agreed-upon procedures
- How to commission an audit, including writing terms of reference and selecting the auditor
- Special issues associated with MFIs' loan portfolios
- How audits are conducted
- How audit reports should be interpreted.

Volume 2 is for external auditors. It provides an overview of the microfinance industry—general concepts that must be supplemented by a thorough education in the business and methodology of the MFI being audited. Volume 2 also provides guidance on a range of audit issues that are specific to MFIs. External auditors would probably find it worthwhile to review volume 1 as well, because it contains material not repeated in volume 2.

Both volumes may be of interest to government regulators and supervisors. As the microfinance industry grows, banking authorities in many countries are being forced to confront the issue of supervising MFIs. Experience has made it clear that efficient supervision of MFIs requires some adjustment in the regulations and examination procedures applied to more conventional financial intermediaries. This handbook is not an examination manual, but its contents might be useful in the preparation of such a manual. In any event, supervisors responsible for overseeing MFIs may wish to refer them and their auditors to this handbook.

A set of annexes illustrates material in both volumes.

## 1.2 Limitations of this handbook

This handbook is not an accounting manual. It provides little guidance on accounting systems or internal controls. MFIs should have their own accounting procedures, manuals, and internal controls in place before commissioning an external audit.

Nor is this handbook an audit manual. It should be used only to supplement authoritative audit standards and the audit firm's internal policies, in the context of the laws and regulations applicable to the entity being reviewed.

Even though the handbook is not an authoritative audit manual, an MFI commissioning an audit may wish to use it in its contracting process. Before contracting an audit, the client might well ask the auditor to review the handbook, and to note in writing and discuss with the client, any major elements of the handbook's guidance that the auditor does not believe should be implemented due to issues of practicality, cost, or conflicting authoritative guidance.

## 1.3 An important caution

This volume has been prepared for clients who want an audit to provide meaningful assurance about the reliability of an MFI's financial information. At the same time, the authors recognize that in the real world, there are many cases where the clients—both MFIs and their funders—want something different from an audit: they want a clean opinion, as quickly and painlessly as possible. This kind of attitude may spring from a pessimistic view of the usefulness of audits. Given past experience with MFI audits, it is not easy to dismiss such pessimism as groundless.

Following the suggestions provided here will probably increase the cost and difficulty of most MFI audits. Thus a donor agency ought to think carefully before it imposes compliance with this handbook as a blanket requirement for all the MFIs it funds. The added cost and trouble of a meaningful audit are justified only in cases in which the MFI and the donor are likely to deal constructively with the issues that a meaningful audit will probably raise.

# Understanding Audits

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*This chapter provides an overview of external audit services. Most of the topics touched on here will be treated in more depth in subsequent chapters. This chapter covers:*

- *The purpose of an external audit*
- *Financial statement audits*
- *Other types of audits and related services*
- *The difference between audits and examinations by financial authorities.*

## 2.1 Why are external audits needed?

Like any other organization, an MFI has to account for its funds and activities. It establishes accounting systems and controls, and produces financial statements that reflect the nature and results of its operations.

An MFI's management and staff provide financial information to other stakeholders, including board members and outside investors such as shareholders or donors. All these stakeholders need some independent confirmation of the validity of this information and the systems that produce it. They often look to external auditors for such confirmation.

*An external audit is a formal, independent review of an entity's financial statements, records, transactions, and operations*

## 2.2 External audit services

An *external audit* is a formal, independent review of an entity's financial statements, records, transactions, and operations, performed by professional accountants to lend credibility to financial statements and other management reports, ensure accountability for donor funds, or identify weaknesses in internal controls and systems. The scope of external audits can differ significantly according to the objectives of each audit.

*External auditors* should be accountants certified by a national professional association of accountants, if one exists in the MFI's country, or certified by another country's recognized national association of accountants. *Audit firms* are usually set up as partnerships of certified accounting professionals governed by the laws of a country. International audit firms may be structured as partnerships or affiliations of national audit firms.

An external auditor can provide a range of audit services, including:

- Financial statement audits
- Special purpose audits

*The financial statement audit is the most common type of external audit*

- Agreed-upon procedures
- Reviews and compilations.

### 2.2.1 Financial statement audits

The financial statement audit is the most common type of external audit. Financial statements include an MFI's balance sheet, income (profit and loss) statement, and statement of changes in financial position (cash-flow statement, or sources and uses of funds). The notes that are part of these statements deserve close attention. Financial statements are primarily the responsibility of the MFI, which prepares them according to its own accounting procedures. Annex A provides an example of an MFI's financial statements.

MFI's commission financial statement audits for three main reasons:

- Regular users of financial statements—the MFI's managers and board of directors, or donors—may want assurance that the statements fairly reflect the state of the business.
- An MFI may wish to provide independent confirmation of its financial information to prospective donors, lenders, or investors.
- An audit may be required by laws or regulations. MFIs that are licensed financial intermediaries are usually required to publish audited financial statements, and some countries require all NGOs to produce audited financial statements regardless of whether they have financial licenses.

In a financial statement audit the external auditor expresses an opinion as to whether an MFI's financial statements are fairly presented in conformity with an identified financial reporting framework—that is, a defined set of *accounting standards*. The conduct of the audit itself is governed by *auditing standards* (box 2.1).

Audit standards require that the auditor plan and perform the audit work to obtain reasonable assurance as to whether the financial statements are free of *material misstatement*. Information is material if its omission or misstatement could influence decisions by users of the financial statements.

The *scope of the audit* includes:

- Examining, on a test basis, evidence supporting the amounts and other disclosures in the financial statements
- Assessing the accounting principles used by the MFI
- Assessing significant estimates made by management
- Evaluating the overall presentation of the financial statements.

Based on the results of audit procedures, the external auditor will provide an *audit opinion* on the financial statements. The audit opinion can be *unqualified* (colloquially referred to as “clean”), *qualified*, or *adverse*.

## BOX 2.1

**Accounting standards and auditing standards**

*Accounting standards.* An MFI's accounting methods should comply with the country's generally accepted accounting principles (GAAP) or, if national accounting standards do not exist, then with the International Accounting Standards developed by the International Federation of Accountants. In any event, a comprehensive written set of accounting standards is needed if an institution is to produce meaningful financial information. An MFI that does not have such standards in place should consider hiring a reputable certified public accountant or accounting firm to design an accounting system that complies with authoritative national or international standards, and to train staff in the system's use.

Within the context of accounting standards, different accounting bases may be used. National and international accounting standards usually call for the accrual basis of accounting, in which the financial effects of transactions are recognized in the periods in which they occur, rather than when cash is actually exchanged. For example, interest accruing on a debt during the present period would be reflected as an expense in the present period, even if it is not due until a later period.

Some MFIs, however, use a cash basis of accounting, under which expenses and income are recognized only when cash is paid or received. Some donors prefer that MFIs report on a cash basis. In other cases MFIs find it more practical to mix the two methods, using an accrual basis for expenses and a cash basis for income. They may consider this a more conservative approach, or they may not have the computer capacity to track accrued interest on loans to clients.

Industry practice sometimes enters into the choice of accounting procedures. An MFI may have to choose between following financial institution practice and non-profit practice. For-profit financial institutions tend to consolidate their income, expenses, and assets without separating them by funding source. Nonprofit NGOs, on the other hand, tend to receive funding from donors who prefer project- or activity-based accounting that segregates the financial information stemming from the donor's contribution. MFIs should probably move toward financial institution practice, but an adequate computerized accounting package makes it possible to combine both approaches.

*Auditing standards.* The conduct of an external audit is guided by auditing standards. For a financial statement audit, the auditor will use one of three types of standards:

- The generally accepted auditing standards set by the country's professional body
- The generally accepted auditing standards of countries with long-established professional bodies (for example, France, the United Kingdom, or the United States)
- The International Standards on Auditing (ISA).

In cases where a choice exists, the use of ISA is recommended. Further details on accounting and auditing standards, as well as examples and sources, are provided in annex B.

*A comprehensive written set of accounting standards is needed if an institution is to produce meaningful financial information*

An unqualified opinion states that the financial statements “give a true and fair view” or “present fairly, in all material respects” the financial position of the MFI, meaning that the financial statements are free of material misstatement. A qualified opinion identifies problems that prevent the auditor from rendering an unqualified opinion. An adverse opinion is given when an entity's accounting systems are unacceptable and its financial reporting is distorted. A fuller discussion of audit opinions, with examples, can be found in chapter 7.

A *management letter* identifies weaknesses in an MFI's internal controls and financial systems that came to the auditor's attention during the audit, and recommends improvements. Audit clients should routinely ask for a management letter as a by-product of the audit process, because internal controls and management information systems in MFIs are often weak. Management letters are discussed further in chapters 4 and 7.

Clients must be aware of what a financial statement audit will *not* do.

*Audit clients should routinely ask for a management letter as a by-product of the audit process*

- A normal financial statement audit will not provide details about the loan portfolio beyond the disclosure required by accounting standards. In an MFI this level of disclosure seldom provides solid assurance that portfolio information and management systems are sound, or that loan loss provisions are reasonable. Assurance on these aspects of the loan portfolio will usually require specially designed procedures, discussed in chapter 5. It may be possible to include these procedures under the umbrella of the financial statement audit, but in many cases it will be necessary to contract separately for *agreed-upon procedures* in order to get a reliable review of the loan portfolio (see below).
- A financial statement audit, even with a management letter, will usually not identify internal control weaknesses beyond those that become apparent in the course of normal audit procedures. Here again, special arrangements must be made if a more comprehensive review of internal controls is desired.
- A financial statement audit can be of limited usefulness in detecting fraud.
- A financial statement audit will not provide a rating of the institution or a global evaluation of its management or business prospects.
- A financial statement audit will not provide a comprehensive evaluation of an institution's management information systems.
- A normal financial statement audit will not provide assurance as to compliance with the terms of contracts with third parties, such as donors.

### 2.2.2 *Special purpose audits*

International Standards on Auditing (ISA) provide that special purpose audits may be called for in certain situations:

- Where financial statements are prepared in accordance with a comprehensive basis of accounting other than International Accounting Standards (IAS) or national standards
- Where an audit is required only for specific accounts or items in a financial statement
- Where an audit is required to assess compliance with contractual arrangements
- Where an audit is of summarized financial statements.

### 2.2.3 Agreed-upon procedures

Agreed-upon procedures are used when a client retains an external auditor to perform specific tests and procedures and report on the results. Examples might include special reviews of loan portfolio or internal control systems. In performing agreed-upon procedures, the auditor provides no opinion, certification, or assurance that the assertions being made in the financial statements are free from material misstatement. The users of reports based on agreed-upon procedures must draw their own conclusions on the results of the tests reported. For example, an external auditor could be asked to look at a certain number of MFI loan files and document which of the required forms are in the files. The auditor would report on the selection and the results of the procedures performed but would not provide a formal opinion with conclusions drawn from the results of the procedures.

*The users of reports based on agreed-upon procedures must draw their own conclusions on the results of the tests reported*

### 2.2.4 Reviews

A review of financial statements requires less work than an audit. The review consists mainly of inquiry and analytical procedures, and does not provide all the evidence that would be required in an audit. Auditors are not required to provide positive assurance that the statements are fairly presented. Instead, auditors are required to state whether their procedures have revealed any cause to believe that the financial statements were not prepared in accordance with an identified financial reporting framework. A review provides moderate assurance that the assertions being made in the financial statements are free from material misstatement, while an audit provides higher—though not absolute—assurance of reliability.

### 2.2.5 Compilations

A compilation uses accounting expertise to collect, classify, and summarize information. This process reduces detailed data to a manageable and understandable form without testing the assertions contained in the information. Unlike an audit, compilations do not enable the accountant to express any assurance on the financial information. Compilations may still benefit users by providing a professional classification of financial data.

### 2.2.6 How do audits differ from examinations?

It is important to understand how audits differ from examinations conducted by a bank superintendency or central bank. An examination is a regulatory procedure to determine compliance with the laws and regulations that govern licensed financial institutions. The examiner, usually from a regulatory institution, reviews a bank's loan portfolio to determine whether loan loss provisions are adequate and whether the bank's level of capital is in compliance with legal standards. The examiner also evaluates whether internal controls are in place to identify problems and

whether management is competent to deal with critical issues in a prudent manner. The examination process often incorporates a rating system—such as CAMEL (*capital adequacy, asset quality, management, earnings, and liquidity*)—that quantifies the financial condition, safety, and soundness of an institution. An examination usually has a much broader scope than an audit.

## Internal Audit and Fraud Control

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*This chapter discusses the differences between internal audit and external audit. It considers fraud issues in an MFI and highlights the uses and limitations of audit in controlling fraud.*

### 3.1 What is internal audit, and who should perform it?

To most people, *audit* means external audit. However, businesses are placing increasing emphasis on the use of internal auditors, and MFIs should consider incorporating such a function. In Bolivia, for instance, an MFI cannot get a license to take deposits without establishing an internal audit function.

Internal auditing has been defined as “a systematic, objective appraisal by internal auditors of the diverse operations and controls within an organization to determine whether (1) financial and operating information is accurate and reliable, (2) risks to the enterprise are identified and minimized, (3) external regulations and acceptable internal policies and procedures are followed, (4) satisfactory operating criteria are met, (5) resources are used efficiently and economically, and (6) the organization’s objectives are effectively achieved—all for the purpose of assisting members of the organization in the effective discharge of their responsibilities.”<sup>1</sup> Internal auditors reports directly to the board of directors. The main differences between internal and external auditors are summarized in table 3.1.

Almost every MFI should have some form of internal audit. In addition to the other benefits it provides, internal auditing can significantly lower external audit costs. External auditors can narrow the scope of their testing procedures if they find that reliable internal audit procedures are in place.

That having been said, small MFIs will seldom find it cost-effective to hire a qualified full-time internal auditor. Such institutions often contract out their internal audit function, sometimes to the same external audit firm that performs the annual financial statement audit. In most cases the external audit firm sends a junior staff member to the MFI on a regular basis to perform the internal audit, and a senior manager at the audit firm supervises his or her work. For a small MFI this arrangement not only saves money, it also brings the backing of a recognized audit firm, which may provide an extra margin of comfort for directors and managers. Similarly, small or young MFIs may wish to contract with their

*Almost every MFI should have some form of internal audit*

TABLE 3.1

**Differences between internal and external auditors**

<i>Internal auditor</i>	<i>External auditor</i>
Is an employee of the audited organization	Is an independent contractor
Serves the needs of the organization	Also serves third parties who need reliable financial information
Focuses on future events by evaluating controls that ensure the achievement of the organization's objectives	Focuses on whether financial statements reflect historical events clearly and accurately
Is directly concerned with preventing fraud	Is incidentally concerned with fraud controls in general, but is directly concerned only when financial statements may be materially affected

*It is seldom cost-effective to mount an in-house internal audit function before an MFI has 100 or so employees*

external auditor to provide ongoing accounting advice—sometimes including assistance with setting up accounting systems and training staff in their use.

Either arrangement means that the auditor has a regular presence in the institution and can offer input on how administrative procedures are carried out—but without taking operational responsibility, which would compromise the auditor's objectivity during the external audit. Both approaches allow the external auditor to become more familiar with the institution throughout the year, which improves quality and efficiency when the time comes for the external audit.<sup>2</sup>

While fuller relationships like these cost more than a year-end financial statement audit, they often cost less than the salary and benefits of an in-house auditor or an accountant sufficiently qualified to provide the same service. It is seldom cost-effective to mount an in-house internal audit function before an MFI has 100 or so employees. Likewise, an MFI may need several million dollars in assets before it can justify hiring a highly qualified finance department manager or chief accountant. Small MFIs tend to be weak in areas of internal controls, management reporting, and financial administration; external audit firms can help fill this gap. As an MFI grows, stronger internal staff can be hired and external auditors can revert to their more traditional role.

When an MFI has grown to a point where it becomes economical to hire a full-time internal auditor, it may consider recruiting someone from a high-quality local audit firm—someone who has rigorous audit training and prior external audit experience. This recruitment strategy can pay obvious dividends in helping the MFI conform with accounting standards and manage external audits. Moreover, the annual financial statement audit generally goes more smoothly when an MFI's internal auditor “speaks the same language” as its external auditor. (At the same time, as the following section points out, a large MFI needs certain dimensions in its internal audit function that go beyond the background and orientation of most professional auditors.)

The specific design and procedures of an internal audit function are beyond the scope of this handbook. An MFI seeking guidance on this subject should contact a major audit firm, another MFI with a solid internal audit function, or the Institute of Internal Auditors.<sup>3</sup>

### 3.2 Fraud issues

Fraud control is important for most businesses. A small number of individuals are always honest, regardless of opportunities to steal or the absence of sanctions. An equally small number of people are always inclined to be dishonest, even if they face the risk of serious sanctions. Most people fall somewhere in between—that is, they will consistently avoid unethical behavior if their internal sense of right and wrong is reinforced by suitable external controls and sanctions.

Many observers assume that MFIs motivated by social concerns are relatively immune from fraud problems. Unfortunately, experience shows that this is not necessarily true. Efficient microfinance services require considerable decentralization of authority, which can increase the opportunity for employee fraud. As a result most MFIs encounter fraud problems at some point in their early years. The fraud may be a single large event or, more frequently, a series of smaller events.

It is easy to overestimate the effectiveness of external audits in detecting and preventing fraud in MFIs. External auditors focus on financial reporting and administrative systems, to determine whether they comply with accounting standards and the MFI's policies and procedures. To the extent that fraud risk stems from failures in such compliance, the external auditor's work can provide some level of fraud control. But noncompliance of the type auditors are used to assessing is not the source of most fraud and portfolio risk in microfinance operations. Even when auditors are diligent in ensuring that the appropriate individuals have signed off on loans, that payments are duly recorded, and that the paper trail is in order, fraud in MFIs can go undetected.

The primary sources of fraud in microcredit operations include phantom loans, kickback schemes and other bribes, and nonreporting of client payments. These risks are augmented by inappropriate refinancing policies. Audits of paper trails may not detect these kinds of unethical behavior quickly and effectively.

Internal auditing, as noted in table 3.1, is supposed to focus on detecting and preventing fraud. But this focus is not easy to implement in an MFI, especially when the internal auditor is oriented to the same sort of compliance-based paper trail review in which most auditors are trained.

This point can be illustrated with the example of phantom loans. A corrupt loan officer can make loans to nonexistent businesses, to existing businesses that are acting as a "front," or to borrowers that offer substantial kickbacks (perhaps with the expectation that collection will not be vigorously enforced). In all of these cases the loan officer captures a substantial part of the cash flow for his or her

*The primary sources of fraud in microcredit operations include phantom loans, kickback schemes and other bribes, and nonreporting of client payments*

*Conventional  
internal auditors  
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prevent fraud  
in an MFI*

own use. This practice often continues as the loan officer generates a pyramid of new phantom loans to repay old phantom loans. Eventually the house of cards collapses as accumulated debt becomes too great for the loan officer to manipulate the payments. The breakdown shows up in delinquency.

The difficulty of detection lies in the fact that the loan officer alone is responsible for generating and following through on loans until the point where they become late enough that someone else in the organization steps in. This can take weeks, or months in organizations where repayment culture is lax. The only way to distinguish a fraudulent delinquency from a normal delinquency is for someone other than the loan officer to visit the client; at this point pressure to repay may reveal the true (fraudulent) nature of the loan. The person doing this kind of monitoring needs the same client management skills as the loan officer.

Traditional auditors, external or internal, often fail to detect this type of fraud, especially when they do not visit clients personally. Their work tends to focus on tracking the documentation of loan agreements and cash payments. As long as phantom loans are being repaid, no evidence of fraud exists, even though the real overhang of unrecoverable debt is mounting. Once payments begin to fall overdue, pursuing them is initially the responsibility of the same loan officer who set up the fraudulent scheme in the first place. Eventually the loan is passed on to the collection department, but rarely to the internal auditor.

Fraud control measures built in at the operational level are often more effective than an internal auditor's ex post review. For example, loan officers may collect and then steal clients' payments if operational procedures are lax. They simply fail to report payments they receive. Considerable time may pass before a supervisor learns that the payment is late and checks up personally with the client. On the other hand, when operating procedures impose tight controls on collections, as in many village banking programs, this kind of fraud can be reduced to a minimum.

For example, at the Association for Social Advancement (ASA), a village banking program in Bangladesh, all the loan officers gather every morning and write on a blackboard the total to be collected during that day's client visits. After their visits the loan officers gather again to write the total actually received. Any discrepancy is noted by the group, and a follow-up visit is scheduled for the next day by the office coordinator. Immediate follow-up dramatically reduces the opportunity for theft. Although ASA has internal auditors who double-check the record-keeping, the primary internal control is carried out by operational staff.

Thus conventional internal auditors do not automatically prevent fraud in an MFI. They usually work more as comptrollers, making sure that accounting standards are applied, administrative procedures are correctly implemented, and the MFI complies with local laws and regulations. This is an essential role. But internal auditors—or someone else in the organization—must go beyond this role to develop work plans and operating procedures that address the potential fraud discussed above.

One approach is to organize a *business risk department* or *operational audit unit*. This unit may be staffed by people with loan officer or collections experience.

They might visit all seriously delinquent clients and make unannounced visits to a certain percentage of all other clients. Such a unit can deter and detect fraud, detect dangerous deviations from the MFI's methodology that need to be addressed in staff training, and identify beneficial methodological deviations that should be considered for incorporation in the MFI's product design.

Of course, other approaches are possible. The essential point is that fraud (and portfolio) risk in MFIs needs to be addressed through operational systems, not just by traditional internal or external audit procedures.

## Notes

1. Lawrence B. Sawyer, *Sawyer's Internal Auditing: The Practice of Modern Internal Auditing*, 4th ed. (Altamonte Springs, Fla.: Institute of Internal Auditors, 1996, p. 3).

2. Use of external auditors as management consultants can present a conflict of interest—for instance, when the audit firm takes responsibility for setting up an accounting system that it is later supposed to evaluate in the external audit. MFIs and auditors must weigh the potential conflict of interest against the cost and time savings in using a single firm for related work. Prevailing professional standards permit an audit firm to carry out non-audit work for the same client provided that the firm's objectivity and independence are not impaired. MFIs wishing to use the external auditor for related consulting services should try to maintain a separation between advice, which the auditor can provide, and management responsibility or operational implementation, which the auditor should not take on.

3. For more information contact the Institute of Internal Auditors, 249 Maitland Avenue, Altamonte Springs, FL 32701-4201, USA; phone: +1 (407) 830-7600; fax: +1 (407) 831-5171; email: [iia@theiia.org](mailto:iia@theiia.org); Web site: <http://www.theiia.org>.

*Fraud risk in  
MFIs needs to be  
addressed through  
operational systems*



## Commissioning the Audit

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*This chapter offers guidance on:*

- *Using a “single-audit” approach*
- *Determining the scope of work for the audit and preparing the terms of reference*
- *Reviewing audit proposals and selecting an auditor.*

### 4.1 Donor requirements and the “single-audit” approach

Donor audit requirements pose special challenges, especially in the common case where an MFI is dealing with more than one donor. First and foremost, donors should avoid requiring any duplication of the MFI’s regular financial statement audit. This problem occurs surprisingly often. It can be eliminated by simply getting all the relevant stakeholders to agree on the terms of reference for the annual financial statement audit and on the selection of the auditor. Donors should try to accommodate themselves to terms of reference that meet the needs of all the other stakeholders.

However, donors often require special audits, or additional work within the context of the financial statement audit, to track the uses of their funds and to confirm compliance with the terms of their grant or loan agreements. For several reasons, donors should reconsider these special audit requirements.

MFI’s are different from many other donor projects. In a food distribution project, for instance, a donor needs to know that its money has been spent on food, and that the food has reached the intended recipients, in order to be assured that the project’s goal has been met. Donors sometimes look at a project with an MFI in the same way: they frame their objectives in terms of delivery of a certain quantity of product—usually loans—to a given number of beneficiaries. But donors are evolving toward the better practice of focusing on the institutional sustainability of the MFI, so that it can continue delivering services long after the project with the donor is over, and ideally move toward expanding these services with nonsubsidized funds.

When a donor’s intervention with an MFI is framed this way—when the purpose of the project is to help the institution develop sustainable capacity to deliver financial services to an ever-increasing clientele—then meticulous tracking of the specific application of the donor’s funds and detailed confirmation of compliance with the terms of a lengthy grant agreement are much less relevant to achieving that goal.

*Donors are evolving toward the better practice of focusing on the institutional sustainability of the MFI*

*MFIs, for their part, need to be proactive in negotiating a single-audit approach with donors and other stakeholders*

The real question is whether an MFI is financially sound and progressing on schedule toward full sustainability. This question can be addressed through a regular financial statement audit, perhaps coupled with special reviews of loan portfolio and internal control systems. These procedures can confirm that amounts shown as loan portfolio are actually being disbursed to clients and, much more important, that the MFI is managing its portfolio soundly and moving toward financial sustainability. If an institution is performing well on these terms, it may be counterproductive to tie its hands by earmarking particular funds to particular uses. After all, money is fungible.<sup>1</sup>

For donor staff who manage the relationship with an MFI, the path of least resistance is simply to impose all of their agency's "boilerplate" financial control and audit requirements. But in many cases these staff may be able to convince their colleagues in the agency's financial control department to adjust these regular policies in line with the special nature of MFI projects. Perhaps the most efficient way to accomplish this is for donors to design separate financial control and audit requirements for projects involving MFIs. This handbook may be useful in structuring such a package.

In other cases it will be impossible to secure any variation from the donor's standard audit requirements. In such cases donors should cooperate with MFIs in negotiating an audit schedule under which any special audits they require are performed in conjunction with the annual financial statement audit. In particular, donors should try to avoid the all too common practice of hiring separate auditors for their special purpose audits. If a special purpose audit must be assigned to a separate auditor, it should ordinarily be scheduled at the same time as the regular external audit so that the two auditors can coordinate their activities and minimize duplication of effort.

When donors fail to do these things, MFIs have to deal with repeated audits during a single calendar year. This can be a costly and often redundant disruption of the work of managers and the finance department, distracting attention from tasks that are much more relevant to the MFI's sustainability and the quality and outreach of its services to poor clients. One MFI in Bolivia, for instance, has had to hire a full-time professional who does nothing but deal with donor audits and reports. Unfortunately, this situation is not uncommon.

MFIs, for their part, need to be proactive in negotiating a single-audit approach with donors and other stakeholders. When they negotiate agreements with donors, they should ensure that the timing of audit requirements fits in with an efficient annual audit program. In Bangladesh there are cases where multiple donors to a single MFI have organized into a consortium that manages the donors' audit and evaluation requirements on an efficient, unified basis.

More important, MFIs should structure an overall audit framework that focuses on the business needs of their managers and directors. Choosing among the various audit services described here, they can design and negotiate with donors a framework that helps them manage the safety, soundness, and growth of their institution, rather than one that simply satisfies formal requirements.

## 4.2 Role of an MFI's board of directors and audit committee

The board of directors is the ultimate governing body of an MFI, responsible for overseeing management. The external auditor is usually engaged by—and ultimately responsible to—the board of directors. Occasionally the external auditor will also have a contractual or fiduciary relationship with an outside stakeholder such as a donor. The integrity and quality of external auditing are one of the board's key responsibilities. Especially in NGOs, whose boards have no personal financial stake in the organization's operations, there may be a tendency to delegate the audit process almost entirely to management. Doing so can compromise the objectivity of the audit and deprive the board of an opportunity to improve its first-hand familiarity with the financial condition and controls of the MFI.

In larger or more sophisticated MFIs, the board may find it useful to appoint an audit committee whose oversight extends not only to external audits, but also to internal audits, internal controls, and external reporting. Ideally, an audit committee is composed of nonmanagement directors and, as needed, outsiders with accounting and financial expertise. In smaller MFIs the audit "committee" may be a single director with financial expertise and audit experience who takes the lead in exercising the board's audit oversight responsibility. The board and audit committee will need extensive assistance from management and staff but, in order to be capable of exercising objective and independent judgment, they should be willing to dedicate the time necessary to stay informed and involved in the entire audit process.

In preparing for an external audit, the audit committee normally consults with the MFI's board and management, determines the scope of services and terms of reference, circulates the terms of reference, selects and engages a firm to do the work, and deals with the auditors during the process. Once auditors have been selected, it is common for them to be present at audit committee meetings. Some time at each meeting may be devoted to an "executive session" during which the auditors and committee members meet by themselves, with no staff or management present. During an executive session, committee members can ask the auditors for impressions about personnel, efficiency, and business risks, in addition to matters more specific to the external audit, such as adjustments needed in the financial statements, the state of internal systems and controls, or new accounting pronouncements that affect the MFI. The external auditors will often be asked to comment on the institution's internal audit function.

*The integrity and quality of external auditing are one of the board's key responsibilities*

## 4.3 Determining the scope of work for an external audit and related services

The audit client—whether the MFI, a donor, or another stakeholder—should begin the process of commissioning an external audit (or other audit procedures) by determining a scope of work that will form the terms of reference for the

TABLE 4.1

**Common external audit services for a microfinance institution**

<i>Service</i>	<i>Purpose</i>	<i>Activities</i>	<i>Deliverable</i>
Annual financial statement audit	To confirm that financial statements are free from material misstatement	Audit of key account balances and underlying evidence and procedures	Audit report, including opinion, and financial statements and notes
Management letter	To obtain constructive comments that management can use to improve operations or internal controls	By-product of the annual financial statement audit	Management letter
Special purpose audit	Usually to audit compliance with donor requirements, including use of funds	Review of specific issues as requested by the client (usually a donor)	Special audit opinion and report
Agreed-upon procedures	To obtain detailed results of specific testing procedures for selected transactions or account balances—such as loan portfolio or cash	Performance of agreed procedures	Report of results of procedures, without opinion. Users of the report draw their own conclusions from the results of the tests reported

engagement. The terms of reference is a document that lists the client's requirements, on which audit firms will base their proposals.

The terms of reference should be prepared by, or at least under the close supervision of, the audit committee. The terms of reference are usually approved by the full board. In formulating its needs, the audit client should be aware of the different types of audit products (see chapter 2). The most common of these products are summarized in table 4.1.

If an audit client wants additional procedures or reports that fall outside the scope of prevailing standards for a normal financial statement audit, it must specifically request them in the terms of reference.

### 4.3.1 Annual audit of financial statements

#### WHAT TO ASK FOR

The terms of reference for a financial statement audit should require the audit firm to submit a proposal for auditing the MFI's financial statements and delivering an opinion on the statements. Because procedures for a financial statement audit are governed by national or international standards, the audit client does not need to delineate each audit procedure in the terms of reference. The client's ability to micromanage the conduct of the audit is limited because most of the auditors' activities will be governed by applicable standards and the normative practices of their firm. Within the parameters of standard audit procedures, however, the audit client can and should require in the terms of reference that the auditor focus on several key issues:

- *Adherence to international or national audit standards.* In commissioning an audit, the client must determine which set of auditing standards a prospective auditor proposes to follow. This determination can affect the likelihood that the audit customer will receive quality services, reliable information, and an audit report that will be credible internationally. Furthermore, most auditing standards provide remedial procedures for the audit client in the event of substandard performance by the auditor.

External auditors of MFIs often fail to comply with applicable standards, so this matter should not be taken for granted. The audit agreement should require that the audit be conducted according to International Standards on Auditing (preferably) or the country's national audit standards. In most cases the audit client should not modify the scope of the audit to levels below the requirements of international or national audit standards. If external auditors' obligations are restricted, they may claim, in the case of poor performance, that the scope of work prevented performance to standards.

- *Use of sampling methods.* The auditor should be encouraged to use statistical sampling methods, where appropriate, to ensure that a representative sample is tested. The audit client should insist on adherence to international or national audit standards in this regard.
- *Branch visits.* As part of testing the loan portfolio, savings, and other key balances, the auditors should visit a representative number of branches, including those in remote areas. Sometimes cost factors will make visits to remote branches impractical, but the client should try to avoid leaving out this procedure. Branches and regional offices should be visited annually, or on a rotating basis.
- *Client visits.* As part of the process of testing loan management procedures and other key aspects of the MFI's operations, the auditor should make a representative number of contacts with customers of the branches visited. Visiting the clients at their home or business for confirmation of their account status and history is essential, because conventional confirmation by mail is almost never effective for MFI clients.
- *Use of this handbook as a guide.* The audit client should request that the selected auditor become familiar with both volumes of this handbook. The handbook should probably not be incorporated into the contract or engagement letter, however, for two reasons. First, this handbook is not an audit manual, and external auditors will be guided by authoritative international or national standards. Second, it would be counterproductive and costly to place auditors in a position where they feel liable for rigid compliance with every suggestion detailed in this handbook.

A better approach would be to require the auditor to review the handbook before contracting the audit, and to indicate in writing any *major* elements of its guidance that the auditor does not believe should be implemented due to issues of practicality, cost, or conflicting authoritative guidance. Any significant proposed deviation should be discussed and resolved with the client.

*The audit client should request that the selected auditor become familiar with both volumes of this handbook*

*Audited financial statements of MFIs often fail to include enough information to allow an analysis of an MFI's financial sustainability*

- *Content and presentation of financial information.* The audited financial statements of MFIs often fail to include enough information to allow an analysis of the institution's financial sustainability, including the condition of its portfolio. To help remedy this problem, CGAP strongly recommends that audited financial statements contain all the elements listed in annex A. How can audit clients make sure that this recommendation is implemented?

The financial statements, and the content of the accompanying notes, are primarily the responsibility of the MFI, not the auditor. Thus one might argue that specifications about the content of those statements do not belong in an auditor's terms of reference or engagement letter. As a practical matter, however, it is often the auditor, rather than the MFI, who prepares the final financial statements and writes the notes that form part of those statements. And in all cases the auditor's opinion on the reliability of the financial statements is supposed to extend to the content of the notes, which are an integral part of the statements.

Thus audit clients may wish to consider including the requirements of annex A in their terms of reference. Alternatively, donors may wish to reach an agreement directly with management that the financial statements to be audited will present all the information called for in that annex.

The form of the agreement is probably not crucial. What is important is to have a documented understanding among all parties that the information called for in annex A will be included in the audited financial statements, and that the auditor's confirmation of those statements will extend to all of this information.

#### WHAT THE AUDITOR WILL DO

In a financial statement audit the external auditor analyzes the financial information produced by the MFI and the processes used to produce it. The auditor determines whether the MFI's financial statements are free from material misstatements—that is, inaccurate information likely to affect decisions made by those relying on the financial statements. To carry out the audit, the auditor develops a step-by-step program specific to the institution, performing *tests of controls* and *substantive procedures* to obtain audit evidence. Chapter 6 provides an overview of these activities. Volume 2 offers detailed guidance for auditors in designing and carrying out the audit work for an MFI.

#### WHAT THE AUDIT CLIENT WILL GET

An audit report on an MFI's financial statements is brief and to the point. It includes:

- An opening statement on the financial statements audited and time period covered by the audit
- A short indication of the scope of the audit, describing standards and methods used in the audit process
- An audit opinion paragraph.

This report will be followed by the financial statements themselves, together with notes explaining various aspects of those statements. Sample audit reports, together with discussion of how to interpret them, are provided in section 7.1.

A properly performed financial statement audit should provide assurance that the audited financial statements are free from material misstatement. However, the level of assurance provided on the loan portfolio and loan loss provisioning may be quite limited, for reasons explained in chapter 5. Thus the audit client may want to supplement the financial statement audit with additional agreed-upon procedures, as described below.

#### 4.3.2 Management letter

##### WHAT TO ASK FOR

Auditors do not automatically provide a management letter—the client must specifically request it in the terms of reference. As a rule, MFIs should always require a management letter. Since its contents are a by-product of the audit work, preparing it should entail little extra cost. This document can be especially useful for MFIs because of their varying levels of internal organizational development and financial management capacity. The management letter can identify functions and procedures that need to be strengthened in the institution. It can also help managers evaluate the work done by their administrative officers, especially in the absence of a strong internal audit department.

Compared with the financial statement audit, the management letter exercise allows more leeway in the terms of reference for the client to request a focus on particular areas, such as:

- Accounting and internal control systems
- Specific systems, such as cash, investment, loan portfolio, and management information systems
- Potential control weaknesses in areas such as segregation of duties, adherence to policies and procedures, physical security, or supervision (particularly at the branch level).

Annex H provides a more detailed list of potential control weaknesses that might be addressed in a management letter. Prior to drafting the terms of reference for the management letter, the audit client might wish to review this checklist and note any areas where concerns are thought to exist.

However, the client must remember that treatment of these areas in the management letter will extend only to issues that become apparent in the course of normal audit work. If a more comprehensive review of some function is needed, the client may have to contract separately for a special purpose audit or agreed-upon procedures.

The client should draft the request for a management letter in a way that allows the auditor to comment on other issues that may be discovered, beyond those iden-

*As a rule, MFIs should always require a management letter*

*Treatment of control weaknesses in the management letter will extend only to issues that become apparent in the course of normal audit work*

tified for specific focus in the terms of reference. An illustrative request for a management letter is included in the audit terms of reference presented in annex C.

#### WHAT THE AUDITOR WILL DO

The external auditor will not perform any additional tests or procedures to prepare a management letter.

#### WHAT THE AUDIT CLIENT WILL GET

The management letter will be addressed to the MFI's board of directors or audit committee and, if requested, to a donor as well. It will describe weaknesses in the institution's administrative, accounting, and internal control systems encountered in the course of the audit, and will recommend improvements. Interpreting and responding to management letters is discussed in section 7.2.

### 4.3.3 *Special purpose audits*

#### WHAT TO ASK FOR

Special purpose audits of MFIs are usually related to donor requirements. As discussed in section 4.1, donors may call for a special audit to track the use of their funds or verify compliance with other terms of their agreement with the MFI. This special purpose audit may be contracted as a separate product. The donor will typically provide, or want to review, the sections of the terms of reference that specify such work.

A slightly different approach is a *financial statement audit supplemented by additional procedures*. Under this approach the auditor performs additional procedures at the same time as the financial statement audit. In the end there are two reports: an audit report for the board and an expanded report for the donor that includes the results of the additional procedures. Whichever approach is used, the important thing is to have the regular and the special audit work performed by the same auditor at the same time if at all possible.

#### WHAT THE AUDITOR WILL DO

The auditor will use procedures tailored to the requirements specified by the client.

#### WHAT THE AUDIT CLIENT WILL GET

The audit client will receive an audit report on the special issues being audited.

### 4.3.4 *Agreed-upon procedures*

#### WHAT TO ASK FOR

Agreed-upon procedures are specific tests and reports requested by the audit client that fall outside the scope of a financial statement audit. Agreed-upon procedures

should generally be performed at the same time as the financial statement audit. Although they can be done at a different time, with a separate terms of reference, and even by a different auditor, such practices should usually be avoided.

There are three types of agreed-upon procedures that MFIs should most commonly consider requesting. It should not be assumed that any of these procedures is necessary every year, as they all involve significant additional expense.

- *Review of loan portfolio systems*, such as operating policies and procedures, information systems, and loan loss provisions and write-offs. These areas are the heart of most MFIs' business and are by far the source of the greatest risk to their financial health. They are also areas where external auditors are least likely to be familiar with the unusual challenges posed by microfinance operations. Thus this topic is given separate detailed treatment in chapter 5. Annex D details illustrative tests that might be included in a terms of reference for agreed-upon procedures. (Note that any review of loan portfolio systems will inevitably entail a review of significant portions of the institution's management information system and internal controls.)
- *Review of the management information system*. These reviews may be useful when an MFI is experiencing fast growth or when it has made significant changes to its information systems, including computer programs, hardware configurations, or administrative procedures. All of these can undermine the effectiveness of the management information system. An independent review, beyond the scope of a regular audit, can put managers at ease or, more important, alert them to situations that need attention. If significant deficiencies have been uncovered, the MFI should consider repeating the review until it believes they have been successfully addressed. After that it may go for some time before requesting another review of the management information system if no problems are apparent and major changes have not occurred in software, hardware, or administrative procedures.

Sophisticated audit firms are usually well prepared to help a client design a terms of reference for a management information system review. Alternatively, the MFI may consider contracting this work to a consultant specialized in management information systems.

- *Review of internal controls*. Young MFIs typically have weak internal controls. Thus it may make sense to request additional procedures to review internal controls as often as necessary, until managers are satisfied that basic procedures have been developed that offer adequate safeguards and that can be controlled through routine internal and external audits. Once internal controls are well established, such agreed-upon procedures probably need to be conducted only if there are substantial changes in the MFI's business, or if concrete problems have emerged.

Most auditors should be able to help the client design a suitable terms of reference for agreed-upon procedures that the auditor would use to analyze internal controls. For example, such procedures could include testing man-

*Agreed-upon procedures are specific tests and reports requested by the audit client that fall outside the scope of a financial statement audit*

agement review of cash counts at all branches and teller windows, or testing reconciliation of all cash accounts to the general ledger. Such testing (and reporting) would not be included in a normal financial statement audit.

#### WHAT THE AUDITOR WILL DO

The auditor will perform the specific procedures and tests laid out in the terms of reference. These will result in additional cost to the client.

#### WHAT THE AUDIT CLIENT WILL GET

The auditor will report on results of the procedures and tests agreed upon with the client. Because external auditors do not provide an opinion on the results of agreed-upon procedures, the users of such reports must draw their own conclusions on the suitability of the tests performed and on the reported results.

*Some elements of the terms of reference can be better specified after exploratory discussions with auditors*

### 4.4 Preparing the terms of reference

Based on its analysis of the desired scope of work, the MFI's audit committee should prepare a draft terms of reference. In some cases this will require input from, or consultation with, a donor or another external stakeholder (such as a commercial creditor). As a practical matter, some elements of the terms of reference can be better specified after exploratory discussions with auditors. Annex C provides an illustrative terms of reference for an annual audit of an MFI's financial statements.

#### 4.4.1 Introduction

The introduction to the terms of reference should indicate:

- The institution to be audited
- The party engaging the audit—for example, the MFI or a donor
- Any other party that will be relying on the results of the audit—such as a donor
- A brief statement of the services requested—a financial statement audit, special purpose audit, agreed-upon procedures, and so on.

#### 4.4.2 Description of the MFI and its organizational structure

An organizational description of the MFI should be provided so that the auditor can understand its structure. This section should identify personnel who will work with the auditor, such as members of the audit committee, the internal audit department, or other staff. Annexes may be attached to the terms of reference with organizational charts, names of senior managers, key financial managers, and accounting and internal audit personnel, a list of branches and personnel, and copies of financial statements.

#### 4.4.3 *Prior year audits*

The terms of reference should specify whether the institution has been audited in the past, and provide names and addresses of previous auditors.

#### 4.4.4 *Objective of the audit*

The audit objective should be clearly stated—for example, “to obtain an audit opinion on the financial statements.” The financial statements to be audited and financial reporting period to be covered should be specified.

*Auditors may be required to identify any major recommendations of this handbook that they do not propose to implement*

#### 4.4.5 *Scope of the audit*

As appropriate, the terms of reference should cover the issues raised under “what to ask for” in sections 4.3.1 and 4.3.2, and list areas of specific concern. In particular, the audit committee may want to consider including a requirement that the prospective auditor review this handbook and identify in writing any *major* elements of its guidance that the auditor does not propose to implement.

#### 4.4.6 *Audit report and financial statements*

The requirements of the audit report and the financial statements, including the notes to those statements, should be clearly specified. The financial presentation requirements specified in section 4.3.1 and annex A would be laid out here.

#### 4.4.7 *Management letter*

The terms of reference should require a management letter and indicate the general areas to be addressed. The terms of reference should also identify any specific issues about which there may be reason for concern, and indicate to whom the letter should be addressed.

#### 4.4.8 *Agreed-upon procedures*

If agreed-upon procedures are to be included in the terms of reference, they should be specified in detail.

#### 4.4.9 *General issues*

The terms of reference should state that the auditor will have access to all needed documentation and request that the auditor review specific materials in conducting the audit (the two volumes of this handbook should be listed, and perhaps other documents). A large MFI might consider requesting that the audit team include a senior auditor from another country. The added cost might be justified by the additional assurance of objectivity, and perhaps the opportunity to have a team

member with more experience with MFI audits. This approach would be especially appropriate if there is reason to expect the audit to be problematic.

#### 4.4.10 *Timing of the audit*

The terms of reference should specify when the audit should be completed.

*The terms of reference should request that the external auditors participate in a pre-proposal survey process*

#### 4.4.11 *Pre-proposal survey*

The terms of reference should request that the external auditors participate in a pre-proposal survey process, requiring them to spend time at the MFI and its branch offices to gain information and understanding of the organization and the audit.

#### 4.4.12 *Proposal format*

The terms of reference should delineate a structure for the auditor's technical proposal and request specific information in each area. See section 14 in the sample terms of reference in annex C.

#### 4.4.13 *Cost proposal*

If the audit is being bid out, the client may specify that the auditors' cost proposals be submitted separately from their technical proposals. The terms of reference should list any specific information the auditors should provide in the cost proposal.

#### 4.4.14 *Submission of proposals*

A deadline should be specified for submission of proposals, and the terms of reference should provide address, phone, fax, and email information. It should also specify whether proposals can be faxed or emailed.

#### 4.4.15 *Oral presentation*

The audit committee should consider asking bidders to give oral presentations to the audit committee or to the MFI's board.

### 4.5 **Deciding whether to use competitive bidding**

Sometimes a donor will require that the auditor be selected through competitive bidding, especially if the donor is paying for the audit. In some circumstances such competition is the most efficient way to secure the best audit at the lowest price. In other circumstances it is not. When an MFI is not faced with an external requirement that the audit be bid out, it is hard to lay down general rules about the best

approach. The board or audit committee will have to use its best judgment in light of local circumstances and relationships.

Most of the discussion in this chapter assumes that auditors are selected through competitive bidding, but in some cases there are factors that might support a sole-source selection:

- Small and even medium-size MFIs tend to be less attractive customers for audit firms, especially large audit firms that have plenty of business. When an MFI's business is small, the engagement may not appear lucrative to the auditor. In addition, the audit firm may face a steep learning curve if it has no prior experience with MFIs, and it may not expect to recoup the staff time spent overcoming that learning curve. In such cases burdensome competitive bidding may lower a good audit firm's interest in an MFI even further, because bidding involves considerable uncompensated effort for the firm—along with the risk that this effort will bear no fruit.
- Sometimes a good audit firm may be willing to commit to auditing an MFI—and even charge less than its normal prices—because of a personal or business relationship with a member of the MFI's board of directors. Obviously, choosing an auditor on the basis of such a relationship can be dangerous: with the wrong incentives, it can result in low-quality work and a lack of rigorous objectivity. But in some situations it can result in a better-quality audit at a lower price than the MFI could get through competitive bidding.
- If an MFI has had a good experience with its auditor for the previous year and is satisfied with the audit cost, the arguments for continuing the relationship are obvious. At the same time, there can be advantages to changing auditors every so often, because a comfortable relationship with an auditor may not guarantee an objective audit. Sometimes periodic changes of auditor are even required by law. In the absence of such a legal requirement, it may be better to rely on the judgment and integrity of the board of directors rather than to automatically bid out the audit each year.

Where competitive bidding is the selected approach, it is customary to request proposals from a short list of firms rather than advertise publicly. The selection of the short list might be guided by the considerations discussed in section 4.7.

#### 4.6 The pre-proposal survey

The audit client should establish a pre-proposal survey process as part of the scope of work included in the terms of reference. This process should require prospective auditors to spend a predetermined amount of time visiting the MFI's offices (including one or more branch offices), reviewing procedures, systems, structure, and so on, and generally familiarizing themselves with the institution. The bidders will incorporate their observations and understanding of the MFI into their proposals for the audit. Making

*Burdensome competitive bidding may lower a good audit firm's interest in an MFI*

this process compulsory can help the client judge the auditors' interest and commitment. A pre-proposal survey can also help auditors prepare a realistic proposal.

The audit committee should appoint one or more of its members to deal with audit firms during the pre-proposal survey. These individuals should schedule the bidders' time at the MFI, make sure they have access to relevant personnel, systems, and documentation, and be available to answer questions.

*The quality of the audit firm and the individual staff who will conduct the audit should be the main selection criterion*

#### 4.7 General observations on selecting the auditor

There is wide variation in the private attitudes that MFIs bring to the selection of external auditors. Some feel that the external audit is a formality for donors, that it provides little value added, and that it is best done by a firm that is friendly to the institution. In this context, "friendliness" implies clean opinions and a lack of rigor in calling attention to problems. Other MFIs are more convinced of the usefulness of external audits, and want them done by a firm that combines independence with high ethical standards and technical quality.

A donor may be able to form a view as to which of these attitudes prevails in an MFI it is working with. Where the former attitude prevails, a donor might be inclined to participate more aggressively in the selection of an auditor. Where the latter attitude prevails, the donor may wish to rely more on the discretion of the institution's board and management.

The next section details a formal process that MFIs might use when selecting an external auditing firm. Readers should recognize, however, that auditing is essentially a personal service. The key to selecting an audit firm is a clear understanding of exactly who will do the audit, because the experience, competence, and integrity of the firm and the individual staff who will actually do the work is the most important selection criterion. It is common—and costly—to give too little attention to the quality of the firm and its commitment to provide staff members who the MFI thinks are competent to do the onsite work. It is equally common—and equally costly—to give too much weight to other factors such as the elegance of the proposal document, scores on elaborate, mathematically weighted evaluation formulas, and even the price. The main focus in choosing an auditor must be on evaluating the firm and the specific people it will put on the job.

Unfortunately, the affiliation of a local accounting firm with a large international accounting firm is no guarantee of high-quality work. The quality and objectivity of local "big six" partner firms vary greatly from country to country. Although some donors insist on internationally affiliated firms for their audit work, nonaffiliated local firms are often well-qualified. An MFI should seek references on any firm it is considering for its external audit, regardless of the firm's affiliation with international organizations.

In evaluating the competence and character of the audit firm, attention should be paid to its reputation in the business community, supplemented by private conversations with customers of the firm. Staff at the bank supervisory authority are usually familiar with the firms that audit banks, and will often respond candidly

to a private inquiry from someone they trust to keep their comments confidential. Well-connected members of the MFI's board of directors can often be very useful in this kind of reference checking.

It is more difficult, but usually possible, to check references on the staff members who are proposed to do the bulk of the audit work. One technique is to ask for a complete list of clients that a staff member has worked with in the past year, and to conduct private inquiries at random. Again, respondents are more likely to be candid if they are confident that their comments will not be quoted. The customary practice of asking a potential auditor to name two or three references is of much less value. Even consistently poor performers can usually find a few people who will give them a good review.

*This emphasis on reference checking may strike some as overblown, burdensome, or even subject to abuse. But it is more likely to yield reliable predictions of performance than some of the other time-consuming analysis that often goes into judging proposals.*

Overall, the MFI must seek a balance. It wants auditors who are rigorously objective. At the same time, it wants to work with audit staff who have the ability and judgment to understand the unique circumstances and challenges of micro-finance. The relationship must be constructive, where the MFI feels that the auditor's recommendations are supportive and the auditor feels that the MFI is making a good-faith effort to address valid concerns.

The next section deals with the formal selection process and criteria. Prior to concluding this selection, the audit committee, along with appropriate MFI staff, should deal with the proposed audit teams in the pre-proposal survey, review the written proposals, and attend the oral presentation.

Clients should be aware that audit firms will not automatically accept every engagement offered to them. Many firms, especially affiliates of large international firms, will use a pre-engagement process to determine whether to accept a client.

## 4.8 Evaluation of proposals

While giving heavy weight to the factors discussed in the previous section, the audit committee may also consider the following issues in evaluating proposals.

### 4.8.1 Understanding of the engagement

Does the audit firm demonstrate a basic understanding of the MFI's business, gained during the pre-proposal survey and perhaps through previous experience? Have the auditors demonstrated this understanding by identifying areas of concern or focus?

### 4.8.2 Audit approach

Which set of auditing standards will the bidder use to conduct the audit? Has the audit firm provided any added value in its proposal—for example, has it

*Evaluation of written qualifications should be supplemented with careful reference checking*

demonstrated understanding of the MFI's requests, indicated how it can work with the institution's internal audit department to minimize time and cost, or provided other insights about how the audit can be accomplished efficiently? Does the audit approach reflect a serious review of this handbook? Does the audit approach respond to the client's needs as outlined in the terms of reference?

#### 4.8.3 *Audit team*

The audit committee should evaluate whether the proposed team includes personnel with adequate experience and qualifications to perform the audit. If possible, evaluation of written qualifications should be supplemented with the careful reference checking discussed in the previous section.

Audit teams are usually composed of the following personnel:

- *The partner* is the senior member of the engagement team and is the only individual authorized to sign the audit report on behalf of the audit firm. The partner is usually the team member who will interact with the board of directors and senior managers of the MFI. The partner will be the ultimate decisionmaker on key issues, such as assessing the institution's loan loss provisions, determining whether accounting treatment is appropriate, and addressing matters requiring the involvement of the board of directors. The partner conducts the final review of the work performed. The partner usually has more than 12 years of public accounting experience. A partner might contribute 5 percent of the effort expended on a typical audit.
- *The manager* is second in charge, and usually deals with planning, staffing, billing, and primary review of the work performed. When issues arise, the manager is the first one called in to discuss them with the MFI's finance director or senior accountant. In addition, the manager usually devotes substantial time to the planning phase of the audit and to continued monitoring throughout the audit process. The manager usually has 6 to 12 years of public accounting experience. A manager might contribute 10 percent of the effort expended on a typical audit.
- *The senior accountant* oversees the onsite audit team at the MFI on a daily basis. He or she reviews the work of staff assistants (see below) and audits higher-risk areas, such as loan systems and provisioning. The senior accountant works daily with the MFI's accounting staff to ensure that schedules of data are being prepared, that questions are being accumulated and posed to the appropriate accountants, and that the overall audit is progressing within the budgeted timeframe. The senior accountant usually is a certified accountant and has three to six years of public accounting experience. Senior accountants might contribute 50 percent of the effort expended on a typical audit.
- Finally, *the staff assistant* audits areas of lesser risk and assists the senior accountant with administrative tasks. The staff assistant often has less than three years

of public accounting experience and may not have taken accountancy qualification examinations. Staff assistants might contribute 35 percent of the effort expended on a typical audit.

In evaluating the personnel proposed for the audit, the audit client should pay particular attention to the qualifications, experience, and references of the manager and senior accountant, since the manager will play a critical supervisory role in the audit engagement and the senior accountant will do most of the daily testing and interact with MFI staff.

Questions to consider include: Did the key members of the proposed audit team (not just the partner) make an oral presentation? How well did they respond to questions? Did the presentation add to the client's understanding of the firm and the audit approach? Generally, how comfortable do MFI staff feel with the team members, based on pre-engagement contacts?

#### 4.8.4 General experience of the firm

The experience of the audit firm and the size of its fees may be related. There are many types of audit firms, ranging from one- or two-person local firms to affiliates of large international firms. "Big six" firms may be more likely to have specialized experts, greater familiarity with audit standards, and more rigorous internal firm processes and guidance. But as noted, a big six affiliation is no guarantee of technical or ethical quality. Local and regional audit firms may have sufficient talent to satisfy the MFI's audit requirements at an economical price, and perhaps with greater commitment. And local and regional audit firms may sometimes be more willing to enter into the more complete relationships with small MFIs discussed earlier.

In evaluating audit proposals, the client should also consider the auditors' experience in the microfinance industry or a demonstrated willingness to become familiar with the industry. Have the proposed audit staff (not just the firm) performed work for other MFIs or financial institutions? Has the auditor demonstrated that it has carefully reviewed this handbook, and that it is really willing to use it as a supplemental guide in conducting the audit? Some big firms view MFIs as relatively unimportant, but a few have attempted to develop microfinance as a practice area.

The client should also consider the independence of the auditor. Auditors should be impartial and independent of the institution and persons appointing them. In particular, no auditor should be employed by, serve as the director of, or have any financial or business relationship with the MFI when engaged as an independent professional auditor. Audit fees should not be contingent on reported income of the audited organization or set in a way that impairs the auditor's independence. Here again, private checking of the auditor's reputation for integrity is an important part of this assessment. Does the audit firm have a history of standing up to clients when necessary?

*In evaluating audit proposals, the client should consider the auditors' experience in the microfinance industry or a demonstrated willingness to become familiar with the industry*

#### 4.8.5 Cost proposal

The level of effort required to audit an MFI varies greatly, ranging from 400 hours for a small MFI to 1,700 hours for a large MFI with many branches and loans. The level of effort also depends on whether there is an internal audit function—that is, whether external auditors can rely on tests performed by internal auditors. The cost of the audit will depend not only on the level of effort, but also on the rates at which the audit firm charges the time of its staff.

#### 4.8.6 Proposal scoring

Some competitive bidding regulations require that proposals be scored using a mathematically weighted formula. However, the usefulness of mathematical scoring is questionable when selecting providers of personal services like an external audit. Clients whose rules do not require such scoring may consider doing without it.

The audit committee should make its choice and present it, with substantiation, to the board of directors. The board of directors should make the final selection.

### 4.9 Contract or engagement letter

Once an auditor has been selected, a contract or engagement letter is used to formalize the audit appointment. When a formal contract is used, it is normally prepared by the client. When an engagement letter is used, it is prepared by the auditor. Annex E provides a sample engagement letter provided by an audit firm.

*The audit client should ensure that the final agreement for the audit appointment reflects—or at least incorporates by reference—the work outlined in the terms of reference and the proposal, as well as the agreed level of effort and cost.* The standard engagement letters provided by audit firms are often not specific enough on these points. A clear and specific agreement lowers the risk of subsequent disputes and provides a basis for resolving them if they occur.

#### Note

1. For a fuller discussion of this issue and other aspects of the relationship between donors and MFIs, see CGAP Focus Note 9, “The Anatomy of a Microfinance Deal,” which is available on the CGAP Web site (<http://www.worldbank.org/html/cgap/cgap.html>) or from CGAP, 1818 H Street NW, Room Q 4022, Washington, D.C. 20433, USA.

# Loan Portfolio Issues

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*This chapter examines the issues and procedures that must be considered in planning the audit of an MFI's most important account balances: the loan portfolio and loan loss provisions.*

The loan portfolio and associated loan loss provisions are the crucial accounts in an MFI's financial statement. The portfolio usually constitutes the bulk of an MFI's assets—and the portfolio and its associated loss provisions are the accounts most commonly subject to material misstatement. The portfolio is the source of the main business risk in MFIs: most MFI failures stem from deterioration in the quality of the loan portfolio. More than any other area, effective audit of the loan portfolio requires that auditors and clients:

- Recognize the specific risks that are present; and
- Reach a clear understanding of which of these risks are to be tested, and what procedures will be used to test them.

Rather than simply accepting a “one-size-fits-all” portfolio review determined solely by the auditor's standards and policies, the audit client should try to discuss portfolio procedures with the auditor and arrive at some definition of the tests and procedures that are appropriate to the client's needs. Then the client should try to determine which of these will be done as part of the audit and which will have to be contracted as separate agreed-upon procedures.

Some external auditors will resist such a discussion on policy grounds. In such cases MFIs that want to be sure that their audit provides real assurance about the state of their portfolio may have to consider looking for another auditor.

## 5.1 General portfolio review issues

Three general issues need to be taken into considered when planning a portfolio review: the unique characteristics of microfinance lending, the depth of the review, and the systems being assessed.

*Most MFI failures stem from deterioration in the quality of the loan portfolio*

*Decentralization can increase the opportunity for deviation from approved policies and for fraud*

### 5.1.1 Characteristics of microfinance lending

All parties to an audit need to understand the unique characteristics of microfinance lending that make an MFI's portfolio risk different from that of a conventional financial institution. Many such characteristics are discussed elsewhere in volumes 1 and 2, but the main ones are:

- MFIs grant a large number of small loans, and so receive an even larger number of small repayments. In addition, microfinance operations are often dispersed over a wide geographic area. Thus, to be efficient, MFIs need streamlined and decentralized operating structures. These factors make it harder to maintain effective portfolio information and management systems.
- Decentralization implies that relatively few staff members are involved in approving, disbursing, monitoring, and collecting each loan. This pattern can increase the opportunity for deviation from approved policies and for fraud. Decentralization can also increase the risk of error or manipulation in transferring information from branches to headquarters.
- To handle small transactions efficiently, MFIs face great pressure to cut costs—sometimes at the expense of adequate portfolio controls and information, as well as sufficient supervision of clients and loan officers.
- Many microfinance portfolios are growing rapidly. This growth puts pressure on systems and can camouflage repayment problems. A rapidly growing portfolio has a higher percentage of loans that are in the early stages of repayment. Delinquency problems are more likely to appear in later stages.
- MFIs generally dislike provisioning for problem loans or writing them off. They want to maintain a good image in the eyes of outsiders, especially donors. MFIs may feel—not always correctly—that they cannot write off a loan on their books without sending a message that the client should stop trying to pay, or the loan officer should stop trying to collect. Moreover, most MFIs do not pay taxes, so provisioning produces no tax savings for them by reducing taxable income.
- For reasons discussed below, MFIs' information systems for tracking loans are seldom integrated with their accounting systems.

### 5.1.2 How extensive should the portfolio review be?

A wide range of procedures can be used to test loan portfolio systems. Some fall within the bounds of a standard financial statement audit, while others have to be requested as agreed-upon procedures. The dividing line is not always clear. What is important is to identify which procedures are appropriate for each MFI, and to make sure that they are performed, whether as part of the financial statement audit or as additional procedures.

No single set of portfolio review procedures is appropriate for all MFIs. Thus the portfolio review, more than any other area of an MFI audit, needs to be tailored to the circumstances of the institution.

To some extent the procedures that are required depend on the MFI's internal portfolio systems and controls. Where these are found to be solid, the auditor will need to do less independent testing of information. But on a more basic level, the depth of portfolio analysis depends on how much assurance a client wants. This in turn is often related to the MFI's level of development. In an institution that is just beginning operations, auditors might test the portfolio with just a few basic procedures required by their audit standards. At the other end of the spectrum, a private investor considering a multimillion-dollar investment in an advanced MFI might employ an external firm to "certify" or "attest" to portfolio quality, offering a categorical assurance based on extremely rigorous and detailed testing. A similar requirement might apply if an MFI wanted to securitize its portfolio for refinancing in capital markets. But hardly any of today's MFIs have accounting, loan tracking, and loan administration systems that would permit the testing necessary for an external reviewer to make such a certification. This is not to say that many MFIs do not have perfectly sound portfolios. Rather, they do not have the information and control systems that would support categorical independent certification of the quality of their portfolios to outside investors.

So in deciding how extensively to test portfolio balances, clients and auditors need to consider the level of development of the MFI being audited. The following typology may help them do this. The typology is conceptual only: many MFIs have features that do not correspond exactly with one of the three stages described. However, the typology gives a framework for analysis that roughly corresponds to the situation of most MFIs.

#### STARTUP

At this stage the MFI is small—say, fewer than 3,000 clients. It may have been in existence for three years or less, though some MFIs stay small longer. Management attention is focused more on developing a suitable loan methodology than on information systems and controls. The institution has only a dozen or two dozen employees, and few branches. It is small enough that managers can stay closely involved with employees and operations, so they should often be able to identify and resolve problems without extensive formalized systems. Implementing elaborate systems could distract managers from the more basic task of refining the lending methodology, and could entail costs that are out of proportion to the size of the portfolio. While most MFIs at this level would like to grow, many of them are not in fact strongly committed to massive expansion.

In general, testing beyond the basic portfolio review procedures in a financial statement audit may not be necessary at this level. A more thorough review would only be appropriate if the MFI plans to embark on massive growth and wants the auditor's help in building systems that will support a much larger operation.

#### TRANSITION

Some MFIs find themselves at the transition stage three to five years after commencing operations. They are on a track to massify their operations. They tend to maintain rapid growth, increasing clientele by 50–100 percent a year. While management may

*So in deciding how extensively to test portfolio balances, clients and auditors need to consider the level of development of the MFI being audited*

*An “institutionalizing” MFI needs an extensive external review of its portfolio systems, well beyond the scope of a conventional audit*

still be personal and informal, problems are beginning to emerge because original systems are being stretched beyond their limits. The “transition” MFI realizes that it cannot continue to move forward without more elaborate formal systems.

At this stage the portfolio review component of the financial statement audit should be more fully developed, and some agreed-upon procedures may be needed beyond the scope of the financial statement audit. More detailed portfolio testing is needed because risks become greater as operations grow to a volume that management can no longer supervise as closely, and because the size of the business justifies a more expensive audit process. The results of this more detailed review can be disconcerting. The review will almost inevitably turn up numerous shortcomings, but the information can be of great help to management as it designs and installs the stronger systems it needs to continue growing.

#### INSTITUTIONALIZATION

At the institutionalization stage, the MFI has expanded beyond 15,000 clients, a hundred employees, and a dozen branches. Clientele growth may slow to something like 25–35 percent a year. Top management can no longer stay in close touch with operations at lower levels. Loan mismanagement, concealed delinquency, and fraud become more serious risks. At this stage internal information and control systems, as well as more formal loan administration policies and procedures, have to be consolidated. A full-blown internal audit function should probably be developed.

An MFI at this stage may want to become licensed as a regulated financial institution. Making this change requires sophisticated internal controls and information systems, because a licensed MFI is subject to periodic examination by the supervisory authority. While the main focus of this examination is portfolio quality, it is not realistic to expect very effective examinations in most poor countries. Examiners tend not to understand the dynamics of microcredit, and the supervisory authority is usually stretched to its limits by its core task of supervising the country’s regular commercial banks.

An “institutionalizing” MFI probably needs an extensive external review of its portfolio systems, well beyond the scope of a conventional financial statement audit. Such in-depth review should be repeated annually until the MFI is satisfied that its systems are working well. Thereafter, in-depth reviews should also be performed whenever there is a major change in systems.

When an MFI wants a review of its portfolio systems that goes well beyond what would normally be included in an annual audit, its options are not limited to agreed-upon procedures with the external auditor. Such an MFI might want to consider using an experienced microfinance consultant instead—though consultants with the requisite experience in portfolio management and systems are not easy to find. A source for such expertise could be another MFI that uses a similar loan methodology and that has a reputation for strong portfolio systems—backed up by a long track record of successful operations.

Across the entire spectrum of MFI development described here, there is an intimate relation between internal systems and external audit reviews. On the

one hand, an MFI—even at the startup stage—might take the initiative to ask for a more extensive external portfolio review in order to guide its efforts at system development. On the other hand, additional levels of audit assurance may be required by outsiders such as donors, bank lenders, or investors. When this happens, the cost of providing the additional assurance can be very high if internal systems have not kept pace. When the auditor is asked to provide assurance on an issue that is not covered well by internal systems, he or she has no choice but to engage in labor-intensive direct testing.

Section 5.3 discusses various portfolio-related areas that can be reviewed during an audit. In choosing which of these areas to address, and what procedures to use in addressing them, clients and auditors need to consider the range of issues discussed above, including most basically:

- The MFI's size and level of development
- The MFI's ambitions in terms of growth, access to commercial funding, and licensing
- The extent to which the MFI wants to use an external review to help it design and solidify its internal systems.

*Three main systems affect an MFI's loan portfolio: the accounting system, the loan tracking MIS, and the loan administration system*

### 5.1.3 An overview of systems

For the sake of clarity in the complex discussion in this chapter, it is important to distinguish between three MFI systems. In practice there may be some overlap at the margins of these systems, but in theory they are separate. The *accounting system* and *loan tracking management information system (MIS)* produce *information*. The *loan administration system* consists of policies and procedures that govern *loan operations*.

#### THE ACCOUNTING SYSTEM

The accounting system receives information about individual loans, but its purpose is to generate aggregate information that feeds into the financial statements.

#### THE LOAN TRACKING MANAGEMENT INFORMATION SYSTEM

The loan tracking MIS is focused on information about individual loans, including:

- Identity of the client
- Amount disbursed
- Loan terms such as interest rate, fee, and length of the loan
- Repayment schedule—amounts and timing
- Amount and timing of payments received
- Amount and aging of delinquency
- Outstanding balance.

Ideally, the loan tracking MIS should contain this information not only for current loans, but for past loans as well. In practice, most MFIs do not main-

*Integrated software packages available for MFIs seldom provide the immediate local technical support that is crucial in dealing with modifications and system crashes*

tain this information, at least in usable form, once loans have been paid off or written off.

The main purpose of the loan tracking MIS is to provide information relevant to the administration of the portfolio, whether or not this information will feed into the financial statements. Some of the data captured by the loan tracking MIS is also captured directly by the accounting system—such as disbursements, payments, and accrued interest. Note that the accounting system and the loan tracking MIS may capture some loan data at different times and from different sources, sometimes resulting in discrepancies between the two systems. Some data from the loan tracking MIS flows only indirectly into the accounting system and financial statements—for example, delinquency information from the loan tracking MIS may be used to estimate provisions in the accounting system. Other data from the loan tracking MIS—such as client identity and payment schedules—never enter the accounting system.

Ideally, the loan tracking MIS would be seamlessly integrated with the accounting system. In practice, this is unusual in MFIs. MFIs cannot use integrated software designed for banks because microfinance loans are too different from bank loans. Several integrated software packages are available for MFIs, but they seldom provide the immediate local technical support that is crucial in dealing with modifications and system crashes. As a result many MFIs find that a standard accounting system (either computerized or manual) can be adjusted to fit their requirements, but that they need to custom build their own loan tracking MIS (again, computerized or manual).<sup>1</sup>

#### THE LOAN ADMINISTRATION SYSTEM

The loan administration system is not an information system, but rather the set of policies and procedures, written or unwritten, that govern the operational conduct of the MFI's lending business, including:

- Loan marketing
- Client and loan evaluation
- Loan sizes and terms
- Loan approval
- Handling of disbursements and payments by loan officers and cashiers
- Recording of disbursements and payments in the “back room”
- Client supervision
- Collection policies for delinquent loans
- Rescheduling of delinquent loans
- Internal controls, both operational and ex post.

## 5.2 Specific portfolio review areas

MFIs and their auditors need to consider 12 specific areas in designing the review of the institution's portfolio and related systems.

### 5.2.1 Accuracy of loan tracking management information systems

*Does the loan tracking MIS correctly reflect loans disbursed, payments received, and current repayment status of outstanding balances?*

The external auditor should examine a statistically significant number of loans, segmented by branch office, chosen on the basis of materiality criteria or at random. Loan documents and transaction records should be compared with ledger accounts, planned repayment schedules, the MFI's credit policies, and the delinquency reports generated by the loan tracking MIS. The auditor should test amounts disbursed, amounts received, dates of payments, and current repayment status of loans. The auditor should also check whether the institution accurately records transactions on the dates they occur, whether the tracking system correctly distributes the payment among relevant accounts, and whether the outstanding loan balance in the tracking system matches the outstanding balance suggested by the application of the institution's credit policies.

In addition to reviewing documents, the auditor should make direct contact with a sample of borrowers to confirm that they exist and that the MFI's recorded account balance is correct. The normal practice of mailing confirmation letters to individual borrowers is next to useless in most microfinance audits. Many clients of MFIs are functionally illiterate, and many more do not have mail service. Thus the auditor must locate the clients and make direct contact with them.

In planning client visits, determining the sample size can be a complicated matter. The number of clients visited will depend on various factors, including applicable audit standards, internal policies of the audit firm, the reliability of the MFI's internal controls and internal audit unit, and the degree of assurance the audit client is willing to pay for. Chapter 6 in volume 2 illustrates a process for determining a sample size.

The external auditor should first determine whether the MFI has an internal audit system that regularly tests the loan tracking MIS, including direct client confirmation. If there is not such a system, if it is not working well, or if the auditor finds serious weaknesses in the loan tracking MIS, then the number of transactions tested and clients visited would have to be larger, in order to assure that the portfolio and provision balances in the financial statements are not materially misstated.

These procedures can be time-consuming and expensive. In a normal annual audit, implementation of the auditor's regular standards will usually result in such tests being performed at a relatively cursory level. A "transition" MFI (see above), or even a "startup" MFI that wants to build loan tracking systems that will permit it to massify, may want to negotiate a level of transaction testing—including the number of client visits—that exceeds minimal audit standards.

For an institution that is serious about massive growth, the credibility of the loan tracking MIS among the MFI's staff is crucial. When no one in the organization expects the loan tracking MIS to be 99 percent accurate, people tend to let down their guard. Situations and trends that ought to cause alarm are sometimes ignored on the assumption that they represent glitches in the information system

*Mailing confirmation letters to individual borrowers is next to useless in most microfinance audits*

rather than actual problems with portfolio quality. And where people think that most anomalies are likely to be MIS problems, fraud is more tempting because it is less likely to be detected promptly.

### 5.2.2 Security and effectiveness of portfolio-related management information systems

*Are accounting and loan tracking systems physically secure? Is their information provided, and really used, on a timely basis?*

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

These issues apply to the entire MIS, not just the components related to the portfolio. They are mentioned here because problems in this respect can have a particularly serious impact on portfolio management.

#### SECURITY

The auditor should review the security of computerized accounting and loan tracking systems, including items such as:

- The external safety environment of computer hardware, including physical access and climate control
- Internal safety features of computer software
- Access control (who can enter, change, or read data)
- Backup procedures and compliance, including physical security of backup files.

For manual systems, the auditor should review internal controls in areas such as preparation and vetting of transaction reports, physical security of ledger card files and other documents, and data access controls.

#### MIS EFFECTIVENESS

Even if data are secure and accurate, they are of little use unless people at all levels of the organization get timely reports in an intelligible form, then use the information. The most common and dangerous instance of this problem in MFIs occurs when loan officers and managers do not get delinquency information in a way that facilitates immediate follow-up on payment problems.

An annual audit usually pays some attention to these issues, especially MIS security. But the degree of attention will fall far short of a thorough MIS review. MFIs should probably request some comment on these topics as part of the management letter. A thorough review will require special agreed-upon procedures, or a separate MIS review done by the auditor or some other consultant.

### 5.2.3 Significance of reconciliation items

*Where loan tracking MIS data fail to reconcile with accounting system data, are the inconsistencies a serious problem, either because their amount is large or because they indicate a fundamental inconsistency between the two systems?*

Such discrepancies are common in MFIs because of the large volume of transactions and because accounting and loan tracking systems are usually not seamlessly integrated. They may or may not be worrisome.

For example, many microfinance programs have clients make loan repayments at banks for security reasons. Because banks typically wait several days before sending the documentation on the payments received, a program might insist that clients bring an extra copy of the payment deposit slip to the MFI for registry. Upon receipt of this copy of the deposit slip, the loan tracking program registers the payment. There will be a temporary discrepancy with the accounting system, which picks up the transaction later, when the bank sends its copy of the deposit slip. But when the bank's deposit slips arrive, they may be incomplete or assigned to an incorrect account, so that some payments stay in suspense accounts until fully cleared. If over time a large number of transactions hang in suspense accounts that are not rigorously controlled, this might be a material weakness in the loan administration system that needs to be addressed. If the amount is large enough, it might affect the auditor's ability to give a clean opinion. If the amount is not material, but the discrepancies suggest a serious inconsistency between systems, the issue ought to be raised in the a management letter.

*Refinancing can conceal a problem, while allowing it to grow ever more serious, for a long time*

#### 5.2.4 *Misrepresentation of loan payoff*

*When the loan tracking MIS shows a loan as paid off, has the client really proved willing and able to satisfy the obligation, or is the apparent paydown affected by the substitution of one type of account for another?*

MFI loan officers and managers often engage in practices that have the effect of showing a loan as being paid off in the loan tracking MIS, even though the client has in fact been unwilling or unable to come up with the cash that was due. Four such practices are common:

- *Refinancing.* Suppose a client is having trouble making loan payments. The loan officer is worried that the client will be unable to keep the loan current, but wants to conceal the problem. The loan officer simply makes a new loan to the client, who uses the proceeds of this new loan to pay off the old one. Eventually the client will probably be unable to meet the payments due on the new loan, at which point the cycle can be repeated. Such “evergreening” is hardly unique to microfinance—commercial bankers practice it regularly in some countries. Refinancing can conceal a problem, while allowing it to grow ever more serious, for a long time. When the scheme finally collapses, the lender has lost a lot more than it would have if the problem had been addressed when it first appeared. (Rescheduling is similar to refinancing except that no new loan is issued. Rather, the old loan is renegotiated, with the term extended, and the unpaid interest is added to the amount of the principal. Rescheduling is treated separately in the next section.)
- *Parallel loans.* When an MFI offers more than one loan product, a loan officer may arrange a second loan for a defaulting client. Both loans stay active.

*Unfortunately,  
many MFIs' systems  
do not maintain  
information on past  
loan performance*

For a while the client uses the proceeds of the second loan to make payments current on the first. Eventually, however, the client will probably be unable to make the payments on both loans.

- *Payment by check.* The client is allowed to “pay off” her loan by giving the MFI a check, usually postdated, that she cannot honor. The loan tracking system shows the loan as paid, while the check drops into a miscellaneous receivables account, where it does not get reflected in the loan officer’s (or the MFI’s) delinquency reports.
- *Payoff with collateral.* Sometimes an MFI will accept physical collateral—for instance, machinery—in payment of an overdue loan. When the machinery is received, the loan is shown as paid off. The machinery shows up in a fixed asset account, but it may never be sold for enough to cover the amount that was due on the debt. The better practice would be to show payoff by check or collateral as contingent, to be fully credited only when the check is collected or the collateral is sold for an amount large enough to cover the outstanding balance on the loan.

Such practices often conceal serious loan portfolio quality problems, resulting in material understatement of loan loss provisions in the financial statements. More important, management may be unaware of problems that can spiral out of control if they do not receive urgent attention.

Ideally, the loan tracking MIS should provide a first line of defense against such practices, and make it easier for the auditor to test for their presence. For instance, the MIS could be designed to automatically flag cases where a new loan (including a parallel loan) is made to a client who had serious repayment problems on the prior loan, or where loans are paid off by check or physical collateral. Few MFIs have loan tracking MISs that do this.

At a minimum, keeping clients’ performance history on past loans in the MIS facilitates auditors’ testing for the presence of these practices. Unfortunately, many MFIs’ systems do not maintain information on past loan performance. (When this serious system deficiency exists, it should be commented on in the management letter.) In such cases the auditor’s only recourse is to physically examine a sample of loan files, concentrating on cases with a pattern of repayment problems followed by payment in full—especially when the payment in full is ahead of schedule or a new loan is given to the client after the repayment problem. Such cases should be examined to make sure that the loan payoff recorded in the system represents a real receipt of cash from the client.

Testing for these problems through a physical examination of documents covering a substantial sample of an MFI’s portfolio is a major task, and would not normally be part of an annual financial statement audit. Only the most obvious practices, such as canceling loans with postdated checks, would be likely to be noted. In the absence of a particularly strong loan tracking MIS, the only way a client can get real assurance on these points is probably to contract agreed-upon procedures.

### 5.2.5 Rescheduling

*Are loan quality problems being hidden by inappropriate rescheduling of loans that are unlikely to be paid in full, or by failure to treat rescheduled loans separately when loan loss provisions are calculated?*

When a client is experiencing repayment difficulties, MFIs will often reschedule (restructure, renegotiate) the loan. Typically, the term of the loan is extended, overdue interest is added to the principal, and a new amortization schedule is established. The old “problem” loan disappears, replaced by a new loan contract that is shown as current—at least until the next payment is due. Sometimes such rescheduling conceals major portfolio problems, in the form of loans that appear current but are unlikely to be paid in full. In fact, rescheduling is often the easiest way to “correct” a poorly performing portfolio.

Thus auditors should pay particular attention to rescheduled loans: Is rescheduling policy and practice appropriate? Are rescheduled loans segregated in the loan tracking MIS? And are adequate loan loss provisions applied to rescheduled loans?

The MFI should have detailed policies and procedures for loan rescheduling that answer the following questions:

- What conditions must be present to qualify for rescheduling? (A few MFIs prohibit rescheduling. Most allow it. The challenge is to provide enough flexibility to accommodate people who are in real need but still likely to repay eventually, while being conservative enough to prevent abuses.)
- How many times can a customer reschedule a loan?
- Who has the power to approve a rescheduling?
- How is a loan accounted for once it has been rescheduled?
- Is accrual of interest income discontinued until payments have been received subsequent to the rescheduling?
- Is a rescheduled loan automatically aged in the “current” category, or does a separate category exist?

Whether or not sound policies exist, the question remains as to what actually happens in practice. This can be determined by looking at a sample of rescheduled loans. The loan tracking MIS should produce regular reports that automatically identify all rescheduled loans, or at least contain the information necessary to produce a one-time listing of rescheduled loans. Where such a list is available, an auditor can sample loans to determine whether the MFI’s policies are being followed. A more complicated question is whether the rescheduling is being done with a realistic expectation that it will enable the client to pay in full, or whether it is being used to camouflage bad loans that are unlikely to be recovered. This question may be answered by looking at the subsequent payment history of a sample of rescheduled loans.

Where the MFI can produce a complete list of rescheduled loans, it may be able to negotiate with the auditor to include the above testing in the annual audit. Most MFIs, however, fail to track rescheduled loans separately. This is a serious

*Failure to track rescheduled loans separately is a serious system weakness*

system weakness that should be noted in the management letter. Absent a list of rescheduled loans, the auditor's only recourse is to review the history behind a sizable sample of the present loan portfolio. If the loan tracking MIS does not preserve performance information on prior loans, the auditor will be forced to review physical documentation of prior transaction records (assuming the MFI keeps them). This kind of work would almost certainly require separate agreed-upon procedures beyond the scope of the regular annual audit.

As is discussed later in this chapter, rescheduled loans must be identified in the aging analysis of portfolio arrears, especially where provisioning for probable loan losses is based on that aging. A loan that has had to be rescheduled is at higher risk of eventual loss than a loan where the client has made every payment as originally scheduled. To show both of these loans as "current" misrepresents the great difference between them.

*Whenever a material yield gap appears, the auditor should track down and report on its cause*

#### *5.2.6 Interest income issues: yield gap and interest accrual policy*

*Is the portfolio yielding as much interest income as it should be, according to the terms of the loan contracts? If the MFI is accruing unpaid interest income, are its accrual policies reasonable?*

By analyzing the terms of the MFI's loan contracts, the auditor can develop a theoretical interest yield—that is, the amount of revenue the portfolio should generate if all interest is paid on time and according to contract.<sup>2</sup> This theoretical yield should be compared with the actual interest income booked each period.<sup>3</sup> This analysis frequently shows a large gap between what the MFI should be earning and what it actually is earning. For instance, an MFI that collects its loans in monthly payments may have an effective contractual interest rate of 2.5 percent a month, but discover that actual interest income received has amounted to just 1.5 percent of the average portfolio each month.

This yield gap analysis should be done as part of the testing of revenue accounts. It is mentioned here because the most common cause of a yield gap is loan delinquency, so this test serves as a cross-check on portfolio quality.<sup>4</sup>

Other situations can also contribute to a yield gap. If an MFI is growing very rapidly and does its accounting on a cash basis, then its interest income may be lower than the theoretical yield because a large share of its portfolio involves new loans whose first payment has not yet fallen due. Sometimes a yield gap turns out to be due to an inaccurate loan portfolio balance in the accounting system. When the loan portfolio balance is updated by adding disbursements and subtracting payments and write-offs, with no independent check, errors made in previous years may get passed along undetected to later years.

Whenever a material yield gap appears, the auditor should track down and report on its cause. If the cause cannot be determined, this fact should be clearly indicated in the audit report or in a note to the financial statements.

This yield gap analysis can be further complicated if an MFI is accruing loan interest income that is past due and unpaid. *When an MFI is accruing material amounts of*

*unpaid interest, the auditor needs to understand the institution's accrual policy and evaluate its reasonableness. In particular, does the MFI stop accruing further interest, and reverse previously accrued but unpaid interest, when a loan reaches a stage of delinquency that raises serious doubts about its recovery?* If the institution's policy is too lax on this point, serious overstatements of income can result. Assuming that the institution's policy is satisfactory, the auditor still needs to determine whether it is being applied consistently.

### 5.2.7 Consistent implementation of the loan administration system

*Are the MFI's basic loan methodology and loan administration procedures being observed by loan officers and credit committees?*

The external auditor should review compliance with the basic policies and procedures governing loan administration in the MFI. Sometimes these policies and procedures are thoroughly documented in loan manuals. In other cases—typically smaller MFIs in a startup phase—they have to be determined through interviews with management. Because of the inherent decentralization of decisionmaking and supervision in an MFI, compliance with these policies and procedures often becomes a problem—especially for MFIs that have grown past their startup phase into a “transitional” or “institutionalizing” stage, as described earlier.

Methodological drift often occurs because of weak staff training and supervision. Over time, loan officers in a decentralized structure start to make credit decisions that run counter to the institution's proven lending principles. For instance, initial loan size may creep up, or subsequent loans to a client may increase in size faster than is prudent. This creates credit risk by allowing clients to push up against their repayment capacity limits too quickly. Another common occurrence is that credit committees become mere formalities, so that credits are not really discussed. This failure of effective peer review will usually increase credit risk.

External auditors are not and will not become experts in microfinance. Thus they should test only the most elemental credit methodology principles and loan administration procedures. These might include:

- Comparing the credit manual's loan approval criteria with actual practice in areas such as size, terms, and conditions of initial loans; limits on size increases for renewal loans; guarantee requirements; and calculation of basic financial ratios used to determine repayment capacity in loan application forms.
- Reviewing compliance with basic loan administration procedures, such as prompt distribution of loan delinquency information to loan officers and immediate follow-up visits to all delinquent borrowers.

This type of review will be handled quite summarily in a regular annual financial statement audit and perhaps commented on in the management letter. This task is more effectively done by an operational audit unit within the MFI, as suggested at the end of section 3.2. This approach has the further advantage that the feedback gets processed more immediately and directly into daily operations and

*Methodological drift often occurs because of weak staff training and supervision*

product design. Where such an internal unit is functioning, external auditors might restrict themselves to reviewing and commenting on the quality of this department's work.

Banking superintendencies charged with overseeing licensed MFIs should understand that this type of review is essential for early detection of credit risk. To conduct such a review, the licensing authority will need staff who are expert in microlending techniques.

*Most fraud in MFIs is related to loan operations and often occurs "off the books"*

#### *5.2.8 Portfolio-related fraud controls*

*Does the MFI have an effective operational audit function capable of detecting the types of fraud most common in microfinance?*

Although external auditors may encounter and comment on fraud in the normal course of their audit program, their basic obligation is not to detect fraud, but to identify situations that increase the opportunity to commit fraud. Other than the treasury and cashier window fraud that can affect any banking institution, external auditors are not well-situated to detect the type of fraud that MFIs normally encounter. Traditional internal auditors may not be effective for this purpose either, for reasons elaborated in chapter 3.

Most fraud in MFIs is related to loan operations. Moreover, such fraud often occurs "off the books." Loan payments are stolen before they are registered, leaving no paper trail for the auditor to follow other than an eventual delinquency report. Or phantom loans are concocted, often with the collusion of the client, in which the loan officer pockets part or all of the proceeds. Eventually payments fall due and are not made. But given the huge volume of transactions, the auditor is not likely to pursue the nonpayment of a loan that happens to be fraudulent. To discover a phantom loan made in collusion with a client, the auditor would have to visit the client and know how to pressure him into confessing the fabrication.

Almost all MFIs experience loan-related fraud at some point. For many it does not reach epidemic proportions. Others are not so lucky.

As suggested in chapter 3, operational controls implemented by experienced loan officers are a stronger tool for fraud detection than are external audits. In relation to portfolio fraud, the annual external auditor might be limited to commenting on the MFI's operational safeguards and other internal controls. (Of course, if any fraud happens to show up in the course of client visits or other tests, it should be reported.)

#### *5.2.9 Adequacy of loan tracking information*

*Is the loan tracking MIS producing information that permits an accurate representation of portfolio quality, as well as finely tuned day-to-day management of the portfolio?*

Loan tracking systems should indicate the age of delinquent loans, the credit history of clients, the existence of unsafe lending practices, and the segmentation of the portfolio.

## AGING

The loan tracking MIS should “age” delinquent loans—that is, group them according to how late the oldest overdue payment is. This information is important not only for establishing loan loss provisions, but also for effective management of the portfolio. The groupings in an aging report should normally correspond to the MFI’s loan repayment schedule. For instance, loans that are repaid weekly might be aged in a weekly scheme (7 days late, 14, 21, 28, and so on), while monthly loans would use a monthly scheme (30, 60, 90, 120, and so on).

Aging standards often fail to coincide with repayment intervals. For instance, in one prominent MFI, a weekly loan that goes into arrears is not considered past due until it is outstanding for 50 weeks. Similarly, in another prominent MFI, although loans are repaid weekly, provisions are based on a regulatory aging scheme of 30, 60, 90, and 120 days.

Aging categories should bear as close a relation as possible to increases in risk of nonrepayment. For this reason loans that the MFI has had to reschedule should be identified separately in the aging report, rather than simply lumped in with nonrescheduled loans.

Late loan payments signal an increased risk not just for the payments that are late, but for the entire outstanding loan balance. Thus the aging report should show the entire outstanding balance of past-due loans, not just the amount of overdue payments.<sup>5</sup>

If the MFI’s delinquency reports fail to age loans that are not current, the auditor should report this as a major system weakness. If there is an aging report but its groupings are inappropriate, this should be commented on in the notes or the management letter.

*Loans that the MFI has had to reschedule should be identified separately in the aging report*

## CREDIT HISTORY

As discussed earlier, the loan tracking MIS should provide summary information on each client’s loan history and past performance. This information is crucial in making sound decisions on requests for repeat loans. If repeat loans are approved without effective consideration of adequate information on the client’s past performance, this is an area of major portfolio risk that requires comment in the annual financial statement audit. In addition, keeping past loan information in the MIS is important for several kinds of analytic work referred to elsewhere in this chapter.

## IDENTIFICATION OF UNSAFE LENDING PRACTICES

Ideally, the loan tracking MIS should automatically flag certain dangerous situations, such as those discussed in sections 5.2.4 and 5.2.5. More practically, it should at least permit identification of such situations:

- Issuance of a new loan to a client with a bad repayment record on an existing loan
- Payoff of a delinquent loan by refinancing—that is, issuing a new loan whose proceeds are used to pay off the old one

- Repeated or otherwise inappropriate reschedulings
- Payoff of loans with postdated checks or delivery of collateral.

#### SEGMENTATION

For “transitional” or “institutionalizing” MFIs, the loan tracking MIS should permit segmentation of the loan portfolio, especially the delinquent portfolio. Appropriate segmentation might be by region, branch, loan officer, type of loan product, and perhaps other categories that might substantially affect loan risk. This segmentation can help make loan loss provisioning more accurate; more important, it guides ongoing management of the portfolio.

*Loans should be written off when the probability of recovery gets very low*

#### 5.2.10 Loan write-offs

*Does the MFI have a reasonable policy for writing off unrecoverable balances? And is this policy consistently applied?*

Many MFIs do not have defined write-off policies. Write-offs are often done reluctantly and arbitrarily. An MFI may feel—not always justifiably—that formally recognizing a loan as a bad debt sends a message to its loan officers that the institution is no longer interested in recovering that outstanding balance. Thus the institution may prefer to carry the nonperforming loan on their books. Since most MFIs are nonprofit organizations that pay no income tax, they have no tax incentive to write off loans.

For example, one MFI in Guatemala carried all bad debts on its books for years and accumulated a portfolio-at-risk indicator of almost 15 percent. This means that 15 percent of its outstanding balance was considered problem loans—of which 9 out of 10 were overdue by more than 180 days, and therefore were very unlikely to be collected. Had the institution written off all loans over 180 days past due each year, its portfolio-at-risk rate would have been just 1.5 percent. However, the MFI was unwilling to correct this distortion because the correction would have involved a huge one-time loss on its income statement. Instead it continued to avoid writing off its bad loans, thus overstating its income and assets, while making its current portfolio appear worse than it really was.

If an MFI has a policy on write-offs, the auditor should examine whether it is reasonable. If there is no policy, the auditor should suggest one. A write-off policy needs to recognize that legal collection of tiny loans is not cost-effective in most poor countries. MFIs can pursue delinquent clients through legal proceedings to set an example, but the legal costs usually exceed the amount collected, reducing the net recovery below zero. Loans should be written off when the probability of recovery gets very low, which often happens long before legal remedies have been exhausted.

Assuming that the MFI has a reasonable write-off policy, the next question is whether it is being consistently implemented. The external auditor of a normal commercial bank might conduct a detailed review of individual write-offs, checking each against policy and applicable regulations. Such an approach is probably not cost-effective when auditing an MFI, beyond testing a modest sample of loans written off.

Some attention to the MFI's write-off practice should be expected in any financial statement audit. However, the materiality of this issue, and the amount of effort devoted to reviewing it, will depend on the quality of the portfolio. In cases where loan default has been genuinely low, the write-off issue is obviously less material in the context of the overall financial statements.

At a minimum, the auditor should ask for an explanation of the MFI's write-off policy and practice, and describe them in a note to the financial statements. Where there is no policy, or the auditor has concerns about its reasonableness, disclosure should be made in the appropriate place—in the management letter, the financial statements, or even the opinion letter, depending on the seriousness and materiality of the issue.

### 5.2.11 Loan loss provisions

*In provisioning for expected loan losses, are the MFI's policy and practice reasonable in light of historical loss experience and the institution's current delinquency situation?*

The financial statements of MFIs often contain loan loss provisions that are materially inadequate. Yet external auditors often give clean opinions on such statements without sufficient disclosure—let alone evaluation—of the institution's provisioning policy.

The bulk of the following discussion is devoted to “scientific” provisioning, based on an aging of the present portfolio and an analysis of the historical performance of portfolio cohorts in previous years. However, a less elaborate system may be appropriate for small MFIs. Whatever the approach, what is important is to have a provisioning policy that is reasonably related both to historical loss experience and to the current status of the portfolio.

A small MFI may simply provision a fixed percentage of its portfolio based on its overall loss experience in previous years. Sometimes a percentage of each loan is provisioned at the time of its disbursement. In such cases the institution needs to check occasionally to make sure that the total amount provisioned maintains a reasonable relationship to the total outstanding portfolio. In other cases individual loans are not provisioned when made, but the provision on the overall portfolio is adjusted periodically to keep it at an appropriate percentage.

When these simple methods are used, the percentage that is provisioned should be based on historical loss rates (at least in cases where the MFI is old enough to have historical data available). Thus the auditor must look at how those loss rates have been determined. The provisioning percentage should be based on the amounts written off each previous year relative to the average outstanding portfolio during that year. As the preceding section indicated, many MFIs do not write off loans aggressively or consistently. In such cases the percentage to be provisioned should be related not to accounting write-offs, but to the real proportion of prior loans that has become uncollectable.

Once the historical loss rate has been roughly estimated, provisioning also has to take into account the situation of the present portfolio. If delinquency lev-

*Provisioning policy should be related both to historical loss experience and to the current status of the portfolio*

els are higher today than they have been in the past, provisions should be set at a level that is higher than the historical loss rate. The same would be true if the MFI is aware of any other factor (such as an economic crisis) bearing on the collectability of its current portfolio.

The materiality of provisioning methods depends on the quality of the MFI's portfolio. If the auditor believes that levels of default and delinquency have genuinely been very low, there is less need for detailed fine-tuning of the institution's provisioning percentage.

Large MFIs, or those that are preparing for massive growth, should consider the more scientific approach to provisioning that is customary in the banking industry. This approach involves segmenting the portfolio into aging categories, as discussed earlier, then assigning a different percentage to be provisioned for each of those categories, depending on the perceived risk level.

The aging categories chosen should be related to the payment period of the loans (say, weekly or monthly) and to critical points in the follow-up process for delinquent loans. For instance, if the branch manager intervenes in follow-up after 90 days, this should be a breaking point in the aging schedule. Loans should be separated out from the "current" category as soon as they are even one day late. An illustrative aging schedule, with provisioning percentages for each aging category, is shown in table 5.1. In using this schedule, *the provisioning percentage is applied to the entire outstanding balance of the loans in each category, not just to the amount of the late payments.*

The provisioning percentage chosen for each aging category will determine the overall loan loss provision. In a licensed MFI the aging schedule and provisioning percentages will usually be prescribed by the regulatory authority, so the auditor only has to check to see whether the institution's provisioning complies with the rules.

In unlicensed MFIs the preferred method is to base provisioning percentages on a historical analysis of how the portfolio has performed. Using this method, the MFI takes a cohort of loans from an earlier period, long enough ago so that it knows the ultimate outcome of almost all the loans in the cohort. This earlier cohort is segmented according to the same aging schedule used for the present portfolio. Then, for each aging category in the earlier cohort, the MFI determines what percentage of the loan amounts went unrecovered. This percentage is used to provision the present portfolio in the same aging category, unless some change in circumstances in the present portfolio calls for a different percentage.<sup>6</sup>

Most MFIs will not be able to provide this sort of historical analysis. Instead, provisioning percentages for each aging category will be based on management's intuitive estimates. In such cases the auditor could test the provisioning percentages by taking a sample of older loans and seeing how well the amounts ultimately collected on those loans correspond to the predictions implicit in the provisioning percentages the MFI is using. Whether such testing is included in the annual financial statement audit or done separately as an agreed-upon procedure should be a subject of explicit discussion and negotiation between client and auditor.

TABLE 5.1

**An illustrative loan aging schedule and corresponding loss provisions**

Loan status	Share provisioned (percent)
<i>Unrescheduled</i>	
Current	0
1–30 days late	10
31–90 days late	25
91–180 days late	50
>180 days late	100
<i>Rescheduled</i>	
Current	10
1–30 days late	25
31–90 days late	50
>90 days late	100

Where historical loss information is not available, MFIs occasionally estimate their loan loss provisions based on a “recovery rate” indicator that divides amounts actually received during a period by amounts that fell due under the terms of the original loan contract during the same period. It is tempting to assume that a recovery rate of 97 percent, for instance, translates into an annual loan loss rate of 3 percent of the portfolio. But this is a serious error, because it fails to recognize that the recovery rate is based on loan amounts disbursed, which can be almost double the outstanding portfolio appearing in the MFI’s books. This assumption also fails to recognize that the amount of loss implied by the recovery rate occurs each loan cycle, not each year. For an MFI that provides three-month loans repaid weekly, a 97 percent current recovery rate translates into a loss of 22 percent of its average outstanding portfolio each year.

Even if auditors are satisfied with the reasonableness of an MFI’s provisioning policy, they still need to examine whether it is being implemented consistently.

More important, the best provisioning policy in the world will generate distorted results if it is applied to erroneous portfolio information. As discussed at the beginning of this section, the auditor’s basic starting point has to be assuring the correctness of the information in the loan tracking MIS, with respect to amounts and delinquency status. To the extent that this involves checking the accuracy of delinquency numbers against other numbers and documents in the system, the auditor should have little problem with the task. However, earlier sections have pointed out areas where MIS shortcomings obscure information necessary to evaluate the portfolio. Further, there are other areas, such as loan officer fraud, where even a perfect MIS will not pick up the problem, because it occurs at a level before any documents enter the system. Auditor tests of detail and client visits can deal with some of these problems, but these procedures can be costly, and the level of confidence they provide may sometimes be questionable.

For the audit client concerned about portfolio quality and adequacy of loan loss provisions, some practical conclusions can be reiterated here:

- It is easy to overestimate the degree of assurance that the typical annual audit will provide with respect to portfolio quality and the reasonableness of loan loss provisions.
- Rather than simply accepting an “off-the-shelf” audit program, clients should have detailed discussions with their auditors about the approaches and procedures that will be used to test the portfolio.
- Some important areas of portfolio risk are better handled by internal operational safeguards than by a traditional ex post audit.

#### 5.2.12 Other portfolio-related business risks

*Is the MFI moving into loan sizes above the limits of its loan methodology? Is it subject to material levels of exchange or interest rate risk? Is it managing its liquidity risk effectively?*

*Assuming that a 97 percent recovery rate implies a 3 percent annual loan loss rate is a serious error*

*Liquidity risk is particularly significant for MFIs*

MFIs can usually handle small, short-term loans using character-based loan methodologies, which rely heavily on peer-group screening, the client's past loan performance, and an analysis of repayment capacity that is often based more on the client's existing household cash flow than on the projected cash flows to be generated by the proposed investment. Sometimes an MFI that has been successfully managing \$100–\$1,000 loans with such a methodology moves up to first-time loans of \$10,000 or more using the same methodology. Experience has proved this situation to be dangerous. Larger loans tend to need a different methodology, with more extensive analysis of the client's cash flow and perhaps more rigorous guarantee or collateral requirements. If an auditor encounters such a situation, especially where a few large loans account for a large percentage of the portfolio, some comment would be in order.

MFIs are sometimes exposed to exchange rate risk when they are funded by hard-currency borrowings but denominate their loans in local currency. A severe devaluation of the local currency can have a disastrous effect on such an MFI. Or there may be material interest rate risk if the MFI is locked into a fixed interest rate on long-term loans to clients, while the interest it pays on its own funds is subject to short-term fluctuations.

Liquidity risk is particularly significant for MFIs, for two reasons. First, many rely on donor funding, whose timing tends to be unreliable. Second and more important, the consequences of a liquidity shortfall are particularly dangerous for an MFI. If a normal commercial bank runs short of loanable liquidity, it can stop making new loans without disastrous consequences for the repayment of its existing portfolio. The same is not true of MFIs, because of the nature of their clients' repayment motivation. Basically, microfinance clients repay because of their confidence in an implicit contract that if they repay their loan today, continuing financial services will be available on demand tomorrow. When a liquidity problem prevents quick disbursement of repeat loans, word spreads quickly. Clients see the MFI as breaching its implicit contract, and repayment of its existing loans can drop precipitously. The microfinance industry does not yet have enough experience to have developed standard liquidity ratios. In the meantime, the auditor should look at whether the MFI is projecting its cash-flow needs and managing its sources and uses of funds to leave a prudent cushion for the funding contingencies it may face.

These analyses fall within the scope of annual financial statement audits. Where material risks are observed, they merit presentation in the notes that accompany the financial statements or in the management letter.

### 5.3 Defining audit procedures for the loan portfolio

Determining and negotiating an appropriate set of procedures to test an MFI's loan portfolio can be complicated. Even after reading this handbook, few MFIs will be in a position to specify the work they want done without prior consultation with

the auditor. In addition, auditors' portfolio testing is to some extent dictated by prevailing audit standards or by the policies of their firm. Some audit firms have policies against discussing the details of their testing procedures with clients.

*In the face of these difficulties, many MFIs leave the design of portfolio review procedures (along with the rest of the audit work) entirely in the hands of the auditor. For the reasons discussed above, an audit done this way is unlikely to provide reliable assurance about the systems and balances related to an MFI's loan portfolio.*

Clients who want a meaningful testing of a microfinance portfolio must be willing to enter into a detailed dialogue with their auditor. A primary purpose of the portfolio-related material in this handbook is precisely to provide a basis for such a dialogue. Ideally, this conversation should yield a reasonably clear picture of the kind of tests and procedures that are desired and the mode of contracting for them—that is, which of them can be expected as part of the regular annual financial statement audit, and which need to be contracted separately as agreed-upon procedures.

As suggested at the beginning of this chapter, if an auditor is unwilling to enter into this sort of discussion, the client has no way to be assured of a reliable audit of its portfolio. Experience shows that simple reliance on the auditor's customary standards and procedures does not produce such assurance.

Clients need to remember that under normal practice, procedures conducted as part of the financial statement audit will produce an opinion but no report of results. In fact, after an audit it is often difficult to get auditors to describe the procedures they used in enough detail to form any kind of independent judgment about their adequacy. On the other hand, the use of agreed-upon procedures will produce a report of results, but no opinion. Arguably, these products are structured in a way that is less than helpful to the client. Some auditors, however, are willing to be flexible in discussing procedures with the client, both before and after the audit.

Annex D provides an illustrative set of procedures for testing two key portfolio areas: the reliability of the payment and delinquency information in the loan tracking MIS, and the consistency with which the MFI's stated loan policies and procedures are implemented. Which of these procedures would fit under the normal audit and which would require separate agreed-upon procedures will vary according to circumstances. This annex is not proposed as a template for all MFIs. Rather, it is intended to help MFIs and their auditors think about which procedures might be appropriate for their specific cases.

*Clients who want a meaningful testing of a microfinance portfolio must be willing to enter into a detailed dialogue with their auditor*

## Notes

1. MFIs that are planning to upgrade their MIS, and that are willing to invest major effort in doing so, may wish to consult Charles Waterfield and Nick Ramsing, *Handbook for Management Information Systems for Microfinance Institutions* (New York: Pact Publications, for CGAP, 1998).

2. A method for calculating theoretical yields can be found in CGAP Occasional Paper 1, "Microcredit Interest Rates," which is available on the CGAP Web site

(<http://www.worldbank.org/html/cgap/occ1.htm>) or in English, French, or Spanish from CGAP, 1818 H Street NW, Room Q 4022, Washington, D.C. 20433, USA.

3. Loan fees and commissions can be included along with interest income for this purpose, or can be treated separately. If the theoretical yield is different for different types or sizes of loans, then weighted averaging can produce an overall yield estimate. The comparison of actual with theoretical yield should be done on a monthly basis or, if it is done on an annual basis, should use a monthly average of the loan portfolio in the calculation. If it is impossible to develop an overall analytical estimate of expected income, then the same issue can be addressed through tests of detail: a sample of individual loans is selected, the contractual interest expected during the period is calculated, and then actual interest received on the loans is checked. If this latter approach is used, the tests should cover the entire period under audit.

4. For a method of calculating the impact of a given level of loan delinquency on a MFI's yield gap, see Martin Holtmann and Rochus Mommartz, *Technical Guide for Analyzing the Efficiency of Credit-Granting Non-Governmental Organizations (NGOs)* (Saarbrücken: Verlag für Entwicklungspolitik Saarbrücken GmbH, 1996).

5. The most common measure of delinquency used by MFIs divides late payments by the total loan portfolio. This indicator is worse than meaningless: it is positively misleading. The problem can be illustrated by imagining a portfolio of 1,000 housing loans, all disbursed on January 1, to be repaid in 100 monthly installments. Suppose that when February 1 rolls around, not a single client pays the first installment that is then due. Using the typical delinquency measure, an MFI in this predicament would report its delinquency at only 1 percent—a number that obviously bears no relation to the profound problem in the portfolio.

A more meaningful delinquency measure is “portfolio at risk,” an indicator whose numerator is outstanding balance of loans late past a specified number of days, and whose denominator is the total outstanding portfolio. An acceptable alternative used by some MFIs is a “current recovery rate,” which divides payments actually received during a period by payments that first fell due during that period under the terms of the original loan contract. Prepayments and late payments will cause this indicator to fluctuate from month to month, so it is important to look at it over a longer period.

6. For a discussion of loan loss provisioning and write-offs for MFIs, see section 2.2.2 of Robert Peck Christen, *Banking Services for the Poor: Managing for Financial Success* (Somerville, Mass.: Accion International, 1997).

# Conducting the Audit: A Brief Overview

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*This chapter briefly describes what happens once the audit begins:*

- *The auditor's activities*
- *The client's responsibilities*
- *The timing of the audit.*

## 6.1 The auditor's activities

The audit process consists of three phases: preparation and planning, obtaining audit evidence, and reporting. The first two phases are discussed in this chapter. The third, reporting, is covered in chapter 7.

### 6.1.1 Preparation and planning

Once the contract or engagement letter has been signed, the external auditor, in consultation with the MFI, will plan the execution of the engagement. In the course of this planning, and throughout the rest of the engagement, the auditor will ask the MFI for a great deal of documentation and analysis. Both parties need to be sure that these requests are clear in terms of content, person responsible for responding, and due date.

Preparation and planning should normally include the following elements:

- *Understanding the microfinance industry.* This phase is important, especially for auditors who have not worked with an MFI before. Some of this familiarization with the industry will have occurred at the pre-engagement stage, but it should be supplemented by further discussions with management and staff once the audit is awarded. In addition to both volumes of this handbook, the MFI may want to provide the auditor with other microfinance literature; useful sources of information are listed in the bibliography in annex I.
- *Gaining knowledge of the MFI's business.* The external auditor will meet with the board of directors, key senior managers (especially those involved in lending), and financial personnel. The purpose of these meetings is to understand management strategy, the MFI's loan methodology, its accounting and internal control processes, and recent circumstances affecting its performance. The external auditor should also visit branches and regional offices

*The audit process consists of preparation and planning, obtaining audit evidence, and reporting*

*The auditor should use a “risk-based” approach so that audit testing can be concentrated in areas of more material risk*

to get a sense of the relationship between the head office and other offices, and to understand the levels of authority. Finally, the external auditor will conduct a preliminary review of reports and systems to check the status of the financial statements, review budgets and strategic plans, and evaluate documentation.

- *Understanding accounting methods and standards.* The external auditor will identify the accounting methods and standards used by the MFI.
- *Understanding accounting and internal control systems.* The external auditor will gain an understanding of the institution’s accounting and internal control systems, and document this understanding. The auditor will also need to understand managers’ and directors’ attitude toward and awareness of internal controls.
- *Identifying relationships with the internal audit department.* If the MFI has an internal audit function, the external auditor will meet with internal audit staff to establish working relationships and assess the extent to which elements of the internal audit system can be relied on, as well as determine where the internal audit staff may be able to assist in the audit process.
- *Assessing risk.* The auditor should use a “risk-based” approach, assessing different kinds of risk so that the work and expense of audit testing can be concentrated in areas of more material risk.
- *Defining materiality.* The auditor will define levels of materiality for each area to be audited, in order to determine the depth to which information is evaluated. Information is considered material if its omission or misstatement could influence economic decisions made by users on the basis of the financial statements.
- *Planning audit tests and procedures.* The auditor will plan the tests and procedures to be used in collecting audit evidence for the institution’s key account balances: loan portfolio and loss provisions, savings, cash, fund balance or capital, and revenues and expenses. The client should be actively involved in this planning, especially for the review of accounts and systems related to the loan portfolio and loss provisions.

### 6.1.2 Obtaining audit evidence

The auditor will design and perform tests and other procedures to obtain evidence about the assertions—both explicit and implicit—that management makes in its financial statements. The assertions can be categorized as follows:

- *Completeness*—there are no unrecorded assets, liabilities, or transactions.
- *Validity* (referred to as “existence” and “rights and obligations” in International Standards on Auditing, or ISAs)—the recorded transactions are valid.
- *Recording* (referred to as “measurement” in ISAs)—transactions are recorded in the proper amount.
- *Cutoff* (referred to as “occurrence” in ISAs)—transactions are recorded in the correct period.

- *Valuation*—assets or liabilities are correctly valued.
- *Presentation*—items are described in accordance with the applicable financial reporting framework.

Because it would be prohibitively expensive to test every transaction that occurred in the period under audit, a sampling methodology is often used. Determining the sample size involves assessing the risks associated with particular account balances. The sampling methodology and sample size are crucial in testing an MFI's loan portfolio. Thus this area should be discussed thoroughly with the auditor. An illustrative case of sample size determination is presented in chapter 6 of volume 2.

Auditors conduct their tests and procedures both at headquarters and at branches. Volume 2 treats auditor activities in greater detail.

*The sampling methodology and sample size are crucial in testing an MFI's loan portfolio*

### 6.1.3 Reporting

The auditor will prepare an audit report, as well as a management letter if the client requests one. Audit reports are discussed in chapter 7.

## 6.2 The client's responsibilities

Since an audit requires the time and effort of people who have other day-to-day operational responsibilities, it should be conducted efficiently. The MFI should appoint an individual—typically the controller or chief accountant—as the day-to-day liaison to the external auditor. The liaison's responsibilities would include, but not necessarily be limited to:

- Ensuring that all schedule and analysis requests are delivered on a timely basis
- Notifying the auditor of any timing issues
- Researching or delegating issues and questions the auditor may have
- Receiving draft management letter comments from the auditor and coordinating the response to them
- Receiving the proposed audit adjustments and coordinating the resolution of them.

The management of an MFI has certain responsibilities during an external audit. ISA 580 requires that auditors obtain an acknowledgment by management of its responsibility for the financial statements—for example, a signed copy of the financial statements, a written representation, or board minutes.<sup>1</sup>

Management is also responsible for policies and procedures for the identification, valuation, and recording of litigation, claims, and assessments. In addition, management must ensure the MFI's compliance with applicable laws and regulations.

During an audit, management will make many representations to the auditor, either unsolicited or in response to specific inquiries. The auditor may request written representation on matters that are material to the financial statements.

Auditors sometimes ask for a *management representation letter* to acknowledge the responsibilities outlined above. This letter usually carries the same date as the audit report and is signed by the MFIs top management. If management refuses any of the representations requested by the auditor, this may be considered a limitation of scope that prevents the auditor from expressing an unqualified audit opinion. Annex F provides a sample of a management representation letter.

### 6.3 Timing of the audit

There is a wide gap between the ideal scheduling of an audit and the actual practice in many MFIs. There is often little pre-engagement planning or activity: the auditor may come in once the MFI is ready with its year-end financial statements and dedicate two to four weeks to the audit, depending on the size of the MFI. The audit report is often not available until four or more months after the end of the fiscal year.

Ideally, pre-engagement planning and activities take place in the second and third quarters of the fiscal year. At the end of the third quarter the audit plan is developed and some tests of control conducted. Most tests of control and some substantive procedures can be performed in the fourth quarter. In the first quarter of the next fiscal year, final substantive work can be performed as soon as is feasible.

#### Note

1. ISAs can be obtained from the International Federation of Accountants, 535 Fifth Avenue, 26th floor, New York, NY 10017, USA; tel.: +1 212-286-9344; fax: +1 212-286-9570; Web site: <http://www.ifac.org>

# Understanding Audit Reports

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*This chapter covers reports generated by the auditor, including the types of opinions that may result from an audit. It also provides suggestions to the client on how to interpret and respond to these reports.*

## 7.1 The audit report

Clients are sometimes surprised when, after extensive testing, analysis, and documentation in a financial statement audit, the “product” delivered is a very brief audit report, with a single paragraph giving the auditor’s opinion on the financial statements. In an annual audit of an MFI’s financial statements, the auditor’s reporting obligations are quite limited, as defined by national and international audit standards. The auditor will usually discuss the procedures and results of the financial statement audit in a follow-up meeting at the client’s request. However, auditors are not required to provide additional written documentation beyond the audit report, the financial statements, and a management letter (if one is requested).

*Clients are sometimes surprised by the brevity of audit reports*

ISA 700 provides the following list of elements for the auditor’s report:

- Title
- Addressee
- Opening or introductory paragraph (containing an identification of financial statements audited and a statement of the responsibility of the entity’s management and of the auditor)
- Scope paragraph (containing a reference to ISA or relevant national standards or practices and a description of the work the auditor performed)
- Opinion paragraph (containing an expression of opinion on the financial statements)
- Date of the report
- Auditor’s address
- Auditor’s signature.

Box 7.1 illustrates the typical format for an audit report expressing an unqualified opinion. As this example shows, the details of specific tests performed and their results are not provided in a written financial statement audit report. The

## Box 7.1

**Example of an auditor's report expressing an unqualified opinion**

## Addressee

We have audited the balance sheet of the Aspire Microfinance Institution as of December 31, 19XX, and the related statement of income and cash flows for the year then ended. These financial statements are the responsibility of the institution's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of [or "present fairly, in all material respects"] the financial position of the institution as of December 31, 19XX, and of the results of its operations and cash flows for the year then ended in accordance with International Accounting Standards.

Name

Date

Address

audit client may, however, request a meeting with the auditor to discuss the specific tests performed and their results.

The opinion paragraph is the crucial part of the audit report. An external auditor may render one of the following types of opinion:

- Unqualified opinion
- Unqualified opinion with an emphasis of matter
- Qualified opinion
- Disclaimer of opinion
- Adverse opinion.

*7.1.1 Unqualified opinion*

An unqualified opinion indicates the auditor's satisfaction in all material respects with the following matters, in accordance with the auditor's terms of reference (see box 7.1):

- The financial information has been prepared using acceptable accounting policies, which have been consistently applied
- The financial information complies with relevant regulations and statutory requirements

## BOX 7.2

**Example of an emphasis of matter paragraph**

In our opinion ... [remainder of opinion paragraph]

*Without qualifying our opinion*, we draw attention to Note X to the financial statements. The institution has entered into an agreement with the superintendency of banks to maintain a capital adequacy ratio of X%.

- The view presented by the financial information taken as a whole is consistent with the auditor's knowledge of the business of the entity or agency
- There is adequate disclosure of all material matters relevant to the proper presentation of the financial information
- Additional requirements that may have been requested in the terms of reference have been met.

### 7.1.2 Unqualified opinion with an emphasis of matter

An auditor's report may be modified by adding an "emphasis of matter" paragraph to highlight a circumstance affecting the financial statements. The paragraph is usually included after the opinion paragraph and explicitly indicates that the auditor's opinion is not qualified in this respect. Box 7.2 provides an example of such a paragraph.

An entity's continuance as a going concern for the foreseeable future is assumed in the preparation of financial statements. The "foreseeable future" is generally a period not to exceed one year after the closing date of the financial statements being audited. If this assumption is unjustified, the entity may not be able to realize its assets at the recorded amounts, and there may be changes in the amount and maturity dates of liabilities. In such cases the audit report should include an emphasis of matter paragraph relating to a going concern, provided there is adequate disclosure in the financial statements. Box 7.3 provides an example. (If adequate disclosure is not made, the auditor should express a qualified or adverse opinion; see below.)

## BOX 7.3

**Example of an emphasis of matter paragraph relating to a going concern**

In our opinion ... [remainder of opinion paragraph]

*Without qualifying our opinion*, we draw attention to Note X in the financial statements. The institution incurred a net loss of XXX during the year ended December 31, 19XX and, as of that date, the institution's current liabilities exceeded its current assets by XXX and its total liabilities exceeded its total assets by XXX. These factors, along with other matters as set forth in Note X, *raise substantial doubt* that the MFI will be able to continue as a going concern.

### 7.1.3 Qualified opinion

In certain circumstances the auditor may choose to render a qualified opinion. A qualification typically stems from a limitation on the scope of the auditor's work or a disagreement with management regarding the acceptability of accounting treatment or the adequacy of financial statement disclosures. The auditor should be guided by ISA 700, which states that:

*A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed, but the effect of any disagreement with management or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion.*

Boxes 7.4 and 7.5 illustrate two possible types of qualified opinions.

### 7.1.4 Disclaimer of opinion

In some instances the auditor may disclaim an opinion. In such cases the auditor should be guided by ISA 700, which states that:

*A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain*

#### BOX 7.4

##### **Example of a qualified opinion due to a limitation on scope**

Except as discussed in the following paragraph, we conducted our audit in accordance with ... [remainder of scope paragraph]

We *did not observe* the counting of the cash on hand as of December 31, 19XX, since that date was prior to the time we were engaged as auditors for the institution. Owing to the nature of the institution's records, *we were unable to satisfy ourselves* as to these quantities by other audit procedures.

In our opinion, *except for the effects of such adjustments*, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the amount of cash on hand, the financial statements give a true and ...

#### BOX 7.5

##### **Example of a qualified opinion due to a disagreement on accounting policies (inappropriate accounting method)**

We conducted our audit in accordance with ... [remainder of scope paragraph]

As discussed in Note X to the financial statements, *fixed assets are not reflected in the financial statements*. This practice, in our opinion, is not in accordance with International Accounting Standards. Fixed assets for the year ended December 31, 19XX, should be XXX. Accordingly, fixed assets should be established and the retained earnings should be increased by XXX.

In our opinion, *except for the effect on the financial statements* of the matter referred to in the preceding paragraph, the financial statements give a true and ...

## Box 7.6

**Example of a disclaimer of opinion due to a limitation on scope**

We have audited the balance sheet of the Aspire Microfinance Institution as of December 31, 19XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the institution's management. [The sentence stating the responsibility of the auditor is omitted.]

[The paragraph discussing the scope of the audit is either omitted or amended according to the circumstances.]

[A paragraph discussing the limitation on scope would be added as follows:]

*We were not able to confirm the existence of a significant number of the loans selected for testing, due to limitations placed on the scope of our work by the institution.*

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements.

*sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.*

For example, a disclaimer of opinion would be warranted if the auditor could not obtain sufficient audit evidence on loans, cash, or other accounts of such magnitude. Box 7.6 provides an example.

If an MFI imposes serious limitations on the scope of the auditor's work during the planning stages of the audit, and if the auditor believes that such limitations would result in a disclaimer of opinion, the auditor would normally reject the audit engagement unless required by statute to accept it.

### 7.1.5 Adverse opinion

ISA 700 states that an adverse opinion:

*should be expressed when the effects of a disagreement are so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.*

## Box 7.7

**Example of an adverse opinion due to a disagreement on accounting policies (inadequate disclosure)**

We conducted our audit in accordance with ... [remainder of scope paragraph]

[Paragraph(s) discussing the disagreement]

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements *do not give a true and fair view of* [or "*do not present fairly*"] the financial position of the institution as of December 31, 19XX, and of the results of its operations and its cash flows for the year then ended, and do not comply with generally accepted accounting principles.

*Inexperienced  
readers of audit  
opinions sometimes  
misinterpret them*

An adverse opinion should be expressed if the basis of accounting is unacceptable and distorts the financial reporting of the MFI. If auditors discover circumstances during the course of the audit that make them question whether they can issue an unqualified opinion, they should always discuss those circumstances with the client before issuing the opinion, in order to determine whether it is possible to rectify the problem. Box 7.7 provides an example of an adverse opinion.

Inexperienced readers of audit opinions sometimes misinterpret them. They understand, correctly, that a significantly qualified or adverse opinion may justify serious concern about the quality of management, the state of accounting systems and controls, or the health of the business. But they sometimes assume, incorrectly, that a “clean” opinion is an assurance that all is well with the institution, that it is free from fraud, that its loan portfolio is sound, and so on. Readers must understand the limitations of external financial statement audits. They may wish to review the end of section 2.2.1, which discusses some of these limitations.

## 7.2 The management letter

As discussed earlier, the terms of reference for an audit should always request a management letter that comments on weaknesses and offers recommendations that arise in the course of the audit. This document is usually addressed to the board of directors or its audit committee. Such letters are sometimes also addressed, or copied, to donors. It is customary for the auditor to obtain management’s responses to a draft of the management letter, and to consider these responses before preparing the final document.

Sometimes auditors will deliver a management letter consisting largely of boilerplate—general material that does not focus much on the specific circumstances and issues of the client. Clients should insist on management letters that respond directly and practically to the concrete issues of the business being audited. A sample management letter is provided in annex H.

The board and management of the MFI should discuss the comments provided by the auditor in the management letter and develop an action plan after reviewing the recommendations. The client can also request a follow-up meeting with the auditor to further discuss comments in the management letter and get the auditor’s input on planned improvements. Where the management letter identifies weaknesses that are particularly serious or pervasive, the MFI may want to consider contracting for technical assistance in making improvements. (Retaining the external audit firm for this purpose can pose a risk of conflict of interest, but in many cases it may be a sensible solution.)

*Readers need to be careful in interpreting management letters*, for two reasons. First, even a sophisticated and well-run MFI will inevitably have a number of areas where, by accident or design, standard controls and procedures are not adhered to. The fact that the management letter contains a number of observations and recommendations does not necessarily mean that financial management is weak or that

the control system is in a dangerous state. Rather, readers must appraise the significance of each item. Second, the management of MFIs sometimes have sound business reasons for departing from controls or procedures that are standard in other businesses. Management, boards, and donors should give serious consideration to the contents of the auditor's management letter—but they should never automatically assume that every recommendation must be implemented.

These perspectives are important. If the board or management believes that every item in a management letter is a reflection on management's competence, or that every recommendation must be adopted, the result is often that managers and auditors waste too much energy on unproductive argument over the contents of the management letter.

This observation about management letters can be generalized to cover the full range of audit recommendations, regardless of where they are expressed. Especially when donor or government bureaucracies are involved, there is a tendency to insist on compliance with any recommendation generated by auditors, because such a policy minimizes risk to the bureaucrat. Where this is the atmosphere in which audit recommendations are received, bad decisions often result. Just as important, the people and institutions being audited often respond to the audit with dread and defensiveness. Taking audit recommendations seriously should never mean accepting them mechanically. Audit recommendations normally should not be the last word, but rather the starting point of a discussion among the stakeholders.

*Taking audit  
recommendations  
seriously should  
never mean accepting  
them mechanically*

### 7.3 Reports of agreed-upon procedures

Where agreed-upon procedures have been part of the audit engagement, the auditor will report on the nature and results of the procedures and tests without expressing an opinion on their overall significance. Thus clients must pay special attention to the original definition of the procedures to be performed, to ensure that they will be able to form their own conclusions about the reported results.