CGAP

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

External Audits of Microfinance Institutions

A Handbook

Annexes

Technical Tool Series No. 3
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Contents

ANNEX A

CGAP Guidelines for Content and Presentation of MFI Financial Statements

Audited financial statements frequently fail to include enough information to allow an analysis of the financial sustainability of an MFI, including the condition of its portfolio. To help remedy this problem, CGAP strongly recommends that audited MFI financial statements contain all the elements laid out in this annex.

For audit clients who choose to accept this recommendation, the initial question is how to make sure that it 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 the financial statements do not belong in an auditor's terms of reference or engagement letter. But as a practical matter, it is often the auditor, rather than the MFI, who prepares the final presentation of the financial statements and writes the notes that form an integral 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.

Thus audit clients may wish to consider including the following specifications in their terms of reference. Alternatively, a donor may wish to obtain an agreement directly with management that the financial statements to be audited will present all the information called for in this 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 specified here will be included in the audited financial statements, and that the auditor's review and confirmation of those financial statements extends to all of this information.

Two comments apply to all of these items:

- Depending on local practice, some of this information might be included in the main text of the financial statements. More commonly, much of it would be included in notes to the statements. The location is not important; the inclusion of the information is.
- In some cases the information requested may turn out to be unavailable, or the cost of assembling it may appear prohibitive. In such cases CGAP does not recommend removing the item from the terms of reference (or a separate agreement between the donor and the MFI). Rather, the terms of reference should specify the information and require that if it is not provided, the fact of its unavailability, and the reason for its unavailability, be

included explicitly in a note to the financial statements.

The rationale for most of these requirements is discussed at length in various manuals for financial analysis of MFIs.[1] The specific requirements appear below.

Segment reporting (unconsolidated statements) for multiservice MFIs

In addition to financial services, many MFIs provide nonfinancial services such as training, marketing, technical assistance, health care, and community development. Such MFIs may not fully segregate the accounting and administration of these disparate services. This situation does not necessarily pose a problem for the auditor in expressing an opinion on a financial statement that presents the consolidated results of the MFI's entire operations. But readers of such a financial statement cannot judge the sustainability of the financial services unless there is a separate presentation of their results—at least the income (profit and loss) statement—based on a reasonable allocation of any income and costs shared between the financial and nonfinancial services.

In the sample financial statements found in annex G, note 12 provides separate income statements for financial services and nonfinancial services. Dividing income between the two services is usually straightforward. Allocating expenses can be more difficult, because many indirect costs are shared between the services—for instance, the time of the executive director and other staff that deal with both services, certain office costs, and so on. Some reasonable allocation formula needs to be determined.[2]

Preparing segregated balance sheets—as opposed to income statements—can be very difficult. For most multipurpose NGOs, reasonable financial analysis is possible if the balance sheet or the notes provide, to the extent practical, enough detail on assets and liabilities to distinguish which are associated with financial services, which are associated with nonfinancial services, and which are shared between the two.

If an audit client wants audited financial statements that allow analysis of the sustainability of the microfinance component of a multiservice MFI, the client must specifically request segment reporting: a separate presentation of the microfinance results, usually by way of a note to the financial statements, containing an unconsolidated income statement. Such a note should explain the specific basis on which the MFI has allocated its costs between financial and nonfinancial operations. Readers can then draw their own conclusions about the reasonableness of the allocations.[3]

Prior years' information

Where practical, financial statements are much more revealing if they show in parallel columns financial information for both current and prior years. This may be difficult if the accounting or reporting basis has changed between years. If prior-year information is included that has not been audited by the current-year auditors, they should note that fact in their report and include an appropriate reference to the prior year's audit (auditor's name, date of report, type of opinion).

Portfolio information

Audited statements for MFIs usually fail to include an adequate note on loan loss provisions and write-offs. The client should require that this note detail gross loan portfolio, provisions, write-offs, and net portfolio. In addition, this note or the note on accounting policies should give a clear and thorough explanation of the policies governing the MFI's loan provisions and write-offs. (If such an explanation is not specifically requested, it will seldom be included.) The amounts written off during the current year, and perhaps prior years, should be specified in the note because they usually do not appear explicitly in the body of the financial statements. Typically, write-offs are not passed through the income statement. Rather, they are effected on the balance sheet by reducing both loan portfolio and loan loss allowance by the amount written off, leaving the net portfolio unchanged. Note 4 in annex G provides a format for tracking loan loss provisions and write-offs. Provisioning and write-off issues are discussed further in sections 5.2.10 and 5.2.11 of volume 1 and chapter 7 of volume 2.

Where convenient, financial analysis will be aided if the note on the loan portfolio gives the average loan portfolio over the course of the year, calculated on a monthly or at least quarterly basis.

Interest accrual

If an MFI accrues interest on its loan portfolio, a note to the financial statements should explain clearly and thoroughly how the accrual is performed and when accrual is stopped—and previously accrued interest is reversed—on nonperforming loans.

Separation of donations as "nonoperating" income

Financial statements for MFIs that are NGOs sometimes lump revenue from donations together with normal "operating" revenue—that is, interest and fee income. Most MFIs cannot rely on such donations being repeated regularly in the future. Thus, to appraise the MFI's long-term viability and capacity to grow without continued infusions of donor funds, stakeholders need to know what the MFI's financial performance would look like without donations. Therefore, either in the main financial statements or in an accompanying note, the MFI's "operating" profit or loss (interest and fee income from normal operations, minus expenses of operations) should be shown, with donations separated out "below the line." The financial statements in annex G are presented in this fashion.

Identification of in-kind subsidies

In addition to cash donations, MFIs often receive in-kind donations that may not appear on their income statement. For instance, a donor may pay the salary of the MFI's executive director, the MFI may be occupying rent-free offices, or fixed assets may bypass the income statement and be recorded directly on the balance sheet. A note should identify any such in-kind subsidies, and where practical estimate the cost or market value of such subsidy. The rationale for including such information is that the goods or services in question may be important for the viability of the MFI's business, and the MFI may have to pay for them in the future, especially as it expands. Thus information about in-kind subsidies may be important in forming an overall picture of the MFI's business prospects.

The income statement must include an appropriate charge for depreciation of any donated equipment.

Details of liabilities

MFIs often receive debt funding at below-market interest rates. Since they cannot depend on being able to fund future growth with a continued flow of such "soft" loans, it is important to know the extent to which MFIs are being subsidized through this mechanism. Accordingly, a note to the financial statements should include the following information for each liability that accounts for more than 10 percent of total liabilities:

- Source of the liability.
- Terms (amount, repayment schedule including grace periods, interest rate, and so on).
- Average outstanding principal balance of the liability during the year, calculated on a monthly or at least quarterly basis. (A monthly average would be the opening balance at the beginning of the fiscal year, plus the balances at the end of each month, divided by thirteen.)
- Actual interest payments made during the year for the liability.

Savings

If an MFI captures both voluntary and compulsory savings, these amounts should be presented separately, either in the body of the financial statements or in a note.

Presentation of capital account

If possible, the balance sheet or a note should break out the capital account so that the following information is available:

- Shareholder or founder capital (statutory or social capital, paid-in surplus, and so on).
- Grants and donations, broken out between cumulative prior years' grants and current year's grants. (This should include all grants or donations, whether they have been passed through the income statement or recorded directly to the balance sheet.)
- Special reserves or other capital accounts, if any.
- Retained operating earnings or losses, broken out between cumulative prior years' earnings or losses and current year's operating earnings or losses. (The earnings or losses included here should not include the effect of any grants or donations.)

The sum of these items would add up to total capital.

Presenting the capital accounts in this fashion allows readers to understand how much of the MFI's current capital position is due to donations and how much is due to operating earnings or losses. For multiservice NGOs that combine financial and nonfinancial services, this breakdown of the capital account may be less meaningful in clarifying the viability of the financial services component, since it will often prove impossible to allocate some of the items—especially prior years' retained earnings or losses—between financial and nonfinancial services. In any event, if it proves impractical to break out the capital account this way, a note should indicate the specific reason why.

The illustrative audit report and financial statements in annex G provide an example of the presentation of the information called for in this annex.

Notes

1. Useful reference materials include IDB (1994), Holtmann and Mommartz (1996), SEEP Network (1995), and CGAP (1998b). See the bibliography (annex I) for details.

2. See CGAP, Occasional Paper 2, "Cost Allocation for Multi-Service Micro-Finance Institutions," which is available from CGAP, 1818 H Street NW, Room Q 4022, Washington, D.C. 20433, USA.

ANNEX B

Accounting Standards and Auditing Standards

Accounting standards

Accounting standards are guidelines that specify the accounting treatment for financial transactions. Such standards are used to ensure the comparability, consistency, and completeness of financial records.

Accounting standards may be national, such as the standards developed by a country's recognized national accountants organization, or international, such as the International Accounting Standards (IAS) developed by the International Accounting Standards Committee. It is important to recognize differences between accounting standards and methods when comparing financial information from different institutions or countries.

To maintain the credibility of its financial statements, an MFI must adhere to a recognized, comprehensive set of accounting standards. An MFI may want to consider retaining the services of a reputable certified public accountant or accounting firm to design an accounting system that complies with national and international standards, and to train staff in the system's use.

Types of accounting standards and methods

Three major issues should be considered in understanding accounting standards and methods:

- Overall standards. Accounting standards and methods can vary by country and even by entity. Many countries have generally accepted accounting principles (GAAP), established by a national professional association of accountants or an accounting standards board. Some countries have used the GAAP of Western countries (France, the United Kingdom, the United States) to develop their own GAAP. In the absence of national standards, some countries use French GAAP, U.K. GAAP, or U.S. GAAP. Other countries use IAS, which are widely accepted around the world. MFIs operating in a country that has neither a strong professional accounting body nor national standards should consider using IAS.
- Accounting methods. Within the context of accounting standards, different accounting methods may be used. Many MFIs use the accrual basis of accounting. Under accrual-based accounting the financial effects of transactions and events are recognized in the periods in which they occur, rather than when cash is actually exchanged. The accrual basis of accounting is

in accordance with most accounting standard–setting bodies.

Some MFIs, however, use a cash basis of accounting, recognizing receipts and payments only when cash is received or paid. The cash basis of accounting is often used in the preparation of financial statements for government entities. In some cases donors that fund MFIs request that the MFIs report on a cash basis.

To be conservative, some MFIs use a mixed basis of accounting, accruing expenses but not income.

- Industry practices. In developing its accounting procedures, an MFI often has the choice of using the industry practices of financial institutions or of nonprofit entities. Financial institutions take a more enterprise-oriented approach to accounting for their operations, showing entity capital and consolidating subsidiary operations. Nonprofits tend to use a fund accounting approach, which segregates funding and expenses by project, activity, or program. Many MFIs use fund accounting because of their NGO status and because they receive large amounts of donor funding. However, an increasing number of MFIs are adopting a financial institution approach.

What accounting standards do

Accounting standards provide guidance on:

- Accounting treatment to be used for different financial transactions and accounts
- Minimum disclosure requirements.

TABLE B.1
Selected international accounting standards

Standard	Description
IAS 1: Disclosure of accounting policies	All significant accounting policies that have been adopted in the preparation and presentation of financial statements need to be disclosed as an integral part of those statements.
IAS 5: Information to be disclosed in the financial statements	Minimum disclosure requirements are set out, divided into general and specific disclosures, as follows: • All material information • Corresponding figures for the preceding period • Specific disclosures are laid out for the following balance sheet items: long-term assets, current assets, long-term liabilities (net of portion repayable within one year), current liabilities, and shareholder interest • Major categories of specific disclosures for the income statement are sales or other

TABLE B.1
Selected international accounting standards

Standard	Description
	operating revenue, depreciation, interest income, investment income, interest expense, income taxes, unusual charges, unusual credits, significant intercompany transactions, net income.
IAS 7: Cash-flow statements	Financial statements of all enterprises must contain cash-flow statements, prepared according to procedures detailed in the standard.
IAS 10: Contingencies and events occurring after the balance sheet date	This standard provides guidance in identifying contingencies and events occurring after the balance sheet date.
IAS 13: Presentation of current assets and current liabilities	This standard is applicable if an enterprise presents current assets and current liabilities separately from other assets and liabilities. The standard sets out items to be considered as current assets and current liabilities and defines presentation and disclosure requirements for such assets and liabilities.
IAS 18: Revenue recognition	Revenue should be recognized if it meets certain standards of transfer of ownership, certainty, collectability, and measurability. Disclosure requirements include any postponement of any revenue recognition.
IAS 20: Accounting for government grants and disclosures of government assistance	Government grants related to assets, including the fair value of nonmonetary grants, should be presented in the balance sheet either by setting up the grants as deferred income or by deducting the grants in arriving at the carrying value of the assets. Government grants related to assets should be recognized over the periods in which the related costs occur. This standard requires disclosure of accounting policy, nature and extent of grants, and any unfulfilled conditions for the grants.
IAS 21: Accounting for the effects of changes in foreign exchange rates	Transactions in foreign currencies should be recorded in the reporting currency of the enterprise and revalued at the closing exchange rate for reporting purposes (the exception being forward exchange contracts, which receive special accounting treatment). Exchange differences arising from such treatment should be recognized in the

TABLE B.1 (continued)
Selected international accounting standards

Standard	Description
IAS 30: Disclosures in the financial statements of banks and similar financial institutions	The disclosure requirements set out in this standard are in addition to those set out in other standards. The standard requires finan-
cial	
	institutions to present an income statement that groups income and expenses by nature and discloses the amounts of the principal types of income and expenses. The
standard	

There are currently 32 IAS; some of them are described in table B.1.[1]

Auditing standards

Auditing standards guide the activities carried out by external auditors.

Types of auditing standards

Auditing standards guide the auditor through each step of the audit process. As with accounting standards, each country may have its own auditing standards established by a national professional association of accountants or by a government body. If a country does not have national auditing standards, auditors often adopt International Standards on Auditing (ISAs)[2] or the generally accepted auditing standards of a country with a long-established professional body (such as France, the United Kingdom, or the United States).

Just as MFIs should adhere to accounting standards, external auditors should adhere to consistent audit standards to ensure an effective audit. Different sets of audit standards yield different audit approaches.

In commissioning an audit, an MFI or donor must find out which set of audit standards is followed by each prospective auditor. This determination is crucial to ensure that the audit customer receives quality services, reliable information, and an internationally credible audit opinion. Furthermore, most audit standards provide procedures for the audit customer to gain remedy in the event of inadequate or substandard performance by the auditor. Chapter 4 of volume 1 provides guidance on this and other issues involved in commissioning an audit.

The use of ISAs is strongly recommended, at least where an alternative set of auditing standards is not required.

What auditing standards do

Auditing standards provide guidance on:

TABLE B.2

Selected international standards on auditing

Standard	Description
ISA 200: Objective and general principles of the audit of financial statements	This standard describes management's responsibility for financial statements and the overall objective and scope of the audit of an entity's financial statements by an independent auditor. The basic principles of an auditor's professional responsibility include integrity, objectivity, and independence; confidentiality, skills, and competence; work performed by others; documentation; planning; obtaining audit evidence; reviewing accounting systems and internal controls; reviewing conclusions reached; and reporting. These basic principles are the cornerstone of all other International Standards on Auditing.
ISA 210: Terms of audit engagements	An auditor's engagement letter to the client is designed to document and confirm the auditor's acceptance of the appointment, the scope of the auditor's work, the extent of the auditor's responsibilities, and the form of any reports. This standard describes the principal contents of an engagement letter, and the appendix contains an example of a letter.
ISA 220: Quality control for audit work	This standard distinguishes between controls on individual audits and the general quality controls adopted by an audit firm. While recognizing the interrelationship of the two types of controls, general quality controls "augment and facilitate" controls on individual audits, but do not replace them. This standard also addresses controls over the delegation of work to assistants on an audit in order to comply with basic auditing principles, and provides practical guidance to audit firms on quality control in their practices.
ISA 240: Fraud and error	The standard defines fraud and error and indicates that the responsibility for the prevention of fraud and error rests with management. The auditor should plan the audit so that there is a reasonable expectation of detecting material misstatements resulting

TABLE B.2 (continued)
Selected international standards on auditing

Standard	Description
ISA 250: Consideration of laws and regulations in an audit of financial statements	This standard lays out auditors' responsibility to consider laws and regulations in an audit of financial statements. When planning and performing audit procedures, and in evaluating and reporting the results, auditors should recognize that an entity's failure to comply with laws and regulations may materially affect financial statements. However, an audit cannot be expected to detect noncompliance with all laws and regulations. Detection of noncompliance, regardless of materiality, requires considering the implications for the integrity of management or employees and the possible effect on other aspects of the audit. This standard also defines management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations. The responsibility for the prevention and detection of noncompliance rests with management.
ISA 310: Knowledge of the business	This standard provides guidance on what is meant by "a knowledge of the business," why such knowledge is important to the auditor, why it is relevant to all phases of an audit, and how the auditor obtains and uses such knowledge.
ISA 400: Risk assessments and internal controls	Management is responsible for maintaining an adequate accounting system that incorporates internal controls appropriate to the size and nature of the business. However, the auditor needs reasonable assurance that the accounting system is adequate and that all the accounting information that should be recorded has in fact been recorded. Internal controls normally contribute to such assurance. This standard describes accounting systems; elements, objectives, and limitations of internal controls; and audit procedures for the study and evaluation of internal controls.
ISA 530: Audit sampling	This standard identifies the factors that an auditor should consider when designing and selecting an audit sample and evaluating the results of audit procedures. This standard applies to both statistical and nonstatistical sampling methods, providing fundamental yet practical guidance on such matters as sampling, risk, stratification, selection methods, and

TABLE B.2 (continued)
Selected international standards on auditing

Standard	Description
ISA 610: Considering the work of internal auditing	The internal audit function constitutes a separate component of internal control undertaken by specially assigned staff within an entity. An objective of the internal auditor is to determine whether internal controls are well-designed and properly operated. Much of the work of the internal audit department may be useful to the external auditor. This standard provides guidance on procedures to consider in assessing the work of an internal auditor.
ISA 700: The auditor's report on financial statements	This standard governs the form and content of the auditor's report issued in connection with a financial statement audit. The standard suggests wording to express an unqualified opinion and discusses circumstances that may result in other than an unqualified opinion. An appendix provides examples of an unqualified opinion, adverse auditor's reports, and a denial

- Procedures to be followed
- Responsibilities of the auditor
- Reporting.

Selected ISAs are described in table B.2.

Notes

1. The International Accounting Standards Handbook 1996 is published by the International Accounting Standards Committee (IASC). Copies are available through the IASC at 167 Fleet Street, London EC4A 2ES, United Kingdom; tel.: +44 171-353-0565; fax: +44 171-353-0562.

2. 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

ANNEX C

Illustrative Terms of Reference for a Financial Statement Audit

Readers are cautioned against using the following example as a template. The terms of reference for any audit should be tailored to the engagement.

1. Introduction

1.1 The board of directors of Aspire MFI invites your firm to submit technical and financial proposals for audit of Aspire MFI. Proposals are invited for two assignments, one covering an annual financial statement audit and one covering agreed-upon procedures. The proposal could form the basis for future negotiations and ultimately a contract between your firm and Aspire MFI. The contract would initially cover a three-year period—fiscal 1996, 1997, and 1998.

1.2 The contracts for these assignments may be renewable upon their completion for a further period, or advertised again, at the discretion of Aspire MFI.

1.3 The cost of preparing a proposal and conducting the pre-proposal survey or any meetings for oral presentations shall be borne by your firm, regardless of the conduct or outcome of the solicitation process. Proposals must offer services for the total requirements: proposals offering only part of the services will be rejected.

1.4 At any time before the submission of proposals, Aspire MFI may, whether at its own initiative or in response to a clarification requested by an invited offeror, modify the solicitation documents by amendment. The amendment will be conveyed in writing or by cable, telex, or facsimile to all invited offerors and will be binding on them. Aspire MFI may, at its discretion, extend the deadline for submission of proposals.

1.5 All proposals must remain valid and open for acceptance for a period of ninety (90) calendar days after the date specified for receipt of proposals.

2. Background

2.1 Aspire MFI was founded in 1975. Aspire has expanded its operations to include 13 branches in 1996, with branches in remote rural areas. Further details about Aspire's operations, including a copy of the previous year's unaudited financial statements, are provided in attachment A.

2.2 Aspire has an audit committee headed by an outside director. Our audit committee will delegate to the director of finance responsibility for day-to-day interface with the external auditor and will supply the external auditor with necessary information.

3. Objective of the external audit

3.1 The objective of the external audit of Aspire MFI's financial statements is to enable the auditor to express a professional opinion on the financial position of Aspire MFI at the end of the three fiscal years (1996, 1997, and 1998) and on the funds received and expenditures for the accounting period ended 31 December for each fiscal year.

4. Scope of the external audit

4.1 The external audit will be carried out in accordance with International Standards on Auditing (ISAs) [or the country's auditing standards], and will include such tests and controls as the auditor considers necessary under the circumstances.

4.2 The auditor should pay special attention to key account balances, particularly the loan portfolio and loan loss provisions, cash and equivalents, and fund balances.

4.3 Given Aspire's large number of loans, the auditor is encouraged to use statistical sampling methods to ensure that a representative sample is tested.

4.4 As part of the audit process, the auditor should visit a representative number of branches each year. It is expected that the auditor will have visited all branches in a two-year period.

4.5 For the purposes of testing, the auditor is required to visit a representative number of clients.

5. Use of CGAP handbook

5.1 The auditor must become familiar with both volumes and the annexes of External Audits of Microfinance Institutions: A Handbook, produced by the Consultative Group to Assist the Poorest, Washington, D.C., which covers key issues relevant to the audit of microfinance institutions. Aspire MFI will provide copies of the handbook to interested bidders at their request. The auditor will be required, before executing the engagement agreement, to specify in writing 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.

6. Financial statements and other information

6.1 Aspire prepares its financial statements according to [specify] accounting standards. Aspire will provide to the external auditor the following financial statements:

- Income statement
- Balance sheet
- Cash-flow statement.

6.2 The financial statements of Aspire will be prepared in conformity with the requirements of attachment B [identical to annex A of this handbook]. While the accuracy of the information requested in this attachment, and the reasonableness of procedures used to derive it, are primarily the responsibility of management, the auditor's review and opinion will extend to all of the disclosures required in that attachment, whether they appear in the main body of the financial statements or in the notes to those statements.

6.3 The auditor will be given access to all legal documents, correspondence, and any other information associated with Aspire MFI and deemed necessary by the auditor.

7. Prior year audits

7.1 Aspire MFI has not been audited in previous years. Thus it is crucial that the external auditor closely examine all the opening balances for this fiscal year.

8. Audit opinion

8.1 The external auditor is required to provide an opinion on the financial statements of Aspire MFI in accordance with ISAs.

9. Management letter

9.1 In addition to the audit report and opinion, the auditor will be required to prepare a management letter. In the management letter the auditor should:

- Comment on the accounting records, systems, and controls that were examined during the audit, including but not limited to systems for handling and recording cash; adherence to policies and procedures in the loan approval and disbursal process; segregation of duties in loan and cash areas; procedures for loan loss provisions; proper recording and cut-off of payables and accruals; and so on.

- Comment on other specific systems and processes, such as the administration system and management information system, particularly at the branch level.
- Recommend improvements where specific weaknesses are identified in any of the above systems and controls.
- Communicate any other matters identified during the audit that might significantly affect the future implementation of Aspire MFI's function, or that the auditor considers pertinent.
- Comment specifically on the appropriateness, and consistency of application, of policies for loan loss provisioning, loan write-offs, allocation of indirect costs between financial and nonfinancial services, and, where applicable, cessation and reversal of accrued but unpaid interest on non-performing loans.

10. Agreed-upon procedures

10.1 In addition to the financial statement audit, the external auditor is required to perform the agreed-upon procedures specified in attachment C [perhaps developed along the lines of annex D of this handbook] and submit a separate report.

11. Timing of the audit

11.1 The audit report and opinion, the management letter, and the report on agreed-upon procedures should be received by Aspire MFI no later than two months after the end of the accounting period to which the audit refers. The auditor should submit the report to Aspire MFI's audit committee.

12. Communications with the audit committee

12.1 The selected auditor will be required to present their audit approach and planned audit program to the audit committee before commencing the engagement.

12.2 The audit partner and manager will be required to attend all meetings of the audit committee.

12.3 If external auditors discover any errors, irregularities, or fraudulent acts during their work, they are required to communicate these immediately to the audit committee.

13. Pre-proposal survey

13.1 Prospective bidders must conduct a pre-proposal survey at their own cost. A team from the audit firm should spend a minimum of two full days at headquarters reviewing key systems and processes, as well as visit one or more branches. The impressions and finding from this survey should be incorporated into the audit proposal.

14. Additional information and proposal structure

14.1 Proposals must incorporate the following information, be organized into the four sections indicated, and be no more than [provide number] pages in length.

14.2 Understanding of the work. Demonstrate understanding of the MFI industry, Aspire MFI, and the nature of the work.

14.3 Audit approach. Describe the proposed approach, timing of tasks, and quality control procedures.

14.4 Audit team. For each member of the audit team, describe roles in the engagement and approximate level of effort. For each licensed auditor proposed for this engagement, provide a separate attachment with name and brief summary of qualifications and experience, including:

- Education and qualifications
- Memberships in professional audit or accounting associations
- Details of audit and accounting work experience, including experience in microfinance
- Written and spoken fluency in English or other languages.

14.5 Firm experience. Provide the following information at a minimum:

- Description. State the legal nature of the firm (sole proprietorship, partnership). State the total number of auditors (excluding support staff) who are owners or employees of the firm. Indicate how many of these are licensed auditors. Indicate services provided by the firm and the approximate percentage of auditing services in the firm's total fee income. State whether the firm has any association or affiliation with any other professional firm as auditors, accountants, consultants, or lawyers, either in the country or abroad. If so, provide details.
- Microfinance experience. Discuss the firm's commitment to serving the microfinance industry and experience with microfinance audits.
- Financial institutions experience. Discuss the firm's experience with financial institution audits.
- Independence of the firm. State whether any of the individuals listed

above (or spouses or close relatives) are employed by, serve as a director of, or have any financial or business relationship with Aspire MFI. If so, provide details.

- Audit practice. Attach a separate list of the firm's main clients (particularly any microfinance institutions, financial institutions, or nonprofit service organizations) in the past five years. Specify the type of service (auditing, consulting, accounting) provided to each client. State whether the firm has performed audits jointly with international audit firms. If so, provide details.
- Audit standards and procedures. State whether the firm adheres to international auditing standards and local auditing standards. Describe how the firm's audit procedures and methods ensure that these standards are followed. State whether the firm's audit procedures and methods are recorded in a manual or similar document. State briefly how employees are supervised. State briefly the internal procedures used to ensure high-quality work and services.

15. Oral presentation

15.1 As part of the proposal process, the three bidders with the highest scores will be invited to present their proposal in person to the audit committee, and to respond to questions from the committee. In the proposal, bidders should discuss their availability and willingness to make such a presentation. All members of the proposed audit team will be required to attend the proposal presentation.

16. Fees

16.1 Each bidder is required to submit a separate cost proposal for this engagement under separate cover. A separate cost proposal is also required for the agreed-upon procedures. The format for the cost proposal is provided in attachment D.

17. Submission and deadlines

17.1 The technical proposal and cost proposal should be submitted to Aspire MFI no later than [provide date].

17.2 All proposals and correspondence should be addressed to:
Audit committee
Aspire MFI
Street address

17.3 Proposals should be mailed or sent by courier.

18. Proposal scoring

18.1 No mathematical weighting will be used in scoring proposals.

ANNEX D

Illustrative Agreed-upon Procedures to Test the Loan Portfolio Delinquency Report and Compliance with Loan Policies and Procedures

Rather than simply accepting a "one-size-fits-all" portfolio review determined solely by the auditor's standards and policies, the MFI client should make every effort to discuss specific 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 might have to consider looking for another auditor.

This annex describes illustrative procedures to address two key loan portfolio concerns:

- Is payment and delinquency information in the loan tracking management information system (MIS) reliable? Unreliable payment information can result in understatement of loan loss provisions. Even if this understatement does not reach material dimensions at present, the unreliability of the system may pose a significant business risk in the future.
- Do the MFI's actual loan operations comply with its stated policies and procedures, especially with regard to key risk elements?

In a typical annual financial statement audit, MFI auditors seldom examine these areas as thoroughly as is illustrated here. Some auditors might perform some of these procedures routinely, but there is no general pattern. Accordingly, it is difficult to say whether a given procedure will be included in the regular financial statement audit, even if the client does not ask for it; will be performed as part of the regular audit, but only if the client asks for it; or will be performed only if the client contracts for it separately as an agreed-upon procedure, beyond the scope of the regular audit.

Separate agreed-upon procedures might be requested for three reasons:

- They may be desired by the client but not fall within the scope of the financial statement audit.
- They may have been carried out as part of the regular audit work, but the client wants the work to be done more intensively—for example, using a larger sample than the auditor would normally have selected.
- They may be no different from what would have been done as part of the regular audit, but the client wants written documentation of the specific tests performed and the results obtained, which are not normally provided in a financial statement audit report.

If agreed-upon procedures are being considered, clients should be aware of the following:

- In an agreed-upon procedures engagement, the scope and sufficiency of the procedures are ultimately the responsibility of the client.
- The scope of the procedures should be different from the procedures that the auditor will undertake in the financial statement audit, in terms of the sample size selected or the types of tests performed.
- These procedures should be undertaken at the same time as the financial statement audit to avoid duplicated or wasted effort.
- Auditors are not obliged to reveal the sample sizes they propose to use in the regular audit.
- Under agreed-upon procedures the auditor is only obliged to report on results of tests performed on the sample specified by the client. Thus if the sample specified for the procedures is 100 and the sample for the audit is 150, the client might only get a report on the 100 tests. However, if the sample for the procedures is 150 and that for the audit is 100, the client will get a report on 150 tests.
- Preparing new loan delinquency reports or policy summaries (see below) is not a normal practice for auditors performing agreed-upon procedures. Thus some auditors may decline to provide such reports, leaving the compilation of the data to the client.

Some of the procedures illustrated in this annex are stated in rather general terms. Where appropriate, the client and the auditor can develop more specific procedures based on the MFI's circumstances. In any event, these terms of reference are illustrative only, and should not be mechanically incorporated into an MFI's audit engagement. Rather, they should be used by clients and auditors as a starting point from which to work out procedures that match the MFI's needs.

Procedures for testing the loan portfolio delinquency report

Objective

The objective of these procedures is to test the loan portfolio delinquency report with respect to real status and amounts of overdue loans, and the degree to which stated loan balances reflect actual cash paydown (see chapter 5 in volume 1).

Timing

These procedures may be done at any time. However, if they are being used to evaluate the appropriateness of loan loss provisions, they should be done at the same time as the annual financial statement audit.

Preparatory tasks

Preparatory tasks consist mainly of conversations with MFI staff to get a general picture of the actual operation of the loan tracking MIS before performing the procedures.

- Discuss with several field staff the extent to which MIS reports on loan repayments are accurate and provided in a timely fashion.
- Discuss with field staff how different types of paydown—including cash receipts, checks (including third-party and postdated checks), refinancing and rescheduling, and receipt of equipment, inventory, or other collateral—are accounted for in the reports on portfolio status.
- Review with the accounting department its policy for recording each type of paydown listed above. This review should cover the accounts that are affected by each type of payment, including the MFI's policy and practice on distribution of such payments, or late cash payments, between principal and interest, particularly on delinquent loans. Are payments being charged to principal that under the MFI's policy or normal good practice should be charged to interest (including penalty interest)? Are payments recorded and distributed the same way in the accounting MIS as they are in the loan tracking MIS?
- Review with the credit department its policy for receiving different types of noncash or partial cash payments on loans. This review should include determination of the authorizations required prior to recording noncash or partial cash payments. Is this policy clearly enunciated in the MFI's credit manual and understood by field staff?
- If not already covered in the prior points, review with the MIS department the extent to which portfolio delinquency reports clearly segregate loans whose payments have been received in noncash or partial cash form, from loans whose payments have been received in full in cash.
- Generate a statement that reflects the understood policy (which will be tested substantively) on the receipt and recording of noncash loan pay-

ments. Ideally, this statement should reflect policy as indicated in the MFI's credit and operational manuals. If necessary, this statement should reflect important elements in the actual policy that need to be updated in relevant manuals.

- Based on available accounting and loan tracking information, generate a preliminary loan portfolio status report that reflects the effect of noncash payments received. This report should reflect the impact of noncash payments on the loan portfolio balance presented in the financial statements. For example, if an MFI has received postdated checks or equipment and canceled a loan, the value of that loan should be added back into the loan portfolio delinquency report (within its appropriate aging category) and considered delinquent until the check is paid or the equipment is sold for an amount that brings the loan current. If the MFI has rescheduled or refinanced delinquent borrowers, these loans should be classified as delinquent or otherwise segregated in a way that clearly reflects their higher level of default risk. This report should identify each type of noncash payment received and its effect on the overall portfolio classification.
- Determine the branches to be visited. At least half of the total number of branches should be included, covering all major geographic areas.
- For a given date at least 60 days prior to the audit for which a complete delinquency report exists, select a sample of all outstanding loans in the selected branches, as follows. First, obtain a listing of all loans classified as performing. Determine and document a sample size of X percent of the total number of performing loans (by value). Select and list this number of individual loans, ensuring coverage across all branches to be visited. Then, obtain a listing of all loans classified as nonperforming. Determine and document a sample size of three times X percent of the total number of nonperforming loans. Select and list this number of individual loans, ensuring coverage across all branches to be visited.

Procedures to test the sample

- For each selected loan, compare the repayment schedule with the payment vouchers that accredit actual payments received. Determine means and dates of past six repayments. Classify loan by type of payments received. Document results of tests.
- Follow each of these payments through to the general ledger, checking compliance with the recording policies established by the MFI for interest and principal amounts and for the recording and accounting treatment of noncash payments. Document results of tests.
- For nonperforming loans, determine the actual aging of the overdue payments according to the repayment schedule and compare it with the delinquency aging report provided by the MFI. This can be done by comparing an individual client's account ledger with the delinquency report. Document

results of tests.

- For each selected loan, determine whether the client's prior loan was repaid by a noncash or partial cash payment (through rescheduling, refinancing, postdated or third-party checks, or receipt of equipment or other collateral). This is done by reviewing the final two or three payments of the client's prior loan to determine repayment behavior. The final payment voucher of the prior loan should be checked to determine actual means of repayment. Document results of tests.

Optional additional procedures

- Visit a substantial number of clients from the sample of nonperforming loans to determine, on the basis of their records or recollection, their repayment history on their present outstanding loan. Compare their understanding of their repayment status with the loan portfolio delinquency report. In the case of noncash payments, compare the client's understanding of their repayment status with that of the MFI. (This procedure could be carried out in conjunction with client visits made in the course of the financial statement audit.)
- Determine how cash payments are actually made to the MFI. For example, are payments made to loan officers in the field? Do group leaders make the group's payment to the MFI office, or to a bank? Determine the documentation provided to clients for their cash payments. Determine documentation provided to clients for noncash payments, specifically with respect to value and conditions.
- Summarize the results of procedures that include statements about the policy on and actual levels of noncash repayment in the loan portfolio and the extent to which delinquency reports accurately reflect repayment status. These reports should identify any substantial discrepancies between reported and actual delinquency levels resulting from rescheduling, refinancing, postdated or third-party checks, or repossession of collateral. This is particularly important when the auditor finds a pattern where prior loans have been canceled with noncash payments and subsequent (current outstanding) loans to the same clients have fallen overdue.
- Reconstitute the portfolio aging report on the basis of the findings. This reconstituted report should indicate or estimate the effects of the findings on overall delinquency for each aging category. If this is not possible, state specifically why it was not possible to generate this report.

Procedures for testing compliance with loan policies and procedures

Objective

The objective of this review is to determine the extent of compliance with loan policy and procedures, particularly with respect to key credit risk factors.

Timing

While these procedures may be done at any time, conducting them at the same time as the procedures for testing the loan portfolio delinquency report (above) is most efficient, since the auditor can use the same sample selection and loan file review for both procedures.

Preparatory tasks

- Discuss with several field staff the key policies and indicators governing credit decisions, focusing especially on those that can be measured objectively. The auditor and credit manager should agree on a limited number (perhaps five to eight) of these indicators, concentrating on elements that are most important in terms of the overall risk profile of the loan portfolio and that are expected to be adhered to under virtually all circumstances. These might include some of the following types of indicators: client qualifications (age, number of years in business, independence in business activity, no criminal record), repayment capacity (method of establishing repayment capacity, minimum levels of repayment capacity, fluctuations in repayment capacity, type of activity to be financed), credit history (loan repayment history with the program, repayment history with other programs, repayment history with basic services), size of the loan and size of regular loan payments relative to key business indicators (such as, working capital, total sales, net income, previous loans and loan payments, and collateral guarantee), and credit delivery methodology (number of members in a solidarity or village banking group, relationships among group members, rate of increase in loan amounts, relationship between loan amounts and compulsory savings, size of other clients' loans and payments in a solidarity group).
- Generate a statement that reflects the understood policy regarding these key indicators. Ideally, this statement should be contained in the credit manual currently in use in the MFI. If not, the external auditor, in cooperation with the credit department of the MFI, should generate a brief statement of the credit methodology parameters that will be measured through the procedures laid out below.
- Meet with the credit department and general management to review how internal control tests correct the application of the credit methodology. Ideally, this should involve some controls beyond the direct supervisory staff of the credit department. The auditor, in cooperation with general management, should generate a brief statement about the internal controls in place. These will be subject to testing.
- Determine the branches to be visited. At least half of the total number of

branches should be included, covering all major geographic areas.

- Select and document a sample of loans using the same procedures for testing the loan portfolio delinquency report.

Procedures to test the sample

- For each sample loan selected, request the loan files for the present loan and the two previous loans. Document results of tests.
- For each selected loan, including the previous loans, test compliance with stated credit policy for the limited number of key elements determined above. For some indicators compliance is based on ratios found in a single loan application (such as the relation of repayment capacity to repayment amount). In others the indicator compares data from two subsequent loans (such as the rate of increase in loan or payment amount). Document results of tests.

Optional additional procedures

- Visit a substantial number of clients from the sample of nonperforming loans to determine the veracity of information contained on the loan application, particularly with respect to the key indicators that can be derived from business-level information. (This procedure could be carried out in conjunction with client visits made in the course of the financial statement audit.) Generally, these indicators will involve information that can be collected and processed by nonspecialized audit personnel. If the MFI wants a more comprehensive examination, it may have to request that the audit team include more specialized personnel who have experience with a similar lending methodology. Alternatively, the auditors doing client visits may be accompanied by an appropriate member of the MFI staff—someone with the necessary independence from the loan officers of the clients being visited.
- Prepare a spreadsheet presentation of the information for each loan reviewed. This report does not constitute an opinion about the application or appropriateness of the MFI's credit policies and practices, but rather reflects the results of substantive procedures. These results should be presented in enough detail, quantitative where appropriate, to allow readers to judge the extent to which credit practice complies with credit policy.

ANNEX E

Illustrative Engagement Letter

> Readers are cautioned against using the following example as a template. The engagement letter for any audit should be tailored to the engagement.
>
> Auditors sometimes propose engagement letters that focus more on the responsibilities of the client than on those of the auditor. Clients should ensure that the auditor's responsibilities are set forth in sufficient detail, perhaps by referring to

[Audit firm letterhead]

Date

Aspire MFI
Address

Attention of: [name of individual authorized to engage auditors]

Dear Sirs/Madams:

You have requested that we audit the balance sheet of Aspire MFI as of 31 December 1997, and the related statements of income and cash flows for the year then ending. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be made with the objective of expressing an opinion on the financial statements. Mr. (Ms.) [partner] will be responsible for the services we perform for Aspire MFI.

It will be the responsibility of Mr. (Ms.) [partner] to ensure that Aspire receives quality service. [He (She) will be assisted by (names of other partners and staff and description of positions).] Mr. (Ms.) [partner] will, as [he/she] considers necessary, call on other individuals with specialized knowledge, either in this office or elsewhere in our firm, to assist in the performance of our services.

While auditing and reporting on Aspire's annual financial statements for the year ending December 31, 1997, is the service that we are to provide under this engagement letter, we would also be pleased to assist with issues as they arise throughout the year. Hence we hope that Aspire will call Mr. (Ms.) [part-

ner] whenever management believes he (she) can be of assistance.
We will perform this engagement subject to the terms and conditions set forth herein and in accordance with the terms of reference (attachment A) and our audit proposal (attachment B).

Audit of financial statements

We will conduct our audit in accordance with International Standards on Auditing (ISAs) [or relevant national standards or practices]. ISAs require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of 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.

Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that some material misstatements may not be discovered.

Management's responsibility

We remind you that the responsibility for the preparation of financial statements, including adequate disclosure, is that of the management of Aspire. This includes maintaining adequate accounting records and internal controls, selecting and applying accounting policies, and safeguarding the assets of the institution. As part of our audit process, we will request from management written confirmation concerning representations made to us in connection with the audit.

We will make specific inquiries of management about the representations embodied in the financial statements. As part of our audit procedures, we will request that management provide us with a representation letter acknowledging management's responsibility for the preparation of the financial statements and confirming certain representations made to us during our audit. The responses to those inquiries and related written representations of management required by generally accepted auditing standards are part of the evidence that we will rely on in forming our opinion on Aspire's financial statements.

Audit report

The objective of our audit is to express an opinion on the fairness of the presentation of Aspire's financial statements in conformity with generally accepted accounting principles, in all material respects. Our ability to express an opinion and the wording of our opinion will be dependent on the facts and circumstances at the date of our report. If for any reason we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of this engagement. If we are unable to complete our audit or if our audit report requires modification, the reasons will be discussed with Aspire's management and audit committee.

Management letter

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems that come to our attention.

Other communications arising from the audit

In connection with the planning and performance of our audit, ISAs require that we ensure that certain matters are communicated to the audit committee. We will report directly to the audit committee any errors, irregularities, or fraudulent acts.

Coordination of the audit

Our audit is scheduled for performance and completion as follows: [insert audit schedule].

Assistance to be supplied by your personnel, including preparation of schedules and analyses of accounts, is described in attachment C. Timely completion of this work will facilitate the completion of our audit.

Fees

Our fees are based on the time required at various levels of responsibility, plus actual out-of-pocket expenses (such as travel, secretarial support, and telephone calls). Details are provided in attachment B. We estimate that our

total fees for this audit will be $ [provide amount], plus expenses. Based on the timing of the work, our fees will be payable approximately as follows: [insert payment schedule]. We will notify you immediately of any circumstances we encounter that could significantly affect our estimate.
We look forward to full cooperation with your staff and we trust that they will make available to us records, documentation, and other information requested in connection with our audit.

If the above terms are acceptable to Aspire and the services outlined are in accordance with your understanding, please sign the copy of this letter in the space provided and return it to us.

(signature)
Name and title
XYZ Audit Co.

Accepted on behalf of
Aspire MFI by

(signature)
Name and title
Date

ANNEX F

Illustrative Management Representation Letter

[MFI letterhead]

Date

XYZ Audit Co.
Address

Dear Mr./Ms. [partner]

This representation letter is provided in connection with your audit of the financial statements of Aspire MFI for the year ended 31 December 1997 for the purpose of expressing an opinion as to whether the financial statements give a true and fair view of [or "present fairly, in all material respects,"] the financial position of Aspire MFI as of 31 December 1997 and of the results of its operations and its cash flows for the year then ended in accordance with [indicate relevant financial reporting framework].

We confirm, to the best of our knowledge and belief, the following representations made to you during your audit.

1. We are responsible for the fair presentation in the [consolidated] statements of financial condition, results of operation, cash flows, and equity in conformity with generally accepted accounting principles.
2. We have made available to you all books of account and supporting documentation and all minutes of meetings of shareholders and the board of directors.
3. There have been no irregularities involving management or employees who have a significant role in accounting and internal control systems or who could have a material effect on the financial statements.
4. We confirm the completeness of the information provided regarding the identification of related parties.
5. The financial statements are free of material misstatement, including omissions.
6. Aspire has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of noncompliance. There has been no noncompliance with regulatory requirements that could have a material effect on the financial statements.

7. The following have been properly recorded and, when appropriate, adequately disclosed in the financial statements:
   - The identity of, and balances and transactions with, related parties
   - Losses arising from sale and purchase commitments
   - Agreements and options to buy back assets previously sold
   - Assets pledged as collateral
   - Arrangements with other financial institutions involving compensating balances or other arrangements involving restrictions on cash balances and line-of-credit or similar arrangements
   - Financial instruments with significant individual or group concentration of credit risk
   - All impaired loans
   - Loans that have been restructured to provide a reduction or deferral of interest or principal payments because of borrower financial difficulties.
8. Aspire has satisfactory title to all assets and there are no liens or encumbrances on the company's assets, except for those disclosed in note X to the financial statements.
9. We have recorded or disclosed, as appropriate, all liabilities, both actual and contingent, and have disclosed in note X to the financial statements all guarantees that we have given to third parties.
10. Other than as described in note X to the financial statements, there have been no events subsequent to period end requiring adjustment of or disclosure in the financial statements or notes thereto.
11. Note X to the financial statements discloses all the facts (that is, significant conditions and events and management plans) of which we are aware that are relevant to Aspire's ability to continue as a going concern.
12. Aspire is responsible for determining and maintaining the adequacy of loan loss provisions as well as estimates used to determine such amounts. Management believes the allowance is adequate to absorb currently estimated credit losses in the loan portfolio as of [date of the statement of financial condition].
13. In preparing the financial statements in conformity with generally accepted accounting principles, management uses estimates. Aspire has disclosed in the financial statements all estimates where it is reasonably possible that the estimate will change in the near term and the effect of the change could be material to the financial statements.

Sincerely,

(signature)

Name
Managing Director/CEO
Aspire MFI

ANNEX G

Illustrative Audit Report and Financial Statements

> The illustrative audit report and financial statements presented on the following pages are for Aspire MFI, a hypothetical nongovernmental organization that provides financial services (loans and savings accounts) as well as nonfinancial services (training) to microentrepreneurs and their households. These illustrative financial statements provide more detail than most MFI statements. This is intentional. However, users are cautioned that these illustrative statements cannot always be used as a template. A country's accounting and auditing stan-

To the shareholders and board of directors of Aspire Microfinance Institution:

We have audited the accompanying balance sheet of Aspire Microfinance Institution (Aspire MFI) as of 31 December, 1997 and 1996, and the related statements of income, equity, and cash flows for the years then ended. These financial statements are the responsibility of the MFI'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 [or relevant national standards or practices]. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and accompanying notes are free of 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 Aspire MFI as of 31 December, 1997 and 1996, and of the results of its operations and its cash flows for the years then ended in accordance with International Accounting Standards.

Name of external audit firm
Date

Aspire Microfinance Institution: Balance sheet, 31 December, 1997 and 1996

Indicator	Note	1997	1996
Assets			
Current assets			
Cash and cash equivalents	3	$39,000	$20,000
Loans, net of allowance for losses of $34,000 in 1997 and $25,000 in 1996	4	876,000	629,000
Current investments	5	3,000	3,000
Other current assets	6	3,000	2,500
Total current assets		920,000	654,500
Noncurrent assets			
Long-term investments	5	50,000	40,000
Fixed assets, net of accumulated depreciation	7	30,000	30,000
Total noncurrent assets		80,000	70,000
Total assets		$1,001,000	$724,500
Liabilities and equity			
Current liabilities			
Deposits	8	$60,000	$45,000
Short-term borrowings	9	18,000	12,000
Other liabilities	10	10,000	10,000
Total current liabilities		88,000	67,000
Noncurrent liabilities			
Long-term debt	9	660,000	510,000
Total liabilities		748,000	557,000
Equity			
Accumulated donations	11	368,800	268,600
Retained earnings		(115,800)	(121,100)
Total equity		253,000	147,500
Total liabilities and equity		$1,001,000	$724,500

Note: The accompanying notes are an integral part of these financial statements.

Aspire Microfinance Institution: Statement of income, 31 December, 1997 and 1996

Indicator	Note	1997	1996
Interest income			
Interest and fees on loans		$407,700	$329,000
Interest from investments		4,400	3,700
Total interest income		412,100	332,700
Interest expense			
Interest on debt	9	60,000	56,000
Interest on deposits	8	3,000	2,000
Total interest expense		63,000	58,000
Provision for loan losses	4	31,000	27,000
Net interest income after provision for loan losses		318,100	247,700
Other operational income	12	50,000	45,000
Noninterest expense			
Salaries and benefits		222,000	200,000
Administrative expenses		135,000	123,500
Depreciation		5,000	4,600
Other		800	700
Total noninterest expense		362,800	328,800
Net operational income		$5,300	($36,100)
Grant income	11	30,000	40,000
Net income after grants		$35,300	$3,900

Note: The accompanying notes are an integral part of these financial statements.

Aspire Microfinance Institution: Statement of changes in equity, 31 December, 1997 and 1996

Indicator	Balance 1 Jan 96	Additions in 1996	Balance 31 Dec 96	Additions in 1997	Balance 31 Dec. 97
Donations (recorded directly to balance sheet)	$128,600	0	$128,600	$70,200	$198,800
Grants (recorded through income statement)	100,000	40,000	140,000	30,000	170,000
Subtotal	228,600	40,000	268,600	100,200	368,800
Retained operating income	(85,000)	(36,100)	(121,100)	5,300	(115,800)
Total equity	$143,600	$3,900	$147,500	$105,500	$253,000

Note: The accompanying notes are an integral part of these financial statements.

Aspire Microfinance Institution: Statement of cash flow, 31 December, 1997 and 1996

Indicator	Note	1997	1996
Cash flows from operations (excluding grants)			
Net operational income		$5,300	($36,100)
Adjustments to reconcile net income with funds provided from operations: depreciation of fixed assets	7	5,000	4,600
Changes in assets and liabilities: increase in other current assets	6	(500)	2,400
Total funds provided from operating activities		9,800	(29,100)
Cash flows from investment activities			
Net increase in loan portfolio	4	(247,000)	(70,000)
Increase in investment in government notes	5	(10,000)	
Purchase of fixed assets	7	(5,000)	(3,000)
Total cash used in investment activities		(262,000)	(73,000)
Cash flows from financing activities			
Increase in short-term debt	9	6,000	4,000
Increase in deposits	8	15,000	(4,000)
Increase in long-term debt	9	150,000	37,300
Increase in donations and grants	11	100,200	40,000
Net cash flows from financing activities		271,200	77,300
Net increase in cash		19,000	(24,800)
Cash and cash equivalents at the beginning of the year		20,000	44,800
Cash and cash equivalents at the end of the year		$39,000	$20,000

Note: The accompanying notes are an integral part of these financial statements.

Aspire Microfinance Institution: Notes to the financial statements for the years ended 31 December, 1997 and 1996

Note 1 Organization and basis of presentation

The accounting and reporting policies adopted by Aspire Microfinance Institution (Aspire MFI) are in accordance with International Accounting Standards.

The more significant accounting policies used in the preparation of the financial statements are as follows:

Nature of business

Aspire MFI, founded in 1975, operates 13 branch offices in the ABC region of country Z. Aspire's primary source of revenue is derived from providing loans to clients, predominately located in ABC region.

The loans are of three types: individual producer loans, individual trader loans, and group loans. Aspire also provides two types of savings products: voluntary savings accounts and compulsory savings accounts (all clients are required to establish a savings account equal to at least 1 percent of the original loan amount). Aspire also provides nonfinancial services in the form of business training courses for its borrowers. Aspire is a nongovernmental organization (NGO) established under the NGO Act and is registered with the Ministry of Rural Development.

Presentation and basis of financial statements

The accompanying financial statements as of 31 December, 1997 and 1996, include both financial and nonfinancial operations after elimination of all material interdepartment transactions. Aspire's accounts are on the accrual basis of accounting.

Note 2 Summary of significant accounting policies

Use of estimates

The preparation of the financial statements in conformity with international accounting standards requires management to make estimates and assumptions that affect reported assets and liabilities as well as reported income and expenses for each year. A material estimate that is particularly susceptible to significant change relates to the determination of provisions for loan losses.

Loans, loan loss allowance, interest accrual, and write-offs

Loans have been reduced by the allowance for loan losses.

Interest on loans is accrued on the principal amount of loans outstanding. Interest on loans is calculated using the simple interest method on daily balances of the principal amount outstanding.

The adequacy of the allowance for loan losses is evaluated regularly by management. Factors considered in evaluating the adequacy of the allowance include the size of the portfolio, previous loss experience, current economic conditions and their effect on clients, the financial condition of individual clients, and the performance of individual loans in relation to contract terms. The allowance for loan losses charged to expense is based on management's judgment of the amount necessary to maintain the allowance at a level adequate to absorb losses.

Management provisions for loan losses every quarter in order to maintain the allowance (reserve) for bad loans at adequate levels. The adequacy of the allowance for loan losses is determined by applying defined percentages to the outstanding balances in various aging categories, as shown here:

Loan status	Allowance (percent)
1–30 days overdue	0
30–60 days overdue	10
60–90 days overdue	25
90–180 days overdue	50
> 180 days overdue	100

Because Aspire is not a licensed financial intermediary, its allowance policy is based not on national regulations, but on management's analysis of the historical performance of the overdue portfolio, aged by the same categories. Loan losses (write-offs) are charged against the allowance for loan losses when management believes that the principal is unlikely to be collected. Loans that have been overdue more than one year are automatically written off every quarter.

Aspire accrues interest on its loans as it is earned. If a loan becomes delinquent on principal or interest for 90 days or more, Aspire automatically stops further accrual of interest and reverses from income any unpaid interest that may have been accrued. Interest received on a loan in nonaccrual status is applied to reduce principal or, if management determines that the principal is collectible, applied to interest on a cash basis. A loan is returned to accrual status after the client has brought the loan current and demonstrated compliance with the loan terms for a sufficient period and management's doubts about collectibility have been removed.

Investments

Investments are carried at historical cost or market value, whichever is less. Short-term investments are readily marketable and are not held for more than one year. Management has the ability and intent to hold both short-term and long-term investments to maturity.

Fixed assets

Fixed assets include property and equipment and are shown at cost, less accumulated depreciation and amortization. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. Estimated useful lives range from 3 to 30 years. Gains or losses on the sale of fixed assets are recognized upon the disposal of such assets.

Maintenance and repairs that do not extend the useful lives of assets are expensed in the year in which they are incurred.

Donations

Donations to subsidize operating and administrative expenses are recorded in the statement of income as grant income.

Donations to finance lending operations or the purchase of fixed assets are shown as direct additions to equity and the corresponding asset account.

Indirect cost allocation

Aspire allocates indirect costs to its two business operations, financial services and nonfinancial services. Significant indirect costs include executive salaries and building leases. Indirect costs are allocated in proportion to the compensation of direct staff dedicated to the two business operations.

Note 3 Cash

Cash and cash equivalent balances as of 31 December, 1997 and 1996, are as follows:

Type of cash	1997	1996
In vault	$34,000	$15,000
In bank	5,000	5,000
	$39,000	$20,000

Note 4 Loans and Loan Loss Allowance

Loan balances as of 31 December, 1997 and 1996, are as follows:

Type of loan	1997	1996
Individual producer	$59,400	$115,000
Trader	210,500	95,000
Group	640,100	444,000
Loan portfolio before allowance	910,000	654,000
Allowance for loan losses	(34,000)	(25,000)
Net loan portfolio	$876,000	$629,000

The average loan portfolio before allowances, calculated monthly, was $711,000 during 1997 and $491,000 during 1996.

Changes in the provisions for loan losses are summarized as follows:

Item	1997	1996
Balance, 1 January	$25,000	$19,000

Provisions for loan losses	31,000	27,000
Loans written off	(22,000)	(21,000)
Balance, 31 December	$34,000	$25,000

The principal balance of past-due loans not accruing contractual interest was $18,000 and $22,000 on 31 December, 1997 and 1996, respectively. Interest not recognized on such loans was $3,000 and $5,000, respectively.

Aspire restructured loans totaling $1,000 and $2,000, respectively, which reduced interest income.

Aspire had no commitments to lend additional funds as of 31 December, 1997.

Note 5 Investments

Investments as of 31 December, 1997 and 1996, are as follows:

Type of investment	1997	1996
Short-term treasury bills (mature 15 January, 1998)	$3,000	$3,000
Long-term treasury note (matures 31 March, 1998)	50,000	40,000
Total	$53,000	$43,000

The treasury note's book value approximated fair value.

Note 6 Other current assets

Other current assets as of 31 December, 1997 and 1996, are as follows:

Type of asset	1997	1996
Advances to suppliers	$500	$500
Utility deposits	300	300
Interest receivable	2,200	1,700
Total	$3,000	$2,500

Note 7 Fixed assets

Fixed assets as 31 December, 1997 and 1996, are summarized as follows:

Type of asset	1997	1996
Land	$10,000	$10,000
Buildings	15,000	15,000
Furniture and fittings	3,000	3,000
Computer equipment	6,000	4,000
Vehicles	11,000	8,000
Subtotal	45,000	40,000

Accumulated depreciation and amortization	(15,000)	(10,000)
Total	$30,000	$30,000

Depreciation and amortization for the years ended 31 December, 1997 and 1996, amounted to $5,000 and $4,600, respectively.

Note 8 Deposits

Deposit accounts as of 31 December, 1997 and 1996, are as follows:

Type of deposit account	1997	1996
Voluntary savings	$15,000	$15,000
Compulsory savings	45,000	30,000
Total	$60,000	$45,000

Aspire requires all clients to establish a savings account that equals a given percentage of the loan balance when originated, and further requires clients to make payments into this account equal to a given percentage of each amortization of principal and interest. Clients can withdraw these compulsory deposits only for group-approved emergencies, or upon withdrawing from membership in Aspire. Voluntary saving deposits, on the other hand, are due on demand by the client.

Interest paid on these deposits totaled approximately $3,000 in 1997 and and $2,000 in 1996.

Note 9 Debt

Debt as of December 31, 1997 and 1996, consisted of the following:

Donor X: Loan of $800,000, with principal payable in five annual installments beginning a year from the date of the final disbursement. The loan accrues interest at 10 percent a year, payable semiannually.

Year	Short-term component	Long-term component	Total	Average annual balance (monthly)	Total interest payment
1997	—	$660,000	$660,000	$583,000	$58,300
1996	—	$510,000	$510,000	$547,200	$54,720

Bank Y: $50,000 line of credit at prime interest rate plus 2 percent, with advances payable in four quarterly installments. There is a 0.25 percent a year fee on undisbursed balances, payable quarterly.

Year	Short-term component	Long-term component	Total	Average annual balance (monthly)	Total interest payment
1997	$18,000	—	$18,000	$10,000	$1,700
1996	$12,000	—	$12,000	$8,000	$1,280

Note: The prime rate averaged 15 percent in 1997 and 14 percent in 1996.

The totals for the donor funds and bank credit are as follows:

Year	Short-term component	Long-term component	Total	Average annual balance (monthly)	Total interest payment
1997	$18,000	$660,000	$678,000	$593,000	$60,000
1996	$12,000	$510,000	$522,000	$555,200	$56,000

Note 10 Other current liabilities

Other current liabilities as of 31 December, 1997 and 1996, are as follows:

Type of liability 1997	1996	
Automobile insurance	$6,000	$6,000
Utilities	4,000	4,000
Total	$10,000	$10,000

Note 11 Donations, grants, and in-kind contributions

Accumulated donations, recorded directly to the balance sheet, consisted of:

Item	Donor A	Donor B	Total
Balance, January 1, 1996	$63,600	$65,000	$128,600
Loan portfolio	—	—	—
Fixed asset purchases	—	—	—
Balance, December 31, 1996	63,600	65,000	128,600
Loan portfolio	40,200	30,000	70,200
Fixed asset purchases	—	—	—
Balance, December 31, 1997	$103,800	$95,000	$198,800

In addition, donor C provided grants of $30,000 and $40,000 as of 31 December, 1997 and 1996, to subsidize Aspire's operations. These grants were recorded as income on the income statement.

Aspire also relied on certain goods and services that were contributed in kind, and that were not recorded on the financial statements:

- The salary of a consultant who serves as Aspire's executive director was paid directly by donor B. Compensation for this officer totaled $45,000 in 1997 and $40,000 in 1996.
- Three of Aspire's branches operate out of offices that are provided rent-free by the municipality. Estimated fair-market rent for similar space totaled $12,000 in 1997 and $11,000 in 1996.

Note 12 Segment reporting of business operations

Aspire provides both financial and nonfinancial (business training) services to its clients. Aspire manages these services as two separate business operations. Indirect expenses, including the cost of staff who are not exclusively dedicated to one operation or the other, are allocated between the two operations in proportion to the division of direct personnel expenses between them—that is, the cost of staff dedicated exclusively to one operation or the other. On that basis, the income and expenses associated with each activity are as follows:

Indicator	Financial services, 1997	Training services, 1997	Total, 1997
Net interest income before provisions for loan losses	$349,100	—	$349,100
Provisions for loan losses	31,000	—	31,000
Net interest income after provisions for loan losses	318,100	—	318,100
Noninterest operating income (training fees)	—	50,000	50,000
Noninterest expense			
Salaries and benefits	162,000	60,000	222,000
Administrative expenses	100,000	35,000	135,000
Depreciation and amortization	3,500	1,500	5,000
Other	500	300	800
Total noninterest expense	266,000	96,800	362,800
Net operational income	52,100	(46,800)	5,300
Plus grants	—	30,000	30,000
Net income after grants	$52,100	($16,800)	$35,300

Indicator	Financial services, 1996	Training services, 1996	Total, 1996
Net interest income before provisions for loan losses	$274,700	—	$274,700
Provisions for loan losses	27,000	—	27,000
Net interest income after provisions for loan losses	247,700	—	247,700
Noninterest operating income (training fees)	—	45,000	45,000
Noninterest expense			
Salaries and benefits	151,000	49,000	200,000
Administrative expenses	95,000	28,500	123,500
Depreciation and amortization	3,100	1,500	4,600
Other	400	300	700
Total noninterest expense	249,500	79,300	328,800
Net operational income	(1,800)	(34,300)	(36,100)
Plus grants	—	40,000	40,000

ANNEX H

Illustrative Management Letter

The term management letter describes the written communication to an MFI's management identifying significant internal control deficiencies, offering constructive recommendations, and noting other matters arising during the audit that the external auditor wants to bring to the attention of the MFI's management and audit committee.

A number of potential control weaknesses may be identified in a management letter; some are listed in box H.1. Following the box is an illustrative management letter.

The auditor should normally solicit and consider management comments on a draft of the management letter before

BOX H.1
Potential control weaknesses that may be addressed in a management letter

Cash

- No segregation of duties
- Delays in preparing and reviewing bank reconciliations
- Lack of physical security over cash on hand
- Inadequate processes surrounding teller cash counts
- Flaws in reconciling interbank and clearing accounts

Investments

- No segregation of duties
- Lack of appropriate authorization of purchases and sales
- Noncompliance with board decisions on investments or investment policy
- Improper calculation of gains or losses on sales
- Lack of physical security over investments

Loans

- No segregation of duties
- Inadequate checks and balances in loan approval process
- Lack of adherence to MFI policies and procedures
- Absence of, or noncompliance with, policies for immediate follow-up on delinquent loans
- Improper loan file documentation
- Loan tracking system fails to flag loans that are refinanced, rescheduled, or paid off with something other than cash
- Excessive refinancing or rescheduling of loans
- Inaccuracy or untimely availability of loan tracking system information
- Material discrepancies between accounting and loan tracking systems
- Existence of related party "insider" loans

(Box continues on next page.)

BOX H.1 (continued)

Potential control weaknesses that may be addressed in a management letter

- Absence of internal audit function, including an operational audit unit (see sections 3.2 and 5.2.8 of volume 1)
- Absence of unannounced visits to branches and clients by managers or internal auditors

Loan loss provisions

- Nonexistent or inaccurate aging schedules
- Unreasonable aging standards
- Growth is masking delinquency problems
- Lack of adherence to laws and regulations
- Unverifiable capital adequacy

Payables and accruals

- No segregation of duties
- No proper cutoff
- Incorrect management assumptions used in the determination of accruals
- No prenumbering of checks
- No matching of bills of lading with invoices and purchase orders

Debt

- No segregation of duties
- No monitoring of covenants
- Improper calculation of premiums or discounts on debt
- No recording of donor loans and improper recording to capital
- No board approval
- Improper calculation of interest expenses

Savings and deposits

- No segregation of duties
- Passbook entries not verified by internal audit
- No monitoring of compulsory savings

Capital

- No segregation of restricted and unrestricted funds
- No board authorization of capital transactions
- Noncompliance with donor agreements
- Noncompliance with capital adequacy requirements and other laws and regulations

Revenues and expenses

- Activity recorded in the wrong period
- Interest income recorded incorrectly
- Interest charged to branches not eliminated in consolidation
- Donor grant revenue incorrectly recognized when received over time
- Improper accounting of fixed assets
- Purchases recorded to expenses
- Salary rates incorrect
- Possible existence of “phantom” employees
- Multiple family members on payroll

Management information systems

- System incapable of handling volume of transactions
- Faulty programming, resulting in distorted financial reporting
- Weakness in access control or other security features
- No disaster recovery plan

Audit committee
Aspire MFI
Address

In planning and performing our audit of the financial statements of the Aspire Microfinance Institution for the year ended 31 December 1997 (on which we have issued our report dated March 15, 1998), we considered its internal control structure in order to determine our auditing procedures for the purpose of expressing an opinion on the financial statements, not to provide assurance on the internal control structure. Such consideration would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by [the country's professional body].

A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material relative to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control structure and its operations that we consider to be material weaknesses as defined above.

We did note other matters related to the internal control structure, and certain other issues. Our comments are presented in the attached report.

This report is intended solely for the information and use of the audit committee, management, and others within the organization.

We will be pleased to discuss these comments with you and, if desired, to assist you in implementing any of these suggestions.

(signature)
Partner
XYZ Audit Co.

Attachment

Aspire Microfinance Institution
Report to management for the year ended 31 December 1997

Contents

Internal audit function

Lack of functions

As Aspire continues to grow both in terms of new branches and disbursed loans, it may prove difficult for personnel in the head office to effectively supervise operations as well as perform their own duties.

It was noted that there is no internal monitoring of Aspire's adherence to policies and procedures.

Recommendation: Management should consider establishing an internal audit function. This newly created function would not only provide management and the audit committee with a degree of assurance, it could also help with the annual external audit, thereby saving money.

Loans

Loan status reports

In some cases loan status reports were not adequately checked and reviewed against loan officers' records and borrowers' passbooks. Thus errors could remain in accounting records for a long time without being detected.

Recommendation: Debtor listings should be produced and checked periodically. They should be regularly checked by loan officers against borrowers' passbooks, and any difference should be investigated promptly. Internal auditors (if an internal audit function is established; see above) should also perform such procedures during the normal course of their work.

Unreconciled differences

All the branches had unreconciled differences between loan tracking system balances and the general ledger. These differences were attributable to the method of apportioning repayments between principal and interest.

Recommendation: The loan tracking system and the general ledger must be reconciled at least monthly.

Credit manual

Aspire does not have a comprehensive credit manual covering the policies and procedures relating to its credit methodology.

Recommendation: Aspire should consolidate all of its policies and procedures into one manual. This manual should be provided to all branches and all loan officers.

Loan loss provisions

Errors in calculation

There were minor errors in the calculation of loan loss provisions. This appears to occur because there is little coordination between loan officers and branch accountants when determining the amounts to provision.

Recommendation: The accounting department should be fully involved in the exercise of provisioning for doubtful accounts. A thorough review of accounts and valuations should be performed to ensure that provisions and write-offs of loans cannot be manipulated.

Cash

Current accounts

Current accounts between the head office and branches are not being reconciled regularly. This shortcoming, which necessitates recording activity into suspense accounts to facilitate consolidation, is attributed to insufficient communication between offices.

Recommendation: Current accounts should be reconciled monthly.

Bank reconciliations

Included in the loan account reconciliation were two checks, amounting to X, that were returned for insufficient funds in August 1997 and had not been reversed in the records as of 31 December 1997.

Recommendation: Bank reconciling items should be identified and promptly resolved. Any recurring reconciling items should be investigated by management.

Segregation of duties

In some branches there is inadequate segregation of duties. For example, the same person handles the functions of loan officer and cashier.

Recommendation: Aspire should properly segregate duties between those accounting for activities and those handling assets. Proper monitoring of adherence to policies and procedures is required.

Capital

Categorization of restricted and unrestricted funds

Aspire's funds are not categorized into restricted and unrestricted funds as required by the accounting standards promulgated by [authoritative body]. This point has been discussed with the senior management of Aspire, who have agreed to comply with recommended practice. Due to time constraints, the financial statement could not be reclassified according to this recommendation.

Recommendation: Aspire should present its next financial statements in accordance with the above requirements.

Various policies

Cost allocation

As indicated in the notes to the financial statements, Aspire allocates indirect costs between financial and nonfinancial services in the same proportion as total compensation of staff whose time is dedicated to one service or the other. While this method of allocation is not especially precise, it is reasonable under the circumstances, since it does not materially distort the costs of the respective services, and a more sophisticated system would be too costly for an institution of Aspire's size.

Portfolio-related policies

The terms of reference for the audit require specific comment on Aspire's policies for loan loss provisioning, loan write-off, and reversal of accrued interest on nonperforming loans. These policies are described in notes 2 and 4 of the financial statements. We found them to be reasonable for Aspire's circumstances, and consistently applied in practice.

Recommendation: None.

ANNEX I

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