Internal Audit Activity Guide

for Boards of Directors of Microfinance Institutions

toolkit

Produced by the Financial Services Working Group
at the SEEP Network

SEEP
Powering connections

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Internal Audit Activity Guide for Boards of Directors of Microfinance Institutions

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Acknowledgments

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International standards of and current approaches to the practice of internal auditing have been drawn from the Institute of Internal Auditors (www.theiia.org), which is considered the international standards organization for internal audits..

Resources such as this guide are never "final," as new professional internal audit standards continue to be developed in response to changing risks. Further, the samples and tools contained herein need to be edited and revised to suit the specific situation of each institution and its context. Feedback and comments are welcome in order to help continually improve and update this guide and its annexes.

This guide is available online without charge at The SEEP Network website, www.seepnetwork.org.

Section 1: Introduction

The *Internal Audit Activity Guide for Boards of Directors of Microfinance Institutions* provides an overview of the roles and responsibilities of the board of directors with respect to an institution's internal audit process. This publication has been developed specifically for microfinance institution (MFI) board directors and Internal Audit Committee members. It offers practical way guidance on how the Board Audit Committee can fulfill its fiduciary and governance responsibilities. The tools and systems explored in this Guide are a means to institutionalize the internal audit function of an MFI board so that it is not dependent on the general manager or other key board members to drive this process. MFI managers and owners (including international NGOs and networks that own or operate MFIs) can also benefit from the use of these materials.

Scope

Rather than provide too much detail on policies and procedures, this Guide provides a general overview of best practices for establishing the internal audit function, together with user-friendly templates and sample documents that can be easily adapted for use by a specific MFI. The resources used to develop the guide are drawn from a number of sources, including The SEEP Network, the International Finance Corporation, the Consultative Group to Assist the Poor, MicroSave, Deloitte Touche, the Mennonite Economic Development Association, ACDI/VOCA, the Institute of Internal Auditors, and trainer-of-trainer materials provided by Howard Brady, among others. The companion document to this Guide, *The Microfinance Internal Audit Toolkit*, provides detailed tools and guidance for implementing the internal audit function within an MFI.[1]

The present Guide begins with a brief overview of risk management, which focuses on the role of the internal audit function in operational risk management. Tactical guidance is offered for the Internal Audit Department, as well as for the Board Audit Committee. This guidance follows both MFI industry best practices that have been established over the last several years and best practices from other segments of the financial industry.

Basic Assumptions

Several underlying assumptions in this Guide directly affect the internal audit function: (a) a given MFI has a well-functioning board of directors; (b) the MFI has an internal audit process in place (with staff who perform duties related to the internal audit), but does not necessarily have a full-time internal auditor or a separate Board Internal Audit Committee; and (c) the board may not have appointed board members to serve on a Board Audit Committee.

[1] The toolkit can be downloaded free of charge from the SEEP Web site: www.seepnetwork.org.

Checklist:

- Does my MFI board understand its responsibilities with respect to risk management and the internal audit function?
- Does my MFI have an internal audit department or activity? Do we know how to go about setting one up?
- Does my MFI have an Audit Committee that oversees the internal audit function?

Section 2: Risk Management for MFIs

Types of Risk

Risk management involves identifying, measuring, limiting, monitoring, and adjusting risk levels, as necessary, in order to protect an MFI from expected and unexpected losses.[2] These risks can be distinguished into a number of categories that usually include:[3]

1. Credit risk
2. Liquidity risk
3. Operational risk
4. Compliance and/or legal risk
5. Reputational risk
6. Strategic risk
7. Market risk (includes interest rate risk)
8. Governance risk
9. People risk
10. Insurance risk (if relevant)

1. ***Credit risk*** – Credit risk is the result of an obligor's failure to meet the terms of his or her contract with an MFI or otherwise perform as agreed. Credit risk arises any time an MFI's funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements.

2. ***Liquidity risk*** – Liquidity risk refers to an MFI's ability to meet its obligations when they come due without incurring unacceptable losses. The ability to manage unplanned decreases or changes in funding affects liquidity risk. Liquidity risk is also affected by an MFI's ability to recognize and address changes in market conditions that affect its ability to liquidate assets quickly with minimal loss of value.

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[2] The authors would like to acknowledge Howard Brady for his contributions to this section of the *Guide*.
[3] For more on these risk categories, please see appendix B.

3. ***Operational (or transactional) risk*** – This risk arises from problems associated with service or product delivery. Such risk is inherent in all MFI products and services and arises on a daily basis as transactions are processed. All products and divisions of an MFI are affected by transaction risk. Controlling this risk is a function of internal controls, information systems, employee integrity, and operating processes.

4. ***Compliance and/or legal risk*** – Compliance risk refers to the risk to earnings or capital arising from violations or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk exposes an MFI to fines, civil money penalties, payment of damages, and/or the voiding of contracts. It can lead to a diminished reputation, reduced franchise value, reduced business opportunities, lessened expansion potential, and lack of contract enforceability.

5. ***Reputational risk*** – Reputational risk refers to the risk to an MFI's capital or earnings arising from negative public opinion. Reputational risk is inherent in all MFI activities. It can affect the institution's ability to attract new clients, retain existing clients, to establish new relationships or services, as well as its ability to continue serving existing relationships. An abundance of caution is needed in dealing with MFI customers and the local community in order to preserve the institution's reputation.

6. ***Strategic risk*** – Strategic risk arises from adverse business decisions or improper implementation of business decisions. This risk is a function of the compatibility between an MFI's strategic goals, its business strategies, the resources that it uses to meet its strategic goals, and the quality of implementation of these goals. Strategic risk incorporates how management analyzes external factors that affect the strategic direction of an MFI.

7. ***Market risk*** – Market risk is the risk engendered by movements in markets that can reduce net income or the value of portfolios, such as changes in the value of foreign exchange, commodity prices, interest rates, credit spreads, or equity prices. Market risk includes *interest rate risk*, which relates to the value of institutional assets in today's interest rate environment, as well as the sensitivity of that value to changes in interest rates. "Repricing" risk, basis risk, yield curve risk, and options risk are all types of interest rate risk that should be considered. Interest rate risk considerations should also include the effect of a change in interest rates on both the institution's accrual earnings and the market value of portfolio equity.

8. ***Governance risk*** – Governance risk is the failure of the framework of rules and practices instituted by an MFI's board of directors to ensure accountability, fairness, and transparency in an MFI's relationship with all stakeholders (i.e., clients, management, employees, donors, bankers, government, and the local community).

9. ***People risk*** – People risk refers to the shortage of adequately qualified people needed to manage MFI business at the board, management, and staff levels.

10. ***Insurance risk*** – Insurance risk is the non-financial risk transferred from the holder of an insurance contract to the issuer of the contract.

This guide will focus on operational risk management, with an emphasis on internal controls and financial and operational reporting. (Please see the following sections for a fuller discussion of the difference between internal controls and the internal audit function.)

Requirements for effective risk management[4] include a clearly stated mission and core institutional values, a supportive work environment, motivated and confident staff, accountability and transparency, sound internal controls, a robust methodology, good portfolio performance, and overall operational efficiency.

Elements of an MFI's internal control structure are its management philosophy and operating style, organizational structure, a functional Board Audit Committee, methods to communicate the assignment of authority and responsibility, management control methods, an internal audit function, and personnel policies and procedures.

The ***goals of the internal control process*** are to provide reliable data, safeguard assets and records, promote operational efficiency, encourage adherence to prescribed policies and procedures, and comply with local legislation and laws in order to achieve organizational objectives.

Control procedures that should be put in place within an MFI include adequate segregation of duties, proper authorization procedures, adequate documentation and records, physical control of assets and records, and independent checks on performance.

The board, together with senior management, is responsible for setting acceptable risk appetite in relation to an MFI's risk capacity.[5] This includes setting a buffer between its risk capacity and risk appetite. These limits help the internal auditor plan and implement her or her responsibilities, as well as set guidelines for reporting non-compliance and unmitigated risks.

The Internal Control and Internal Audit Functions

Scope of internal audit function: To accomplish its mission, the internal audit function should have full, unrestricted access to all MFI activities, records, property, and employees. It is responsible for the confidentiality of all information received.

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[4] From SEEP FSWG, 2007, "MFI Internal Audit: Ignore at your own Risk!", presentation at the SEEP Annual Conference, October 2007.

[5] Risk appetite is defined by the International Institute of Finance's "Reform in the Financial Services Industry: Strengthening Practices for a More Stable System" (2009, p.AII.2) as "the amount and type of risk that a company is able and willing to accept in pursuit of its business objectives." Risk capacity is defined as "the maximum amount of risk a firm is able to or could reasonably assume it is able to take on given its capital base, liquidity, borrowing capacity, and regulatory constraints."

Periodic audits are undertaken on a regular basis, with their frequency determined by the risk profile of the MFI. These audits are part of the annual plan submitted by the internal audit department to the Audit Committee.

Various *types of audits* are performed by the internal audit department or function:

- financial audits assess the reliability of the accounting system, data, and financial reports;
- compliance audits assess the quality and appropriateness of the system established to ensure MFI compliance with relevant laws, regulations, policies, and procedures;
- operational audits assess the quality and appropriateness of operational systems and procedures, analyze the MFI's organizational structures with a critical mind, and evaluate the adequacy of operational methods and resources;
- management audits assess the quality of the approach of MFI managers to risk and control within the framework of MFI objectives;
- reviews evaluate the means of safeguarding assets and, as appropriate, verify the existence of such assets;
- evaluations of internal control systems assess the deterrence and detection of fraud and alertness to indications of fraud;
- periodic audits of computer systems and post-installation evaluations of major data processing systems determine whether they meet their intended purposes and will fulfill their objectives; and
- special reviews are conducted at the request of the CEO or board.

Consultancy

The internal audit function is often asked to participate in the planning, design, development, implementation, and operation of major systems to determine whether:

- adequate controls have been incorporated into the system;
- thorough system testing is performed at appropriate stages;
- system documentation is complete and accurate; and
- the needs of users are met.

Such requests are understandable as they avoid wasted costs, but there is a fine line that must not be crossed that could cause professional audit standards of independence to be compromised by conflicts of interest.

Audit Management Responsibility

The internal audit function should deliver "value for money." In order to do so, it must:

- be involved with the annual statutory audit. This does not mean that the internal audit function should do anything and everything on behalf of external auditors. It does mean that:

(a) the internal audit function should substitute for external auditors whenever it is cost effective, and

(b) the internal audit function must be prepared to comment to the Board Audit Committee on the conduct of external auditors' work, with a view toward eliminating areas of duplication or obtaining cost savings

- avoid internal checks and other operational responsibilities, as these tasks are the responsibility of functional management (this includes running systems and providing for internal checks and supervision); the job of the internal audit function is to see that these tasks are being done properly, but not do them
- cover all areas of business to ensure that all sections of the organization benefit from an independent review and, hence, enhance the potential for improving the effectiveness, efficiency, and economy of the MFI
- endeavor to approach all its work with the intention of reviewing the efficiency, effectiveness, cost-effectiveness, and fairness of operations

- work to standardize its methods, both to assist staff training and the continuity of audit work
- spend 70 percent of its time in direct auditing activity
- ensuring that audit reports and Management Letters are issued speedily, knowing that such reports are time-critical action documents whose impact and effectiveness is inversely proportional to the time lapse between the end of an audit and their issuance. All final audit reports must be issued no more than 10 days after end of audit fieldwork, a deadline that may be met by

(a) drafting sections of the audit report during fieldwork and discussing it with management at that stage, and

(b) using audit summary working papers as much as possible

- check the effectiveness of risk management, control, and governance processes
- comply, as far as is reasonable in the environment of the given MFI, with the Standards for the Professional Practice of Internal Auditing

Similarities between the Internal Control and Internal Audit Functions

Both types of audits:

1. have a control motivation
2. seek the most efficient operational platform
3. intend to eliminate/minimize loss
4. hold mutual respect for each other
5. have integrity
6. review and steward the process, not just the person
7. are open to challenge and question
8. are a team effort
9. share the same mission and core values

Internal control: Internal control is broadly defined as a process effected by an MFI's board of directors, managers, and other personnel that is designed to provide reasonable assurance of the achievement of objectives in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial reporting; and
- compliance with applicable laws and regulations

The board of directors is ultimately responsible for the system of internal control and reviewing its effectiveness. However, such a system is designed to manage, rather than eliminate, the risk of failure to achieve business objectives and can provide only reasonable, not absolute, assurance against material loss.

No internal control system, however elaborate, can by itself guarantee efficient administration or the completeness and accuracy of records, nor can it be proof against fraudulent collusion, the outright override of systems, or abuse on the part of those holding positions of authority and trust.

The following are the elements of a good internal control system:

- honest and capable staff
- clear delegation and separation of duties
- proper, visible procedures
- documented processes
- control over physical assets
- control over records
- independent verification
- management supervision
- management ownership

A well-coordinated internal control system can be viewed as a:

- healthy and beneficial process
- process for prevention, NOT blame
- chance to check the position and/or progress of an MFI on a regular basis
- visible sequence of checks and tests that an MFI can constantly perform, review, amend, and record
- permanent record and evidence that demonstrates to any concerned party the MFI's professional approach
- free source of advice

Each of these areas is described in more detail in later sections of this Guide.

Checklist:

- Does my MFI board have a risk policy and/or risk appetite in place? Has it undergone a risk assessment—internally or contracted externally? Does the board have any idea of the MFI's risk profile and does it update it regularly (at least twice a year)?
- Does my MFI have current, up-to-date operating policies and procedures for all areas of operations?
- Does the board review external auditor reports as well as Management Letters, with a special focus on control weaknesses?
- Do we include training on internal audit issues for new board members?

Section 3: The Role of the Internal Audit Function in Overall Risk Management

Definition

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 accomplish its objectives by bringing a systematic, disciplined approach to evaluating and improving its operations and control processes.

Role of the Internal Auditor

Every MFI should have an independent internal audit function to provide reasonable assurance of its compliance with established corporate rules and regulations, as well as its stated policies and procedures. Reports for senior management and the board of directors should be produced weekly, or at least monthly, to document any and all breaches of those policies.

The internal audit department should have a direct functional reporting line to the board of directors (through the Audit Committee), but an administrative reporting line to the MFI general manager. The objective of this reporting structure is to ensure the department's independence and objectivity, yet ensure that the internal audit function supports management objectives. The internal auditor is a business partner and a resource to management, not an adversary. All internal audit activities should be coordinated with and communicated to the MFI general manager.

The internal auditor's role, as stated above, is to provide reasonable assurance of compliance with corporate policies and procedures. All departments of the organization are subject to auditing by internal auditors. Furthermore, internal auditors are also encouraged to visit clients in order to ensure that clients have received their loan(s) and are using them for the purpose stated in their loan agreements.

Why the Internal Audit Function is Important

Regulatory statutes for most organizational structures require an annual external audit. For example, central banks generally require all supervised, regulated banks and institutions to have a professional internal audit process in place. Legal and/or regulatory statutes generally require that microfinance institutions also have such a process in place. As part of management's responsibility for internal controls, an internal audit tests compliance with internal controls. In contrast to an external audit, the internal audit is not as focused on account balances *per se*, but on the systems that generate balances, produce financial and operational information, and uphold internal controls. The internal audit function is an important fraud deterrent that needs to be embraced by senior management, who should value a clean audit report at the branch level. When audit reports are used to measure management performance, however, the consequences are seldom positive.

The internal audit process looks at the big picture of how operations are accomplished and helps improve those operations. Clearly, a simple system is easier to maintain than a complex system. The internal auditor's annual work plan should outline a systematic process for reviewing operations, but include unallocated time to address special investigations or procedures at the request of management. Branch managers should be comfortable with contacting internal auditors should they suspect that something is amiss in their branch processes. As a result, the internal auditor plays an important role in ensuring that MFI operations are efficient and effective.

Tasks Associated with the Internal Audit Function

The internal audit department is charged with the independent review of risk management processes and the control environment. The department's mission is to provide the MFI with a high-quality, cost-effective internal audit and consultancy services designed to support the achievement of the MFI's overall objectives. It accomplishes this mission by:

- performing independent assessments of the MFI's departments, control systems, and efficiency, guided by professional standards and using best-practice approaches;
- advising management on all aspects of MFI risk management;
- providing fraud prevention, detection, and investigation services; and
- maintaining a dynamic, team-oriented environment that encourages personal and professional growth and encourages MFI employees to reach their full potential.

Purpose of an Internal Audit

The purpose of an internal audit is to:

- systematically test internal controls for design flaws and application lapses (see below);
- design the audit program
- identify and test key internal controls (e.g., verify that there are two signatures on checks);
- identify key documents that prove that procedures are being properly followed (e.g., review of signatures on invoices, comparison of signatures on loan applications and loan documents to verify that the person who made the application received the loan, etc.);
- verify that management's internal control system is effective and functioning well;
- verify and test the adequacy of management's risk mitigation measures in reducing risk;

- provide reasonable assurance of the reliability of financial and operating reports; and
- provide reasonable assurance to management on the achievement of specified objectives.

Internal Audit Responsibilities within the MFI

Board of Directors

- Ensure an effective control structure is in place
- Ensure an audit policy is adopted and followed correctly
- Together with the CEO, ensure implementation of all agreed actions resulting from internal audit recommendations
- Ensure reputational risk

CEO

- Ensure overall achievement of MFI business performance objectives
- With the support of the entire management team, ensure that all staff have the required technical skills and knowledge to achieve excellence in all aspects of their operational responsibilities
- Assign specific controls and/or tasks to MFI staff
- Together with the board, ensure implementation of all agreed actions resulting from internal audit recommendations

All managers

- Provide expertise for all aspects of a given unit's activities
- Provide technical support, guidance, and coaching to all staff to ensure that they are technically competent and understand all aspects of their operational responsibilities
- Ensure overall achievement of performance objectives for their units and/or departments, including the audit department
- Ensure that their teams are aware of MFI internal control standards

Audit managers

- Undertake and manage a program of periodic and surprise checks (these checks are part of the audit framework that ensures risk is minimized in MFI operations)
- Ensure that all staff are aware of and trained in their individual internal audit responsibilities

Role of Risk Management in the Internal Audit

The current paradigm of the internal audit function goes beyond compliance in matters of internal controls and the reliability of financial reporting. It takes a risk-based approach that is applied to the entire operations and structure of an MFI. Internal auditors generally conduct a risk assessment before beginning an audit assignment. In other cases, auditors develop the internal audit plan based on an MFI's risk assessment, as conducted by an external evaluator, the risk manager, or the Board Risk Management Committee. The outcome of a risk assessment is to develop a risk profile that prioritizes areas of greatest risk, determine whether risk mitigation is effective, and understand whether risks are increasing or decreasing, as well as the overall materiality of risk within MFI operations.

The errors detected by an internal audit vary in significance. An error in the calculation of interest by the management information system (MIS) is, for example, more troubling than a clerical error in adding petty cash slips. Similarly, an error in the design of the internal control system that could allow savings to be mishandled is more troubling than a failure to consolidate the portfolios of all branche and transmit the consolidated figure to the head office every day. A rule of thumb to follow is that systematic issues are more troubling than isolated cases. An internal auditor looks to the dollar volume of a potential error when weighing risks.

Checklist:

- Does my MFI have an Internal Audit Charter that clearly describes the scope, purpose, authority, and responsibilities of the internal audit department?
- Does the internal auditor's job description clearly outline his or her role in relation to risk management?
- Does my MFI have a Board Audit Committee that coordinates with the internal auditor and his or her department?
- Does the Board Audit Committee fulfill its functions and expectations as required by regulatory bodies, the stakeholders, and the MFI board in general?

Section 4: Internal Audit Responsibilities of the Board of Directors

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 function 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 can ensure that the internal audit department is appropriately staffed and adequately budgeted. The institution should choose an engaged board member for this task 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, for example, a certified public accountant. He or 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. The key responsibilities of the board in the oversight of internal audit activities are to:

1. Ascertain key areas of risk within the MFI (see annex A), 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; ethics and fraud.

2. Confirm and assure the independence of the internal auditor, specifically:

    - 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 for the purpose ensuring that risk coverage is complete and reduces redundancy and that MFI 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.

3. Coordinate with both the internal auditor and MFI management to determine a rolling audit plan.

MFIs should have corporate policies that outline the Board's responsibilities with respect to risk, risk management, risk tolerance, and internal audit (see annex B).

Checklist:

- Does my MFI have an Internal Audit Committee Charter (see annex D)? Does the Internal Auditor have a clear job description?
- Does my MFI have a Code of Ethics for both the internal audit department and the board of directors (see annex E)?
- Do Board Audit Committee members have job descriptions, an annual plan or calendar (see annex F), and clearly identified expectations for their function?
- Does the Audit Committee meet regularly as agreed on, review internal audit reports, and issue updates on the status of effective risk management in the MFI?

Section 5: The Work of the MFI Internal Audit Department

Overview

The internal audit function is separate, distinct, and independent from an MFI's annual external financial audits (see annex G for a sample internal audit department charter). It is also distinct and independent from the management and implementation of operations. Pursuant to applicable regulations and standards published by local regulatory bodies (e.g., the national board of accountants and auditors, International Audit Standards, etc.) the internal auditor should report to MFI management in such a way that allows the internal audit department to accomplish its reporting responsibilities independently and objectively. In this regard, the internal auditor consults the MFI general manager for guidance in establishing the audit plan, scope, and direction, and presents his report to the MFI Board Audit Committee for strategic direction, reinforcement, and accountability.

A strong and credible internal audit system gives confidence to an MFI's founders, donors, investors, and other stakeholders. The internal audit function contributes directly to effective risk management, promotes good governance within the organization, and provides a solid framework for internal controls by department managers across the institution.

The board of directors ensures the real and perceived independence of the internal audit department by ensuring:

- the inclusion of technically competent and experienced members in the Board Audit Committee;
- the organizational independence of internal auditors who perform audit functions; and
- the creation and application of a risk management policy.

All departments and branches, as well as the MFI as a whole, should be supported by professional and comprehensive internal audit coverage. This critical activity requires the development of an internal audit manual, which should include all applicable procedures and audit templates. The manual should not be a theoretical text book, but a practical guide that explains the planning, implementation, reporting, and effective functioning of internal audit activities. In keeping with these principles,

- the MFI general manager and senior managers remain fully responsible for the results of internal audit reports on their departments;
- the general manager is responsible for taking action on audit results;
- the general manager is responsible for ensuring internal auditing standards are achieved and facilitates the access of the internal audit department to professional resources.

Overall, the general manager is responsible for focused, sustained, functional leadership of the internal audit process across the MFI in order to build and develop capacity, as well as ensure adequate levels of professionally qualified human resources and adherence to professional standards. The general manager also ensures that rigorous methodology is used to prepare internal audit reports.

The internal auditor(s) provides annual comprehensive reports to the general manager and the board of directors on the effectiveness and adequacy of the MFI's risk management, internal control systems, compliance with internal operating policies and procedures, and governance processes in departments and branches, as well as reporting on individual risk-based audits.

Similarly, the general manager reports annually to the board of directors on actions taken to improve risk management, internal control systems, and governance processes across all levels of the MFI. In this report, he or she addresses fundamental controls, including basic reporting controls for financial statements; thematic controls, for example, for a specific lending product or activity; and the results of risk-based internal audit work carried out within individual departments.

MFI managers support the internal audit function as an independent and objective activity designed to add value and improve operations. This function assists an MFI in accomplishing its objectives by bringing a systematic and disciplined approach to the evaluation and improvement of the effectiveness of MFI risk management, internal control systems, and governance processes.

The internal audit department is responsible for the development, review and modification of its own policies and procedures. Depending on how quickly an MFI grows, the internal audit function could for a time be outsourced to CPA firm other than the firm that conducts the annual external audit.

Staffing and of the Internal Audit Department

The scope of an MFI internal audit department encompasses the examination and evaluation of the adequacy and effectiveness of the institution's system of internal controls and the quality of performance of assigned responsibilities at the organizational, departmental, and program levels.

Prior to recruiting an internal auditor, the following tasks can be accomplished by existing MFI staff:

- The operations manager (and other head office visitors) can perform "audits" during branch visits. Such "audits" could take the form of reconciling petty cash, or making sure that loan documents are filed consecutively, or pulling five loan files to verify that all records are complete.
- Results of spot audits should be documented and shared with other members of senior staff.
- The frequency of branch visits can be increased if it appears that policies and procedures are not being followed.

- Any staff person who is "independent" of the person doing the audited task can be part of the internal control solution.

When to hire the first, and additional, internal auditor(s):

The suggested benchmark for hiring a full-time internal auditor is one or more of the following:

- the MFI has more than 5,000 clients
- the outstanding portfolio of the MFI is greater than US$ 2 million
- a remote branch
- more than one regional office

The following calculations can useful for determining when to hire additional internal auditors:

- Assuming that 50 percent of internal auditor time is spent at MFI branches, with 1 two-week audit each year, or 2 one-week audits each year for each branch, one auditor could audit 12–13 branches in a year, plus the head office.
- If an audit only takes two days due to population density, an auditor could handle more coverage.

For example, BRAC strives to audit its units twice per year. To cover all 1,000 branches, BRAC has calculated that it needs 50 internal auditors, with a single auditor reasonably expected to cover a maximum of 20 branches a year (2003 data).

Candidates for internal audit staff

Operational staff, such as branch managers with 2–4 years of experience, should know the internal control environment fairly well and would be suitable candidates for an internal auditor job. External auditors can be either a good or a bad source of internal auditors. For example, they might want to audit balances and not transactions, which is incorrect. Experience with transaction-based auditing is desired.

The Work of the Internal Audit Department

Internal audit procedures and risk assessment processes are approved by an MFI's board of directors and should be revised at least on an annual basis. The activities of the internal audit department are outlined in an annual internal audit plan (see annex H and approved by the board before the beginning of plan year. This plan is developed at the same time that the institution prepares its budget and annual operating plans. The annual audit plan should take into consideration past experience, existing high-priority areas, and issues arising from both internal and external sources.

A feedback loop must be established to ensure that senior staff is notified if specific staff members are not following appropriate procedures. If there are no consequences for willful disregard of internal controls, the controls are not effective, which increases the overall risk to an MFI.

Major findings of the chief internal auditor, such as fraud or serious incompetence, must be reported to the board and senior staff immediately. In some cases, the legal department must be notified for application of disciplinary measures and possible termination of the offending staff member.

Main tasks of internal auditors

The main responsibilities of internal auditors are to**:**

- review the MFI's financial and operational information for reliability and integrity;
- assess compliance of all MFI departments with internal policies and procedures, as approved by the board of directors;
- assess compliance of all MFI departments with national laws and regulations that have an impact on operations;
- review the fixed **asset registr**y process to preserve the integrity of assets and, as appropriate, verify the existence of such assets;
- review and appraise the economy and efficiency with which resources are used;
- review established systems of internal controls to ascertain whether or not they are sufficient and functioning as designed;
- monitor and evaluate the effectiveness of MFI operational risk management processes;
- investigate and report on alleged violations of policies, procedures, rules, and regulations; verify compliance with grants; investigate and report on errors, fraud, and misuse of MFI assets (this task may require liaising with law enforcement bodies, when appropriate);
- perform and report on follow-up reviews to determine whether internal audit recommendations have been implemented; and
- review specific operations, programs, functions, or activities at the request of the board of directors or MFI management.

Internal audit testing

As a reasonable benchmark, approximately 50–60 percent of the internal auditor's time should be spent in the field and the rest of time in the office. The auditor's office-based time should be focused on the following activities:

- selecting samples;
- testing the accuracy of the MIS and accounting systems;
- testing payroll systems;
- testing fixed asset purchasing systems;
- testing treasury management systems;
- preparing internal audit reports to inform management of audit findings; and
- providing an expert opinion on internal audit documentation and processes.

Likewise, field audits should consist mainly (60–70 percent of audit time) of portfolio testing, as the portfolio is the core component of an MFI's operations. The remaining 30–40 percent of audit time can be used to test the:

- petty cash system;
- existence of fixed assets;
- proper use of computers and transportation resources; and
- compliance with board and management mandates.

As part of loan file testing, internal auditors may want to test to verify whether clients, at the moment they become clients, fit the definition of "poverty" established by the institution.

Types of audit reports

There are a number of reports that the audit department should produce. The focus of these reports include, but are not limited to:

- compliance by credit department staff with loan disbursement policies and procedures;
- compliance by finance department staff with human resource guidelines in the calculation of staff salaries and bonuses; payment by this staff of employee social security taxes; and compliance with petty cash control procedures;

- compliance by human resources staff with established procedures for hiring, termination, promotion, and the maintenance of employee personnel files;
- verification of effective staff supervision by MFI managers;
- compliance by staff drivers with vehicle maintenance guidelines;
- compliance by senior management with corporate loan-loss write-off policies; and
- compliance by loan officers with loan policies and procedures, file management, and verification, so that loan usage by clients is consistent with their stated reason for the loans in their loan applications.

It is recommended that an internal auditor visit each branch at least twice a year. During each visit, the auditor should complete all of the above-mentioned reports (see annex I for sample reports). Copies of these and any additional reports that may be generated should be provided to the board of directors and the MFI general manager. If possible, the board should require the general manager to provide written comments on each of the auditor's findings (see annex J for examples of such comments). Following agreement on audit recommendations, the internal auditor or audit department should periodically issue follow-up reports on the implementation of these recommendations (see annex K).

Special audits

In addition to regularly scheduled audits, the internal audit department may be asked to perform special audits by the MFI general manager or board of directors. For example, if there is a suspected case of fraud in a certain branch, the general manager or board may ask the internal auditor to spend time at that branch to evaluate the situation. The extent to which a general manager is free to make such a request of the internal auditor directly, without prior board approval depends on the degree of latitude given to the general manager by the board.

From a working relationship perspective, the general manager and the internal audit department should have a collegial relationship. The former should be looked on as a "business colleague" by the general manager and other senior managers, as the department provides assurance of staff compliance with policies and procedures and minimizes the incidence of fraud, theft, error, and risk, thereby keeping the organization strong.

Checklist:

- Does the Board Audit Committee review and approve the internal auditor's strategic plan, annual plan, and budget?
- Are the internal audit department and its staff continuing their professional development?

- Is there, at minimum, an annual review of the internal audit department? The Audit Committee, the external auditor, or an external consultant might facilitate this process. It should include feedback from management and the Audit Committee as well.
- Does the internal auditor provide quarterly updates to the Board Audit Committee on the status of its work, compared with its annual plan, as well as updates on risk management and a summary of audit report recommendations?

Section 6: Responsibilities of the MFI Board Audit Committee

MFI boards structure committee responsibilities in different ways. In some institutions, Risk and Compliance Committees are established that address all matters related to risk, risk management, and compliance with risk-mitigating controls. In other institutions, the board creates an Audit Committee. Some MFIs establish a committee that addresses both Risk and Internal Audit. And still others establish a Finance and Audit Committee. In addition to overseeing the internal and external audit function, this committee also handles budget, asset management, investment, and banking issues.

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. The purpose, scope, authority, and responsibilities of the Audit Committee are generally laid out in an Internal Audit Committee charter (see annex D). 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, including review of competing bids by external audit firms (see annex L);
- 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 MFI executive managers who monitor institutional compliance with the MFI's 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," 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 shall 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; and
- 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.

Checklist:

- Does my MFI have an Audit Committee (it may be combined with the Risk Committee)?
- Does the Audit Committee have an internal audit charter (see annex D)?
- Has it undertaken a recent (within the last 12 months) self-assessment to identify key gaps in auditing processes? (See annex M for a sample self-assessment)
- Does it have a written code of conduct, a conflict of interest policy (see annex N), a charter, and other needed guiding documents?
- Does it have written procedures regarding the reception and treatment of confidential anonymous submissions by employees regarding possible violations of the MFI’s code

of conduct (i.e., a "whistle blower" policy[6]), including a policy of "no retaliation" against employees reporting such violations?

[6] A "whistle blower" policy refers to a written policy adopted by an MFI board of directors that specifies that any employee who reasonably believes that some policy, practice, or activity of the organization is in violation of law or the MFI's own Code of Conduct or is unethical may file a written complaint with the chief executive officer (CEO) or another designated representative of management.

Section 7: Ensuring an Effective Audit Committees

An effective Audit Committee, comprised of at least three financially literate members with shared audit experience, actively manages the Committee and their own performance. Audit committee members should have at least one member with financial expertise, including technical competency in auditing. This individual would be the most likely choice for the position of Audit Committee chairperson and assume relevant committee oversight duties for the MFI. Committee members may be appointed from outside the board if there are not enough board members available to suitably discharge the Committee's responsibilities.

To increase its effectiveness, the Audit Committee should annually review its mandate, performance standards, and responsibilities. An annual review is particularly important if any of the following conditions have occurred during the prior fiscal and/or calendar year:

- changes in legal and/or regulatory requirements;
- delegation of new responsibilities to the Audit Committee by the board of directors;
- assignment by the board of duties that are not legally required to be implemented by the Audit Committee to other board committees;
- a change in MFI bylaws that affect the composition of the Audit Committee or how its members are appointed; and
- identification of common practices that the Audit Committee wishes to incorporate into its charter.[7]

On the basis of the review exercise, the Committee should assess its responsiveness to its charter, as well as the effectiveness of its relationships and communications with executive management, the internal audit department, external auditors, and the board of directors. In addition, the Committee should create an annual calendar of committee activities and responsibilities (see annex F), including a list of regular meetings and agendas to cover risk management, oversight, selection of the MFI's external auditor, communication with the chief internal auditor, and MFI asset management.

The Audit Committee should set forth its annual performance plan in its charter. It is recommended that the MFI's external auditor also assess the Committee's performance on an annual basis to confirm:

- the independence of the Committee from MFI management;
- which and to what degree Committee responsibilities are articulated and understood by management and the Committee;

[7] Deloitte, 2006, *Audit Committee Resource Guide* (Detroit, Michigan: Deloitte Development LLC). http://www.deloitte.com/view/en_CN/cn/services/audit/corporategovernance/article/df937eb4971fb110VgnVCM100000ba42f00aRCRD.htm (accessed April 2010).

- interaction between the Committee, senior financial officers of the MFI, the chief internal auditor, and the external auditor;

- whether the Committee raises pertinent and timely questions with MFI management and the external auditor (these questions must indicate the Committee's understanding of critical accounting policies and judgmental accounting estimates); and

- whether the Committee has been responsive to issues raised by the external auditor.

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 be carried out in consultation with legal counsel. Recommendations for best practices for evaluating an Audit Committee's performance include:

- Some combination of the Board's governance committee (or the entire board), the chief internal auditor, and/or executive management should 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 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 evaluation 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.

- The Audit Committee chairperson should assess the contributions and performance of individual Audit Committee members for review by the Board chairperson and general manager of the MFI.

The internal audit department could facilitate the survey of Audit Committee members and external individuals, as well as accumulate results for future Committee discussions and actions. However, to ensure objectivity and independence, it is preferable that an independent board member or an external resource conduct this work.

The goal of an evaluation is to develop a plan for improvement and, ultimately, a more effective and efficient Audit Committee. A performance evaluation, when properly targeted and executed, should deliver information on the Committee's composition, qualifications, technical competency, members' understanding of key issues, critical financial reporting areas and issues and the appropriateness of meeting agendas.

Tools

Annex M is a self-assessment tool that can be adapted by an MFI for an evaluation of how well its Audit Committee is meeting its governance responsibilities. A self-assessment survey should assist the Committee in determining how well it is functioning and identify areas where it might improve its performance to better meet the mission and goals of the organization.

Checklist

- Does the Audit Committee charter set expectations for the performance of the Committee and its members?
- Are Committee members fulfilling their roles and responsibilities? Are they regularly evaluated? Does the Audit Committee charter identify the required skills and qualifications of Committee members?
- Does the Committee conduct an annual self-evaluation?

Section 8: Challenges and Constraints

The Audit Committee and, indeed, the managers and board of directors of an MFI will encounter several challenges and constraints to operating the institution with a financially sound, well-balanced approach to risk. This section, while not exhaustive, attempts to illuminate a few of the most common challenges and constraints that an Audit Committee may confront in executing its duties.

Lack of Skilled Audit Committee Members

MFI Audit Committees may find that they lack capable, experienced professionals with sufficient financial expertise and knowledge of microfinance to serve as Committee members. Members may also not understand or exercise their governing role, and consequently delegate responsibilities to management that really rest with them. Members should be experienced, seasoned professionals able to exercise discretion, good judgment, and reasonable approaches to working and communicating with others. Their qualifications include having a mature understanding of their role in the risk management and internal audit process without becoming interfering, irresponsible, or apathetic.

Vague or Non-existent Regulations and Laws

Many environments in which MFIs operate have nascent or nonexistent microfinance sectors. Consequently, central banks and government finance ministries struggle to understand and develop microfinance-friendly legal and regulatory frameworks. Lack of such frameworks continues to complicate the work of MFIs in assessing risk, monitoring compliance, and preparing audit responses, among other issues. Audit Committees may, for example, find little guidance in legal and regulatory matters and look to international accounting standards and the rules and regulations of developed countries for guidance.

Limited Risk Management Strategies

MFIs generally operate in environments where capital markets are underdeveloped or nonexistent. Lack of access to financial vehicles may limit the hedging strategies that MFI management may implement. Audit Committees may consequently be faced with a choice between conservative alternatives to preserve MFI assets or unacceptably risky financial vehicles to boost returns and meet expansion goals. MFI management must weigh these decisions carefully with sufficient oversight from the board, the internal audit department, and the Audit Committee.

Weak External Auditor Skills

The Audit Committee may find that in addition to experiencing difficulties in recruiting capable board members to the Committee, independent external audit services may not meet either the MFI's requirements or international standards. The Audit Committee, in conjunction with the board of directors, may need to weigh the benefits and costs of contracting an international independent

auditor to deliver a higher standard of auditing services instead of using a local auditor who may produce unsatisfactory results.

Legal Counsel

As stated in other constraints above, MFIs generally operate in contexts without clear regulations, confusing or contradicting laws for financial institutions (some of which may not apply to MFIs), and inappropriate legal entities for microfinance. Audit Committees may thus wish to consult legal counsel in assessing audit and risk-related issues. Legal counsel may, however, be generally unfamiliar with microfinance institutions, their incorporated entities, and relevant legal issues.

Lack of Risk Culture

Many MFI lack a "risk culture,"[8] often due to their current or legacy status as an NGO. The need to manage risks and returns, as well as to establish an effective system of internal controls, is a challenge for boards of institutions that have recently transformed from NGOs into regulated financial institutions.

Checklist

1. Which of these weaknesses does my MFI share with the broader industry?
2. How can my MFI address these areas of weakness?
3. Does the Board discuss these issues?

[8] Risk culture in a MFI or financial institution is the aspect of its culture that determines how individuals and business units take risks. While rules and controls define the boundaries of certain aspects of managing risk, there is a large area that is affected by corporate culture in which rules and controls do not apply, are ineffective, or fail.

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Annex A: Sample Risk Assessment Tools

Sample A: Basic Risk Assessment Tool

This approach is adapted from a *MicroSave* toolkit."[9] Its basic objective is to summarize and profile the key risks identified in operational work processes and help MFIs prioritize riskier events or areas.

For example, assume that a particular event represents client loan repayments in transit. The tool would plot the event according to the frequency or the probability of the event and its impact on the institution. The risk of losing weekly cash collections due to hijacking theft during transit from a small satellite office to the bank might be plotted as follows:

	High impact	**Medium impact**	**Low impact**
High frequency			
Medium frequency			
Low frequency		**X**	

In assessing risks, it is important to determine the "risk drivers": the root causes, and not simply the resulting indications of problems. When MFIs evaluate risks, they need to select the ones that they will ignore, the ones that they will transfer to third parties, and the ones that they will accept. Risks that are accepted need to be prioritized and risk mitigation strategies and internal controls developed to manage them.

If an MFI is able to quantify risks, the more precise and rational its risk management strategies will tend to be. There are multiple calculations that can be made to quantify risk. A simple calculation is:

Risk = Probability of the Risk (Frequency) x Cost of the Eventuality (Impact)

However, risk managers should keep in mind that quantifying risks is not in and of itself a one-stop solution. The human element in the financial services industry increases an element of unpredictability. Further, using qualitative risk assessment indicators is often more helpful in assessing non-financial impacts of risk; it also ensures that these people who are assessing risks do not simplify the process by applying numerical values without grappling with core matters.

[9] Pikholz, Lynn, Pamela Champagne, Trevor Mugwang'a, Madhurantika Moulick, Graham A.N. Wright, and David Cracknell, 2005, "Institutional and Product Development Risk Management Toolkit," Shorebank Advisory Services and MicroSave, Nairobi, Kenya. The toolkit is available on the MicroSave Web site (www.microsave.org), which requires users to register before accessing documents. Once registered, a user can find the toolkit at http://www.microsave.org/system/files/toolkits/toolkits/Institutional%20and%20Product%20 Development%20Risk%20Management%20Toolkit.pdf.

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Sample B: Institutional Risk Assessment Summary

This approach is also derived from the abovementioned *MicroSave* toolkit ("Institutional and Product Development Risk Management Toolkit").

The following illustration looks at broad risk events across an MFI by area of risk and risk event. It analyzes the frequency and the impact of risks, their "drivers," mitigation strategies, and whether the risks should be managed. Although a risk assessment tool and report can be as broad or as detailed as an MFI chooses, it is most helpful if areas of risk are probed and explored in detail. The illustration below illustrates highlights a summary of an assessment approach adapted from the *MicroSave* toolkit.

Table B1. Risk Assessment Approach Summary

Area of risk	*Risk event (examples for illustration only)*	*Frequency (H, M, L)*	*Impact (H, M, L)*	*Risk Level*	*Risk Mitigation Strategy*	*Risk Managed (Y/N)*
Credit	Concentration in loans to used clothing vendors	H	H	HH	Control	
Interest Rate	Mismatch between asset and liability pricing structure of the MFI's balance sheet	M	M	MM	Control	
Liquidity	Bank is unable to meet financial obligations; run on savings deposits; reliance on short-term deposits	L	H	LH	Control	
Foreign exchange risk	Exposure to foreign exchange losses on loans denominated in hard currency	H	H	HH	Avoid	
Finance	Assets moved around without tracking	M	M	MM	Control	
Operations						
• Transaction errors	Risks vary, depending on specific examples from the					

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• ATM systems, points of sale (POS) • Information technology • Human resources • Management • Governance • Fraud	MFI
Strategic risk	Loss of major funding source
Reputational risk	Bad publicity due to seizure of client assets
External risk (competition)	A competing MFI begins to offer similar products

Note: H – high; M – medium, L –low.

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Sample C: Excel Spreadsheet Risk Assessment Tool

The Excel spreadsheet, "MFI Risk Assessment Ranking Tool," (please see "Annex A: MFI Risk Assessment Ranking Tool.xls") can be adapted and edited to conduct preliminary risk assessments, support the development of risk mitigation policies and strategies, and conduct ongoing evaluations of risk and risk management in order to manage an MFI's risk profile.

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Annex B: Sample Board Risk Management Policy

Risk Overview

The Board of Directors recognizes the need to monitor the various types of risk inherent in the business of microfinance. The purpose of this policy is to establish a framework within which the senior management of _____ (hereafter, "the Institution") may effectively manage and control these risks. The purpose of this policy, therefore, is to provide management, employees, and trustees a written reference on how risk within the Institution will be managed.

Objectives and Goals

This policy will identify the Institution's various risk exposures and establish appropriate risk management systems to control that risk. To the extent feasible, including cost effectiveness, one objective of this policy is to establish a sound risk management program that supports the Institution's overall risk management approaches.

The goal of this policy is to ensure that the Institution has in place acceptable limits for the risks identified by the board of directors, management, and regulators. This risk management approach will encompass the following:

- defining the types of risks that will be addressed by each functional area or corporate policy;
- ensuring that mechanisms for managing (identifying, measuring, and controlling) and monitoring risk are implemented and maintained in order to provide organization-wide risk management;
- creating and maintaining risk management tools that are either established or directed by the board, such as policies, procedures, controls, independent testing, personnel management and training, and planning;
- instituting and reviewing risk measurement techniques within the Institution so that the trustees and senior management may use risk measurement techniques to establish the Institution's risk tolerance, risk identification approaches, risk supervision or controls, and risk monitoring processes;
- establishing the appropriate management reporting systems regarding these risks so that individual managers are provided with a sufficient level of detail to adequately manage and control the Institution's risk exposures; and
- creating a reporting mechanism for the board of directors that summarizes the overall risk assessment of the Institution.

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Generally, the approach of managing risk at the Institution starts with the nomination and election of the directors and the hiring of employees. In nominating, electing, or hiring anyone to work for the Institution, there is substantial due diligence completed on the individual to ensure that they have the integrity and discipline to operate within a regulated and trusted industry. Through background checks, interviews, and other means, the Institution, as deemed appropriate, evaluates whether or not a candidate will work well within an organization that has a high level of internal controls and be willing to carry out the Institutions' policies and procedures in an ethical manner. Time is spent with each candidate, during which the Institution's commitment to risk management is expressed, including that each person shares in the responsibility of carrying out its risk management policy.

In addition to the hiring process, which provides the best means of reducing risk to the Institution, a general approach of controlling risks is taken with respect to products and services and their implementation and delivery. Though making loans in its simplest form is a business of accepting risk, the board and senior management of the Institution generally choose not to participate in programs or products that, despite their promise of immediate financial benefit, possess greater-than-normal operational or reputational risk.

The oversight of institutional risk and the management of this risk are primarily carried out by the effective utilization and adherence to existing policies of the Institution. The Institution has extensive board-approved policies that address the risk concerns that are inherent in each functional area, corporate activity, and situation. Each policy is supported by written operating procedures that ensure policy requirements are met. This risk management policy structure allows the overlay of risk management techniques throughout the financial institution, using the existing corporate policy and governance structure as the basic element of practical risk management.

Board of Directors' Responsibilities

The Institution's board of directors has ultimate review responsibility and approval for risk levels throughout the organization. It is necessary that the board have a clear understanding and working knowledge of the types of risks inherent in the microfinance business and establish policies to control these risks. The use of functional area policies approved by the board is the primary tool for carrying out these responsibilities. A board governance policy should be used in conjunction with this policy in assisting the board of directors to assess the overall risk of the Institution while carrying out its duties and responsibilities with respect to overall direction of the Institution.

Risk Management Guidelines

The Institution will identify, measure, and monitor the risks involved in various aspects of its operations. The board of directors recognizes that all microfinance products and services carry a certain element of risk; therefore, recognizing risk is a factor of doing business. The board of directors believes that effective risk management comprises several factors:

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- identifying, within each functional area, the risk of each product or service
- understanding the implications of the risks involved in each product and service, grouped by functional area
- using appropriate, accurate, and timely tools to measure risk within each functional area
- setting acceptable risk parameters for each product and service offered by the institution within which each relevant responsible functional area should operate
- maintaining risk at acceptable levels at the functional and institution-wide level

Risk Categories

The Institution's risk management program will focus on the following risk categories:

- credit risk
- interest rate risk
- liquidity risk
- operational/transaction risk
- compliance risk
- reputation risk
- strategic risk

Credit Risk

Credit risk is the result of an obligor's failure to meet the terms of any contract with the Institution or otherwise to perform as agreed. Credit risk arises any time Institution funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements.

Credit risk is managed through policies such as a loan policy, investment policy, and liability risk management policy. These policies identify the various risks associated with lending and investing, provide the parameters within which management will operate, and define reporting requirements to the board. The Institution may also engage an outside firm on an annual basis to perform loan review procedures. These procedures provide an independent analysis of the quality of the loan portfolio, adherence to credit administration procedures outlined in the loan policy, and review calculations for the adequacy of the allowance for loan losses.

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Interest Rate Risk

Interest rate risk relates to the value of the Institution in the current interest rate environment and the sensitivity of that value to changes in interest rates. Repricing risk, basis risk, yield curve risk, and options risk are all types of interest rate risk to be considered. Interest rate risk considerations should include the effect of a change in interest rates on both the Institution's accrual earning and the market value of portfolio equity.

Interest rate risk is managed through adherence to the funds management and interest rate risk policy. This policy identifies the acceptable level of risk for changes in interest rate movements and the impact of these changes on earnings and capital. According to the funds management and interest rate risk policy, an independent party may be engaged to perform a review of the Institution's interest risk management model and the interest rate risk management process to ensure their integrity, accuracy, and reasonableness.

Liquidity Risk

Liquidity risk refers to the Institution's ability to meet its obligations when they come due without incurring unacceptable losses. The ability to manage unplanned decreases or changes in funding sources affects liquidity risk. Liquidity risk is also affected by the Institution's ability to recognize and address changes in market conditions that affect its ability to liquidate assets quickly with minimal loss in value.

Liquidity risk is managed through adherence to the Institution's funds management and interest rate risk policy and investment policy. Liquidity management may also reviewed by an independent party.

Operational/Transaction Risk

This risk arises from problems with service or product delivery. Such risk is inherent in all Institution products and services and arises on a daily basis as transactions are processed. All institution products and all divisions of the Institution are affected by transaction risk. Controlling transaction risk is a function of internal controls, information systems, employee integrity, and operating processes.

Operational and transaction risk are managed through several policies including the following:

- information technology policy
- IT contingency plan
- business continuity policy
- funds transfer policy

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These policies are accompanied by a significant number of procedures that are reviewed on a regular basis with employees at the Institution. In addition, a Compliance Committee and an Information Technology Committee, both made up of Institution employees representing all main functional areas of the Institution, monitor operational and transaction risks. Policies and their corresponding procedures are discussed at these meetings for adherence, clarification, and recommended changes that will be submitted to senior management and the board.

Compliance Risk

Compliance risk refers to the risk to earnings or capital arising from violations or nonconformance with laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk exposes the institution to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can lead to a diminished reputation, reduced franchise value, limited business opportunities, lessened potential for expansion, and lack of contract enforceability.

Compliance risk is managed through the Institution's comprehensive compliance program and the adherence to the various policies stipulated by this program. Policies included in this program include:

- the Institution's secrecy policy, which includes provisions relating to Anti-Money Laundering (AML), Customer Identification Programs (CIP), and Know Your Customer (KYC); and
- the Institution's loan policy.

Compliance is the responsibility of department managers, who ensure training on compliance regulations at all levels of the organization, including the board of directors, on a regular basis. The Institution also supports a mandatory annual compliance refresher course for all employees and the board of directors.

Reputation Risk

Reputation risk refers to the risk to Institution capital or earnings arising from negative public opinion. Reputation risk is inherent in all institution activities. It can affect the Institution's ability to establish new relationships or services, as well as its ability to continue serving its existing clients. An abundance of caution is needed in dealing with Institution customers and the community to preserve the institution's reputation.

Reputation risk is managed in a broad sense by ensuring that the Institution employs only employees who maintain the highest ethical standards. In addition to the policies noted in the operational and transaction risk section above (given that failure to have appropriate systems in this area may lead to reputation risk), this risk is also managed through the use of the Institution's conflict of interest and code of ethics policy, privacy policy, and customer compliance policy.

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Strategic Risk

Strategic risk arises from adverse business decisions or improper implementation of business decisions. Strategic risk is a function of the compatibility between the Institution's strategic goals, business strategies (including the resources used to meet strategic goals), and the quality of implementation of those goals. Strategic risk incorporates how management analyzes external factors that affect the strategic direction of the Institution.

Strategic risk is managed through the Institution's personnel policy and the annual review and approval of the strategic plan.

Risk Assessment and Reporting

A report of the Institution's overall risk position should be completed on a semi-annual basis, or as necessary, should significant events occur that impact the overall risk of the Institution. The report should include an assessment of each risk category. This assessment will be made using a rating system of LOW, MEDIUM, and HIGH, where LOW represents a low risk rating at the Institution for that category. The low- and medium-risk assessments are deemed acceptable risk levels, whereas high is deemed unacceptable. Any risk assessed at a HIGH level requires that a plan of correction be devised within 30 days to bring the risk to an acceptable level.

There are two parts to the process: the first measures the quantity of risk and the second assesses the level of risk. For each risk category, the quantity of associated risk is determined by a matrix, where the horizontal axis represents the likelihood of an occurrence and the vertical axis represents the impact of an occurrence. The points of intersection on this matrix represent the quantity of risk.

The quantity of risk so determined is used in a second assessment matrix in which the horizontal axis represents the quantity of risk and the vertical axis represents the adequacy of risk management. The adequacy of risk management is determined by assessing the four risk management activities listed below. The points of intersection on this matrix represent the risk assessment (see annex 3).

An elevation in the risk assessment of a category or item, or a determination of high risk, would call for additional attention to that category by management and the board.

Impact of Associated Risks on Institution

The impact of risks addresses the nature, complexity, and volume of the activities that give rise to the risk in question.

High-impact risk exists where the risk category is significant in relation to the Institution's resources or to its peer group, where there are a substantial number of transactions, or where the nature of the risk category is inherently more complex than normal. Thus, the risk category could potentially result in a significant and harmful loss to the Institution.

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Medium-impact risk exists where risk rankings are average in relation to the Institution's resources or to its peer group, where the volume of transactions is average, and where the risk category is more typical or traditional. Thus, while the risk category could potentially result in a loss to the Institution, the loss could be absorbed by it in the normal course of business.

Low-impact risk exists where the volume, size, or nature of the risk category is such that even if internal controls have weaknesses, the risk of loss is remote or, if a loss were to occur, it would have little negative impact on the Institution's overall financial condition.

Adequacy of Risk Management

When assessing the adequacy of the Institution's risk management systems for each risk category, primary consideration is placed on the following key elements of a sound risk management system:

- active board and senior management oversight
- adequate policies, procedures, and limits
- adequate risk management, monitoring, and management information systems
- adequate internal controls

These key elements are taken into account to assess the relative strength of the risk management processes and controls for each risk category. Relative strength can be characterized as strong, acceptable, or weak as defined below.

Strong risk management indicates that management effectively identifies and controls all major types of risk posed by the risk category. The board and management participate in managing risk and ensure that appropriate policies and limits exist, and that the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide the necessary information and analyses to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.

Adequate risk management indicates that the Institution's risk management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the Institution's business plan. While there may be some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies, limits, risk monitoring procedures, reports, and management information systems are considered effective.

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Weak risk management indicates that risk management systems are lacking in important ways and, therefore, are cause for more than normal concern. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by failure to adhere to written policies and procedures. The deficiencies associated with these systems could have adverse effects on the Institution.

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Annex C: Sample Board Risk Assessment Tools

Risk Assessment and Reporting

A report of the Institution's overall risk position should be completed on a semi-annual basis, or more frequently, if significant events occur that impact the overall risk of the Institution. The report will include an assessment of each risk category. This assessment will be made using a rating system of LOW, MEDIUM and HIGH, where LOW represents a low risk rating at the Institution for that category. The low and medium risk assessments are deemed to be acceptable risk levels whereas high is not. Any risk assessed at a HIGH level requires, within 30 days, a detailed plan to bring the risk down to an acceptable level.

There are two components to the process, the first measures the quantity of risk and the second assesses the level of risk. For each risk category, the quantity of risk associated is determined by a matrix that along the horizontal axis is the likelihood of an occurrence and along the vertical axis the impact of an occurrence. At the intersection on this matrix is quantity of risk. See attached example.

The level of risk so determined is used in a second assessment matrix that along the horizontal axis is the quantity of risk and along the vertical level axis the adequacy of the risk management. The adequacy of risk management is determined by assessing the four risk management activities listed below. The point of intersection on this matrix is the risk assessment level.

An elevation in the risk assessment for a category or a determination of high risk would call for additional attention to that category by management and the board.

Impact of Associated Risks on Institution

Impact of risk assesses the nature, complexity, and volume of the activities giving rise to the risk in question.

High impact risk exists where the risk category is significant in relation to the institution's resources or to its peer group, where there are a substantial number of transactions, or where the nature of the risk category is inherently more complex than normal. Thus, this risk category could potentially result in a significant and harmful loss to the institution.

Medium impact risk exists where positions are average in relation to the institution's resources or to its peer group, where the volume of transactions is average, and where the risk category is more typical or traditional. Thus, while the risk category potentially could result in a loss to the institution, the institution in the normal course of business could absorb the loss.

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Low impact risk exists where the volume, size, or nature of the risk category is such that even if the internal controls have weaknesses, the risk of loss is remote or, if a loss were to occur, it would have little negative impact on the institution's overall financial condition.

Adequacy of Risk Management

When assessing the adequacy of the institution's risk management systems for each risk category, primary consideration is placed on the following key elements of a sound risk management system:

1. Active board and senior management oversight;
2. Adequate policies, procedures, and limits;
3. Adequate risk management, monitoring, and management information systems
4. Adequate internal controls.

These key elements are taken into account to assess the relative strength of the risk management processes and controls for each risk category. Relative strength can be characterized as strong, acceptable, or weak as defined below:

Strong risk management indicates that management effectively identifies and controls all major types of risk posed by the risk category. The board and management participate in managing risk and ensure that appropriate policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide the necessary information and analyses to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.

Adequate risk management indicates that the institution's risk management systems, although largely effective, may be lacking to some degree. It reflects an ability to cope successfully with existing and foreseeable exposure that may arise in carrying out the institution's business plan. While there may be some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered effective.

Weak risk management indicates risk management systems are lacking in significant ways and, therefore, are a cause for more than normal concern. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated with these systems could have adverse effects on the institution.

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Annex D: Sample MFI Audit Committee Charters

SAMPLE 1. BOARD AUDIT COMMITTEE CHARTER

Purpose

The Audit Committee (the "Committee") is elected by the Board of Directors (the "Board") of the MFI. The primary function of the Committee is to assist the Board in fulfilling its oversight responsibilities to donors, the investment community, and other stakeholders related to MFI's financial, operational and compliance information, primarily through:

- overseeing management's conduct of the MFI's financial reporting process and systems of internal accounting and financial controls;
- overseeing the annual external audit of MFI financial statements;
- 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 charters;
- overseeing the MFI's compliance with its code of ethics and/or consumer protection policy; and
- providing an avenue of communication among external auditors, MFI management, and the Board.

Composition

The Committee shall be elected by the Board and consist of at least three Board members who are independent of MFI management and the MFI. Each member shall meet requirements of independence, experience, and financial expertise. Members must be "financially literate" and, at a minimum, one member must be designated a "financial expert." The Committee shall establish a continuing education program for members.

Meetings

The Committee shall meet quarterly and/or call special meetings as circumstances dictate. The Board shall elect a chairperson who will prepare and/or approve an agenda in advance of the meeting and maintain minutes and/or records of meetings and activities of the Committee.

Duties and Responsibilities

The Audit Committee shall be responsible for overseeing activities of the MFI's executive management related to the appointment, compensation, and retention of any registered public accounting firm for the purpose of issuing an audit report or performing any other audit, review, or attestation services. Each registered public accounting firm must report directly to the Audit Committee. The primary responsibility of the Committee is to oversee the MFI's financial reporting

process and annual external audit on behalf of the Board and report the results of these activities to the Board. Executive Management is responsible for preparing the MFI's financial statements and the independent auditors are responsible for auditing those statements. The Committee should take appropriate action to set the overall corporate "tone" for quality financial reporting, sound business risk practices, and ethical behavior.

General

- The Committee shall have the power to conduct or authorize investigations into any matters within the Committee's scope of responsibilities.
- The Committee shall have unrestricted access to MFI personnel and documents and will be given resources to engage independent legal counsel, accountants, or other personnel, as deemed appropriate to discharge its responsibilities.
- The Committee shall review and assess at least annually its charter, responsibilities, and performance, and shall report and make recommended changes to the Board for their approval.
- The Committee should meet at least annually with executive management, the internal auditor, and the external auditors in separate executive sessions to discuss any matters that the Committee or each of these groups believes should be discussed privately.
- The Committee shall establish procedures for the receipt, retention, and treatment of complaints received by MFI concerning accounting, internal controls, or auditing matters, as well as for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters or other complaints of corporate or management wrongdoing pursuant to the MFI's Code of Conduct.

1. Overseeing Management's Conduct of the MFI's Financial Reporting Process and Systems of Internal Accounting and Financial Controls

- The Committee shall review the effectiveness of, or weaknesses in, the MFI's internal controls, including computerized information system controls and security, the overall control environment, and accounting and financial controls.
- The Committee shall discuss with executive management the MFI's major financial risk exposure and the steps management has taken to monitor and control such exposure, including the MFI's risk assessment and risk management policies.
- The Committee shall arrange for periodic reports from management, external auditors, and/or internal auditor to assess the impact of significant regulatory changes and/or accounting and reporting developments that may affect the MFI.

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2. Overseeing the Annual External (Independent) Audit of the MFI's Financial Statements

- The Committee shall have a clear understanding with management and the external (independent) auditors that the latter are ultimately accountable to the Board and Committee, as representatives of the MFI's stakeholders.
- The Committee shall oversee the external audit coverage, including annual retention of the independent auditors, the scope of audit services, audit engagement letters, estimated fees, timing of auditor visits, coordination with the internal audit function, monitoring of audit results, and review of the independent auditor's performance and services.
- The Committee shall review the results of the external/independent auditors' annual audit and interim financial reviews to include: (1) annual financial statements and accompanying footnotes, (2) any significant changes required in audit plans or scope, (3) any material differences or disputes with management encountered during the course of the audit, (4) material management letter comments and management's responses to recommendations.
- The Committee is responsible for overseeing the resolution of any disputes between management and external auditors.
- The Committee shall inquire into any accounting adjustments that were noted or proposed by the independent auditors but were not recorded in the financial statements.
- The Committee shall review and discuss with management and the independent auditors the MFI's audited financial statements
- The Committee shall review and discuss with management and the independent auditors any significant estimates and judgments underlying the financial statements, all critical accounting policies, and major changes to the MFI's accounting principles and practices.
- The Committee shall discuss with management and the independent auditors and approve any material transaction involving the MFI and any related party, and any material transaction involving the MFI and any other party in which the parties' relationship could enable the negotiation of terms on other than an independent, arms'-length basis.

3. Overseeing the Independence and Performance of the MFI's External Auditors

- The Committee shall obtain and review a report from the external auditors at least annually regarding: (a) the independent auditors' internal quality control procedures, (b) any material issues raised in the most recent internal quality review or peer review and any inquiries by governmental or professional authorities regarding the firm's independent audits of other clients, (c) any steps taken to deal with any such issues,

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and (d) all relationships between the independent auditors and MFI, taking into account the opinions of management and MFI's internal auditors.

- The Committee shall receive written disclosures and shall discuss with the external auditors their independence.
- The Committee shall ensure that the lead audit partner of the independent auditors and the audit partner responsible for reviewing the audit are rotated at least every 3 to maximum five years.

4. Overseeing the Performance of the MFI's Internal Audit Function

The Committee shall review annually the Internal Audit Policy and recommend approval to the Board for changes or revisions.

- The Committee shall review the appointment, replacement, reassignment, or dismissal of internal audit staff and recommend approval of same to the Board.
- The Committee shall review any difficulties the Internal Auditor encounters in the course of his or her audits, including any restrictions on the scope of work or access to required information.
- The Committee shall review annually the internal audit budget, the competency and adequacy of internal audit staff, and the audit plan.
- The Committee shall review quarterly the material findings of internal audit reviews, management's response, and the status of corrective actions.
- The Committee shall review the appointment, replacement, performance, and recommended compensation of the internal auditor.

5. Monitoring Compliance with Laws, Policies, Ethics Programs, and Loan Agreements with International Financial Institutions or Debt Investors

- The Committee shall review with management actions taken to monitor compliance with any code or standards of conduct for the MFI established by the Board.
- The Committee shall discuss with the MFI's legal counsel any legal, tax, or regulatory matters, and any other legal matters that could have a significant, adverse impact on the MFI's financial statements.
- The Chair of the Committee shall provide regular reports to and review the committee minutes with the Board.

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SAMPLE 2. AUDIT COMMITTEE CHARTER

I. PURPOSE

The primary function of the Audit Committee is to assist the board of directors in fulfilling its oversight responsibilities related to MFI corporate accounting, financial reporting practices, the quality and integrity of financial reports, as well as compliance with legal and regulatory requirements and the business conduct of the MFI. Key components of fulfilling this charge include:

- facilitating and maintaining an open avenue of communication among the board of directors, the Audit Committee, senior management, the independent external accountants, the internal audit and compliance functions of the MFI;
- serving as an independent and objective party to monitor the MFI's financial reporting process and internal control system;
- reviewing and appraising the efforts of independent accountants; and
- providing direction to and oversight of the internal audit and compliance functions of the MFI.

II. ORGANIZATION/COMPOSITION

The Audit Committee shall be comprised of XX (X) directors having staggered terms of XX (X) years each. Every year at the Annual Meeting of the board of directors, the Directors shall elect XX of their members to the Audit Committee for a XX (X) term, or until his or her successor has been elected and qualified. The members will be independent and free of any financial, family, or other material personal relationship that, in the opinion of the Board or Audit Committee members, would interfere with the exercise of his or her judgment, independent of management and the MFI. Ideally, all members of the committee will have a working familiarity with basic finance and accounting practices.

III. MEETINGS

The Committee will meet at least XX (X) times annually. Additional meetings may occur more frequently as circumstances dictate. Committee members will have sole discretion in determining meeting attendees and agendas.

IV. RESPONSIBILITIES AND DUTIES

The Committee's job is one of oversight. MFI management is responsible for the preparation of the Company's financial statements and the independent external auditors are responsible for auditing those financial statements. The Committee and the Board recognize that MFI management, the internal audit department, and the independent external auditors have more resources and time and more detailed knowledge and information regarding the Company's accounting, auditing, internal control and financial reporting practices than does the Committee. Accordingly, the Committee's oversight role does not provide any expert or special assurance as to the financial statements and other financial information provided by the Company.

The Audit Committee believes its policies and procedures should remain flexible in order to best react to changing conditions and provide reasonable assurance to the Board that the accounting and reporting practices of the MFI are in accordance with requirements and that an effective compliance program exists.
The Audit Committee will fulfill their duties and responsibilities as follows:

A. General

- Adopt a formal written charter that is approved by the full board of directors that specifies its scope of responsibility, processes, membership, etc. The charter will be reviewed as necessary, but at least annually.
- Maintain minutes or other records of meetings and activities.
- Report Committee actions to the Board with such recommendations, as the Committee may deem appropriate.
- As part fostering open communication, the Committee will meet in separate executive sessions with the external (independent) auditors and without members of senior management in order to discuss matters that the Committee or any of these groups believe should be discussed privately.
- Conduct or authorize investigations into any matters within the Audit Committee's scope of responsibilities. The Committee shall be empowered to retain independent counsel, accountants, or other personnel to assist it in the conduct of any investigation.

B. External/Independent Accountants

- Recommend to the Board the selection of the independent external accountants, considering independence and effectiveness, and approve the fees to be paid to these accountants. The Committee will ensure that a formal statement delineating all relationships between the accountant and the MFI is received from the outside accountants on an annual basis. The Committee will discuss with the independent accountants all significant relationships that the accountants have with the MFI to determine their independence.
- Approve any replacement of the external accountants.
- Consult directly with the independent external accountants without the presence of MFI management about internal controls and the fullness and/or accuracy of the financial statements as well any material weaknesses identified in the Management Letter.
- Meet with the independent external accountants and financial management of the MFI to review the scope of the proposed external audit for the current year. This scope shall include a requirement that the independent accountants inform the Audit Committee of any significant changes in their original audit.

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- Review the coordination of internal and external audit procedures to promote an effective use of resources and ensure a complete but non-redundant audit.
- Instruct the independent external accountants that the board of directors is the accountant's client.

C. Internal Audit

- Review and approve the annual internal audit plan and any significant changes to it.
- Review the adequacy of internal audit staff qualifications as well as the number of internal audit staff on an annual basis.
- Make inquiries of the internal audit department regarding the adequacy and effectiveness of the MFI's accounting and financial controls and request recommendations for their improvement.
- Review the internal audit department of the corporation, including its independence and the authority of its reporting relationships.
- Review a summary of findings of completed internal audits and a progress report on executing the approved internal audit plan.
- Make inquiries of the internal audit department regarding any difficulties encountered in the course of its audits, including any restrictions on the scope of its work or access to required information.
- Review and concur in the appointment, replacement, reassignment, or dismissal of the staff of the internal audit department.

D. Financial Statements/Internal Controls

- Review the audited financial statements and discuss them with MFI management and the independent external auditors. These discussions shall include consideration of the quality of the company's accounting principles as applied to its financial reporting, including a review of particularly sensitive accounting estimates, reserves, and accruals; judgmental areas; audit adjustments—whether or not recorded; and other such inquiries as the Committee or the independent external auditors shall deem appropriate.
- Determine that the independent external auditors are satisfied with the disclosure and content of the financial statements, including the nature and extent of any significant changes in accounting principles. Upon completion of this review by the Committee, submit the audit report of the independent external auditors, together with its comments and recommendations to the board of directors, at the next regular meeting of the Board.
- Consider the judgments of the independent external auditors regarding the quality and appropriateness of financial statements.

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- Make inquiries of management and the independent external auditors concerning the adequacy of the company's system of internal controls.
- Advise the MFI's financial management and the independent auditor that they are expected to provide a timely analysis of significant current financial reporting issues and practices.
- Advise the MFI's financial management and the independent auditor to discuss with the Audit Committee their qualitative judgments about the appropriateness—not just the acceptability—of the accounting principles and financial disclosure practices used or proposed to be adopted by the MFI.

E. Compliance and Business Conduct

- Provide oversight to the MFI's compliance and business conduct programs.
- Review the programs and policies of the MFI designed by management in order to ensure compliance with applicable laws and regulations and monitor the results of such compliance efforts.
- Require management to report on procedures that provide assurance that the MFI's mission and values, as enumerated in its business and strategy plan, are properly communicated to all employees on an annual basis.
- Encourage management and the board of directors to reflect the MFI's mission and values in their decisions and actions in order to convey to all employees acceptable business conduct in practice.

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Annex E. Sample Skills and Characteristics Required of Board Directors

The goal of _____ (company name). is to contribute to the development of economically disadvantaged individuals and communities in Country A by providing them access to widespread and affordable financial services on a sustainable business basis._____ (company name) (hereafter, "the MFI") will establish a _____ (type of institution) to serve the urban and rural poor, particularly those who need _____ (type of services) for their micro and small-scale businesses.

Under law, Boards are made up of directors who are responsible for the conduct of the business. Their overriding duty is to act in the best interests of the MFI, not to make private profits from their office and to avoid conflicts of interest between themselves and the MFI. The goals and nature of MFI operations require that Board directors possess specific skills, knowledge, and experience to lead and direct the MFI successfully. The following have been determined to be skills and characteristics that the MFI Board and its individual directors require.

Skills and Characteristics of the Collective Board:

- knowledge of the small enterprise development sector and the client community
- business knowledge and experience
- banking and financial management knowledge and experience (i.e., directors will include bankers, accountants, and financial analysts)
- knowledge and experience in human resource development and corporate management, particularly in the financial sector
- corporate and financial planning experience
- experience in advocacy and legal counsel, with knowledge of the legal, tax, and regulatory environment relevant to MFI operations
- qualified accounting knowledge and experience
- government contacts
- team building skills
- banking contacts
- business and community contacts

Skills and Characteristics of Individual Board Drectors:

- emotional commitment to the organization's mission
- strong communication skills
- performance orientation (i.e., can accomplish and implement tasks, plans, results)
- of high repute and integrity in business, profession, and the community generally
- time availability
- analytical skills and business acumen
- at least one of the skills and characteristics required by the collective Board

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Annex F: Sample Board and Internal Audit Department Code of Ethics

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

Internal auditors are expected to apply and uphold the principles shown in the box below.

Box F1. 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 other 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.

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SAMPLE BOARD OF DIRECTORS CODE OF CONDUCT

Board members are expected to comply with the prescribed Code of Conduct shown below, which encourages the development of a spirit of collective decision making, shared objectives, and shared ownership of and respect for Board decisions. The Code of Conduct succinctly state the essential principles intended to govern the conduct of the Board and staff of the MFI.

Box F2. Code of Conduct

Board members and staff of the MFI will at all times conduct themselves in a manner that:

- supports the objectives of the MFI
- serves the overall best interests of the MFI, rather than any particular constituency
- brings credibility and good will to the Corporation
- respects the principles of fair play and due process
- demonstrates respect for individuals in all manifestations of their cultural and linguistic diversity and life circumstances
- respects and gives fair consideration to diverse and opposing viewpoints
- demonstrates due diligence and dedication in the preparation for and attendance at meetings, special events, and all other activities on behalf of the MFI
- demonstrates good faith, prudent judgment, honesty, transparency, and openness in their activities on behalf of the MFI
- ensures that the financial affairs of the MFI are conducted in a responsible and transparent manner with due regard for the fiduciary responsibilities and public trusteeship of the board of directors and MFI staff
- avoids real or perceived conflicts of interest
- conforms with the MFI's by-laws and the policies approved by the Board, in particular this Code of Conduct, relevant oaths of office, and confidentiality and conflict of interest policies
- publicly demonstrates acceptance of and respect and support for decisions legitimately taken in transaction of the MFI's business.

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Annex G: Sample Audit Committee Calendar

Schedule of standing agenda items	Qtr 1	Qtr 2	Qtr 3	Year end
Agenda items: Full Board				
1. Approve minutes of previous meeting	X	X	X	X
2. Approve annual budget				X
3. Approve unbudgeted capital expenditures over $xxxxx	X	X	X	X
4. Review actual versus budgeted financial results	X	X	X	X
5. Litigation review		X		
6. Review financial performance of MFI versus that of its competitors	X	X	X	X
7. Review/approve strategic plan		X		
8. Appoint external auditors			X	
9. Approve Board Committee reports	X	X	X	X
Agenda items: Audit Committee				
10. Review audit plan		X		
11. Consider tax planning opportunities		X		
12. Assess insurance coverage			X	
13. Approve internal audit annual plan				X
14. Meet alone with external auditors	X			
15. Review management letter	X			
16. Review and approve risk matrix for MFI	X		X	
Compensation Committee				
17. Approve management bonus payments	As per approved schedule			

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18. Approve stock allocations	As per approved schedule			
19. Compare management compensation to industry		X		
Governance Committee				
20. Coordinate Board self-assessment			X	
21. Present results of Board self-assessment				X
22. Propose slate of committee appointees				X
Finance/Budget Committee				
23. Work with management on annual budget	As per approved schedule		X	
24. Work with management on business plan	Annually			X
25. Review and approve financial projections for next 3 to 5 years, as presented by management	Annually			X

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Annex H. Sample Internal Audit Reports

ANNEX H: SAMPLE MFI INTERNAL AUDIT REPORTS

SAMPLE MFI INTERNAL AUDIT REPORT: TEMPLATE A

Branch/Office: _____
Date(s) of Audit: _____
Office: _____
Auditor: _____

AUDIT OBJECTIVES:

SCOPE OF AUDIT WORK

Audit Time Period: _____

Checklists Completed: Cash _____ Financial Reports _____ Human Resources _____
Loans_____ Savings_____Other_____

Transactions tested or
Files reviewed on a sample basis: Number of transactions or files Basis for selection

1) Cash receipts _____
_____

2) Cash disbursements _____
_____

3) Personnel files _____
_____

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4) Loan files _____
_____

5) Savings _____
_____

List other audit work programs:

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Reviewed previous Audit Report:

Date of Previous Report: _____ Period Covered: _____

Number of Recommendations Listed: _____ Number of Items still outstanding: _____

Auditor Comments:_____

Management Comments:_____

Office _____ Date: _____

`

KEY ISSUES	FINDINGS	RISK	RECOMMENDATIONS

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KEY ISSUES	FINDINGS	RISK	RECOMMENDATIONS

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CONCLUSIONS:

(Conclusion should be very concise, only restating items of particular concern, and noting items from previous reports that have not been corrected.)

ADDITIONAL MANAGEMENT COMMENTS:

Report Prepared by _____ **Date** _____

Report Received by _____ **Date** _____

`

SAMPLE INTERNAL AUDIT REPORT: TEMPLATE B

Audit Report Outline

1. Title Page and Contents

2. Signature

The audit report must be signed by the head auditor.

3. Introduction

Describes the type of audit and the area of activity. Makes reference to previous audits, if appropriate, and discusses the status quo of previous recommendations that have not yet been implemented.

4. Objectives

Declares the audit objectives, which are the same as those outlined in the audit agenda.

5. Scope

Describes the depth and scope of the audit that was needed to attain audit objectives.

6. Methodology

Clearly explains the collection of evidence and the analysis techniques used to attain audit objectives.

7. Audit Standards

Includes a declaration that the audit was performed in compliance with international audit standards and discloses if and when applicable standards were not complied with.

8. Audit Findings

Provides the auditor's opinion on each audit objective.

9. Conclusions and Recommendations

Each recommendation should consider:

- facts established by the audit
- criteria, causes, and effects
- advice to management to remedy the problems identified by the audit
- whether it is a major, medium, or minor priority
- the response of the auditee to the audit report and recommendations

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SAMPLE INTERNAL AUDIT REPORT: TEMPLATE B

Document Ref. #:_____

NAME OF AUDIT

MONTH YEAR

DISTRIBUTED TO

`

Document Ref. #: _____

AUDIT NAME
AUDIT REPORT

TABLE OF CONTENTS

Page

`

DOCUMENT REF. #
AUDIT NAME
DATE

EXECUTIVE SUMMARY

Purpose & Limitations

The executive summary provides the audit perspective and highlights, on a summarized basis, the significant findings discussed throughout the body of the detailed audit report. Care should be exercised in reaching conclusions solely based on a review or reading of this summary. It is necessary to read the specific detailed sections and/or the report in its entirety to understand the breadth of the background, ramifications, and recommendations relating to each issue and/or finding.

Audit Opinion

As discussed more fully in my opinion on page _____ of this report, …

Relevant Findings

- List a summary of each finding (without a statement on its ramifications and/or implications). Cross-reference the finding to the relevant section of the report.

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DOCUMENT REF. #
AUDIT NAME
DATE

INTRODUCTION

Background

Provide background information about the purpose/mission/motives of the audited department/area. Identify the auditor who performed the audit.

Audit Perspective

Present audit status. Indicates whether or not this is a follow-up on a previous audit.

Recent past audits. Provides findings, conclusions, and recommendations of other similar or related audits.

External audit coverage. Provides findings, conclusions, and recommendations of external audits.

Scope & Objectives

This section should be brief and discuss the timing, type, and purpose of the audit; the nature and extent of audit tests performed; the audit procedures and evaluation criteria used; and the standards that guided the conduct of the audit. Types of audits or reviews include financial, compliance, IT, and investigative. Internal control evaluations are included under compliance. The auditor should make the determination as to whether national or international standards apply. *Internal auditing standards always apply*.

Note: "Audit" should be used in the report when actual tests were performed to corroborate the opinion. "Review" should be used in the report when no tests were performed to corroborate the opinion. Comments should speak directly to what was done, that is, if a test was performed, the word "test" should be used. If a review was performed, the word "review" should be used.

Example: The scope of the audit was financial and operational in nature and covered the period from *month* through *month*. The audit was performed to ensure that financial data was properly recorded and adequate operational procedures existed in the petty cash function. The audit was conducted in accordance with the Standards for the Professional Practice of Internal Auditing and other the applicable standards. The last day of fieldwork was _____.

The objectives of the audit were as follows:

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- Determine that payments and/or purchases were recorded correctly as an expense type, with amount and period.
- Ascertain that all payments and/or purchases were justified and for the benefit of the MFI.
- Ascertain that internal controls were correctly implemented, including authorization of expenses and segregation of duties.

DOCUMENT REF. #
AUDIT NAME
DATE

Internal Audit Opinion

This section states the auditor's opinion or conclusion, based on the audit objectives and the effect of findings on the MFI's operations. The conclusion should be clear and motivated. It could cover all or part of the activity of the department or area that was audited or only its specific issues.

Example: In my opinion, I found the _____ to be adequate, or inadequate (detail of inadequacies to follow the word inadequate).

I have identified opportunities to improve the controls of the department(s) as discussed in this report.

_____ _____

INTERNAL AUDITOR DATE

Note: *The above opinion relates primarily to operational audits or reviews. The following may be used for financial and compliance audits or reviews respectively.*

Example: In my opinion, I found the financial transactions of _____ to be properly recorded and the operational procedures adequate for the period under audit. However, I have identified opportunities to improve the efficiency and effectiveness of certain operating procedures as discussed in this audit report.

In my opinion, I found _____ to be in compliance with (or not in compliance with) MFI policies and procedures, investor or donor regulations, etc.

I have identified the areas of noncompliance to be corrected in this report.

`

DOCUMENT REF. #
AUDIT NAME
DATE

Detailed Report

Overview

Pages X through XX outline the **specific findings** resulting from my substantive audit testing. In addition, I examined recent historical trends in productivity and performance measures (see Exhibits X and XX)**.**These findings are discussed in detail in the report and are categorized as primary findings (significant internal control deficiencies and items that could potentially have a significant or adverse effect on the unit's operations) or other matters (items of a lesser nature that require attention, but are unlikely to have a significant or adverse effect on the unit's operations). The findings are generally presented in each section in order of importance, based on the stated ramifications and/or implications of each finding.

Primary Findings

I. TITLE OF COMMENT

Insert summary of the finding included in the Executive Summary

Finding

Ramifications/Implications

Recommendation(s)

Auditee's response (if the auditee does not agree with the findings, s/he signs the report noting disapproval and attaching an annotated document substantiating this disapproval)

Other matters

II. TITLE OF COMMENT

Insert summary of the finding included in the Executive Summary

Finding

`

Ramifications/Implications

Recommendation(s)

Auditee's response

`

Sample OF Internal Audit Management Responses

The templates below assume that an internal audit department employs a number of auditors and that multiple branches are being audited each year. Without a systematic and managed approach, the internal audit function can simply be an activity. It is strong management that makes the function an effective, helpful one in an MFI. This annex offers two templates for a management response to an internal audit.

INTERNAL AUDIT MANAGEMENT RESPONSE: TEMPLATE A

Document Ref. #:

TO:

CC: Director
Audit Committee

FROM:

DATE:

Subject: Response to (NAME) Audit Findings

This is the management response to the final draft of the recent audit of (NAME) conducted by the Internal Audit Department. Our responses/agreed actions to your findings and recommendations are summarized below as follows:

1. **Finding 1**

   Management Response –

2. **Finding 2**

   Management Response –

3. **Recommendation 1**

   Management Response –

4. **Recommendation 2**

   Management Response –

Implementation date for all the above agreed recommendations will be no later than (**dates**).

`

INTERNAL AUDIT MANAGEMENT RESPONSE: TEMPLATE B

Document Ref. #

Program: _____

Date(s) of Audit: _____

Office: _____

Auditor: _____

SCOPE OF AUDIT WORK

Audit Time Period: _____

Checklists Completed: Cash _____ Financial Reports _____ Human Resources_____ Loans _____ Savings_____Other_____

Reviewed previous audit report:

Date of Previous Report: _____Period Covered: _____

#	Recommendation	Management Response

`

Other Comments:

Dated: _____

Signed: _____

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Annex I: Sample Internal Audit Follow-up Reports

MFI Internal Audit Follow-up Report: Template A
(Monthly or Quarterly Report to the Audit Committee)

Document Ref. #:_____
Branch #1:_____

Date of audit	Recommendations not yet addressed	Risk levels and comments

Branch #2:_____

Date of audit	Recommendations not yet addressed	Risk levels and comments

Submitted by: _____

Date: _____

`

MFI Internal Audit Follow-up Report: Template B

Document Ref. #: _____

Audit Name: _____

Prepared by: _____

MFI – INTERNAL AUDIT DEPARTMENT **AUDIT RECOMMENDATION STATUS REPORT**		**MFI Department/Branch:** **Audit Report No.**			**Quarter Ending:**
Rec.No.	**RECOMMENDATION/RESPONSE** Print/Type Recommendation, if response is required, place directly below applicable recommendation *Enter audit recommendations number as shown in the audit report*	**STATUS** *Check appropriate column*			**IMPLEMENT. OR TARGET DATE** *Enter date implemented or the target date for implementation*
		Implemented	**Partly Imple-mented**	**Not Imple-mented.**	

Annex J: Evaluating External Auditor Quotes

(adapted from CGAP Operational Risk Management course materials, Campion, and other resources)

The scope of an external audit can vary significantly, depending on its objectives. The financial statement audit is the most common audit, but there are also management letters, special-purpose audits, and/or additional agreed-upon procedures for the conduct of an audit.

Table J1. Common External Audit Services for an MFI

Service	***Purpose***	***Activities***	***Output***
Annual financial statement audit	To confirm that the financial statements are free from material misstatement	Audit, on a test basis, key account balances and underlying evidence and/or procedures	Audit report, including an opinion, financial statements, and notes
Management letter	To obtain constructive comments that management can use to improve operations or internal controls	By-product of the annual financial statement audit	Management letter
Special-purpose audit	Generally to audit compliance with donor requirements, including use of funds	Review of specific issues as requested by the client, usually on behalf of a donor	Special audit opinion and report
Agreed-upon procedures	To obtain detailed results of specific testing procedures for selected transactions or account balances	Performance of agreed-upon procedures	Report of results of procedures without an opinion—.users draw their own conclusions

Managing the External Audit Process

The external auditor is usually engaged by, and ultimately responsible to, the board of directors. In NGOs where board members have no personal financial stake in the organization, this responsibility is too often delegated almost entirely to management. The audit process then becomes something that must be done to satisfy donors or regulators, rather than something of benefit to the institution.

Commissioning the External Audit

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It is crucial for the board of directors to be involved in the planning and oversight of the external audit. Sometimes oversight is provided by an Audit Committee of the Board, or in smaller MFIs, by a single director with financial expertise. The board representative(s) will need extensive assistance from MFI management and staff but, in order to exercise objective and independent judgment, they should spend the time necessary to stay informed and involved in the process. An external audit also presents Board members with an opportunity to improve their first-hand familiarity with the financial conditions and controls of the MFI.

The process of commissioning an external audit begins by determining the scope of work that will form the basis of the terms of reference for the engagement. The terms of reference list the MFI's requirements, on which audit firms will base their proposals. The terms of reference are generally approved by the full Board.

Key Elements of the Terms of Reference

1. Introduction: institution to be audited, party engaging the audit, and a brief statement of services requested.
2. Description of the MFI and its organizational structure: identify key financial managers, list of branches, etc.
3. Prior year audits (if any).
4. Objective: clearly state the financial statements, portfolio quality, and period to be audited.
5. Scope: specify expected procedures (e.g., adherence to specific standards, percentage and associated costs for client visits, additional procedures, etc.).
6. Audit report and financial statements: detail the content and presentation of the statements.
7. Management letter: general areas to be addressed and specific areas of concern.
8. Agreed-upon procedures: review of portfolio, MIS, or/and internal control system.
9. Timing: deadline for completion of audit report
10. Pre-proposal survey: ask the bidding firms to spend time at the MFI (at their expense) to gain information and an understanding of the organization.
11. Proposal format: outline in detail the items to be included in the proposal, including:
    a) understanding of the work
    b) audit approach, i.e., timing, procedures, etc.
    c) Audit team, i.e., roles and required experience and qualifications
    d) firm information, i.e., relevant experience, statements of independence, principal clients, adherence to standards
12. Cost proposal: request a separate submission of costs.
13. Deadline for submission of written proposals.

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14. Oral presentations to the Board (if desired).

Evaluating the Proposals

The MFI must seek a balance in selecting an external audit firm. It wants auditors who are rigorous and objective. At the same time, it wants to work with audit staff that have the ability and judgment to understand the unique circumstances and challenges of microfinance. The relationship between the firm and the MFI must be constructive: the MFI must feel that the auditor's recommendations are supportive and the auditor must feel that the MFI is making a good faith effort to address valid concerns. Questions to guide the selection process include:

- Does the audit firm demonstrate an understanding of the MFI by identifying elements of concern or focus?
- Which set of auditing standards will the bidder use to conduct the audit?
- What grading system is suggested for assessing portfolio quality?
- Does the external audit team include personnel with adequate experience and qualifications?
- How well did they respond to questions during the oral presentation?
- Does the proposal include any added value (e.g., suggestions on how to conduct the audit more efficiently)?

Negotiating a Fee

The fee is generally a function of the level of effort and the hourly rates charged by the firm. The level of effort depends on the size of the MFI, whether the MFI has an internal audit department, and whether the external auditor can rely on tests performed by the internal auditors.

The bidder with the lowest price is not always the best choice for the engagement. On the other hand, the most expensive "big four" affiliated firms are no guarantee of technical or ethical quality. The decision should be based on the factors discussed above and presented to the Board for approval.

Contract or Engagement Letter

A contract or engagement letter is used to formalize the audit appointment. Generally, the audit firm issues the letter. The MFI must ensure that the final agreement for the audit work reflects the work outlined in the terms of reference and the proposal, as well as the agreed level of effort and cost. Standard engagement letters provided by audit firms are often not specific enough on these points. A clear and specific agreement lowers the risk of subsequent disputes and provides a basis for resolving them if they occur.

Annex K: Sample Conflict of Interest Policy and Certificate

Good governance practices expect directors to be conscious of actual or potential conflicts of interest and to disclose such matters to the Board when such an occasion may arise. Broadly speaking, a conflict exists whenever a director's independent and unbiased judgment is compromised because of an existing or potential relationship.

A director and the third party are engaged in such a relationship when:

- a material financial interest exists or is being sought
- the Director serves as a personal representative of the third party
- gifts or other favors (i.e., significant material items) have been received or are expected
- indebtedness, as in the case of a loan (current or potential), exists between them
- a family relationship exists
- the parties are professionally connected in a meaningful way

Sample Conflict of Interest Certificate

I _____, Board member of _____ (name of MFI), hereby declare that I have no personal, social, political, or business interests that might interfere in my Board responsibilities for the organization.

If any such interests arise in my tenure as Board Member, I promise to disclose these matters to the Board for deliberation as necessary.

_____, Board member
(signed)

_____, Witnessing Board member (Chair)
(signed)

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Annex L. Audit Committee Performance Self-assessment Tool

Adapted from www.auditnet.org/docs/IIANOVA/AC-Assess.doc- AUDIT COMMITTEE PERFORMANCE SELF-ASSESSMENT SURVEYS

Table M1. Self-assessment Survey

HOW SATISFIED ARE YOU THAT:	NOT SATISFIED		SATISFIED		NOT SURE
	1	2	3	4	NS
1. **CHARTER** – All Audit Committee members clearly understand the Committee's mission, roles, responsibilities, and committee direction outlined in the Audit Committee Charter.					
2. **ROLES** – There is a clear understanding of roles and responsibilities between the Audit Committee and the Board.					
3. **COMPOSITION** – The proper mix of financial, legal, and other relevant business talent is maintained among Audit Committee members. If not, the Audit Committee cultivates and recruits the appropriate talent in order to strengthen its composition.					
4. **ORIENTATION** – The Board provides new Audit Committee members with a comprehensive orientation, including relevant industry-specific risks, organizational strategies, and key responsibilities.					
5. **RELATIONSHIPS** – An atmosphere of mutual trust and respect exists between the Audit Committee and staff, while Committee members maintain a spirit of healthy skepticism.					
6. **EDUCATION** – Management and staff are proactive in assisting the Committee in keeping current on important business, financial, operational, and regulatory matters.					
7. **MEETINGS** – The Audit Committee receives, at least one week in advance of a meeting, a complete, clear, and succinct agenda and support materials (e.g., audit reports, follow-up summaries, organizational responsibility reports) that are focused on substantive issues.					
8. **DISCUSSIONS** – Audit Committee members have adequate opportunity to discuss issues and ask probing and/or challenging questions of management, when necessary.					
9. **SIGNIFICANT MATTERS** – The Audit Committee is kept apprised of the significant operational, financial, and/or regulatory issues currently being faced by the organization.					

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10. **TIME MANAGEMENT** – An appropriate balance of meeting time is achieved, based on reading agenda packet materials beforehand, dialogue on relevant issues, and prepared questions.					
11. **BOARD REPORTING** – Meaningful Audit Committee results are reported to the full Board in a clear, concise, and timely manner.					
12. **EXECUTIVE SESSIONS** – Audit Committee members respect the confidentiality of executive sessions with management, the internal audit department, independent public accountants, and the Compliance Officer.					
13. **OVERALL SATISFACTION WITH COMMITTEE PERFORMANCE**					

Please describe any specific improvement opportunities for the Audit Committee:

Note: Another excellent tool can be purchased on the Web site of the American Institute of CPAs, www.aicpa.org:
The AICPA Audit Committee Toolkit (2008) — see "Conducting an Audit Committee Self-Evaluation: Guidelines and Questions" in Part III

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Annex M: Sample Annual Plan for an Internal Audit Department

Objective of the department

- Strengthen and support the internal control systems of the MFI
- Provide assurance as to the reliability of financial and operating reports
- Support management in its risk mitigation framework and strategies
- Ensure compliance with MFI policies and procedures
- Follow-up on the implementation of proposed recommendations
- Support senior management and the board to achieve MFI objectives and goals
- Coordinate the activities of all auditors (internal and external)

Annual objectives

- Update and maintain the audit manual
- Recruit and assign one new regional auditor
- Update job descriptions of regional auditors
- Supervise each regional auditor to conduct audits at all branches
- Evaluate all internal control systems and make recommendations
- Coordinate the activities of the regional office auditors
- Coordinate the activities of all auditors (internal and external)
- Evaluate the performance of internal audit staff
- Review all internal auditors' working files and issue audit reports with recommendations for improvements.

Background on Developing Plans

The internal auditor must develop an **annual work plan and budget** for the department, regardless of the number of auditors. Note that regulated MFIs may be required to comply with specific internal audit plans, tools, and approaches. If an MFI is regulated, it falls to the regulator to determine any specific requirements. In general, an MFI's annual internal audit work includes:

- conducting first-time internal control assessments and follow-up assessments
- reviewing policy and procedure updates

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- conducting two audits per year (as appropriate), depending on the given MFI's needs and risks
- writing audit reports and issuing recommendations to revise procedures and strengthen controls
- meeting with senior management representatives to discuss audit findings and reports, and to provide input into strengthening internal control systems and managing newly identified risks
- meeting with senior management and the audit committee to review the reports and evaluations of the internal audit department

The primary budget items for the department will include staff salary and benefits, travel and accommodation costs (for visiting branches), professional publications, and possibly, professional trainings or meetings. Access to transportation is vital for the department. An annual internal audit work plan and budget should be incorporated into an MFI's overall annual plan to ensure that the function is part and parcel of the MFI's operations.

The work plan and budget will vary among MFIs, depending on their size, the number of branches, lending methodology, and reporting systems.

Sample Annual Audit Plan 20XX

Audit	Risk Rating	J	F	M	A	M	J	J	A	S	O	N	D	Total
1														
2														
3														
4														
5														
6														
7														
8														
Training														
Annual leave														
Other														
To be allocated														
Total days available														

Note: The ratings and numbers in the table above are given as examples.

Attached to this annual plan is the proposed annual department budget for board approval. The budget outlines staffing, transportation, training, materials, and computer hardware and software costs.

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Comments:

Approval and Dates

Audit Committee Representative: _____

Management:_____

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Resources

Council of Microfinance Equity Funds. 2005. "The Practice of Corporate Governance in Shareholder-owned Microfinance Institutions." Council of Microfinance Equity Funds, Boston, MA. http://www.cmef.com/Document.Doc?id=571. Accessed April 2010.

Deloitte Development LLL. 2009. "Center for Corporate Governance: Audit Committee." Web page. Deloitte Development LLC, Detroit, Michigan. http://www.corpgov.deloitte.com/site/us/audit-committee/. Accessed April 2010.

IFC (International Finance Corporation). N.d. Corporate Governance Web page: "Past External Trainings." (Powerpoint presentations on corporate governance.) IFC, Washington, DC. http://www.ifc.org/ifcext/corporategovernance.nsf/Content/ Trainings_external_past. Accessed April 2010.

IIA (Institute of Internal Auditors). N.d. "Audit Committees & Boards of Directors." Web page. IIA, Altamonte Gardens, Florida. http://www.theiia.org/guidance/additional-resources/audit-committees-board-of-directors/?search=Audit%20Committee:%20Discussions%20on%20Performance. Accessed April 2010.

Among the resources offered by this Web page are:

- "Audit Committee: Discussions on Performance"
- "Audit Committee: Self-Assessment Guide"
- "20 Questions Directors Should Ask About Internal Audit"

———. N.d. "Audit Committee Related Guidance." Web page. IIA, Altamonte Gardens, Florida. http://www.theiia.org/guidance/ additional-resources/audit-committees-board-of-directors/audit-committee/?search=Audit%20Committee. Accessed April 2010.

———. N.d. "Internal Auditing: Adding Value across the Board/" IIA, Altamonte Gardens, Florida. http://www.theiia.org/theiia/about-the-profession/about-the-internal-audit-profession/. Accessed April 2010.

———. N.d. "Tone at the Top" (IIA corporate governance newsletter). IIA, Altamonte Gardens, Florida. http://www.theiia.org/periodicals/newsletters/tone-at-the-top/. Accessed April 2010.

IIA Research Foundation. 2009. "International Professional Practices Framework." Altamonte Gardens, Florida: IIA Research Foundation.

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———. 2005. *Audit Committee Effectiveness: What Works Best*. 3rd ed. Alamonte Gardens, Florida: IIA Research Foundation.

IIF (Institute of International Finance). 2009. "Reform in the Financial Services Industry: Strengthening Practices for a More Stable System." IIF, Washington, DC.

KPMG Audit Committee Institute. 2008. "The Audit Committee Journey; Charting Gains, Gaps, and Oversight Priorities: A Global View; 2008 International Audit Committee Member Survey." KPMG International. http://www.kworld.com/aci/surveys.asp#ACI_NACD_Journey07_08_POSTFINAL. Accessed April 2010.

Jacobs, R., R. Mbeba, and B. Harrington. 2007. *Board Governance in Microfinance Institutions Toolkit*. Kenya: MicroSave. http://www.microsave.org/toolkit/board-governance-in-microfinance-institutions-toolkit. Accessed April 2010.

This publication offers guidance on Board roles and responsibilities, the role of the CEO, and strategic direction, as well as sample templates, including:

- Examples of Vision, Mission and Goals Statements
- Sample Code of Conduct
- Sample Conflict of Interest Agreement
- Sample skills required of Board Directors
- Board Recruitment Grid
- Sample Board Rotation Policy
- Sample roles and Responsibilities of Board Directors
- Sample Orientation of Board of Directors Checklist
- Sample Job Description for Board Chairperson
- Sample Board Director Job Description
- Sample Board Committee Structure
- Sample Executive Committee Charter
- Sample MFI Audit Committee Charter
- Sample Loan Credit Committee Charter
- Sample Annual Calendar of Board Tasks
- Sample Board Meeting Agenda
- Sample Board Performance Evaluation Form
- Board Information
- Sample Board Development Plan
- Sample Board Governance Policy
- Sample CEO Job Description
- Sample CEO Appraisal Tool
- Sample CEO Succession Policy
- Sample Board Governance By-Laws

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- Sample Conflict Resolution Process
- Sample Oath of Office and Confidentiality
- Sample Board Governance Risk Management Policy
- Sample funds Management and Interest Rate Risk Policy
- Sample Personnel Policy
- Sample of Table of Contents for Credit Policy
- Sample Information Technology Policy
- Sample Compliance Program
- Sample Compliance Program Chart
- Sample Board Governance Risk Management Questionnaire
- Strategic Planning Elements
- Strategic Plan Implementation Chart

Pikholz, Lynn, Pamela Champagne, Trevor Mugwang'a, Madhurantika Moulick, Graham A.N. Wright, and David Cracknell. 2005. "Institutional and Product Development Risk Management Toolkit." Shorebank Advisory Services and MicroSave, Nairobi, Kenya.

The toolkit is available on the MicroSave Web site (www.microsave.org), which requires users to register before accessing documents. Once registered, a user can find the toolkit at http://www.microsave.org/system/files/toolkits/toolkits/Institutional%20and%20Product%20Development%20Risk%20Management%20Toolkit.pdf.

Shepherd, Nick A. 2005. *Governance, Accountability, and Sustainable Development: A New Agenda for the 21st Century*. Toronto: Thomson Carswell.