CGAP

Operational Risk Management for Microfinance Institutions

Consultative Group to Assist the Poor
1818 H Street, N.W.
Washington, DC 20433

Internet: http://www.cgap.org
Email: cgap@worldbank.org
Telephone: +1.202.473.9594

Table of Contents

Acknowledgments....................iv
Introduction....................v
Overview of the Course....................vii
References for the Course....................ix

Course Materials

Session 1: Welcome and Introduction....................RM-1
Handouts....................RM-21

Session 2: Risk Management....................RM-31
Handouts....................RM-55

Session 3: We Are the Institution....................RM-61
Handouts....................RM-81

Session 4: Tools for Risk Management....................RM-95
Handouts....................RM-109

Session 5: Business Cycles, Risks, and Internal Controls....................RM-119
Handouts....................RM-137

Session 6: Internal Audit....................RM-155
Handouts....................RM-173

Session 7: External Audit....................RM-183
Handouts....................RM-203

Session 8: Mitigating Risks – Implementing Corrective Controls and Moving Forward....................RM-223

Session 9: Action Plan, Evaluation, and Closure....................RM-227
Handouts....................RM-229

Acknowledgments

CGAP would like to thank those who were instrumental in the development and design of the Operational Risk Management for Microfinance Institutions course: Janis Sabetta, Jennifer Isern, Joyce Lehman, Howard Brady, Michael McCord, Betty Sabana, Pamela Champagne, Steven Kelly, André Hue, Alex Silva, Xavier Reille, Leslie Barcus, Ann Wessling, and all CGAP training hubs and partners.

Introduction

BACKGROUND OF THE CGAP *SKILLS FOR MICROFINANCE MANAGERS* COURSE SERIES

In 1997, Jennifer Isern and Brigit Helms of CGAP launched a pilot program in Africa to provide financial management courses to microfinance institutions (MFIs), based on industry-wide observation that the greatest constraint to the development of microfinance in the region was the lack of management capacity. The Pilot initiative had two complementary long-term objectives: 1) to improve the institutional viability of MFIs in Africa and 2) to enhance the human resource base in microfinance in Africa through sustainable training programs that would help develop stronger MFIs and increase the market for local training services. By 1999, the Africa Pilot program had become the MFI Training Program, with new partners in South and South-East Asia, Central Europe, and the Newly Independent States (NIS). In addition, CGAP launched AFCAP, an East/Southern Africa program focusing on 12 countries and CAPAF, the Francophone Africa program focusing on 19 countries, to build the capacity of national training service providers to offer training and consulting services. During the early years, Jennifer Isern and Brigit Helms served as overall coordinators of the MFI Training Program and regional programs with colleagues Tiphaine Crenn, Nathalie D'Ambrosio-Vitale, Mike Goldberg, and Joyita Mukherjee, and primary consultants Janis Sabetta, Ruth Goodwin, and Kim Craig.

Through this initiative, CGAP developed seven courses for MFI managers conceived to be globally relevant, short and practical, and incorporating adult training design. These courses are collectively called the *Skills for Microfinance Managers* series. Based on feedback from trainers and participants from hundreds of courses, the courses were revised and improved over several years. As the program matured, Jennifer Isern, Leslie Barcus, and Tiphaine Crenn managed the Global MFI Training Program. By the time CGAP transferred its training activities to the Microfinance Management Institute in January 2007, CGAP's 39 training partners had trained more than 12,000 people in 52 countries.[1] In 2007–2008, Tiphaine Crenn coordinated revisions and overall editing of the MFI courses to reflect changes in microfinance standards, especially in financial statements and ratios.

In line with CGAP's role as a global resource center on microfinance, the full trainer materials for the seven courses developed under the MFI Training Program are now being made publicly available.

NOTICE ABOUT USING THE CGAP *SKILLS FOR MICROFINANCE MANAGERS* COURSE MATERIALS

In parallel to developing course materials, the program aimed to identify qualified national and regional training institutions and help build their capacity to deliver high-quality courses, expand their training markets, and offer courses on a cost-recovery basis. Hundreds of training of trainer (ToT) sessions were organized for the seven courses throughout the world. In some regions, CGAP also developed a certification process, and certified trainers were given broad access to the training materials. Certified training partners invested heavily in building their reputation for offering high-quality, useful courses and building up their businesses.

Although the CGAP *Skills for Microfinance Managers* course materials are now publicly available, CGAP recognizes only those partners and trainers who went through the certification process as CGAP training partners. Others who offer a course using materials from one of the CGAP *Skills for Microfinance Managers* course should not refer to themselves as CGAP trainers or CGAP-certified.

CGAP also requests that all those who offer the "Operational Risk Management" course use the following text in their marketing materials and course descriptions: "The Operational Risk Management course is based on the materials developed by CGAP which are publicly available on

[1] By December 2008, the number of people trained was closer to 14,000, given the ongoing training activities of CAPAF's 19 training partners in Francophone Africa.

http://www.cgap.org. CGAP is a leading independent resource for objective information, expert opinion, and innovative solutions for microfinance. CGAP works with the financial industry, governments, and investors to effectively expand access to financial services for poor people around the world."

HOW TO WORK WITH THE COURSE MATERIALS

The CGAP *Skills for Microfinance Managers* course materials are all organized in the same manner, with eight to twelve sessions in each course. Each session generally consists of the following sections:

1. **Trainer Instructions** give step-by-step instructions to trainers on how to lead the session, including when to show which PowerPoint slide, distribute handouts, organize participant activities, discuss during short lectures or general discussions, etc. The instructions include suggested timing, although this should be adapted according to the context. The first page (Session Summary) of the Trainer Instructions section in each session lists all the supplies, technical materials, overheads, handouts, and case study sections that will be required for that specific session. ***Optional overheads and handouts, which are included in the course material for use at the discretion of the trainer, are clearly identified within shaded boxes in the Session Summary.*** If there are additional technical materials in the session, the Trainer Instructions include a section called Trainer Materials, marked M in the right-hand top corner. Trainer Instructions are not intended for participants. If technical explanations are included in the Trainer Instructions, they are also generally provided in the handouts for the participants.
2. **Overheads** introduce topics, underscore key messages, and summarize issues. Overheads are clearly marked O in the right-hand top corner. (For example, RM3-O2 means that this is the second overhead of the third session in the Risk Management course.) ***Optional overheads*** are identified by black (as opposed to white) reference numbers. The overheads are in PowerPoint format but can be printed out on transparencies and shown using an overhead projector. Overheads are not meant to be distributed to participants since the handouts in the same session will cover the same points, generally in greater detail.
3. **Handouts** are marked H in the top right-hand corner, in the same manner as the overheads. Handouts include exercises, instructions, and financial statements, as well as additional reading and in-depth information on the topic. Some handouts give instructions to the trainers about a publication to distribute, and these publications may need to be ordered or downloaded separately.
4. **Case studies** are used in most of the CGAP courses. Files for the case study are sometimes kept separate from the other handouts. The instructions in the Trainer Notes explain the section of the case study at each point in the session. Printing case studies on colored paper (and using different colors for different sections of the case) makes it easier for participants to organize their materials.
5. **Reference materials** and additional reading are listed for each course. Excerpts or the entire document are often included in the handouts. On the Web site, each course home page contains a box on the right-hand side with links to download the documents, if they are available publicly, or information on how to purchase them.

Please note that the overheads in PowerPoint format need to be downloaded separately. The course file contains the trainer instructions, the trainer technical materials, the overview of the overheads, the handouts, and the case study. The pages are formatted to be printed double-sided and blank pages are included as necessary.

Overview of the Course

The "Operational Risk Management for Microfinance Institutions" course is one of the four courses in the Operational Management Curriculum, along with "Business Planning," "Information Systems," and "Product Development." This four-day course helps microfinance institutions develop and improve the quality of their own risk management processes and focuses on problem prevention and early problem identification and control. Participants are provided with guidelines for establishing operational activities that assist an MFI to identify its vulnerabilities, design and implement controls, and monitor the effectiveness of controls. Through exercises, group discussions, and case studies, participants review concepts such as internal controls, fraud, and internal and external audit.

INTENDED AUDIENCE

This course is recommended for Executive Directors, Finance Managers, Credit Managers, Operations Managers, Branch Managers, and Board Members from Microfinance NGOs, credit unions, banks, and other financial institutions.

COURSE OUTLINE

Session 1: Welcome and Introduction

Session 2: Risk Management

- The key areas of risk for an MFI
- Risk management – components and definitions
- A systematic process for risk management
- Preventive, detective, and corrective controls

Session 3: We Are the Institution

- Mission and core values of an MFI
- Institutional values and their relation to an MFI's operations
- Barriers to institutionalizing values
- The role of people in risk management
- Key elements in effective risk management

Session 4: Tools for Risk Management

- Human Resource policies and mitigating risks
- Preventive actions to mitigate risks
- Proper separation of job functions
- Using policies and procedures to mitigate risks
- The critical role of the information system in risk management

Session 5: Business Cycles, Risks, and Internal Controls

- Using the cycle approach to identify risk areas and need for internals controls
- Objectives and purpose of internal controls
- Characteristics of effective controls
- Limitations of IC and how to compensate for them

Session 6: Internal Audit

- The difference between internal and external audits
- The role of internal audit in the internal control system
- Characteristic internal audit activities
- How to use internal audit results

Session 7: External Audit

- The role of external audit in risk management
- Planning and coordinating external audit activities
- Formulating terms of reference (ToR) and establishing scope for an external audit
- Selecting quality external auditors
- Evaluating audit results and planning for appropriate corrective action

Session 8: Mitigating Risks – Implementing Corrective Controls and Moving Forward

- Corrective controls and their role in risk management
- The dynamic process of risk management

Session 9: Action Plan, Evaluation, and Closure

Date of last substantive update: 2002

References for the Course

(updated in 2008)

KEY DOCUMENTS

Internal Controls and Internal Audit

Basle Committee on Banking Supervision. 1998. *Framework for the evaluation of internal control systems.* Basle, January.

Campion, Anita. 2000. “Technical Guide No. 1: Improving Internal Controls.” Washington, D.C.: ACCIÒN.

Committee of Sponsoring Organizations of the Treadway Commission. *Internal Control over Financial Reporting: Guidance for Smaller Public Companies.* Altamonte Springs, FL: 2006. https://www.imanet.org/pdf/COSO%20FAQs.pdf

Lehman, Joyce B. 2000. “Internal Controls and Fraud Prevention in Microfinance Institutions.” Fraud workshop, MEDA Consulting Group, Waterloo, Canada.

MEDA and MicroSave. 2007. MFI Internal Audit and Controls Toolkit. http://www.microsave.org

SEEP Financial Services Working Group. 2007. “MFI Internal Audit Toolkit.” Washington, DC: SEEP Network. http://www.seepnetwork.org

World Council of Credit Unions. 2002. “Development Best Practices in Credit Union Supervision: Internal Control Requirements.” Madison, WI: WOCCU, December. http://www.woccu.org/functions/view_document.php?id=Internal%20Control%20Requirements

External Audit

CGAP. 1999. “External Audits of Microfinance Institutions: A Handbook.” Technical Tools Series, No. 3. Washington, D.C.: CGAP, March. http://www.cgap.org/p/site/c/template.rc/1.9.2999

Rosenberg, Richard, Patricia Mwangi, Robert Peck Christen, and Mohamed Nasr. 2003. *Disclosure Guidelines for Financial Reporting by Microfinance Institutions,* 2d edition. Washington, D.C.: CGAP, July. http://www.cgap.org/p/site/c/template.rc/1.9.2785

Loan Portfolio Management

Christen, Robert Peck. 2005. “Due Diligence Guidelines for the Review of Microcredit Loan Portfolio: A Tiered Approach.” http://www.microfinancegateway.org/content/article/detail/26200

MicroSave. 2006. *Loan Portfolio Audit Toolkit.* http://www.microsave.org

Rosenberg, Richard. 1999. “Measuring Microcredit Delinquency: Ratios Can Be Harmful to Your Health.” Occasional Paper 3. Washington, D.C.: CGAP. http://www.cgap.org/p/site/c/template.rc/1.9.2698

Risk Management

Abrams, Julie, and Louise-Schneider-Moretto. 2007. *From Dollar to Dinar: The Rise of Local Currency Lending and Hedging in Microfinance.* New York: Women’s World Banking, October. http://www.swwb.org/from-dollar-to-dinar-rise-of-local-currency-lending-in-hedging-in-microfinance

Pact Publications. 2001. *CARE Microfinance Risk Management Handbook.* Washington, D.C.: Pact Publications.

Cavazos, Rocio, Julie Abrams, and Ann Miles. 2004. "Foreign Exchange Risk Management in Microfinance." Financial Products and Services Occasional Paper. New York: Women's World Banking, July. http://www.swwb.org/foreign-exchange-risk-management-in-microfinance

Featherston, Scott, Elizabeth Littlefield, and Patricia Mwangi. 2006. "Foreign Exchange Rate Risk in Microfinance: What Is It and How Can It Be Managed?" Focus Note 31. Washington, D.C.: CGAP, January. http://www.cgap.org/p/site/c/template.rc/1.9.2522

Federal Reserve Bank of San Francisco. 2005. "Stress Tests: Useful Complements to Financial Risk Models." FRBSF Economic Letter. San Francisco: Federal Reserve Bank, June.

Powers, Jennifer, Karla Brom, and Barbara Magnoni. 2005. "Shifting Technical Assistance Needs for Commercial MFIs: A Focus on Risk Management Tools." New York: Banyan Global.

Reihl, Heinz. 1999. *Managing Risk in the Foreign Exchange, Money, and Derivative Markets.* New York: McGraw Hill.

Schneider-Moretto, Louise. 2005. "Tool for Developing a Financial Risk Management Policy." Financial Management Series: Tool #1. New York: Women's World Banking.

Women's World Banking. 2006. *WWB e-Course: Developing and Using Financial Risk Management Tools.* New York: Women's World Banking. http://www.swwb.org/developing-and-using-financial-risk-management-tools-e-course

Other Documents

Isern, Jennifer and Julie Abrams with Matthew Brown. 2008. *Appraisal Guide for Microfinance Institutions. Resource Manual.* Washington, D.C.: CGAP, March. http://www.cgap.org/p/site/c/template.rc/1.9.2972

Isern, Jennifer and Julie Abrams with Matthew Brown. 2008. *Appraisal Guide for Microfinance Institutions. Revision of 1999 Appraisal Handbook.* Washington, D.C.: CGAP, March. http://www.cgap.org/p/site/c/template.rc/1.9.4394

Isern, Jennifer, Julie Abrams and Kim Craig with Matthew Brown. 2007. *Appraise.xls: Spreadsheet for Appraisal Guide for Microfinance Institutions*. Washington, D.C.: CGAP, March. http://www.cgap.org/p/site/c/template.rc/1.9.2968

Web Sites

Institute of Internal Auditors: http://www.theiia.org/

SESSION 1: WELCOME AND INTRODUCTION

Session Summary

OBJECTIVES: By the end of the session, participants will be able to:

- State each other's names
- State the training objective and agenda
- Relate objectives to their own expectations

TIME: 100 minutes

SUPPLIES: Flipchart paper and markers for each group, masking tape
LED projector or overhead projector and markers
Name tags and name tents (samples included)
Index cards
Tape recorder/radio to play music

COURSE REFERENCE MATERIALS

CGAP *Audit Manual*

MFN/GTZ *Improving Internal Control: A Practical Guide for Microfinance Institutions*

MEDA Fraud Workshop: *Internal Controls and Fraud Prevention in Microfinance Institutions*

CARE *Microfinance Risk Management Handbook*

CGAP Disclosure Guidelines

TRAINER MATERIALS

RM1-M1 Expectation Exercise – Notes and Script
RM1-M2 Operational Risk Management – Precourse Skills Audit Answer Guide
RM1-M3 Suggested Duration of Sessions
RM1-M4 Sample Name Tents

PARTICIPANT MATERIALS

OVERHEADS: RM1-O1 Goal
RM1-O2 Risk Management Objectives

HANDOUTS: RM1-H1 Operational Risk Management – Precourse Skills Audit
RM1-H2 Risk Management Goal and Objectives
RM1-H3 Mini Action Plan
RM1-H4 Fraud Experience Form **Optional**

PREPARED FLIPCHARTS:

- Introduction and Directions
- Two flipcharts titled Hibiscus – Why are you studying operational risk management?
- Two flipcharts titled Frangipani – What outcomes do you want to achieve?
- Two flipcharts titled Orchid – What criteria will you use to measure success? How will you know when you have achieved the learning outcomes of this course?

Session 1: Welcome and Introduction

While waiting for participants to assemble, trainers may use RM1-H4 (or something similar) to get participants focused and to gather information on fraud experience for later anonymous reference.

WELCOME

1. *(8 minutes)* Set the stage. Make opening remarks and welcome participants to the course using the following points as a guide:
    - Over the past 20 years, a microfinance industry has emerged in response to the lack of access to formal financial services for most of the world's poor. Microfinance institutions serve an ever-increasing number of poor clients, but the demand for such financial services still far outstrips their capacity.
    - In the normal course of business, MFIs must take risks. Risks are not inherently bad, and often they are necessary to accomplish our goals. It is important to manage those risks, both through preventive and detective methods. This process will help reduce the likelihood that a loss will occur at all and minimize the scale of loss should it occur.
    - Financial service businesses have a larger share of inherent risk because they deal with money, often cash. Without effective systems and controls, microfinance institutions can—and often do—undermine themselves.
    - CGAP designed this course to help microfinance institutions develop a process for operational risk management. *Risk management* includes both the prevention of potential problems and the early detection and correction of actual problems should they occur. This course will provide guidelines for establishing operational activities that will help you identify vulnerabilities, design and implement controls, and monitor the effectiveness of those controls.
    - During this course we will review some basic concepts of risk management and focus on operational risks, internal controls, fraud, and internal and external audits. Our major teaching tools will include exercises, group discussions, and critical incidents (mini case studies) from MFIs. Your active participation in these activities is critical to the success of the course and, most important, to your learning, remembering, and taking the information home to apply it in your MFI.
    - We will acknowledge various types of risks, and we will focus on the management of operational risks specific to microfinance.
    - Before we get started, let us find out who is here and why you came!

PARTICIPANT INTRODUCTIONS AND EXPECTATIONS

Trainers may substitute other experiential activities that achieve the goals of learning who the participants are and finding out participants' expectations.

Participant Introductions

2. *(2 minutes)* Introduce the interview exercise. Ask each person to interview someone they do not know and then introduce that person to the large group. Display the flipchart with the following introductory questions: Name, Organization, Role in organization, and Answers to: If you could change anything in your MFI to prevent fraud, what would it be and why?

3. *(8 minutes)* Conduct interviews. After 3–4 minutes, ask participants to stop and reverse interviewer/interviewee roles.

4. *(15 minutes)* Exchange introductions. Have participants return to their original seats; facilitate the introductions. Tell participants that they will have 30 seconds to introduce their partner. Facilitator must keep time! Distribute name tags and tents after introductions.

5. *(10–15 minutes)* Conduct the precourse skills audit. Explain that in order to fine-tune course time together, trainers need to understand what participants already know. Ask participants to fill out the precourse audit, reminding them that if they knew all the answers, they would have no need to attend this course. (Joke that you hope they will leave some blanks so that we trainers can keep our jobs!) Distribute RM1-H1 (Operational Risk Management – Precourse Skills Audit). Collect the audit for later analysis for forming groups and determining course emphasis.

Expectations

6. *(1 minute)* Tell participants that you would like to know why they are here. State, for example: "Training is a journey, and in this section we will take a few moments to hear what you expect from this journey." Have flipcharts prepared.

7. *(3 minutes)* Read the script. See Trainer Materials RM1-M1 (Expectation Exercise – Notes and Script) for the script of an activity to elicit expectations.

8. *(3 minutes)* Prepare the exercise. Ask who chose the mystery prize. Ask those people to sit down and wait for a moment. Ask who chose the hibiscus, the frangipani, and the orchid. Ask participants to notice the flipcharts with these headings; point to where the hibiscus, frangipani, and orchid flipcharts hang and ask them to form a group at each of the flipcharts.

   Tell those who chose the mystery prize that they've won a free scuba-diving trip to the shark-feeding frenzy, then send them to the flower groups to balance the number of participants in each group.

9. *(3 minutes)* Once participants are at their charts, allow a minute for them to read the question on the flipchart. Announce that they're about to hear a piece of music. While the music is playing, they must use the marker to write as many short answers as they can to the question on the flipchart sheets in front of them. When the music stops, each group is to take its pen and move around the room clockwise to the next flipchart, then repeat the process for the new question. Again, when the music stops they are to move to the third flipchart and add responses as before. *Ensure that flipcharts are well spaced and that there are plenty of markers.*

10. *(15–20 minutes)* Perform the exercise. Check that everyone understands, and begin. Allow participants time to read the first question, and then turn on the music. Play the music and allow the groups to complete each task. Stop the music and have them move to the next chart. Allow no more than 4 minutes per chart.

11. *(10 minutes)* Discuss results. Ask the groups to return to their seats. Ask a few participants to share the most notable response they saw on the sheets. Review some of the points. Try to match the outcomes to the goals and objectives. Ask the following questions:
    - What steps do you think your MFI may need to take to reach the goal?
    - How will you feel going through each step?
    - How are you likely to feel when you've achieved this goal?
    - Now that you have had time to build these lists, do you feel more like a team with shared objectives?

WORKSHOP OVERVIEW

12. *(5 minutes)* Using overheads RM1-O1, Goals, RM1-O2, Objectives, and handout RM1-H2, briefly go over the workshop goals and objectives, tying the sessions into the expectations expressed by participants earlier. If certain expectations will not be met, candidly explain why. If you have prepared a course schedule (based on RM1-M3), distribute and review it.

13. *(5 minutes)* Describe materials. Distribute and briefly introduce copies of recommended materials. If trainers have prepared a binder with the reference materials listed on the first page of this session to hand out to all the participants, state that they have also received an Operational Risk Management Course binder. Explain that they will receive other materials throughout the week that they will insert into this workbook.

14. *(2 minutes)* Describe workshop norms and logistics. Complete a list of ground rules for the workshop by soliciting input from the participants (e.g., start on time, make sure everyone participates, no smoking, one person speaks at a time, there is no such thing as a stupid question, so to ask if anything is unclear). Introduce the concept of the *energizer* and decide how it will work. For example, tell

participants that the last person to enter the room is the energizer for the day. Explain that when someone feels as if the session is dragging a bit, they can have the energizer lead a one-minute activity to perk everyone up. The energizer can tell a joke or lead a round of calisthenics.

Review any logistics, such as hotels, meals, break times, etc.

15. *(2 minutes)* Introduce course methodology. Explain the course approach:
    - Participants are a vital part of this learning process. You will be able to build on the experience and knowledge of other participants, and will share your knowledge and experience for the benefit of others.
    - You will receive various resources for making learning a continuous process (publications, exercises, critical incidents, facilitators, etc.).
    - We will be using the latest in adult education methods, which are built on learning by doing. Sessions do not involve lecturing, as you may be accustomed to, so we ask you to bear with us and allow the process to run its course. We are available to answer questions as needed, but the best remembering comes from your own discoveries!

16. *(3 minutes)* Develop action plans. Remind participants of the importance of taking this new knowledge home and applying it in their MFIs. This is a major training goal. Hand out RM1-H3, the Mini Action Plan worksheet. Make the following points:
    - Trainers will periodically encourage you to develop your own action plan based on what you have learned and what you know is most important to your MFI. We do this on an ongoing basis because at the end of this training, tackling an entire action plan would be overwhelming, and it is sometimes difficult to remember all that has been learned during training.
    - Remember to use your Mini Action Plan worksheet whenever you feel a point has particular relevance to you and your MFI.
    - At the end of training, we will give you another opportunity to expand and summarize the main points, while we are helping you look at ways of implementing these ideas back at work.

17. *(1 minute)* Conclude the session. Take any questions that participants have at this point. Thank them for their attention and participation. Introduce the next session: An Introductory Overview of Risk Management. Bridge to session 2: “Let’s get started!”

REMINDER

After completion of this session, remember to evaluate the Precourse Skills Audit forms and group participants accordingly.

RM1-M1

Expectation Exercise – Notes and Script

Preparation: Adjust the setting to match the group culture. Perhaps it is a skiing trip and participants will choose from three mountains, or it's a photo safari and participants are choosing wild animals.

SAMPLE SCRIPT

This is a message from your pilots, Captains *[use the names of the trainers]*. This training course is being held on a beautiful tropical island on the Barrier Reef, where barriers to learning disappear.

Welcome to Flight [OPERATIONAL RISK MANAGEMENT]. Please take your seats on the aircraft for the short flight to the island. Once you all are seated, please turn around and shake hands with the person behind you. *[Of course, they cannot do this, because the person behind them has also turned around. This produces some confusion and humor as people look to you for help. Smile and acknowledge their confusion without comment.]*

Buckle your seatbelts. Training creates a safety zone where you as learners can try new things, step out of your comfort zones into a risk-free environment. Now, please settle into your seats and close your eyes.

[Pause briefly before moving into the next announcement. Begin this announcement as if you are making a safety announcement in an aircraft.]

We are on the tarmac to begin a learning journey together. This is Flight *[OPERATIONAL RISK MANAGEMENT]*. We are beginning a relaxing, well-deserved, first-class trip to a beautiful tropical island on the Barrier Reef.

[Pause] Now we have taken off on the journey and are approaching our destination. As our flight is nearing the island, you are preparing yourself to learn many new things and you are opening your mind to new experiences. Think about where you are going on this flight and why you are on this plane. Consider what you are going to get from this trip that you will bring home with you. *[Allow a moment or two for consideration.]*

We are now arriving at the airport, disembarking from the plane and, as we feel the warm, balmy breezes, a local welcoming party is meeting us. They are offering you a welcome of beautiful flowers, but you have to choose which one you want.

Here are your choices:

Hibiscus – picture the beautiful colors
Frangipani – smell the perfume
Tropical orchid – admire the wonderful shapes
Or select the mystery prize!

RM1-M2

Operational Risk Management – Precourse Skills Audit Answer Guide

Name: ___________________________ Organization: ___________________________

Please answer these questions to the best of your ability, including any formulas or indicators as requested. This is *not* a test, but it will help us identify which topics to emphasize during the course. Use the reverse side of this paper if necessary to complete your answers.

1. Describe three major risk areas for an MFI.

Operational, institutional, external, financial
(interest rates, liquidity, foreign exchange, fraud, political situations, mission drift, etc.)

2. Who is responsible for risk management in an MFI?

Everybody

3. What does *internal control* mean to you?

Operating policies and procedures, and monitoring

4. Name four specific control techniques.

Segregation of duties, proper authorization levels
Do not write checks to cash
Preprinted, prenumbered receipt books
Physical security
Staff rotation – mandatory leave policies
Client visits – every time a loan is issued, visit the client using a third party

5. Why does fraud occur?

Opportunity exists; personal situation pressures, character flaws

6. What are the most common types of MFI fraud?

Ghost loans
Kickbacks
Theft of cash
Manipulation of data

7. What are the differences between internal and external audits?

Different function, focus, and audience

RM1-M3

Suggested Duration of Sessions

OPERATIONAL RISK MANAGEMENT COURSE

		Minutes	
		Min	***Max***
1	Welcome and Introduction	100	100
2	Risk Management	55	70
3	We Are the Institution	95	105
4	Tools for Risk Management	180	205
5	Business Cycles, Risks, and Internal Controls	120	145
6	Internal Audit	140	160
7	External Audit	185	185
8	Mitigating Risks – Implementing Corrective Controls and Moving Forward	105	115
9	Action Plan, Evaluation, and Closure	45	60
	Total minutes	**1,025**	**1,145**
	Total hours *(divide by 60)*	**17.08**	**19.08**
	Total 6-hour days	**2.85**	**3.18**
	Total 6.5-hour days	**2.63**	**2.94**

RM1-M4

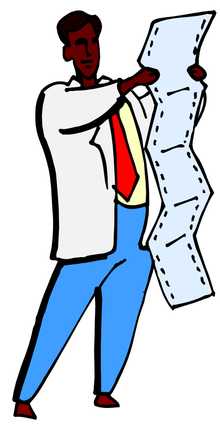
Sample Name Tents

participant name goes here

I hear, I forget

I see, I remember

I do, I understand



To Use: Cut along solid lines, then fold on dotted line. Make sufficient copies (preferably copied on hard paper) for all participants. Distribute to participants and ask participants to write their name in the space provided.

participant name goes here

I hear, I forget

I see, I remember

I do, I understand

participant name goes here

I hear, I forget

I see, I remember

I do, I understand

Overheads

THE COMPLETE SET OF OVERHEADS IS IN A SEPARATE POWERPOINT FILE ENTITLED "CGAP OPERATIONAL RISK MANAGEMENT OVERHEADS"

RM1-O1

Goal

Improve the quality of risk management in microfinance institutions (MFIs) by:

- Understanding the importance of an institutional culture of support for strong control systems
- Assessing and measuring the vulnerability of your own institutions to areas of risk
- Applying techniques for identifying and mitigating risks
- Monitoring effectiveness of risk management strategies

CGAP

RM1-O2

Risk Management Objectives

- Define risk management as it applies specifically to microfinance
- Identify risk areas (areas of vulnerability) for MFIs
- Educate stakeholders on the importance of risk management strategy to an MFI
- Develop internal controls for your MFI in conjunction with stakeholders
- Install internal audit in the internal control system for effective monitoring
- Ensure that information systems play a critical role in the risk management system
- Commission and use external audits effectively

CGAP

Handouts

Operational Risk Management – Precourse Skills Audit

Name: ________________________ Organization: ________________________

Please answer these questions to the best of your ability, including any formulas or indicators as requested. This is *not* a test, but it will help us identify which topics to emphasize during the course. Use the reverse side of this paper, if necessary, to complete your answers.

1. Describe three major risk areas for an MFI.

2. Who is responsible for risk management in an MFI?

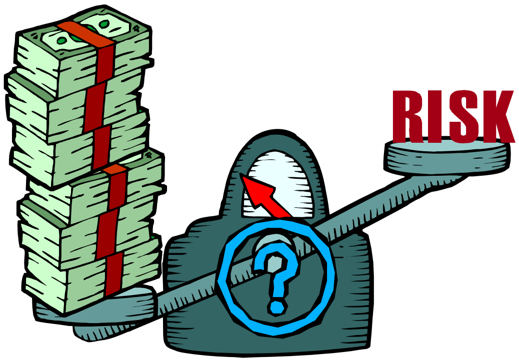
3. What does *internal control* mean to you?

4. Name four specific control techniques.

5. Why does fraud occur?

6. What are the most common types of MFI fraud?

7. What are the differences between internal and external audits?



Risk Management

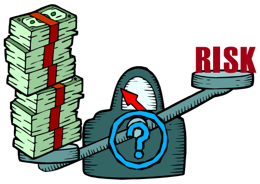
Goal

Improve the quality of risk management in microfinance institutions (MFIs) by:

- ✓ **Understanding the importance of having a institutional culture of support for strong control systems**
- ✓ **Assessing and measuring the vulnerability of your own institutions to areas of risk**
- ✓ **Applying techniques for identifying and mitigating risks**
- ✓ **Monitoring effectiveness of risk management strategies**

Objectives

- ✓ **Define risk management as it applies specifically to microfinance**
- ✓ **Identify risk areas (areas of vulnerability) for MFIs**
- ✓ **Educate stakeholders on the importance of risk management strategy to an MFI**
- ✓ **Develop internal controls for your MFI in conjunction with stakeholders**
- ✓ **Install internal auditing in the internal control system for effective monitoring**
- ✓ **Ensure that information systems play a critical role in the risk management system**
- ✓ **Commission and use external audits effectively**



MINI ACTION PLAN

What have I learned? What are the important points for me?	How can I apply this plan after training? How can I ensure that I use this plan?

Fraud Experience Form

To get a head start on topics we'll cover while we are here, please answer the following.

1. **Has your MFI experienced fraud? Describe the incident.**

2. **What conditions made your MFI vulnerable to this (or any other) incidents of fraud?**

3. **What have you done to try to reduce your vulnerability?**

SESSION 2: RISK MANAGEMENT

Session Summary

OBJECTIVES: By the end of the session, participants will be able to:

- List and define key areas of risk for an MFI
- Explain risk management components and definitions
- Define a systematic process of risk management
- Define preventive, detective, and corrective controls

TIME: 55–70 minutes

SUPPLIES: Flipchart paper, markers, masking tape
LED projector or overhead projector
Index cards
75 sheets of plain paper
Adhesive putty (such as Blu Tak or Fun Tak)

TRAINER MATERIALS

RM2-M1 Technical Materials – Excerpts from CARE *Microfinance Risk Management Handbook*

RM2-M2 Technical Materials – Excerpts from MFN/GTZ *Improving Internal Control: A Practical Guide for Microfinance Institutions*

PARTICIPANT MATERIALS

OVERHEADS: RM2-O1 Categories of Microfinance Risks
RM2-O2 Risk Management/A Systematic Approach
RM2-O3 Control Environment
RM2-O4 Risk Management Process Feedback Loop
RM2-O5 Internal Controls

HANDOUTS: RM2-H1 Risk Management Process Feedback Loop
RM2-H2 Risk Management (Technical Notes)

PREPARED FLIPCHARTS:
Risk Management Includes (circle diagram as shown in RM2-O3)
Risk Management Process Feedback Loop (as shown in RM2-O4)

Session 2: Risk Management

This short session is an introductory, climate-setting session to focus participants' attention on the information to come. It is primarily question-and-answer format, and the trainer should strive to keep it lively and fast-paced.

IDENTIFICATION OF RISKS

1. *(2 minutes)* Risks are about potential loss. Ask participants: What does the word risk mean to you? Why should we be concerned about risks? Take a few answers. Ask: What happens to our MFIs if we ignore risks? Answer: Failure!

2. *(4 minutes)* Ask what kinds of risks exist for an MFI. Have all the participants quickly list 5 to 10 risks that they face in their MFIs.

3. *(3 minutes)* Quickly, without discussion, list some of the responses on a flipchart. Answers can include loan loss, fraud, nonpayment of loans, theft, changing interest rates, fire, clients stealing money, operational losses, liquidity, personnel inefficiency, changes in the law, inflation, interpersonal conflict, high staff turnover, loss of assets, donor dependency, lack of systems, staff capacity, unstable banking environment, client dropout, and more.

4. *(4 minutes)* Begin to comment on the list. Ask: Is it possible to group the risks we've listed into major categories? What would the categories be? Answer: institutional, operational, financial, and external. Don't spend a lot of time fitting risks into categories. Only highlight that there are logical groupings.

   Summarize and focus using RM2-O1. Briefly discuss the major types of risks faced by an MFI. Highlight with examples from the flipchart list. Explain that the discussion will come back to this list a little later in the session. Refer participants to the CARE *MFI Risk Handbook* chapter 1; see RM2-M1.

   Conclude: External risks can be prepared for and should be seen as opportunities, not excuses for poor performance.

DEFINITION OF RISK MANAGEMENT

5. *(2 minutes)* Begin the discussion of risk management systems by posing the question: If risks are about losses, what do you think risk management is about? Answer: Risk management is about controlling or minimizing the losses associated with the risks.

   Summarize by using RM2-O2: *Risk Management: A Systematic Approach to Identifying, Measuring, and Mitigating Risks in an MFI*. Explain that MFIs that have strong risk management systems and maintain healthy portfolios can reduce the risk of loss and in general succeed! Remind them that this is what we all want for our institutions and why we are here.

6. *(5 minutes)* Ask what participants think makes up the risk management environment. Take a few answers. Show RM2-O3. Briefly define the components through questioning.

    - What are the major components of risk management?
    - What are the major tools we use to manage risks?

    Risk management is the process of controlling the likelihood and potential severity of an adverse event. *Internal control* is the institution's mechanism to monitor risks before and after operations. An *internal audit* is a systematic ex post appraisal of an institution's operations and financial reports. *External audits* further evaluate an institution's controls, audits, and statements. The *control environment* includes all of the above.

    Refer participants to RM2-M2, excerpts from MFN/GTZ *Improving Internal Control* for more information.

7. *(5–10 minutes)* Remind participants that risk is about loss, and risk management is about minimizing those losses. Brainstorm and write the main points on a flipchart. Ask:

    - How do you think we go about actually managing risks?
    - What steps have you taken in the process of risk management in your MFI?
    - Main points to remember: identify risks, prioritize, develop systems and procedures, implement, monitor and evaluate, revise.

RISK MANAGEMENT PROCESS LOOP

8. *(5–10 minutes)* In a mini lecture, suggest an approach for the risk management process using RM2-O4 with RM2-M2 for explanation. Link the main points from the previous step as appropriate. Hand out RM2-H1, Risk Management Process Feedback Loop, and post a flipchart of the same for future reference. Explain that the remainder of the course follows this process (RM2-O4).

9. *(5 minutes)* Discuss the control environment in relation to the risk management process (RM2-O3, RM2-O4, and the flipchart). Ask participants to identify the internal control and audit steps in the process cycle.

    State that the first step in the process feedback loop is to identify the MFI's risks. The next steps are concerned with developing strategies to measure and mitigate risks. These strategies are called internal controls.

TYPES OF CONTROL

10. *(5–10 minutes)* Looking back at the steps that you identified as internal controls, ask participants to comment on them. Do they all have the same purpose? Ask how steps 3–4, 5, and 6 differ in terms of the purpose of the controls. Use questioning to elicit the reference to preventive, detective, and corrective controls.

Showing RM2-O5, define each type of internal control and relate the strategies back to the RM process feedback loop (RM2-O4) by asking which steps in the loop are predominantly preventive (3 and 4), detective (5), and corrective (6). Note that the loop provides for all three types of internal control, acknowledging overlap.

What is important is not how each type fits precisely into the loop but that the loop provides for a cycle of prevention, detection, and correction. Summarize by stating the importance of each type of control to the risk management environment. Note that future sessions will continue to work with these concepts.

WHY FOCUS ON OPERATIONAL RISK

11. *(5 minutes)* Ask participants to go back to the list of risks identified at the beginning of the session (on the flipchart) and to their own list of risks to their MFIs.

    Lead a discussion using the following questions as prompts:

    - What does this tell us about MFI risks in general?
    - Are the risks evenly distributed in the four categories?
    - In which areas do the majority of your risks lie?

    Ask how many participants had fraud on their list. Why so many? State that fraud is by far the major risk to be managed in MFIs. Emphasize MFIs' particular vulnerability due to the volume of transactions and cash management. Note that the rest of the sessions will refer often to the risk of fraud in MFIs.

    Ask participants why they think the focus of this course is on operational risk management. Answer: Because the operations of an MFI present the most relevant risk and pose the greatest exposure to fraud. It is also the area where an MFI stands to lose the most.

    Note that the course will touch on some other institutional risks (mission and values) and how they relate to MFIs' operations. These other types of risk are quite important to recognize and manage. Financial risks are usually routinely covered in other literature and courses. Though external risks must be anticipated and planned for, they are not usually controllable, so they will be covered briefly as they relate to other risks.

    Emphasize the need to manage all risks in an MFI. Note also that the operations take place within the systems of the other risk categories and that risks are often related to one another. Because of the importance of operational risks to microfinance, this course focuses on the management of operational risks.

12. *(5 minutes)* Recap definitions of risks, risk management, internal controls, and the risk management process. Take any questions. Ask: Now that we know about these risks, what can we do about them? Answer: Manage! What happens if we don't? Failure!

RM2-M1

Technical Materials – Excerpts from CARE *Microfinance Risk Management Handbook*

Chapter 1: Risk Assessment Framework

Most microfinance institutions are small, unprofitable, and operate without proper systems to reduce risk exposure. Although the microfinance literature focuses on this industry's success stories, such as BancoSol in Bolivia or BRI's microfinance units in Indonesia, these organizations are the exceptions rather than the rule. For microfinance programs that are striving to fulfill their **dual mission** of sustainability and outreach to the poor, CARE suggests the implementation of the risk assessment framework described below. This framework addresses two agendas:

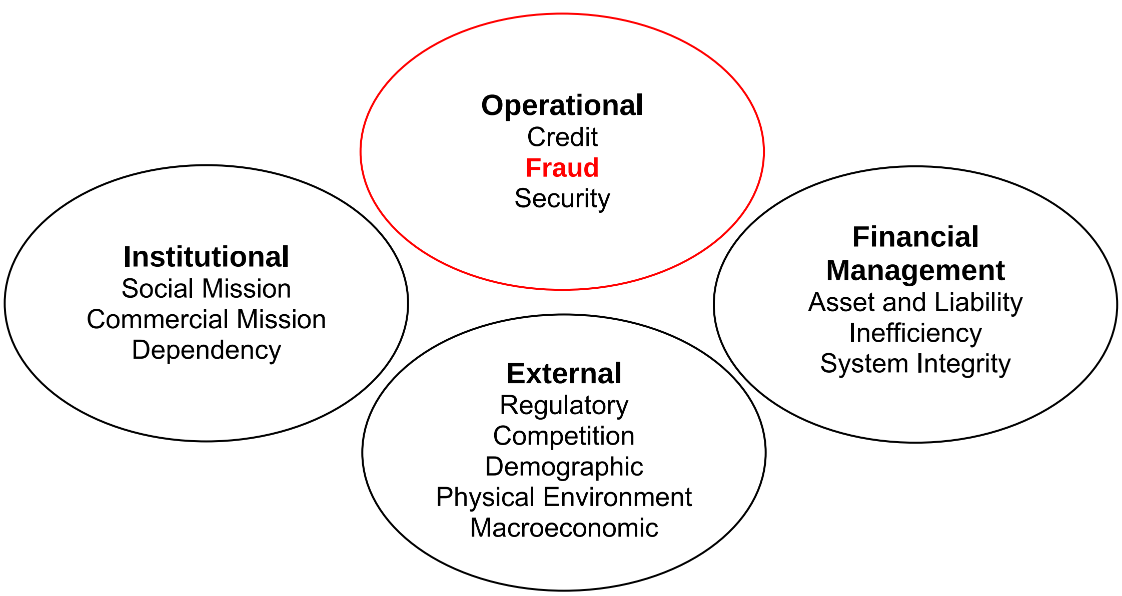
1. Financial Health
2. Institutional Development

A standard risk assessment of a financial institution typically addresses the first issue only. In assessing the financial health of a bank or other financial institution, one would consider the organization's asset and liability management, including credit risk, as well as operational risks such as fraud and inefficiency.

While this traditional approach is incorporated into the CARE framework, microfinance risk assessment also needs to embrace an institutional development perspective. As the microfinance industry evolves from donor dependency into a commercial approach, clear vision, reliable systems, effective governance, and staff capacity become critical factors in an institution's ability to manage risk.

This integrated risk assessment framework for microfinance institutions, which analyzes both institutional development and financial health issues, is organized into four categories of risk: institutional, operational, financial, and external. This framework provides managers and directors of microfinance institutions with a step-by-step means of assessing their organization's current and potential vulnerabilities.

Figure 1: Categories of Microfinance Risks



1.1 Institutional Risks

Microfinance success is defined as an independent organization providing financial services to large numbers of low-income persons over the long term. An assessment of risks against this definition results in three categories of institutional risk: social mission, commercial mission, and dependency.

1.1.1 Social Mission

While all MFIs do not have the same mission statements, in general they have a dual mission: a social mission and a commercial mission. Their social mission is to provide valued financial services to large volumes of low-income persons that will enable them to improve their welfare. Microfinance institutions are vulnerable to social mission risk if they do not have a clearly defined target market and monitoring mechanisms to ensure that they are providing appropriate financial services to their intended clientele.

1.1.2 Commercial Mission

The commercial mission of MFIs is to provide financial services in a way that allows the organization to be an on-going concern—that is, to exist for the long term. MFIs are exposed to commercial mission risk if they do not set interest rates high enough to cover costs and if the organization is not managed as a business.

The social and commercial missions are sometimes in conflict with each other. For example, it might be easier to become sustainable if the institution offered larger loans, which could undermine the social mission to serve low-income and harder-to-reach people who traditionally demand smaller loans. The microfinance challenge is to balance the social and commercial missions to achieve them both.

1.1.3 Dependency

Dependency risk is similar to commercial mission risk, but it is most pronounced for MFIs that were started and supported by international organizations such as CARE, particularly when the microfinance activities are operated as a project rather than as an independent organization. These MFIs are vulnerable to dependency on the strategic, financial, and operational support provided by the external organization. While this support may seem like an advantage at first, it can significantly undermine efforts to build an independent institution that will exist for the long term.

1.2 Operational Risks

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

1.2.1 Credit

As with any financial institution, the biggest risk in microfinance is lending money and not getting it back. Credit risk is a particular concern for MFIs because most microlending is unsecured (i.e., traditional collateral is not often used to secure microloans).

To determine an institution’s vulnerability to credit risks, it is necessary to review policies and procedures at every stage in the lending process to determine if they are designed to produce an acceptable level of delinquencies and loan losses. These policies and procedures include the loan eligibility criteria, the application review process and authorization levels, collateral or security requirements, as well as the “carrots and sticks” used to motivate staff and compel borrowers to repay. Besides analyzing whether these policies and procedures are sound, it is also necessary to determine whether they are actually being implemented. The best policies in the world are meaningless if staff members are not properly trained to implement them or choose not to follow them.

1.2.2 Fraud

Any organization that handles large volumes of money is extremely vulnerable to fraud, a vulnerability that tends to increase in poor economic environments. Exposure to fraud is particularly acute where money changes hands. These vulnerabilities in a microfinance institution can be exacerbated if the organization has a weak information system, if it does not monitor clearly defined policies and procedures, if it has high staff turnover, or if the MFI experiences rapid growth. The management of savings, particularly voluntary savings, creates additional vulnerability in that a failure to detect fraud could lead to the loss of clients' very limited cash assets and to the rapid deterioration of the institution's reputation. In the detection of fraud, timeliness is a critical factor to address the problem and send a sharp message to staff before it gets out of hand.

1.2.3 Security

As with vulnerability to fraud, the fact that most MFIs handle money also exposes them to theft. This exposure is compounded by the fact the MFIs tend to operate in environments where crime is prevalent or where, because of poverty, temptation is high. For example, in high-volume branches the amount of cash collected on a repayment day can easily exceed the average annual household income in that community.

1.3 Financial Management Risks

1.3.1 Asset and Liability

The financial vulnerability of an MFI is summarized in asset and liability risks, which include interest rate, liquidity, and foreign exchange risks. Interest rate risk arises when the terms and interest rates of assets and liabilities (which fund assets) are mismatched. For example, if the rates on short-term liabilities rise before an MFI can adjust its lending rates, the spread between interest earnings and interest payments will narrow, seriously affecting the MFI's profit margin. MFIs operating in inflationary environments are particularly vulnerable to this type of risk. Liquidity risk involves the possibility of borrowing expensive short-term funds to finance immediate needs such as loan disbursement, bill payments, or debt repayment. MFIs are most vulnerable to foreign exchange risk if they have to repay loans in a foreign currency that they have converted to local currency and therefore are earning revenue in the local currency.

1.3.2 Inefficiency

Efficiency remains one of the greatest challenges for microfinance institutions. It reflects an organization's ability to manage costs per unit of output, and thus is directly affected by both cost control and level of outreach. Inefficient microfinance institutions waste resources and ultimately provide clients with poor services and products, as the costs of these inefficiencies are ultimately passed on to clients through higher interest rates and higher client transaction costs.

1.3.3 System Integrity

Another aspect of financial management risk is the integrity of the information system, including the accounting and portfolio management systems. An assessment of this risk involves checking the quality of the information entering the system, verifying that the system is processing the information correctly, and ensuring that it produces useful reports in a timely manner.

1.4 External Risks

Although they have less control over them, MFI managers and directors should also assess the external risks to which they are exposed. A microfinance institution could have relatively strong management and staff, and adequate systems and controls, but still be prone to major problems stemming from the environment in which it operates. External risks are usually outside the control of the MFI; however, it is important that these risks are perceived as challenges that the MFI must address, rather than excuses for poor performance.

1.4.1 Regulatory

Policy makers, banking superintendents and other regulatory bodies are becoming increasingly interested in, and concerned about, microfinance institutions. This concern is heightened when MFIs are involved in financial intermediation—taking savings from clients and then lending out those funds. In many jurisdictions, policy makers are regulating the activities of microfinance institutions, occasionally with policies that can threaten the institution, such as usury laws. Other regulations that can create vulnerability in an MFI include restrictive labor laws, contract enforcement policies, and political interference.

1.4.2 Competition

In some environments, microfinance is becoming increasingly competitive, with new players, such as banks and consumer credit companies, entering the market. Competition risks stem from not being sufficiently familiar with the services of others to position, price, and sell their own institution's services. Competition risk can be exacerbated if MFIs do not have access to information about applicants' current and past credit performance with other institutions.

1.4.3 Demographic

Since most MFIs target disadvantaged individuals in low-income communities, microfinance managers need to be aware of how the characteristics of this target market increase the institution's vulnerability. In assessing demographic risks, [managers should] consider the trends and consequences of illness and death (including HIV/AIDS), education levels, entrepreneurial experience, the mobility of the population, the social cohesiveness of the communities, past experience with loans and repayment, and local tolerance for corruption.

1.4.4 Physical Environment

Some areas are prone to natural calamities (floods, cyclones, or drought) that affect households, enterprises, income streams, and microfinance service delivery. In addition, the physical infrastructure—such as transportation, communications, and the availability of banks—in the MFI's area of operations can substantially increase its vulnerability.

1.4.5 Macroeconomic

Microfinance institutions are especially vulnerable to changes in the macroeconomic environment such as devaluation and inflation. This risk has two facets: (1) how these conditions affect the MFI directly and (2) how they affect the MFI's clients, their business operations, and their ability to repay their loans.

1.5 Conclusion

The management and board of a microfinance institution should consider each of the risks identified in this chapter as vulnerability points. It is their responsibility to assess the institution's level of exposure, prioritize areas of greatest vulnerability, and to ensure that proper controls are in place to minimize the MFI's exposure. The following four chapters address the controls and monitoring tools required to manage each of these four categories of risk.

Figure 2: Organization of Microfinance Risks by Chapter

Chapter 2	Institutional Risks	Social Mission Commercial Mission Dependency
Chapter 3	Operational Risks	Credit Fraud Security
Chapter 4	Financial Management Risks	Asset and Liability Inefficiency System Integrity
Chapter 5	External Risks	Regulatory Competition Demographic Physical Environment Macroeconomic

Chapter 6 then presents the accounting and portfolio management systems required to create an effective risk monitoring system.

The Ultimate Risk Management Controls:
Good Governance and Quality Human Resources*

This document contains a host of controls to mitigate the specific risks to which a microfinance institution is exposed. There are two ultimate controls, however, that deserve special mention because they cut across numerous risks and serve as critical building blocks on which many of the other controls are based.

Good Governance: The board of directors plays a critical control function in a microfinance institution. One of the board's key responsibilities is to analyze risks and ensure that the MFI is implementing appropriate controls to minimize its vulnerability. This handbook, therefore, is a valuable tool for directors to comprehensively review possible risks and to pinpoint the areas of greatest vulnerability.

Unfortunately, the microfinance industry is not particularly well known for its effective governance, which presents its own set of risks. In the search for effective governance, consider the following guidelines:

The composition of the board should include a majority of external directors, with the diversity of skills and perspectives that are needed to govern an MFI. The composition should balance the dual mission of microfinance, with some directors more concerned about the social mission and others focused primarily on the commercial mission.

It is critical that board members dedicate sufficient time to fulfill their functions. It is not appropriate to appoint directors solely for their "political" value; while it might seem nice to have the names of famous people in the annual report, if they do not actually attend board meetings or play a meaningful role, then they are not providing good governance.

There needs to be a clear separation of roles and responsibilities between the board and management. The board oversees the work of senior managers and holds them accountable, which includes setting performance targets and taking disciplinary action if necessary.

The board should meet often enough to keep a close eye on the organization. During periods of change, that may mean weekly meetings. In mature, stable MFIs, quarterly meetings might suffice, especially if there is an executive committee of the board that is in more frequent contact with management.

Boards should be regularly rejuvenated so that new ideas and fresh energy are injected into the organization. This can be accomplished through term limits and/or a performance appraisal system that encourages inactive and ineffective directors to step down.

Trained and Motivated Personnel: The other "building block" control is the MFI's employees. As a service industry, the delivery of microfinance products is just as important as (if not more important than) the products themselves. An MFI can dramatically reduce its vulnerability to most risks if it has well-trained and motivated employees. This is accomplished through a three-pronged strategy:

Hiring: The first step is finding the right people. In hiring field staff, you are probably not going to find people with microfinance expertise, so instead you should look for certain values (honesty, commitment to the target market, a willingness to get their shoes dirty), personality characteristics (outgoing, team player), and aptitudes (combination of "hard" and "soft" skills). Once you identify the ideal traits of a loan officer, then you can design your screening techniques accordingly. When you find a few of the ideal people, then figure out where they came from to see if there are more of them out there. Sometimes certain schools, religious groups, or social organizations are excellent sources of new employees.

Training: Once you have hired the right people, the next step is to train them well. Training often focuses on the nuts and bolts of doing a job—such as what forms you fill out for what purposes—but to serve as an effective control, training should impart much more than just technical skills. New staff orientation is the ideal time to indoctrinate your employees; to bathe them in the institution's culture; to cultivate their commitment to the organization, its mission, and its clients; and to teach and practice the social skills needed to perform their jobs, such as group mediation and facilitation, adult education, customer service, and time management. Training should not end once the loan officer hits the streets. To retain quality people, and to ensure that they grow and develop as the organization evolves, it is necessary to provide regular in-service training as well. In the search for increased efficiency, MFIs are constantly looking for ways to streamline operations and cut corners; they should resist any temptation to short-change the training of new or existing employees.

Rewarding: It is difficult to keep employees motivated and enthusiastic about their work. MFIs should view their best employees the same way they view their best customers: once you have them, do everything possible to keep them. An MFI that wants to retain staff needs to position itself as an employer of choice. This involves providing a competitive compensation package, but it is much more than just wages. Salaries are already the biggest line item in most MFI budgets—so it is necessary to find creative ways of rewarding and motivating staff. Other factors that influence an employee's satisfaction, and therefore their willingness to remain with the employer, include:

- Benefits such as health insurance and vacation time
- An institutional mission that helps people feel that they can make a difference
- Workplace design that is comfortable and conducive to productivity
- An institutional culture that is unique so that employees feel like they are part of a special team
- Recognition of individual and group accomplishments
- Staff development and job enrichment opportunities

Excerpted from CARE *Microfinance Risk Management Handbook.*

Technical Materials – Excerpts from MFN/GTZ *Improving Internal Control: A Practical Guide for Microfinance Institutions*[1]

1. Introduction to Internal Control

Bank failures and widespread losses over the past two decades have elevated the importance of effective risk management and internal control within the formal financial sector worldwide. In the United States, bank failures rose over 200 percent in the 1980s, partly due to fraud and mismanagement. Internationally, the collapse of Barings Bank and Yamaichi Securities further focused the financial sector's attention on risk management and internal control. The Basle Committee[2] analyzed the problems related to these losses and concluded that they probably could have been avoided had the banks maintained effective internal control systems.[3] In addition, a review of traditional banks asserted that the implementation of effective internal control systems played an important role in reducing bank failures throughout the 1990s.[4]

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

What Is Internal Control?

According to the Basle Committee on Banking Supervision,[5] the primary objectives of the internal control process in a financial institution are:

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

---

[1] Excerpted from Campion, A. 2000. *Improving Internal Control: A Practical Guide for Microfinance Institutions,* Technical Guide No. 1, MFN/GTZ International, chapters 1 and 2.
[2] The Basle Committee is a group of supervisory authorities, established by the central bank governors of the Group of Ten countries, that developed a framework for the evaluation of financial institutions' internal control systems.
[3] Basle Committee on Banking Supervision, 1998.
[4] Williams, Clark, and Clark, 1995, p. 55(4).
[5] Basle Committee on Banking Supervision, 1998.

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

- Risk management is a systematic approach to identifying, measuring, monitoring, and managing business risks in an institution.
- Internal control is the institution’s mechanisms to monitor risks before and after operations.
- Internal audit is a systematic “ex-post” appraisal of an institution’s operations and financial reports.

Figure 1: Relationship between Risk Management and Internal Control

Microfinance practitioners often confuse internal control with internal audit. Practitioners often define internal audit too narrowly, following a simple paper trail to verify financial data. This publication distinguishes internal control from internal audit and places internal control within the context of risk management. It highlights the importance of client visits to verify financial records and uncover risk exposures in a microfinance institution.

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

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

2. The Risk Management Approach to Internal Control

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

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

2.1 Risk Management Feedback Loop

The risk management approach implies a shift in responsibility for internal control from the traditional back-office and support functions to the board and chief executive officer.[6] Only by involving the board of directors and senior management can an MFI develop and integrate a strong culture of risk management into all areas of operation. To reach its fullest potential, MFIs need to recognize risk management as an important ongoing internal function rather than view it as the role of the annual external audit. Outside assessments are often too limited in scope and arrive too late to provide the depth and timeliness of feedback needed to protect the MFI from significant financial loss.

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

1. **Identify, assess and prioritize risks.** The risk management process begins with management identifying and prioritizing the key risks, which are reviewed and approved by the board of directors. This step requires the board and management to determine the degree of risk the MFI should tolerate and to conduct assessments for each risk of the potential negative impact if it is not controlled. The most significant

[6] Southworth and Singh, *USBanker*, November 1995, p. 92(1).

risks faced by microfinance institutions include operational risk, credit risk, liquidity risk, interest rate risk and fraud risk, which are described in the next section. Other risks include foreign exchange risk, compliance risk, and mission risk, which this publication does not discuss because they are not applicable to all institutions and typically pose a smaller threat to the MFI's financial integrity.

2. **Develop strategies to measure risks.** The board approves policies for measuring and tracking risks and monitors the MFI's adherence to them. Management identifies key indicators and ratios that can be tracked and analyzed regularly to assess the MFI's exposure to risk in each area of operations. Management sets the acceptable range for each indicator, outside of which would indicate excessive risk exposure. Management also determines the frequency with which each indicator should be monitored and analyzed.
3. **Design policies and procedures to mitigate risks.** Next, management develops sound procedures and operational guidelines to mitigate each risk to the degree desired. Sound policies and procedures clearly instruct employees how to conduct transactions and incorporate effective internal control measures. Common internal control measures are discussed in Chapter 3.
4. **Implement controls into operations and assign responsibility.** Management now selects cost-effective controls and seeks input from operational staff on their appropriateness. If the control measure will have an impact on clients, then management should speak with loan officers or other line staff to understand the potential repercussions. If the potential for impact is significant, the MFI can also solicit input directly from clients, such as through surveys or focus groups. The institution should assign managers to oversee implementation of the controls and to monitor them over time. Table 1 summarizes the key roles and responsibilities for risk management within the MFI.
5. **Test effectiveness and evaluate results.** The MFI should have clearly defined indicators and parameters that determine when a risk is not adequately controlled. Then, the board and management review the operating results to assess whether the current policies and procedures are having the desired outcome and whether the MFI is adequately managing its risks. Some indicators, such as portfolio quality, require weekly or monthly monitoring, while others, such as operational efficiency, require less frequent monitoring.

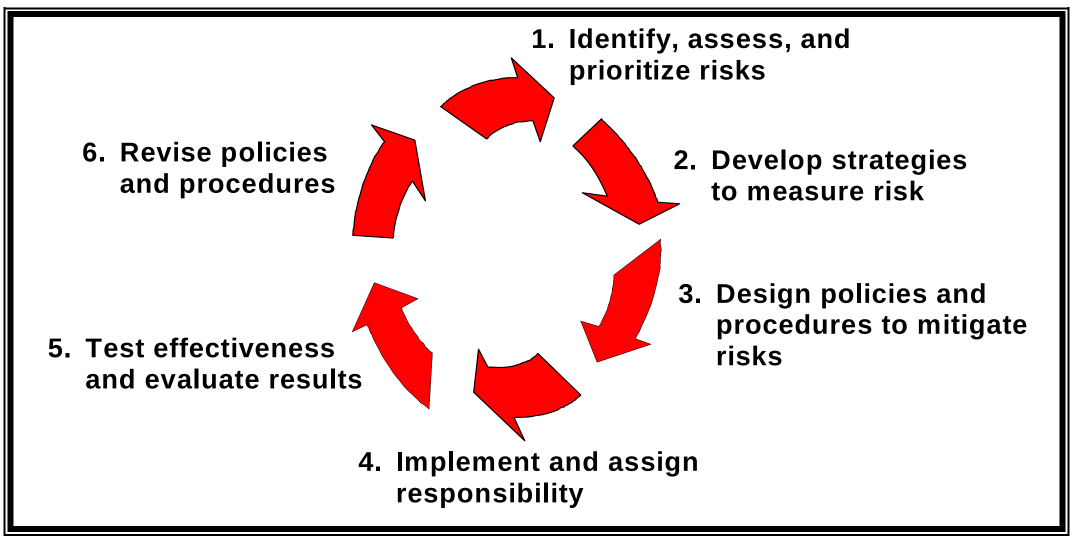
Table 1: Roles and Responsibilities in Risk Management

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

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

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

Figure 2: Risk Management Feedback Loop[7]



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

[7] GTZ's *A Risk Management Framework for Microfinance Institutions*, 2000, p. 36.

2.2 Common Risks to MFIs

MFIs face many risks that threaten their financial viability and long-term sustainability. Some of the most serious risks come from the external environment in which the MFI operates, including the risk of natural disaster, economic crisis, or war. While the MFI cannot control these risks directly, there are many ways in which the MFI can prepare itself and minimize their potential for negative impact.[8] This publication, however, focuses strictly on those risks that are inherent within the MFI's internal operations; it does not address external risks. Furthermore, since the management of headquarters-level operations varies significantly from one MFI to another, the publication limits its discussion to controlling the most common risk exposures, namely operational, credit, liquidity, interest rate, and fraud risks, to the degree they are managed at the branch level.

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

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

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

Interest rate risk is the risk of financial loss from changes in market interest rates. Interest rate risk arises from differences in the timing of rate changes and the timing of cash flows (repricing risk), from differences in yield curves (basis risk), from rate variations across the spectrum of maturities (yield curve risk), and from interest-related options within financial products (options risk).[9] In MFIs, the greatest interest rate risk occurs when the cost of funds goes up faster than the MFI can adjust its lending rates. Though most MFIs manage their interest rate risk at the headquarters level, there are a few MFIs, such as Fundusz Mikro in Poland and the Banks Perkreditan Rakyat (BPRs) in Indonesia, that allow branch managers to set and adjust interest rates according to their specific market needs.

---

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

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

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

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

Overheads

THE COMPLETE SET OF OVERHEADS IS IN A SEPARATE POWERPOINT FILE ENTITLED "CGAP OPERATIONAL RISK MANAGEMENT OVERHEADS"

RM2-O1

Categories of Microfinance Risks

Operational
Credit
Fraud
Security

Institutional
Social Mission
Commercial Mission
Dependency

Financial Management
Asset and Liability
Inefficiency
System Integrity

External
Regulatory
Competition
Demographic
Physical Environment
Macroeconomic

CGAP

RM2-O2

Risk Management
A Systematic Approach

Identifying,

Measuring,

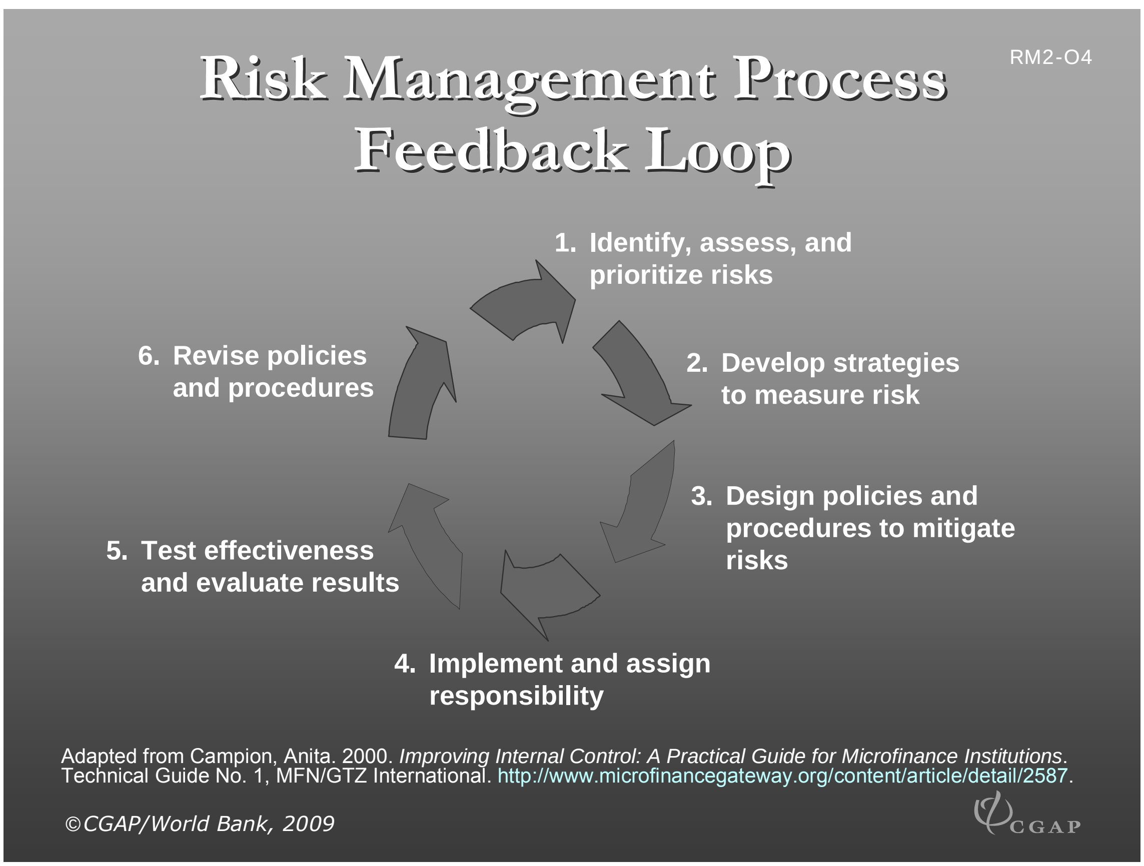
and

Mitigating

Risks in an MFI

CGAP


RM2-O3
Control Environment
Risk Management
Internal Control
Internal Audit
External Audit
©CGAP/World Bank, 2009
CGAP

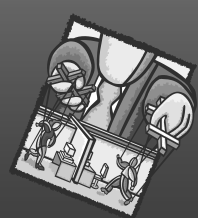

RM2-O4
Risk Management Process Feedback Loop
1. Identify, assess, and prioritize risks
2. Develop strategies to measure risk
3. Design policies and procedures to mitigate risks
4. Implement and assign responsibility
5. Test effectiveness and evaluate results
6. Revise policies and procedures
Adapted from Campion, Anita. 2000. Improving Internal Control: A Practical Guide for Microfinance Institutions. Technical Guide No. 1, MFN/GTZ International. http://www.microfinancegateway.org/content/article/detail/2587.
©CGAP/World Bank, 2009
CGAP

RM2-O5

Internal Controls

Preventive

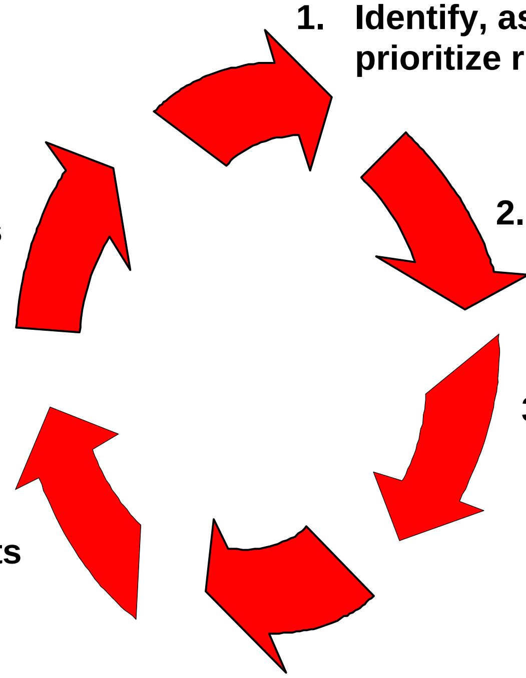
Detective



Corrective

Handouts

Risk Management Process Feedback Loop



1. Identify, assess, and prioritize risks

2. Develop strategies to measure risk

3. Design policies and procedures to mitigate risks

4. Implement and assign responsibility

5. Test effectiveness and evaluate results

6. Revise policies and procedures

Adapted from Campion, Anita. 2000. *Improving Internal Control: A Practical Guide for Microfinance Institutions.* Technical Guide No. 1, MFN/GTZ International. http://www.microfinancegateway.org/content/article/detail/2587.

Risk Management (Technical Notes)

Operational risk management is a systematic approach to identifying, measuring, and mitigating operational risks in an MFI.

Internal Controls (ICs)

Internal controls are all of the resources and procedures used by managers to properly control their activities. Using the process allows the management and its personnel to be reasonably sure that their objectives have been met. ICs help correct contradictions and detect anomalies that occur among different decision centers who have varying degrees of autonomy.

Internal controls can be:

- Preventive – designed and installed to prevent undesirable outcomes *before* they happen.
- Detective – designed to identify undesirable outcomes when they *do* happen. Detective ICs identify errors *after* they occur.
- Corrective – designed to make sure that corrective action is taken to reverse the undesirable outcomes or to see that they do not recur. Corrective ICs are exercised to correct the identified errors.

All of them, in concert, function to ensure that some management objective or goal will be met.

Internal Audit

Internal auditing is an independent appraisal function that is established within an organization to examine and evaluate its activities. The objective of internal auditing is to provide a service to the organization by assisting members of the organization in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed. The audit objective includes promoting effective control at reasonable cost. At some levels it serves to monitor and evaluate the applications of established controls. Occasionally an MFI may contract an external auditor or firm to conduct its internal audit function.

External Audit

An *external audit* is conducted by an individual or firm that is independent of the company being audited. These independent auditors audit the books of a company generally once per year after the completion of the company's fiscal year. Their role is to give an opinion of the financial statement's reflection of the status and operations of the company being audited. Depending on what they witness during the audit, external auditors will also produce a management letter for use by management and the board,. Although a financial statement audit is the most common type of external audit, external auditors may also conduct special-purpose audits, which might include performing specific tests and procedures and reporting on the results, performing a less intensive review (donors commonly request such a review), and doing compilations.

SESSION 3: WE ARE THE INSTITUTION

Session Summary

OBJECTIVES: By the end of the session participants will be able to:

- State the mission and core values of their microfinance institution
- Analyze institutional values relative to their operations
- Identify barriers to institutionalizing values
- Relate the role of people to the institution and risk management
- List and describe key elements in effective risk management

TIME: 95–105 minutes

SUPPLIES: Flipchart paper, markers, masking tape
LED projector or overhead projector

TRAINER MATERIALS

RM3-M1 Technical Materials – Excerpt from CARE *Microfinance Risk Management Handbook*

RM3-M2 Anecdote to Illustrate Strategies for Gaining Insights into Staff Values

RM3-M3 Technical Materials – Excerpt from *Internal Controls and Fraud Prevention in Microfinance Institutions*

RM3-M4 Technical Materials – Excerpt from MFN/GTZ *Improving Internal Control: A Practical Guide for Microfinance Institutions*

PARTICIPANT MATERIALS

OVERHEADS: RM3-O1 Everyone Has a Role in Risk Management
RM3-O2 A Mission Statement
RM3-O3 WHY? Because
RM3-O4 Keys to Effective Risk Management

HANDOUTS: RM3-H1 Mission Statement and Core Values Worksheet
RM3-H2 Technical Materials – Mission Definition and Excerpts

PREPARED FLIPCHARTS:
Title only – Model for Sustainable Capacity Building

Session 3: We Are the Institution

INTRODUCTION

1. *(2 minutes)* Summarize that the course has defined and identified some risks and begun to look at a process of risk management. Ask where to begin and take a few answers. Ask: Whose role is risk management? Take a few answers; show RM3-O1 and explain. State: In this session we will look at who MFIs are as an institution.

2. *(2 minutes)* Ask where people get the guidance for what they do and how they do it. State: We need some ideas on what we stand for and who we are so that we may gain insight into what we are protecting!

MISSION

3. *(3 minutes)* Ask: What do you think we are talking about when we say *mission*? How can we find out who we are as an institution? Take a few answers. Summarize: Who we are is usually reflected in a mission statement. Ask: What is a mission statement? Show RM3-O2 as needed. Lead a brief discussion. State that most MFIs have both commercial and social aspects of their mission statements, and both have their inherent risks. A mission statement is one institutional item that supports or guides employees, helping them carry out their duties, including risk management. (See RM3-M1, CARE excerpts, for more background.)

4. *(5 minutes)* Distribute RM3-H1 worksheet. Ask participants to think a moment about their MFI and to individually complete question 1 only (mission statement).

5. *(5 minutes)* Ask a few participants to read their mission statements aloud. Then ask for a show of hands as to who could easily remember and write the statement. Ask and discuss: Is the mission statement posted anywhere in the MFI offices? Do you feel your operations are still fulfilling your mission? Why or why not? (Relate an example on risk of mission drift if appropriate.)

VALUES

Trainers should have some relevant examples prepared in case the participants present none during session.

6. *(5 minutes)* Ask: Why do you think having a mission statement is important? How is it important to risk management? What does it tell us with regard to understanding what we are protecting? And with regard to planning our risk management strategy? How do we instill the mission? Lead a brief discussion that gets to values. Ask: What do we mean by core values? Why are we concerned with them?

Discuss: Core values are the fundamental principles or qualities that are intrinsic to an MFI and that staff need to possess to ensure that goals and the MFI mission are met. Core values support the staff's ability to fulfill their roles in risk management.

Ask participants to think about what the core values of their MFIs are and to write them on the previously distributed worksheet, RM3-H1 questions 2 and 3. Give participants time to seriously think about this.

7. *(3 minutes)* Ask participants to state some of the values they have written in the worksheet. Write some of the responses on a flipchart. Answers should include integrity, justice, fairness, quality, accountability, respect, commitment, importance of staff and clients, belief in service, success, etc.

8. *(5 minutes)* Ask participants why MFIs should be concerned with core values. Take answers, showing RM3-O3 in background. Ask for examples of how values affect operations. Briefly discuss.

PEOPLE

9. *(5 minutes)* Ask: Who possesses the core values we just discussed? Who implements the mission statement? Who is responsible for reaching the goals of your MFI? Remind participants that everyone has a role in risk management.

   Ask them to give specific titles of staff who have a role in risk management and write the titles on a flipchart. Ask them to give a brief example of that person's role in risk management, if possible.

   Discuss how vital staff members are to the organization and to risk management. Remind participants that everyone has a role in risk management and of the importance of attracting and retaining staff.

10. *(3 minutes)* Reiterate: The success of our operations depends on the people who are involved. Everyone involved with the organization—the management, the staff, the clients, the investors—must understand and believe in the mission and be committed to the core values in order to carry it out. The first point of commitment to meeting the goals of the MFI is with the people who will be carrying out the mission.

    Ask: How do we ensure that our personnel have what it takes to carry out the mission? How can we instill these core values?

11. *(15–20 minutes)* Divide the group randomly into subgroups of three to five. Assign one or two of the values listed previously to each group (integrity, justice, fairness, quality, accountability, respect, commitment, importance of staff and clients, belief in service, success, etc.). Ask the subgroups to discuss and be prepared to describe how that particular value or those values are (or can be) reflected or validated in the day-to-day operations of an MFI. Have them discuss how the MFI can make having these values and sticking to them worthwhile to the members of

the MFI. Give one example if needed; have each subgroup prepare an example as well. Suggestions can include during the training of both staff and client, employee of the month, staff retreats, visuals posted in offices with mission, slogans, etc.; also incorporating into performance appraisals, incentive schemes, staff handbook that emphasizes core values, etc. See RM3-M2.

12. *(5–10 minutes)* Have subgroups summarize their discussions, including their examples of how core values are (or can be) embedded in MFI operations. Discuss points as necessary.

13. *(10–15 minutes)* Ask participants if the values are manifested as they described. Why or why not? What do they say actually happens? What may prevent the people from integrating the values into an MFI's operation? Discuss obstacles, which may include values not being stated or discussed, lack of commitment and support of management, lack of transparency, lack of motivation, lack of skills, opportunity to violate, lack of direction, no human resource policies, lack of communication, lack of communication, lack of communication!

14. *(5 minutes)* Focus the discussion on solutions. Ask participants to reflect on their own MFIs and to write down their ideas on how to better instill core values and mission in their MFI's personnel and operations. Use RM3-H1 questions 4 and 5.

15. *(5–10 minutes)* Ask: What would you do first to ensure that your MFI's values are instilled in operations through staff? Have participants discuss their solutions.

16. *(5 minutes)* Summarize. Draw the Model for Sustainable Capacity Building (see RM3-M3), circle by circle, on a blank flipchart page. Note that values are at the center of the operation. The institution sets policies and procedures consistent with those values and establishes strategies for implementation (incentives and disincentives for carrying out the values and mission). These procedures and strategies are all reflected in the staff hiring, retention, and personnel policies, which reinforce how people represent the values of the organization.

    State that if the mission and core values of an institution are not stated, communicated, and agreed to, the rest doesn't really matter. This is a critical element in managing risks in an MFI—establishing a climate of core values and having people in the forefront who conduct their business and act in accordance with those values.

OTHER KEYS FOR SUCCESSFUL RISK MANAGEMENT

17. *(10 minutes)* This segment has stressed and will continue to stress the importance of people in risk management and the need to have an organizational mission and core values that supports them. There are a few other related themes that are also prerequisites for establishing an enabling control environment and that lead to more effective risk management. Ask: What might these fundamentals be? Show RM3-O4, Keys to Effective Risk Management.

Reveal components one by one and briefly lead a discussion of each one through questioning, soliciting examples as necessary. See RM3-M4. Alternatively, if energy is low and time allows, ask neighboring triads to briefly discuss one element and be prepared to define it and give examples. Allow 5 minutes for the triad discussion and 5–10 minutes to process.

18. *(5 minutes)* Summarize by emphasizing that people who understand the mission and core values of the institution, and are committed to them, are a critical element in risk management. They are at the center of the effort and are supported by the organization's mission, values, culture, organizational structure, sound methodology, and conducive environment. All are there to ensure that the MFI reaches its goals.

    There are many ways for MFIs to mitigate risks. They will vary depending on the mission, values, and culture of the institution, as well as on the level of threat. Another consideration is the cost versus the benefits of implementing controls. But people are at the core and are instrumental in preventing risks.

    Take any questions.

19. *(1 minute)* Close and present a bridge topic to the next session. State: We have introduced risk management; discussed who is responsible for risk management in our MFIs; stated the importance of people, values, and mission in risk management; and analyzed other elements that contribute to effective risk management. Now we will begin to look at the process in more detail.

    Distribute RM3-H2 and refer the group to the references that support the topic.

RM3-M1

Technical Materials – Excerpt from CARE *Microfinance Risk Management Handbook*

(From chapter 2, concerning mission risk)[1]

Institutional risks come in two types. The first type involves the institution's **mission**, which has two aspects of its own: the **social** and **commercial**. Microfinance is a powerful development strategy because it has the potential to be a long-term means of fighting poverty and inequity. One of the greatest challenges in designing and running microfinance operation is to balance the dual mission so that your MFI: 1) provides appropriate financial services to large volumes of low-income persons to improve their welfare (social mission); and 2) provides those services in a financially viable manner (commercial mission). Too heavy a focus on one or the other, and microfinance will not live up to its potential.

The second institutional risk is the **dependency** of a microfinance program on international support organizations such as CARE. MFIs that rely on strategic, financial, and operational support from international organizations are at risk because the longer those links continue, the harder it is to break them—yet no one should be under the illusion that those links can continue indefinitely. Microfinance programs that were created as CARE projects, rather than separate institutions, are particularly vulnerable to dependency risk.

2.1 Social Mission Risk

The social mission of microfinance institutions is to 1) provide appropriate financial services 2) to large volumes 3) of low-income persons 4) to improve their welfare; these four elements are highlighted in the left-hand column in Figure 1. The right-hand column lists the four Ms: controls and monitoring tools that MFIs need to mitigate social mission risk.

Figure 1: The Four Ms of Controlling Social Mission Risk

Social Mission	Controls and Monitoring
Provide Appropriate Financial Services	**M**arket Research
To Large Volumes	**M**anaging Growth
Of Low-Income Persons	**M**ission Statement
To Improve Their Welfare	**M**easuring Impact

The process of controlling social mission risk begins by identifying the target market. In its mission statement, the governing body of the MFI has to clearly articulate *who* the institution wants to serve and *why* it wants to serve them. The mission statement should also indicate that the organization intends to serve this market for the long term as an independent and self-sufficient institution. This mission statement then serves as a guiding light for managers and employees as they apply it in their daily activities.

In developing the mission statement, it is important to strike a balance between the social and commercial mission. If the organization narrowly defines the target market, then it may have difficulty achieving sufficient scale and efficiencies to fulfill its commercial mission. For example, if the MFI only wants to serve refugees or people with AIDS, then the potential market for its services may not be large enough to create a sustainable institution, or it may

[1] Churchill, C., and D. Coster. 2001. CARE International and Pact Publications, 2001.

be too expensive to identify and deliver services to a market that is geographically disparate, or the risks of serving a narrowly defined target group may be too high.

The composition of the board of directors can contribute significantly toward ensuring that the institution has a good balance, both in its mission statement and in how it goes about fulfilling its mission. It is difficult to find individuals who embody the dual mission of microfinance, so boards are often constructed to be balanced, with roughly half of the directors personifying a social bias and the other half with a commercial bias. This may create some tense board meetings, but it tends to produce appropriate microfinance policy.

Commercial Banks and Social Mission

Do all microfinance institutions have to have a social mission? Many commercial banks, including CARE's partner in Zimbabwe, are beginning to serve the microenterprise market without a strong sense of social mission. Banks may be motivated to serve low-income persons because they have been pushed down market by increasing competition at the upper end, or because they see microenterprises as a profitable niche market, or for public relations reasons—but they are rarely concerned about alleviating poverty. It remains to be seen whether microfinance players who only have a commercial mission will be successful. It is logical though that an organization that deeply cares about its clients *and* serves them on a commercial basis will be more successful over the long term than an MFI that is purely profit-driven.

- Does your organization have a clear mission statement that balances the social and commercial objectives and identifies the target market?
- Do employees know the organization's mission statement and use it to help guide their actions?
- Does the composition of the board reflect the dual mission of microfinance?

2.2 Commercial Mission Risk

Although intended to serve the poor, microfinance is a business operation that must run on business principles. This means that a microfinance institution should make decisions based upon sound business rules, not on charitable sentiment. If an institution's managers and board members do not share a business-like perspective, the MFI will be extremely vulnerable to commercial mission risk.

It seems counter-intuitive that an organization dedicated to helping the poor needs to charge high interest rates and strives for profitability. The commercial approach makes sense, however, if you adopt a long-term view. Many of CARE's development initiatives are short-term projects with a specific end date. Microfinance, on the other hand, has the unique ability to provide developmental services on an ongoing basis if it is designed and implemented properly. With microfinance activities, it is critical to adopt a long-term perspective because clients do not just want loans for the next three to five years. They want—and deserve—a safe place to save their money and a convenient place to borrow funds *indefinitely*. The only way to provide them with this extremely valuable service over time, and generate its important development benefits, is by fulfilling the commercial mission of microfinance.

Controls for commercial mission risk include: setting interest rates, designing the capital structure, planning for profitability, and managing for superior performance.

RM3-M2

Anecdote to Illustrate Strategies for Gaining Insights into Staff Values

Excerpted from the Fifth Conference of the Microfinance Network

The most important fraud prevention strategy is to create a culture in the organization, from the top down, that fraud is unacceptable. Fraud prevention begins with staff training. From the very first day of training, PRODEM emphasizes the following core values: teamwork, transparency, and responsibility. At the end of the training, there is an exercise where new hires write a list of the ways they could destroy the organization. For example, one credit officer trainee wrote: "If I am irresponsible, if I am late for work, if I touch the institution's funds, steal, lie, make bad use of the methodology, issue bad loans, do not work with my colleagues, issue ghost loans, or if there is no common objective." After a series of fraud cases, management reviewed the training records of staff members who were fired for fraud, and nearly all of them neglected to write that stealing would destroy PRODEM. Now the organization reviews these exercises more closely to see who neglects to mention that stealing could destroy the organization.

Other Tactics Used to Help Ensure That Core Values Are Upheld

- Staff incentive schemes
- Market-based salaries
- Morale boosters—MFI t-shirts, parties, etc.—to gain sense of belonging and pride
- Training exercises that include case studies on ethics and how to respond to situations
- Reference checks when hiring
- Requirement that employees agree to a code of conduct

<u>Bangladesh Example</u>

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

ASA does allow its loan officers to collect loan payments and savings deposits in the field. ASA reduces the risk of theft from its loan officers by scheduling visits to clients in a way that minimizes the amount of cash the loan officer will carry throughout the day. For example, the loan officer would first visit a group that is a net savings group and then use the excess cash to fund loan disbursements for the next group. ASA's regional managers conduct client visits to verify the amount of cash collected, which reduces the risk of theft by its loan officers.

Staff Motivation

A demotivated staff member and/or wide staff demotivation is widely recognized as a danger point in an organization. What can management do to motivate staff?

- Organize work and give responsibility to people so that they can see, preferably day by day, that they have achieved their objectives. Achievement is being researched as a prime motivator.
- Delegate responsibility and authority as far as is wise, but demand accountability.
- Ensure there is continuous recognition of achievement and an appropriate award system.
- Try to make each person’s work as interesting, challenging, varied, and fulfilling as possible.
- As far as possible, promote from within and have training staff committed to the MFI.
- Ensure [that] pay and benefits are as good they can be. Poor salaries and benefits demotivate, good salaries are not the only motivation in the long run.
- Deal quickly with staff dissatisfaction.

Technical Materials – Excerpt from *Internal Controls and Fraud Prevention in Microfinance Institutions*[2]

MEDA Fraud Prevention Workshop

1 Institutional Values and Accountability

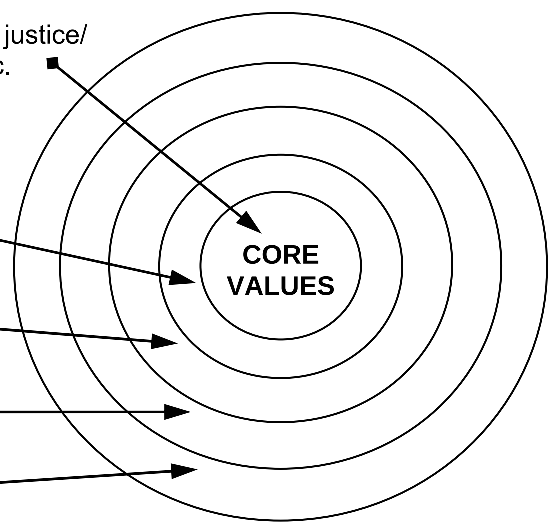
1.1 Values – Entrench the Vision

To be successful, microfinance institutions must recognize the importance of having organizational values and be committed to a process of developing those values. Staff is the most critical factor for success, and each one must catch the vision and mission of the institution and commit to those stated values.

Values are the core of effective capacity building. Stated values lead to policies that lead to goals, objectives, and strategies for implementation. This in turn leads to hiring people who will commit to these values. These people are worthy of the resources committed to their training, equipping, and facilitating. With this planning cycle, "Capacity Building" is more likely to be sustained.

MODEL FOR SUSTAINABLE CAPACITY BUILDING

1. Begin with stating the core values of the institution: justice/fairness, integrity, quality, commitment, respect, etc.
2. Set policies and procedures consistent with the values
3. Set strategies and objectives for implementation
4. Hire staff who share the core values
5. Train and equip staff



Each MFI must determine what values are appropriate for their institution and constantly seek to have those values internalized by every board member, manager, and staff member.

1.2 Accountability

A key principle undergirding accountability is that of **interdependence**. To reach full maturity, every person, organization, and nation must move through the periods of dependence and

[2] Presented by Joyce B. Lehman, CPA (US); MEDA Consulting Group; 155 Frobisher Drive, Suite I-106; Waterloo, ON N2V 2E1 Canada

independence to the recognition that we need others. We need a partnership with others whose strengths make up for our weaknesses and who enable us to build on our strengths.

But with such a partnership comes the requirement that we be accountable to each other. Interdependence recognizes the essence of accountability.

Having been entrusted with resources and a purpose, it is obligatory to account for how and when those resources are used and those tasks accomplished.

1.2.1 Forms of Accountability

Personal accountability is the starting point for all other forms of accountability, whether managerial, political, or multiple. Each individual has a personal code of conduct against which he or she brings himself or herself to account.

Managerial accountability requires managers to carry out their tasks in accordance with agreed criteria and with satisfactory results. It includes:

- Financial accountability – the obligation to ensure and report that money has been spent as agreed
- Effectiveness accountability – the obligation to ensure that intended program outcomes have been achieved
- Efficiency accountability – the obligation to ensure that value for money has been achieved in the process
- Legal accountability – the obligation to ensure that the organization's policies, procedures, laws and regulations have been observed in decision making
- Professional accountability – the obligation to ensure that professional ethics are observed in rendering service and in the way we conduct ourselves

1.2.2 Delegation

Delegation moves responsibility and authority from a senior person to a less senior one and then demands accountability in return. With that delegation of authority for a task goes the responsibility to get it done **and** the accountability to the one who delegated.

Delegation and accountability are two-way processes.

Delegation is NOT abdication.

RM3-M4

Technical Materials – Excerpt from MFN/GTZ *Improving Internal Control: A Practical Guide for Microfinance Institutions*[3]

2.3 Elements of Effective Risk Management

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

2.3.1 Risk Management within the Methodology

Most microfinance risk management strategies are those that are integrated directly into the methodology and operations, thereby systematically and proactively reducing risk. By anticipating the characteristics and motivations of its borrowers, MFIs minimize the potential for attracting high-risk borrowers, i.e., clients that would likely default on a loan. Table 1 lists a number of practices that incorporate risk management into microlending methodologies.

In addition to risk management practices within the microfinance methodology, MFIs that effectively mitigate risk also integrate risk management strategies into their normal operations. There are five additional key elements prevalent in MFIs that can reduce risks: (1) a conducive environment, (2) transparency, (3) simplicity, (4) individual accountability, and (5) security.

2.3.2 Conducive Environment

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

Many employees may have negative attitudes about internal control from past experiences with internal auditors whose focus was on identifying problems and assigning blame. Management can work to overcome negative perceptions by encouraging employee participation in the internal control system, stressing the benefits of risk mitigation, and emphasizing solutions to problems rather than placing blame.

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

---

[3] Excerpted from Campion, Anita. 2000. *Improving Internal Control: A Practical Guide for Microfinance Institutions*. Technical Guide No. 1, MFN/GTZ International.

Table 1: Risk Management within Microfinance Methodologies

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

Table 2 presents a summary of methods MFIs use to screen employees and clients for character traits.

2.3.3 Transparency

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

Table 2: Employee and Client Character Screening

Methods for Screening Employee's Character:	Methods for Screening Client's Character:
• Conduct personality and psychological tests that assess the potential employee's character • Check past employment and personal references, for example: – ask former employers whether they would hire the person again – ask personal contacts whether they would entrust their money to this person • Interview and ask employees questions to understand their ethics • Hire for a trial period to review employee's character and behavior	• Check personal and community references to assess the potential client's reputation • Use peer groups in which clients select other group members who they believe are honest and reliable individuals • Maintain and check blacklist of past poor performers to avoid repeat lending to bad clients • Interview client to understand his or her motivation for borrowing money • Check client history with suppliers or with credit bureau, if available

- To uncover hidden control issues, some MFIs rotate staff or use support staff to fill in for employees during vacation or sick leave. Rotating loan production staff to other branches can help to uncover employee errors and fraud identified by the employee's replacement, or if management notices a pattern linked to the employee's accounts. However, few microfinance institutions like to rotate field staff because they value the close relationship established between field officers and clients. As an alternative, ASA uses support staff to cover for employees on vacation and sick leave. ASA's unit managers act as field officers when one of their field staff is out on leave.
- An effective management information system (MIS) is one that focuses on a few key indicators for each level of responsibility and produces accurate, timely, and relevant information. Additionally, the MIS can incorporate early warning flags for management. For example, Mibanco branch managers receive daily reports on delinquent accounts per loan officer, ranked by number of days delinquent. An aging report such as this allows the branch manager to monitor more closely the work of those loan officers whose portfolios are experiencing increasing delinquencies. Refer to CGAP's *Handbook for Management Information Systems for Microfinance Institutions* for more information on good reporting.[1]

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

[1] Waterfield and Ramsing, February 1998.

2.3.4 Simplicity

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

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

As in traditional financial institutions, MFIs should develop and maintain operations manuals that detail the steps required for each transaction, explain how to handle exceptions, and delineate lines of authority. Operations manuals can reduce confusion and conflict at the branch level by ensuring standard application of policies and procedures. To be effective, the operations manual should be clearly written, regularly updated, and accessible to all employees.

2.3.5 Accountability

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

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

- Upon hiring, MFIs should give all employees a clearly written job description. Employee job descriptions should indicate where employee authority begins and ends. Managers can refer to job descriptions to assess and discuss employee performance, which reinforces individual accountability.
- Microfinance institutions can increase an employee's commitment to the goals of the microfinance institution by linking employee pay to performance. While some MFIs like to use team-based incentives to encourage team spirit, the use of individual incentives more strongly communicates the need for individual accountability.

2.3.6 Security

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

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

- All microfinance institutions should have some system whereby branch information is protected from destruction or loss. MFIs that maintain a computerized database should create daily backup files and store them off premises. MFIs can protect noncomputerized information systems by storing duplicate copies in another location. ASA learned this lesson the hard way. One ASA unit lost all its records when the unit caught on fire. The field officers had to collect all the client passbooks to recreate the accounts.
- To protect against unanticipated loss, such as from fire or theft, microfinance institutions can take out insurance policies or can self-insure by making regular deposits into a reserve account that the MFI can use in case of emergency. In this way, the MFI protects itself from large unforeseen expenses by redistributing the cost of this protection over a longer period of time. MFIs that operate in environments that are prone to natural disaster, such as flooding in Bangladesh, should have some type of plan to protect themselves and their clients against excessive loss in any one year of operation. In response to the floods of 1998, ASA issued new loans to some clients and allowed others to withdraw their savings. This response facilitated ASA's clients' return to normal operations.[2] In addition, ASA has a program in which its clients make weekly life insurance payments based on 0.30 percent of the loan.[3] In the event of death, the insurance relieves the client's family of the responsibility for repaying the remaining loan balance.

[2] For more information on reducing risks related to natural disasters, refer to *Microfinance in the Wake of Natural Disaster: Opportunities and Challenges* by Geetha Nagarajan, April 1998.
[3] ASA requires all borrowers of loans greater than 9,000 taka ($180) to purchase this insurance, which entitles the beneficiary to an amount equal to the initial loan amount. ASA insures loans under 9,000 taka at no additional cost.

Overheads

THE COMPLETE SET OF OVERHEADS IS IN A SEPARATE POWERPOINT FILE ENTITLED "CGAP OPERATIONAL RISK MANAGEMENT OVERHEADS"

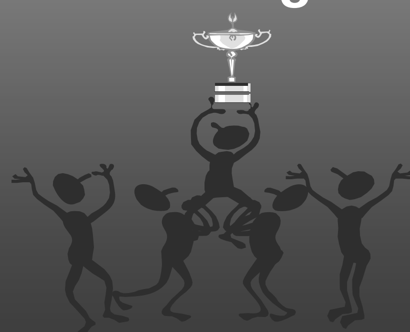
RM3-O1

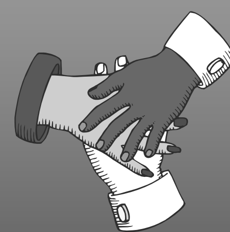
EVERYONE

Has a Role

in

Risk Management

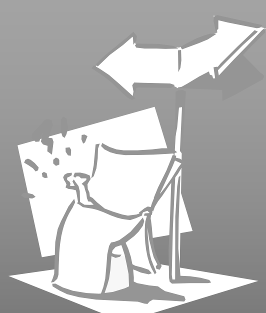




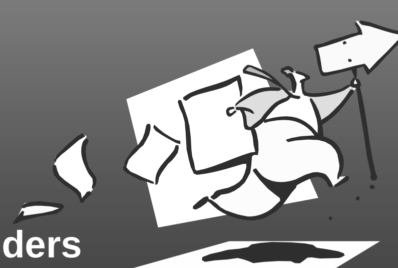
CGAP

RM3-O2

A Mission Statement



- Describes the purpose of the MFI or its reason for existing
- Provides the strategic orientation for the MFI
- Communicates to stakeholders where the MFI is going
- Tells us the MFI's contribution and commitment to its stakeholders

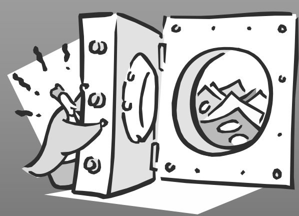


CGAP

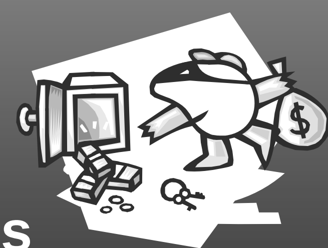
RM3-O3

WHY? Because

Values



Affect



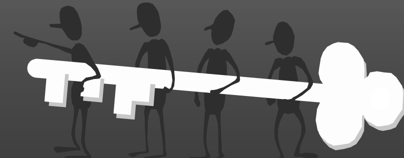
Operations

CGAP

RM3-O4

Keys to Effective Risk Management

- Stated mission and core values
- Motivated and confident people
- Conducive environment
- Sound methodology
- Accountability and transparency
- Security
- Performance and efficiency



CGAP

Handouts

Mission Statement and Core Values Worksheet

1. A mission statement is a statement that describes the purpose or reason for the existence of the organization. It provides the strategic orientation of the organization.

   The mission statement of ________________________, my MFI, is….

2. Our core values are:

3. Who decided on the core values for your MFI? Or
   Who/how do you think the core values should be established for your MFI?

4. Provide an example of how core values can affect operations.

5. We do or need to do the following in order to ensure that everybody (staff, clients, Board, investors, etc.) understands and believes in our mission and values and stays committed to implementing them:

Technical Materials

MISSION DEFINITION

A key to shaping strategic success is clarity of mission. Individuals need to understand what business the company is in and how its values drive that business. Without such understanding employees will not develop much commitment or loyalty to the organization and its success.

A mission statement provides a sense of purpose and incorporates a vision of future accomplishment. With specific reference to:

Purpose – What is the institution's purpose?

Values – Why is this purpose important? What beliefs guide the MFIs behavior/attitude?

Services Provided – What will the institution DO to fulfill this purpose?

Clients – Who does the institution serves?

Benefits – How will the organization benefit its stakeholders?

EXCERPT FROM CARE *MICROFINANCE RISK MANAGEMENT HANDBOOK*

(From chapter 2, concerning mission risk)[1]

Institutional risks come in two types. The first type involves the institution's **mission**, which has two aspects of its own: the **social** and **commercial**. Microfinance is a powerful development strategy because it has the potential to be a long-term means of fighting poverty and inequity. One of the greatest challenges in designing and running microfinance operation is to balance the dual mission so that your MFI: 1) provides appropriate financial services to large volumes of low-income persons to improve their welfare (social mission); and 2) provides those services in a financially viable manner (commercial mission). Too heavy a focus on one or the other, and microfinance will not live up to its potential.

The second institutional risk is the **dependency** of a microfinance program on international support organizations such as CARE. MFIs that rely on strategic, financial, and operational support from international organizations are at risk because the longer those links continue, the harder it is to break them—yet no one should be under the illusion that those links can continue indefinitely. Microfinance programs that were created as CARE projects, rather than separate institutions, are particularly vulnerable to dependency risk.

2.1 Social Mission Risk

The social mission of microfinance institutions is to 1) provide appropriate financial services 2) to large volumes 3) of low-income persons 4) to improve their welfare; these four elements

---

[1] Churchill, C., and D. Coster. 2001. CARE International and Pact Publications, 2001.

are highlighted in the left-hand column in Figure 1. The right-hand column lists the four Ms: controls and monitoring tools that MFIs need to mitigate social mission risk.

Figure 1: The Four Ms of Controlling Social Mission Risk

Social Mission	Controls and Monitoring
Provide Appropriate Financial Services	**M**arket Research
To Large Volumes	**M**anaging Growth
Of Low-Income Persons	**M**ission Statement
To Improve Their Welfare	**M**easuring Impact

2.1.1 Mission Statement

The process of controlling social mission risk begins by identifying the target market. In its mission statement, the governing body of the MFI has to clearly articulate *who* the institution wants to serve and *why* it wants to serve them. The mission statement should also indicate that the organization intends to serve this market for the long term as an independent and self-sufficient institution. This mission statement then serves as a guiding light for managers and employees as they apply it in their daily activities.

In developing the mission statement, it is important to strike a balance between the social and commercial mission. If the organization narrowly defines the target market, then it may have difficulty achieving sufficient scale and efficiencies to fulfill its commercial mission. For example, if the MFI only wants to serve refugees or people with AIDS, then the potential market for its services may not be large enough to create a sustainable institution, or it may be too expensive to identify and deliver services to a market that is geographically disparate, or the risks of serving a narrowly defined target group may be too high.

Commercial Banks and Social Mission

Do all microfinance institutions have to have a social mission? Many commercial banks, including CARE's partner in Zimbabwe, are beginning to serve the microenterprise market without a strong sense of social mission. Banks may be motivated to serve low-income persons because they have been pushed down market by increasing competition at the upper end, or because they see microenterprises as a profitable niche market, or for public relations reasons—but they are rarely concerned about alleviating poverty. It remains to be seen whether microfinance players who only have a commercial mission will be successful. It is logical though that an organization that deeply cares about its clients *and* serves them on a commercial basis will be more successful over the long term than an MFI that is purely profit-driven.

The composition of the board of directors can contribute significantly toward ensuring that the institution has a good balance, both in its mission statement and in how it goes about fulfilling its mission. It is difficult to find individuals who embody the dual mission of microfinance, so boards are often constructed to be balanced, with roughly half of the directors personifying a social bias and the other half with a commercial bias. This may create some tense board meetings, but it tends to produce appropriate microfinance policy.

- Does your organization have a clear mission statement that balances the social and commercial objectives and identifies the target market?
- Do employees know the organization's mission statement and use it to help guide their actions?
- Does the composition of the board reflect the dual mission of microfinance?

2.2 Commercial Mission Risk

Although intended to serve the poor, microfinance is a business operation that must run on business principles. This means that a microfinance institution should make decisions based upon sound business rules, not on charitable sentiment. If an institution's managers and board members do not share a business-like perspective, the MFI will be extremely vulnerable to commercial mission risk.

It seems counter-intuitive that an organization dedicated to helping the poor needs to charge high interest rates and strives for profitability. The commercial approach makes sense, however, if you adopt a long-term view. Many of CARE's development initiatives are short-term projects with a specific end date. Microfinance, on the other hand, has the unique ability to provide developmental services on an ongoing basis if it is designed and implemented properly. With microfinance activities, it is critical to adopt a long-term perspective because clients do not just want loans for the next three to five years. They want—and deserve—a safe place to save their money and a convenient place to borrow funds *indefinitely*. The only way to provide them with this extremely valuable service over time, and generate its important development benefits, is by fulfilling the commercial mission of microfinance.

Controls for commercial mission risk include: setting interest rates, designing the capital structure, planning for profitability, and managing for superior performance.

EXCERPT FROM *INTERNAL CONTROLS AND FRAUD PREVENTION IN MICROFINANCE INSTITUTIONS*[2]

1 Institutional Values and Accountability

1.1 Values – Entrench the Vision

To be successful, microfinance institutions must recognize the importance of having organizational values and be committed to a process of developing those values. Staff is the most critical factor for success, and each one must catch the vision and mission of the institution and commit to those stated values.

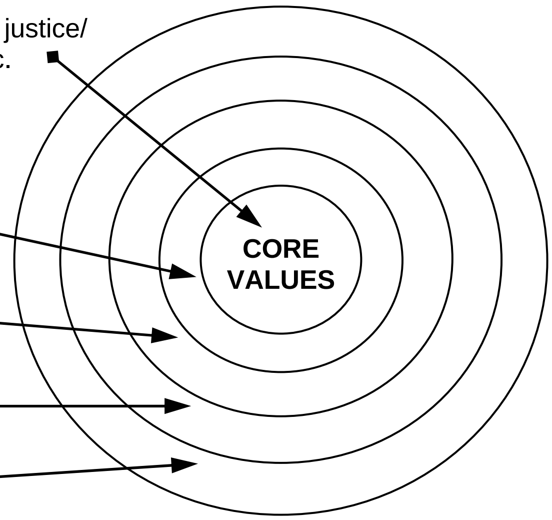
Values are the core of effective capacity building. Stated values lead to policies that lead to goals, objectives, and strategies for implementation. This in turn leads to hiring people who will commit to these values. These people are worthy of the resources committed to their training, equipping, and facilitating. With this planning cycle, "Capacity Building" is more likely to be sustained.

Each MFI must determine what values are appropriate for their institution and constantly seek to have those values internalized by every board member, manager, and staff member.

[2] Lehman, Joyce, 2000. MEDA Consulting Group, 155 Frobisher Drive, Suite I-106; Waterloo, ON N2V 2E1 Canada.

MODEL FOR SUSTAINABLE CAPACITY BUILDING

1. Begin with stating the core values of the institution: justice/ fairness, integrity, quality, commitment, respect, etc.
2. Set policies and procedures consistent with the values
3. Set strategies and objectives for implementation
4. Hire staff who share the core values
5. Train and equip staff



1.2 Accountability

A key principle undergirding accountability is that of **interdependence**. To reach full maturity, every person, organization, and nation must move through the periods of dependence and independence to the recognition that we need others. We need a partnership with others whose strengths make up for our weaknesses and who enable us to build on our strengths.

But with such a partnership comes the requirement that we be accountable to each other. Interdependence recognizes the essence of accountability.

Having been entrusted with resources and a purpose, it is obligatory to account for how and when those resources are used and those tasks accomplished.

1.2.1 Forms of Accountability

Personal accountability is the starting point for all other forms of accountability, whether managerial, political, or multiple. Each individual has a personal code of conduct against which he or she brings himself or herself to account.

Managerial accountability requires managers to carry out their tasks in accordance with agreed criteria and with satisfactory results. It includes:

- Financial accountability – the obligation to ensure and report that money has been spent as agreed
- Effectiveness accountability – the obligation to ensure that intended program outcomes have been achieved
- Efficiency accountability – the obligation to ensure that value for money has been achieved in the process
- Legal accountability – the obligation to ensure that the organization’s policies, procedures, laws and regulations have been observed in decision making
- Professional accountability – the obligation to ensure that professional ethics are observed in rendering service and in the way we conduct ourselves

1.2.2 Delegation

Delegation moves responsibility and authority from a senior person to a less senior one and then demands accountability in return. With that delegation of authority for a task goes the responsibility to get it done **and** the accountability to the one who delegated.

Delegation and accountability are two-way processes.

Delegation is NOT abdication.

EXCERPT FROM *IMPROVING INTERNAL CONTROL: A PRACTICAL GUIDE FOR MICROFINANCE INSTITUTIONS*[1]

2.3 Elements of Effective Risk Management

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

2.3.1 Risk Management within the Methodology

Most microfinance risk management strategies are those that are integrated directly into the methodology and operations, thereby systematically and proactively reducing risk. By anticipating the characteristics and motivations of its borrowers, MFIs minimize the potential for attracting high-risk borrowers, i.e., clients that would likely default on a loan. Table 1 lists a number of practices that incorporate risk management into microlending methodologies.

In addition to risk management practices within the microfinance methodology, MFIs that effectively mitigate risk also integrate risk management strategies into their normal operations. There are five additional key elements prevalent in MFIs that can reduce risks: (1) a conducive environment, (2) transparency, (3) simplicity, (4) individual accountability, and (5) security.

2.3.2 Conducive Environment

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

[1] Excerpted from Campion, Anita. 2000. *Improving Internal Control: A Practical Guide for Microfinance Institutions*. Technical Guide No. 1, MFN/GTZ International.

Table 1: Risk Management within Microfinance Methodologies

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

MFI's attitude toward risk, as well as corresponding appropriate behavior, to new employees.

Many employees may have negative attitudes about internal control from past experiences with internal auditors whose focus was on identifying problems and assigning blame. Management can work to overcome negative perceptions by encouraging employee participation in the internal control system, stressing the benefits of risk mitigation, and emphasizing solutions to problems rather than placing blame.

Creating a supportive atmosphere or culture that has a low risk tolerance is especially important for an MFI that operates in an environment with a high tolerance for fraud. If the MFI operates in a country that condones fraud, management must work hard to distinguish the culture of the MFI from the surrounding environment. In Kenya, a country where corruption is common, K-Rep has successfully employed this approach by screening employees and clients based on character and by strictly enforcing a policy by which

Table 2: Employee and Client Character Screening

Methods for Screening Employee's Character:	**Methods for Screening Client's Character:**
• Conduct personality and psychological tests that assess the potential employee's character • Check past employment and personal references, for example: – ask former employers whether they would hire the person again – ask personal contacts whether they would entrust their money to this person • Interview and ask employees questions to understand their ethics • Hire for a trial period to review employee's character and behavior	• Check personal and community references to assess the potential client's reputation • Use peer groups in which clients select other group members who they believe are honest and reliable individuals • Maintain and check blacklist of past poor performers to avoid repeat lending to bad clients • Interview client to understand his or her motivation for borrowing money • Check client history with suppliers or with credit bureau, if available

employees are fired not only for stealing and other fraudulent acts, but for lying as well. Table 2 presents a summary of methods MFIs use to screen employees and clients for character traits.

2.3.3 Transparency

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

- To uncover hidden control issues, some MFIs rotate staff or use support staff to fill in for employees during vacation or sick leave. Rotating loan production staff to other branches can help to uncover employee errors and fraud identified by the employee's replacement, or if management notices a pattern linked to the employee's accounts. However, few microfinance institutions like to rotate field staff because they value the close relationship established between field officers and clients. As an alternative, ASA uses support staff to cover for employees on vacation and sick leave. ASA's unit managers act as field officers when one of their field staff is out on leave.
- An effective management information system (MIS) is one that focuses on a few key indicators for each level of responsibility and produces accurate, timely, and relevant information. Additionally, the MIS can incorporate early warning flags for management. For example, Mibanco branch managers receive daily reports on delinquent accounts per loan officer, ranked by number of days delinquent. An aging report such as this allows the branch manager to monitor more closely the work of those loan officers whose portfolios are experiencing increasing delinquencies. Refer to CGAP's *Handbook for Management Information Systems for Microfinance Institutions* for more information on good reporting.[4]

[4] Waterfield and Ramsing, February 1998.

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

2.3.4 Simplicity

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

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

As in traditional financial institutions, MFIs should develop and maintain operations manuals that detail the steps required for each transaction, explain how to handle exceptions, and delineate lines of authority. Operations manuals can reduce confusion and conflict at the branch level by ensuring standard application of policies and procedures. To be effective, the operations manual should be clearly written, regularly updated, and accessible to all employees.

2.3.5 Accountability

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

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

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

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

2.3.6 Security

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

- Most microfinance institutions that store cash in the branch or unit office safeguard it by storing it in a safe or strong box. In Mali, Kafo Jiginew builds a safe directly into the branch office building so that thieves cannot steal the branch's money by confiscating the entire safe. Like many institutions, BRI has a two-key system whereby the unit manager and one other unit employee each hold one of the two keys required to open the safe. Security measures should match the risk. For example, all BRI units have locks on doors and windows, security alarms, and a night guard; but units that are located in cities where crime is prevalent also have bars covering the windows.
- All microfinance institutions should have some system whereby branch information is protected from destruction or loss. MFIs that maintain a computerized database should create daily backup files and store them off premises. MFIs can protect noncomputerized information systems by storing duplicate copies in another location. ASA learned this lesson the hard way. One ASA unit lost all its records when the unit caught on fire. The field officers had to collect all the client passbooks to recreate the accounts.
- To protect against unanticipated loss, such as from fire or theft, microfinance institutions can take out insurance policies or can self-insure by making regular deposits into a reserve account that the MFI can use in case of emergency. In this way, the MFI protects itself from large unforeseen expenses by redistributing the cost of this protection over a longer period of time. MFIs that operate in environments that are prone to natural disaster, such as flooding in Bangladesh, should have some type of plan to protect themselves and their clients against excessive loss in any one year of operation. In response to the floods of 1998, ASA issued new loans to some clients and allowed others to withdraw their savings. This response facilitated ASA's clients' return to normal operations.[5] In addition, ASA has a program in which its clients make weekly life insurance payments based on 0.30 percent of the loan.[6] In the event of death, the insurance relieves the client's family of the responsibility for repaying the remaining loan balance.

---

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

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

SESSION 4: TOOLS FOR RISK MANAGEMENT

Session Summary

OBJECTIVES: By the end of the session participants will be able to:

- Explain the importance of human resource policies in mitigating risks
- Mitigate risks through preventive actions
- Design an organizational chart with proper separation of function
- Analyze and develop job descriptions with proper segregation of duties
- Recognize the use of policies and procedures to mitigate risks
- Ensure the critical role of the information system in risk management
- Use various tools and strategies to prevent risks

TIME: 180–205 minutes

SUPPLIES: LED projector or overhead projector
Blank transparencies
Overhead markers
Index cards

TRAINER MATERIALS

RM4-M1 Segregation of Duties Exercise – Answers and Discussion

PARTICIPANT MATERIALS

OVERHEADS: RM4-O1 The MFI
RM4-O2 My MFI *(organization chart)*
RM4-O3 Don't design it this way
RM4-O4 Policies and Procedures
RM4-O5 Ask if the information is

HANDOUTS: RM4-H1 Segregation of Duties Exercise, Personnel Problem 1 – Accounting Officers
RM4-H2 Segregation of Duties Exercise, Personnel Problem 2 – Branch Officers
RM4-H3 Policy and Procedures Worksheet
RM4-H4 Action Planning

Session 4: Tools for Risk Management

INTRODUCTION

1. *(1 minute)* Introduce the session by asking: What presents the biggest risk to an MFI? People! Why? What presents the biggest source of methods to control risks? People!

2. *(5 minutes)* This session will further explore the premise that people prevent risks and look at systems that support those efforts. The discussion will look at human resources, policies and procedures, and other tools that are available to ensure that MFIs are protected. Show and explain RM4-O1.

HUMAN RESOURCES

3. *(5–10 minutes)* Begin by examining how risks can be mitigated through people. Ask: How can we prevent fraud in our MFIs? Answer: By attracting and maintaining the right people who are doing the right thing! Have participants suggest some specific ways that fraud could be prevented with respect to human resources and what is in place in their organizations that address these issues. Try to elicit many responses. Write the best ideas on a flipchart.

   Suggestions might include use of an organizational chart (separation of function, job descriptions (segregation of duties), and other practices concerning hiring, training, competitive compensation, reporting (documentation of procedures), appraisals, incentives, and disciplinary action should all be reflected in personnel policies.

   Ask for a show of hands as to whether participants' MFIs have these written documents. Ask: Have you seen them? Are they easily accessible? Are they used as working documents? How effective are they? Briefly discuss. Summarize by stating that having written human resource policies and procedures is a necessary first step in supporting people in their work to control risks. This session looks at a few of these elements within the human resources arena.

ORGANIZATIONAL CHART – INTRODUCTION TO SEPARATION OF FUNCTION

4. *(8 minutes)* Start with the big picture: organizational structure, in particular, an organizational chart. Ask participants to suggest what this represents, for example, how the people are positioned within the organization, what department they are in, who they report to, and so on. Some charts are specifically designed to show reporting requirements. Ask: What kinds of things should we look for in an organizational chart when we think control? Take a few answers.

   Show RM4-O2. Ask: If this were your MFI, what would you change? What would you keep the same and why? Use colored overhead markers to rearrange the chart (only if using an overhead projector) or draw a new chart on a flipchart for comparison. Have index cards with the positions written on them. Discuss, and attach the cards to the flipchart where participants recommend.

In particular, insert where Internal Audit and Branch Auditor go, highlighting the importance of maintaining an independent internal audit function that reports to the board of directors, clear reporting lines, and management all on the same level.

5. *(5 minutes)* Finally, ask participants to brainstorm factors that contribute to a good organizational chart. Record answers on the flipchart. Answers can include separation of function, clear lines of authority, reporting, audit committee, internal auditor that reports to the audit committee or the board. Include notation of how the chart is written and posted or shared, and that it needs to be combined with good job descriptions. Summarize the use of organizational charts as a tool to reduce risks.

JOB DESCRIPTIONS – SEGREGATION OF DUTIES

6. *(2–3 minutes)* Ask participants: Now that we see the big picture, how do we know what people actually do? Answer: Job descriptions. Follow up with questions: What is a job description? What is its purpose? How are they used? What do they tell the employees? What is their role in risk management? Summarize the importance of job descriptions to the organization.

7. *(5 minutes)* Propose thinking about job descriptions in a little more detail. Ask participants to each list the duties of a typical loan officer in his or her MFI. Record a list of duties on a flipchart based on the participants' responses. Summarize by noting that MFIs ask loan officers to perform lots of duties. Job descriptions, therefore, can also help MFIs see where employees may have problems doing what is expected of them.

8. *(5 minutes)* Ask: Do you see any problems with our list? What are the inherent risks in this "job description?" Lead the discussion to segregation of duties, defining and giving reasons to do this. Ask and discuss briefly: On what basis do we segregate duties?

9. *(10–20 minutes)* Develop some ideas on how to control risks tied to job responsibilities. Ask participants to form groups of four to complete the exercise on handout RM4-H1 and H2. Give half the groups problem 1, on financial duties, and the other half problem 2, on loan officers' duties. Distribute cards with the duties written on them to aid discussion.

10. *(10 minutes)* Quickly ask for and review responses. Concentrate on why duties were separated.

11. *(5 minutes)* Summarize the exercise. A good job description should address segregation of duties. Ask: What major functions and duties should always be separated? Answers include disbursement and collection of loans, loan approval

and disbursement, purchasing approval and receipt of deliveries, purchasing approval and check signing, cashier and bank reconciliation, etc. State that it is a complicated process and that tasks need to be analyzed. Keep in mind—don't approve, record and do; think about how fraud could happen and how likely it is. Fraud is the result of someone's decision. Employees should not be in the position of being both able to make a mistake and to conceal it. In essence, all matters involved with recording, approving, and doing should be separated! Show RM4-O3. Don't approve, do and record!

12. *(5 minutes)* Having said all that, ask how MFIs can responsibly apply this theory, especially small organizations. Discuss how fraud could happen, then describe what to do to prevent it. Review question 1c in the handouts: What controls should be in place if segregation is not always possible?

    Brainstorm responses, which should include recognizing the increased risk in small organizations, adding more controls, and evaluating the costs and benefits of the segregation of duties (for example, will it cost more to employ a new person than the potential loss in case of fraud?) Develop some ideas that will be useful to the participants, such as putting in place clear guidelines about levels of authorization according to loan size, cross-signatures, and not keeping more than a certain amount of cash in the branch.

    Remind participants of the danger of having one person or department approve a transaction, implement it, and record the transaction, and restate the need to implement controls if duties aren't well segregated.

13. *(1 minute)* Summarize subsession. Personnel need to have the core values of the MFI and know what they are supposed to do and to whom they report. They also need to be clear on what happens when they do not do their jobs correctly. These are all things MFI managers can do to help motivate their staff.

Recruitment and Personnel Actions

14. *(15 minutes)* Now that participants have thought about what their MFI's employees do and who they report to, ask again: How does an organization recruit and hire the right people in the first place? Quickly divide the group into neighboring subgroups and have each briefly discuss actions that they can implement to ensure they hire and keep the right people in their MFIs *(10 minutes)*. Briefly explore the subgroups' ideas *(5 minutes)* on nepotism, advancement, qualifications, incentives, disciplinary actions, etc.

15. *(2 minutes)* Summarize briefly how the people in an MFI are vital to achieving the organization's goals, including managing risk. Point out that participants have helped come up with a number of ideas to ensure that their MFIs hire and retain good people.

    Human resources are perhaps the most important resource in the business of microfinance. All employees have a role in controlling risks. All are responsible for communicating identified operational problems, deviations from established standards, and violations of policy and law.

Reiterate that MFIs can control risk by establishing a climate and environment that values employees and acknowledges their role in the MFI's success. Good human resource practices—beginning with recruitment and training and lasting throughout the individual's employment with the institution—stimulates and motivates staff and deplores fraud. Finally, separation of function and duty are a major means to control risks.

POLICIES AND PROCEDURES

16. *(4 minutes)* Refer back to RM4-O1 and point to Systems, Policies and Procedures. These were discussed to some extent in reference to personnel. What role do policies and procedures play in risk management?

17. *(3 minutes)* Ask: What do we mean by policies and procedures? How would you define them? Take a few answers and show the RM4-O4 definitions. Ask: What are some characteristics of effective policy and procedures? Take a few answers and use RM4-O4 to summarize the main points.

18. *(1 minute)* Ask participants to raise their hand if their MFI has policies and procedures. Note that almost everyone has them. Ask: Now how do we know if they are effective?

19. *(5–10 minutes)* Distribute RM4-H3. Ask participants to complete—individually or in same-MFI pairs—the worksheet based on the situation in their MFI.

20. *(5 minutes)* Process the individual answers by asking and recording on a flipchart what areas and functions their policies and procedures cover. The list should include credit and saving operations, administrative, procurement, payroll, accounting, reporting, personnel/HR, etc. Ask: Who wrote them? When? Who updates them? How often are they updated? How does your MFI ensure that employees have access to them? Discuss the answers.

21. *(5 minutes)* Ask and discuss what conclusions can be drawn about policies and procedures and their role in risk management. State that MFIs need to establish procedures so that similar transactions are consistently treated the same. Examples include deciding which level of staff authorizes which level of loan amounts, which accounting method to use for different types of transactions, and HR policies such as sick pay or vacation days. Employees should have easy access to those sections in the policy and procedure manual that are general in nature and that pertain to the employee's particular functions.

22. *(5 minutes)* Summarize the subsession. Reiterate that policies and procedures can only be followed when they are known. The most effective way of doing this is to state them clearly in writing, keep them up to date, make them available to the people responsible, and ensure they are used! Policies and procedures need to

support getting the right people and, more important, keeping them! The next sessions give participants a chance to practice using policies and procedures to mitigate risks.

STRATEGIES, TOOLS AND TECHNOLOGY, AND INFORMATION

23. *(2 minutes)* Ask: What other means do we have available to control risks? Take some answers and briefly discuss. This session first focuses on those related to information.

24. *(3 minutes)* Point out that information and an information system are vital to the risk management process. Ask: What do we mean by this? What role does information play in controlling risks? **Answer**: We can't control what we don't know! We need information to follow and mitigate our risks—not only in accounting but in all facets of our operations. Therefore, we need a system that manages and controls information content and flow. The next point to talk about is *how* information plays a part.

25. *(10 minutes)* State that MFIs need information to reach organizational goals. Have neighboring groups of three think of their experiences and list some risks associated with information. Have them identify some controls to mitigate those risks. State that some of the risks are lost, late, false, and incomplete information; loan losses; system crashes; fraud; and unprofitable operations. Give another example: MFIs need to know if clients are attending meetings, but their information system does not record and report that, so they do not know that this risk exists.

26. *(5–10 minutes)* Process the triads' work. Ask for a few examples of risks that can occur that relate to information (or lack thereof).

27. *(5 minutes)* Ask: How do MFIs ensure that they get the information they need? How can they ensure they get timely information? How do they ensure that the information is reliable? Who produces the reports?

    Other questions participants need to ask include: Is the information distributed to the correct people? Accessed by the correct people? Backed up? Well formatted? Able to be tracked?

    Continue to ask: Do their MFIs' staff appraisals include the expectation of timely and accurate reports? What happens when forms are updated? Are instructions written clearly and disseminated? Do they know what information flowcharts are and who uses them? How can the flowcharts help with the MFI's information needs? Summarize using RM4-O5.

28. *(2 minutes)* Emphasize again the role of timely, accurate, reliable information in MFIs' efforts to control risks. Remind participants that CGAP has an entire course devoted to helping MFIs design information systems. Information systems are critical tools in managing MFIs' risks.

OTHER

29. *(10–15 minutes)* Ask and lead a discussion about what other tools participants use to control risks in their MFIs. List major points on a flipchart, such as technology, computers, infrastructure, physical security of cash and personnel, password controls, other access controls to files and offices, safes to prevent security risks, vehicle log books, and so on.

30. *(1 minute)* MFIs use a number of tools daily to help control risks. Those tools are interrelated and must work together for optimal success of the risk management effort.

SESSION SUMMARY

31. *(5–10 minutes)* Ask participants for their thoughts on what they learned in this session. Take any remaining questions.

32. *(5 minutes)* Ask participants to summarize the main messages of the session. Ask: What have we been talking about? Answer: Essentially, we have begun to talk about preventive controls!

    The main messages of this session include:

    - Pillars of prevention include human resources, policies and procedures, and information systems and technology. Risks are inherent and can be managed using a systems approach and tools that are available.
    - People have key roles in reducing risks and implementing controls.
    - Everyone in the organization should be involved in controlling operations.
    - You can't control if you cannot measure! So MFIs need good information.

33. *(15 minutes)* Note that the most important part of learning is being able to use what was learned. Ask: How can you take these ideas home? Distribute worksheet RM4-H4. Tell participants that in the next sessions they learn to plan how they can effect change in their MFIs when they return home.

34. *(5–10 minutes)* Ask if anyone would like to share a strategy from his or her action plan. Comment and discuss.

35. *(2 minutes)* Give closing thoughts to bridge to the next session:

    We have already begun to talk about controls. Most of these controls have been preventive in nature. The timing perhaps reflects its import in the process—an ounce of prevention is worth a pound of cure. We will continue discussing controls as we move around the risk management process loop.

Segregation of Duties Exercise – Answers and Discussion

Personnel Problem 1 Discussion – Accounting Officers

1a. State how you would distribute the functions (listed in the handout) among the three employees.

Employee 1	Employee 2	Employee 3
• Maintain general ledger • Prepare checks for signature • Maintain disbursement journal	• Maintain accounts payable ledger • Handle and deposit cash receipts	• Maintain accounts receivable ledger • Reconcile the bank account

1b. List possible unsatisfactory combinations of the above-listed duties.

- Maintain accounts receivable and prepare checks
- Maintain all ledgers
- Deposit cash and reconcile bank account

1c. What controls would you put in place if segregation were not always possible?

- Conduct spot checks and unannounced cash counts, perform frequent reconciliation, etc.

Personnel Problem 2 Discussion – Branch Officers

2a. State how you would distribute the functions (listed in the handout) between the two employees.

Employee 1	Employee 2
• Identify potential clients • Collect savings • Collect repayments • Follow up delinquent clients • Conduct periodic cash counts	• Approve loan applications • Disburse loans • Manage the petty cash • Submit delinquency reports to head office • Make bank deposits • Conduct periodic client audits

2b. List unsatisfactory combinations of the above-listed duties or other duties that a branch officer might have.

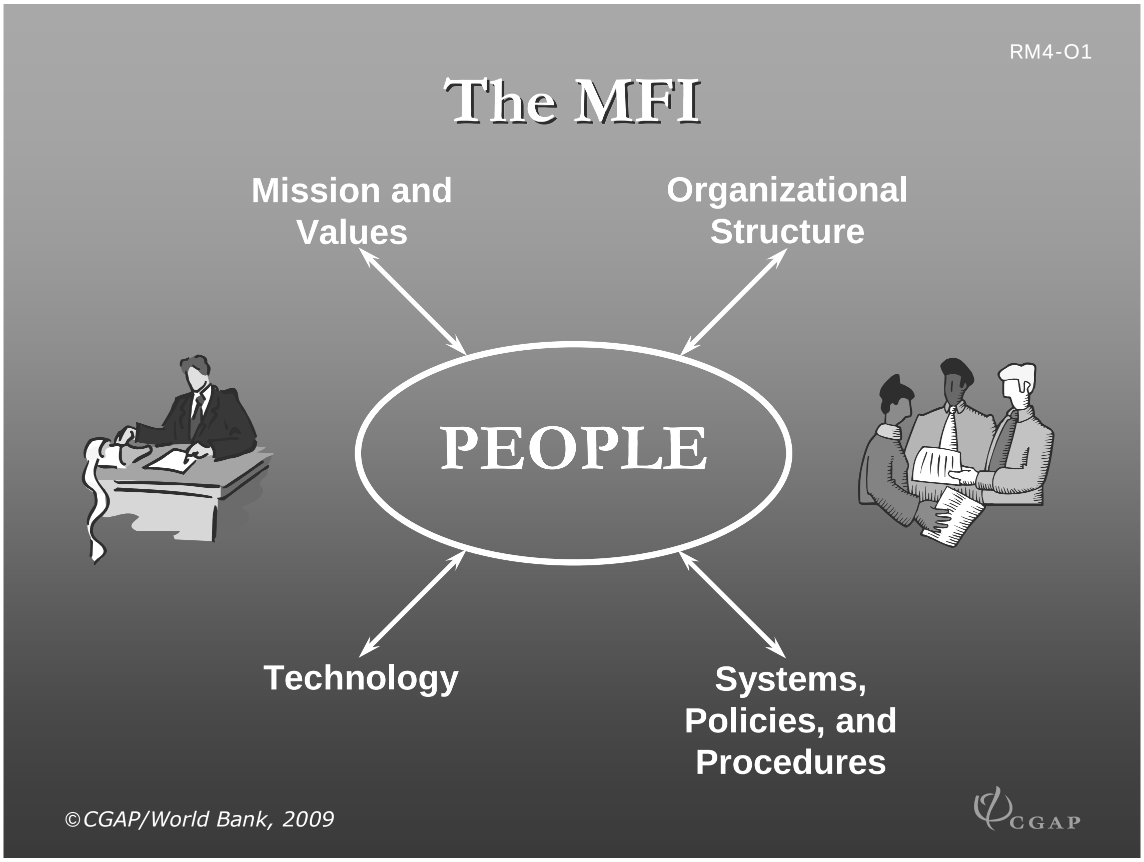
- Approve loans and disburse cash
- Conduct cash counts and manage petty cash
- Follow up on delinquent clients and submit delinquency reports to head office

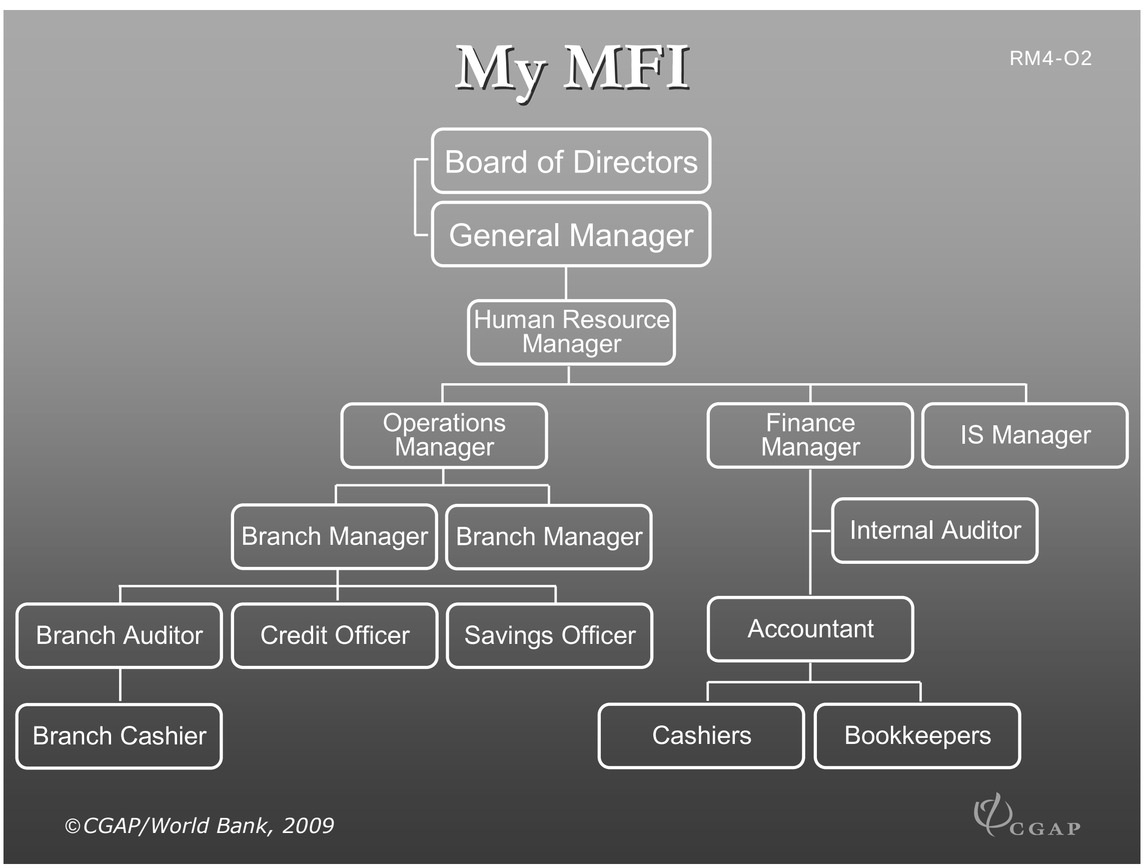
2c. What controls would you put in place if segregation were not possible?

Frequent monitoring from HQ, minimum of two people per branch, limited amounts of cash available, client visits, etc.

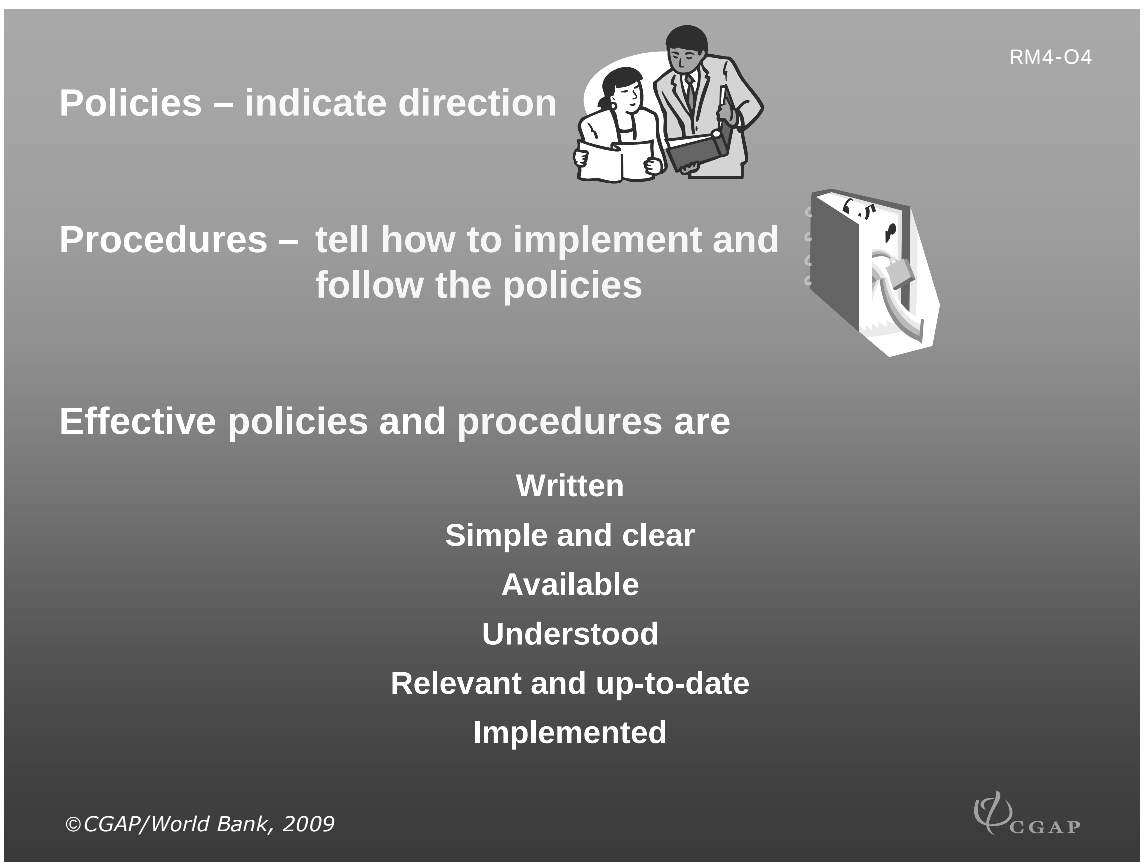
Overheads

THE COMPLETE SET OF OVERHEADS IS IN A SEPARATE POWERPOINT FILE ENTITLED "CGAP OPERATIONAL RISK MANAGEMENT OVERHEADS"


RM4-O1
The MFI
Mission and Values
Organizational Structure
PEOPLE
Technology
Systems, Policies, and Procedures
©CGAP/World Bank, 2009
CGAP


RM4-O2
My MFI
Board of Directors
General Manager
Human Resource Manager
Operations Manager
Finance Manager
IS Manager
Branch Manager
Branch Manager
Internal Auditor
Branch Auditor
Credit Officer
Savings Officer
Accountant
Branch Cashier
Cashiers
Bookkeepers
©CGAP/World Bank, 2009
CGAP


RM4-O3
Don't design it this way
Approve ME
Do MYSELF
Record I
no way
©CGAP/World Bank, 2009
CGAP


RM4-O4
Policies – indicate direction
Procedures – tell how to implement and follow the policies
Effective policies and procedures are
Written
Simple and clear
Available
Understood
Relevant and up-to-date
Implemented
©CGAP/World Bank, 2009
CGAP

RM4-O5

Ask if the information is

- Relevant
- Timely
- Accurate
- Distributed to the correct people
- Accessed by the correct people
- Well-formatted
- Retrievable
- Traceable (able to be audited)

CGAP

Handouts

Segregation of Duties Exercise, Personnel Problem 1 – Accounting Officers

1. The MFI has a problem. It has three employees who must perform the following functions:

   - Maintain general ledger
   - Maintain accounts payable ledger
   - Maintain accounts receivable ledger
   - Prepare checks for signature
   - Maintain disbursement journal
   - Reconcile the bank account
   - Handle and deposit cash receipts

   Assuming there is no problem as to the ability of any of the employees, you are requested to assign the above functions to the three employees in a manner that achieves the greatest segregation of duties. It may be assumed that these employees will perform no other accounting functions than the ones listed and that any other accounting functions not listed will be performed by persons other than these three employees. Be prepared to give reasons for your decisions.

1a. State how you would distribute the above functions among the three employees.

1b. List any possible unsatisfactory combinations of the above-listed duties and give reasons.

1c. What controls would you put in place if segregation is not always possible?

Segregation of Duties Exercise, Personnel Problem 2 – Branch Officers

2. Branch officers perform the following duties:

   - Identify potential clients
   - Approve loan applications
   - Disburse loans
   - Collect savings
   - Collect repayments
   - Manage the petty cash
   - Submit delinquency reports to head office
   - Make bank deposits
   - Follow up delinquent clients
   - Conduct periodic cash counts
   - Conduct periodic client audits

   Assuming there is no problem as to the ability of any of the employees, you are requested to assign the above functions to two employees in such a manner as to achieve the highest degree of segregation of duties.

2a. State how you would distribute the above functions between the two employees. Provide rationale for your decisions.

2b. List unsatisfactory combinations of the above-listed duties or other duties that a branch officer might have. Explain why they would be unsatisfactory.

2c. What controls would you put in place if segregation is not possible?

Policy and Procedures Worksheet

Complete the worksheet for the functional areas for which your MFI has written policies and procedures.

Functional area	Who wrote them?	When were they written?	Last updated? Who is responsible for updating?	Are they available to staff? How disseminated?	Comments: How effective do you think they are in controlling risks?

Action Planning

Prevention is worth a pound of cure! We have been discussing the use of preventive controls to mitigate risks as identified in various activities of MFI operations. Which do you think your MFI needs most? Take a few moments to write down the concepts you would like to review and improve once you return to your office.

1. I think the major risks in my MFI are:

2. I would like to review, update, install, and/or implement the controls as follows:

Human Resources

Policies and Procedures

Information Systems

Other: Technologies, Physical Infrastructure, Tools, etc.

SESSION 5: BUSINESS CYCLES, RISKS, AND INTERNAL CONTROLS

Session Summary

OBJECTIVES: By the end of the session participants will be able to:

- Use the cycle approach for identifying risk areas and the need for internals controls
- State the definition, objectives, and purpose of internal controls
- Explain the characteristics of effective controls
- Identify limitations of internal controls and compensate for them

TIME: 120–145 minutes

SUPPLIES: Flipchart paper, markers, masking tape
LED projector or overhead projector

TRAINER MATERIALS

RM5-M1 Risk Prioritization Guide

RM5-M2 Overview of Fraud in MFIs

PARTICIPANT MATERIALS

OVERHEADS:

RM5-O1 Business Cycles of an MFI
RM5-O2 Pillars and Cycles
RM5-O3 Steps to Identifying Risks and Internal Controls Using the Cycle Approach
RM5-O4 Expenditure Cycle Worksheet
RM5-O5 FRAUD *(definition)*
RM5-O6 Limitations of Internal Controls

HANDOUTS:

RM5-H1 Cycles – Definition and Approach
RM5-H2a MFI Credit and Savings Cycle Worksheet
RM5-H2b Procurement Cycle Worksheet
RM5-H2c Treasury and Financing Cycle Worksheet
RM5-H3 Controlling Fraud – Examples of Detection and Control
RM5-H4 Technical Materials – Internal Controls and Techniques for Mitigating Identified Risks

PREPARED FLIPCHARTS:

Steps to Identify Risks and Internal Controls (as shown in RM5-O3)
Using the Cycle Approach (Application questions from point 21)

Session 5: Business Cycles, Risks, and Internal Controls

It would be helpful for this session to have small groups sitting next to each other. This will enable participants in step 14 to discuss the controls for the risks they identified with a neighbor.

INTRODUCTION

1. *(3 minutes)* Reiterate that many participants previously stated that fraud was a risk in their MFI. Ask: How do you know what exactly to do in order to prevent, detect, or correct the situation? Take a few answers. Focus on those that lead to understanding the causes of fraud and risk and of ways to establish controls to address the causes. Describe the purpose of the session: To introduce a systematic approach to risk and to identifying internal controls that will enable participants to better understand how to develop a risk management strategy. Remind them that MFIs have the power and tools to control risks.

2. *(5 minutes)* Ask: Where should the process start? Answer: By examining current practices and processes to discover exactly where risks are. That is a big job. Ask: How can we break that task down? Are there logical divisions? Answer: Yes, through business cycles. Lead to and introduce the (common) business cycle approach to risk identification. Use RM5-O1 to further clarify the business cycles of an MFI. The cycles are the MFI credit and savings operations cycle; the procurement cycle (cash and credit purchases, fixed assets, payroll); and the treasury/financing cycle (cash, investments, funding).

   State that this session will use the business cycles to focus on how MFIs can mitigate risks. Show RM5-O2 to briefly explain how the cycle approach interfaces with the pillars of prevention.

THE BUSINESS CYCLE APPROACH

3. *(5 minutes)* Ask participants how they think this approach will work for an MFI. Take a few answers. Show RM5-O3 and describe how this session can break down an MFI's operations into these cycles and then explore the processes, activities, and transactions involved to further identify points of weakness that are risks. Then state that, in this session, participants will examine those risks, prioritize them, and begin to develop controls to mitigate them. Post the flipchart of RM5-O3 for future reference.

4. *(3 minutes)* Ask for participants' reactions to the approach. Discuss the pros and cons, and stress the reasons why this approach is being presented. Answer that the approach is systematic, making it easy to identify points at risk; it is a common approach that is accepted by many accounting firms; it considers objectives, including authorization, accounting, and safeguarding of assets, and acknowledges standards; and it can be easily applied to various types of business entities.

IDENTIFYING ACTIVITIES AND TRANSACTIONS AND THEIR RISKS

5. *(5–10 minutes)* Describe the steps involved in practicing this approach: Look at what is involved in each transaction, ask who is involved, identify and prioritize areas of potential risks, and finally identify controls to reduce or eliminate the risk.

   The first step in the process is to identify the activities and transactions in the business cycles. Look at procurement as an example of a business cycle, and ask what activities would be included in procurement. Take a few answers from the group. Summarize: Procurement is the acquisition of goods and services from vendors, such as desks, computers, training of staff, and legal services. Payroll is included because your employees' time is procured. Show RM5-04 and suggest an activity to focus on—for example, buying a computer. Through questioning, fill in the overhead with a few examples of activities (request, check with budget, seek approval, put out tenders, identify vendor, request check, pay vendor, receive goods); also list who is involved (office manager, IT person, finance manager, accountant, etc.).

6. *(5–7 minutes)* After the activities of the process are listed, next ask participants to identify the risks that may be associated with each activity. Ask and briefly review the types of risk: operational, credit, fraud, security, interest, liquidity, foreign exchange, and others.

   Ask participants what kinds of risks are involved in the example. At what points? Answers should include fraud! Show RM5-O4 again and complete.

7. *(5–10 minutes)* Discuss how critical the risk is to the MFI. Ask: What criteria would you use to prioritize these risks? Stimulate discussion through questioning: How often could it happen? What is the frequency? High or low? And how much would the MFI lose? What is the impact on the MFI? High or low (see RM5-M1)?

   Ask: Why do we want to focus on the major risks? Answers may include the allocation of resources, the cost versus benefit of managing the risk, etc. Briefly discuss. Responses should refer to where the MFI could lose the most. State that each MFI will have to establish a method of and criteria for prioritization for consideration.

DEVELOPING CONTROLS

8. *(5 minutes)* Ask: What kinds of controls could be put into place to mitigate the risk of fraud during procurement? Review the tools previously discussed as necessary. Examples can include: requirement for multiple price quotations, double-checked signatures system, segregation of duties (same person does not identify supplier, sign check, and buy), hiring of honest people with strong values, spot checks, etc. The controls should be a combination of tools (human resources, policies, information) and controls (preventive, detective, and corrective).

Summarize the discussion and state:

> After we have this kind of information on the activities and identified risks, we would revisit our operations, identify internal controls to mitigate those risks, and examine the costs of installing the controls, both in monetary and operational terms. Then we would implement the controls and also set up a system to monitor the controls to ensure effective implementation. Let's practice, starting back at the beginning.

IDENTIFYING ACTIVITIES, RISKS, AND CONTROLS BY MFI CYCLE

9. *(20–30 minutes)* Practice identifying activities, risks, and controls by cycle. First, divide the group up into subgroups and assign them different cycles to work on. There should be at least three subgroups, one for each cycle. Distribute RM5-H1 (Cycles), and RM5-H2 (MFI Credit and Savings Cycle Worksheet). When the groups get to the control column, they should complete the list as prioritized, while first concentrating on controlling those risks they identified as most critical.

10. *(15 minutes)* Reconvene all participants to have subgroups report back to the whole group. Review the credit cycle last. Focus the report on the process (of identifying weaknesses and establishing controls to strengthen them) and on the controls that were identified. Note some controls on a flipchart and ask if the controls were preventive, detective, or corrective. Stress the need for all types to have the best control.

11. *(5 minutes)* Ask participants to consider, based on the presentations, which cycle will be of greatest concern to an MFI. Answer: the credit cycle, because that is where an MFI stands to lose the most! Briefly discuss, relating credit cycle risks to the focus on fraud.

FRAUD

Trainers should be prepared with an example or two of fraud, just in case someone asks!

12. *(5 minutes)* Fraud in the credit cycle is a major concern. Ask: What is fraud? Why is fraud a risk? What are the most common types of fraud in an MFI? Write responses on a flipchart (examples are fictitious loans, kickbacks, theft, etc.) Ask for participants' experiences with fraud. Seek specific examples. Ask why and when MFIs are most vulnerable to fraud. Show RM5-O5 to summarize. (See RM5-M1, the Risk Prioritization Guide, and RM5-M2, Overview of Fraud in MFIs.)

13. *(5 minutes)* Ask and discuss: How is fraud most often detected? Prevented? Corrected? Ask what tools managers have available to control fraud. Answers include policies, procedures, personnel, operations, organizational structure, accounting and reporting systems, etc.

14. *(10–15 minutes)* Since microfinance can be extremely vulnerable to fraud, especially in the credit cycle, the exercise is worthy of a little more practice. Continuing in the small groups, present handout RM5-H3, a list of actual fraud incidents. Have participants discuss the incidents and develop controls that might have prevented them from occurring.

15. *(10 minutes)* Reconvene the large group and review answers. Ask to suggest notable or creative responses and discuss. Ask participants about what stumbling blocks they discovered in trying to come up with controls. Were there risks for which they could not come up with any controls?

16. *(2 minutes)* Ask: What is the key to fraud prevention? Answer: People. Ask why they think all these actual cases of fraud happened. Why do people do it? Answers can include opportunity and need, lack of values, unsupportive institutional culture. It seems as if the responsibility comes back to people again!

17. *(3 minutes)* In general, what are some things MFIs can do to deter employees from committing fraud? (Suggestions are decent salaries, supervision, an environment that motivates staff, company pride, written policies and procedures, incentives, commitment to core values, action taken when problems arise, etc.) Remind participants never to underestimate the importance of core values and people who are committed to them when combating risks, especially the risk of fraud.

LIMITS OF INTERNAL CONTROL

18. *(5 minutes)* This session showed a method for developing specific controls to address the risks identified through the activities of various business cycles. The next step is to consider internal controls in general.

    Ask: How foolproof are internal controls? Take a few answers. Point out that no matter how well internal controls are designed, they can only provide *reasonable assurance* that objectives will be achieved. Some limitations are inherent in all control systems. Ask and discuss: What are the limitations of internal controls? Why might they not work? Summarize and use RM5-O6. Note that most of the limitations listed are human factors!

    Warn participants: Just because you have established internal controls, it doesn’t mean you can relax. There are no guarantees; you must continue to be vigilant! See RM5-H4, Technical Materials, and MEDA document for further explanations.

CONCLUSION

19. *(5 minutes)* Review the basic concepts of this session: using the cycle approach to identify risk and establish internal controls, with special emphasis on controlling fraud in the credit cycle. Take any questions.

20. *(2 minutes)* Summarize by stating the process: Identify activities of business cycles, recognize priority risk areas, and plan to prevent the risks through the use of internal controls. Remind participants that, to decide whether a particular control should be established, the risk of failure and the potential effect must be considered along with the cost of establishing the control. Internal controls are more than a necessary evil required by some auditors. Their use is good business. They help provide assurance that an MFI's goals will be accomplished and its assets protected. They help MFI management function more effectively and efficiently. Internal controls also ensure that activities and transactions are handled in a consistent manner from day to day.

21. *(5–10 minutes)* Briefly discuss participants' reactions to the cycle approach to identification of risks and controls. Ask the participants to form pairs to discuss the following questions, which are written on a flipchart titled Using the Cycle Approach. How do you think you can employ this tool in your MFI? What steps will you need to take? What will be easy to do? What obstacles do you anticipate? How will you overcome them?

    After a few moments, ask participants to share a few responses with the large group.

22. *(2 minutes)* To close, restate that this session very briefly discussed what internal controls are, so participants understand how vital they are to MFIs' business, what qualities contribute to their effectiveness, and what means MFIs have to instill them. These ideas were discussed within the context of fraud. Give participants handout RM5-H4, Technical Materials.

    In the next session, cycles will again be used to look more in depth at how MFIs can specifically to go about developing internal controls. Note that the session will look at some specific ways to mitigate risks in MFIs.

RM5-M1

Risk Prioritization Guide

Some participants may request guidance in prioritizing risks. This grid has helped participants in the past to grasp the concept and assign rankings.

For each activity that you are prioritizing, think about the impact and the frequency of occurrence. A high/high response would signal a higher priority than a low/high or low/low.

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

RM5-M2

Overview of Fraud in MFIs[1]

Definition

Fraud is a deception deliberately practiced in order to secure unfair or unlawful gain.

MFI Fraud Cases

CASE	DETECTION	LOSS In US$
Loan officer sets up 90 ghost group loans in a successful high-growth branch. Repays loans from new loans. Collusion with supervisor and regional internal auditor.	Tip from an employee	900,000
Loan officer in rural program makes fictitious loans. Repayment comes from new loans, which soon become delinquent. Collusion with accountant.	Increase in delinquency noticed by the central office and investigated	100,000
Loan officer sets up 18 fictitious loans for personal use. The loans become delinquent.	USAID officer wants to show a high-volume branch for a visit by the ambassador. A client selected for the visit does not exist.	2,500
Loan officer pays a microentrepreneur to use his name and address to originate a loan for his own personal use. No payments are made.	Increase in delinquency reports for that officer was noticed by the central office and investigated.	Unknown
Loan officer charges his clients a fee to apply to the loan program. Officer keeps the fee.	Tip from a client	100
Trusted administrative officer purchased computers and furniture at higher-than-market prices, receiving a kickback. Officer leaves to take on a better job.	When new furniture is purchased months later, new administrator discovers the high prices paid by the prior employee.	Unknown
An employee takes cash from petty cash over the weekend.	Missing funds discovered in a cash count exercise the next workday	100

[1] From Lehman, Joyce. 2001. “Internal Controls and Fraud Prevention in Microfinance Institutions” (MEDA Fraud Workshop, Boulder, CO). MEDA Consulting Group; 155 Frobisher Drive, Suite I-106; Waterloo, ON N2V 2E1 Canada.

CASE	DETECTION	LOSS In US$
Loan officer collects repayments from clients and keeps half for himself. Records only half paid on the books.	Internal audit department reviews reports daily and discovers insufficient repayment from clients of one loan officer.	500
Loan officer in rural area disburses and collects loans in cash. Officer keeps some of the repayments. Argues that he lost loan payment receipts. Most clients don't demand receipts.	Loan officer under suspicion because of sloppy paperwork. Delinquency increases and central office investigates.	3,000
Trusted credit manager makes 13 large loans to small business clients and takes back a major portion of the loans for personal use. Manager has authority to approve loans.	Increase in delinquency noticed on these larger loans. Collections attorney investigates.	6,000
Cashier steals last group loan payment of the day. Does not record payment on the system, but stamps clients' receipt as paid.	Credit officer notices group has not paid its loan. Visits group and discovers the fraud.	100
Trusted financial manager transfers funds to his personal bank account, intending to repay soon. He is then switched to another management job.	New financial manager discovers the missing funds, and the former manager admits the theft.	10,000
Branch manager authorizes loans to relatives who do not repay. When delinquency rises, he makes more new loans to reduce the delinquency rate. When delinquency rises again, he steals from petty cash to repay loans.	Increase in delinquency is noted by central office. Accountant conducts a surprise visit and discovers the missing petty cash.	10,000

4.2.1 What are the most common types of MFI fraud?

- Fictitious loans
- Kickbacks
- Cash theft
- Collusion in issuance of loans
- Manipulation of financial data

4.2.2 Fraud detection signals

DANGER SIGNALS	**EXAMPLES OF PROBLEMS THAT MAY RESULT**
An employee exceeding scope of responsibilities	Individual negotiates contracts and assumes responsibility for approving invoices in order to get kickbacks.
An unusual reduction in or loss of a regular customer's business	Key employee has silent partnership with a new competitor.
Absentee ownership of a small business	Manager pays personal debts with company funds.
A loan officer who also approves a loan	Asset appraisals or financial information is inflated and loans are given in exchange for kickbacks.
An employee who appears to be living beyond his/her means	Employee is embezzling to support the "high life."
Open-ended contracts with clients or suppliers	With no confirmation of loan size (or amount delivered with suppliers), supervisor must take the loan officer's or client's word.

4.2.3 How is fraud most often detected?

- Increase in delinquency

  There is a link between fraud and delinquency.

  Organizations must reexamine both lending policies and reporting procedures.

- Accounting irregularities

  There is a link between fraud and inadequate controls.

  Organizations must examine accounting procedures and maintain a system of independent review.

- Employee tips

  There is a link between fraud and unmotivated employees.

  Organizations must examine the institutional culture and create a "fraud awareness" philosophy.

Reducing the Likelihood of Fraud

In addition to maintaining strong control systems, motivated staff, and a strong portfolio, there are other key aspects of MFIs that are crucial for successful fraud-control programs.

4.3.1 Market pricing

> **Lending at an interest rate that is greater than or equal to the local market rate is an important step that an MFI can take to reduce fraud.**

Below-market pricing of loans will guarantee that two types of distortions occur:

- There will be distortions of who gets the credit.
- Subsidized rates invite direct bribes to the employees who make loan decisions.

4.3.2 Simplicity of operations

The more complex an organization, the more opportunities there are for fraud. Keep it simple:

- Limit potential for loan negotiation
- Limit the number of loan products available
- Limit overlapping roles for employees

4.3.3 Transparency

Transparency is the ability to see clearly what is happening at a lending point and to pinpoint responsibility for outcomes. This starts with the accounting system.

- Each lending point should be a separate profit center (able to cover its own costs) with its own accounting records.

Preventing fraud must be an element in several phases of the lending process:

- **Loan origination**
  - Always visit the site of the loan.
  - Loan appraisal and loan approval must not be done by the same person.
- **Loan monitoring**
  - Continually monitor loan payment history.
  - Be aware of clients that repay one loan with another.
- **Supervision**
  - Regularly review reports from lending units.
  - Regularly perform unannounced visits to lending units and clients on a spot-check basis.

- **Sanctions**
  - Informal mechanisms are generally most effective.
  - Response must be swift, decisive, and consistent.
  - Action taken must send a clear message that fraud is taken seriously and will not be tolerated.

4.3.4 When are MFIs most vulnerable to fraud?

- Weak information and accounting systems
- Changing systems
- Late completion of financial reports
- Weak internal control system
- High employee turnover
- Non-standardization of loan products and programs
- Loan officers handle cash
- In a significant cost reduction mode
- Experiencing high growth

4.3.5 What are the key challenges?

- Maintaining effective control of fraud without excessive cost or burdensome procedures as the program grows
- Maintaining high staff morale and culture of ethics in a large, growing program
- Maintaining awareness of new and more complex types of fraud as the MFI develops new products and becomes more sophisticated

Overheads

THE COMPLETE SET OF OVERHEADS IS IN A SEPARATE POWERPOINT FILE ENTITLED "CGAP OPERATIONAL RISK MANAGEMENT OVERHEADS"

RM5-O1

Business Cycles of an MFI

- MFI Credit and Savings Operations Cycle
- Procurement Cycle
- Treasury and Financing Cycle

RM5-O2

Pillars and Cycles

Credit
and
Savings

Procurement

Treasury

Human
Resources

Policies
and
Procedures

Tools
and
Technology

RM5-O3

Steps to Identifying Risks and Internal Controls Using the Cycle Approach

Classify transactions, activities, and processes by cycle

⬇

Identify who is involved in the activities

⬇

Identify risk points

⬇

Prioritize risks

⬇

Establish and implement policies to mitigate risk (internal controls)

CGAP

RM5-O4

Expenditure Cycle Worksheet

Procurement (e.g., of office equipment)

Activities and transactions	Who is involved	Risks	Ranking of gravity of risk	Controls needed

CGAP

RM5-O5

FRAUD

The risk of loss of earnings or capital as a result of intentional deception by an employee or client*

MFIs most vulnerable to fraud

- Weak information and accounting systems
- Changing systems
- Late completion of reports
- Weak internal control system
- High employee turnover
- Nonstandardized products and operations
- Loan officers handling cash
- High rate of growth

*Adapted from Campion, Anita. 2000. *Improving Internal Control: A Practical Guide for Microfinance Institutions*. Technical Guide No. 1, MFN/GTZ International. http://www.microfinancegateway.org/content/article/detail/2587.

CGAP

RM5-O6

LIMITATIONS Internal Controls

Cost versus benefits
Abnormalities
Human error
Staff turnover
Workload volume
Staff irresponsibility
Judgment
Management override
Staff resistance
Collusion
Breakdowns
Obsolete systems

CGAP

Handouts

Cycles – Definition and Approach

- **MFI Credit and Savings Cycle**
  - Credit application and approvals
  - Loan disbursements
  - Recovery – collection of payment for services
  - Portfolio quality review and provisioning
  - Approval for savings membership
  - Collection of savings
  - Forecasting of demand – marketing, monitoring, and reporting demand and potential clients
  - Equates to the sales cycle of any other business

- **Procurement Cycle**
  - Equates to the expenditures and purchasing cycle, goods and supplies acquired from vendors, payments to vendors and employees
  - Purchasing – functions involved in initiating requests for goods and other assets and services
  - Payroll – functions of hiring, compensation, reporting on attendance and work performed, accounting for all payroll costs, payroll deductions, benefits, and other adjustments
  - Disbursement – functions involved in preparing, signing, and issuing checks or distributing cash to suppliers
  - Holding and safeguarding of fixed assets

- **Treasury/Financing Cycle**
  - Funds received from equity and debt investors (savings)
  - Funds temporarily invested until needed for operations
  - Liquidity management
  - Asset and liability management
  - Functions involved with issuance and redemption of capital stock, debt and investment management, investigation and selection of appropriate forms of financing
  - Donations

Cycle Approach to Risk and Control Identification

- Classify and group transactions and activities according to cycles
- Identify activities and transactions that involve potential risk
- Prioritize risks
- Identify the criteria and standards appropriate for the transaction according to the objectives to be met
- Establish and implement internal controls
- Measure the existing control procedures and techniques and expected output against the criteria

MFI Credit and Savings Cycle Worksheet

Activities and transactions	Who is involved	Risks	Rank gravity of risk	Control

Procurement Cycle Worksheet

Activities and transactions	Who is involved	Risks	Rank gravity of risk	Control

Treasury and Financing Cycle Worksheet

Activities and transactions	Who is involved	Risks	Rank gravity of risk	Control

Controlling Fraud – Examples of Detection and Control

	Case	Detection	Cycles and Controls
1	Loan officer sets up 90 ghost group loans in a successful high-growth branch. Repays loans from new loans. Collusion with supervisor and regional internal auditor.	Tip from an employee Loss of US$900,000	
2	Loan officer pays a microentrepreneur to use his name and address to originate a loan for his own personal use. No payments are made.	Increase in delinquency reports for that officer was noticed by the central office and investigated. Loss in U.S. dollars unknown.	
3	Trusted administrative officer purchased computers and furniture at higher than market prices, receiving a kickback. Officer leaves to take a better job.	When new furniture is purchased months later, new administrator discovers the high prices paid by the prior employee. Loss in U.S. dollars is unknown.	
4	Loan officer in rural area disburses and collects loans in cash. Officer keeps some of the repayments, arguing that he lost loan payment receipts. Most clients don't demand receipts.	Loan officer under suspicion because of sloppy paperwork. Delinquency increases and central office investigates. Loss of US$3,000.	
5	Trusted credit manager makes 13 large loans to small business clients and takes back a major portion of the loans for personal use. Manager has authority to approve loans.	Increase in delinquency noticed on these larger loans. Collections attorney investigates. Loss of US$6,000.	
6	Trusted financial manager transfers funds to his personal bank account, intending to repay soon. He is then switched to another management job.	New financial manager discovers the missing funds, and the former manager admits the theft. Loss of US$10,000.	
7	Branch manager authorizes loans to relatives who do not repay. When delinquency rises, he makes more new loans to reduce the delinquency rate. When delinquency rises again, he steals from petty cash to repay loans.	Increase in delinquency is noted by central office. Accountant conducts a surprise visit and discovers the missing petty cash. Loss of US$10,000.	
8	Loan officer charges his clients a fee to apply to the loan program. Officer keeps the fee.	Tip from a client. Loss of US$100.	

Technical Materials – Internal Controls

Definitions and Purpose

Internal controls (ICs) are all of the resources and procedures used by managers to properly control their activities. Using the process allows the management and its personnel to be reasonably sure that their objectives have been met. ICs help correct contradictions and detect anomalies that occur between the different decision centers, which have varying degrees of autonomy.

They are necessary because of the:

- Growth and size of institutions
- Diversity and complexity of the operations processed
- Multiplicity of risks from many outside pressures, including competition; economic, fiscal, and labor relations; technical progress; market tensions; growing importance of regulatory constraints applicable to institutions; and application of senior management objectives.

In sum, ICs are a set of safety devices that contribute to managing an organization. Use of internal controls aims:

- To ensure the application of management instructions and encourage improved performance
- To maintain the organization's efficiency
- To collect reliable information
- To preserve the organization's assets

ICs are part of the organization, the methods, and the procedures of each of the institution's activities to ensure its continuity.

Essentials of Good Internal Controls

Control Environment

The control environment is the tone of the organization at all levels. It includes integrity, ethical values, and competence. It consists of management's philosophy and operating style, its methods of assigning authority and responsibility, and the organization and development of staff. Also included is the attention and direction of the board of directors. Managers and employees should maintain a supportive attitude toward ICs. Those involved in the operation of ICs should have a level of professional and personal integrity and competence adequate to operate the controls so as to achieve the internal control objectives.

Risk Assessment

Risk assessment is the identification and analysis of relevant risks to the achievement of objectives, the determination as to how risks will be managed, and the identification of risks associated with change.

Control Activities

Control activities are policies and procedures relating to approvals, authorizations, verifications, reconciliation, reviews of operations, security of assets, and segregation of duties. Specific, comprehensive, and reasonable control objectives are to be identified or developed for each organizational activity. Control activities should give reasonable assurance that the internal control objectives will be achieved.

INFORMATION AND COMMUNICATION

Pertinent information must be communicated to enable people to carry out their responsibilities. Information should be shared effectively with customers, vendors, government, and stockholders.

MONITORING

The internal control systems must be monitored to determine the quality of the system's performance. Managers must continually monitor the output of the control systems and take appropriate action on deviations that warrant such action.

STANDARDS

The structure of the IC system, all transactions, and significant events must be clearly documented. Such documentation must be readily available. Transactions and events must be authorized and executed by properly designated persons. Transactions and events must be promptly recorded and properly classified.

The activities of authorizing, processing, recording, and reviewing transactions should be separated among individuals (and units).

Supervision should be competent and ongoing to ensure the achievement of IC objectives.

Access should be limited to authorized individuals, some of whom are accountable for the custody and use of resources and others who maintain the records. This aspect should be periodically verified by comparing physical and recorded amounts.

Characteristics of Controls

TIMELINESS

Controls should detect potential or actual deviations early enough to limit costly exposures. Controls should be timely, although cost-effectiveness must also be considered. Managers should anticipate and provide for problems disclosed by the controls. The inevitable "unknown unknowns—events for which experience is not a guide and that present unexpected problems—should be identified and dealt with in a timely manner.

ECONOMY

Controls should provide "reasonable assurance" of achieving intended results at a minimum cost and with the fewest undesirable side effects.

Absolute control may be possible (though unlikely), but it may also outweigh the benefits to be gained. Controls should pay for themselves by reducing potential losses and expenses beyond the added costs. Thus, management should compare the cost of exposures to be prevented, detected, or corrected with the cost of related controls. Management must be concerned not only with effectiveness of controls, but also with their efficiency and economy. Controls should be increased only as long as the benefits they provide are greater than their incremental costs.

The balancing of exposure and protection may not always be easy or, indeed, objectively measurable. Some controls may be mandated by considerations of safety, the environment, sensitive situations, or enhanced reputation. So, in some cases, management may need to use subjective evaluations when establishing the rigor of particular control systems.

ACCOUNTABILITY

Controls should help people demonstrate their accountability for tasks assigned. Managers need controls to help them meet their responsibilities. Managers should therefore be aware of the purpose and operation of controls to that end and be able to take advantage of them.

PLACEMENT

Controls should be positioned where they are most effective and installed with foresight:

- Before an expensive part of a project
- Before points of no (or difficult) return
- Where one phase of an operation ends and another starts
- Where measurement is most convenient
- Where corrective action is easier to take
- When time is left for corrective action
- After a completed task or the completion of an error-prone activity
- When accountability for resources change

FLEXIBILITY

Circumstances are bound to change. Plans and procedures are almost sure to be altered with time. Controls that will accommodate such changes without themselves requiring change are preferable to avoid the need to change. Changes in controls to match operation changes tend to bring about additional confusion.

CAUSE IDENTIFICATION

Prompt corrective action is aided if controls identify not only the problem but also the cause. Standard responses can be prepared in advance and readily put to use if the control points to the cause of the difficulty. No corrective action is truly effective unless the cause of the defect is addressed.

APPROPRIATENESS

Controls should meet management's needs. They should help achieve the objectives of management's plans, and they should fit into the personnel and organizational structure of operations. The most efficient and useful controls are those that work on an exception basis, responding only to significant deviations.

LIMITATIONS OF INTERNAL CONTROLS

No matter how well internal controls are designed, they can only provide reasonable assurance that objectives will be achieved. The following limitations are inherent in all internal control systems:

Judgment – The effectiveness of controls will be limited by decisions made with human judgment under pressure to conduct business based on information at hand.

Breakdowns – Even well-designed internal controls can break down. Employees sometimes misunderstand instructions or simply make mistakes. Errors may also result from new technology and the complexity of computerized information systems. Controls may become obsolete with new systems and operations.

Management override – High-level personnel may be able to override prescribed policies or procedures for personal gain or advantage. These actions should not be confused with management intervention, which is an action that departs from prescribed policies and procedures for legitimate purposes.

Collusion – Control systems can be circumvented by employee collusion. Individuals acting collectively can alter financial data or other management information in a manner that cannot be identified by control systems.

Costs – It may be too costly to install certain controls based on the anticipated benefits of installing the controls.

People – People can make mistakes, be misdirected, be irresponsible, show poor judgment, have high workloads, or be affected by high staff turnover. (They might not know what to do, or how to do it or where.)

In determining whether a particular control should be established, the risk of failure and the potential effect must be considered along with the cost of establishing the control. Excessive control is costly and counterproductive. Too little control presents undue risk. A conscious effort should be made to achieve an appropriate balance.

For a system of internal controls to be effective, ALL of the following must be present:

- Honest and capable employees
- Clear delegation and separation of duties
- Proper procedures for processing of transactions
- Suitable documents and accounting records
- Adequate physical control over assets and records
- Independent verification of performance

Techniques for Mitigating Identified Risks

Organizational Structure

Policies and Procedures

- Have them in writing, current, simple, available, understood, and applied
- Identify areas where internal controls enter into policies and procedures (cash transacted and recorded)

Structural Issues – Organizational Chart and Segregation of Duties

- Clearly identify areas of responsibility, with job descriptions for segregation of duties (including board).
- Indicate who is responsible for internal controls (to determine/document independence)

Management Information System

- Provide the right information at the right time to the right people. If you can’t measure it, you can’t control it.

Insurance

- Protect (cover) your assets (deposits, fixed assets, collateral)

Staff and Personnel – Training and Culture

- Place education before understanding and implementation

Oversight Environment

MANAGEMENT

- The process starts with management.
- Without you, internal controls don't work.

BOARD

- The buck stops here.

INTERNAL AUDIT

- A system ensures constant vigilance.

EXTERNAL AUDIT

- Without one, the organization could lose everything.
- If you want investors/creditors, you'll need an audit.

SUPERVISORS AND REGULATORS

- These are the ultimate authority; they can shut you down!

SESSION 6: INTERNAL AUDIT

Session Summary

OBJECTIVES: By the end of the session participants will be able to:

- Define and differentiate internal and external audits
- Incorporate internal audit into the internal control system
- Explain at least four characteristics or features of an internal audit
- Plan internal audit activities
- Formulate and use internal audit results

TIME: 140–160 minutes

SUPPLIES: Flipchart paper, markers, masking tape
LED projector or overhead projector

TRAINER MATERIALS

RM6-M1 Small Group Assignment – The Internal Auditor Function
RM6-M2 Technical Materials on Internal Audit

PARTICIPANT MATERIALS

OVERHEADS: RM6-O1 Control Environment
RM6-O2 Internal Audit *(definition)*
RM6-O3 Comparison of Internal and External Audits
RM6-O4 Function of the Internal Auditor
RM6-O5 Major Areas of Focus of Internal Audit
RM6-O6 Internal Audit Output Example – Audit Finding Sheet
RM6-O7 Internal Audit Output Example – Summary Audit Report

HANDOUTS: RM6-H1 Job Description: Chief Internal Auditor
RM6-H2 Technical Materials – Internal Audit

Session 6: Internal Audit

INTRODUCTION

1. *(1 minute)* Introduce the topic by asking what kind of controls the sessions have primarily discussed. Answer: preventive. Ask what other types of controls have been mentioned. Answer: detective and corrective. Refer to the flipchart of the risk management process feedback loop from session 2 to show where detective and corrective controls are represented.

2. *(3–5 minutes)* Ask participants what they know about these types of controls. Build on their responses and conduct a brief lecture with continued questioning. Note that detective and corrective are sometimes referred to as secondary-level of controls, which rely on and work together with first-level preventive controls. These secondary controls often check to see if the preventive measures are working, being used correctly, and getting the desired results.

   When establishing and using controls, MFIs also must have a system of continuous monitoring, and must pay attention to the relevance of the controls (are they up to date? keeping pace with operational innovations?), as well as monitor the costs and benefits of the control system. Also note that the key is to formalize the process, making the controls a permanent part of operations and allocating the necessary resources to implement them.

WHAT IS AN INTERNAL AUDIT FUNCTION?

3. *(5 minutes)* Earlier sessions noted that everyone is involved in risk management. Although in general this is true, who is most involved in and responsible for the second level of controls? Ask: Who is involved in detection? Correction? List responses on a flipchart. They should include the board of directors, management, various staff functions, internal and external auditors, supervisory and regulatory bodies, and so forth. Once again note that many levels of the organization are involved and that some outsiders are also getting involved.

4. *(5 minutes)* Ask for and discuss examples of what these people listed above actually do in the second level of controls. They monitor reports and processes to determine if people are following the policies and procedures established to prevent a risk.

   Ask what tools these people use. Answers can include reports (daily/periodic exception reports), policies and procedures, financial performance ratios, surprise visits, review of documentation, sampling, surprise cash counts, bank reconciliation, ensuring that staff take leave when scheduled, etc.

   Ask: What do we mean by monitoring and evaluation of the internal control system? Briefly discuss. Concepts should include keeping the system current, relevant, appropriate, and cost-effective. Ask for specific examples to illustrate the points.

Ask: How can we ensure that all this happens? Answer: By formalizing and institutionalizing the work. How? By creating an audit function—both internal and external. Show RM6-O1 and explain how the internal and external audits fit into the environment.

5. *(5–10 minutes)* Ask and briefly discuss participants' understanding of the term *audit function*. Ask: How do they function? How are they a part of the risk management system? (Optional to review earlier sessions for emphasis.)

   Acknowledge that perhaps most people are more familiar with traditional external audits. Ask: What is an external audit? Answer: a formal, independent review of an entity's financial statements, records, transactions, and operations. Ask: What is an internal auditor? Take a few answers and show RM6-O2.

6. *(5 minutes)* Brainstorm list of differences between internal and external audit function. Summarize using RM6-O3 (from CGAP Audit Manual, p. 12). State that this session will focus on the internal audit. Ensure that participants understand that the discussion is about audits in the broader sense and include operational and financial goals.

7. *(2 minutes)* Review. Ask: What are the main purposes of the internal audit? Answer: To detect compliance with preventive controls and continue to identify new areas of risk. Point out that the internal audit will also help with the external audit if assessed to be reliable. The external audit will also test the internal audit. It should be responsive to management requests and new or changing institutional direction.

ROLE OF THE INTERNAL AUDITOR

8. *(3 minutes)* Ask: Who would carry out this function? People! Discuss the difference between the internal audit function and an internal auditor. State that regardless of whether this is a specific position or not, the *function* of the internal audit should be incorporated into operations.

   Ask who performs the role of ensuring that the internal control system works if there is no internal auditor or internal control department. Answer: Often, the finance manager or operations manager, or even a periodic external consultant, performs the internal auditor's function.

   Remind participants how important people are to their MFI. Ask: Given that the position of internal auditor is vital to your MFI, what is the first task? To find the right person for the job! The next exercise will help them do that.

9. *(15–20 minutes)* Divide the participants into four subgroups. Tell them that the goal is to develop some parameters for the internal audit function. Give each group one of the four different assignments listed on RM6-M1. Tell the groups they will have 10 to 15 minutes to discuss the scenario and complete their tasks. They should be prepared to share their results.

10. *(20 minutes)* Ask each group to present its results. Discuss and list key points on a flipchart.

11. *(5 minutes)* Summarize the role of the internal auditor using RM6-H1 and H2 and, if appropriate, list the major characteristics that an internal auditor should have to be successful. Add responses to flipchart as needed. Answers include independence, knowledge of MF, fraud prevention, accounting and recording skills, policy and procedure development skills, interpersonal skills, etc. Hand out RM6-H1 (the sample job description) and RM6-H2. Show RM6-O4 to summarize. Remind participants that the internal auditor's function is an integral part of an MFI's risk management system.

12. *(5–10 minutes)* Ask: What does it mean to be independent? Why is independence vital to an internal auditor's success? Answer: The auditor needs resources and reporting structure and autonomy over the work plan and processes. For example, what is the process if the auditor encounters suspected fraud? What do you think the relationships should be between the internal auditor and management? Staff? The board of directors?

    Ask: What problems do you think could arise with this function? What experience have you had in your MFI with this function? Discuss resistance. Employees may feel policed and not like the internal auditor's function. Emphasize the importance of communicating to all employees the key role an internal auditor plays in risk management, and thereby in the survival of the MFI.

13. *(3 minutes)* Ask: So what do internal auditors actually audit? What are the key areas that need to be audited in microfinance institutions? Take answers and discuss. Show RM6-O5 to summarize. Point out that the internal audit relates to reviewing operations on a rotating basis to ensure that every control relevant to a strong control environment within the department is upheld and followed. It also relates to assessing efficiency and effectiveness, assessing new and potential risk areas, observing compliance procedures, and reviewing integrity of data and reports. Tell them that the list presented is by no means exhaustive, but the audit should always include major operational areas.

EXERCISE IN PLANNING AN AUDIT PROGRAM

14. *(15 minutes)* Ask: How does an internal auditor do his or her job? Take some time to discuss specific activities that an internal auditor may carry out. Have participants think back to the job descriptions used earlier. State that it is fundamental that the internal auditor be able to direct the audit and generate his or her own work plan.

    Describe an audit program or plan (checklist) as being a common tool that auditors would use. Explore what is in the plan. Divide the large group into neighboring triads. Assign each triad an area from the list of MFI audit areas. Ask each triad to create a list of activities or questions that an auditor might use in his or her investigations. Begin to outline that plan. Ask what questions they would ask if they were auditors (for example, an auditor might ask who approves loans above $100).

> *Note: The trainer may wish to give the audit area of loans to more than one group and subdivide it into assessment, disbursement, and repayments for three groups. One triad could then be assigned to work on two audit areas that are less complex, such as interest rates and fixed assets.*

15. *(15 minutes)* Ask each group to share a few points. (Presentations should not exceed 2 minutes. Use MFN/GTZ *Improving Internal Controls,* pages 27–40, as reference.)

16. *(2 minutes)* Now that they've worked on the audit plan, ask what participants envision the output of the internal audit to be. Answer: Reports!

    Those reports can include methods used, transactions tested, results (loan disbursements viewed), significant areas where internal controls were not followed, monthly summary results, details of regional audit activities, results of ad hoc investigation of unusual accounts or balances, policy recommendations, etc.

INTERNAL AUDIT REPORTS

17. *(5 minutes)* Describe reports as usually containing the following points, as noted in MFN/GTZ page 43:

    The auditors should write up an audit finding sheet, which outlines

    i. the conditions (what the problem is)
    ii. the criteria (what the correct procedure should be)
    iii. the cause
    iv. the impact (potential for loss or negative impact on the MFI)
    v. the recommendation

    Show some sample report formats. RM6-O6 presents a sample audit finding sheet. Point out that in an MFI, the audit team leader then would compile all the findings into the summary audit report, a sample of which is presented in RM6-O7.

    Point out that, when possible, auditors should refer to specific MFI policies and procedures to support their findings. Statements should be made in a neutral manner, making references to audited parties by title or position rather than by name.

18. *(5 minutes)* Describe what happens to the reports, the results of the internal audit effort. First they are sent to the board of directors for review, validation, and action. When the internal auditor identifies problems, the person in charge of overseeing that area implements corrective action. If the problem occurs in the accounting function (inadvertent misapplication of debits/credits, late reconciliation, old outstanding items), then the accounting manager responds.

Ask: What is the follow-up? How does the MFI know if action was taken and a correction occurred? Whose responsibility is it? The corrective action is subsequently tested in future audits, both internal and external. Records should be kept for future reference. The board or the audit committee or both should take responsibility for ensuring follow-through.

CONCLUSION

19. *(10 minutes)* Review and summarize the definition of internal audit, characteristics of an internal audit, main areas of an MFI to be audited, and activities of the internal audit function.

    Ask participants: What qualities do you think would contribute to the success of the internal audit effort? Elicit answers through further questioning and write the responses on a flipchart. Suggest the following factors:

    - The auditor would be a person who acts independently, with competence and discretion, who has great integrity, who maintains professional distance, who has the trust and respect of employees, and who is an integral part of the risk management system.
    - The MFI would allow independence and reports to the board of directors; support senior management; have an understanding of the role; and provide adequate resources for the audit function.

20. *(5 minutes)* Ask and discuss: What conclusions can you draw on the role of the internal audit in the risk management process?

21. *(5 minutes)* Ask and discuss: What did you learn that you would like to try out in your MFI?

22. *(5 minutes)* Take any final questions. Stress that it is important that the function be part of all institutions, no matter what their size or make-up! Close the session, bridging to the next one on external audits.

RM6-M1

Small Group Assignment – The Internal Auditor Function

Copy this page, cut out the four scenarios, and distribute copies to individuals in each group.

Group 1

You are planning to advertise for an internal auditor. What qualifications and experience should the candidate have to apply for the job?

Group 2

You are planning to hire an internal auditor. Develop a list of primary responsibilities and activities of the position.

How will you fit them into your organizational structure? What will their reporting requirements be? (Content, to whom, frequency, etc.)

Group 3

You are planning to hire an internal auditor. Develop a list of values that the applicant should have and list ideas on how you will test for those values.

Group 4

You are thinking of applying for a position with an MFI. The title of the position is Internal Auditor. Develop a list of questions that you wish to ask the MFI about the position, to better understand what the job entails.

RM6-M2

Technical Materials on Internal Audit

Guidelines to Support Group Discussion

INTERNAL AUDIT DEFINITIONS

An *internal audit* is a systematic, objective appraisal by internal auditors of the diverse operations and controls within an organization to determine whether:

- Financial and operating information is accurate and reliable
- Risks to the enterprise are identified and minimized
- External regulations and acceptable internal policies are followed
- Satisfactory operating criteria are met
- Resources are used efficiently and economically
- The organization's objectives are effectively achieved

all for the purpose of assisting members of the organization in the effective discharge of their responsibilities. Internal auditors report directly to the board of directors.

From CGAP Audit Manual, page 11; Also, Sawyer, Lawrence P. 1996. *Sawyer's Internal Auditing*: *The Practice of Modern Internal Auditing.* Altamonte Springs, FL: Institute of Internal Auditors.

Internal auditing *is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.*

From Institute of Internal Auditors, http://www.theiia.org/.

WHAT SHOULD THE BOARD DO?

- Have the ultimate responsibility to monitor risk and ensure that an appropriate system of control is in place
- Instill in management the importance of control *(make it part of compensation)*
- Recognize that management can be part of the problem *(audit committee)*
- Establish a functioning audit committee and procedures
- Ensure that the internal auditor reports to the audit committee
- Establish and follow reporting requirements

WHAT SHOULD MANAGEMENT DO?

- Establish and follow policies and procedures that install necessary controls in the MFI
- Conduct regular unannounced spot checks
- Establish an environment in which controls are important

WHAT SHOULD REGULATORS AND SUPERVISORS DO?

- Focus on compliance
- Understand requirements and keep up to date
- Develop good relations with regulators and supervisors, because they can help
- Note that the regulator's requirements may not be sufficient to manage an MFI's risk

SAMPLE QUESTIONS TO ASK APPLICANTS FOR INTERNAL AUDITOR DUTIES

Key Elements	Sample Questions
Experience	How long have you been an auditor *(>3 years)*? What type of business activities have you audited *(prefer finance, banking, MFI)*? Names of professional references.
Integrity	Provide a specific example of a time when you had to present a finding that was unpopular with management or the board *(should show where they stood up for right and did not back down)*. How would you address the situation if you found that the CEO was taking kickbacks from suppliers *(gather documentation/evidence, provide report and discussion of it to board contact, follow up as directed by board contact; however, if no action from board contact, discuss with board chair)*?
Independence	Have you worked in any way with this MFI? Do you have any friends on the staff *(consider that you do not want relationships that might hinder independence)*?
Understanding of MFIs	Have you ever worked with an MFI *(prefer yes)*? What are the key audit elements to consider in an MFI audit *(credit cycle and cash)*?
Adaptability	Provide an example of how you integrated yourself into your last position *(you want someone who will try to build their knowledge of the company, and work in a way that does not intentionally inflame other staff—this reduces effectiveness)*?

SAMPLE QUESTIONS THAT MFI SHOULD BE ABLE TO ANSWER ABOUT THE IA FUNCTION:

- Will the board have an audit committee *(should be yes)*?
- Who will be the contact person for the internal auditor (IA) *(should be chair audit committee)*? What is their experience *(prefer accounting, audit experience)*? How often will they meet with the IA *(at least once per month, but IA should have access to them at any time—someone who travels frequently is not a good candidate)*?
- When will the IA's first review occur *(after three months)*? Who will do it *(audit committee chair)*?
- How will the IA be reviewed on an ongoing basis *(using regular company review structure and schedule, reviewed by chair audit committee)*? How will their salary be reviewed *(using regular company review structure and schedule, reviewed by chair audit committee)*?
- When will the IA's first audit plan be due *(within three months of start)*?
- Who will approve the IA plan *(audit committee)*?
- How will the CEO oversee the IA *(facilitating access to all functions, providing access to resources, making sure the auditor is working)*?
- How will IA reports be utilized *(CEO will ensure that managers respond in writing within one week of receipt and CEO will ensure follow-up and correction of weaknesses identified)*?
- What will happen if the IA has a dispute with the CEO *(audit committee will intermediate)*?

Overheads

THE COMPLETE SET OF OVERHEADS IS IN A SEPARATE POWERPOINT FILE ENTITLED "CGAP OPERATIONAL RISK MANAGEMENT OVERHEADS"

RM6-O1

Control Environment

RM6-O2

Internal Audit

An internal audit is a systematic, objective appraisal of the diverse operations and controls within an organization to determine whether:

- **Financial and operating information is accurate and reliable**
- **Risks to the enterprise are identified and minimized**
- **External regulations and acceptable internal policies are followed**
- **Satisfactory operating criteria are met**
- **Resources are used efficiently and economically**
- **The organization's objectives are effectively achieved**

The result is a system that assists members of the organization in the effective discharge of their responsibilities.

Sources: CGAP Audit Manual, p. 11; also, Sawyer, Lawrence P. 1996. Sawyer's Internal Auditing: The Practice of Modern Internal Auditing, Altamonte Springs, FL: Institute of Internal Auditors.

RM6-O3

Comparison of Internal and External Audits

Internal Audit	External Audit
Conducted by an employee of MFI	Done by an independent contractor
Serves the needs of the MFI	Also serves third parties
Focuses on *past and future events* by evaluating controls to ensure achievement of goals	Focuses on whether statements reflect *historical events* clearly and accurately
Is *directly* concerned with preventing fraud	Is *incidentally* concerned with fraud controls

Source: CGAP Audit Manual, p. 12.

CGAP

RM6-O4

Function of the Internal Auditor

- Acts independently
- Reviews transactions in the field
- Compares actual procedures with those documented events
- Frequently reports to the board through written reports and presentations
- Reports on open items from previous audits

CGAP

RM6-O5

Major Areas of Focus of Internal Audit

Cash

Loan operations

Write-Offs

Savings operations

Procurement

Are policies and procedures being followed?

Source: Campion, Anita. 2000. *Improving Internal Control: A Practical Guide for Microfinance Institutions*, p. 28. Technical Guide No. 1, MFN/GTZ International. http://www.microfinancegateway.org/content/article/detail/2587.

RM6-O6

Internal Audit Output Example

Audit Finding Sheet

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

Source: Campion, Anita. 2000. *Improving Internal Control: A Practical Guide for Microfinance Institutions*. Technical Guide No. 1, MFN/GTZ International. http://www.microfinancegateway.org/content/article/detail/2587.

RM6-O7

Internal Audit Output Example *(continued)*

Summary Audit Report

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

Source: Campion, Anita. 2000. *Improving Internal Control: A Practical Guide for Microfinance Institutions*. Technical Guide No. 1, MFN/GTZ International. http://www.microfinancegateway.org/content/article/detail/2587.

CGAP

Handouts

Job Description: Chief Internal Auditor

1. **QUALIFICATIONS:**
   a. Possess a bachelor's degree in accounting, commerce, or a related discipline from a recognized university
   b. Be an experienced auditor, either from within the bank or outside of banking, knowledgeable in audit techniques, standards, and computer processing
   c. Possess excellent communication skills, both written and oral, with demonstrated managerial, organizational, and analytical skills. Incumbent must be an independent thinker, capable of forming sound conclusions and recommendations.

2. **PRIMARY RESPONSIBILITIES:**
   a. Provide prudent audit coverage at a reasonable cost for all elements of the bank
   b. Assist board of directors in fulfilling their responsibilities relating to audits
   c. Maintain an open line of communication with the chief executive officer and the audit committee of the board of directors, when formed
   d. Develop a professional audit staff

3. **SPECIFIC ACTIVITIES:**
   a. Develop a comprehensive audit program to provide audit coverage for the bank
   b. Execute annual audit plan, including financial budget, coordinating efforts with external auditors to avoid unnecessary costs and duplication of efforts
   c. Ensure primary audit focus is to determine the effectiveness of internal controls and the degree of compliance with policies. Secondary objectives include reviewing operating efficiency, measuring attainment of objectives, and making recommendations for cost reduction and earnings improvement.
   d. Review modified or new systems prior to implementation to ensure any internal control deficiencies that might occur can be corrected at a time when it is practical to make system changes
   e. Ensure that audit standards for written audit programs and work papers are adhered to, and that sufficient, competent documentation is required to evidence audit work performed and conclusions drawn
   f. Prepare and issue reports to management after audits are completed, obtain responses from management, and review responses prior to submitting to the chief executive officer and the audit committee of the board of directors, when formed
   g. Inform chief executive officer and, when formed, audit committee of the board of directors, of audit activities and material audit findings through routinely scheduled reports and/or meetings, as required
   h. Manage the audit function independently of management, however, in keeping with the bank's current organization chart, functionally reporting to the chief executive officer until such time as an audit committee of the board of directors may be formed, then reporting to the chief executive officer administratively

i. Maintain and develop a professional audit staff, requiring highly qualified candidates from recruitment authorities in the bank, obtaining effective training programs through the bank's training authorities, and practicing job rotation

j. Establish and maintain professional ties in related professional groups

k. Participate in actual field work as appropriate to ensure quality of work and procedures

SAMPLE QUESTIONS TO ASK APPLICANTS FOR INTERNAL AUDITOR DUTIES

Key Elements	Sample Questions
Experience	How long have you been an auditor *(>3 years)*? What type of business activities have you audited *(prefer finance, banking, MFI)*? Names of professional references.
Integrity	Provide a specific example of a time when you had to present a finding that was unpopular with management or the board *(should show where they stood up for right and did not back down)*. How would you address the situation if you found that the CEO was taking kickbacks from suppliers *(gather documentation/evidence, provide report and discussion of it to board contact, follow up as directed by board contact; however, if no action from board contact, discuss with board chair)*?
Independence	Have you worked in any way with this MFI? Do you have any friends on the staff *(consider that you do not want relationships that might hinder independence)*?
Understanding of MFIs	Have you ever worked with an MFI *(prefer yes)*? What are the key audit elements to consider in an MFI audit *(credit cycle and cash)*?
Adaptability	Provide an example of how you integrated yourself into your last position *(you want someone who will try to build their knowledge of the company, and work in a way that does not intentionally inflame other staff—this reduces effectiveness)*?

SAMPLE QUESTIONS THAT MFI SHOULD BE ABLE TO ANSWER ABOUT THE IA FUNCTION:

- Will the board have an audit committee *(should be yes)*?
- Who will be the contact person for the internal auditor (IA) *(should be chair audit committee)*? What is their experience *(prefer accounting, audit experience)*? How often will they meet with the IA *(at least once per month, but IA should have access to them at any time—someone who travels frequently is not a good candidate)*?
- When will the IA's first review occur *(after three months)*? Who will do it *(audit committee chair)*?
- How will the IA be reviewed on an ongoing basis *(using regular company review structure and schedule, reviewed by chair audit committee)*? How will their salary be reviewed *(using regular company review structure and schedule, reviewed by chair audit committee)*?

- When will the IA's first audit plan be due *(within three months of start)*?
- Who will approve the IA plan *(audit committee)*?
- How will the CEO oversee the IA *(facilitating access to all functions, providing access to resources, making sure the auditor is working)*?
- How will IA reports be utilized *(CEO will ensure that managers respond in writing within one week of receipt and CEO will ensure follow-up and correction of weaknesses identified)*?
- What will happen if the IA has a dispute with the CEO *(audit committee will intermediate)*?

Technical Materials – Internal Audit

The Role of the Internal Auditor

The internal auditor conducts the **internal audits** of the MFI based on directions from management and the board. Several key factors help to improve their effectiveness. These include:

- Independence,
- Adequate resources,
- Senior management support, and
- Full understanding of their role and responsibilities.

Generally, the **internal auditor's** activities revolve around the several areas within the institution. These include:

- **Financial** audits, where the auditor analyzes the economic activity of the MFI, reviewing for accuracy, timeliness, and completeness.
- **Compliance**, which includes a comprehensive review of financial and operating controls to assess their conformity with written policies, laws, established standards, regulatory requirements, donor agreements.
- **Operational**, which includes a comprehensive review of portfolio, savings, cash and other operations, assessing efficiency and effectiveness, as well as risk of the various activities.
- **Fraud investigations** are another important aspect of the work of the internal auditor. A fraud investigation is a confidential review of the circumstances surrounding misconduct either on the part of clients or staff. The internal auditor, based on evidence derived from audit activities, often initiates these investigations.

They are usually full-time employees of the MFI, though sometimes MFIs will contract external auditors to perform the internal audit function. This will impair the independence of the auditor or firm relative to the annual audit.

Internal auditors can play a critical role in improving the efficiency of an external audit by obtaining guidance from the external auditors and collecting audit evidence in a manner that can be used with confidence.

The relationship between internal and external auditors can become strained at times. Management should ensure a fruitful and collaborative relationship between these parties.

WHAT IS THE PURPOSE OF AN INTERNAL AUDIT?

According to the **Institute of Internal Auditors (IIA)**, the purpose of an **internal audit** is to evaluate the adequacy and effectiveness of a company's internal control system and determine the extent to which assigned responsibilities are actually carried out. The IIA's five audit scope standards outline the internal auditor's responsibilities:

1. Review the reliability and integrity of operating and financial information and how it is identified, measured, classified, and reported.
2. Determine whether the systems designed to comply with operating and reporting policies, plans, procedures, laws, and regulations are actually being followed.
3. Review how assets are safeguarded and verify the existence of assets as appropriate.
4. Examine company resources to determine how effectively and efficiently they are utilized.

5. Review company operations and programs to determine whether they are being carried out as planned and whether they are meeting their objectives.

The internal auditor is usually an employee of the organization being audited and follows management's requirements of the audit.

AT WHAT POINT SHOULD WE HIRE AN INTERNAL AUDITOR?

The MFI should consider hiring an internal auditor when it is economically feasible and operationally beneficial to do so.

From a purely direct cost perspective, some argue that an MFI should hire an internal auditor once it has 100 employees. At this point, it is argued, an MFI will be easily able to cover the costs incumbent in the new position.

Others argue for hiring the initial internal auditor much earlier. Their arguments center around capacity building and strengthening internal controls early in the life of the MFI to protect it from large problems. Their considerations include:

- It takes time to develop the audit function and an MFI should have the internal auditor in place to oversee it as you build their capacity.
- It takes time to build the capacity of the internal auditor. They should have full capacity when the institution really needs their oversight rather than searching for someone when the institution is already overdue in terms of institutional needs.
- MFIs tend to enter a new phase of growth at about 3,000-5,000 clients, requiring a reassessment of policies and internal controls. It helps to have an independent internal auditor to focus on their development without vested interests.
- MFIs often provide a great deal of independence to their field staff and elevate supervisors from the credit officer staff. Thus, independent staff are often weakly supervised. The internal auditor can provide an important oversight to this operational structure.
- When major control problems occur early in a program's life it can create serious problems for future growth. An early internal auditor can help detect and avoid such problems before their impact is excessive on the institution.

An MFI, using a group- or individual-based methodology, may have staff servicing between 5,000 and 20,000 clients, once there are 100 staff members. Much of this work is done independently and controls must be strong and frequently reinforced. This requires the expertise of an internal auditor. An appropriate approach might be to hire a junior internal auditor (at least one year audit experience) at about 3,000 clients and a senior internal auditor at about 10,000 clients. This varies significantly depending on the structure of the MFI. In general, the more decentralized the activities, the sooner you need an internal auditor.

If having an internal auditor can eliminate 1/3 to 1/2 of the work that is needed by the external audit firm, and the external audit costs $10,000, then an annual salary of $3,333 to $5,000 may be justifiable. Explicit conversations with the external audit firm can help in identifying cost savings attributable to the internal audit function. Do not just expect that by hiring an internal auditor that costs of the audit will decline rapidly if you have not had this conversation beforehand.

Occasionally, companies will hire audit firm staff from the audit firm they work with in order to staff their internal audit position. If the MFI feels that one of the members of the external audit team would make a good employee, it is important that this fact not be discussed until after the audit report is issued for the year the staff member is working on the audit.

HOW DO THE ROLES OF MANAGEMENT AND THE BOARD DIFFER REGARDING THE INTERNAL AUDIT?

Roles of management and the board with respect to the internal auditor:

Management

- Establish and follow policies and procedures, then install necessary controls in the MFI
- Day-to-day supervision
- Establish an environment that says controls are important to the MFI
- Facilitation of access to all areas of institution
- Conduct regular unannounced spot checks
- Requests special audits
- Provides necessary resources
- Receives copies of audit reports
- Enforces response provision by affected departments/staff
- Oversees correction/implementation of IA recommendations

Board

The ultimate authority regarding the internal audit function is the board of directors.

- Oversight of IA function. Board has the ultimate responsibility to monitor risk and ensure that an appropriate system of control is in place.
- Oversees job description preparation and IA hiring process, and finalizes selection of senior internal auditor.
- Board should establish a functioning audit committee. Establish procedures. Designates a person (audit committee chair) to act as board contact for internal auditor. Board should ensure that the internal auditor reports to the audit committee. Reporting requirements should be established and followed.
- Assesses performance of IA.
- Conducts periodic salary assessments.
- Instill in management importance of control. Recognize that management can be part of the problem. Mediates issues between management and the IA.
- Receives IA report at board meetings.
- Approves annual IA work plan.
- Assigns special audits.

WHAT SHOULD REGULATORS/SUPERVISORS DO?

- Their focus is compliance.
- Make sure you understand what the requirements are, and keep up to date.
- Develop good relations with them; they can help.
- Note well that regulators' requirements may not be sufficient to manage your risk.

SESSION 7: EXTERNAL AUDIT

Session Summary

OBJECTIVES: By the end of the session, participants will be able to:

- Explain the role of external audit in risk management
- Give reasons why, historically, MFI audits haven't met expectations
- Plan and coordinate external audit activities
- Formulate terms of reference (ToR) and establish scope for an external audit
- Select quality external auditors
- Evaluate audit results
- Plan for appropriate corrective action

TIME: 185 minutes

SUPPLIES: Flipchart paper, markers, masking tape
LED projector or overhead projector
Props for the skits—hats, drinks, setting, music, etc.

Trainer should visit the CGAP Web site (http://www.cgap.org) prior to delivery of this session to access up-to-date information on the topic and have the following resources on hand:

CGAP Audit Manual (Part 1)
CGAP Disclosure Guidelines
CGAP Portfolio Due Diligence Tool

TRAINER MATERIALS

RM7-M1 Script for Introduction – Explaining the Need for an MFI Financial Audit

RM7-M2 Trainer's Notes for Terms of Reference Exercise and Responsibility Discussions

RM7-M3 Trainer's Guide for Management Letter Exercise

PARTICIPANT MATERIALS

OVERHEADS: RM7-O1 External Audit *[definition]*
RM7-O2 Why have MFI external audits not delivered desired results in the past?
RM7-O3 External Audit Planning
RM7-O4 Terms of Reference includes
RM7-O5 Desired Audit Output

HANDOUTS: RM7-H1 Audit Information Needs Worksheet
RM7-H2 Terms of Reference Exercise
RM7-H3 Exercise – Analyze Sample Management Letter and Report
RM7-H4 Improved Management Letter and Report
RM7-H5 Technical Materials – Why haven't MFI external audits delivered the intended results?
RM7-H6 CGAP Disclosure Guidelines for Financial Reporting by Microfinance Institutions *[Trainer will download current guidelines and photocopy for distribution.]*

OPTIONAL FLIPCHART:

Audits will shield the innocent from suspicion, protect the weak from temptation, and keep the clever from opportunity.

Session 7: External Audit

Trainer should visit the CGAP Web site (http://www. cgap.org) prior to delivery of this session to access up-to-date information on the topic and have the following resources on hand:

CGAP Audit Manual (Part 1)
CGAP Disclosure Guidelines
CGAP Portfolio Due Diligence Tool

UNDERSTANDING THE EXTERNAL AUDIT

1. *(3 minutes)* Introduce session by acting out script (RM7-M1) using cotrainers or preassigned participants.

2. *(5 minutes)* Ask participants what they thought happened. Why does the executive director want the name of the auditor? (For example, she saw benefits, got funding, avoided potentially risky situations, obtained buy-in, planned to get information desired, etc.)

   Explain that external audits often have been conducted solely at the demand of donors or investors, and the MFI has not seen many direct benefits to its operations as a result of those audits. Explain that since audits are inevitable, this session will help participants better understand audits and discuss how to make them work for the maximum benefit of the MFI. The session will present ideas on how to select an auditor, contract him or her, monitor the audit, and request and interpret reports. With a better understanding of the process, participants will be convinced of the usefulness of audits and look forward to the benefits they provide in helping their MFI reach its goals.

3. *(5 minutes)* Ask and discuss: What is an external audit? (Get to definition here.) What is the traditional purpose of an external audit? Why do you think we are discussing it? How does it fit into our risk management environment? How does it relate to internal audits?

   Refer to flipcharts of concentric circles and the risk management feedback loop from session 2. Explain where external audits fit into the MFI's risk management system, how they overlap with other parts of the risk management system, and how they are detective in nature. Summarize by stating the purpose and benefits of audits. Show RM7-O1.

PLANNING THE EXTERNAL AUDIT

4. *(5 minutes)* Ask participants who has had an external audit. Have them take a few minutes to reflect on their experiences with external audits while you distribute RM7-H1, the Audit Information Needs worksheet. Ask participants to individually write answers to the questions.

5. *(10 minutes)* Divide participants up into small groups. Ask them to briefly discuss their individual responses and, as a group, to rank the answers to question 1, and to present their top five information needs from an audit on a flipchart.

6. *(10 minutes)* Have groups present their responses. Draw notice to similarities and come up with a final list of five to ten most important needs from an audit.

7. *(5 minutes)* Ask participants if their audits are providing this information. Ask and discuss: Why do you think audits often fail to deliver your desired outputs? Show RM7-O2 in summary. Tell them that they can change this! With more active participation in planning the external audit, they can get the output and information they want.

8. *(2 minutes)* Now that participants know a little about what external audits are, discuss how they can benefit from them. Ask: How do you think this can happen? Answers include careful selection, understanding of what is possible, and careful planning of the audit with various stakeholders to achieve the desired results.

9. *(5 minutes)* Ask participants: Who has planned an audit? Have them describe what they did. List the main points on a flipchart. Ask them what additional steps they wish they had taken. Use RM7-O3 to summarize. Link the discussion to points on the overhead, explaining and describing when necessary. *Refer to the CGAP Audit Manual chapter 4 for more complete explanations*.

10. *(5 minutes)* Ask: Who in your MFI is responsible for the external audit process? Discuss roles of the board of directors and management using two flipcharts in the front of room, one labeled Board, the other labeled Management. *See RM7-M2 and CGAP Audit Manual for reference.*

11. *(5 minutes)* Ask and discuss: What factors affect how the MFI would determine the scope of work and type of audit? What things might need to be considered when you are ordering an audit? Answers can be the following:

    - There are certain regulations and standards that MFIs must comply with. These are usually established internationally, by country and industry, and must be met at some minimum level.
    - The experience of the auditors available will also dictate what can be achieved.
    - The audit client—the MFI, investor, donor, etc.—should begin the process of commissioning an external audit to determine what they want (determining the scope). The scope of work will form the basis for the terms of reference (ToR). If the client wants more than the prevailing standards for the financial statement audit, then these additions must be specifically requested in the ToR.

Some tools are available that may guide this process. The CGAP Disclosure Guidelines may be adapted and the Portfolio Due Diligence tool may also be of some assistance to help the MFI request certain outputs.

UNDERSTANDING AND USING TERMS OF REFERENCE

12. *(5 minutes)* Ask: What are the key elements of a ToR? Summarize by showing and explaining RM7-O4. State that developing a detailed ToR enables the MFI to specify what it wants the auditors to do and the expected results and outputs. State that, for example, if the MFI does not specify that the portfolio is to be examined to ensure that it is not overstated, then it might not get done!

13. *(5 minutes)* Because the ToR is critical to the success of the audit, ask participants to read the terms of reference handout (RM7-H2) individually.

14. *(15 minutes)* Have participants get into groups of three or four and ask them to discuss the ToR. Ask them to be prepared to present a summary of their thoughts. Specifically, they should list the points they thought were particularly good or important, those that appear procedurally incorrect, and items that were not included but should be.

15. *(10 minutes)* Have groups present their findings. Ask subsequent groups to focus on points that are different from those already presented. Ask participants what they think about ToRs. Lead a discussion toward the conclusion that ToRs are necessary and have benefits—a lot of details and perhaps a lot of work, but well worth it! Acknowledge the great jobs everyone did reviewing and redesigning the ToRs.

CHOOSING THE AUDITOR

Refer to CGAP Audit Manual chapter 4 for more detailed supporting information.

16. *(10 minutes)* Ask and discuss what else must be considered to proceed: Choosing the auditor. Have participants work with their neighbor to make a list of the criteria they will use to select an auditor. Solicit suggestions from the pairs. The answers might include experience, availability, microfinance experience, cost, responsiveness, reputation for delivering work on time.

    For example, the MFI can make its choice by rating written and oral presentations, taking recommendations from other MFIs and donors, looking for a professional, reputable audit firm, preferably with microfinance experience, finding out who actually does the work (not just the reputation of the firm but also the reputation of the individual actually doing the work).

    Ask what might prevent these criteria from being used. Answers could include favoritism, lack of available auditing options, auditor prespecified by donor/investor, etc.). Ask and discuss: What can you do to overcome these obstacles?

17. *(5 minutes)* Brainstorm with participants what the process of selecting an auditor might entail. Write responses on a flipchart. They should include request proposals, evaluate responses, interview potential candidates, check their references, establish a time frame for work to be started and completed, and others.

    Ask participants if these steps are being followed in their MFIs. Why or why not? Why do you now think you should convince your MFI to follow such a selection process?

18. *(3 minutes)* Ask what steps this session has reviewed so far: Understanding the usefulness of an external audit, developing ToRs, assigning responsibilities between management and the board of directors, choosing an auditor(s), planning for them, scheduling the event, etc. Take any questions and then ask: Where do we go next? Answer: Directing the external audit activities.

—Take a break and stretch.—

DIRECTING THE EXTERNAL AUDIT ACTIVITIES

19. *(3 minutes)* Reenergize the group after the break by carrying out a very brief introductory skit. One trainer acts as the arriving auditor. Another trainer is a staff member (secretary) of the MFI that is scheduled to be audited. The MFI is not ready for the audit—files are a mess, key managers were called away for an emergency. The auditor is dismayed and does not know what to do.

20. *(5 minutes)* Process the scenario. Ask: What was the problem and why was the MFI not prepared? Answers include lack of communication, management that didn't acknowledge the importance of preparing. What could have been done to prevent it? Whose responsibility is this? Answer: Management is responsible for coordinating the day-to-day activities of the audit.

    Ask what the MFI should have in place for the auditors. Answers include financial data and statements, related files, portfolio reports, bank statements, staff available for interviews and consultation, a place for auditors to work, etc.

    Make the points that management should take the audit seriously (and would if they understood the benefits) and should have a plan in case situations arise. The better prepared they are, the better the audit will be. If the audit is delayed or rescheduled, it will cost more and possibly result in a reduction of scope. Emphasize that the preparation will take time but will be well worth the effort.

21. *(3 minutes)* Discuss how the MFI can facilitate the audit to improve its quality and effectiveness. Ask participants to suggest some important items to consider when coordinating an audit. Answers should include preparing schedules, reviewing the auditor's work plans, holding frequent progress meetings, responding quickly to audit inquiries, preparing additional schedules, if needed, drafting a representation letter, etc.

Point out that the more schedules the MFI can prepare for the auditor before the audit team arrives, the faster and smoother the audit will progress. Emphasize the importance of reviewing the audit work plan before the work starts—first, to make sure that the auditor has prepared and second, to be able to facilitate the audit as much as possible.

INTERPRETING THE RESULTS OF THE AUDIT

Trainers can use the CGAP Audit Handbook, chapter 7 and annex G, for reference.

22. *(5–10 minutes)* State that participants have learned how to order, plan, and coordinate an external audit. Ask: What do we get out of the audit? What are the results? What do those results mean? Present some answers: A formal audit report includes a management letter, financial statements, notes, and opinions (recommendations). Show RM7-O5. Define each item through questioning. Also ask for and define the types of opinions. Tell participants that the MFI can get more than this, if previously arranged.

23. *(15 minutes)* To review a management letter, divide the group into six or eight working groups. Distribute RM7-H3. Ask the groups to analyze the management letter and to make notes on what they would improve, if needed.

24. *(15 minutes)* Have groups report back and comment on each other's responses. Use the trainer's guide RM7-M3 to discuss wrong points in the management letter. Distribute RM7-H4, the improved version of the letter. Ask: Why is this discussion important for managers?

    Summarize the main points of the exercise, including that a management letter can also incorporate comments on management improvements or nonresponsiveness to matters raised in previous years. This is helpful in case management denies or disowns all the incidences in the report when the board or audit committee questions them.

    Emphasize that the outputs should meet the requirements as set forth in the scope of work, ToR, and work plan. They should present the information needed by the MFI to improve its internal control system. Remind participants that the MFI stated its needs when it wrote the ToR and selected an auditor, and its management can get what they want from the output!

25. *(10 minutes)* Ask and discuss: What do you think happens to the management letter following the audit? Who responds to the audit report and management letter? What do you do with the information? Who gets the information? How can you use a management letter that cites deficiencies? How do you know if the information provided is meaningful or valid? How will the MFI use it in its risk management system? Finally, how does the MFI ensure that the recommendations are implemented? See the CGAP Audit Manual, chapter 7, section 2, for suggested answers.

26. *(3 minutes)* Remind participants that the information from management letters is only worth the effort if it is used, not shelved. Reacting to the results must be part of the plan from the beginning. The plan should consider who will follow up to ensure that the recommendations are acted upon. Emphasize that participants' MFIs should use the external audit to full advantage: By requesting what information they want, hiring good auditors, being prepared, and working with the auditors to get useful information to help their MFIs grow sustainably with minimal risks!

CONCLUSION

27. *(5 minutes)* Review the main points of the session. The success of the external audit needs management buy-in and direction or coordination. The MFI should know what it wants from the audit, take time in selecting an auditor, and be in a position to get the expected results.

28. *(2 minutes)* Close the session. Distribute RM7-H5, Technical Materials, and RM7-H6, CGAP Disclosure Guidelines. Explain that the guidelines are not directed at MFIs per se but can be used to guide an MFI as to what and why things should be done. Show the optional flipchart with quote, if desired. Bridge to the next session.

RM7-M1

Script for Introduction – Explaining the Need for an MFI Financial Audit

PURPOSE: To explain the need for and benefits of an external audit to participants through a skit

> *Note: Distribute this handout to two outgoing participants either during a break or the evening before the section on external audits will be discussed. Participants should feel free to add from their own experience, to make the encounter realistic and humorous, while keeping to the time limit of 5 minutes or so.*

SCENE *(presented to the group by the trainer)*:

In a training conference on Management Information Systems for MFIs, two colleagues, both executive directors (EDs) of MFIs formed within the past 3 years, meet for the first time in 18 months. They catch up on what has happened personally and professionally when one mentions:

ED 1: But the most valuable bit of work we did this last year was to have our first external audit.

ED 2: You said valuable. That's an interesting choice of words. Why did you say valuable?

ED 1: I used the external audit to receive a loan from National Bank to double operations. We're now in five additional communities, you know. The auditors gave us what they call a "management letter" that identified some structural issues regarding segregation of duties that could have created fraud in our institution. We've…

ED 2: Wait a minute, you had an instance of fraud?!

ED 1: No, the management letter noted that our accountant who enters transactions into the accounting system prepares the bank reconciliation. He also prints the checks from his printer. Although I sign all checks, the auditors pointed out that it could be possible for this accountant to print out a check to himself or to a friend and deposit it. And if the bank were not checking signatures, he could have made off with a significant amount of money. Now, we trust this guy a lot, but now that we have five accountants, it makes sense to distribute those duties over the entire department. As an additional control over disbursements, I open all of the bank statements personally and review the signatures and vendors for discrepancies.

ED 2: Wow! That was great service. It must have cost you a mint.

ED 1: Not really. We were very careful in identifying our needs and created a good ToR for the competing audit firms.

ED 2: Tore?

ED 1: Sorry, terms of reference. It took some time, but we considered several sources of information, such as the CGAP Audit Guide for sample ToR points. Some points weren't as applicable, as we don't capture savings yet, but many points were applicable. They had a format for notes to the financial statement; they called it disclosure guidelines, which our donor found very informative. In fact, they ended up approving our proposal for an institutional strengthening grant, based on what they saw in the audit, although there were many issues identified in the management letter that weren't flattering.

ED 2: They didn't shut you down?

ED 1: Nope. We presented the package to them with an explanatory letter noting the steps that we'd like to take and their costs. They saw it as progress and agreed that this would be a good investment and that their funding would be more secure if they helped us out a bit.

ED 2: This conversation has helped me out a lot. I thought that an audit was to be avoided at all costs. I've heard that external auditors ask uninformed questions and you end up explaining your operations to them over and over again. But from what you've said, it appears that if an audit is appropriately planned and you know what you want out of it, it can be a real tool that can indeed create value for your organization.

ED 1: You're right, but be careful about which audit firm you choose. It often doesn't pay to select the cheapest audit firm that comes around. You need to consider prior MFI audit experience, the experience level of the audit staff assigned to your account, and how well they understand the eccentricities of MFIs.

ED 2: Good advice. Would you recommend the firm that did your audit?

RM7-M2

Trainer's Notes for Terms of Reference Exercise and Responsibility Discussions

Trainer should draw a "T" on flipchart paper or on overhead transparency.

Suggested Improvements for ToR Exercise*

Questionable items/Items excluded	**Good items/Items included**
• One-year contract; why not three? • Financial Manager is contact vs. board. The Financial Director is more likely to head the audit committee. • Sample MFI shouldn't restrict information to only the information they want to supply the auditor. • Timing section is excluded. • Microfinance experience is omitted. • Date audit is due is not included. • Financial statements should have been prepared. • Period of audit is not consistent.	• Background items—nature of business, branch network, number of staff, overview of operations, etc. – ISAs used as a basis for auditing – Introduction was good • Loan portfolio identified as a specific area • Audit team qualifications requested • Two-day pre-proposal investigation • Oral presentation – Cost-structure style budget (not just one number) – Client visits required – Review of financial statements – Comprehensive scope of work • Managemen t letter

*Items listed do not represent all possible improvements, just the most important.

Roles of Management vs. Board

Board	**Management**
• Set ToR • Agree to scope of the audit, including areas of focus (you cannot limit the scope but you can expand) • Review proposals • Select the external auditor	• Research audit firm candidates • Provide prospective auditors with information needed to create a quality proposal, including significant time when needed

Trainer's Guide for Management Letter Exercise

(Issues highlighted and underlined are points that are not correct/appropriate)

Audit Committee
Aspire MFI
Manila

In planning and performing our audit of the financial statements of the Aspire Microfinance Institution for the year ended 31 December 2006 (on which we have issued our report dated September 15, 2007), 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
Big Four Audit Co.

Attachment

Aspire Microfinance Institution
Report to management for the year ended 31 December 2006

Contents

Internal audit function
Cash
Capital
Various issues

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 hiring Big Four Audit Company to conduct its internal auditing.

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 semi-annually.

BANK RECONCILIATIONS

Included in the loan account reconciliation were two checks that were returned for insufficient funds on 29 December 2006 and had not been reversed in the records as of 31 December 2006.

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 telephone receptionist.

Recommendation: Aspire should properly segregate duties among their staff. 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 the Central Bank (Aspire's regulatory authority). 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.

Various issues

UNRECONCILED DIFFERENCES

All the branches had unreconciled differences.

Recommendation: Accounts should be reconciled.

Overheads

THE COMPLETE SET OF OVERHEADS IS IN A SEPARATE POWERPOINT FILE ENTITLED "CGAP OPERATIONAL RISK MANAGEMENT OVERHEADS"

RM7-O1

External Audit

A formal, independent review of an entity's financial statements, records, transactions, and operations that is performed to express an opinion of an MFI's financial statements

Benefits

- **Lends credibility to financial statements and other management reports**
- **Ensures accountability of investors' funds**
- **Identifies weaknesses in internal controls and systems**

The *scope of audits* may differ significantly and cannot be limited, and objectives can be added to each audit.

CGAP

RM7-O2

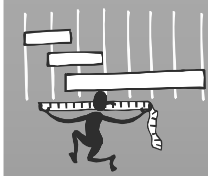
Why have MFI external audits not delivered desired results in the past?

- **Poorly understood audit purpose**
- **Weak information system and internal controls**
- **Minimal compliance with normal standards**
- **Poor credibility of auditors**
- **Management techniques not matched to MFI portfolio risks**
- **Costs**
- **MFI's business not understood**

BUT external audits can and **do deliver!!**

CGAP

RM7-O3



External Audit Planning

1. Appoint a contact person to oversee the audit
2. Determine the scope of work and type of audit
3. Prepare Terms of Reference for the audit
4. Call for proposals
5. Negotiate fees, schedule, and work plan
6. Choose an auditor

Source: CGAP Audit Manual, pp. 20–23.

CGAP

RM7-O4

Terms of Reference includes

- Objective of the audit
- Scope of the audit
- Audit report and financial statements
- Management letter
- Agreed-upon procedures
- General issues
- Timing of the audit
- Cost proposal
- Submission of proposals
- Oral presentation

CGAP

RM7-O5

Desired Audit Output

- Financial statements
- Notes to financial statements
- Unqualified opinions
- Management letter
- Other output as agreed upon

CGAP

Handouts

Audit Information Needs Worksheet

THINK **ANSWER** **DISCUSS**

1. What information would you like to get from an audit of your MFI?
    -
    -
    -
    -
    -
    -

2. Do your audits currently deliver this information?

3. Why do you think audits fail to deliver this information to your MFI?

4. Prioritize the list you generated in question 1. Rank what information you would most like to get, to the least needed.
    -
    -
    -
    -
    -
    -

Terms of Reference Exercise

Instructions: The Terms of Reference (ToR) for MFI XYZ are attached below. Identify 5 items that are omitted or procedurally incorrect in the following sample ToR. Also identify at least 5 items that impress you as important for inclusion in a ToR.

1. Introduction

1.1 The board of directors of MFI XYZ invites your firm to submit technical and financial proposals for audit of MFI XYZ. 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 MFI XYZ. The contract would be for fiscal year 2000.

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

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, MFI XYZ 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. MFI XYZ 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 MFI XYZ was founded in 1985. XYZ has expanded its operations to include 13 branches in 2005, with branches in remote rural areas. Further details about XYZ's operations, including a copy of the previous year's unaudited financial statements, are provided in attachment A.

2.2 XYZ has an audit committee headed by its financial manager. The director of finance will have 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 MFI XYZ's financial statements is to enable the auditor to express a professional opinion on the financial position of MFI XYZ at the end of the three fiscal years [2003, 2004, and 2005) 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), 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 XYZ'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 CGAP Washington, D.C., which covers key issues relevant to the audit of microfinance institutions. MFI XYZ 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 MFI XYZ prepares its financial statements according to local accounting standards. XYZ will provide to the external auditor the following financial statements:

- Income statement
- Balance sheet
- Cash-flow statement

6.2 The financial statements of XYZ will be prepared in conformity with the requirements of attachment B. 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 other information associated with MFI XYZ and deemed necessary by MFI XYZ.

7. Prior-year audits

7.1 MFI XYZ 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 MFI XYZ 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 MFI XYZ'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 nonperforming 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 the CGAP Audit Manual] and submit a separate report.

11. Communications with the financial manager

11.1 The selected auditor will be required to present his or her audit approach and planned audit program to the financial manger before commencing the engagement.

11.2 If external auditors discover any errors, irregularities, or fraudulent acts during their work, they are required to communicate these immediately to the financial manager.

12. Pre-proposal survey

12.1 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.

13. Additional information and proposal structure

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

13.2 *Understanding of the work*. Demonstrate understanding of the MFI industry, MFI XYZ, and the nature of the work.

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

13.4 *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

13.5 *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.
- *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 MFI XYZ. 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.

14. Oral presentation

14.1 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.

15. Fees

15.1 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.

16. Submission and deadlines

16.1 The technical proposal and cost proposal should be submitted to MFI XYZ no later than __________________.

16.2 All proposals and correspondence should be addressed to:

Financial Manager
MFI XYZ
Street address

16.3 Proposals should be mailed or sent by courier.

17. Proposal scoring

17.1 No mathematical weighting will be used in scoring proposals.

Attachment A
Details about MFI XYZ's operations
Copy of previous year's unaudited financial statements

Attachment B
Requirements for content and preparation of financial statements
CGAP disclosure guidelines attached

Attachment C
Agreed-upon procedures
As needed (not included)

Attachment D
Format for the cost proposal

1. Fees Total

Position	Hours	Rate	Cost
Partner			
Senior manager			
Manager			
Senior accountant			
Staff			

2. Expenses Total

Travel
Per diem
Communications
Report production
Other

3. Grand Total

Exercise – Analyze Sample Management Letter and Report

Audit Committee
Aspire MFI
Manila

In planning and performing our audit of the financial statements of the Aspire Microfinance Institution for the year ended 31 December 2006 (on which we have issued our report dated 15 September 2007), 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
Big Four Audit Co.

Attachment

Aspire Microfinance Institution
Report to management for the year ended 31 December 2006

Contents

Internal audit function
Cash
Capital
Various issues

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 hiring Big Four Audit Company to conduct its internal auditing.

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 semi-annually.

BANK RECONCILIATIONS

Included in the loan account reconciliation were two checks that were returned for insufficient funds on 29 December 2006 and had not been reversed in the records as of 31 December 2006.

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 telephone receptionist.

Recommendation: Aspire should properly segregate duties among their staff. 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 the Central Bank (Aspire's regulatory authority). 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.

Various issues

UNRECONCILED DIFFERENCES

All the branches had unreconciled differences.
Recommendation: Accounts should be reconciled.

Improved Management Letter and Report

Audit committee
Aspire MFI
Manila

In planning and performing our audit of the financial statements of the Aspire Microfinance Institution for the year ended 31 December 2006 (on which we have issued our report dated 15 March 2007), 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 2006

Contents:

Internal audit function; Loans; Loan loss provisions; Cash; Capital; Various policies

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 and valuations of accounts by the accounting department should be performed to ensure that provisions and write-offs of loans cannot be manipulated. Loan officers should not be responsible for establishing the provisions.

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 2006 and had not been reversed in the records as of 31 December 2006.

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.

Recommendation: Aspire should present its 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.

Technical Materials – Why haven't MFI external audits delivered the intended results?*

- External audits are not clearly understood by management, board of directors, and donors.
- Information systems and internal controls are weak, which make MFIs difficult to audit.
- No standard set of guidelines is used for MFI financial statements.
- Auditors are preoccupied with minimal compliance with auditing and reporting standards (instead of providing a product that would be valuable to the MFI/client).
- Levels of quality, experience, and credibility of auditors vary.
- MFI portfolio risks and management techniques are different from those of conventional banks, and are not amenable to ordinary audit tests.
- Management and board are antagonistic toward audits.
- Auditors don't always understand the MFI's business.

Types of Audits

Special-Purpose Audit

- Assesses contractual compliance
- Audits financial statement not prepared according to accepted accounting standards
- Audits only specific items
- Audits summarized financial statements

Agreed-Upon Procedures

- Are the only way to get specific information for the MFI
- Can include portfolio testing, MIS evaluation (although an MIS specialist may be a better person to perform this work), internal controls assessment
- May detail tests and results; no opinion expressed in the report. MFI draws its own conclusions. Auditor does not agree to comment on results, only discloses the test results.

Financial Statement Audit

- Assures stakeholders that statements fairly reflect the state of the business
- Provides independent confirmation of its financial information
- Is required by law or regulations
- Examines, on a test basis, evidence supporting amounts and other disclosures in financial statements
- Assesses accounting principles
- Assesses significant estimates made by management
- Evaluates overall presentation of the financial statements

*CGAP Audit Manual, pp. 6, 8–9

CGAP Disclosure Guidelines for Financial Reporting by Microfinance Institutions

Trainer will download current guidelines and photocopy for distribution.

SESSION 8: MITIGATING RISKS – IMPLEMENTING CORRECTIVE CONTROLS AND MOVING FORWARD

Session Summary

OBJECTIVES: By the end of the session participants will be able to:

- Explain corrective controls, give examples, and state their role in risk management
- Explain the dynamic process of risk management
- Summarize the main points of the course

TIME: 105–115 minutes

SUPPLIES: Flipchart paper, markers, masking tape

Session 8: Mitigating Risks – Implementing Corrective Controls and Moving Forward

CORRECTIVE CONTROLS DESCRIBED

1. *(2 minutes)* Introduce this session by referring to the flipchart of the risk management feedback loop from session 2 and point out that the course is nearing the end of the cycle. Ask: What is left to be done? Answer: Corrective controls. Ask participants the purpose of this step and how it fits into the risk management environment.

   Point out that risk management is a dynamic process, and as part of an MFI's control system, corrective actions and continued monitoring are necessary. MFI processes and activities might be open to new vulnerabilities, and management must ensure that old ones have been satisfactorily controlled. The risk management process never ends!

2. *(3 minutes)* Ask participants what *corrective controls* are. Define them as the process in which the MFI acts to remedy its weaknesses. Remind participants that both internal and external audits produce reports, which include noting an MFI's vulnerabilities. In many cases, the results will suggest a need for some changes to policy and procedures, and possibly identify previously unidentified risk exposures.

   Ask: Who is responsible for ensuring that corrections take place? Answer: The general manager and an appropriate manager should design new risk control measures and oversee their implementation. When the internal auditor identifies problems, the person in charge of overseeing that area implements corrective action. If the problem occurs in the accounting function (inadvertent misapplication of debits/credits, late reconciliation, old outstanding items), the accounting manager responds. After the new controls are implemented, the MFI tests their effectiveness and evaluates the results.

PUTTING CORRECTIVE CONTROLS IN PLACE

3. *(5 minutes)* Refer to the discussion in the past two sessions of some ideas how MFIs can ensure that correction takes place. Put all the ideas together now by leading a general review of how to respond to the results of the audit findings. List major points and steps on a flipchart.

   Points to note include putting new people, policies, and procedures in place; identifying a person to be in charge of ensuring that the work gets done; charging the internal audit function with monitoring the actions taken and reporting on its effectiveness; and keeping records of shortcomings and suggested remedies for ease of monitoring.

4. *(5 minutes)* Remind participants of the fraud examples, in which controls were identified to correct those instances. When fraud was committed, a violation occurred. Ask: Do you wait for an external audit before you do something?!

5. *(5–10 minutes)* Ask: Does your MFI have a plan in place so that you can quickly mitigate the damage caused by fraud when it occurs? If so, what does the plan consist of? Ask participants to share experiences of their MFIs. Have them describe what the plan should include. List the actions on a flipchart.

   Stress the importance of acting quickly to correct the situation. Link the discussion to the establishment of core values and an environment that does not tolerate fraud. Also discuss how to carry out the plan; for example, if the plan calls for immediate dismissal of an employee, then this must happen.

6. *(3 minutes)* Ask: How do we know if the corrective action occurred? Note that the corrective action is subsequently tested in future HR, policy, and technology changes; risk identification and control exercises; and future audits. Records should be kept and utilized in the future. The board of directors or the audit committee (or both) should take responsibility for ensuring follow-through, thus beginning the loop all over again.

7. *(5 minutes)* Ask if participants have any questions on correction and corrective controls and discuss the answers.

COURSE SUMMARY EXERCISE

8. *(5 minutes)* Tell participants that it is time to review the entire risk management feedback loop, since the process is back at the beginning. Divide the group into six smaller groups and tell them they will have 25 minutes to review the course, discuss, and list the main messages of each topic. They should present main points with new examples and explain how it links to other topics.

9. *(25–35 minutes)* As groups gather to prepare their summary, remind them that they should highlight people and fraud as themes in their examples.

   > *Trainers may use other participatory methods to review the risk management feedback loop. For example, subgroups can develop questions and a quiz-like game can follow.*

10. *(5–10 minutes)* Assign each group one session to present to the large group. Give them 5 minutes to prepare.

11. *(45 minutes)* Facilitate the subgroups' presentations of their summaries, encouraging participants to add any missing points.

12. *(5 minutes)* Take any final questions. Bridge to the final session by telling participants that the last step is to redraft the action plan—putting the pieces into a full plan.

SESSION 9: ACTION PLAN, EVALUATION, AND CLOSURE

Session Summary

OBJECTIVES: By the end of the session participants will be able to:

- Plan for risk management in their MFIs
- Complete the Postcourse Skills Audit
- Complete course evaluation forms

TIME: 45–60 minutes *(Trainer will adjust time depending on the timing of the earlier sessions.)*

SUPPLIES: LED projector or overhead projector
Goal (RM1-O1) } *(Optional background)*

PARTICIPANT MATERIALS

HANDOUTS: RM9-H1 Action Plan
RM9-H2 Operational Risk Management Postcourse Skills Audit
RM9-H3 Operational Risk Management Course Evaluation Form – Sample

Session 9: Action Plan, Evaluation, and Closure

ACTION PLAN

1. *(2 minutes)* Remind participants that they have covered a lot of ground in the past three days. But all that learning will go to waste if they cannot plan *how* they will begin managing risks in their own MFIs. This final session will begin that process.

2. *(15 minutes)* Distribute RM9-H1 and ask participants to complete the action plan.

3. *(5–10 minutes)* Ask participants to share the one thing they will try to implement first when they return to their MFI. Give participants some words of encouragement to go home with!

EVALUATION

4. *(10–15 minutes)* Remind participants that they have completed the course and convey your hopes that they have met their goals for this training. To check how effective the training has been, ask them to take 5 minutes to complete the Postcourse Skills Audit. Hand out RM9-H2 and note that it is the same as the Precourse Skills Audit they completed at the beginning of the course. Mention that you hope they will be encouraged by seeing how much better they can answer the questions!

5. *(15 minutes)* Ask participants to evaluate the course using the Course Evaluation form (RM9-H3). Encourage the participants to be objective in completing the evaluation form, since their input will be used to improve the course. Distribute the forms for participants to complete while still in the room.

   Collect the completed evaluation forms.

CONCLUDING REMARKS

Make closing remarks.

Issue participation certificates to the participants, if desired.

Official close of the workshop.

Handouts

Action Plan

The course has presented a step-by-step approach to risk management. Think through the steps and consider how they will be applied to your MFI. Focus on the obstacles and on ideas to overcome those obstacles.

CORE VALUES – MISSION, VALUES, PEOPLE

Points of most interest or need to my MFI:

Anticipated obstacles:

Ideas to overcome the obstacles:

PILLARS OF PREVENTION – HUMAN RESOURCES, POLICIES AND PROCEDURES, TOOLS AND TECHNOLOGY

Points of most interest or need to my MFI:

Anticipated obstacles:

Ideas to overcome the obstacles:

CYCLE APPROACH TO RISK IDENTIFICATION AND CONTROLS

Points of most interest or need to my MFI:

Anticipated obstacles:

Ideas to overcome the obstacles:

INTERNAL AUDIT FUNCTION

Points of most interest or need to my MFI:

Anticipated obstacles:

Ideas to overcome the obstacles:

EXTERNAL AUDIT

Points of most interest or need to my MFI: Anticipated obstacles: Ideas to overcome the obstacles:

Any other issues or ideas not to be forgotten!

Operational Risk Management Postcourse Skills Audit

Name: ______________________________

1. What is the most important way to prevent risk? How does an MFI do that?

2. Describe the relationship among the components of the risk management environment.

3. Name and explain the steps of the risk management feedback loop.

4. How can fraud be prevented, detected, and corrected?

5. What are the pillars of prevention? What does this mean?

6. What are the business cycles of an MFI? How are they used in risk management?

7. Explain the function of internal audit. What are the keys to making it successful?

8. How can you make an external audit work for you?

9. What is the most significant thing that you learned during this course? Why?

Operational Risk Management
Course Evaluation Form – Sample

[Use similar design, as appropriate to your needs and market]

Please rate and comment on the following:
1 = Poor   2 = Fair   3 = Average   4 = Good   5 = Excellent

Overall Course	1	2	3	4	5
Comments:					
Length of Course	1	2	3	4	5
Comments:					
Course Content	1	2	3	4	5
Comments:					
Course Methods	1	2	3	4	5
Comments:					
Course Materials	1	2	3	4	5
Comments:					
Trainer Name ____________________________________	1	2	3	4	5
Comments:					
Trainer Name ____________________________________	1	2	3	4	5
Comments:					
Course Organization	1	2	3	4	5
Comments:					
Precourse Organization, Communication, Advertising	1	2	3	4	5
Comments:					
Facilities	1	2	3	4	5
Comments:					

1. What I learned most from this course was:

2. What I still need to learn more about is:

3. I will apply the following in my organization:

4. I will have difficulty applying the following to my organization:

5. My overall feeling about the course is:

6. The course might have been more effective if:

7. Any other comments (please use another page if necessary):