

MFI Audit Course Handbook

Aclaim Africa



Overview and objectives

This programme is based on materials found in the CGAP Operational Risk Management Course, a CGAP one-day seminar capacity development for MF external auditors, the CGAP auditors handbooks volume 1 and 2, and audit work programmes developed by Sam Lankester for Carr Stanyer Simms & Co.

Objectives

- Obtain overview of MF and MF methodologies
- Identify the major stakeholders of MF external audit and understand their expectations
- Distinguish the inherent risks and unique features of MFI audit
- Appreciate the risk of major MFI account components and the audit approach
- Learn about the inconsistencies in MF accounting with International Accounting Standards (IAS)
- Learn about MF accounting disclosure best practice
- Learn about difficulties in applying ISA in MF audit report

Target group – Auditors in AMFIA

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MINI ACTION PLAN

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

1 The MFI Industry

1.1 Background

There is a long history of informal finance in Uganda. The Micro Finance Industry began with social welfare objectives, initiated mostly by cooperatives and NGOs. The last 10 years have seen significant growth in this industry, although it is now levelling off. Best practice in the industry is relatively young, although it is now quite clearly defined.

The MFI Industry is unusual in straddling the boundary between business and NGO. They have a double bottom line: sustainable services for the poor. The increasing recognition for the need for financial sustainability has led to more and more MFIs aiming to move towards commercial viability.

Uganda has the leading MFI in Africa, with over 500 outlets in 52 of Uganda's 56 districts. There are some 600,000 active clients, of whom 70% are women, but only 20% are rural. There is a greater concentration in Central and Western regions. MFIs are grouped into different categories:

Cat.	No.	Characteristics
A	6	Over 20,000 active clients Company structure or in transformation >90% financially self sustaining (FSS) Well documented procedures / MIS Compliant with MF best practice
B	10	5000-20000 active clients NGO, SACCO or company 50-89% FSS Fair documentation of procedures / MIS Applying best practice
C	40	500-5000 active clients NGO, SACCO, FSA or company 35-49% operating self sufficiency Business plan reflecting good practices Know what's going on in the Industry
D	>300	<500 active clients NGO, SACCO, FSA, ROSCA, ASCA or company Savings & credit core activity Not so aware of what's going on in the Industry Little awareness of Best Practice
E	1000s	Multipurpose NGOs, cooperatives, projects / programmes and support institutions promoting microfinance Microfinance not core activity Potentially important linkage partners

1.2 Industry prospects

Prospects for the industry are very good because there is a very conducive environment for growth. There is excellent cross sector coordination, including donors, government, MFIs, consultants and auditors, greatly facilitated by the existence of associations such as AMFIU and AMFIA. In all areas of the industry there is a commitment to International Best Practice as the way forward, and a determination to overcome the obstacles in seeing it implemented. Since 2003 there is also a stringent regulatory framework embodied in the Microfinance Deposit Taking Institutions Act 2003.

For auditors, some investment is likely to be necessary to build skills and capacity to carry out effective audits. This is well worth it, as donors and even MFIs themselves are hungry for effective audits that meet their needs. The market is ripe!

1.3 The MDI Act 2003

In 1999, the BoU categorised all Financial Institutions into 4 Tiers:

Tier 1: Commercial Banks

Tier 2: Credit Institutions

Tier 3: Microfinance Deposit Taking Institutions

Tier 4: Institutions in microfinance that do not qualify for 1, 2 or 3

This tier structure should not be confused with the categories A-E described above. An MFI in Category A may be in a position to and choose to apply for registration under the MDI Act. Once accepted, that Category A MFI will move from Tier 4 to Tier 3. Belonging to Category A does not automatically mean that the requirements for registration as an MDI are met, or that an MFI wishes to register as an MDI. Registration brings with it the benefit of credibility, which attracts clients and donors. In June 2005, only 1 Ugandan MFI (FINCA) has registered under the bill, and 3 applications are in process.

The overall objective of the Act is regulation and supervision of Tier 3 Financial Institutions. Some of the key areas covered in the Act include

- Licensing (allowing) or restricting certain types of transactions and dealings,
- Stringent requirements for ownership and corporate governance: e.g. no shareholder may own more than 20%
- Supervision, receivership & liquidation
- Sustainability & outreach

1.4 Characteristics of MFI clients

MFI clients often operate tiny informal businesses. There is usually no perceived difference between the individual and the business, and rarely are formal books or records maintained. Traditionally, micro-entrepreneurs have not had access to bank loans. The loans they need - anywhere from \$25 to \$1,000-are too small for conventional banks to handle economically. Because of their lack of collateral, bookkeeping methods, and informal status, most bankers view micro-entrepreneurs as unacceptable credit risks. As a result their sources of credit have mainly been limited to family members, suppliers, and informal moneylenders who charge extremely high interest rates.

But over the past decade a wide variety of institutions, mainly non-profit social service organizations, have developed methods that enable them to deliver loans to micro-entrepreneurs and other poor clients at a manageable cost while maintaining high repayment rates. In many developing countries microfinance has grown dramatically: it is supporting the income and welfare of tens of millions of customers

1.5 Characteristics of MFI operations

In meeting the needs of their clients, MFIs generally give out quite small loans, and require small regular repayments. There are therefore huge volumes of tiny transactions to be captured and reported. The key to the success of MFIs lies in their innovative lending methodologies, as shown in the table below:

Achievement	Methodology
Low transaction costs	Low level approval Little segregation of duties
High outreach	Decentralisation Cash
Speed of processing	Simple standardized procedures Few documents
Unsecured loans	Character based assessment Group lending and cross guarantees
High repayment rates	Incentive of access to future credit Good loan officer relationship Start small, graduated loan sizes Training Tough on delinquency Peer pressure

1.6 Individual vs. group lending

One of the key characteristics of MFI methodology is group lending. The following table compares individual and group lending.

	Individual Lending	Group Lending
Collateral	Loans guaranteed by collateral	Mutually guaranteed with other borrowers
Participant Screening	Potential clients screened by credit checks	Potential clients screened by their peers
Loan Analysis	Loan amount based on thorough viability analysis	Little or no analysis of the business, except by peers
Loan Flexibility	Tailored to needs of the business	Follows pre-set gradual growth curve
Loan Size and Term	large sizes, medium to long terms	Generally short and amounts small
Staff-Client Relationships	Close, long-term relationships with clients	More distant relationship with large numbers of clients
Cost per Client	High – lower volume	Low – high volume
Cost per Loan	Low – larger size	High – small size

1.7 Consultative Group to Assist the Poorest (CGAP)

CGAP is a multi-donor consortium dedicated to the advance of sustainable micro-finance worldwide. They have three main teams:

- Client end – issues relating to clients needs / product development / impact on poverty reduction
- MFI team – Investment grants and capacity building for MFIs
- Industry team – Industry wide issues e.g. accounting policies, loan tracking software, financial reporting, auditing etc

CGAP has become the definer of Best Practice in the MFI Industry worldwide. The course materials presented in this course were developed largely by CGAP.

1.8 Significant challenges

There are many challenges facing the industry, but some of the most acute relate to accounting, reporting and auditing:

- **Accounting** – inconsistency in accounting policies, lack of integration between loan tracking and accounting software
- **Reporting** – Financial Statements often contain insufficient information to assess portfolio performance or financial sustainability
- **Auditing** – auditors find standard procedures are ineffective, managers and donors find audit reports are not helpful

2 MFI audits – stakeholder expectations and audit risks

2.1 Definition of audit

The financial statement audit is the most common type of external audit. In this audit the external auditor expresses an opinion as to whether an MFI's financial statements are fairly presented in conformity with an identified financial reporting framework—that is, a defined set of *accounting standards*. The audit is conducted with an identified *auditing standard*.

2.2 Stakeholder expectations

Stakeholder	Legal compliance	F/S presents fair view	Sustainability
Donor	High	Medium	High
Regulatory Body	High	Medium	High
Mgmt	Medium	High	High
Members	Low	Low	High

➤ **Donors:** The donors' primary concern is whether the MFI has complied with the terms of the grant agreement. Most donor personnel are from a non-finance background and thus have limited knowledge about understanding and interpreting financial statements.

MFI sustainability is also not always a big issue unless it is specifically mentioned in the grant agreement. Donor projects always work on a fixed time frame and poverty focused programs mostly have a purely development orientation (e.g. education, health, etc.) and thus are delivery oriented with a relief/charity mindset. The goal of a self-sustaining program for the poor, as in the case of microfinance, is a new concept for which most donor personnel are not properly equipped or trained.

➤ **Regulatory bodies:** These have been formed either from NGO or Central Bank perspective and thus are not really suitable for MFIs. Financial statements and sustainability are not critical factors for regulating NGOs. Central Banks have their own bank supervisors and MFI's are still very new to them. Banks have been around for hundreds of years.

➤ **MFI Management:** Like most auditees, auditors are a pain in the neck and have to be tolerated as it is required by the donor and/or regulatory authority. All the management wants is a "clean" audit report.

➤ **Members:** No MFI members know about the external audit. But it is this group which is most affected by the performance of a MFI.

2.3 Sustainability

An MFI is operationally sustainable when it can meet all its expenses, including loan write-offs, from its interest income. Financial sustainability of micro-finance projects has been a hard lesson to learn; one that flew in the face of the signals that donors were giving pioneers in the microfinance business in the 1970s and 1980s. In those early days, any amount of funding was available to any microfinance provider able to show that they could disburse loan funds to the poor in substantial amounts rapidly and with good documentation. This is easy to do if you offer potential clients heavily subsidised interest rates. However, as donor funds dried up and official aid flows declined in both relative and absolute amounts in the 1990s, financial sustainability of microfinance programs became a life and death issue for MFIs.

Even now many donor and government funded programs have the characteristics of a welfare program and not a financially viable vehicle for the long-term delivery of financial services to the poor. As many case studies show, poor people are more than willing to pay the full cost for the microfinance products that they need, including a profit margin sufficient to keep the microfinance provider in business. Financial viability leads to management demands that are focused on serving poor people instead of donors or governments, with every possibility that the administrative requirements are significantly less complex than those required for donor accountability and reporting.

The alleviation of poverty through microfinance services requires sustained effort. One round of loans is not enough to ensure that poor households will lift themselves above the poverty line and remain above it. If MFIs are to be there to provide service to their clients over the long period, they themselves must become financially viable.

Making a profit is important to enable the MFI to build up equity, attract investment capital, service loans taken up for on-lending to poor clients, and instil a philosophy into programme implementation staff that is consistent with what they themselves expect of their poor clients who similarly seek to scale-up their enterprises. Earning a profit, in turn, requires that their income, which largely comes from the interest they charge on loans, must be able to cover all operating costs (including depreciation on assets), a reasonable loan loss provision, and the costs of funds (including protection of the loan fund from depletion by inflation), and still leave an adequate surplus to build up equity. These are the building blocks of full financial sustainability.

2.3 Sustainability (contd)

It is the poor member who stands to lose the most if the MFI fails. If the MFI fails, the members may lose their only opportunity to get financial service at a reasonable cost. The loss to the society of a MFI collapse is much more than that of a commercial bank or an NGO. As the more fortunate economic group in the society, we auditors have an obligation to the less fortunate ones. If the MFI is to be sustainable in the long run, it must fulfil the other two expectations in the short run.

2.4 MFI Audit Features

MFI audits have very high inherent control risks. Auditors who have experience in the banking, NGO or business sectors, find that MFIs are actually quite different to any of them. They are certainly complex.

Internal control risks

- MFI managers have social work background, not financial services
- Good deal of physical cash transfers
- Limited segregation of duties
- Decentralisation of authority
- Inadequate information systems
- Inexperienced accountants

Unlike traditional banking practices

- Simple loan documentation
- Symbolic value of guarantees
- Undocumented financial analysis of client's business
- Approvals at low level
- Lack of segregation of duties between approval and collection

Unlike other NGOs

- Financial self sufficiency is a key factor in MFIs being able to have a sustainable effect on poverty alleviation.
- Disbursement of grants cannot be treated as an expense
- Need to consider more business like aspects such as product costing and sophisticated MIS

Unlike most business or 'for-profit' institutions

- Weak governance structures
- Ineffective external supervision
- Non-performance driven financial statements
- Unique equity structures
- Financial policies do not conform to GAAP

2.5 Key account balances

- **Cash and equivalents** are important because cash transactions comprise the major part of an MFI with its consequential inherent risks (fraud?) and we should always keep that in mind during all stages of our audit.
- **Loan portfolio & loan loss reserve** are the most important account balances as they include most of the institution's assets and are the source of the most serious risk of misstatement.
- **Savings and deposits** are increasingly becoming an important account balance in some MFIs
- **Capital accounts (fund balance)** require special attention as most MFIs receive grant fund from donors.
- **Creditors and accruals** are important because MFIs are exposed/susceptible to possible understatement in these accounts
- **Revenues and expenses** require attention because MFIs are often inconsistent in their treatment of them.

3 Auditing basics revision

In summary, this section deals with the following aspects of the audit:

- Audit planning
- Gathering evidence
- Evaluating evidence
- Review and completion

3.1 Audit planning - overview

Time spent effectively planning the audit before launching into fieldwork can ensure that the audit is efficient and adequately addresses the key risk areas.

- Engagement letter
- Document review
- Understanding business and systems
- Pre-audit meeting
- Preliminary Analytical Review of draft financial statements
- Materiality assessment
- Risk assessment
- Sample sizes for control and substantive tests
- Detailed audit programmes – may need to be tailored
- Time / budget and logistics

3.1.1 Engagement letter

This may need to be modified if some special procedures are to be followed as recommended by CGAP. See Auditors handbook which may be downloaded from CGAP website, or AMFIA has a hard copy.

3.1.2 Document review

Last year's accounts and management letter, correspondence file, points forward from last year's file, PAF, grant agreement etc

3.1.3 Understanding the business and systems

- Appreciate the **contextual variables**: markets, who the current borrowers are, competition in the area, local repayment culture, planned growth.
- Review the **credit policies**: loan approval, credit history, rate of increase in loan size, required savings, multiple loans.
- Understand the **accounting and loan tracking** – how are loans, repayments and interest entered in the ledger and MIS, loan loss write off and provision policy.
- Assess the **attitude of management** – do they know the PAR? What do they consider to be acceptable levels of delinquency? How many clients should there be per loan officer? Are they on top of portfolio trends?

3.1.4 Risk assessment

Audit risk is the risk of issuing an incorrect opinion on whether the financial statements present a true and fair view. Audit risk is a function of 4 other types of risk that make up the risk equation:

$$AR = IR \times CR \times DR \times ER$$

- **Inherent:** risk of a material error arising in the financial statements. The auditor measures this risk (both entity and account specific risks), usually via use of standard questionnaires.
- **Control:** risk of a material error that has arisen not being found by the client's own internal control systems. The auditor measures this risk by assessing the adequacy of control procedures and testing to see effectiveness.
- **Detection:** risk that the auditor fails to detect a material error that has arisen. The auditor manipulates sample sizes to give low enough detection risk given the significance of the other risks.
- **Ethical:** risk that a material identified error is not reported or disclosed. The auditor minimizes this by removing threats to objectivity, independence and integrity.

3.2 Gathering evidence

There are two main types of tests that may be done: compliance tests check whether the internal control procedures are being complied with, whereas substantive tests check actual account balances, either by tests of detail or analytical review.

3.2.1 Best times of year to gather evidence

When the controls route is used (which makes more sense when there are large volumes of small transactions), it is often better to do tests of controls before the year end at an interim audit. Testing of year end account balances may then be done after the year end.

3.2.2 Directional testing for substantive tests of detail.

Debits are tested for overstatement, starting with the ledger and tracing to the source documentation / evidence. Credits are tested for understatement, starting with the source documentation / evidence and tracing through to the ledger.

DOLS CUSL - (Debit Overstatement Ledger to Source / Credit Understatement Source to Ledger)

For example, debtors are debits, so the auditor takes the balances shown in the ledger and verifies that they are recoverable by reference to supporting evidence. Income is a credit, so the auditor started with a complete population of receipt numbers and traces them through to the ledger to confirm that they are all recorded correctly.

3.3 Evaluating evidence

Summarise the effect of extrapolated errors and compare with materiality levels set in the planning stage, both for specific account balances and overall opinion materiality. Carry out more tests as necessary, prepare audit adjustments and draft the audit report accordingly.

3.4 Review and completion

The following elements may be seen on audit file completion checklists

- Audit programmes signed off
- Lead Schedules updated
- Final analytical review
- International Accounting Standard compliance checklists
- Management letter drafted
- Manager / Partner review points raised and cleared
- Letter of representation
- Audit opinion agreed
- PAF updated
- Time analysis
- Points forward noted
- Fee notes

Such checklists are a crucial aspect of auditor quality control.

4 Auditing approach – cash and equivalents

4.1 Background

These include cash held at banks as well as cash on hand with cashiers and collectors. Due to resource constraints most MFIs have the same person (collector and cashier) responsible for both handling and recording cash.

Fraud risk is a serious threat in many MFIs. External auditors should ensure their MFI clients understand that, while cases of fraud may be identified in the normal course of audit activities, detecting fraud is not the primary focus of the audit. Rather, auditors should identify control weaknesses that increase opportunities for fraud and propose recommendations for improvement. Fraud through staff collusion is not uncommon in MFIs. An adequate number of branch and client visits need to be made and including a thorough analysis of the internal controls. The auditor needs to think like the crooked employee – what are the loopholes in the system which will allow me to steal some money.

4.2 Cash - risks summary

Potential business risks

- ➔ Liquidity risk
- ➔ Fraud risk

Potential audit risks

- ➔ Inherent risk
- ➔ Control risk

4.3 Liquidity risk

Liquidity risk is higher for MFIs than for commercial banks or other businesses. MFI clients' motivation to repay their loans is closely linked to their expectation that good repayment performance will result in repeat loans. When a liquidity crisis forces an MFI to defer loan disbursements, word spreads quickly, often resulting in severe outbreaks of delinquency by other loanees.

The auditor should evaluate whether the MFI is managing liquidity; a number ignore the function and operate on ad hoc basis in terms of responding to branch requests for liquidity - and whether the MFI has an adequate system for projecting its sources and uses of cash. Obvious weaknesses should be noted in the management letter.

4.4 Fraud risk

Fraud, both external and internal, and robbery are significant risks for MFIs. The absence of guards or security cameras in branches makes MFIs susceptible to robbery. Collection and transfers outside the branches compound the risk. The external auditor should enquire whether robbery has been a problem for the MFI.

4.4 Fraud risk (contd)

The primary sources of fraud in micro-credit operations include phantom loans, kickback schemes and other bribes, and non-reporting of client payments. Such unethical behaviour is not effectively detected by audits of paper trails as the loan officer alone is responsible for generating and following through on loan disbursement and recovery. Traditional audit procedures, external or internal, are ill-equipped to detect this type of fraud because they do not usually involve extensive client visits. Traditional procedures tend to focus on tracking the documentation of loan agreements and cash payments.

4.5 Control risk

A major cause of control risk is lack of proper segregation of duties for cash transactions. The auditor should examine segregation of duties or internal controls for cash transactions at all levels of the MFI. Fraud control measures built in at the operational level are often more effective than an auditor's ex post review. If an MFI has internal auditors, which most MFIs do not, their work should be considered when testing controls on cash. But even strong, independent internal auditors are not always effective in controlling fraud in an MFI, given their traditional accounting orientation.

From traditional audit perspective, MFIs may appear weak in their internal controls. They do not, and should not, develop the paper trails and hierarchical decision making found in commercial banks. But successful MFIs do exert substantial operational control on their loan officers and cashiers, who are the principal originators of fraud.

5 Auditing approach – loan portfolio

In summary, this section deals with the following aspects of auditing the loan portfolio:

- Characteristics
- Business risks
- Effective controls
- Sample sizes
- Substantive tests
- Loan loss write off / provision
- Audit programme

5.1 Loan portfolio characteristics

- Large no of loans, tiny repayments
- Decentralized operations
- Inadequate controls due to cost efficiencies
- Rapid growth
- Inadequate provisioning
- Non integrated information systems
 - Accounting information
 - Loan tracking

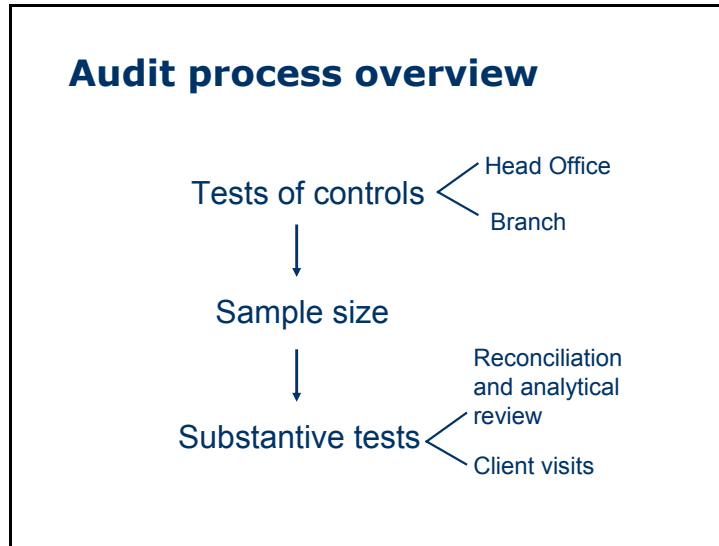
The accounting system receives information about individual loan transactions, but its purpose is to generate *aggregate* information that feeds into the financial statements. The loan tracking MIS is focused on information about individual loans. Some of the data recorded in the loan tracking MIS are also recorded in the accounting system- such as disbursements, recoveries, and accrued interest.

Ideally, the loan tracking MIS should be seamlessly integrated with the accounting system. In practice this is unusual. MFIs cannot use integrated software designed for banks as their loan systems are too different from those of banks. Many MFIs have found that a standard accounting system (computerized or manual) can be adjusted to fit their requirements, but they need to develop their own loan tracking MIS (computerized or manual).

5.2 Loan portfolio business risks

- **Credit** risk: delinquency rates typically low but volatile
 - Systems for managing delinquency critical
- **Fraud** risk: high and difficult to detect
- **Interest rate** risk: long term financing
- **Exchange rate** risk: donor loans

5.3 Overview of loan portfolio testing process



5.4 Effective controls testing

We have seen that the normal controls one would normally be expected to find in a bank cannot be applied to an MFI. But many successful MFIs have managed to implement effective controls.

5.4.1 Head Office controls testing

- Credit policies design
- Management Information Systems
- Loan Officer incentives
- Internal audit

Credit policies – these are the core of the MFIs business. Whether documented in a manual or not, it is crucial the policies are well designed, understood and practiced by all. More details are in the MFI External Audits Handbook issued by CGAP. (AMFIA has a copy).

Elements of a credit policy:

- Client qualifications: age, no of years in business, gender, independence in business activity, criminal record etc
- Repayment capacity: method of establishing, minimum levels, fluctuations, type of activity being financed
- Credit history: With the program, with other programs, with basic services (e.g. water, electricity)
- Size of loan and repayments: Fixed?, based on business, collateral, previous loans
- Credit delivery methodology: Group size, rate of increase in loans, forced savings, client to Loan officer ratio, client training
- Interest fee structure
- Loan approval procedures
- Action on delinquent loans, including refinancing or re-scheduling

5.4 Effective controls testing (contd)

Management Information systems – As substantive tests of detail for MFI portfolios are burdensome, auditors and managers need to be able to rely on the integrity of the loan tracking MIS. If no one in the organization expects the loan tracking MIS to be 99% accurate, people tend to let down their guard. Thus it needs to be checked for accuracy, security and effectiveness.

Internal audit – The auditor should look, in particular, whether the MFI has, or should have, an operational audit function bearing in mind the limitations of traditional internal audit procedures when applied to microfinance portfolios.

Compensation policy – The auditor should examine how the MFI measures loan officer or branch performance in managing the loan portfolio, especially if incentive pay or promotions are tied to such measurement. For example, if heavy weight is given to increasing loan volume-especially where a compensating weight is not given to high repayment rates the incentive structure may lead loan officers to make too many risky loans.

5.4.2 Branch visits

- Which ones and how often
- Check compliance with policies and procedures
- Perform substantive tests on significant number of loans
- Visit clients

Branch visits – The auditor, not management, should select the branches to visit. Many MFIs have “model” branches that are far superior to other branches. For MFIs with few branches, auditors should probably visit all branches every year. For MFIs with many branches, all branches should be visited within at least a two- to three-year timeframe. To the extent possible, visits should be unannounced. This element of surprise makes it harder for branch or regional managers to cover up problems.

Compliance - Throughout the testing at retail outlets, the auditor should focus on whether loan policies and procedures are being complied with. Auditors must pay close attention to actual practice in follow-up on delinquent loans, such as prompt distribution of delinquency information to loan officers and immediate visits to all delinquent borrowers. MFIs that fail to respond aggressively to delinquency seldom survive long.

Client visits – External auditors of MFIs must locate and contact a sample of clients directly. Visits are intended to confirm that the client exists and that the loan details represented in the files are valid and accurate. This also includes verifying that the controls around loan rescheduling and refinancing are effective. Client visits should be unannounced. Otherwise, loan officers may “coach” the clients to cover up problems.

5.5 Substantive tests

5.5.1 Reconciliation between MIS and ledger

The aggregate figure for outstanding loan portfolio is in the accounting records. The breakdown by client is in the loan tracking MIS. It is not unusual to find reconciliation discrepancies between loan MIS and accounting records in MFIs. The external auditor should decide whether the reconciliation discrepancies discovered represent systematic weaknesses. If the discrepancies are large enough to be material, management should be required to explain them and reconcile the accounts in order for the audit to proceed. If management cannot do so, the auditor cannot issue a clean opinion. Even in cases where the discrepancies are not above the materiality threshold, they may suggest a serious inconsistency between systems that should be noted in the management letter.

5.5.2 Analytical review

Because so much reliance is placed on an MFI's controls, substantive analytical procedures are important tests for the end of the reporting period. The external auditors should take the loan balance at the end of the reporting period and compare it with the loan balance that was subjected to tests of control. In addition, loan portfolio data for the current year should be compared with data for previous years. Significant fluctuations should be discussed with management.

Loan MIS of many MFIs segregate loan portfolio into similar populations for trend and characteristic analysis. For instance, the portfolio may be segregated by loan product, client or business type, or geographic location. The comparison of these sub-populations and trends in their activity or balances can be analyzed. The more detailed the analysis is, the higher is the level of confidence that sampling has produced a representative picture of the portfolio, and that no material misstatement exists.

5.5.3 Sample based tests of detail – client visits

To test the year-end balance for the loan account, the auditor tests a selection of loans. As with tests of control, the auditor rather than management makes the selection, drawing the sample from a loan list whose total reconciles to the general ledger.

The sample size for client visits, for the purpose of testing year-end balances, is usually larger than the sample size for tests of control. Some auditors visit as many as 10 percent of active clients, particularly for small MFIs.

There is, however, no universal guideline for the percentage of clients to be visited. The sample size depends on the materiality level established and on the auditor's conclusions about the reliability of internal controls.

5.5.3 Sample based tests of detail – client visits (contd)

- If materiality is high, errors below that high figure are not material, therefore sample size may be reduced
- If materiality is low, even smaller errors have impact, therefore sample size needs to increase
- If internal controls are found to be effective, sample size may be reduced
- If internal controls are weaker than expected, sample sizes may need to be increased.

5.5.4 Materiality

Establishing materiality levels is crucial in determining the nature, extent and timing of audit procedures. A materiality level is a threshold over which potential errors are considered problematic. There are no general standards for establishing materiality levels for an MFI. Auditors of MFIs sometimes use total assets as a critical component and set 2 percent as a materiality level.

5.5.5 Determining sample sizes

Assume that an MFI has total assets of \$1,000,000 of which the gross loan portfolio balance is \$900,000. The MFI has 3,000 clients, whose average outstanding balance is \$300.

If a materiality factor of 1% is used and the critical component is total assets, then the materiality level is 1% of \$1,000,000, or \$10,000. The sample size could then be calculated by dividing the total account balance by the materiality level (or selection interval). In this case the sample size would be:

$$\begin{array}{rcl} \text{Account balance} & \$900,000 & \\ \hline & = & \\ \text{Selection interval} & \$10,000 & = 90 \text{ selections (3\% of clients)} \end{array}$$

Provided there is no loan larger than the \$10,000 selection interval, the 90 selections would equal 90 loans.

If the auditor has high confidence in the MFI's internal controls, the materiality level could be raised to 1.2% of total assets (\$ 12,000). The sample size would then be:

$$\begin{array}{rcl} \text{Account balance} & \$900,000 & \\ \hline & = & \\ \text{Selection interval} & \$12,000 & = 75 \text{ selections (2.5\% of clients)} \end{array}$$

5.5.5 Determining sample sizes (contd)

If much reliance cannot be placed on the internal controls relating to the loan balance, the materiality level might be lowered to 0.6% of total assets (\$6,000), giving a larger sample size:

$$\begin{array}{rcl} \text{Account balance} & \$900,000 & \\ \text{-----} & = & \text{-----} \\ \text{Selection interval} & \$6,000 & = 150 \text{ selections (5\% of clients)} \end{array}$$

There is inevitably a subjective element in assessing internal controls and choosing materiality levels, making it impossible to recommend specific sample sizes.

5.6 Summary of tests on loan portfolio

Summary of tests of control

At head office

- Document credit policies and procedures;
 - test compliance
- Review MIS for accuracy, security and effectiveness
- Determine reliability of internal audit
- Examine compensation-based incentive structures

At retail outlets/branches

- Assess the control environment
- Check compliance with policies and procedures
- Perform tests on a significant number of loans
- Visit clients

Summary of substantive tests

Analytical procedures

- Comparison with previous balances
- Analysis by sub-population

Detailed tests

- Client visits
- Reconciliations between g/l and loan tracking system
- Rescheduled and refinanced loans
- Loans fully recovered in advance, immediately followed by another loan
- Delinquent loans suddenly cleared

5.7 Example audit programme extract

1 Year end balances outstanding agrees to list of individual balances				
Test	Description	Ref	Initials	Date
1	Obtain a breakdown of the closing balances figure, into individual balances, or branch sub-totals. For selected branches, obtain a breakdown of the branch sub-totals into individual balances.	N11		
2	Cast the list / breakdown to ensure the population is complete.	N12		
3	Where the TB figure differs from the list total, pass an adjustment to bring the TB total into line with the list total.	N12		

2 Analytical review is reasonable				
Test	Description	Ref	Initials	Date
4	Prepare or obtain a schedule showing Bal Bfwd, disbursements, interest accrued, principal received, interest received and amounts written off for the year, for each branch.	N13		
5	Check that the schedule casts and cross casts, and comment on any unusual trends	N14		
6	Ascertain the number of active clients at each branch and calculate the average balance outstanding and loan size, for each branch. Comment on findings	N14		
7	Calculate the % portfolio at risk for each branch and comment on findings.	N14		

3 Disbursements and year end balances are not overstated				
Test	Description	Ref	Initials	Date
8	Calculate the total sample size, based on the control risk assessment and materiality factor.	N16		
9	Select a sample of branches for testing. All branches should be visited at least every three years.	N17		
10	Select half the sample of loans from the list of balances carried forward and the other half from the list of disbursements during the year. Select on a systematic basis (e.g. every 20 th figure), depending on the size of your population.	N17		
11	Perform visits for each of the selected clients in the selected branches and complete the questionnaire. NB Client visits should be unannounced.	N17		
12	Compare the timings and amounts of disbursements and repayments, and loan terms from each client with the MIS.	N17		
13	Summarise and evaluate your findings	N17		

5.7 Example audit programme extract (contd)

4 Repayments made by clients are not understated				
Test	Description	Ref	Initials	Date
14	Identify the best source documents for loan repayments, and assess their completeness. (E.g. receipts – check all the receipt books are available for inspection. Daily / weekly collection forms – check all the forms are there)	N18		
15	Select a sample of repayments from the complete population of source documents identified in 14 above. This sample may be ¼ the size of the sample used in 8 above	N18		
16	For each sample in 15 above, trace the amounts and timings from the source documents through to the cashbook, loan ledger card and MIS.	N18		

5 The delinquency status report at year end is accurate				
Test	Description	Ref	Initials	Date
17	Obtain a copy of the delinquency status report at the year end.	N19		
18	Ascertain and comment on the basis for calculating the delinquency ratios	N19		
19	For each of the clients visited, confirm that the status of their balance is correctly classified. Where a repayment is past due, ensure that the entire balance is shown as 'at risk', not just the overdue repayments.	N19		
20	Check the casting of the delinquency report	N19		

6 Loan provision policy is adequate				
Test	Description	Ref	Initials	Date
21	Ascertain and comment on the client's loan provisioning policy	N20		
22	Confirm that the calculations have been made in accordance with the policy	N20		

6 Auditing approach – loan loss provision

Every MFI audit should include careful testing of loan loss provisions, similar to banks. In 1996 Corposol, the largest MFI in Columbia, came to the brink of collapse. The annual audit by a “big six” auditing firm affiliate had failed to detect a drastic deterioration in portfolio quality.

The risk is higher during periods of rapid growth as existing systems may not be able to cope with the strains. Rapid growth on weak systems will only aggravate the risk. Global figures and ratios do not always display the true picture as good loans may average out the bad ones. Rapid growth has the effect of greening the portfolio and tends to mask a growing portfolio at risk.

Without adequate allowance for likely losses, the loan account on the balance sheet can be materially misstated. Likewise, loss provisioning directly affects the MFI’s profit reporting. Finally, an accurate loan loss allowance gives a good initial indication of the competence with which the MFI is managing the riskiest aspect of its business-loan delinquency. The competence of the audit firm is also reflected.

6.1 Provisioning methods – small MFIs

Small MFI’s may simply provision a fixed percentage of its portfolio based on its overall loss experience in previous years. Sometimes a percentage of each loan is provisioned at the time of its disbursement. The auditor must look at how these loss rates have been determined and judge their adequacy (MFIs should certainly be encouraged to perform an aging analysis. They don’t always do). Provisioning also has to take into account the present performance of the portfolio. If delinquency levels are higher today, provisions should be set at a level that is higher than the historical loss rate. The same would be true if there are other factors (flood, draught) that will affect loan recovery.

As many MFI’s do not write-off loans aggressively or consistently, the provision percentage should be related not to accounting write-offs, but to the real portion of prior loans that have become unrecoverable as shown in the loan MIS.

6.2 Provisioning methods – larger MFIs

Large MFIs, or those that are preparing for massive growth, should consider the more scientific approach that is customary in the banking industry. Under this approach the loan portfolio is segmented into aging categories-that is, according to how many days late the most recent payment is- and then assigning a different percentage to be provisioned for each category, depending on the perceived level of risk.

Loans should be separated out from the “current” category as soon as they are even one day late. An illustrative aging schedule, with provisioning percentages for each aging category is shown below:

6.2 Provisioning methods – larger MFIs (contd)

Provisioning % on portfolio age

Age	Unrescheduled	Rescheduled/ Refinanced
Current	0	10
1-30 days late	10	20
31-90 days late	25	50
91-180 days late	50	100
> 180 days late	100	100

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The provisioning percentage is applied to the entire outstanding balance of the loans in each category (portfolio at risk, or PAR), not just to the amount of the late payments. Many MFIs will not have a provisioning policy and will need guidance to establish one.

6.3 Write-offs

Many MFI's feel-not always justifiably- that formally recognising a loan as a bad debt sends a message to its loan officers and clients that the institution is no longer interested in recovering that outstanding balance, and so carries such loans on its books.

If an MFI has no policy on write-offs, the auditor should suggest one. A write-off policy needs to recognize that the cost of pursuing some delinquent clients may be more than the amount collected.

Audited financial statements should always include a clear and precise explanation of the MFI's provisioning and write-off policy and practice.

6.4 Loan loss provision – tests of controls

- Accuracy of delinquency report - external auditor must test the accuracy of the delinquency report, including the aging of arrears. If the MFI has a computer generated delinquency report, the auditor should consider testing it using a computer-assisted audit technique.

6.4 Loan loss provision – tests of controls (contd)

- Non-cash loan recovery issues - when a client falls behind on a loan, many MFIs will reschedule the loan. The rescheduled loan may be shown as current in the delinquency report, which misrepresents its real risk level. Another common practice is to issue a new loan to the delinquent client to pay off the delinquent loan (refinancing) and show the new loan as a current loan.
- Compliance with policy and procedures

6.5 Loan loss provision – substantive procedures

- Detailed tests
 - Confirm year end balances
 - Test components (opening balance, provisions, write offs, closing balance)
- Analytical review
 - Write offs and % of loans
 - Subsequent recoveries and % of write offs or loans
- Compliance with law and regulations
 - Reserve and capital requirements

Specifically check that rescheduled and refinanced loans are tracked, reported and provisioned separately, since their risk profile is different from current loans.

6.6 Importance of delinquency

Delinquency is the single most common cause of MFI failure. It often creeps up unexpected because of inadequate delinquency reporting, or inadequate MIS that cannot track delinquency accurately. There is therefore a need to focus on policies, practices and systems for managing delinquency in the loan portfolio.

7 Auditing approach – interest

Because interest is an MFI's main source of income, it needs to be tested carefully.

7.1 Interest accounting policy

The external auditor should understand the MFI's accrual policies and evaluate their reasonableness. In particular, the auditor should determine whether the policy stops accrual of further interest, and reverses previously accrued but unpaid interest, on loans that have gone unpaid for so long that the recovery of amounts due is highly unlikely.

7.2 Interest income testing: analytical review

This is performed by developing an independent expectation of income and comparing it with the actual balances recorded by the client. One type of analytical review compares interest income from the current period with interest income from the previous period, taking into account identified changes in the portfolio-such as growth-between the periods.

7.3 Yield gap analysis

A more powerful procedure, which should be performed in almost all MFI audits, is a *yield gap analysis*, which compares actual interest receipts with an independent expectation of what the portfolio should be yielding, based on the loan terms and the average portfolio over the period. This analysis frequently shows a large gap between what the MFI should be earning and what it is actually earning. The most common cause of a yield gap is loan delinquency, so this test serves as a cross-check on portfolio quality. The yield gap in a rapidly growing MFI will be high, as its interest income may be lower than the theoretical yield because a large percentage of its portfolio is in new loans whose first payment has not yet fallen due.

Some MFI's charge fees/commissions in addition to interest on loans. The yield-gap analysis of such organisations may comprise both interest and fees/commissions.

8 Compliance with International Accounting Standards

MF accounting practices do not always adhere to IAS

8.1 Accounting for interest income

IAS 1 requires the consistent application of the accrual basis of accounting on all components. Auditors will want to make adjustments to convert interest income recognized on a cash basis to turn it into accrual basis, whereas MFIs want to avoid being 'un-prudent', and may not have MIS capable of tracking interest due but not paid.

Interest arises from a charge for the use of funds (IAS18), no matter how this charge is presented to clients, either flat basis or declining balance basis.

Auditors have a hard time understanding the flat basis of interest rates and question whether it is best practice. They are not enthusiastic about quoting and charging interest on a flat basis and in some countries may insist on an adjustment of interest income and loan portfolio to convert flat basis to declining basis. Supervisors will insist that MFIs adapt a declining basis before they can be issued with a banking license (IAS30).

8.2 Accounting for grant income

According to IAS 20, grants must never be booked directly into income. Receipt of a grant does not of itself provide conclusive evidence that the conditions attaching to the grant have been or will be fulfilled. Grants should be recognized as income over the periods necessary to match them with the related costs which they are intended to compensate, on a systematic basis. They should not be credited directly to shareholders' interests. Two broad approaches are given- the income method and the equity method. Our discussion will be on the income method under which grant receipts should be recorded as a liability and taken as income or to a 'restricted fund' on utilization of the grant.

- On receipt – record as liability
- Grant for **revenue expenses** - transfer to income as the grant is expended
- Grant for **fixed assets** - set up a restricted fund reduced by depreciation
- Grant for **on lending** – set up a revolving loan fund

Unutilized donor grants are to be refunded or treated as income depending on the terms of the donor agreement. Grants received for revenue expenses during the same reporting period, may be booked into income and offset against the period's expenses. The residual profit/loss goes to retained earnings.

8.2 Accounting for grant income (contd)

Grants for fixed assets are booked as deferred income and transferred to income at amounts equivalent to depreciation on the assets acquired. The amount transferred to income effectively offsets the depreciation expense on those assets. Alternative treatment allows a grantee to offset the depreciation expense for the year by the amount of depreciation on fixed assets acquired through grant funding.

Grants for on-lending to clients are transferred from the grant liability account to a 'restricted' revolving fund or loan fund account.

MFI compliance with IAS 20 is spotty and many auditors ignore it especially where national standards conflict with IAS on the treatment of grant funds.

The difference is often material and warrants disclosure.

9 Accounting Disclosure best practice

CGAP is currently the best source for MF accounting guidelines

9.1 CGAP Disclosure Guidelines

Donors, other investors, board members, and managers of MFIs rely on an MFIs financial statements when they assess its financial sustainability and condition of the loan portfolio. But many financial statements do not include enough information to permit such an assessment. To help address this problem, the donors who make up the CGAP approved Disclosure Guidelines in 2003, which specify information that should be included in MFI financial reporting:

- Information required in financial statements in order to assess
 - Financial sustainability
 - Loan portfolio
- Not accounting standards
- No requirements for particular chart of accounts or formats

Authoritative guidance on accounting standards can be found in International Accounting Standards and publications of national accounting standards boards. The guidelines complement IAS disclosure requirements, particularly on the loan portfolio reporting for MFIs.

The examples provided in the guidelines are simply illustrations of one possible way to present the information; there is no requirement to use the same formats. Consequently, the guidelines can be used in any country, regardless of its accounting standards and methods of financial presentation.

The guidelines require some information not normally found in financial institutions. Most MFIs are unusual institutions; they use a financial business to pursue a social mission that is often supported by grants or soft loans. In addition, MFIs use loan methods that are very different from those used by conventional banks.

9.2 Segmental reporting

Segment reporting – In addition to financial services, many MFIs provide non-financial services-such as training, production or marketing assistance, health care, or community development- that are not essential to the delivery of their financial services. It will be impossible to determine the sustainability of microfinance operations unless their financial results are presented separately from those of other operations. This is in addition to the consolidated income statement and balance sheet for the institution as a whole.

A clear explanation is to be given of the methods used to allocate shared costs or revenues between financial and non-financial services.

Even if a segmented balance sheet is not provided, the financial report should indicate which balance sheet accounts are completely or almost completely tied to microfinance services.

9.3 Portfolio accounting

Expenses related to actual or anticipated loan losses should be shown separately from other expenses in the income statement. The amount of the loan loss reserve should be shown, usually as a negative asset deducted from the loan portfolio. The amount of loans written off during the period must be shown. The underlying accounting policies should be clearly described.

The financial presentation should include a table that reconciles the accounts affecting the loan portfolio, including:

- Loan loss reserves at the beginning and end of period
- Loan loss provision expenses recognized during the period
- Write-offs of uncollectible loans.

If an MFI accrues unpaid interest on late loans, there should be a clear and thorough explanation of its policies on this matter- especially the point at which further accrual of unpaid interest is stopped and previous accruals are reversed out of income.

9.4 Portfolio quality and management

- Amount of late loans: quality ratios
- Renegotiation of delinquent loans (rescheduling and refinancing)
- Insider loans

Conventional financial statements usually do not include a delinquency report. To assess the financial health of an MFI, a delinquency report is crucial. As most MFIs are not subject to banking regulations, they are not bound by external rules in setting their loan loss reserves.

The core of a delinquency report is usually a ratio or ratios that summarize the condition of the loan portfolio. At a minimum the portfolio report required by these guidelines must contain one or more of the ratios, along with a precise explanation of what is being measured.

There are 3 common types of delinquency ratios:

- **Portfolio at risk** – the numerator is the outstanding balance of loans that are at higher risk because a payment is late by a specified number of dates, and the denominator is the outstanding balance for the entire portfolio.
- **Collection or repayment rates** – the numerator is payments received and the denominator is payments due.
- **Arrears rates** – the numerator is late payments received and the denominator is some measure of the total portfolio.

9.4 Portfolio quality and management (contd)

Renegotiated loans

A portfolio report should clearly describe an MFI's approach to allowing, tracking and provisioning for the renegotiation of delinquent loans.

Insider loans- whether to members of an MFI's management, governing body, or parties related to them-should be fully disclosed, including outstanding amounts, interest rates, collateral, and repayment status. Loan programs for employees – for instance, to buy motorcycles or for personal emergencies- can be reported as a group.

9.5 Donations

- Income from donations shown separately
- Source and amount of current period donations
- Accounting method
- In-kind donations or subsidies
- Cumulative amount of all prior period donations (optional)

If donations are included in the income statement, it should be separated out as non-operational income. If no donations have been received during the current period, there should be an explicit statement to that effect.

In-kind donations: A donor may pay the salary of the MFI's executive director, or it may have free use of vehicles owned by international organizations. It is important to identify any such in-kind subsidies and estimate the additional expense the MFI would incur in their absence-even if the estimate is not based on a rigorous valuation.

Cumulative reporting: Such information will often imply large accumulated operational deficits that have been funded by donations. These deficits require careful interpretation, and are not necessarily a negative reflection on management performance.

9.6 Other significant accounting disclosures

- (a) Details of all loans that account for more than 10 percent of the MFIs total liabilities should be provided.
- (b) Any type of deposit account that is tied to clients' ability to obtain future micro-loans should be shown separately from other deposits, and there should be a general description of the conditions of the account and its linkage to loans.
- (c) Accounting policies on the accrual or deferral of income or expense should be briefly explained.
- (d) MFIs with assets or liabilities denominated in a foreign currency should disclose any significant currency mismatch (financial assets balanced against liabilities denominated in a different currency). Accounting treatment of unrealized gains or losses due to foreign currency fluctuations is to be reported.

10 Audit reports and management letters

10.1 Compliance with CGAP Disclosure guidelines

- Separate paragraph in audit report or separate letter
- Indicating
 - Comply fully with guidelines; or
 - Comply substantially with the guidelines; or
 - Do not comply with the guidelines

"The terms of reference for this audit call for the auditor to express a conclusion as to whether the financial statements comply with CGAP's Disclosure Guidelines for Financial Reporting by Microfinance Institutions. These guidelines are voluntary norms recommended by a consultative group of international donors. Thus an institution's failure to comply with the CGAP guidelines would not necessarily imply that the institution or its financial statements are in violation of any legal or other authoritative accounting or reporting standards.

We conclude that the financial statements herein with accompanying notes comply with the CGAP guidelines in all material respects".

Possible objections raised by MFIs: The standard audit report format prescribed by ISA 700 is used by all MFIs. Even if the client MFI issued the audit terms of reference as desired by the donor, it may not want to take the risk of any changes in the standard audit report wordings as the local regulators could make a fuss, particularly if there is some non-compliance with CGAP guidelines.

10.2 Compliance with IAS

MF accounting practices may require modification in audit report in accordance with International Standards on Auditing (ISA). The following issues are often problematic.

	MF accounting practice	MF reasons	Reason for audit qualification
1	Interest income is recognized on cash basis	Easy accounting. Be prudent and not show inflated income.	Accrual accounting is a 'fundamental accounting assumption' per IAS 1
2	Interest on loans is not calculated on outstanding loan balance	Easy for both client and MF. Accepted industry practice.	Calculation of interest on outstanding loan balance is considered best practice by all commercial lending institutions. The client is charged on his loan balance.
3	The full donor grant is shown as income, or equity.	Easy accounting. Shows higher profit and no liability.	Contravenes IAS 20.
4	Fixed assets given by donor not shown in accounts.	It was not purchased by MFI.	Value of all assets of the MFI need to be shown in the Balance Sheet.
5	Bad loans not written off in last five years.	Staff and clients will think that the loan does not have to be recovered. There will be a large loss in the income statement.	Income and assets are overstated.

Aside from audit qualification, auditors make recommendations for appropriate adjustments, and reports in the management letter in case the qualification is not material.

10.3 Management letter

This is the written communication by the external auditor to the client management identifying significant internal control deficiencies, offering constructive recommendations, and noting other matters arising during the audit that the external auditor wants to bring to the attention of the MFI's management and audit committee. Knowledgeable donors also invariably ask for a copy of the management letter.

This letter is particularly important for MFIs as many have weak internal controls. It is also the opportunity for the external auditor to publicise his expertise.

The auditor normally solicits and considers management comments on a draft of the management letter before issuing the letter in final form. Management letters normally have at least three sub-headings for each finding.

- 1) Fact or issue
- 2) Recommendation
- 3) Management response

10.4 Management letter points to consider

Examples of control weaknesses that may be addressed in a management letter are given below:

Cash

- Delays in preparing and reviewing bank reconciliations
- Lack of physical security over cash in hand
- Inadequate processes surrounding cash counts

Loans

- Inadequate checks and balances in loan approval process
- Lack of adherence to MFI policies and procedures
- Absence of, or non-compliance with, policies for immediate follow-up on delinquent loans
- Improper loan file documentation
- Loan tracking system fails to flag loans that are refinanced, rescheduled, or paid off with something other than cash
- Excessive refinancing or rescheduling of loans
- Inaccuracy or untimely availability of loan tracking system information
- Material discrepancies between accounting and loan tracking systems
- Existence of related party "insider" loans
- Absence of unannounced visits to branches and clients by managers or internal auditors

10.4 Management letter points to consider (contd)

Loan loss provisions

- Non-existent or inaccurate aging schedules
- Unreasonable aging standards
- Growth is masking delinquency problems
- Lack of adherence to laws and regulation

Savings and deposits

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

Equity and Funds

- No segregation of restricted and unrestricted funds
- No board authorisation of capital transactions
- Non-compliance with donor agreements

Revenues and expenses

- Interest income recorded incorrectly
- Interest charged to branches not eliminated in consolidation
- Donor grant revenue incorrectly recognized when received
- Improper accounting of fixed assets
- Absence of a capitalization policy, or inconsistent application.

Management information systems

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