Financial Services
Working Group

Pocket Guide

to the Internal Audit Activity Guide for Boards of Directors of Microfinance Institutions

guide

seep
Powering connections

November 2011

Acknowledgements

This document is a condensed version of the Internal Audit Activity Guide for Board of Directors of Microfinance Institutions, produced by the Financial Services Working Group at the SEEP Network in 2010.

SEEP's would like to thank Ruth Dueck- Mbeba and Herminia Rubio-Gutierrez (CARE) for their time an effort in finalizing the content of this pocket guide. SEEP would also like to acknowledge the contributions and input of the Financial Services Working Group members who reviewed the pocket guide and provided critical feedback.

The SEEP Network

1875 Connecticut Avenue, NW, Suite 414

Washington, DC 20009

(tel) 202.534.1400   (fax) 202.534.1433

www.seepnetwork.org

Contents

Boxes, Figures and Tables

Internal Audit: What is it?

The internal audit function is an independent, objective assurance and consulting activity designed to add value and improve the efficiency and security of an MFI's operations. It helps an MFI improve its operations by bringing a systemic, disciplined approach to evaluating and improving its operations and control process. The Institute of Internal Auditors (IIA), an international professional association of more than 12,000 members, defines internal auditing as "…independent, objective assurance and consulting services 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 governance, risk management, and control processes." [1]

The internal audit function is **systematic** in that the work follows predesigned plans and programs. It is **independent** in that the work is performed independently of both management and operations. The work of an internal audit department is characterized by the following elements:

- a direct reporting line to the board of directors, ideally through an audit committee;
- an internal audit charter or policy approved by the board, establishing the auditor's authority, scope, and mandate;
- appropriate communication with the executive director;
- recognized standards of conduct, practice, and ethics by qualified internal audit professionals such as The Institute of Internal Auditors where possible;
- strategic long-term and short-term plans, operational work plans, and schedules;
- a sufficient dedicated budget to cover operational costs such as travel, equipment, and audit software tools and training; and
- a separate and secure workspace that allows for sufficient confidentiality.

Internal Audit Policy of an MFI Board

Current best practices for the governance of both commercial and nonprofit microfinance institutions (i.e., MFIs that are nongovernmental organizations, or NGOs) specify that the board of directors should have an internal audit policy in place. To achieve this goal, most boards of regulated MFIs and banks develop and operate within the framework of an internal audit charter.

Internal Audit Charter

According to The IIA, "The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal au-

[1] IIA, 2009, International Standards for the Professional Practice of Internal Auditing (Standards), Revised October 2008 (Altamonte Gardens, Florida: IIA), http://www.theiia.org/guidance/standards-and-guidance/ippf/standards/?search=iNTERNATIONAL%20STANDARDS, 18 (Accessed October 2009).

dit charter establishes the internal audit activity's position within the organization; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities."

As a document that is developed and approved by the board of directors, the internal audit charter places the role and responsibility of the internal audit function squarely within the scope of board management. The charter also clearly identifies the role of both the internal audit department and the board audit committee in the risk management process.[2]

Internal Audit Objectives

Internal auditing services may be classified into three categories that correspond to the three broad objectives of internal control: financial, compliance, and operational control.

Box 1. The Three IIA Categories of Internal Auditing Services

The Institute of Internal Auditors (IIA) specifies that:

"**Financial auditing** looks at the past to determine whether financial information was properly recorded and adequately supported. It also assesses whether financial statements reporting on past performance are fair, accurate, and reliable.

Compliance auditing looks at the past, but also examines the present, asking such questions as:

- Have we adhered to laws and regulations?
- Are we currently complying with legal and regulatory requirements?
- What are our organization's corporate standards of business conduct?
- Do all members of our staff and management team consistently comply with internal policies and procedures?

Operational auditing focuses on the here and now, with a clear perspective on possibilities for the future. It is closely aligned with the organization's mission, vision, and objectives. It also evaluates the effectiveness (ensuring the right things are done), efficiency (ensuring things are done the right way), and economy (ensuring cost-effectiveness) of operations. This mindset includes such areas as product quality, customer service, revenue maximization, expense minimization, fraud prevention, asset safeguarding, corporate social responsibility and citizenship, streamlined workflows, safety, and planning for the future. With an eye on the horizon, it concentrates on what's working and what's not, and the many opportunities for improvement tomorrow and beyond."

Source: "Tone at the Top," 2006, Institute of Internal Auditors Research Foundation, Altamonte Springs, Florida.

[2] IIA, 2009, International Standards, 16.

Figure 1. The Role of Internal Controls and Internal Audits in Risk Management

Source: Adapted from Anita Campion, 2000, "Improving Internal Control: A Practical Guide for Microfinance Institutions," Technical Guide No. 1, MicroFinance Network and GTZ, Washington, DC.

Internal Audit: What the function cannot do!

The internal audit function cannot detect every error or breakdown in internal controls. It cannot prevent ALL fraud or errors in an organization. No matter how well-designed and implemented an internal control system may be, it can only provide **reasonable assurance** of the achievement of an organization's objectives. The likelihood of achievement is still affected by the limitations of all internal control systems. These limitations include the following factors:

- the realities that human judgment can be faulty and that breakdowns can occur due to simple human error;
- controls can be circumvented by the collusion of two or more people;
- controls can be circumvented by the ability of management to override the internal control system; and
- controls can be limited by the need to consider the relative costs and benefits of controls.

These limitations of an internal control system result in what is known as residual risk.

Table 1. The Role of the Internal Audit vs. the Role of Board and Management

Function	Role of Internal Audit	Role of Board and Management
Risk Management Risk management involves identifying, measuring, limiting, monitoring, and adjusting risk levels, as necessary, in order to protect an MFI from expected and unexpected losses.[3]	Internal auditors can provide advice and support to an MFI in implementing a risk management strategy without impairing the independence of the audit function. They can: • give assurance on the risk management process; • give assurance that risks are correctly evaluated • evaluate risk management processes • evaluate the reporting of key risks and • review the management of key risks.[4] However, to remain independent and objective, internal auditors CANNOT become engaged in risk management directly!	Risk management is the responsibility of the board and management through risk committees, policies and chief risk officers. It is their role to: • set risk appetite; • impose risk management processes; • provide management assurance on risks; • make decisions on risk responses; • implement risk responses on management's behalf; or • accept accountability for risk management.[5]
Internal Controls These are broadly defined as a process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations.[6]	Internal auditors test the effectiveness of internal controls, evaluate internal controls, and advise management on improvement and strengthening of internal controls. However, to remain independent and objective, the development, compliance and management of internal control procedures is NOT the domain of internal audit.	Management is responsible for the development, management and implementation of internal control systems and procedures. Internal audit may comment or advise, but not take any managerial responsibility in internal control systems. This is management's role.

[3]The authors would like to acknowledge Howard Brady for his contributions to this section of the Guide.
[4]COSO, n.d., "FAQs for COSO's Enterprise Risk Management—Integrated Framework," Institute of Internal Auditors, Altamonte Springs, Florida, http://www.coso.org/erm-faqs.htm (accessed March 2009).
[5]Ibid.
[6]Committee of Sponsoring Organizations of the Treadway Commission (COSO), "Internal Control—Integrated Framework," 1992, COSO, Altamonte Springs, Florida, 3.

Function	Role of Internal Audit	Role of Board and Management
Compliance	It is not the internal audit's role to enforce or ensure compliance, only to test for compliance.	It is management's role to ensure that there is institutional (all staff and management) compliance to policies, risk mitigation strategies, regulations, and internal control procedures.
External Audit The external audit is an activity performed by a professional organization, contracted by the board of directors to express an independent and objective opinion on the fairness and reliability of the financial statements at a particular point in time and for a particular period of time.	The internal auditor is often appointed as the key contact for the external auditor's work and coordination in the organization. The external auditor will generally review the work, scope, results, and impact of the internal audit function in their evaluation and assessment of internal controls. This may affect the external audit plan and levels of materiality.	It is the board's role to appoint the external auditor after evaluation of quotations to the board's request for proposals.

The Internal Audit: Who does it?

Professional Audit Personnel

A **chief internal auditor** generally leads the internal audit function and should have the following professional qualifications:

- university-level degree in accounting and auditing;
- banking, accounting, or professional auditing experience;
- (current) professional accounting or auditing qualifications; and
- membership (in good standing) and/or ties with recognized professional associations in accounting and auditing.

The **chief internal auditor**'s managerial role in the department generally includes:

- ensuring that a strategic internal audit plan for the MFI is devised and implemented via annual plans;
- ensuring that financial and human resources are allocated for effective implementation of the annual audit plan;
- ensuring that audit planning, fieldwork, reporting, and follow-up are performed in accordance with the standards of The IIA and IFAC;[7]
- maintaining and updating the internal audit manual as necessary, including conducting regular reviews of audit programs;

[7]International Federation of Automatic Control (IFAC) is a multinational federation of member nations that develops and advocates for global accountancy standards and best practices.

- drafting the annual audit report;
- managing the department, including ensuring that it has sufficient and adequately trained human resources;
- coordinating with external auditors in order to avoid duplication of audit efforts and reduce MFI audit fees. Usually, audit plans are shared. Internal audit working papers would thus be reviewed by external auditors, who should hold periodic meetings with the internal audit department to keep it well informed of external audit work; and
- perform internal auditing themselves, except for the largest internal audit departments.

Practical experience as an external or internal auditor—especially in other MFIs, internationally recognized accounting firms, auditing firms, or banks—is desirable for internal auditors and strongly recommended for a chief internal auditor.

Internal audit staff should have training and/or have completed a progression within a recognized accounting or auditing program. Qualified candidates from within an MFI can be hired for the internal audit department or recruited from outside the organization. Personal characteristics and skills of internal audit team members should include:

- demonstration of ethics and integrity in the performance of duties, as well as being perceived as ethical;
- a work and personal history free of fraud, misrepresentation, abuse of office, or other illegal activity;
- organized and attentive to details;
- good judgment—knowing what is important and using discretion wisely;
- excellent written and verbal communication skills;
- trustworthy and respected—people who will do the right thing and maintain confidentiality;
- a pleasant personality and temperament, making them easy to work with;
- objective and principled thinkers who are also creative and independent—people who can draw sound conclusions and form relevant recommendations; and
- demonstration of a commitment to ongoing training and personal professional development. The continuing education of internal audit staff is vital for ensuring efficient and effective audits, complete with recommendations that enhance the overall operations of an MFI.

The chief internal auditor must also have strong leadership and management skills, as well as a demonstrated ability to organize, train, and supervise staff. Also essential for a chief internal auditor is the ability and credibility to communicate—both verbally and in writing—with board members, the audit committee, external auditors, donors and funders, representatives of international ratings companies, investors (both local and foreign), and other professionals.

Code of Ethics

Internal auditors are expected to apply and uphold the principles shown in Box 2. The board audit committee is also expected to adhere to the same ethical and professional standards of conduct.

The complete **Code of Ethics of The Institute of Internal Auditors** can be found at The IIA's website at http://www.theiia.org/guidance/standards-and-guidance/ippf/code-of-ethics/english.

Objectivity is defined as an unbiased mental attitude of internal auditors toward their work engagements, an honest belief in their work product, and a commitment not to make significant quality compromises. Objectivity requires internal auditors not to bow to pressure and subordinate their judgment on audit matters to that of others.

According to The IIA, the internal auditor's basic rules of conduct are summarized in the quality of integrity. Internal auditors shall:

- perform their work with honesty, diligence, and responsibility;
- observe the law and make disclosures expected by the law and the profession;
- not knowingly be a party to any illegal activity or engage in acts that are discreditable to the profession of internal auditing or to the organization;

Box 2. IIA Code of Ethics for Internal Auditing: The Principles

Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process under examination. Internal auditors make a balanced assessment of all relevant circumstances and are not unduly influenced by others' or their own interests in forming judgments.

Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

Competency

Internal auditors apply the knowledge, skills, and experience needed to perform internal auditing services.

Source: IIA, 2009, "Code of Ethics of the Institute of Internal Auditors," IIA, Altamonte Gardens, Florida.

and

- respect and contribute to the legitimate and ethical objectives of the organization.[8]

The IIA further notes:

> Impairments to organizational independence and individual objectivity may include personal conflicts of interest, scope limitations, restrictions on access to records, personnel, and properties, and resource limitations (funding).
>
> Conflict of interest refers to any relationship that is or appears to be not in the best interest of the organization. A conflict of interest would prejudice an individual's ability to perform his or her duties and responsibilities objectively.[9]

Internal Audit: What is the role of the board?

The board of directors bears the final responsibility for and accepts the risks of an MFI—its operations, mission, and financial management, especially when an MFI is not regulated. Through the internal audit committee or risk management committee, the board has a high level of involvement in an MFI's financial and risk management. As a result, the MFI depends on its board to establish and implement adequate fiscal policies and a risk management framework, which senior managers are then responsible for implementing. The work and function of the internal audit professionals is to monitor and communicate the effectiveness of the board-approved risk management framework, the degree to which risks are reduced, and which organizational objectives are being met.

It is important to select a board representative who, in serving as the chair of the internal audit committee or risk management committee, can ensure that the internal audit department is appropriately staffed and adequately budgeted. For this task, the institution should choose an engaged board member who is comfortable becoming involved in the details of operations, as well as conversant with the big-picture aspect of the internal audit function, such as the strategic direction of MFI management. It is preferable to select, if possible, a board member who has a background in accounting and financial management. He/she should have sufficient free time to occasionally shadow the internal auditor to better understand the audit process, be willing to learn, and fully understand and accept the internal audit responsibility of the board of directors.

Board Responsibilities

The board chiefly addresses its internal audit responsibilities through the board audit committee described in section 6 of the *Internal Audit Activity Guide for Boards of Directors of Microfinance Institutions.*[10] The key responsibilities of the board in the oversight of internal audit activities are to:

1. Confirm and ensure the independence of the internal auditor; specifically:
    - establish corporate policies that outline the board's responsibilities with respect to risk, risk management, risk tolerance, and internal audit;

[8] IIA, 2009, "Code of Ethics."
[9] IIA, 2009, International Standards, 16 and 17.
[10] SEEP, 2010, Internal Audit Activity Guide for Boards of Directors of Microfinance Institutions

- review the annual plan, budget, audit scope, and procedural plans of the internal auditor;
- receive internal audit reports complete with management responses, and resolve agreed actions for management implementation;
- coordinate both internal and external audits to ensure that risk coverage is complete and reduces redundancy, and that resources are used effectively;
- authorize internal investigations or special reviews, as required;
- review with the internal auditor the adequacy of the MFI's internal controls, including:
  - computerized information system controls and security;
  - any significant findings of an internal audit, together with management's responses; and
  - any serious difficulties or disputes encountered with MFI managers while performing the audit function (including any restrictions placed on the internal auditor during the course of his or her work);
- conduct an annual review of the internal audit function; and
- together with senior management, conduct a performance review of the chief internal auditor.

2. Coordinate with both the internal auditor and MFI management to determine a rolling audit plan
3. Ascertain key areas of risk within the MFI, which may include but are not limited to, credit operations; financial operations; liquidity and interest rate risk; institutional reputation; human resources; organizational culture; information technology and computer systems; compliance with MFI regulations, rules, procedures, and corporate conduct guidelines; and ethics and fraud.

MFIs should have corporate policies that outline the board's responsibilities with respect to risk, risk management, risk tolerance, and internal audit.

The Internal Audit: Where do I start?

The *Microfinance Internal Audit Toolkit and Resources* at www.seepnetwork.org provides detailed steps and resources to help MFIs establish and implement an internal audit function.

- Board buy-in, mandate, and assigned committee and responsibilities (refer to the resources at www.seepnetwork.org). This includes the establishment of an internal audit charter
- Appointment of a professional Internal Auditor with a clear job description, scope of work, adequate budget and workplans
- Risk assessment of the entire institution
- Development of detailed risk-based internal audit workplans

The *Internal Audit Toolkit* provides an overview of best practices for a well-functioning internal audit department in an MFI. It focuses on operational risks, rather than external risks (e.g., those related to regulation, competition, and the environment) or financial risks (e.g., those related to interest rates, foreign exchange rates, and liquidity). The toolkit assumes that an MFI's board and governing bodies lead the risk management agenda of the MFI and effectively hold management accountable for the implementation of risk mitigation strategies.

This toolkit and its annexes are designed for application and use by the internal audit managers and staff of an MFI. They are intended to support the mission and objectives of an MFI; produce reliable financial statements; minimize operational risks; and prevent fraud, error, and inefficiencies. As with all tools and templates, the resources offered in this toolkit must be reviewed and customized to meet the specific needs and requirements of a given MFI.

This toolkit does not address in great depth the board governance issues that are fundamental to good internal audit practices. Furthermore, the toolkit does not attempt to "create" professional internal auditors—MFIs need to ensure that they hire trained, qualified, and capable staff for the work of an internal audit department. Rather, the toolkit aims to provide practical resources for internal auditors. In order to understand local standards, regulatory requirements, and the ever-changing norms of internal audits, MFIs are advised to investigate professional accounting and auditing bodies in their countries of operation, as well as their central banks, the international public domain of professional accounting and auditing bodies (through the websites cited in the toolkit's bibliography), as well as local and regional training institutions.

The Board Audit Committee: Where do I start?

MFI boards structure committee responsibilities in different ways. In some institutions, risk and compliance committees are established to address all matters related to risk, risk management, and compliance with risk-mitigating controls. In other institutions, the board creates an audit committee, or establishes a committee that addresses both risk and internal audit. Some MFIs establish a finance and audit committee which, handles budget, asset management, investment, and other banking issues in addition to overseeing the internal and external audit functions.

Regardless of the structure created by the board of directors, the primary function of a board audit committee is to assist the board in fulfilling its oversight responsibilities relative to the MFI's financial, operational, and compliance processes and controls. The purpose, scope, authority, and responsibilities of the audit committee are generally laid out in an internal audit committee charter. This board-approved document forms the foundation of the committee's work.

The board audit committee fulfills its responsibilities primarily through:

- supervision of MFI executive managers in their management of the MFI financial reporting process, accounting systems, and financial and internal controls;

- supervision of the MFI's annual external audit process;
- monitoring the performance of the MFI's internal audit function;
- monitoring the independence and performance of the MFI's external auditors;
- monitoring the MFI's compliance with relevant laws and regulations;
- supervision of the MFI executive managers in monitoring compliance with the MFI code of ethics and any consumer protection policies; and
- providing a channel for communication among external auditors, executive management, and the board.

Composition of committee

The audit committee should consist of at least three board members who are independent of management and the MFI. Each member should satisfy the requirements of independence, experience, and financial expertise. These members must be "financially literate" and, at a minimum, one must be designated as its "financial expert." Many institutions also appoint independent committee members who do not hold a board position, but meet the necessary skill requirements of the audit committee. The committee should also establish a continuing education program for its members.

Main Powers and Responsibilities

- Conduct or authorize investigations into any matter within its scope of responsibilities.
- Gain unrestricted access to MFI personnel and documents.
- Engage independent legal counsel, accountants, or other professionals, as deemed appropriate, to discharge its responsibilities.
- Review and assess, at least annually, its mandate, responsibilities, and performance, and report and make recommended changes to the board of directors for its approval.
- Meet at least annually with executive management, the chief internal auditor, and external auditors in separate executive sessions to discuss any matters that the committee or any of these groups believes should be discussed.
- Establish procedures for the receipt, retention, and treatment of complaints received by the MFI concerning accounting, internal controls, or auditing matters.
- Establish procedures for the reception and treatment of confidential, anonymous submissions by employees regarding questionable accounting or auditing matters, or other complaints of management wrongdoing reported pursuant to the MFI's code of conduct.

The Board Audit Committee: Checks for Effectiveness and Challenges

There are no established comprehensive guidelines for assessing the performance of an audit committee. For this reason, it falls to the members of the committee and the board to devise a process that is appropriate for a given MFI. It is suggested that when appropriate, this process should be carried out in consultation with legal counsel. Recommendations for best practices for evaluating the committee's performance include:

- The board and audit committee will likely find that some combination of the board's governance committee (or the entire board), the chief internal auditor, and/or executive management is appropriate to lead the performance evaluation.
- Informal feedback should be solicited from the board, general manager, CFO, compliance officer, and the chief internal and external auditors on specific suggestions to improve audit committee effectiveness.
- The party leading the evaluation should develop a plan for identifying and addressing opportunities to improve the committee's effectiveness.
- A self-assessment survey should be completed, and/or individual interviews should be conducted with each member of the audit committee, followed by a review of the results with the full board, MFI executive management, and the chief internal and external auditors.
- The party leading the performance assessment process should identify the external individuals who have interacted most frequently with the audit committee over the past year and solicit their feedback to provide a well-rounded view of its performance.
- Have the audit committee chairperson assess the contributions and performance of individual audit committee members for review by the board chairperson and general manager of the MFI.

Regardless of how closely an MFI tries to follow best practices and standards for an effective board audit committee, there are limitations, challenges, and barriers to its effectiveness. Addressing these challenges is a process that takes time, but it is necessary if the internal audit function is to work optimally.

Challenges to the establishment of an effective board audit committee include:

- Lack of skilled audit committee members;
- Vague or non-existent regulations, laws, or legal counsel;
- Limited risk management strategies; and
- Weak external auditor skills
- Lack of risk culture

Tools and Resources

The *Internal Audit Activity Guide for Boards of Directors* of Microfinance Institutions is available at www.seepnetwork.org, and provides a comprehensive overview, tools, and resources to implement a board audit committee function that takes responsibility for leadership and management of internal audit in an organization. The samples, tools, and checklists at right are included.

The *Microfinance Internal Audit Toolkit and Resources* is also available at www.seepnetwork.org and provides a thorough, step-by-step guide to setting up and implementing the internal audit function in an MFI.

Table 2. Tools in the *Internal Audit Activity Guide for Boards of Directors of Microfinance Institutions*

Function	Role of Internal Audit
Annex A	Sample Board Risk Management Questionnaire
Annex B	Sample Board Risk Management Policy
Annex C	Sample Board Risk Assessment Tools
Annex D	Sample MFI Internal Audit Charter
Annex E	Sample MFI Internal Audit Committee Charter
Annex F	Sample Skills and Characteristics Required of Board Directors
Annex G	Sample Board and Audit Code of Ethics
Annex H	Sample Audit Committee Calendar
Annex I	Sample Internal Audit Reports
Annex J	Sample Internal Audit Monitoring Reports
Annex K	Evaluating the External Auditor Quotes
Annex L	Sample Conflict of Interest Policy and Certificate
Annex M	Sample Conflict Resolution Process
Annex N	Audit Committee Self-Assessment Tool and Process

The SEEP Network
1875 Connecticut Avenue, NW, Suite 414
Washington, DC USA 20009-5721
Phone: +1 202 534 1400
Fax: +1 202 534 1433
Email: info@seepnetwork.org
Website : www.seepnetwork.org