Microfinance Internal Audit

Toolkit and Resources

toolkit

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seep
Powering connections

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Acronyms

ALM	asset and liability management
AML-CFT	anti-money laundering and combating the financing of terrorism
ATM	automatic teller machine
CHF	Cooperative Housing Foundation
COSO	Committee of Sponsoring Organizations of the Treadway Commission
ICT	information and communication technology
IFAC	International Federation of Accountants
IIA	Institute of Internal Auditors
IS	information system
ISACA	Information Systems Audit and Control Association
IT	information technology
MFI	microfinance institution
NGO	nongovernmental organization
PAR	portfolio at risk
POS	point of sale
WOCCU	World Council of Credit Unions
USAID	United States Agency for International Development

Note: All currency amounts in U.S. dollars unless otherwise noted.

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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 the practice of internal auditing.

Resources such as this toolkit are never "final," as new professional standards continue to be developed in the practice of internal auditing. Further, the samples and tools contained herein need to be edited and revised to suit the specific situation of each institution and its context. Microfinance institutions and their operating environments undergo constant change, as do the needs of these institutions and their stakeholders. Feedback and comments will thus help continually improve and update this toolkit and its annexes.

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

Introduction

As microfinance institutions (MFIs) grow in size and complexity, the need for strong internal control systems to manage operating risks also grows. One of the key tools for ensuring effective internal control is the internal audit. How does an MFI make an internal audit department effective? What is the difference between an internal and external audit and how do they relate? How do MFIs ensure that internal audit recommendations are implemented? How can both staff and management be persuaded to value the internal audit function and thus make the best use of it?

The answers to many of the above questions are provided by an MFI's management and board of directors and the system that they put in place for risk management and internal audits. The board and management set the tone for an organization, influencing the way in which staff view internal controls. This control "environment" is fundamental for implementing an effective internal audit department.

Scope of the Toolkit

Risk is an enterprise issue. The topics of risk and risk management have received increased attention in the microfinance industry in recent years. The governance role of an enterprise board of directors in risk management is also widely accepted. In fact, this role has become pivotal in the work of management, accountants, and auditors—both internal and external.

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

A mere internal audit manual is insufficient for the work of an internal audit department. The department needs a document that guides auditors in their day-to-day tasks and is used regularly as a resource. This toolkit and its annexes are designed for application and use by the internal audit managers and staff of an MFI. They are intended to support the mission and objectives of an MFI; produce reliable financial statements; minimize operational risks; and prevent fraud, error, and inefficiencies. As with all tools and templates, the resources offered in this toolkit must be reviewed and customized to meet the specific needs and requirements of a given MFI.

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

1.0 Overview of Risk and Risk Management

Risk is the possibility that current and future events, expected or unanticipated, may have an adverse or harmful impact on an institution's objectives, capital, or earnings. Risk is measured in terms of impact and likelihood. Microfinance institutions are faced with many risks—both internal and external. Risk is an inherent part of business in general, and of an MFI's environment and operations, in particular. In order to grow, thrive, and sustain themselves, MFIs need to manage risk carefully.

Risk management is about managing uncertainty. It is the systematic process of identifying, assessing, managing, and controlling potential events to provide reasonable assurance of achieving the objectives of an organization. Risk management includes balancing risk-taking against a well-designed control environment. It effectively reduces the likelihood that a loss will occur, minimizes the scale of potential losses, should they occur, and adds value to an organization by helping it meet its objectives.

Risk management must be proactive, led by an active board and senior management. The function includes identification and prioritization of risks; elaborating policies on risk tolerance; and implementing adequate policies, procedures, and limits that minimize risks. Risk management also includes comprehensive internal controls and an effective communication and feedback loop to ensure operational alignment of an MFI with its risk management policies. Finally, risk management encompasses evaluation of the adequacy of the risk management system itself, that is, evaluation of an MFI's risk measurement, monitoring, and management information systems.

> In order for a microfinance institution to realize its mission,
> it must identify and mitigate the risks that pose the
> greatest threats to its financial health and long-term survival.

The responsibility for implementing an MFI's risk management strategy lies with the managers of the organization. Organizations, banks, and MFIs take a variety of approaches to implementing risk management. Many institutions establish a risk department (or officer) or a risk and compliance department (or officer). A risk manager's role is to support the effective and efficient governance of an organization and the implementation of an enterprise-wide risk management strategy. She or he continually monitors and measures the institution's evolving external and internal risks, generally in conjunction with board member(s) or board appointees charged with risk management. Other successful institutions form a risk management committee comprised of senior managers from all operating units and areas of the organization. A strong committee will ensure that a risk management strategy is well incorporated into all of an MFI's business activities.

Risk management is an ongoing process because vulnerabilities change over time. Periodic risk assessments of an MFI help identify, measure, and prioritize risks. A risk assessment exercise often recommends acceptable risk parameters, risk reporting, and means of monitoring specified risks on a periodic basis.

Some organizations appoint an independent consultant or evaluator to conduct an objective, independent assessment; such an evaluator reports directly to the board. In other MFIs, the risk management committee or a risk officer is responsible for conducting regular risk assessments. In some cases, the internal auditor is requested to conduct a risk assessment or to take a more active role in the risk management process.

The role of an internal auditor is to independently and objectively test and assess the effectiveness of risk management strategies and internal controls. Therefore the role of an internal audit in the risk assessment process needs to be carefully managed in order to maintain audit independence. Internal auditors may perform an advisory role in the identification and management of risks, but should not be involved in implementation of an organization's risk management policies.

As an MFI grows in size, scale, and complexity, its board may choose to appoint a risk committee or a risk officer. Most small- to medium-sized MFIs do not have a risk manager and until one is appointed, the entire role of risk assessment and reporting often falls to the internal audit department, a task that threatens to compromise the objectivity of its internal audits.

Practitioners, donors, funders, and networks (both regional and international) must recognize that effective risk management—including a strong internal audit department—must be owned, led, and driven by an MFI board and its senior management. Anything less may diminish the work and results of an internal audit department. In actual practice, many boards fall short of their governing role in risk management. This fact is recognized as a widespread challenge in the microfinance sector.

Neither risk management nor internal auditing should be confused with internal controls. However, the three are interconnected in current best practices and should be well understood and coordinated to maximize their respective efficiency and effectiveness.

1.1 Risk Management and the Role of Internal Control

Internal control is the integrated set of components and activities that are promoted by an organization to address the risks, challenges, and issues that it faces in the pursuit of both financial and social objectives. The "Internal Control—Integrated Framework" published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) is the commonly accepted model of internal control, although other reliable models also exist. The COSO framework defines internal control as follows:

> Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:
>
> - effectiveness and efficiency of operations,
> - reliability of financial reporting,
> - compliance with applicable laws and regulations.
>
> The first category addresses an **entity's basic business objectives**, including **performance and profitability goals** and the **safeguarding of resources**. The second relates to the **preparation of reliable published financial statements**, including interim and condensed financial statements and selected financial data derived from such statements, such as publicly reported earnings releases. The third deals with **complying with those laws and regulations** to which the entity is subject. These distinct but overlapping categories address different needs and allow a directed focus to meet the separate needs.[1]

A risk-based approach to internal control links this control to the organization's objectives, identifies risks to achieving these objectives, and mitigates those risks through appropriate internal control systems.

[1] Committee of Sponsoring Organizations of the Treadway Commission (COSO), "Internal Control—Integrated Framework," 1992, COSO, Altamonte Springs, Florida, 3.

Box 1. Illustration: An MFI Perspective on Risk

MFI objective: **Protect the loan portfolio from loss and deterioration in quality.**
Risk: Delinquency, which will erode the value of the portfolio.
Control objective: Maintain high percentage of on-time repayments.
Control techniques:

- Make regular monitoring visits to clients.
- Conduct immediate follow-up with delinquent clients.
- Ensure timely and reliable portfolio information is available to credit operations staff.

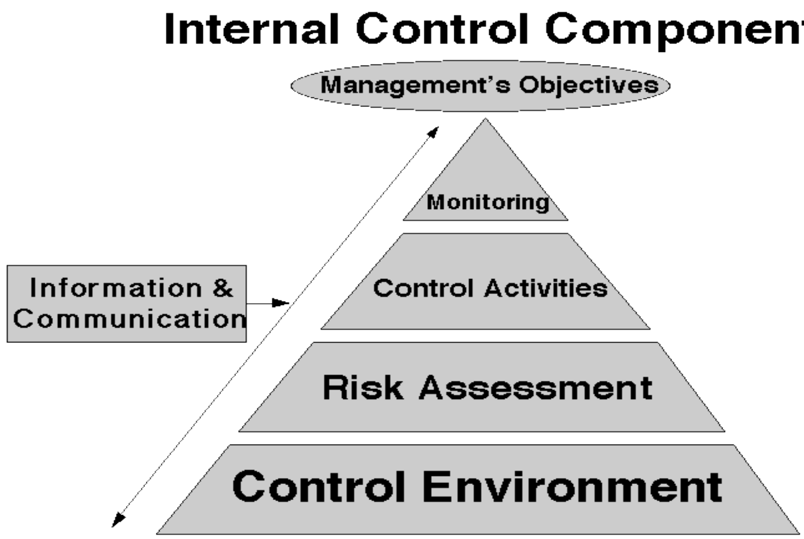
MFI objective: **Protect cash resources.**
Risk: Staff theft.
Control objective: Segregation of staff duties.
Control techniques:

- Ensure that loan officers do not handle repayment collections.
- Assign cashiers to handle all cash transactions.
- Assign accounting clerks to record transactions.

Internal controls are more than the financial policies and procedures of an organization alone. An internal control system is a key component of risk management—particularly operating risk management. Further, an MFI's internal control and risk management strategies need to be effectively integrated into all its processes, policies, and procedures.

An internal control system consists of five interrelated components, as shown in figure 1. Note that these components do not act as separate, sequential independent units. Rather, they interact in an integrated management process.

Figure 1. COSO Internal Control Framework



Source: COSO Web site, n.d., http://bibiconsulting.homestead.com/coso_s_internal_control.ppt#260, Slide 6 (accessed October 2009).

The five components of internal control work to support the achievement of an MFI's mission, strategies, and related business objectives. The internal control environment (i.e., the tone and values of the organization set by the board and senior management and implemented by all staff) and the internal control system (e.g., processes, policies, and procedures; checks and balances; and human resources) must be designed to manage and minimize risks within acceptable margins in a cost-effective manner.

Many banks and MFIs reinforce the implementation of strong operational internal control systems by integrating compliance activities into the work of the risk management department. Small MFIs usually implement these concepts into their operations in less formal or structured ways, but must nevertheless ensure that they maintain effective internal control.

1.1.1 What is the role of the internal auditor in the internal control framework?

According to the Institute of Internal Auditors, "Internal auditing reviews the reliability and integrity of information, compliance with policies and regulations, the safeguarding of assets, the economical and efficient use of resources, and progress towards established operational goals and objectives. Internal audits encompass financial activities and operations. . ."[2] The activities of an internal audit therefore directly address the objectives of internal control.

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[2] James Kincaid, William Sampias, and Albert J. Maracella, 2004, *Certification in Control: Self-Assessment Study Guide* (Altamonte Springs, FL: Institute of Internal Auditors' Research Foundation), 2.

Besides evaluating the design of the **control activities** established by management, an internal auditor is directly involved in **monitoring and evaluating** the implementation of the internal control system. As the people ultimately responsible for the control system, managers and supervisors are also involved in monitoring activities, but the internal audit function is an independent and authoritative voice in the organization.

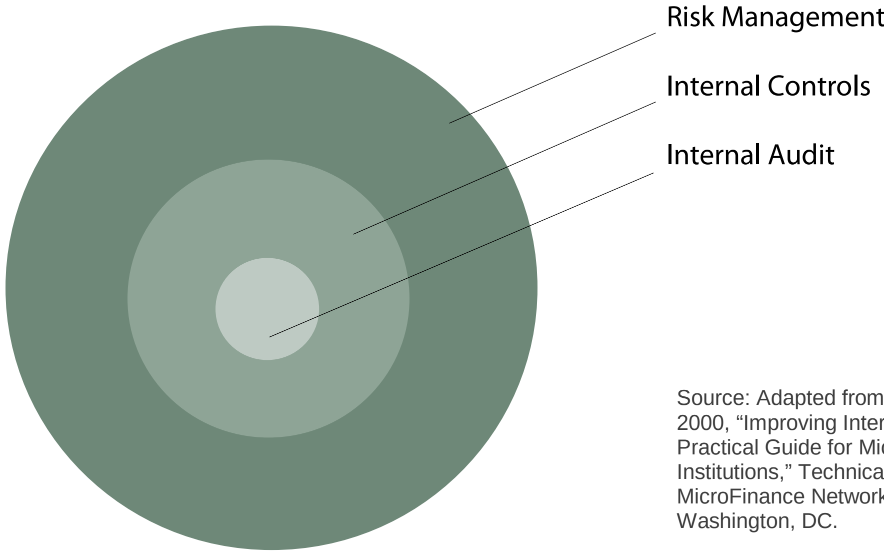
By evaluating the effectiveness of control activities, it can make a strong contribution to promoting management objectives. An internal auditor also plays a key role in the **information and communication** component of the framework, since the auditor reports both to the board and senior management and interacts with operational and managerial staff throughout the course of his or her work.

1.2 Risk Management and the Role of the Internal Audit

The relationship between risk management and the internal audit is critical; the two need to be synchronized and coordinated to be efficient and effective. One of the key roles of the internal audit department is to verify staff compliance with internal control systems. The focus on compliance is crucial, since control systems are designed to minimize risks, and adherence to policies and procedures should reduce losses arising from fraud, theft, or security breaches. An internal audit department also provides feedback and communication to an MFI's board and management concerning staff compliance with policies and procedures and the effectiveness of the organization's risk minimization strategies.

However, if an internal audit department focuses only on internal compliance or, conversely, noncompliance, with policies and procedures, other operating risks or external risks to an MFI may actually threaten the very existence of the institution. Ideally, the internal audit function also needs to scan environmental and external risks in conjunction with the board's broader responsibility of risk assessment (i.e., external risk assessment) and point out any previously unidentified risks. Failure to do so may mean that the department will simply "rearrange the deck chairs on the Titanic" while the MFI sails straight for an iceberg.

Figure 2. The Role of Internal Controls and Internal Audits in Risk Management



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

1.2.1 What is the role of the internal audit function in risk management?

Internal auditors can provide advice and support to an MFI in implementing a risk management strategy without impairing the independence of the audit function. The Institute of Internal Auditors has issued a document, "FAQ's for COSO's Enterprise Risk Management—Integrated Framework," that highlights the following core internal audit roles with regard to enterprise risk management:

- giving assurance on the risk management process;
- giving assurances that risks are correctly evaluated;
- evaluating risk management processes;
- evaluating the reporting of key risks; and
- reviewing the management of key risks.[3]

[3] COSO, n.d., "FAQs for COSO's Enterprise Risk Management—Integrated Framework," Institute of Internal Auditors, Altamonte Springs, Florida, http://www.coso.org/erm-faqs.htm (accessed March 2009).

In order to maintain objectivity and independence, the risk management process can be supported, but not implemented or driven by, the internal audit department. In particular, internal auditing should not:

- set risk appetite;
- impose risk management processes;
- provide management assurance on risks;
- make decisions on risk responses;
- implement risk responses on management's behalf; or
- accept accountability for risk management.[4]

[4] Ibid.

2.0 Overview of MFI Risks

The following section provides a very brief overview of a variety of risks—internal and external—that MFIs face. The items noted are not intended to be exhaustive, but are used to create a context for discussing a risk-based approach to the internal audit function. (Many of the items are adapted from the *MicroSave* resource, "Institutional and Product Development Risk Management Toolkit."[5]) MFIs need to evaluate seriously their exposure to any and all risks, as prevention is generally the best, and sometimes the only, strategy against failure and loss.

2.1 Internal Risks

2.1.1 Institutional risks

A successful microfinance institution is defined as an organization that provides financial services to large numbers of low-income clients over the long term. Using this definition, the following categories of institutional risk can be defined as follows:

Social mission risk: the risk of not achieving an MFI's mission of providing appropriate financial services to its intended clientele.

Commercial mission risk: the risk that an MFI is not sustainable in the long term.

Dependency risk: the risk that an MFI will continue to need strategic, financial, and operational support from an external organization.

Legal risk: the risk of loss due to contractual or legal omissions, errors, fraud, or negligence. **Compliance risk** is usually a part of this category.

Reputational risk: the risk of lost earnings or capital from negative public opinion.

Governance and management risk: the risk that an MFI board and/or senior managers will fail or be inadequate in meeting their obligation to lead and manage the institution.

Strategic or business risk: the risk of loss that an MFI will incur as a result of not meeting its strategic objectives, caused by the business or regulatory environment,

[5] Lynn Pikholz et al., 2005, "Institutional and Product Development Risk Management Toolkit," MicroSave, Nairobi, Kenya, http://www.microsave.org/system/files/toolkits/toolkits/Institutional%20and%20Product%20Development%20Risk%20Management%20Toolkit.pdf (accessed October 2009).

exposure to economic cycles or technological changes, or failure to position itself in the market relative to competitors with unique value-added products and services.

2.1.2 Operational risks

Operational risks are the vulnerabilities that an MFI faces in its daily operations, including concerns over portfolio quality, error, fraud, and theft—all of which can erode an institution's capital and undermine its financial position. Operational risks are primarily internal in nature and are within the range of the control and monitoring responsibilities of MFI managers.

Credit risk: the risk of lending money and not getting it back. There are many reasons that credit risk may be an issue, including the appropriateness of loan products, client demand and preferences, management practices, and, at times, external environmental factors.

Fraud risk: the risk of intentional deception for the purpose of illegal or unfair personal gain. Fraud encompasses the abuse of office, intentional failure to follow policies or procedures, outright theft or diversion of MFI property or resources, and the manipulation or falsification of data or documents.

Security risk: the risk of theft or harm to the property or staff of an MFI. Since most MFIs conduct business in cash within their institutions, there are risks related to retaining, transferring, and collecting cash. Documents (e.g., a receipt, purchase order, or requisition) are also sensitive, since they are at times readily convertible into cash or goods. Fire risk also poses a security risk.

Error risk: the risk of unintentional errors in conducting business or recording transactions due to lack of staff capacity or proper training. This risk is often a result of rapid staff growth, high staff turnover, an inadequate number of staff, poor communication, or the inability of an MFI to attract and train qualified and motivated staff.

Information technology (IT), transactions, or systems risk: the risks inherent in operations that use and rely on automated information systems (e.g., loan, deposit, and other databases, accounting systems, etc.) for transactions, processing, and reporting. Financial service providers generally rely on information technology—both hardware and software—and, increasingly, satellite and mobile communication networks for operational support. System errors, breakdowns, and security breaches all threaten effective operations and reporting. If an information system does not create accurate financial statements or portfolio reports, the senior managers of an MFI are more likely to make costly mistakes based on inaccurate information.

2.1.3 Financial management risks

This category of risk includes asset and liability risks, including those associated with interest rates, liquidity, and foreign exchange. Financial management risks are also largely a control responsibility of senior management. Efficiency ratios, financial ratios, continual research of market options and trends, due diligence, and strong monitoring systems are critical for mitigating financial management risks. For the purposes of this toolkit, however, these elements will not be emphasized in great technical detail.

Interest rate risk: the risk of financial losses to an MFI from changes in interest rates, particularly market interest rates. The greatest interest rate risk for MFIs occurs when the cost of funds goes up faster than an MFI can adjust its lending rates.

Liquidity risk: the risk to an MFI's capital or earnings that arises from an inability to meet its obligations when they come due. MFIs must meet regular demands for cash, such as loan disbursements, savings withdrawals, payment of operating costs, and debt payments.

The goal of liquidity management is to keep an acceptable level of liquid assets on hand while balancing the need to earn revenue. Too much cash on hand results in lost income, as idle cash does not earn interest and may actually increase the cost of funds. On the other hand, too little cash on hand can lead to lost opportunities for loan disbursements (that could have earned income), damage the reputation of an MFI in the community due to the institution's inability to meet client credit needs, delay bill payments, raise borrowing costs, and prevent the institution from meeting deposit obligations.

Foreign exchange risk: the risk of financial exposure that an MFI faces when a foreign currency mismatch exists between assets and liabilities, particularly long-term liabilities. Most MFIs operate in developing or emerging economies, in which specific vulnerabilities are tied to the strength and stability of the local currency. Exchange rates, for example, can be liberalized to fluctuate with market conditions after a long period of fixed rates. Revaluing foreign-based liabilities, particularly those in stable, strong currencies, in rapidly devaluing local currency incurs high foreign exchange losses.

Inefficiency risk: the risk that both cost controls and the scale of outreach of an MFI can result in high costs per unit of output. This risk may be increasingly impacted by an MFI's strategy to offer services in rural and difficult-to-reach areas, as well as an inability to automate and use technology to bring down per-unit costs.

2.2 External Risks

Although they have less control over external risks, MFI managers and directors must still assess them. An institution can have relatively strong managers and staff and adequate systems and controls, but still experience major problems due to the environment in which it operates. It is important that these risks are recognized and prepared for, rather than used as excuses for poor performance.

Regulatory risk: these risks result from changes in regulations, including banking laws, labor laws, laws pertaining to seizure of collateral, and changes in the enforcement of those laws.

Competition risk: this risk can be reduced by familiarity with competitors' products with respect to market position, price, and services.

Demographic risk: this risk is variance in the target market, which can be mitigated by assessing characteristics of the target market and ascertaining whether any notable trends or shifts are predicted.

Physical environment risks: these risks include natural disasters and/or damage to physical infrastructure.

Macroeconomic risks: these risks include inflation, economic downturns, and their effect on both an MFI and its clients.

Political and/or governmental risk: the risk that political instability and civil unrest may create an operating environment that is unmanageable to work in. Not all such risks involve unrest. A negative political opinion against microfinance can, for example, be a serious threat to operations, but can be moderated if monitored well.

Market risk: the risk that movements in market factors, including foreign exchange rates, commodity prices, interest rates, credit spread, and equity prices will reduce net income or the value of the portfolio of an MFI.

Systemic risk: the risk that arises from the interdependencies of a system or market, where the failure of a single entity or group of entities can have a domino effect and bring the entire system or market down.

The senior management and board of a microfinance institution should consider each risk a point of vulnerability. It is their responsibility to assess the institution's level of exposure, prioritize areas of greatest vulnerability, evaluate its tolerance to risk, and ensure that proper strategies and controls are in place to minimize the MFI's exposure to loss or failure.

A **Sample MFI Risk Management Policy** can be found in **annex 1**.

3.0 Overview of Operational Risk Management

While there are a number of MFI success stories, many operational challenges have contributed to slow MFI growth, ongoing challenges, and failure in the sector. The vast majority of MFIs are small and many still struggle to cover all their operational and financial costs. Too many operate without proper systems to reduce their exposure to loss, error, and fraud—creating risks not only for themselves but for the sector more broadly.

> An effective internal control system is the best management strategy to mitigate operating risks.

In order to be effective, the following elements must be part of an overall internal control system:

- mission and core values that are both stated and communicated
- honest and capable employees
- conducive environment
- sound methodology
- accountability and transparency
- security
- performance and efficiency
- sound accounting and financial documentation
- policies and procedures
- clear delegation and segregation of duties
- reliable management information systems

Box 2. WOCCU Internal Control Requirements

The World Council of Credit Unions (WOCCU) developed an "Internal Control Requirements" document in 2002 as part of its initiative, Development of Best Practices in Credit Union Supervision. The document lists several accounting and administrative controls that are minimally required of WOCCU credit union affiliates. The list represents common, although not necessarily exhaustive, internal control features needed by most MFIs. The entire document can be accessed at www.woccu.org/bestpractices/operations.

Accounting Controls

- **Daily posting** of transactions should be made to ensure timely reporting.
- **Subsidiary records** should be maintained and reconciled monthly for loans, savings, advances, share accounts, and bank accounts.
- **Internal reports** should be prepared for key areas of operations on a regular schedule.
- **Recording of transactions** should follow consistent accounting policies.
- **Sequential numbers** should be given to all documents, including checks, vouchers, and receipts, with dual control of unissued, pre-numbered items.
- **An audit trail**—i.e., a paper or electronic documentation trail—should trace each transaction from inception to completion.
- **An audit program** should be put in place that includes audit management, supervision, and monitoring; an internal audit committee; and external audit services.

Administrative Controls

- The **accounting system** needs to be flexible in capacity and rigid in its controls and standards.
- **Written policies and procedures** need to be in place for all aspects of operations.
- **Board approval and monitoring of information** should be required for annual budgets, strategic plans, and business plans, as well as for regular financial and operational reporting.
- **Cash controls** need to be implemented, including controls over cash access, documentation, security, balances, limits, and verification.
- **Segregation of duties** requires that different staff members be responsible for the handling, recording, and approval of transactions.
- **Dual control** needs to be established over key assets (e.g., the cash vault, night depository, etc.) and documents that are convertible to cash.
- **Protection of assets** is achieved through physical control over access, together with policies and procedures for the safeguarding of fixed assets, databases, technology, and cash.
- **Personnel policies** must be established, including policies for recruitment,

competitive salary packages, training, supervision, and a performance management system.

- **Rotation of personnel.**
- **Anti-fraud culture and policy.**
- **Succession planning.**
- **Mandatory vacations.**
- **Quality control processes.**

Table 1 below outlines a generally accepted process for risk management. It is often illustrated as a circular cycle called the "Risk Management Feedback Loop," which stresses that the process never ends. Risk management is ongoing, given than risks evolve and change, as do operating environments. The table lists the basic steps of the risk management process and identifies the parties responsible for each step and activity.

Table 1. The Risk Management Process

Process step	*Responsible party*	*Tasks*
1. Identify, assess, and prioritize risks.	Senior management	Identify and assess the severity of risk
	Board and/or risk evaluator	Review and approve prioritization of risks
2. Develop strategies to measure risks.	Senior management	Develop measurement indicators Set acceptable risk tolerance and ranges
	Board	Approve indicators and ranges Establish frequency of monitoring
3. Design policies and procedures to mitigate risks.	Senior management	Design operational policies, systems, and guidelines to reduce risk Provide clear instructions for procedures that implement these policies
	Board	Approve operational policies
4. Implement controls and assign responsibility.	Senior management	Assign responsibility for implementation
	Other management	Design, document, and implement control procedures Monitor compliance

Process step	*Responsible party*	*Tasks*
	Operations staff	Provide input on appropriateness of policies and procedures Offer suggestions for needed policies Comply with established policies and procedures Monitor risks on a routine basis, provide accurate and relevant information
5. Test effectiveness of controls and evaluate results.	Internal audit staff	Test and monitor compliance with policies
	Senior management	Monitor internal controls Respond to recognized weaknesses and lapses
	Board	Review results of internal control testing and evaluation Monitor and assess risks on a routine basis. Manage risks through close oversight and evaluation of performance
6. Revise policies and procedures as necessary.	Various	Repeat the above steps in order to update controls, policies, and procedures

Risk management strategies, particularly the internal control system that addresses operating risks, include the **prevention** of potential problems, the early **detection** and **correction** of actual problems when they occur, and **policies and procedures** that promote desirable activities.

Prevention of operational risks and potential problems generally involves addressing the key issues of the business processes of an MFI: people, policies, paper and money, as described below.

People: Effective human resource policies that attract and retain qualified, trained, and motivated staff are one of the primary components of good MFI risk management, since people are the heart of the financial services industry. Good MFI leadership and management are critical for creating a conducive working environment and strong staff morale.

Policies: Relevant and adequate policies and procedures guide staff and senior management in operational activities to achieve an MFI's mission and account for financial transactions.

Paper: Good management information systems store, calculate, and provide accurate, reliable, and timely reports to MFI managers on every aspect of operations. Of particular note are reports on cash, loan, and savings transactions and balances.

Money: The vast majority of MFIs operate in cash-based economies. Proper cash handling, recording, controlling, securing, monitoring, and reporting are critical for good management of cash risks.

4.0 The Role of the MFI Board in Risk Management and the Internal Audit Function

In current management practice and thinking, the role of governance and board structures are taking on greater importance. The Institute of Internal Auditors refers to **governance** as the "combination of processes and structures implemented by the board in order to inform, direct, manage, and monitor the activities of the organization toward the achievement of its objectives."[6]

The Institute further defines the board and related committees as

> . . . an organization's governing body, such as a board of directors, supervisory board, head of an agency or legislative body, board of governors or trustees of a nonprofit organization, or any other designated body of the organization, including the audit committee to whom the chief audit executive may functionally report.
>
> . . . Most boards are organized into smaller subcommittees that take responsibility for specific areas of governance, for example, an Executive Committee, a Nominating Committee, an Asset and Liability Committee, and an Audit Committee.[7]

The board of directors of an MFI is generally comprised of primary stakeholders, founding members or investors, and qualified professionals. The board is expected to take leadership responsibility for risk management and set the tone of the MFI's control environment.

An effective board is responsible for ensuring that an objective and realistic risk assessment of MFI operations is conducted from time to time and that reasonable risk mitigation strategies are developed, implemented, and regularly monitored. One of the effective fundamental means of managing the operational risks of an MFI is through a strong system of internal controls.

The "control environment" includes the **overall attitude, awareness, integrity, and actions of the board of directors, managers, and all staff** regarding the internal control system and its importance. If top management does not demonstrate that

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

[7] Ibid., 16.

internal controls are important, other MFI staff will sense this attitude, and internal controls will then be further weakened by poor design and lack of adherence. Factors that comprise the control environment include:

- the involvement of the board of directors and its committees, particularly the audit committee;
- the philosophy and operating style of senior management, as well as its commitment to competence;
- the commitment of senior management and staff to integrity and ethical values;
- the organizational structure of an MFI and the methods used to assign authority and responsibility within this structure;
- design of the control system and control methods, including the internal audit function, by senior management;
- human resource policies and procedures, including segregation of key duties; and
- senior management's awareness of and attention to external influences.

The Institute of Internal Auditors defines internal auditing as "…independent, objective assurance and consulting services designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of governance, risk management, and control processes."[8]

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

[8] Ibid., 18.

Box 3. The Three IIA Categories of Internal Auditing Services

The Institute of Internal Auditors (IIA) specifies that:

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

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

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

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

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

In summary, the internal audit function is one of key means by which the board monitors the effectiveness of an MFI's internal control system, verifies the reliability of financial reports, tests compliance with policies and procedures designed to minimize risks, and communicates the results of those tests. An internal audit department acts as the "eyes and ears" of the board, identifying any other risks not previously identified and making recommendations to improve operations or the internal control system to enhance the achievement of MFI objectives.

Ideally, the MFI board should appoint an audit committee that operates as a subcommittee of the board with a specific mandate to oversee the internal and external audit functions. The audit committee is preferably composed of a qualified accountant or auditor, a treasurer (if the board has such a position), and perhaps another individual well versed in accounting and auditing matters. **The audit committee reports to the board and should not be composed of an MFI's management team.**

In order to achieve independence and objectivity, the chief internal auditor (also referred to as the head internal auditor or chief executive auditor) should have a direct functional reporting line to the audit committee, while coordinating and communicating with the executive director of the MFI.

The audit committee must act as a conduit between the internal audit department and the board of directors, on one hand, and the internal audit department and MFI management, on the other. The audit committee or the board must also require senior management to respond to audit reports and take necessary and appropriate corrective action(s).

Annex 2 features **MFI and Bank Organizational Charts** that illustrate appropriate reporting lines for the internal audit function.

This toolkit does not provide extensive resources on the work and functions of a board of director's audit committee and its relationship with the internal audit department.[9] In general, an audit committee of an MFI may perform some or all of the following tasks:

- manage the hiring, salary, and performance review of the chief internal auditor;
- review and approve the internal audit department's strategic and annual plans and risk assessments;
- confirm and assure the independence of the internal audit function;
- coordinate internal and external audits to ensure that risk management coverage is complete and that this coverage reduces redundancy and uses resources effectively;
- authorize internal investigations or special reviews when requested;
- commission an external risk assessment of an MFI;
- review, with the internal audit department, the adequacy of an MFI's internal controls, including the controls and security for computerized information systems;
- review, with the internal audit department, any significant audit findings, together with the responses of senior management to these risks;
- review and address any serious difficulties or disputes with management encountered by the internal audit department while performing its

[9] A future SEEP resource guide will address this topic. Also see "Audit Committees and Boards of Directors," Institute of Internal Auditors, Altamonte Gardens, Florida, www.theiia.org/guidance/additional-resources/audit-committees-board-of-directors/ (accessed March 2009).

function, including any restrictions placed on it during the course of its work;

- on behalf of the board of directors or the shareholders, be responsible for an MFI's relationship with external auditors; and
- review an MFI's financial statements, ensuring that they are understandable, transparent, and reliable, and include sufficient disclosure.

5.0 Risk Assessment and Risk Tolerance

As described in chapter 4, the board and senior management of an MFI carry ultimate responsibility for leading the risk management process in the institution. This process includes commissioning a risk assessment and developing a risk mitigation strategy. As noted previously, an MFI board may also appoint an external evaluator to conduct a broad, objective risk assessment. This evaluation, together with the input of senior management, should include recommendations on key risk management strategies to minimize the risks identified by the assessment.

Many MFIs do not have the resources to conduct an external assessment and may ask an internal audit team to perform the task. However, there is a danger that an internal audit department may lose its objectivity when later evaluating an MFI's risk assessment and mitigation strategy and/or become directly involved in implementing risk management. Wherever possible, an MFI board or its senior management should lead this process.

After organizational and operational risks have been identified, an assessment or analysis needs to be performed. This task includes:

- estimating the significance of a risk;
- assessing the likelihood (or frequency) of the risk occurring; and
- considering how the risk should be managed (i.e., what actions need to be taken).

5.1 Rating the Risks

A risk is assessed as high, medium, or low, based on its significance and the likelihood (probability) and frequency of its occurrence. The final product of a risk assessment is a list of processes and/or areas of activity with a corresponding risk score. This risk profile is then reported in the strategic and annual audit plans of the MFI, which facilitates the setting of priorities.

A risk of insignificant impact and a low likelihood of occurrence does not generally warrant serious concern, whereas a significant risk with a high likelihood of occurrence usually demands considerable attention. Circumstances in between these two extremes require difficult judgments, so it is important that analysis be rational and careful.

The range of grading the impact of each risk can be related to a value in an MFI's income statement or balance sheet. Assigning a numerical value to a ranking may be helpful in quantifying a risk and may more reliably justify the related appropriate reactive measures. This approach can also support analysis of institutional risk tolerance by the board and senior management. Many institutions, however, choose to rank risks using simply qualitative grading and judgments.

Box 4. Illustration: Quantifying Risk in an MFI

Consider the financial impact of an estimated loss that is the equivalent of 6 percent of the surplus of an MFI. The risk indicators of various losses might be assessed on a scale of 1 through 5 as follows:

- Low (1) = less than 2 percent of the surplus
- Medium (3) = between 2 and 4 percent of the surplus
- High (5) = between 4 and 6 percent of the surplus

Note: This example only describes the concepts of low, medium, and high risks. The estimated loss of 6 percent of the surplus is used for illustrative purposes only and should not be considered a standard or a norm.

Risks can also have potential non-monetary impact that is just as damaging to the institution, for example, a lost reputation and/or damaged image, low staff morale, or high staff turnover. The likelihood of occurrence of a risk cannot be similarly quantified in many cases, making a risk estimate purely judgmental, although based on specific circumstances.

The operating model and business processes of an MFI will to a large extent determine the likelihood of risk occurrence. Operational processes that are prone to fraud because of inherent risk or context will be considered significant and therefore need to be assessed, not necessarily because of their individual impact, but because of the reputational risk or the potential accumulated loss that they represent.

An MFI's organizational culture or stated policy on staff fraud will also delineate the institution's level of tolerance toward issues of fraud. Fraud or corruption that breaches client trust in the institution may in fact have a low financial impact on an MFI on a per-incident basis, but cause severe reputational risk that could create significant financial losses in the future. Therefore, operating processes that are vulnerable to fraud or corruption would normally be ranked as "high risk," no matter what the frequency, likelihood, or impact.

Sample Risk Assessment Tools can be found in **annex 3**.

Box 5. Illustration: Determining Risk Level

An MFI collects client repayments at decentralized centers during regular meetings. Loan officers and the group cashier are present during collections. Cash is rarely in excess of the required collection amount; rather, it is repeatedly less than the collection amount by about $10. This shortage is considered immaterial to the MFI on a one-time basis. However, the fact that it occurs roughly two to three times a week is a concern—even though the amount is not material—because the message sent to both staff and clients is that continual cash shortages are "business as usual."

5.2 Developing Strategies to Measure Risk

Before designing policies and procedures to manage and mitigate risks, it is important to think through how risk will be measured, what indicators will be used, what range of performance will be acceptable, and how frequently these indicators will be reported on.

A whole range of methods and indicators can be used in trying to measure and monitor indicators of the various levels of risk facing an MFI:

- SWOT (strengths, weaknesses, opportunities, threats) analysis and market surveys
- impact analysis
- performance indicators (e.g., portfolio at risk, capital adequacy, liquidity margins, foreign exchange rate risk exposure)
- budget comparisons and variance analysis
- compliance with internal and external audits
- compliance with government regulations
- growth in client numbers; dropout rates
- staff retention rates
- service delivery times to clients

Without thinking through and identifying the measurements for various risks, it will be difficult to for a board and senior management to determine the level of risk tolerance of an MFI. Balancing the risks against the reward for taking risks is a continual conversation in this exercise.

A classic MFI example is balancing the quality and quantity of an individual loan officer's caseload. It is desirable to have loan officers performing at high levels of efficiency, but at some point, the quality of their portfolio will deteriorate if they do not give adequate attention to the assessment and maintenance of good loans. Yet this focus may result in too much time spent on delinquency management in the long run. Finding the optimum caseload balance is the solution, and it varies according to the methodology used, the experience of the staff member, and the location (urban vs. rural), among other factors.

5.3 Managing Risk

The following tasks are options that senior managers of an MFI may choose to address individual risks:

- accept the risk as it stands;
- transfer the risk by insuring or hedging against it;
- avoid the risk by stopping the activity that gives rise to the risk; or
- control the risk by introducing mitigating measures.

When considering the introduction of mitigating controls, the associated costs and benefits should be analyzed. An MFI should not implement a control that costs more than the potential savings of avoiding the risk, taking into account reputational risk and all other potential damages or losses. Together with actions for managing risk, management staff must also establish procedures to enable them to monitor the implementation and effectiveness of the actions taken to mitigate risk.

While senior management is responsible for designing and implementing risk mitigation and monitoring procedures, the role of an internal audit is to evaluate those procedures and related results. The internal audit department must examine the methods employed by management to ensure that they are adequate for measuring and addressing identified risks. This review of risk management must be included not only in an MFI's strategic and annual plan, but also carried out by the internal auditor in a more detailed manner at the beginning of individual audits.

Management's own assessment of risks should not substitute or override the assessment of risk by the internal audit department. However, an internal auditor evaluates the quality of management's risk assessment through his or her department's own assessment of risks. Where management does not have a formalized risk management methodology, internal auditors should highlight this fact in their audit report, as well as identify risks to the MFI and provide recommendations for risk management.

An internal audit department should obtain and analyze the following information prior to assessing the risks to an MFI:[10]

- results of and length of time since the last internal audit;
- the budget and strategic plans of the MFI;
- changes in the business environment (e.g., competition, new products);
- changes in the IT systems of the MFI;
- changes in the enabling environment (e.g., changes in national laws, regulations, etc.);
- management concerns and needs;
- management team changes and evaluations (e.g., for competence and integrity);
- quality of MFI staff and staff turnover; and
- information concerning fraud or errors that have come to its attention.

[10] This list should not be viewed as all-inclusive.

Box 6. Risk Management and Control

The Institute of Internal Auditors (IIA) defines the following terms in the realm of risk management and control:

Control refers to "any action taken by management, the board, and other parties ***to manage*** risk and increase the likelihood that established objectives and goals will be achieved. Management plans, organizes, and directs the performance of sufficient actions to provide reasonable assurance that objectives and goals will be achieved."

Control processes refer to "the policies, procedures, and activities that are part of a control framework, designed to ensure that risks are contained within the risk tolerances established by the risk management process."

Adequate control is "present if management has planned and organized (designed) in a manner that provides reasonable assurance that the organization's risks have been managed effectively and that the organization's goals and objectives will be achieved efficiently and economically."

Residual risks are the risks that remain "after management takes action to reduce the impact and likelihood of an adverse event, including control activities that respond to a risk."

Source: IIA, 2009, *International Standards,* 16, 17, 19.

No matter how well-designed and operational an internal control system may be, it can only provide ***reasonable assurance*** of the achievement of an organization's objectives. The likelihood of achievement is affected by the limitations of all internal control systems. These limitations include the realities that human judgment can be faulty and that breakdowns can occur due to simple human error. Additionally, controls can be circumvented by the collusion of two or more people or by the ability of management to override the internal control system. Another limiting factor is the need to consider the relative costs and benefits of controls. These limitations of an internal control system result in what is known as residual risk.

For a practical, technical resource on MFI risk assessment, refer to the MicroSave toolkit, "Institutional and Product Development Risk Management."[11]

[11] See footnote 5.

6.0 Internal Audit Framework and Policies

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

- a direct reporting line to the board of directors, ideally through an audit committee;
- appropriate communication with the executive director;
- a budget, work plan, and schedule;
- a sufficient dedicated budget, together with processes for the training, hiring, and development of an internal audit team; sufficient equipment and other resources; and sufficient funds to cover necessary travel costs; and
- a separate and secure workspace that allows for sufficient confidentiality.

6.1 Internal Audit Policy of an MFI Board

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

6.2 Internal Audit Charter

According to the IIA, "The internal audit charter is a formal document that defines the internal audit activity's purpose, authority, and responsibility. The internal audit charter establishes the internal audit activity's position within the organization; authorizes access to records, personnel, and physical properties relevant to the performance of engagements; and defines the scope of internal audit activities."[12]

As a document that is developed and approved by the board of directors, the internal audit charter places the role and responsibility of the internal audit function squarely

[12] IIA,2009, *International Standards*, 16.

within the scope of board management. The charter also clearly identifies the role of both the internal audit department and the board audit committee in the risk management process.

A **Sample MFI Internal Audit Charter** can be found in **annex 4**. The website of the Institute of Internal Auditors (www.theiia.org) also provides a sample.

7.0 Internal Audit Department

7.1 Internal Audit Departments and MFI Size

All MFIs, regardless of size, age, or organizational structure, should conduct regular internal audits in some form to reduce the impact of risks from within. Failure to do so could impact growth and increase operational costs, potentially increasing interest rates for clients. For MFIs that mobilize deposits, failure to conduct regular internal audits puts client savings at risk and, when the MFI is relatively large, can jeopardize the stability of the financial sector beyond the immediate MFI.

The size and sophistication of the internal audit function and the number of staff assigned to the function depend on the needs of the institution. These factors will vary based on the operational modality, the level of technology used, the extent to which an institution is centralized or decentralized, and the professionalism and qualifications of staff.

7.1.1. Internal audits in small MFIs

Smaller (and usually newer) MFIs are often characterized by small portfolios, few staff, and limited financial resources. Often these considerations make the hiring of a specialized internal auditor too costly for an MFI, and the function may be overlooked or underused within the organization. In these cases, an MFI has options for implementing the internal audit function without investing significant resources.

For example, the internal audit function in small MFIs may be performed by supervisory staff from other departments. Accountants and finance staff can, for example, audit credit operations, while the executive director might audit cash functions. However, these responsibilities should be clearly delineated and checks and controls on each staff member responsible for auditing should be created in order to prevent collusion.

It is essential that MFI employees do not perform both internal audit work as well as operational work, particularly accounting. For example, an employee should not be assigned 50 percent to work as an auditor and 50 percent as an accountant in the same organization. If work needs to be reallocated, certain supervisory work that would not compromise the audit could be reassigned. For example, the credit manager could visit individual clients as a check on loan officers to ensure that the clients exist and the loan assessment information is correct.

Another alternative is for small MFIs to contract the internal audit function to an external consultant. In this case, the contracted party, preferably from a reputable auditing firm, should follow all professional codes of conduct and standards applied to internal auditors.

To reduce the risks involved in hiring an outside consultant, an MFI should ensure that the consultant is both highly skilled and trustworthy. The consultant should have prior experience in conducting internal audits for financial institutions. Additionally, the external consultant should not be from the same firm used to perform the external audit, as this could potentially impair the independence of the external audit according to current best practices in the auditing field.

7.1.2 Internal audits in larger MFIs

As the portfolio, assets, staff, operations, and available financial resources of an MFI grow in size and complexity, the possibilities for fraud also increase and further development of the internal audit function becomes both affordable and crucial. In many countries, internal audit departments are required by the local regulator when MFIs become regulated institutions. While the point at which the hiring of a full-time internal auditor becomes a necessity varies significantly, it is generally accepted that an MFI with approximately 75 staff or over 5,000 clients should have at least one full-time internal auditor. As the MFI continues to grow, it will need to add staff to the internal audit department.

In growing MFIs, the internal department may add auditors to perform work within specified regions and branches[13] who will be managed by the chief internal auditor. In large MFIs or banks, the internal audit function is often complemented by departments with operational experience responsible for ***operational audits,[14] business risks, credit monitoring, or compliance***. (These departments may also visit clients to detect and/or prevent fraud, as well as to monitor risks. Coordination between these departments and the internal audit department will increase their respective efficiency).

[13] There is a particular risk that regional internal auditors can be given authorizing duties, such as reviewing and effectively authorizing payments or other documents, and thus becoming part of an MFI's standard internal control system. It is important to avoid this possibility and require that all internal auditors, including regional auditors, follow best practices.

[14] An operational audit department is a management unit within the operational division of an MFI that is responsible for a structured review of the systems and procedures of an organization in order to evaluate whether they are being conducted efficiently and effectively. An operational audit involves establishing performance objectives, agreeing on the standards and criteria for assessment, and evaluating actual performance against targeted performance.

MFIs that mobilize deposits are generally under the supervision of the central bank and regulations mandate that they have a functioning, professional internal audit department.

7.1.3 Internal audits in rapidly growing MFIs

Periods of high growth provide numerous opportunities for fraud and errors. Without sufficient capacity to conduct internal audits, a rapidly growing MFI may soon find its growth severely constrained or threatened.

MFIs that are expanding rapidly should plan their audit structure to meet future needs. While the current level of transactions of an MFI might on its own justify only a single staff member, if the MFI is growing rapidly, it may require a team of auditors sooner than management anticipates. Skilled staff may also be difficult to find. This is particularly important if an MFI is planning to offer multiple financial products, such as savings, in the near future.

7.2 Code of Ethics and Conduct for Internal Auditors

The IIA defines its Code of Ethics as follows:

"The Code of Ethics of The Institute of Internal Auditors (IIA) are Principles relevant to the profession and practice of internal auditing, and Rules of Conduct that describe behavior expected of internal auditors. The Code of Ethics applies to both parties and entities that provide internal audit services. The purpose of the Code of Ethics is to promote an ethical culture in the global profession of internal auditing."[15]

Internal auditors are expected to apply and uphold the principles shown in box 7.

[15] IIA,2009, *International Standards.*

Box 7. 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.

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.

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

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

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

- respect and contribute to the legitimate and ethical objectives of the organization.[16]

The IIA further notes:

> Impairments to organizational independence and individual objectivity may include personal conflicts of interest, scope limitations, restrictions on access to records, personnel, and properties and resource limitations (funding).
>
> Conflict of Interest refers to any relationship that is or appears to be not in the best interest of the organization. A conflict of interest would prejudice an individual's ability to perform his or her duties and responsibilities objectively.[17]

In many societies in which MFIs operate, family and social ties are extensive and powerful. Internal auditors may have relatives and close friends who are clients of the MFI, making it possible that a relative or friend may be chosen by chance for an audit sample. The auditor should not change such a sample, but he or she must declare his or her relationship with the client or third party in the working papers of the internal audit and to the chief internal auditor. If possible, a fellow audit team member should take over the testing of any clients related to an auditor who are selected for sampling.

An internal auditor should also not be a close relative of any MFI employee.

MFI staff and clients are often afraid of internal auditors and may withhold information or be uncertain of auditor motives. Internal auditors themselves may at times reinforce the "police" image by acting in an intimidating or judgmental manner with those they meet. Current best practices in the field of internal auditing recommend that an internal auditor work as a qualified professional, but also as a business partner interested in examining the business processes of an MFI and preventing problems. Accordingly, they should be approachable, careful, discreet, and objective. Their job is to protect and promote the MFI and its staff, clients, and all other stakeholders.

7.3 Professional Standards of Internal Auditors

The Institute of Internal Auditors recognizes that internal audit activities are performed in diverse legal and cultural environments; within organizations that vary in purpose, size, complexity, and structure; and by a range of persons with varying skills and backgrounds.

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[16] IIA, 2009, "Code of Ethics."
[17] IIA, 2009, *International Standards*, 16 and 17.

Compliance with the IIA's "International Standards for the Professional Practice of Internal Auditing" (hereafter, the IIA Standards) is essential if internal auditors are to meet their responsibilities.[18]

7.4 Managing the Internal Audit Department

7.4.1 Internal Audit Staff and their Qualifications

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

- ensuring that a strategic internal audit plan for the MFI is devised and implemented via annual plans;
- ensuring that financial and human resources are allocated for effective implementation of the annual audit plan;
- ensuring that audit planning, fieldwork, reporting, and follow-up are performed in accordance with the standards of the IIA and IFAC;
- maintaining and updating the internal audit manual as necessary, including conducting regular reviews of audit programs;
- drafting the annual audit report;
- managing the department, including ensuring that it has sufficient and adequately trained human resources;
- coordinating with external auditors in order to avoid duplication of audit efforts and reduce MFI audit fees. Usually, audit plans are shared. Internal audit working papers would thus be reviewed by external auditors, who should hold periodic meetings with the internal audit department to keep it well informed of external audit work; and
- perform internal auditing themselves, except for the largest internal audit departments.

The **chief internal auditor** should have the following professional qualifications:

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

[18] See footnote 7.

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

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

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

Experience in the operational side of an MFI or bank is a strong asset for any member of an internal audit team. Within an MFI, the internal audit function is broader than that of a traditional internal auditor, as the most effective fraud control measures in an MFI are active measures at the operational level (including visiting clients), rather than the review of documentation and compliance with manuals. Thus, familiarity with loan operations is highly desirable, as an auditor who already "knows all the tricks" will increase his or her effectiveness. As a result, loan officers are often transferred to an internal audit team because they have an edge in reviewing internal controls and uncovering fraud.

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

There are several approaches to finding internal auditors. National, regional, and local organizations of internal auditors may serve as resources for finding appropriate employees. Line internal auditors are often developed internally by an MFI by selecting specific loan officers who have the qualities necessary for an internal auditor.[19] In larger MFIs, internal auditors may be recruited by attracting former external auditors, which is beneficial because these internal auditors will then "speak the same language" as the external auditors and bring their experience in reviewing and evaluating internal control systems to the task of internal audits.

Sample Job Descriptions for an Internal Audit Department can be found in **annex 5**.

7.4.2 New staff

All new staff members of the internal audit department should undergo orientation and training sessions regarding the work of the MFI and the audit department that review:

- the MFI's functions, structures, environment, etc.;
- relevant legislation;
- policies on anti-money laundering and countering the financing of terrorism (AML-CFT), if applicable;
- MFI procedural manuals, including the internal audit manual;
- the mission, standards, and methodology of the internal audit department;
- the MFI's risk assessment methodology; and
- filing and IT systems of the MFI, including those of the internal audit department.

[19] If an internal auditor is recruited internally, however, policies must be defined to prevent him or her from auditing former loan clients or a former regional office, etc., until a certain time period has elapsed. If there is only one auditor or, for geographic reasons, it is impossible to avoid auditing former recent regional offices or colleagues, this fact should be noted in the internal audit report. Credit supervisors or other appropriate staff should assist in the internal audit if an internal auditor's former clients are included in the audit sample.

7.4.3 Timekeeping

Timekeeping and budgeting provide overall guidelines for the performance of each audit; those documents also monitor whether the department is on track with specific and annual audit plans. Audit timesheets are usually approved by the chief internal auditor, enabling him or her to control the audit work in process for the department. **Annex 6** provides a **Sample Internal Audit Timesheet** that can be adapted by an MFI.

7.4.4 Quality control

The chief internal auditor is responsible for the quality of the audit department's activities and files.

Working papers and audit reports are reviewed by the chief internal auditor or another internal auditor, who checks compliance of the completed work with departmental standards; he or she also verifies individual conclusions and evidence with the audit findings. The chief internal auditor also ensures that the planned timetable is met and the time allocated for an audit is used effectively.

General Quality Criteria for Audits

A quality audit is achieved when:

- The audit results in a positive impact on processes, where such an opportunity exists.
- There is good communication between auditor and auditee.
- The perspective and needs of the auditee are incorporated into the audit process.
- Audit objectives, scope, and procedures are constantly re-assessed to ensure efficient use of audit resources.
- Audit objectives are achieved in an efficient and timely manner.
- Audit work is adequately documented.
- Auditees have an opportunity to review audit findings, conclusions, and recommendations with the auditors and strive for mutual agreement.
- The standards of the Institute of Internal Auditors for the Professional Practice of Internal Auditing are met.

Auditee Feedback

Relations with auditees can be improved and further quality assurance provided by a feedback mechanism whereby auditees are regularly provided the opportunity to comment and give input into the work of the internal audit department. This kind of mechanism can provide a healthy balance for environments where auditors may still project a "policeman" image.

Quality Assurance Program

The purpose of this program is to provide reasonable assurance that audit work conforms to the internal audit charter and applicable policies and standards. Not all MFI internal audit departments have a quality assurance program, but they should give some thought to continuous self-evaluation and improvement of their services. It is helpful, for example, for the department to undertake periodic self-reviews in compliance with the IIA Standards for the Professional Practice of Internal Auditing. A **Sample Internal Audit Performance Evaluation** is located in **annex 7** that can be edited as appropriate for an MFI's use.

A quality assurance program should include the following elements:

- supervision and review of the work of the internal audit department;
- internal reviews; and
- external reviews—primarily by the external auditor.

External auditors, who are part of the auditing profession, are in a good position to appraise the quality of the operations of an internal audit department, including its audit procedures, documentation, reporting, and follow-up work.

7.4.5. Reporting on internal audit department activities

It is beneficial for the internal audit department to prepare an annual report, in conjunction with the annual report activity of the MFI as a whole, for presentation to the board audit committee and the executive director. The report should quantify the value added to the MFI by the department as much as possible.

The annual performance report of the internal audit department or internal audit function of an MFI should cover the following areas of operation and performance:

- implementation of the annual department activity plan, indicating the variance between planned and implemented audits and any ad-hoc audits or investigations or other assignments;

- any cases in which an audit scope was limited, together with an explanation of the causes and potential risks;
- summary of the principal findings and recommendations of the audits undertaken in that year, including any significant deficiencies detected in the MFI's internal control system;
- review of the status of implementation of audit recommendations, corrective actions, and deficiency elimination;
- recommendations that remain unimplemented which the audit department considers important, together with the associated risks of non-implementation;
- the sufficiency of human and material resources to carry out the audits that were planned;
- training of internal audit department staff during the year and training planned for the subsequent year, including not only audit training, but training in the IT systems and operations of the MFI; and
- any other important information relevant to the work of the department.

7.4.6 Information security within the internal audit department

The internal audit department should develop policies to guide the security of the information collected in the course of audit work. The following standards are designed to allow efficient access to information by those who need to use it, yet protect the integrity of the original files.

Restricted information. All information obtained or reviewed in the course of an audit, as well as information to which auditors have access, should be considered confidential. Working papers, audit reports, and investigation reports are not to be disclosed to a third party other than the external auditor, unless the department is instructed in writing to do so by the board audit committee.

Working papers. Upon completion of an audit, working papers held in hard copy should be maintained in locked file cabinets in the internal audit department. Electronic copies should be organized in appropriate folders, backed up, and standard password protection used to limit access to them.

Data ownership. Internal audit department files are considered the property of the department, rather than the property of the individual who created them, whether the files are retained in electronic or paper format. All files, whether paper or electronic, may need to be accessed from time to time by the audit team, and the department's archival system should permit such access.

Protection of sources. The internal audit department should protect the identity of and prevent reprisals against any staff member, client, or member of the community who discloses information or otherwise cooperates in any audit, investigation, or who makes a legitimate and reasonable complaint.

7.5 Additional Internal Audit Responsibilities

7.5.1 Operational audits: Efficiency and effectiveness

In the traditional auditing paradigm, internal audits often focus on tests of financial transactions, examinations of financial reports, compliance with policies and procedures, and verification of checks and balances. Operational audits[20] in particular are seen as the specific scope of work of the internal auditor or an external evaluator.

An operational audit is an appraisal of the overall management of an institution: its coordinating and organizing processes, work processes, business systems, and the activities conducted to meet its goals and objectives. It often includes evaluating for effectiveness, efficiency, and economy. **Effectiveness** means the assurance that the right things are being done and an institution's objectives are being achieved. **Efficiency** describes the relationship between the intended and actual impact of an activity. **Economical** means that objectives are being accomplished with minimal resources, which are used in proportion to the relevant risk.

Operational audits look at such areas as product quality, customer service, revenue maximization, expense minimization, fraud prevention, asset safeguarding, corporate social responsibility and citizenship, as well as streamlined workflows, safety, and planning for the future. As discussed previously, many institutions include operational auditing within the mandate of senior management. If they do, the work of an independent internal auditor in the area of operational auditing should be coordinated with the internal audit department to ensure efficiencies, clear planning, and useful reporting.

Current thinking in the field is that the internal audit function adds value to and improves all areas of operations, including efficiency and effectiveness. Operational auditing, like compliance auditing and financial auditing, is within the scope of the internal audit department and should form part of its strategic and annual plans. It is important to note that specific audit objectives and procedures must be developed to evaluate the operational effectiveness of an MFI.

[20] Also called performance or management audits.

Internal audit conclusions should be supported, where possible, by mathematical information on the cost of a control and an estimate of the benefit derived from or potential loss avoided by the control. The economical use of inputs to achieve an MFI's objectives should also be evaluated. Any issues of waste or mismanagement should be highlighted in an operational audit report, or if serious, reported immediately.

7.5.2 Policies on Anti-Money Laundering and Countering the Financing of Terrorism (AML-CFT)

The aim of these policies are to ensure that an MFI meets local and international requirements to prevent money laundering and counter the financing of terrorism, as well as all other relevant legal acts, bank regulations, or donor-funder requirements dealing with this issue. This is not an issue relevant to all MFIs, but may well be part of a donor-funded condition, a central bank requirement, or simply a legal requirement of an MFI receiving operational or capital funding.

In smaller MFIs, the internal audit department is often responsible for AML-CFT compliance. Although this situation is not ideal because internal auditors can obviously not objectively audit their own work, it is recognized that the AML-CFT compliance officer should, to a certain extent, work independently. The details of AML-CFT policies are not elaborated in this toolkit, but can be accessed from the regulations of specific donors (e.g., the United States Agency for International Development, or USAID), national regulators, or the internationally recognized Financial Task Force on Money Laundering.[21]

7.6 Accessing External Expertise for Internal Audit Work

Under normal conditions, internal audit work should be performed by staff of the internal audit department. Circumstances may arise, however, where internal audit department staffing resources must be supplemented by the appointment of consultants.

According to the Institute of Internal Auditors, an external service provider is "a person or firm outside of the organization, who has special knowledge, skill, and experience in a particular discipline."[22]

The internal audit department may use the services of an audit services provider to:

- satisfy internal audit department staffing needs during workload peaks;

[21] See its website at www.fatf-gafi.org (accessed March 2009).
[22] IIA,2009, *International Standards*, 18.

- assist the internal audit department in the effective discharge of its responsibilities (e.g., by conducting an external review of the internal audit department);
- assist in the evaluation of MFI risks and the controls over them;
- provide specialized knowledge or skills, such as forensic auditing, legal expertise; or
- carry out an IT audit.

Appointing external service providers should be subject to a detailed proposal and justification by the chief internal auditor and approved by the board audit committee. Any internal audit work, expertise, or specialty that is outsourced must follow the same standards of implementation, ethics, reporting, and competence to which the MFI audit department adheres.

8.0 Guidelines for Sampling in an Internal Audit

Because all audits involve an examination of a sample of the transactions, documents, and processes that are being audited, this chapter explains how to effectively use sampling in internal MFI audits. It is written to enable auditors without training in statistics to easily use statistical sampling. If internal auditors understand the logic of sampling, it will hopefully give them more confidence to implement it regularly. As a result, their audit work will be more reliable and defensible.

The chapters that follow describe how to develop internal audit plans, then implement and document audits—including the use of sampling. Although sampling is part of audit implementation, it demands a dedicated chapter due to its technical nature. It is thus addressed here in the toolkit before the text turns to implementation as a whole.

8.1 Sampling: An Introduction

Auditors use sampling to efficiently obtain information about the characteristics of all items in the area under audit (e.g., transactions, loans, etc., in a given balance or class of items, defined as a "population"). It is self-evident that it is less time-consuming to audit a sample rather than 100 percent of a population and sampling, particularly statistical sampling, allows auditors to reliably extrapolate conclusions to the population as a whole.

Many MFIs do not use sophisticated sampling techniques and often apply subjective and judgmental approaches when determining which areas to audit. Although internal auditors may audit identified areas of risk (e.g., a new branch, a loan officer's delinquent portfolio, all loans over a certain value, etc.), conclusions about an MFI's operations based on such a targeted sample may be misguided because the sample is not representative. Auditing specific areas of concern is a legitimate audit activity, but should be a special-purpose audit and reported accordingly. Targeted audits should not replace a general internal audit of a representative sample of all operational activities.

The subject of sampling is often overwhelming. However, sampling is an efficient way to conduct audit work in an organization. If sampling techniques and approaches are well documented, the conclusions drawn on the audit sample are also more reliable.

Internal auditors can make more reliable general conclusions about the activities that are the focus of an audit by applying statistical techniques instead of judgmental sampling.

It would be misleading to say that statistics is an easy subject, especially since many of the tasks involved are "counterintuitive," that is, the formulas or tables used may seem illogical. Sampling is further complicated by the fact that different terminology is often used for the same concept (e.g., precision, confidence interval, margin of error). Nevertheless, sampling is not as intimidating as many people believe and its benefits exceed the costs: an auditor may well discover how assertions made in past audits were overstated or the sample sizes used were too large or too small.

Many parts of this chapter are not applicable to most internal audits. For instance, many internal auditors do not need to use variable sampling, which is the most complicated of the sampling types explained below. **At a minimum, it is recommended that internal auditors testing internal controls use:**

- **acceptance or attribute sampling** to determine sample sizes and interpret results, and
- **interval or random number sampling** to actually select the samples that will be tested or reviewed.

Further explanations and information on sampling are found in **annexes 8A, 8B, and 9** of this toolkit.[23] It may also be helpful for an MFI to invest in audit statistical sampling software, such as **ACL** or **IDEA**. In fact, the first step in sampling is to see whether the software packages used by the MFI include a sampling facility or module, as this capability is becoming more and more common.

8.2 Sampling and Non-sampling Risk

The risk of drawing a wrong conclusion from a sample can be broken down into two risks: sampling risk and non-sampling risk.

Sampling risk is the risk that a sample is not representative of the population of items being evaluated, leading an auditor to reach the wrong conclusion.

[23] Two documents available on the Internet are particularly useful for auditors. The first is a 2004 Power Point presentation on audit sampling prepared by the city government of Seattle, Washington: http://www.seattle.gov/audit/training_files/audit_sampling.ppt. The second is a sampling guide prepared by the National Audit Office of the United Kingdom: http://www.nao.org.uk/publications/0001/sampling_guide.aspx. (Both documents accessed March 2009).

As long as sampling is used, there will always be some sampling risk. However, most auditors believe that the efficiency advantages derived from sampling outweigh sampling risk.

Sampling risk decreases as the sample size increases, that is, the larger the sample size, the lower the chances of a wrong conclusion. Sampling risk can also be reduced if an auditor uses his or her knowledge of the population when designing the sample (e.g., ensuring the sample is representative, stratifying the population into different subpopulations, etc.).

Non-sampling risk arises from factors unrelated to the use of sampling that may lead an auditor to reach an incorrect conclusion. Examples of non-sampling risk are an auditor failing to recognize an error in a sample item. This same type of error could occur even if 100 percent of the population was audited, thus the risk is not related to the use of sampling. In fact, the risk of an auditor not recognizing an error is often found to be higher if an auditor is under time pressure or becomes bored performing the same task over and over again. Thus non- sampling risk can in some cases be counteracted by the use of sampling.

8.3 Statistical and Judgmental Sampling

There are various types of sampling. To start, sampling can be categorized into two basic methodologies: statistical and judgmental. These methods can be used to determine both the sample size and the selection of individual sample items, or one of the two.

8.3.1 Statistical sampling

Statistical techniques allow auditors to measure sampling risk and are also more defensible against suspicions of bias or insufficient testing. Basically, an auditor can justify his or her work better and feel more confident about interpreting results by using statistical sampling. Another major advantage of this type of sampling is that it often results in smaller sample sizes. Finally, it provides a technical basis for justifying a request for extra staff should an internal audit department be short-staffed.

8.3.2 Judgmental sampling

In judgmental sampling, sometimes called non-statistical sampling, **the auditor determines the sample size and chooses the individual sample items by using non-statistical methods**. The planning and set-up for judgmental sampling is less time-consuming than for statistical sampling, although the time savings is often offset by larger sample sizes.

8.4 Introduction to Sample Size

It is often erroneously assumed that sample size should be based on a percentage of the population, for example, 10 percent of total clients or total monthly transactions. However, the most significant factors of a sample are the actual size of the sample and, where monetary estimations or confirmations of amounts are involved, the standard deviation[24]—not the percentage of the population that is sampled. This fact is often contrary to many people's belief, including those of auditees. Population size is relevant only when the statistical sample size is a large proportion of a population—in which case the statistical projection will be distorted, although in a positive sense, as actual assurance of results will be increased.

This principle is illustrated by the following explanation. Assume that a company wants to introduce a new product for which they need to determine the percentage of different city populations that is left-handed. Table 2 below shows the sample sizes that would be derived if 10 percent were used as a guide for sampling the populations of the various city groups.

Table 2. Using a Percentage Sample Across the Board

Population	*Population size*	*Sample size (10% sampling method)*	*Comments*
City 1	100	10	Insufficient evidence—high sampling risk
City 2	1,000	100	Reasonable (see Section 8.5.8)
City 3	10,000	1,000	Inefficient
City 4	100,000	10,000	Very inefficient
City 4	1,000,000	100,000	Extremely inefficient

8.5 Stages of Audit Sampling

The sequential steps of audit sampling are as follows:

- specify the audit objective and deviation conditions*
- determine the type of statistical sampling
- define the population*
- determine the confidence level

[24] The standard deviation of a population and/or sample is the measure of the variability within the population or sample.

- determine the tolerable deviation rate for acceptance sampling or the maximum tolerable error for variable sampling
- determine the required precision for attribute sampling or variable sampling
- estimate the proportion for attribute sampling
- determine the sample size*
- select the sample*
- evaluate the evidence produced by the audit tests*

** These steps are also required for judgmental sampling.*

8.5.1 Specify the audit objective and deviation conditions

The audit objective and deviation conditions should be defined in the audit plan (usually called the audit program); it is their importance to the sample that will be tested which is emphasized here. **Specifying the audit objective is critical for determining which type of statistical sampling will be used**.

An example of defining a deviation would be a loan contract that is missing an authorization signature. By contrast, a missing date beside a signature might not be considered a deviation, although the auditor may note it in the working papers of an audit. It is particularly important to agree on deviations ahead of time if more than one internal auditor is involved in an audit.

8.5.2 Determine the type of sampling

In addition to the two broad classes of judgmental and statistical sampling, there are several statistical sampling methodologies. For reasons relating to the mathematics of statistics, the choice of which methodology to use is determined by the objective of the testing.

The objectives of attribute sampling (estimating the proportion of an attribute or occurrence) and acceptance sampling (determining whether the occurrence or proportion is below a maximum value) are similar when used to evaluate internal controls. For internal audit purposes, reporting that the estimated proportion of internal control breakdown is either 5 percent (attribute sampling) or 5 percent or less (acceptance sampling) is acceptable for the evaluation of internal controls. Therefore, if the attribute sample formulas discussed below seem intimidating or the acceptance table appears too inflexible, an auditor might consider whether changing audit objectives would significantly impact audit reporting. (The details of how to use the individual types of statistical sampling are covered in subsection 8.5.8 below.) The relationship of objectives and sample types is summarized in table 3.[25]

Table 3. Sample Objectives and Types

Objective	*Sample type*
Estimate a percentage within a population, for instance, the percentage or proportion of loan contracts signed above the authorized approval level.	Attribute sampling
Determine whether an occurrence rate (proportion) is below an acceptable level and thus whether internal controls can be considered operational. For example, if the percentage of loans signed above the authorized approval level is below 2 percent, the control can be considered to be basically operational.	Acceptance sampling
Discover fraud (or specific unusual) items, for example, a fraudulently authorized invoice.	Discovery sampling
Estimate a monetary value normally used to verify account balances, for example, a general ledger account for expenses.	Variable sampling

Of course, an auditor usually has more than one objective and conducts different tests on the same sample. **Since internal auditors tend to focus on testing internal controls, however, the sample size for acceptance or attribute sampling should normally be the guide for an internal audit of an MFI.[26]**

8.5.3 Define the population

As noted earlier, ***population*** is the term used for all items in a balance or class of transactions being audited. For instance, if the task is to audit the revenue from commissions and fees, all transactions affecting the account for this revenue, including any accounting adjustments or reversals, should be included in the population. In other words, the audit should not focus just on payments received. An internal auditor may also want to stratify or divide a population into several smaller populations, such

[25] The sample size for attribute and acceptance sampling vary, yet their objectives are similar for internal auditors. Attribute sampling provides an estimate of the most likely result with a precision around it. By estimating that a deviation (or applicable attribute) rate is below a certain percentage, acceptance sampling is, in fact, referring to a range within which the percentage of errors can fall. For this reason, the two types of sampling are not so interchangeable in other fields: acceptance sampling is typically used for quality assurance (e.g., should a shipment or lot be accepted based on the quality of the sample?), whereas attribute sampling tends to be used for surveys or health statistics. There is quite a difference to a patient between the statistic of a 45 percent recovery rate with a precision of 5 percent, versus the statistic of a recovery rate being anywhere between 0 to 45 percent.

[26] The basis for determining the sample size for all tests performed on a population should be the lowest acceptable percentage of errors for acceptance sampling or the sample with the highest estimated deviation rate for attribute sampling.

as segmenting all new loans by loan officer or separating adjustments or reversals into a separate population. (See section 8.5.9, "Stratified selection.")

8.5.4 Determine the confidence level

Confidence level[27] refers to the reliability (i.e., the reasonable assurance) of the results of a statistical sample. Confidence level is generally expressed as a certain percentage, the most common being 90 or 95 percent. It is comparable to saying, "I am 90 percent (or 95 percent) sure of something." Confidence levels are necessary for all types of statistical sampling. The simplest method is to start with a standard confidence level of 95 percent for all audits and ensure that the audit committee is in agreement. **A daily life equivalent would be: "I am 95 percent sure that I passed the test."**

8.5.5 Determine the tolerable deviation rate

Tolerable error is the maximum error in a population that auditors are willing to accept and still conclude that an MFI's internal controls are operating reliably. The desired control risk level and its tolerable rate is a matter of auditor judgment. In particular, an auditor must assess which rate of deviation or error signals a problem: 2 percent? 5 percent? 10 percent? The lower the tolerable deviation rate, the larger the sample required.

Many internal audit departments will accept a 5 percent error rate, or tolerable deviation, for compliance with key internal controls (i.e., policies and procedures) in operations, accounting, and human resources departments. The tolerable risk level selected should be agreed with the chief internal auditor and reviewed with the board audit committee from time to time. In cases of suspicion of fraud, however, the tolerable error rate should be reduced. **An equivalent in daily life for tolerable error would be: "It's okay as long as I got less than 15 percent of the questions wrong."**

Tolerable misstatement is similar to the previous term, but applies to monetary amounts. Such misstatement must be below "materiality," another term used in accounting and auditing professions; any error in financial statements that might influence the decisions of statement users if they had knowledge of the correct information is considered "material." The concept of materiality is in itself relative and subjective because the size and volume of MFI activities differs greatly among institutions, therefore levels of materiality or immateriality will also differ significantly. **A standard rule of thumb is to use a tolerable misstatement error of 5 to 10 percent or less.**

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[27] Note that "confidence level" and "confidence interval" are not the same thing. To add to the confusion, the term "confidence level" in the descriptive statistics of Excel software is incorrect: the value is actually the confidence interval.

8.5.6 Estimate the proportion for attribute sampling

The formula for attribute sampling requires an estimate of the proportion, or percentage, of the attribute (which is normally a deviation from an internal control). The estimation of this proportion is normally based on previous experience. Note that the proportion must be 50 percent or less: if it were greater than 50 percent, then unfortunately the rate of correct implementation would be less common than the rate of incorrect implementation. **An example from daily life would be: "I think I will get around 15 percent of the questions wrong."**

8.5.7 Determine the required precision for attribute or variable sampling

Precision (also called margin of error or confidence interval) is a statement of how close sample results are to the results of examining every item in a given class or group of transactions. If a sample resulted in an estimate of 5 percent with a precision of 2 percent at a 95 percent confidence level, this would be expressed as, "At a 95 percent confidence level, the actual proportion of deviations is estimated to fall into the range of 3 to 7 percent" (i.e., the estimate of 5 percent, plus or minus 2 percent). Or it can be written as, "We estimate at a 95 percent confidence level that the actual proportion is 5 percent with a precision of 2 percent." **An example of using precision in daily life would be: "I think that I got between 80 percent and 90 percent of the questions right."**

Precision is required for attribute and variable sampling. If a sample resulted in a monetary estimate of $1,000 with a precision of 2 percent at a 95 percent confidence level, this would be expressed as, "At a 95 percent confidence level, the actual balance is estimated to lie in the range of $800–$1,200."

Table 4. Summary of Sampling Concepts

Concept	*Daily-life equivalent*
Confidence level	"I am 95 percent sure that I passed the test."
Tolerable error rate	"It's okay as long as I got less than 15 percent of the questions wrong."
Estimated proportion for attribute sampling	"I think I will get around 15 percent of the questions wrong."
Precision	"I think that I got between 10 and 20 percent of the questions wrong."

8.5.8 Determine the sample size

One of the major advantages of statistical sampling is that it allows auditors to reduce sample size and still be able to justify this size. The formulas or statistical sampling tables, such as the **Poisson Sampling Table** in **annex 8A**, that are used to determine sample size are discussed below. (For purposes of efficiency, the methodology used to evaluate sampling results is also included in the following explanations of the different statistical sampling methodologies.) In general, auditors are advised to round sample sizes up rather than down, unless it is only slightly above an integer.

Attribute sampling

Attribute sampling is used to estimate the proportion of an attribute in a population, such as loans that have not been correctly approved. Two simple formulas are used to calculate attribute sample size and interpret the results.

A worksheet, found in **annex 8B (Attribute Sampling Worksheet)**, has automated formulas, allowing for sample size, precision, and point estimate (best estimate) to be calculated automatically after the parameters are input into the appropriate boxes. In order to calculate sample size, an auditor must input the desired confidence level, the maximum acceptable precision, and an estimate of the proportion of errors or deviations expected. The actual number of errors or deviations discovered in the testing must be input to calculate the point estimate (the best estimate) and the precision.

Detailed information on how to use the actual formulas is included in **annex 9 (Statistical Sampling Supplement).** The worksheet refers to "z" scores. An explanation of these scores is included in the same annex.

Acceptance sampling

As applied in internal auditing, the objective of acceptance sampling is to establish an error rate below a tolerable limit. Acceptance sampling differs only slightly from attribute sampling, since both estimate an attribute occurrence rate (proportion). However, the different objectives of these two types of sampling require different methods for determining sample size and interpreting the results of sample testing.

To determine an acceptance sample size and interpret the results of sample testing, use the statistical tables based on the Poisson Sampling Table in annex 8A. It is easiest to explain this methodology by using an example. If an auditor seeks 90 percent confidence with a tolerable error rate that does not exceed 5 percent, then according to the table in annex 8A, a sample of 50 would be chosen. The acceptance rate for errors on this sample would be 0 percent. If an auditor expects to find one error, then the sample size would be 100. If two errors are found, then the auditor's confidence level that errors are under 5 percent would slip to 87 percent. In order to accept the audit under the original parameters, the auditor would have to increase the audit sample to at least 150 to ensure a confidence level of 90 percent.

If the sample size is more than 10 percent of the population, the results of sample testing will be slightly distorted, but the distortion will be in favor of the auditor (i.e., the actual confidence level will be slightly higher than that shown in the table).

Discovery sampling to determine sample size for detecting fraud

The objective of discovery sampling is to encounter at least one deviation if there are erroneous items in a population. Discovery sampling is often used to pick a sample when looking for fraudulent transactions, but it can also be used to look for deviations or miscalculations after a new system has been introduced. For example, if irregularities are suspected and an auditor wants to be 95 percent confident that he or she discovers at least one irregularity in a sample, then the sample size should be 300 (based on the Poisson Sampling Table in annex 8A and a maximum 1 percent error rate). Discovery sampling only works if a population has an irregularity rate of at least 1 percent—no meaningful assurance can be provided by a sample in which the rate of irregularities in a population is less than 1 percent. In this case, the auditor should use judgmental sampling.

Variable sampling

(also called sampling for testing of detail or sampling for the mean)

Attribute, acceptance, and discovery sampling are used when looking for particular attributes (e.g., whether or not an invoice was correctly approved). Variable sampling is used with variables expressed in monetary units (e.g., the U.S. dollar), such as an invoice or a loan, with a range of values. This type of sampling is often used by external auditors to estimate the total balances of accounts. Thus, an external auditor might take a sample of invoices to estimate a general ledger expense account. It is important that internal auditors be aware of variable sampling, even though it is of less use to their work than it is to that of external auditors. The variable sampling formulas and how to use them are explained in **annex 9,** Statistical Sampling Supplement.

Stop-and-go sampling

Stop-and-go sampling is a method of using acceptance, attribute, or variable sampling. For efficiency reasons, auditors choose the smallest sample possible, assuming there are no errors, even though an auditor may believe that some errors will be found. If no errors are discovered, then the testing is complete. However, if errors are discovered, then the sample size is increased.

Taking the earlier acceptance example (i.e., the auditor seeks 90 percent confidence that the proportion of errors, or error rate, does not exceed 5 percent and thus chooses a sample of 50). The acceptance rate for errors for this sample was 0 percent. If one error is found, the auditor can only claim that he or she is 71 percent confident that the error rate is 5 percent or less, or that he or she is 95 percent confident that the error rate is under 10 percent. To maintain a tolerable error rate of 5 percent and a confidence level of 90 percent, the auditor would increase the sample size to 100 and, if no more errors were found, he or she would be 95 percent confident that the error rate was 5 percent or less.

If one or more errors are found in the second sample, the auditor would conclude that the error rate is probably above 5 percent. Another possibility would be to apply another audit technique (such as an analytical review) or to increase the sample size again.

8.5.9 Select the sample items

When selecting samples, the following two criteria should be met:

- Sampling units must be selected from the population to which an auditing conclusion will apply. For example, the sample should be selected from transactions made in the period being audited. All relevant adjustments or unusual transactions must be included in the population. Thus to evaluate an expense account, not only the invoices, but also adjustments and reversals should be included in the population.
- A sample must be representative of the population from which it is selected. In this context a representative sample is one that reflects the characteristics of the population. For example, if a loan population covers several regions, the sample should reflect those regions in approximately the same proportion.

Either random or interval sampling is highly recommended for the selection of actual sample items. Provided sufficient records are kept (e.g., retaining the random number table used), the auditor can defend his or her sample choice unequivocally against any accusations of bias and the chief internal auditor can reduce the chance of internal corruption. If a sample size is determined using non-statistical methods (i.e., judgmental method), there is still an advantage to using random, interval, or haphazard selection techniques. The reverse, however, does not apply. There is no value in using statistical methods to determine a sample size and then applying judgmental, that is, non-representative, sampling selection.

Auditors can attempt to attain representativeness by selecting sample items with one of the following techniques:

Random sample selection

Random sample selection reduces sampling risk because it is the method that is the least biased, that is, each item has exactly an equal opportunity of being selected as all other items. In order to select random samples, each item in a population must have a unique number, such as a loan or account number. If the population is in the software program Excel, then an auditor would use Excel to randomly select the sample (refer to **annex 9**).

If a population cannot be downloaded into Excel, obtain a selection of random numbers (available on the Internet at www.random.org) to identify individual sample units. As this process is frequently too time-consuming, interval or haphazard selection is often performed instead.

Interval selection (also called systematic or periodic selection)

Although not truly random, this procedure is adequate for most audit purposes and is **usually the most efficient method for selecting a sample** for all but the largest audits. If there are concerns about audit bias or corruption and Excel is used to select the sample, interval sampling is preferable because it is difficult to prove that no one has tampered with Excel's random number selection.

Interval sampling can only be used when both the population and the sample size (see below) are known. **This type of sampling begins with a random or haphazard start, that is, a randomly or haphazardly selected number is used to identify the first item to be audited. Every subsequent item to be audited is then a defined interval after the item that precedes it.** A random start can be determined by using a random number or taking the last figure of a dollar bill or other currency chosen haphazardly from a wallet.

Interval sampling can best be described by using an example, as shown in box 8.

Box 8. Example of Interval Sampling

- Assume 1,000 payments in the expense account, of which 50 payments will be audited.

  $\frac{1000}{50}$ = every 20th deal is selected for audit in the random start

  Obtain a random start* and select every 20th payment to audit.
- Most samples are selected by this method using about 5 random starts.

  Example: $\frac{1000}{(50/5)}$ = every 100th deal is selected from each random start

*Note:** If the population of items is not easily divisible, e.g., 1033 transactions divided by 50, simply randomly choose a start point from 1 to 33.

An auditor must be careful that selection of the interval does not coincide with a pattern in the data. For example, if a survey is made of busy days for deposits at MFI branches, but the interval chosen results in a disproportionate number of days in the sample being days when the government paid civil servants, the sample would not be a good reflection of how busy the branches actually were on average.

The "Data Analysis" function in Excel can be used for interval selection as well. Unfortunately, Excel does not have a random start function. To overcome this, the auditor can haphazardly pick a number that is less than the interval amount and add that number of rows to the beginning of the range. For example, if the interval is 20 for a population of 500 and the number 17 is haphazardly picked, 17 blank rows are added at the top of the relevant worksheet and the input range for Excel becomes a1:a517.

Haphazard selection

Haphazard selection is an unsystematic method of selecting sample units. An example would be arbitrarily choosing loans for sampling by physically selecting loan files (i.e., perhaps with one's eyes shut) out of a file cabinet. A reader might think that this process equates to the randomness of random numbers, but, in reality, the chances of each item being selected may not be exactly the same: for instance, the first and last files are less likely to be chosen. This method can be used when the most unbiased and preferred methods of interval sampling or random number sampling are too time consuming. It is also useful when the population size is unknown and interval sampling cannot be used.

Block sampling (also called cluster sampling)

This type of sampling chooses segments of transactions to review. Block sampling should be avoided because to have enough blocks to meet the requirements of randomness requires that a huge number of transactions be audited. However, it can be useful when physically accessing individual items would be time consuming. An example would be to select all loan applications done on randomly selected days of the year because the applications are filed by date and difficult to access. Auditors often use block samples for areas or dates that are at high risk, for example, looking for unusual expenses just before year- or budget-end, to supplement other samples.

Stratified selection (stratifying the population)

In stratified selection, the population is split into different groups (e.g., loans under $5,000, loans between $5,000 and $10,000, and loans over $10,000), with different samples taken from the different population groups—one sample from each group.

Separating year-end adjustments or breaking down a sample into different branches or loan officers is a common way to stratify the population of transactions to be audited. External auditors use this method particularly when materiality and financial estimations are significant. Internal auditors might use this approach for special audit assignments, such as ensuring compliance with policies or contractual commitments or when auditing areas of operations with identified risks.

Judgmental sample selection

In judgmental selection, a sample chosen is based solely on an auditor's judgment. Although convenient, its use should be discouraged since it is less defensible and more prone to misrepresenting the population.

8.5.10 Evaluate the evidence

After auditing the selected samples, the evidence from testing is then examined.[28] Whether or not an auditor uses any of the audit methodologies above, there are four possible courses of action that can be followed if the error rate found in the testing is greater than the level defined as acceptable.

First, the auditor can analyze the sample to see if it is representative. For instance, it may be found that a key employee was ill during the period under audit, so the auditor may want to stratify the population into periods when this employee was working and when he or she was not. Other options are:

[28] Statistical sampling can be used to evaluate audit testing results, even if it was not used to calculate the sample size. Simply plug the results into the attribute sampling worksheet in annex 8B or the formulas given in section 8.5.8.or, for acceptance sampling, use the Poisson table in annex 8A. However, if a sample size chosen through judgmental sampling is too low, the precision may be too broad to provide meaningful results.

- **Increase the sample size**

  This is the preferred course of action. For example, if acceptance sampling was used and a sample size of 50 was chosen for a 95 percent confidence level, a second sample of 50 or 100 should be taken if one error is found. (Note that if two errors are found in 100, the confidence level slips to 87 percent).

- **Perform other audit procedures**

  Other audit procedures, such as analytical review, may be performed.

- **Decide that the control is not working (not effective)**

  This is not an ideal result, but if several errors or deviations are discovered, or other evidence is available (for example, an interview or observations that indicate that the control is not working), this would be the logical response.

- **Raise the tolerable error level or lower the confidence level**

  This step should only be taken if an auditor has determined that other compensating controls are effective and reliance on this control is not essential for audit objectives. Diversions from standard confidence levels (or tolerable error rates or margin of errors) should, however, be agreed with the chief internal auditor and noted in the audit report.

Table 6. Summary of Statistical Audit Methodology

	Attribute	*Acceptance*	*Discovery*	*Variable*
Description	Reaches a conclusion regarding the rate of occurrence or proportion of an attribute	Determines whether the occurrence/ proportion is at or below an acceptable level	Searches for a particular occurrence	Estimates or confirms values such as account balances or other monetary amounts
Objective/ when to use	Estimate the proportion of deviations	Determine if internal controls are operating sufficiently	Search for fraud when suspicion of fraud exists; alternatively, search for a particular error after introduction of new systems	Determine whether a monetary amount (e.g., the general ledger account balance) is accurate
Estimates/ judgments required	Estimate of proportion (usually based on previous experience)	Tolerable error rate		
Constraints (sample size must be at least 25 to be statistically valid)			Probability of the occurrence (e.g., fraud) must be greater than 1%	
Tools to obtain sample size	Formula or Annex 8B	Poissons Table (Annex 8A)	Poissons Table (Annex 8A)	Formula
Analysis of data	Formula or Annex 8B	Poissons Table (Annex 8A)	Poissons Table (Annex 8A)	Excel data analysis
Examples from actual internal audit reports	". . . based on a confidence level of 95% and a margin of error of 7%, a random sample of 204 travel expenses were tested against the audit criteria. A judgmental sample of 45 high-risk travel claims, such as international trips, trips with a high value, etc., was also included in the testing"[a]	"To assess internal controls for a low level of risk, we used a 95%. . . confidence level and a tolerable error rate of 7% or less. At this low level of risk, a high reliance can be placed on the system of internal controls governing the accuracy and completeness of the data in the Clearinghouse Database."[b]	"Discovery Audit Activities: We are seeking new audit initiatives to identify taxpayers who are filing but not including all of their income in accordance with the Revenue and Taxation Code."[c]	"We project an unbiased point estimate of $1,428,351 in unreimbursed warranty repair costs. We also report a precision of plus or minus $450,753 at a 95 percent confidence level, resulting in a range of $977,598 to $1,879,104 of unreimbursed warranty repair costs."[d]

Notes: [a] Environment Canada, 2007, "Audit Travel Expenses and Compliance with Disclosure Policy," Environment Canada, Quebec, Canada, http://www.ec.gc.ca/doc/ae-ve/trav-eval/trav_fin_E.doc (accessed March 2009).

[b] U.S. Census Bureau, 2004, "Results Assessment of Federal Audit Clearinghouse Database Utilizing Agreed-on Measures," U.S. Department of Commerce, Washington, DC, http://www.oig.doc.gov/oig/reports/2004/ESA-ATL-16202-4-05-04.pdf (accessed March 2009).

[c] Franchise Tax Board, 2007, "Franchise Tax Board at a Glance," Franchise Tax Board, Sacramento, California, http://www.ftb.ca.gov/forms/misc/1041_0207.pdf (accessed March 2009).

[d] Grant Thornton, LLP, 2000, "Audit of the United States Postal Service Warranty Repair of Tractors," Report No. CA-AR-00-0001, USPS Web site, Washington, DC, http://www.uspsoig.gov/FOIA_files/CA-AR-00-001.pdf (accessed March 2009).

8.6 Sampling Plan

Whether an audit uses judgmental or statistical sampling or a combination of both, the Institute of Internal Auditors requires a sampling plan that states the audit objectives. Table 7 below is an illustration of the relevant portion of a sampling plan, followed by an example of how it could be described in an MFI's quarterly report. Although it might be considered informal in conjunction with the audit procedures used, all the necessary information is included.

Table 7. Sampling Plan for Audit of Internal Controls of MFI Loan Portfolio

Population	*Total items*	*Sample type*	*Sample size*	*Sample selection*	*Explanation*
Corporate loans	7	100%	7	100%	These loans represent 20% of total loan portfolio, thus they include all corporate loans
Performing individual loans	9,328	Acceptance	100	Random number	Confidence level (CL): 96% Tolerable error (TE): 5% 1% errors expected
Performing group loans	3,853	Acceptance	50	Interval	CL: 92% TE: 5% (lower CL as loan amounts are lower) 0 errors expected Interval sample selection
Individual portfolio at risk (PAR)	731	Attribute	70	Random	CL: 95% Estimated proportion of deviations: 3% Precision: 4%
Group PAR	419	Attribute	50	Interval	CL: 90% (low loan amounts) Estimated proportion of deviations: 3% Precision: 4%

Population	Total items	Sample type	Sample size	Sample selection	Explanation
					Interval sample selection
Written off	38	100%	12	100%	Include all written-off loans due to high risk
Loans granted to employees	11	Judgmental	3	Judgmental	Will focus on loans to branch management due to higher risk and high loan amounts

Note: Population includes all loans outstanding as of December 31, XXXX.

The above sample sizes can be allocated among an MFI's branches, to be audited in one audit period (such as a quarter). A generous allowance should to be made for the expected number of errors, perhaps overestimating to allow for a cushion. Otherwise, if the error rate is found to be too high to maintain the desired confidence level after the first branches have been audited and the sample size is accordingly increased, there will be a distortion of the allocation among earlier and later branches. It should be noted that an internal audit department would not normally combine acceptance and attribute sampling; they are mixed here simply to give an example.

Table 8. Example of Allocation of One Sample Size Across Different Units

	Weighted proportion of loans		*Sample size: individual loans*		*Sample size: group loans*	
Branch	*Performing*	*PAR*	*Performing*	*PAR*	*Performing*	*PAR*
A	35%	38%	35	19	24	19
B	27%	24%	27	12	19	12
C	13%	20%	13	10	9	10
D	25%	18%	25	9	18	9
Total	**100%**	**100%**	**100**	**50**	**70**	**50**

8.6.1 Sampling reporting

The results of an audit based on the sampling plan shown in tables 7 and 8 can be presented in a periodic report, such as a quarterly report. An example explaining the methodology is listed immediately below and examples of two opening statements of an audit report are provided at the end of this subsection.

Sample section of quarterly report on sampling for loan portfolio audit

During the quarter, the audit team tested the loan portfolio for branches: A, B, C, and D using statistical sampling. A sample of 100 performing loans for individuals were tested across the four branches audited in the quarter, based on a weighted proportion of the loans. This sample size was based on a 95 percent confidence level and an expected discovery of three errors. In view of the smaller average outstanding amount of group loans, a 90 percent confidence level was used for group loans, resulting in a sample size of 50. Judgmental sampling was used for corporate (100 percent) and staff loans because of their limited number, size, and/or high risk, with a focus on loans to branch managers, which have a higher value and risk.

Concern has been expressed about the quality of loan files for the portfolio at risk (PAR) rate for both individual and group loans, thus separate samples were chosen to estimate the proportion of deviations. A sample size of 70 PAR individual loans was chosen, and 50 PAR group loans were selected for testing, based on 95 percent and 90 percent respective confidence levels, an estimated proportion of 3 percent errors (derived from previous audits), and a required precision of 4 percent. All written-off loans were audited. A table summarizing the sample sizes and populations by branch and product or quality of loans is included in annex 1 of this report.

Summary comments on results

The error rate of the performing loans is estimated to be below 5 percent with a 95 percent confidence level… At a confidence level of 95 percent, the point estimate for the error rate for non-performing loans is 3 percent, with a precision of 2 percent.

Excerpt from the opening statement of an actual audit report

The following is an excerpt from a government report that explains the sampling methodology used in an internal audit. A government report is used since typically only a government makes internal audit reports public. The entire report can be found on the referenced Web site.

> The need to perform an audit of financial coding was identified as part of the planning exercise of fiscal year 2004–2005. . . Financial data for the period of April 1, 2004 to January 31, 2005 were obtained from Finance and Corporate Branch. . . resulting in a total of 271,372 records with a value of $291,040,996. . . Based on a 95% confidence level and a 7% margin of error, a random sample of 206 transactions was selected with ACL (Audit Command Language) software.
>
> The sample was selected in proportion to the total value of the transactions in each region.[29]

[29] Environment Canada, 2006, "Audit and Evaluation Report, 2005–2006," Environment Canada, Quebec, Canada, http://www.ec.gc.ca/ae-ve/default.asp?lang=En&n=E8CE72D9-1&offset=1&toc=show (accessed March 2009).

	Absolute value	*Proportion*	*# of samples*
Atlantic	$15,709,432.48	5.4%	11
Burlington	$28,175,319.15	9.7%	20
Dorval CMC	$16,693,102.90	5.7%	12
Downsview	$45,137,088.09	15.5%	32
Edmonton	$30,855,950.85	10.6%	22
NCR Accounting	$113,455,603.37	39.0%	80

Source: Environment Canada (2006).

9.0 Implementing the Internal Audit Function

This section of the toolkit explains the steps for conducting an internal audit, from the initial assignment through fieldwork. These details would normally be laid out in an MFI's internal audit manual. As with all operational manuals, the internal audit manual must be updated from time to time as an MFI grows, adopts new technology, and increases its range of products and services—all of which change the risks that it faces.

The flowchart presented on the next page provides a global view of the internal audit process.

- The left part of the chart indicates each step of the process with reference to the related operational procedure.
- The right part of the chart indicates the output documents of the step, samples of which are often illustrated in annexes to this document.

For smaller MFIs, many of the following steps may be too formal or seem unnecessary. However, as an MFI matures and is subjected to more rigorous financial discipline or supervision, a formal internal audit approach will be warranted. Further, external auditors, raters, and external evaluators will be able to place greater reliance on the work of an internal audit department if well-documented work plans, communications, working paper files, supporting documentation, and reports are in place.

Special audits and investigations may require a different approach than that outlined in figure 2 below; these types of audits are defined on a case-by-case basis.

Figure 3. The Internal Audit Process

PHASE	OPERATIONAL PROCEDURE	OUTPUT/ STANDARD FORM
PLANNING AND OPENING CONFERENCE	**Strategic Audit Plan → Annual Audit Plan**	Annex 3: Sample Risk Assessment Tools Annex 10: Sample Strategic Plan for an Internal Audit Department Annex11: Sample Annual Plan for an Internal Audit Department
	Audit initiation	Annex 12: Sample Engagement Letter/Email for an Internal Audit
	Opening conference	Annex 13: Sample Opening Meeting Memo
FIELDWORK	**Preliminary survey**	Permanent files Annex 14: Sample Internal Control Self-Assessment Questionnaire Annex 15: Sample Internal Control Questionnaires
	Assessment of internal controls	Annex 16: Typical Control Objectives of Financial Transactions Annex 17A: Typical Internal Audit Procedures, Definitions, and Illustrations Annex 17B: Sample Internal Audit Procedures and Work Plans Irregularity and Fraud: **See chapter 15 of this Toolkit** Sampling Plan → see section 8.6 of this Toolkit
	Determine audit procedures/ sample	
	Perform audit work	
	Working paper review	Annex 18: Internal Audit Working Papers Template Annex 19: Sample Internal Audit Findings Form
	Exit Interview	Annex 20: Sample Internal Audit Exit Meeting Memo
DRAFT AUDIT REPORT AND CLOSING CONFERENCE	**Draft report writing**	Annex 21: Sample Internal Audit Report Templates
	Draft report review	
	Draft report transmitted to auditee	
	Management responses	Annex 22: Sample Management Responses
FINAL AUDIT REPORT	**Final report**	Annex 21: Sample Internal Audit Report Templates
	Distribution of final report	Annex 23: Sample Transmittal Cover Letter/ Email for Internal Audit Distribution

PHASE	OPERATIONAL PROCEDURE	OUTPUT/ STANDARD FORM
FOLLOW-UP PLAN	Follow-up process	Annex 24: Sample Audit Recommendations Follow-up Report
INTERNAL QUALITY REVIEW	Audit performance evaluation	Annex 7: Sample Internal Audit Performance Evaluation

9.1 Strategic Planning for Internal Audits

Long-term planning for internal audits, that is, the strategic audit work plan, must identify all auditable areas within an MFI and ensure that they will be covered by the internal audit department during the subsequent two to three years. The plan should also identify any areas that are not covered in the cycle and the reasons why they will not be audited.

Identification and prioritization of auditable areas should be based on:

- an assessment related to an MFI's objectives and the degree of risk associated with them;
- human resources and the expertise of the internal audit department;
- discussions with the audit committee, the executive director, and senior management; or discussion of specific internal audit requests by the MFI;
- anticipated changes in operations (e.g., new branches) or the introduction of new products or technology;
- changes in the regulatory environment; and
- time elapsed since the last audit and the results of that audit.

The strategic audit plan should not only be sufficiently comprehensive to ensure a complete and effective review of an MFI's activities on a cyclical basis, but also allow the flexibility to accommodate special tasks, investigations, and audits requested by the board audit committee or the executive director, or as judged needed by the internal audit department, based on events or findings.

The risk assessment should provide a basis for:

- establishing the frequency of review for each area (based on the risk analysis);
- establishing the nature or type of review; and
- assessing the resources needed for review assignments.

The strategic audit plan should be updated annually by the chief internal auditor and approved by the board of directors or the board audit committee, in consultation with the executive director of an MFI. A **Sample Strategic Plan for an Internal Audit Department** is found in **annex 10.**

9.2 Annual Planning for Internal Audit

Each year an MFI's internal audit department should prepare an annual internal audit plan that includes objectives, priorities, a schedule, and resource requirements. This plan should be a general plan for the department, although it may include more specific plans for various auditors in the department.

The annual plan is primarily a subset of the strategic plan, but provides more detail on the activities, human resources, and budgets to be considered during the year. It also forms the basis for ongoing review of the strategic work plan. Prepared by the chief internal auditor, it must be approved by the board audit committee and should be endorsed by the executive director.

Since the internal audit department reports to the board audit committee, the executive director's approval is not required. However, his or her endorsement of the annual plan demonstrates senior management support of the internal audit department to all MFI employees. The annual internal audit plan should also be incorporated into the overall annual work plan of the MFI that is submitted to the board of directors for approval. A **Sample Annual Plan for an Internal Audit Department** is found in **annex 11**.

The annual plan, which should tie into the institution's risk analysis, should specify:

- activity/operations and/or units to be audited and the type of audits to be performed during the upcoming year, as well as schedules for those audits;
- estimated audit days or estimated days per audit;
- the number of surprise audits;
- allocated resources;
- staff training and development for the department;
- a reserve of flexible hours or days set aside for ad-hoc audits, special investigations, or previously unannounced training that becomes available; and
- preparation of the internal audit department's annual and other periodic (e.g., quarterly) reports.

Senior management should be consulted as to the appropriate timing of planned internal audits that are not surprise audits so as to ensure that appropriate auditee staff are available and that the audit does not interfere with auditee peak periods. **During annual audit planning, internal auditors should ask regional or branch**

managers for their specific requests for audits or other review services. The decision whether or not to carry out requested services is then taken by the chief internal auditor in consultation with the executive director and/or the board audit committee.

If at any point the internal audit department is requested to undertake a special (i.e., unplanned) assignment or if there is a change in the risk assessment of the MFI's operations that requires amendment of the approved plan, the chief internal auditor should:

- revise the audit plan;
- inform and/or consult with the executive director; and
- submit the revised annual internal audit work plan, along with an explanation of the change(s), to the board audit committee for approval.

The management of an auditee department may request a delay in an audit due to poor timing, unusual circumstances, or special issues facing the MFI. All such changes should be approved by the board audit committee.

> Approximately 15 percent (this figure should be customized, based on the previous experience of an internal audit department) of the annual work time of each auditor should be left undistributed in an annual plan to allow for flexibility for unanticipated circumstances (e.g., possible illnesses, execution of unplanned audits or investigations, other important circumstances).

The chief internal auditor is responsible for implementation of internal audit plans through his or her management of the department's human and financial resources. In addition to managing the department, the chief internal auditor should also provide the executive director and board audit committee periodic oral or written interim progress reports. Ideally, he or she would prepare a table that lists all audits completed and the progress of all other planned audits. Section 7.4 of this toolkit, "Managing the Internal Audit Department," elaborates further on departmental progress reporting. All changes in audit scope and other relevant issues should also be provided in written form.

9.3 Specific Audit Planning: The Audit Plan

A specific separate plan for each audit should be drawn up before starting an audit.

9.3.1 Purpose of an audit plan

An audit plan is a task plan. It is prepared as a framework for an audit assignment that guides the auditors who undertake it. The purpose of the plan is to document the activities and actions to be performed during the audit that will achieve audit objectives.

The audit plan is also a record of supervisory approval of work to be performed. It provides a basis on which an audit can be budgeted and controlled. Following an approved, detailed audit plan prevents an auditor from getting off track and pursuing irrelevant items.

In conjunction with an audit plan and a risk assessment—in particular, an internal control rating—an auditor develops audit programs to be approved by the chief internal auditor. These audit programs are completed on site after an initial review of the internal control system and will be discussed in more detail later in this chapter.

9.3.2 Content of the audit plan

Table 9. Individual Audit Plan and Associated Activities

Plan component	*Explanation*
Background	At the beginning of the audit plan, provide a brief, general overview of auditee operations.
Planning	The planning component must be written before any time is incurred on the audit.
Audit scope	The audit scope should mention the specific period, area, and operation(s) that will be covered by the audit.
Audit objectives	Objectives should fit within the overall scope of the audit. Every audit procedure should help answer one of the objectives, and every objective should be addressed in the procedures or steps. All stated objectives must be answered and supported by test work and refer to audit programs developed by the audit staff.
Administration and wrap-up	Includes all steps not related to planning and testing, such as completing forms, working papers, report writing, etc.

9.3.3 Periodic reviews and meetings

It should be noted that the objective(s), scope, timing, and budget of an audit should be constantly reassessed throughout the audit process to ensure efficient use of audit resources. That is, questions such as the following should be asked periodically: Should the remaining audit steps be eliminated? Should the objective or scope be expanded or changed? Have more efficient procedures been identified? Should additional hours be allocated? If, through continuous reassessment, significant changes are made to the objective and/or scope initially agreed with the chief internal auditor, the audit committee, or MFI senior management, these changes should be communicated accordingly.

All audit reports should be reviewed and authorized by the chief internal auditor.

9.3.4 Audit timekeeping

The internal audit department should record time spent by auditors by specific audit in order to monitor the department's current performance and assist in planning future audits and projects. A **Sample Audit Timesheet** can be found in **annex 6.**

9.4 Guidelines on Testing and Gathering Information in Auditing

In planning an audit, an internal auditor must ensure that there will be adequate evidence to evaluate the reliability of internal controls, the accuracy and reliability of financial information and reports, the appropriateness of risk mitigation measures (through testing controls), and compliance with policies and procedures.

9.4.1 Obtaining information

An audit is based on obtaining information. There are various methods for obtaining information about an activity or a system of control under review. Audit procedures are more specifically laid out in section 9.8 below. In brief, they include:

- interviewing appropriate personnel, clients, and other relevant parties;
- reviewing procedural manuals and policies;
- reviewing laws and other local, MFI, or donor or funder regulations;
- reviewing job descriptions and organizational charts;
- reviewing or preparing flowcharts or other auditee procedural narratives;
- tracing one or more transactions through related documents (also known as a "transaction walk-through");
- completing internal control questionnaires; and
- observing operations.

9.4.2 Types of tests: Compliance and substantive

Although an internal auditor's efforts may be directed more toward the internal controls of an MFI than to the resulting financial statements that are of prime concern to the external auditor, the fundamental approach for both is the same: reliance upon an effective system of internal control. The purposes of compliance and substantive testing differ, however, although both are implemented during audit fieldwork.

Compliance testing: the purpose of this type of testing is to provide reasonable assurance that internal control procedures, as prescribed by policies, procedures, rules, and regulations, are being consistently applied.

Substantive testing: the purpose of this type of testing is to obtain evidence of the validity and propriety of the accounting treatment of transactions and balances or, conversely, to obtain evidence of errors or irregularities in the accounting treatment of transactions and balances, as well as evidence of compliance with legal requirements. This type of testing often involves vouching, that is, matching transactions shown in the accounts to the source documents, such as the loan contract or invoices (for expenditures), and does not place reliance on the internal control system.

The difference outlined above can be explained by an example. If an auditor wants to verify the fixed asset balance in the financial statements of an MFI, he or she can rely solely on substantive testing, such as physically matching each fixed asset and related invoice to the financial records. If this task requires significant travel and/or audit hours, the auditor would normally reduce audit time by verifying that there were sufficient and correctly implemented internal controls (e.g., procurement committees, appropriate segregation of duties, physical security, etc), and thus use a combination of compliance and substantive testing.

9.4.3 Compliance procedures

An internal auditor's testing and evaluation of the implementation of internal controls is conducted through compliance testing. When auditing financial reports or statements, an auditor may decide not to rely on prescribed procedures because he or she concludes that:

- the audit trail of such procedures is not satisfactory for the purpose of compliance testing;
- the control is inadequate, or
- the control is irrelevant to the audit objective.

Compliance tests are concerned with answering such questions as:

- Were the necessary procedures performed?
- How were they performed?
- Who performed them?

- Were the procedures performed consistently?

Tests of supervisory procedures require inspection of related documents or databases to obtain evidence in the form of signatures, initials, certification stamps, and electronic authorizations, or tests of computer system controls to determine whether and by whom these controls are performed, as well as to evaluate the propriety of their performance.

Other aspects of internal control require segregation of duties so that certain procedures are performed independently, such as accounting and payments. The performance of these duties is largely self-evident from signatures, limited access to information and technology (IT) systems and databases, or computer records of the parties that input or electronically authorize input. Tests of compliance with such procedures are primarily to determine whether such persons are performing incompatible functions. Auditors must also verify that staff members have appropriate skill levels.

Internal control procedures that leave an audit trail of documentary evidence should be compliance tested by a sampling of transactions.

Internal control procedures that depend on the segregation of duties and do not leave an audit trail should be compliance tested through observation or inquiry. Whereas inquiries should relate to the entire audit period, observations are confined to the periods when an auditor is present.

9.4.4 Substantive testing

Substantive testing gathers evidence concerning the completeness, accuracy, and existence of transactions and operations. Substantive tests are normally used to measure the extent of misstatements in account balances and, in particular, how the value of misstatements detected compares to the value of planned materiality for the account balance. This audit task consists of "tests of details" of classes of transactions and account balances. Tests of details are direct tests of financial statement balances that are not analytical procedures. In other words, auditors gather evidence of the extent to which each material account balance is materially complete, valid, and accurate.

Substantive procedures:

- test of details, which includes selecting a sample of items from the major account balances and finding hard evidence (e.g. invoices, bank statements) to verify those items
  - physical examination

    - inspection
    - vouching
    - recalculation
    - confirmation inquiry

- analytical procedures, which include
    - reasonableness tests
    - scanning
    - review
    - ratio analysis

Box 9. Examples of Substantive Tests in an Internal Audit

Legality and regularity of an activity

Checking that a completed activity conforms to relevant regulations or laws. For example, tests could examine whether the human resources department is meeting its legal obligations. Tests could also examine whether clients meet the legal eligibility criteria for receiving a loan.

Completeness of financial and other records

Checking that financial and other information systems record all relevant details of transactions. A substantive test of financial records could check that individual transfers to employee bank accounts match employee salary payments in the salary expense account for all employees. Analytical procedures may be used in connection with these tests, especially ratios and predictive tests. For example, the salary expense account could be compared with a calculation multiplying by 12 the sum of all employees' monthly salaries, allowing for any staff turnover.

Validity of an operation

Checking that the operations recorded within financial and other systems actually took place. For example, a substantive test could check that disbursements of loans to clients recorded in financial systems actually took place through checking bank transfers. Analytical procedures may be used here, especially ratios and trend analysis. Another important substantive test is visiting clients to ensure that they exist, have received stated loan amounts, and are using loans for the purposes stated in loan application documentation.

Measurement of an activity

Checking that transaction amounts are calculated on the correct basis. An example of a substantive test would be to check that the software calculating loan repayment schedules, interest rates, and repayment frequency does so correctly.

Valuation

Checking that assets and other items are recorded at the correct value in financial records. For instance, a substantive test may verify that the purchase of an asset is recorded at the correct value in the accounting system by checking the original invoice, check, or bank transfer. One key test is an auditor's judgment that a loan value, as included in the loan portfolio, is reasonable.

Existence or verification

Checking that assets and other items actually exist. For example, a substantive test would be a fixed asset count, which means verifying that an asset recorded on the fixed assets account exists and is clearly distinguishable from other similar assets on the account. This task includes taking a look at the asset and ensuring that it is in reasonable working condition.

Ownership
Checking that assets recorded are actually owned or properly used by the MFI by checking purchase contracts, invoices, and payments.

9.4.5 The nature of evidence

Testing internal controls, activities, and transactions results in audit evidence. Audit evidence supports the conclusions of the audit and its evaluation of internal controls, it therefore must be both ***sufficient*** (i.e., there needs to be enough evidence to justify a finding, such as different sources, a sufficient sample, or analytical support) and ***competent*** (i.e., valid and reliable). The following general guidelines of the Institute of Internal Auditors (IIA) apply to assessing the competency of information. They are important to keep in mind when planning an audit and developing audit procedures.

- Independent sources generally provide more competent evidence than non-independent sources.
- Good control systems provide more competent evidence than weak control systems.
- Directly obtained evidence (e.g., through observation, examination, computation, or inspection) is generally more competent than indirectly obtained evidence (e.g., through interviews).
- Original documents generally provide more competent evidence than copies.
- Testimonial evidence is more competent when it is obtained from people who are unbiased, who have complete knowledge about the subject, and who are able to speak freely.[30]

9.5 Initiating the Internal Audit

9.5.1 Internal audit engagement letter

According to current best practices in internal audits, an internal audit department generally notifies an auditee in writing (via an engagement letter or entrance email) that a regular audit has been scheduled. Surprise audits are, of course, unannounced.

[30] Kincaid, James K., William J. Sampias, and Albert J. Marcella Jr., 2004, *Certification in Control Self-Assessment* (Altamonte Springs, Florida: Institute of Internal Auditors Research Foundation), 103.

The “audit engagement letter” announces the date of the audit work, basic terms of reference, scope of work, and **informs the auditee** that the audit is about to begin. The IIA defines the terms as follows:

> *Engagement: In audit language, an engagement is a specific internal audit assignment, task, or review activity, such as an internal audit, control self-assessment review, fraud examination, or consultancy. An engagement may include multiple tasks or activities designed to accomplish a specific set of related objectives.*
>
> *Engagement Work Program: This is a document that lists the procedures to be followed during an engagement, designed to achieve the engagement plan.*[31]

Refer to **annex 12** for a **Sample Engagement Letter/ Entrance Email for an Internal Audit.**

9.5.3 Opening meeting

An opening meeting should be held to gather information about the overall situation of auditee operations (which will be used in the preliminary review process), as well as to explain the goals of the audit. During the initial meeting, it is important to address the wishes of any member of senior management or auditee staff that the audit include identified issues or areas of special concern. It may also be advisable to ask for requests or suggestions during the meeting.

9.5.4 Opening meeting memo

The date, attendees, and significant items discussed at the opening meeting that directly relate to the scope, objectives, timing, or confidentiality of the audit should be documented using an opening meeting memo. Refer to **annex 13** for a **Sample Opening Meeting Memo**.

Following the opening meeting, an updated memo may be sent if there are any changes or significant issues that are not covered in the audit entrance memo or letter of engagement.

9.6 Evaluating Internal Controls

The following list of standard procedures is used to conduct a preliminary survey to evaluate internal controls.

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[31] IIA, 2009, *International Standards*, 17.

Organizational review: review of the organization of a branch or department. This step is a broad overview of the activities, staffing, and reports produced by the unit being audited, together with highlights of its work.

Financial profile: review of the budget, the general ledger, and, for loans, the portfolio tracking software. (An auditor should know the magnitude of funds involved and the MFI's exposure to risk.)

Internal control review: review of the internal control structure and organizational chart of the departments and/or branches being audited—a time-consuming but essential exercise. The review of internal controls helps the auditor determine the areas of highest risk that were not previously highlighted and then design tests to be performed during audit fieldwork.

A good overview policy document on internal controls has been published by the World Council of Credit Unions (WOCCU),[32] which outlines key points of good practice for all MFIs.

Interviews and operating instructions: interviews and a review of important written instructions and procedures. An auditor also conducts a transaction walk-through at this point, which will form the basis of preliminary survey narratives and flowcharts, as well as the evaluation of internal controls. In addition to obtaining a good understanding of operations, an auditor should document this understanding to illustrate that he or she has a suitable understanding of the context.

Self-assessment questionnaire: a questionnaire filled out by auditee management. The questionnaire not only provides audit information, but also requires auditee management to focus on internal controls. (Auditee management should not be requested to fill out a self-assessment questionnaire more than once a year.) See **annex 14** for **a Sample Internal Control Self-assessment Questionnaire**.

During this stage of the audit, as at all other stages, notes should be taken during interviews. If it is possible that any confusion remains after an interview or if an auditor especially wants confirmation, the record of the interview should be given or emailed to the interviewees for their confirmation.

There are specific areas to observe and note in evaluating internal controls, addressed individually in the paragraphs below.

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[32] WOCCU, 2002, "Internal Control Requirements," Best Practices Web page, WOCCU, Madison, Wisconsin,http://www.woccu.org/bestpractices/operations (accessed October 2009).

9.6.1 Control risk

Control risk is the risk that controls do not prevent or detect errors or deviations, especially where there is evidence that controls are of poor quality or there has been reorganization. A control risk includes the risk that the systems of the MFI are inadequate to ensure that assets are used economically and efficiently and for the purposes intended, or to properly report the use of funds.

Among the various risks that are considered control risks are:

Efficiency risk

- inefficient procedures and processes
- inadequate development of the internal audit function
- inadequate development of the accounting manual and/or procedures
- inadequate development of operational manuals
- inadequate IT development

Cycle-time risk

- external information or data are not received in due time (e.g., bank statements, reports)
- procedures are not respected within prescribed time frames
- the MFI is not able to meet its financial reporting schedule

Information processing risk

This risk means failure to adequately restrict access to information (e.g., data or programs) that may result in unauthorized knowledge and use of confidential information or, conversely, overly restricting access to information so that it precludes personnel from performing their assigned responsibilities effectively and efficiently. Examples include:

- poor and/or incorrect input/output data
- inadequate verification of data
- improper backup of IT systems
- inadequate training
- improper security measures (e.g., user names, access levels, passwords, physical security)
- improper virus or firewall protection

Fraud and corruption risk

- improper segregation of duties
- overriding of controls
- unauthorized use of resources
- conflicts of interest
- improper maintenance of confidential files and information

To assess risks in the design of an internal control system, an auditor should use internal control questionnaires (refer to the **Sample Internal Control Questionnaires** in **annex 15**) and analyze the key controls or the lack thereof present in relevant operational procedures.

9.7 Developing Audit Objectives

In planning an internal audit work program or plan, an internal auditor must first decide the specific objectives of an audit. Specific audit objectives are developed taking into account the individual circumstances of the entity, the nature of its activity, and the accounting practices that characterize its business. Audit objectives should also relate to the control objectives and techniques that management has implemented in its risk mitigation strategy.

Some examples of internal MFI audit objectives include verification of compliance with operating procedures, the accuracy and reliability of portfolio and financial reports, the authenticity of microfinance clients, and the eligibility of these clients for services. Objectives may be broad and general, but a number of specific objectives are usually more helpful in developing specific audit procedures.

Audit procedures are determined by the audit objectives selected. Audit objectives and procedures do not necessarily have a one-to-one relationship. Some procedures may relate to more than one objective. Furthermore, a combination of procedures may be needed to achieve one objective.

Box 10. Example of MFI Internal Audit Objectives

MFI objective: **Protect cash resources in order to optimize cash management.**
Risk: Staff theft and/or fraud.
Control objective: Segregation of duties.
Control techniques:

- Ensure that loan officers do not handle disbursements and repayment collections.
- Assign cashiers to handle all cash transactions.
- Assign accounting staff to handle all recording of transactions.

Audit objectives:

- Verify that cash handling policies are well known among staff.
- Verify that loan disbursements bypass loan officers.
- Verify that only cashiers handle cash and issue receipts.
- Verify that loan repayments are duly recorded by accounting staff.

Annex 16 provides a list of **Typical Control Objectives of Financial Transactions.** Financial auditing should also include the development of audit objectives that confirm and verify the validity, completeness, accuracy, and timeliness of financial transactions and accounts.

Most MFIs put operational policies and procedures in place to help them meet their objectives. Table 10 illustrates the audit objectives of an MFI internal audit department that is conducting a compliance audit designed to test its adherence to certain strategic, legal, and regulatory objectives.

Table 10. Control versus Audit Objectives in an MFI Internal Audit

Control objectives and techniques	*Audit objectives*
Lending operations shall target the identified client group, as laid out in the MFI's strategic plan.	Verify that clients meet the credit criteria established to serve the target group (e.g., location, business size, business type, etc.).
Client lending shall be conducted through "know your client" criteria in order to meet contractual investor commitments and protect against terrorist financing and anti-money laundering.	Verify that loan officers conduct and document client assessments so as to meet the "know your client" criteria set out in the MFI's credit policies.
MFI lending practices shall meet credit criteria and guidelines in order to minimize credit risk.	Verify that loans disbursed do not exceed the maximum limit set in the MFI's credit policies. Verify that loan officers conduct adequate business assessments in order to support appropriate loan sizes and repayment terms.

9.8 Audit Procedures

Once audit objectives have been established, specific audit procedures and work plans are developed to guide the collection of information and evidence during an audit. Audit procedures are the detailed steps and activities that accumulate the audit evidence used to evaluate whether an MFI's transactions and operations meet its control objectives, whether they comply with policy and procedures, and whether financial information and reports fairly represent operations.

Annex 17A provides **Typical Internal Audit Procedures, Definitions, and Illustrations** that may be helpful in planning specific audit procedures.

When developing audit procedures, the primary focus is to document and analyze the auditee's control procedures and decide which controls and key points the audit will test (check) during fieldwork. The design of audit procedures should be based on this analysis. Normally an auditor tests key controls, such as verifying that the branch manager signs loan contracts and that loan amounts and terms adhere to the policies and procedures established by the head office credit department. An auditor also uses his or her judgment to evaluate decisions, such as whether a loan should have been granted.

Sometimes an auditor may determine that something does not need to be checked. For example, a form may be filled out for the person who enters data into the IT system. The sole purpose of the form is to help the data entry staff type the correct information into the system. Because it is essential that the database agree with the loan contract, an audit step would be to trace information directly from the loan contract to the loan database. Checking the input sheet would not add extra value unless inconsistencies between the loan contract details and the database were discovered and the auditor was searching for the cause of these inconsistencies.

It is not sufficient to mechanically verify control compliance. An auditor must evaluate if implementation of procedures is sufficiently effective to meet their overall purpose and objectives. Thus audit procedures should always also include an evaluation of reasonableness by the auditor.

Box 11. Compliance with Controls: The Reasonableness Test

An MFI that makes salary loans requires the employer of a borrower to provide a guarantee as security for the loan. The auditor discovers that one borrower is a sole proprietor of a small business, that is, he works for himself through a registered business. The borrower took out a loan to use in his business and had this business, as the employer, provide the guarantee. All forms and signatures were in accordance with the credit procedures.

Technically, official procedures were followed, but it is obvious that a guarantee from this business provides virtually no extra security or protection to the MFI in the event the borrower defaults. The overall control objective has thus not been met. The internal auditor should note this fact and make recommendations for procedures to protect the MFI in case of loan defaults by sole proprietors.

To help write audit procedures for the credit department, a useful approach is to make a table that lists all documents, including any electronic documents, required for the audit. An example for loan and security files is given below. Note that an audit of the IT system and loan-related revenue is covered in different audit programs. For the sake of brevity, a limited number of documents are included in table 11. This type of table should be edited and developed based on the specific institutional context and processes of the auditee.

Table 11. Sample Document Audit List for Credit Department

Document	*Who signs*	*Key points*
Loan application	Client, loan officer	Purpose, amount, contact details, date
Loan assessment	Client, loan officer, loan supervisor	Loan purpose, financial data, loan officer's opinion of his/her visit to client
Credit committee minutes	All credit committee members	Loan approved amount, client name, ID, loan purpose, loan term, security and/or collateral
Loan contract	Client, loan officer, branch manager	Client name and ID number, loan purpose, principal and installment amounts, commission, insurance, interest fees, collateral and/or guarantees
National credit registry credit report	n/a	Client name and ID number, total loans outstanding and current status of these loans, credit history
Photocopy of client ID	Contains client signature	Information is up to date
Repayment schedule	Client, loan officer	Principal, interest rate, installment dates, commissions *(produced by the IT system)*
Environmental impact assessment (only if funded by NGO X)	Client, loan officer, loan supervisor	Loan purpose
Photocopy of business license *(government documents will vary by country)*	Stamped and signed by local government agency	Purpose of business *(note: only required by law if business turnover is above XXX)*
Security (i.e., collateral and/or guarantee) documents *(will vary significantly by country and/or MFI)*	Various	Matches loan assessment and loan contract, client signatures
Visit report	Loan supervisor reviews and authorizes monthly online	Date, loan officer's analysis and comments *(kept on the intranet)*
Input sheet	Loan officer, data entry clerk	*(would be redundant to audit)*
Loan checklist	Loan officer	All documents

Working from the above table, a set of audit procedures based on key controls and key data can be prepared similar to the samples found in **annex 17B, Sample Internal Audit Procedures and Work Plans**. However, they must be customized to meet an individual MFI's' procedures, focusing on approval systems, required documents, and the IT system's reflection of loan contracts. A customized version of table 11 can also be useful for auditors as a handy reference sheet during an audit.

9.8.1 Developing internal audit steps for individual loans

Table 12 illustrates an example of how to develop audit steps and procedures based on specific audit objectives for approvals, identification, and service of individual loans.

Objectives of the audit program:

1. Verify that the credit committee operates effectively.
2. Verify the security of loan files, security files, and credit data.
3. Verify that loan applications are correctly followed up.
4. Verify that clients for whom a loan has been rejected are notified promptly and professionally.
5. Verify that loans granted are included in the IT system and that the filing of the physical loan files is up to date.[33]

[33] Just as the sample of loans to be audited is taken from the database for other audit procedures, a sample is also taken from the physical files to check for loans that exist, but are not in the database, that is, a test to check the completeness of the database.

Table 12. Template for Developing Audit Steps

Other credit audit steps	*Auditor and date*	*Reviewer and date*	*Comments*	*Working paper reference*
1. Attend two credit committee meetings to ensure that they are properly run, with the correct members (all of whom are encouraged to participate), and that sufficient analysis has been performed.				
2. Verify that there is correct restricted access to the loan files, security files, and the IT system.				
3. Verify that the security and loan files are protected against destruction from fire, water, vandalism, etc.				
4. Take a sample of minutes from the credit committee meetings and verify that clients for whom a loan has been rejected were professionally notified within the official time frame.				
5. Evaluate whether the rejection of the loan was justified.				
6. Take a sample of one loan application for one random day per month from the loan application register and verify that these applications were all followed up. Verify that authorized loans were included in the IT system.				
7. From the physical loan files, haphazardly choose five of each type of loan and verify that they are correctly listed in the IT database (client name and loan account number).				

Throughout the audit, professional judgment should be used to determine whether the evidence gathered is sufficient, relevant, competent, and useful for making conclusions regarding the established objectives of the audit. Based on the information gathered, an auditor should constantly reassess the audit objectives, scope, and procedures to ensure efficient use of resources.

Box 12. Important Reminders on Internal Audits

- Keep overall audit objectives in mind throughout the audit. Handle only enough detail to adequately cover these objectives.
- Use good judgment in determining priorities and the amount of time allocated to various phases of the audit.
- Keep the time schedule flexible enough so that the job can be done. Be considerate of the auditee's time frames and work schedule. Provide sufficient notification to loan officers when they will be needed to visit clients, even if you do not inform them of which clients you want to visit.

Audit procedures are generally found in audit work plans, also called audit programs or checklists. As noted above, **annex 17B** provides **Sample Internal Audit Procedures and Work Plans** for the entire range of activities and operations of an MFI. Auditors should add to the list in this annex and adapt the objectives, procedures, and tests to their local context, as necessary.

9.8.2 Finding illegal acts or serious irregularities

An illegal act is a violation of a law and/or a regulation. When auditors conclude, based on evidence obtained, that an illegal act has occurred or is likely to have occurred, they should promptly report all relevant information to the executive director and relevant senior management staff. This topic is discussed in depth in chapter 15, "Auditing for Fraud and Corruption."[34]

9.9 Documenting the Work of an Internal Audit

All audit work performed should be supported by evidence. An auditor should document an overall conclusion for each audit step completed. Each audit program should thus be supported by and cross-referenced to working papers (e.g., schedules, memos, spreadsheets) on which the testing performed and results achieved are documented. The strengths and weaknesses of the internal controls that are tested should also be identified in the working papers.

[34] The AuditNet Web site (www.auditnet.org) offers a variety of tools and sample audit programs for auditors, including an "Irregularity and Fraud Checklist" that guides a high-level overview of an organization to determine whether conditions or signals of fraud exist.

Documentation and working papers are covered further in chapter 10, with an **Internal Audit Working Papers Template** found in **annex 18**. Note that copies of documents should appear in the working papers only once.

9.9.1 Audit findings form

The purpose of the audit finding form is to gather, in one location, an auditor's analysis of "problem" situations and his or her opinions regarding all findings discovered during an audit. A **Sample Internal Audit Findings Form** is found in **annex 19**.

A working paper entry should be created whenever an auditor identifies a possible:

- opportunity for operational improvement
- discrepancy
- error
- irregularity
- weakness
- deviation from internal control standards, regulations, or policies

An audit finding form documents the results of an analysis of a problem and/or a resolution process when a problem is identified or clarified. Simply completing the form is not a substitute for critical analysis of the situation. The auditor should answer such questions as:

- Did I understand the situation?
- Does the auditee agree that a problem exists?
- Do we understand the extent of the problem?
- Is there a practical solution to the problem?
- Do others, especially those responsible for executing the solution, understand and agree with our recommendations?

One audit planning step that is taken before commencing an audit is reviewing the previous audit or related audits. Reports from such audits, together with audit finding forms and follow-up reports, should be especially reviewed and used to the extent possible in order to avoid recreating an earlier finding.

As described above, the audit finding form should document an auditor's analysis (i.e., criteria, condition, cause, effect, and corrective action) of the findings. The relevant working papers used in the analysis that results in the findings, as well as supporting working paper references, should be cross-referenced to the audit finding form. (Documenting the analysis prepares an auditor to discuss findings with the auditee.)

9.9.2 Communication principles in auditing

As an audit progresses, an auditor generally discusses any significant findings with the auditee. Hopefully, the auditee can offer insights and work with the auditor to determine the best method for resolving each finding. Usually these communications are oral. However, in more complex situations, memos, and/or emails are written in order to ensure full understanding by the auditee and the auditor. Any agreements reached will eventually be documented in the exit meeting memo or audit report. Useful tips for the auditor at this stage include:

- Remember to maintain contact with senior management staff and keep them informed of developments.
- Demonstrate that questions can be raised and suggestions made that will benefit senior management and the auditee.
- Return files and records promptly and in neat condition. Set a good example in filing and keeping documents in order.
- Respect security controls, including the use and confidentiality of passwords.

If, however, in the course of its activities, the internal audit department should discover a serious breakdown of control or an unmanaged risk, it should immediately notify the appropriate management staff, the executive director, and/or the board audit committee.

9.9.4 Working papers review

Before beginning the process of drafting a report, an auditor must ensure that working papers are properly prepared. These papers document the evidence gathered during the audit and thus support the work performed. Normally this review is done by the chief internal auditor. At a minimum, this auditor reviews all audit reports and, in all but the largest audit departments, reviews all working papers.

10.0 Audit Documentation: Working Papers

10.1 Introduction

As noted in the previous chapter, auditors document the work performed during an audit in working papers. Traditionally, the term “working papers” refers to all internal documentation for an audit, whether in paper or electronic format, including audit evidence. Working papers serve as the connecting link between an audit assignment, audit fieldwork, and the final report. They contain the records of audit planning and preliminary surveys, audit procedures, results of audit testing, findings, and other documents related to an audit.

Working papers also document the auditor's conclusions and the reasons why those conclusions were reached. They thus constitute the basis for the audit report, as they substantiate audit conclusions and recommendations. A helpful tool in this regard, mentioned in the previous chapter, is the **Internal Audit Working Papers Template** found in **annex 18.**

According to international standards, the basic rules for audit documentation are:

- The audit work could be re-performed by another auditor based solely on the documentation in the working papers.
- Sufficient evidence has been documented to support the auditor’s conclusions.

In order to achieve these standards, the audit team needs to:

- Clearly identify the sample items chosen for testing. These items should be unambiguously highlighted on any relevant printouts or listed on spreadsheets or otherwise documented. Items such as voucher numbers or loan account numbers will suffice.
- Clearly document the steps of the audit.
- Ensure that there is sufficient evidence to support audit findings and conclusions—including positive conclusions—in the reports.

Working papers should be completed throughout the audit. Accordingly, the internal audit department needs to employ an audit methodology that requires the production of working papers that document:

- planning
- examination and evaluation of the internal control system

- audit procedures employed
- the audit sample, the information obtained from the sample, and the associated conclusions
- supervisory review
- reporting
- follow-up

Working papers also provide a basis for evaluating the quality assurance program of an internal audit department and demonstrating its compliance with the standards of the Institute of Internal Auditors (IIA) and the International Federation of Accountants (IFAC). Complying with these standards is essential for external auditors to determine whether or not they can rely on the work performed by an internal audit department.

Although the quantity, type, and content of working papers will vary between audits, it is essential they are sufficiently extensive to:

- assist auditors in the conduct of their work, including the planning of subsequent audits;
- provide adequate support for the auditor's opinion;
- enable the work that has been carried out to be independently reviewed; and
- encourage a methodical approach to the audit.

10.2 Requirements

All audits must be assigned a number and a title. Auditors should prepare an audit file and indicate the audit number on it. The audit title should include:

- designation of auditee
- year
- sequential number

Working papers should be clear and understandable. The auditor should keep in mind that other people will examine and refer to the working papers. These papers should therefore stand alone and not need any supplementary information. Anyone reviewing the working papers should be able to tell what the auditors set out to do, what they did, what they found, and what they concluded—without referring to documents outside of those included in the working papers and without asking questions.

Auditors should include in their working papers only what is essential and ensure that each working paper included serves a purpose that relates to an audit procedure. Each working paper should feature:

- a heading (title) and reference number (i.e., identification of the form)
- date of completion
- date of review
- signatures of the auditor(s) and reviewers or, in the case of an electronic working paper, name of the auditor(s) and reviewer(s)

10.3 Cross-referencing

Working papers should be prepared using an appropriate cross-referencing system. The audit plan should be cross-referenced to the audit procedures, which are in turn cross-referenced to evidence, the audit findings form, and interview summaries. Examples of cross-referencing can be found in annex 18.

Cross-referencing should also be used to reference information that is relevant in more than one place in the working papers, or to reference other pertinent information, including the source of information (where appropriate), composition of summary totals, or references to other relevant documents or examples of transactions. As noted earlier, the purpose of each working paper should be directly tied to a specific audit procedure. For example, an audit finding form should be referenced to the audit procedure that uncovered the finding.

10.4 Retention Policy

Working papers may be either in electronic form, hard copy, or a combination of both. If both mediums are used, extra care must be taken that sufficient cross-references are made. All working papers, in whatever medium, must be retained in organized files and held for a number of years, as prescribed by local regulations or by the regulations of the MFI or its internal audit department—usually for seven to ten years. All audit planning files should be retained for at least the same period.

10.5 Audit Files

Audit files consist of what are called temporary files, which are related to a specific audit, and permanent files, which contain information used from year to year.

10.5.1 Permanent files

The purpose of a permanent file is to provide auditors with a source of background information about the departments or sections of an MFI that are audited. These files allow auditors to obtain a greater understanding of the systems of these departments and avoid conducting the same research from year to year. Typically, permanent files would contain or refer to the electronic locations of auditee policies, procedures, other relevant information, as well as excerpts from relevant laws or other legal regulations.

Permanent files should be updated each year. For audits that take place less than once a year, the permanent files should be updated with each audit undertaken in order to provide the auditor the most up-to-date information available.

10.5.2 Temporary files

Temporary files contain the working papers related to a particular audit (see sections 10.2 and 10.3). These working papers should be prepared at the time work is carried out. Such papers are the property of an MFI and its internal audit department, which is responsible for ensuring their safe custody and confidentiality.

10.6 Documentation Management and Control

To ensure proper management and traceability of both paper and electronic documents that are produced and issued by an internal audit department, the following principles must be met:

- Documents should be assigned an identification code (See annex 18).
- Each working paper should be uniquely traceable to the audit program.
- Each document should be uniquely numbered and show the audit identification and reference.
- When a report or other document is distributed, it should have a defined distribution. All recipients of original copies of documents or electronic files shall receive subsequent amendments and ensure that previous versions are suitably identified to show that they have been superseded.
- The internal audit department's charter and procedures manual should have an amendment record to identify changes to previously issued documents.

10.7 File Structure, Identification, and Traceability

Table 13 illustrates a typical referencing system for audit working papers that would be applied to both electronic and paper files. It is included as an example only. Other audit departments may use a simple numbering system. It must be kept in mind that file organization is a critical component of efficient, reliable internal audit work and the performance standards of the profession. Table 14 illustrates a typical referencing system for the permanent files of an internal auditing department.

Table 13. Referencing Example: Internal Audit Working Papers (Temporary Files)

File name	*Working paper reference*
Folder A – Report Section	
Final report	FR
Draft report (s)	DR (1, 2…)
Management Responses	MR (1,2…)
Audit Follow-up Report	FUR (Qtr 1, 2…)
Transmission Email to Audit Committee/Executive Director	TRE
Folder B – Working Paper Section*	
Audit Finding Forms	AFF (1,2...)
Audit Plan	APL
Summary Sheet – Credit	Sum_CR
Audit procedures and resultant working papers – Credit	APR_CR
Testing results and other working papers – Credit	WP_CR_1…
Summary Sheet – Administration	Sum_AD
Audit procedures and resultant working papers – Administration	APR_AD
Testing results and other working papers – Administration	WP_AD_1…
Summary Sheet – Human Resources	Sum_HR
Audit procedures and resultant working papers – Human Resources	APR_HR
Testing results and other working papers – Human Resources	WP_HR_1…
Summary Sheet – XXX	Sum_XXX
Audit procedures and resultant working papers – XXX	APR_XXX
Testing results and other working papers – XXX	WP_XXX_1
Folder C – Preliminary Review/ Internal Control Review*	
Self-Assessment Questionnaire	SAQ
Internal Control Questionnaires – Credit	ICQ_CR
Internal Control Questionnaires – Administration	ICQ_AD
Internal Control Questionnaires – Other	ICQ_XXX
Documentation of Auditee's Procedures	Doc_AP
Summary of Interviews	ICQ_SOI
Folder D - Administrative Section	
Audit Engagement Letter/ Entrance Email	AEE
Opening Meeting Memo	OMM
Exit Meeting Memo	EMM
Other Correspondence with Auditee	XXX
Audit Time Sheets	ATS

File name	*Working paper reference*
Audit Performance Evaluation Questionnaire	APEQ

Note: *Working paper files are used to document both the results of testing and the evidence used to support audit conclusions. They are indexed based on the audit procedures for which they document the testing results; the indexing must be simple and easy to follow. Thus APR_
CR 1 would be linked to WP_CR 1, WP_CR 1.1, etc. Audit findings must always be referenced to the audit procedure that led to their discovery.

Table 14. Referencing Example: Permanent Files of Internal Audit Department

File name	*Working paper reference*
Planning Folder: Audit Plans **Year**	
Current strategic plan	PLS Year
Current annual plans	PLA Year
Annual report of the internal audit department	ANR Year
Risk assessment and supporting documentation	RAS
Permanent Files and Materials	
Applicable rules, laws, and regulations	PF_1_XXX
Organizational information on the MFI: division of staff duties and responsibilities, number of employees, job descriptions, organizational chart	PF_2_XXX
Financial information	PF_3_XXX

Copies of all versions of MFI departmental manuals (e.g., accounting, human resources, operations, credit, finance, etc.), including that of the internal audit department, should be kept in hard copy or electronic form by the internal audit department for a specified period of time, usually determined by local regulations.

11.0 Communicating Audit Findings

11.1 Exit/Closing Meeting

At the conclusion of their fieldwork, internal auditors will usually meet with the auditee to discuss their findings, outstanding issues, recommendations, and the draft audit report. At this meeting, further management comments are sought for the draft audit report and the group works to reach understanding and agreement on all audit findings. An exit memo often documents the session, which later serves as the basis for the management response in the audit report. **Annex 20** provides a **Sample Internal Audit Exit Meeting Memo**.

11.2 Drafting the Internal Audit Report

The purpose of the internal audit report is to communicate in writing all significant audit results to the auditee, senior management, the board audit committee, and other authorized recipients. Audit reports should be clear, concise, objective, constructive, balanced, and timely. They should include coverage of:

- audit objectives;
- audit scope;
- description of the audit methods employed, including sampling methodology and sample size;
- conclusions on all key issues that were identified and/or an evaluation of the design and implementation of the MFI's internal control system, including deficiencies and limitations;
- audit findings and recommendations; and
- management responses to audit recommendations, including agreed actions.

Each finding in the report must be supported by sufficient evidence contained in the working papers and should be within the scope and objectives of the audit. Other findings, such as those that came to light by chance during an audit, may be included in a separate section.

Each recommendation must fit the facts of the finding and materially reduce potential risk, as indicated by the facts of the finding.

Each finding must also be provable. It is not important what an internal auditor believes; but that he or she can justify a finding. Without proper documentation, auditor beliefs should not be included in the written report. **Sample Internal Audit Report Templates** can be found in **annex 21.**

The senior auditor who led the audit is normally responsible for writing the report, although he or she may assign specific sections to the auditor who performed that part of the audit. The author should also consider the action(s) he or she would like the official recipients to take as a result of the report, as well as the impression he or she wants to make on the reader, that is, the kind of tone that he or she wants to convey.

Most audit opinions are normally expressed in terms of ***"negative assurance."*** For example, an auditor will issue a statement of what they do not know as opposed to what they do know. Thus an audit opinion might state that "the information gathered did ***not disclose any significant weaknesses in the control process,"*** rather than "the audit demonstrated that the controls were effective."

11.3 Review of the Audit Report

The report should be reviewed by the chief internal auditor or another auditor prior to its release. The review should answer the following questions:

- Does the report respect the standard format?
- Are enough headings used to guide the reader?
- Are the most important comments presented first?
- Does the report balance positive and negative results?
- Are related comments combined?
- Is repetition avoided?
- Is detail presented in annexes or appendices?

All statements of fact should be traceable to the working papers of the audit, including dates, numbers, percentages, computations, titles, proper names, quotes, and legal citations mentioned by the author.

11.4 Management Responses

After being reviewed, the draft audit report should be sent to the management staff of the auditee, who prepare any further responses. Several versions of the report may be prepared in this process, as the audit department and auditees reach agreement on the report and responses. While the department should attempt to accommodate auditee concerns, it should not compromise its report or opinion. **Sample Internal Audit Management Responses** can be found in **annex 22**.

11.5 Preparation and Distribution of the Final Report

The final report, with auditee responses, is prepared and approved by the chief internal auditor prior to its release. Normally, the internal audit department distributes the final report to the:

- executive director and other members of senior management
- audit committee of the board of directors
- management staff of the auditee(s)

If there is an error detected in the final report after it is issued, the internal audit department issues a note correcting the report. Upon approval of the chief internal auditor, this note is distributed to all recipients of the final report. The final internal audit report follows formats illustrated in annex 22 and is accompanied by a cover letter or email (see **Sample Transmittal Cover Letter/Email for Internal Audit Distribution** in **annex 23)**.

12.0 Follow-up of Audit Recommendations

The purpose of making audit recommendations is to strengthen an MFI's ability to achieve its business objectives, strengthen its risk mitigation strategy, increase efficiencies, and encourage corrective actions and measures to reduce the risk of error and fraud. While an internal audit department follows up internal audit recommendations, the department itself is not responsible for implementing recommendations or ensuring that senior management does so. Rather, **the internal auditor's role in follow-up activity is to independently monitor and report back to senior management and the board audit committee.**

12.1 Follow-up Process

The objective of the follow-up process is to determine whether the concerns raised during the audit have been adequately addressed by management. It is defined as a process in which internal auditors determine the adequacy, effectiveness, and timeliness of actions taken by senior management on reported audit findings. Auditors thus ascertain whether actions taken on audit findings remedy the underlying conditions.

Urgent or significant items will be followed up based on a schedule agreed in the related audit report. Otherwise, the internal audit department should perform a follow-up review on a quarterly basis to verify the resolution of audit report findings.

The same standards are applied to follow-up audit evidence as those applied to original audit evidence.

During the follow-up process, an auditor will find one of the following situations:

- A concern has been adequately addressed by the implementation of the original corrective action.
- A concern has been adequately addressed by the implementation of an alternate corrective action.
- A concern no longer exists because of other changes.
- A corrective action has been initiated but is not complete.
- A concern has not been addressed.

12.2 Follow-up Report: Audit Recommendation Status Report

The review process concludes with a follow-up report that describes the situation and the actions taken by the auditee to resolve the original audit report findings. The auditor's finding on the status of corrections (e.g., implemented, implementation withdrawn, not implemented) should be documented in the audit recommendation follow-up report. **Annex 24** provides a **Sample Internal Audit Recommendations Follow-up Report.**

Follow-up results should be communicated by the auditor to the auditee. If concerns raised by the original audit have not been adequately addressed, a meeting may be required. Follow-up and discussions with the auditee continue until corrective actions are resolved. The internal audit department should submit a recommendations follow-up report on a regular basis, often quarterly, to the board audit committee and senior management.

If at any time auditors doubt that an audit concern will be addressed in a reasonable amount of time, they should document their opinion in working papers and discuss the matter with the executive director and the board audit committee, rather than simply noting that the actions of auditee management staff are "in progress."

12.3 Evaluating the Internal Audit Process

Following the close of an audit, it is useful for the chief internal auditor to conduct a quality assurance review. This process is discussed further in chapter 7 of this toolkit and illustrated in the **Sample Internal Audit Performance Evaluation** found in **annex 7.**

13.0 Internal Audit of an Information Technology System

It has become accepted practice that the audit of management information systems or information technology (MIS or IT)—specifically, software and its applications—is a specialty audit. In fact, the information technology departments of large MFIs and organizations usually have a separate division that is responsible for the IT internal audit function.

The Information Systems Audit and Control Association (ISACA) seeks to advance globally applicable standards for such audits.[35] The development and dissemination of MIS/IT auditing standards are the foundation of the association's professional contribution to the audit community.

The work of ISACA dovetails with that of the internal auditing profession, as its mandate, standards, code of ethics, and audit procedures are consistent with those of the Institute of Internal Auditors.

What is the connection of ISACA to microfinance? As microfinance institutions grow, they are increasingly entering innovative delivery partnerships and adopting modern technologies to expand their services. Mobile phone banking, automatic teller machines (ATMs), smart cards, point of sale (POS) outlets, and agent relationships with commercial (savings) banks and insurance providers (microinsurance) all rely on effective information and communication platforms that are dependent on IT systems.

However, in smaller MFIs today, an IT audit usually remains a task of the general internal audit department. It is therefore imperative that auditors assigned to IT audits are well-versed in the institution's IT systems, applications, and security.

Even without extensive training, there are some basic questions that auditors can ask about an IT system, including:

- Does the input data come out correctly in the output, including unusual items, such as adjustments?
- Are there systematic controls for data entry to ensure that correct reporting periods and dates are assigned to the data?
- Is there a system for regularly and frequently backing up data and storing it off-site in a secure location?

[35] See the ISACA website at www.isaca.org (accessed March 2009).

- Do all computers have sufficient, reputable anti-virus software, firewalls, and spyware that are automatically updated?
- Is the operational software kept up to date?
- Are IT staff capable? Is there a risk of not being able to replace an IT employee quickly if one leaves the MFI?
- Have IT users been sufficiently trained in the use of the MFI system? Is there an understandable and comprehensive IT manual?
- Is there appropriate limited access to all computers?
- Are the MFI's communication systems, especially the satellites it uses, secure from hackers?
- Is there a sufficient audit trail of electronic authorizations, other activities, and transactions?
- What is the likelihood of staff sharing passwords, even if just to speed up authorizations?
- Is there sufficient climate control in the server rooms and other locations of sensitive IT equipment?
- Are there sufficient controls against employees downloading software? (Such downloads quite often harbor viruses, worms, or other software.)
- Are there sufficient secure alternative procedures for approving transactions, including online banking, when one of the holders of a password is unexpectedly not present?

Given the diversification of delivery channels in the future, the specialized services of IT auditors are bound to become in higher demand among MFIs. For example, an MFI that offers standalone ATMs needs to consider the IT issues addressed in box 13, in addition to other operating controls:

Box 13. Auditing Standalone ATMs

Standalone ATMs have “embedded processing units” in which manufacturing and programming logic is built in, along with autonomous functions, operating systems, and software. An internal audit of ATMs involves answering the following questions:

- How are the operating system and software updated?
- How are the units secured?
- What networks are they attached to?
- What controls are in place to secure those networks?
- What safeguards are in place?
- Does the MFI have a record of all installations, updates, and IT maintenance of the ATMs?

Box 14 provides a cursory list of areas to audit for a mobile phone application that transfers funds to and from a financial institution.

Box 14. Auditing Mobile Cell Phone Systems

An MFI utilizing mobile cell phones (classified as Information and Communication Technology, or ICT) to disburse and collect loan repayments needs to consider the following audit needs with respect to operations and the technology itself.

Operations and reporting:

- Regular reconciliations of information and transactions between parties are essential for good control. The ICT provider should provide daily reports to the MFI of any transactions that have taken place. This will inform the MFI of any delinquency in a timely manner.
- The ICT provider should also provide daily transaction reports to the MFI so that cash and other balances can be updated promptly.
- All transactions must be entered and any reporting of cut-off dates, such as month- or year-end dates, must be strictly observed.
- Depending on the accounting standards applied, notes to the financial statements must clearly disclose the use of any technology, the existence of agreements with any ICT provider or partnership banks, and confirmation of period-end balances.

Systems technology:

- What are the processes for system security and back-up of the ICT provider?
- What safeguards are in place for uploading information? Continuous electricity? Secure networks?
- What controls and oversight does the ICT provider have in place?

14.0 Relationships of Internal Audit Department with Other Stakeholders

The internal audit department and its function also relate to external MFI stakeholders and interested parties. Most of these relationships are consultative in nature, but at times, the work of the internal audit department is relied on and used for other work, such as external audits, due diligence by raters or investors, external evaluations, risk evaluations, and donor and/or funder compliance audits. Therefore the work, documentation, and role of the internal audit department go significantly beyond the needs of the institution. This work must therefore be conducted with the utmost professionalism, integrity, and care.

14.1 External Auditor

An external audit is a formal, independent, and objective review of the financial statements prepared and presented by management. The purpose of an external audit is to provide an objective opinion or assessment of the financial statements, that is, whether they are "fairly" presented. An external audit is not a declaration of error-free or fraud-free financial statements.

The purpose of an external audit is not to detect fraud. It is management's responsibility to create and ensure the implementation of strong internal control systems, keep adequate systems of books and records, and take all necessary precautions to prevent loss and fraud with respect to an entity's assets and resources. External auditors offer an opinion on financial statements, whereas management is responsible for the internal control system.

External auditors plan the scope and procedures of an external audit based on an assessment of the strengths and weaknesses of an MFI's internal control system. This system is assessed based on the process and results of the institution's risk management approach, including the work of the internal audit department. An internal audit function that is implemented according to an effective governance mandate and professional international standards of internal auditing, one that is effective in ensuring the implementation of recommendations and risk minimization, strengthens an institution's internal control system.

External auditors should consider the work of the internal audit department as a measure of an MFI's risk management and internal control system. This approach will influence the audit procedures that external auditors undertake, help them be more cost effective, and thus reduce the audit fee.

The primary differences between external and internal audits are described in table 15 below.

Table 15. Differences between External and Internal Audits

Areas of difference	*External audit*	*Internal audit*
Attitude towards fraud	1. Incidentally concerned with fraud controls and the discovery of fraud 2. Directly concerned with fraud when it affects the "true and fair" reflection of information in the financial statements, that is, when fraud is material	Directly concerned with prevention of fraud and improvement of pertinent operational system
Time periods reviewed	Financial activities in the past that are reflected reliably and accurately	Forward-looking orientation—focuses on future events by evaluating the design and implementation of the internal control system
Entity performing the audit	Independent external audit firm	1. Specialized internal person or department **OR** 2. External contractor or audit firm acting as a consulting internal auditor
Needs served	1. Requirements of external parties for standardized reliable financial statements 2. Internal needs of the organization are secondary	1. Internal needs of the organization: evaluates internal controls 2. Compliance with internal policies and procedures approved by the board 3. Suggestions for increased efficiency when evaluating operational procedures 4. Assurance of reliable financial statements
Timing and duration	Annually at the end of the fiscal year (may be supplemented by interim work to avoid overload at year-end)	Continuous throughout the year

Table 16 outlines the services usually provided by external auditors.

Table 16. Overview of External Audit Services

Services	*Purpose*	*Activities*	*Outputs*
Annual audit of financial statements	Confirm that the financial statements are free from material misstatement	Audit, on a test basis, evidence and procedures underlying key account balances	An opinion on whether the financial statements and accompanying notes fairly represent the position of an entity
Management letter	Provide constructive comments that management can use to improve operations or internal controls	By-product of the annual external audit	Management letter
Special- purpose audit	Generally, compliance with donor or funder requirements, including the use of funds	Review of specific issues, as requested by a client, usually on behalf of a donor or funder	Special audit opinion and report
Agreed-on procedures	Obtain detailed results of specific procedural testing for selected transactions or account balances	Performance of agreed-on procedures (e.g., verification of an MFI's client accounts)	Report of results of procedural testing without an opinion—readers draw their own conclusions

14.2 Donor or Funder Compliance Audits

Donor or funder compliance audits fall under the category of "special-purpose audits," which are often assigned by a donor or funder to an external audit firm. In general, the purpose of this kind of compliance audit is to determine whether the conditions of the contractual agreement with the funder have been met. Most often, the conditions include budget categories, procurement requirements, anti-terrorist regulations, and the like.

This type of audit work is over and above the normal work of an internal audit department, which also conducts audits to ensure that an MFI is compliant with relevant laws, regulations, and contractual commitments. However, similar to the normal annual external audit, the external auditors who conduct a special-purpose audit may rely on work performed by the internal audit department if they feel it is reliable.

Many external auditors include special schedules in the annual audited statements that detail and segment MFI receipts and expenditures by donor or funder, division, and operations. Normally these schedules meet the current reporting requirements for segmented operations under International Financial Reporting Standards.

14.3 International NGO Networks

Many MFIs have been "created" by an international NGO network that may have a very weak or unskilled board that is nevertheless expected to provide leadership and direction for the institution. Many NGOs deliver a range of social development services and may also be ill-equipped to handle the corporate functions of a board audit committee. Other NGOs fully understand their fiduciary and legal board responsibilities, but may be in a difficult position because they cannot, in fact or in appearance, dominate or dictate the board's governance function.

When a founding member or investor, such as an international NGO, needs to exert some level of influence or control over the risk management of an MFI, there may be scope for it to participate in these functions through appropriate representation on the board's audit committee. This is not an uncommon practice among major investors or stakeholders in banking institutions and MFIs. In this way, an international NGO may be able to better protect its investments—both financial and social. Furthermore, membership on an audit committee may give an international NGO greater control over fulfillment of contractual donor and/or funder obligations. Such obligations typically relate to operational or capital funding that is channeled through the NGO to its MFI partners and subsidiaries.

14.4 Other Stakeholders

As the microfinance sector is maturing, many **debt and equity investors** are entering the market, looking for suitable institutions in which to invest. In the normal course of their due diligence, investors and raters look to the work, professionalism, results, and effectiveness of the internal audit department as part of their assessment of an MFI's internal control system and risk management approach. Raters and evaluators who conduct due-diligence assessments frequently also evaluate an MFI's internal audit function as a measure of the overall governance and management oversight of an institution.

15.0 Auditing for Fraud and Corruption

Fraud is defined as any illegal act characterized by deceit, misrepresentation, concealment, or the violation of trust. These acts do not necessarily involve the threat of violence or physical force. Fraud is perpetrated by persons and organizations to obtain money, property, or services; to avoid payment or loss of services; or to secure personal or business advantages.[36]

Fraud risk is the probability that fraud might occur and the potential severity or consequences to an MFI when it does occur. The probability of a fraudulent act is usually based on how easy it is to commit, the motivational factors behind it, and the history of fraud at a given MFI.

Fraud poses a particular risk to all financial institutions. MFIs in particular are vulnerable to fraud risk because they:

- offer unsecured loans to vulnerable populations who are often desperate for cash;
- operate through highly decentralized structures;
- operate primarily with cash; and
- are often under pressure to reduce administrative costs, thereby reducing the staff needed to ensure segregation of duties.

Exposure to the risk of fraud is greater in MFIs that are in a weak financial state, or which have or are experiencing any of the following:

- a weak internal control system;
- weak information and accounting systems;
- implementation of a new information system;
- high employee turnover;
- non-standardized loan products and programs;
- loan officers who handle cash; or
- late completion of financial reports.

[36] IIA,2009, *International Standards*, 18.

15.1 Why Fraud Occurs

In general, there are three factors that influence the commission of fraud.[37]

- **situational pressure** (or motive), including:
  - personal financial difficulties
  - job dissatisfaction
  - unreasonable work targets or work expectations
  - pressure from fellow employees or friends
  - pressure from increased extended family responsibilities
  - greed and personal egotism
  - personal issues, such as additions to drugs, alcohol, or gambling
- **opportunity**
  - close working relationship with suppliers of goods
  - lack of proper internal controls, verification, or supervision
  - ability to override controls
  - failure to enforce existing controls
  - non-existent or inadequate rules of conduct
  - incomplete or late bookkeeping and reporting
- **rationalization or attitudes**
  - depersonalization of the act
  - justification of the act
  - believing one can temporarily conceal a theft and repay the funds later
  - thinking one cannot be caught

15.2 Minimizing and Detecting Fraud

The senior management of an MFI is responsible for establishing and maintaining an effective control system that helps minimize fraud at a reasonable cost. Senior management is also responsible for recruiting and retaining motivated, capable, and honest staff. MFIs should have a specific code of ethics and fraud policies that describe both prohibited activities and how violations of honesty will be handled if detected. It is important to communicate a clear and consistent message about fraud to MFI staff and clients as a preventive control.

[37] The three factors are generally referred to as the "Fraud Triangle," which is attributed to criminal sociologist Dr. Donald Cressey (1919–1987).

Internal auditors should have sufficient knowledge of fraud, its warning signals, and the work of investigating and reporting fraud without necessarily having the expertise of an auditor who specializes in fraud. Internal auditors are responsible for considering fraud risks during an assessment of the design of controls and when planning audit steps. They should assist MFI managers to prevent fraud by examining and evaluating the adequacy and effectiveness of the institution's internal control system, in conjunction with assessing the extent of the institution's potential exposure to fraud.

The fairly broad "Irregularity and Fraud Checklist" found on the AuditNet Web site (www.auditnet.org) can be used to evaluate an MFI's exposure to risk and irregularities. This checklist looks at the conditions or events that increase the risk of fraud or irregularities. In an attempt to flag signals or indications of fraud, it focuses on management behavior, motivation and attitudes, the regulatory environment, IT issues, discrepancies in records and reporting, and an MFI's relationship with its external auditor.

Annex 25 ("**Internal Control and Audit Steps Targeting the Prevention and Detection of MFI Fraud)** contains a matrix of fraudulent activities that are common in microfinance operations in credit delivery and management, cash transactions, procurement, and financial statement or report preparation. These steps also provide preventive internal controls and audit procedures for the detection of such fraudulent activities.

Internal auditors must be able to conduct sufficient tests to determine if control weaknesses actually have resulted in fraud, gather evidence to prove who was involved, and prove that these people acted intentionally. They must also be able to professionally and adequately evaluate evidence and determine appropriate remedial action(s). This process may include initiating an investigation, identifying required specialized services (e.g., computer forensics), and notifying legal authorities.

15.3 Investigating Fraud

When internal auditors find that a fraud has occurred, they have a number of special auditing and reporting responsibilities, including the responsibility to:

- **Notify senior management and the board** as soon as it is clear that fraud has occurred. However, an auditor needs to be careful about questioning staff and the confidentiality of information pertaining to the fraud.
- **Undertake appropriate audit work** to determine the extent of financial loss, risks to the MFI, and the people involved. This type of audit investigation will not involve sampling, but rather, detailed analysis and

review in a process that gathers evidence to document and substantiate the events that have taken place.

- **Issue a report** that describes in detail audit findings, conclusions, recommendations, and corrective actions. Depending on the situation, an auditor may simply report observations and findings and provide an opinion on next steps (e.g., whether a full investigation should be pursued).
- **If necessary, consult with legal counsel** regarding the handling of evidence, gathering of evidence, and any other matters relating to possible legal matters. It is advisable to send a draft report to the MFI's legal counsel for review before releasing such reports to management or law enforcement authorities.

All communication about a fraud should be confidential and discreet. News of a fraud investigation may prevent people from talking freely or getting sound information. Moreover, if a group of individuals are involved in a fraud, they may decide to destroy documentation, block the investigation, or abscond with evidence.

Box 15. Basic Steps for Conducting a Fraud Investigation

Investigate to determine the extent of the fraud, how it was committed, who was involved, who may have been in a position to prevent the fraud, and whether this person(s) did not recognize it as such or knew about it and simply did not report it.

Determine the necessary knowledge and skills of the team needed to conduct an investigation and ensure that each is independent of the individuals and situation involved.

Develop appropriate and adequate investigative procedures. This task includes investigating the details of the event(s), the extent of the fraud, the persons involved, and what control weaknesses allowed it to occur.

As necessary, **coordinate investigative activities with others** brought in to assist in the investigation, including human resources staff, management, specialists, and legal staff.

Ensure that all standards, especially of objectivity, documentation, evidence, and cross-referencing, are strictly adhered to in the working papers, supporting documentation, and audit report.

Maintain professionalism at all times—in personal conduct, objective assessment, and confidentiality of information. Failure to do so could expose the MFI or investigator to legal action by the individuals under investigation.

Most often, MFI fraud that results in a legal process takes the form of a civil case to recoup lost funds or resources. Criminal cases for fraud are generally very costly to prepare and even in the best legal systems, require inordinate time and careful investigation. Successful convictions, moreover, are few relative to the number of incidents.

Conclusion

Historically, the internal auditor in an organization was a formidable, hostile figure who acted more like a policeman, checking a list of "dos" and "don'ts" rather than as a business partner. Internal audits were often conducted in an atmosphere of fear and blame that resulted in poor information, irrelevant reports, low staff commitment to internal controls, and power struggles between an institution's management and the auditor or between management and the board.

Sadly, many internal audit departments today still function within this outdated paradigm.

The past decade has provided many cases and examples from the commercial world of the inability of external audits to deliver results for users of financial statements and the failure of governing boards to prevent fraud, abuse, and failure in large international corporations. The recent financial sector crisis in North America and Europe illustrates the perils of unattended and unidentified risks.

The operating environments of MFIs are inherently risky. Lending, particularly lending to a vulnerable sector of the population, is risky. Many MFIs operate in cash economies with inadequate internal control systems. Competition for market share, product and service innovations, and new technology are the changing dynamics of the MFI world today. As a result, the internal audit profession must undergo continuous change and improvement as well.

In today's business language, the terms "risk," "governance," "controls," and "internal audit" are generally used in the context of an integrated, comprehensive framework. This toolkit has focused on providing the tools and resources for an internal auditor to fulfill audit responsibilities within that integrated framework.

In the "Microfinance Banana Skins Report 2008,"[38] governance and management quality were identified as the two most significant risks of the microfinance sector. In current best practices of the internal auditing profession, the internal audit function has an important role in supporting management and boards in their risk management responsibilities.

As the "eyes and ears" of the governing body, an independent, objective, and professional internal auditor is one of the best mechanisms for providing assurance

[38] D. Lascell, 2008, "Microfinance Banana Skins 2008: Risk in a Booming Industry," Center for the Study of Financial Innovation, London, UK. Available at http://www.citi.com/citi/microfinance/data/news090703a1.pdf.

that an MFI's risk management is effective and that the institution is indeed successful in achieving its objectives.

Stakeholders in an MFI should accordingly remain vigilant, aware of changes in its operating and regulatory environment, and make continuous improvements to the internal audit function of the institution.

Table 17. Overview of Annexes to this Document

Annex	*Document Title*	*Description and Purpose*
Annex 1	Sample MFI Risk Management Policy	An MFI's risk management policy is a recognition of key risks by senior management and indicates their risk tolerance for risk and risk monitoring processes. The risk management framework should address all aspects of risk to the institution. Risk management should be comprehensively addressed through the MFI's processes, controls, and reporting functions. Risk management should be regularly updated to address new issues faced as a result of growth, expansion, and new operating activities.
Annex 2	MFI and Bank Organizational Charts	All organizational charts differ slightly. The primary distinction for an internal auditor is to ensure that his or her function is independent of the management function, yet coordinated with management in reporting to the board of directors and the audit committee. Usually, an internal auditor reports functionally to the board or audit committee, but administratively to senior management.
Annex 3	Sample Risk Assessment Tools	This annex includes very basic risk assessment tools that can be used to establish an overall risk profile for an organization. These tools can also be adapted to identify, develop, or evaluate risk mitigation approaches or to develop a risk-based auditing approach to operations and reporting. They can also be used by an internal auditor, but ideally, such tools should be part of a board exercise that objectively evaluates ALL risks to an MFI.
Annex 4	Sample MFI Internal Audit Charter	An internal audit policy is generally articulated in a document called an internal audit charter. The charter lays out the roles and responsibilities of the internal audit department, reporting responsibilities, ethics, standards, and, more importantly, the authority of the department to operate independently and objectively.
Annex 5	Sample Job Descriptions for an Internal Audit Department	Job descriptions vary by MFI. These documents should include an overall description of each job, key duties and responsibilities, reporting relationships, location, qualifications, and required skills and abilities. They should also identify key duties and responsibilities with respect to the planning, implementation, monitoring, reporting, and evaluation of internal audits.

Annex 6	Sample Internal Audit Timesheet	Auditors are expected to complete monthly time sheets of how their time has been utilized. This document helps in planning and budgeting, both annually and by audit assignment. It also helps the internal audit manager ensure that resources are applied most efficiently.
Annex 7	Sample Internal Audit Performance Evaluation	In current audit practice, it is common for the internal audit department to ask for feedback and suggestions from auditees. Internal audits are intended to add value to an MFI; this exercise seeks to strengthen the internal audit department's ability to help the MFI meet its objectives.
Annex 8A	Sampling Calculation Tools: Poisson Sampling Table	Many MFIs audit very randomly or restrict their review and inspection of documents and processes to special audit procedures, fraud investigations, or other matters. Annexes 8A and 8B are intended to assist auditors in using statistical sampling in ongoing, regular auditing work in an efficient manner. Sampling supports the reliability of audit findings, results, and observations regarding the whole population of items being audited (for example, the whole population of outstanding loans). The Poisson Sampling Table is used to determine the sample size of such populations.
Annex 8B	Sampling Calculation Tools: Attribution Sampling Worksheet	This worksheet provides automated formulas that calculate sample size, precision, and point estimate (best estimate) for populations of items and processes that will be audited.
Annex 9	Statistical Sampling Supplement	Most MFIs do not use sophisticated auditing software for their work, making statistical sampling difficult. This handout details simple instructions for using the Excel software program to conduct sampling.
Annex 10	Sample Strategic Plan for an Internal Audit Department	Internal audit plans are part of senior management's strategic risk management framework. A strategic plan should take a long-term approach to planning and implementation of internal audits, particularly during changing economic times and periods of institutional growth and change. The strategic plan should be updated annually on a three-year "rolling forward" basis.
Annex 11	Sample Annual Plan for an Internal Audit Department	The annual internal audit plan, together with an associated budget, is part of an institution's annual plan and budget, and should reflect overall institutional need, specific to the risks and activities of a given year.

Annex 12	Sample Engagement Letter/Entrance Email for an Internal Audit	As a partner in risk management, internal auditors inform auditees of their plans, objectives, and activities with respect to upcoming audit activities. The purpose of an engagement letter or entrance email is to help management plan, participate in, and maximize the effectiveness of audit work.
Annex 13	Sample Internal Audit Opening Meeting Memo	In normal audit practice and conduct, an audit begins with an opening meeting with management and staff of the departments that are to be audited. The objective of the meeting is to discuss the audit plan and its objectives, discuss any special issues or concerns, and ensure the full participation and cooperation of the auditees.
Annex 14	Sample Internal Control Self-assessment Questionnaire	In preparation for audit work, it is current practice to get the auditee's own assessment of their internal control system. Many times, auditees already have suggestions and ideas for improving their own systems. Normally this type of assessment would only be conducted annually by staff and management.
Annex 15	Sample Internal Control Questionnaires	To help an auditor understand the strength of internal controls, it is helpful to conduct an assessment (usually annually) of key controls in operations and systems. The questionnaires used in such assessments must be updated as operations change and evolve. Weaknesses in controls will indicate areas of key risk that warrant attention in the audit.
Annex 16	Typical Control Objectives of Financial Transactions	This annex simply outlines the primary control objectives of financial transactions. These control objectives are crucial in the microfinance sector because it is a financial services industry in which financial transactions capture the core business activities.
Annex 17A	Typical Internal Audit Procedures, Definitions, and Illustrations	This annex provides tips and illustrations about key auditing procedures, how they are used and what evidence they produce. It is important to understand these definitions and procedures, since they are used in the development of internal audit procedures themselves.

Annex 17B	Sample Internal Audit Procedures and Work Plans	These samples outline audit objectives and procedures for different microfinance operations and activities. They must be adapted to each MFI's unique operating context and activities, using professional judgment and discretion. Audit objectives may vary and change from assignment to assignment, depending on the risks identified and the needs of management.
Annex 18	Internal Audit Working Papers Template	One of the professional standards of internal auditing is that all work and evidence must be carefully and clearly documented. Documentation helps support conclusions based on audit work and provides evidence and analysis on which others can rely (i.e., other auditors, external auditors, evaluators). Templates are generally recorded in a spreadsheet that also enables results and findings to be quantified.
Annex 19	Sample Internal Audit Findings Form	The detailed working papers in annex 18 are summarized as findings in the audit file. All findings are referenced to working papers. By summarizing audit findings, an auditor is able to identify broad trends, form sound conclusions supported by the evidence, and eliminate irrelevant or insignificant information.
Annex 20	Sample Internal Audit Exit Meeting Memo	According to the professional standards of the profession, a verbal meeting is held with auditees at the conclusion of an audit to debrief them on audit work, clarify and highlight findings, and discuss recommendations. This meeting always precedes a written report. The memo documents the key points of the meeting and provides the basis for the audit report.
Annex 21	Sample Internal Audit Report Templates	Writing a concise, meaningful, and relevant report is one of the greatest challenges of an internal auditor. One of the samples provided in this annex is a simple, concrete way for a writer to organize his or her thoughts and present findings. A second sample is a report used by professional auditors when expressing an opinion, for example, an assurance of the reliability of information, an assurance that no irregularities were noted in the sample, or an opinion as to the reliability of internal control systems.
Annex 22	Sample Internal Audit Management Responses	Management responses form part and parcel of the final internal audit report. These responses can be in a separate document, but it is often more useful to include them directly in the internal audit report, as illustrated in annex 21.

Annex 23	Sample Transmittal Cover Letter/Email for Internal Audit Distribution	Documenting the distribution of internal audit reports is a part of the department's communication function.
Annex 24	Sample Internal Audit Recommendations Follow-up Report	This tool can be used to periodically (for example, quarterly) report to senior management and the board audit committee on the status of previous audit work and associated recommendations, as well as any other issues or priorities. This reporting ensures that the internal audit department maintains an objective monitoring role in the identification of weaknesses in an MFI's risk management system and ensures that risks are minimized through appropriate action.
Annex 25	Sample Internal Control and Audit Steps Targeting the Prevention and Detection of MFI Fraud	This tool provides an overview of common areas of fraud in MFIs that relate to cash, clients, loans, and reporting. It identifies key steps for detecting fraud in these areas (through an internal audit), together with the principal measures for preventing fraud in these same areas (through internal controls).

Annex 1: Sample MFI Risk Management Policy

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
- create a reporting mechanism for the board of directors that summarizes the overall risk assessment of the Institution.

Risk Overview

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:

- 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.

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

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 only employees who maintain the highest ethical standards are employed by the Institution. 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.

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.

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.

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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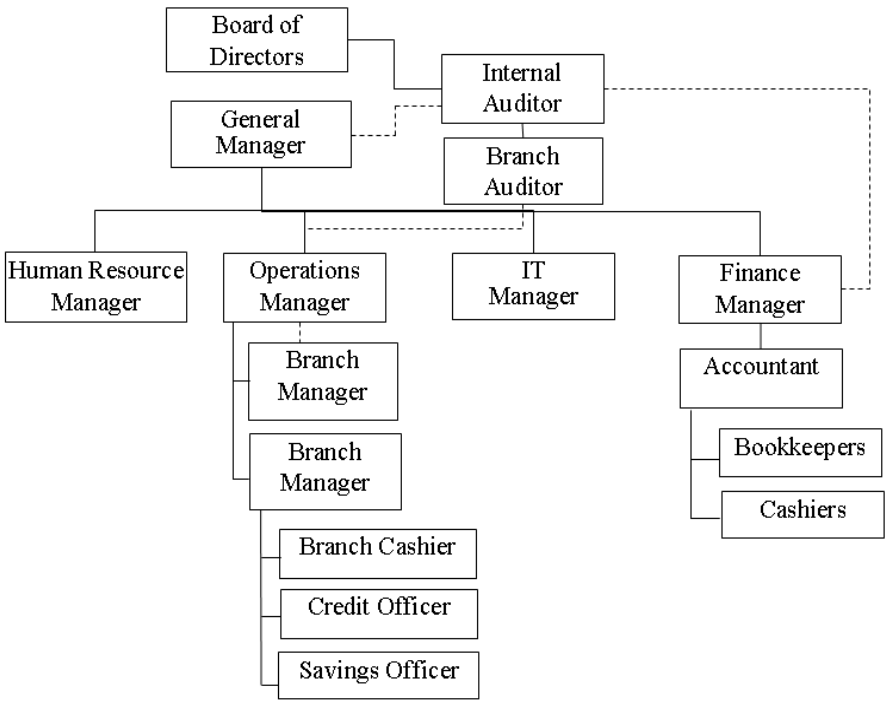
Annex 2: Sample MFI and Bank Organizational Charts

Sample A



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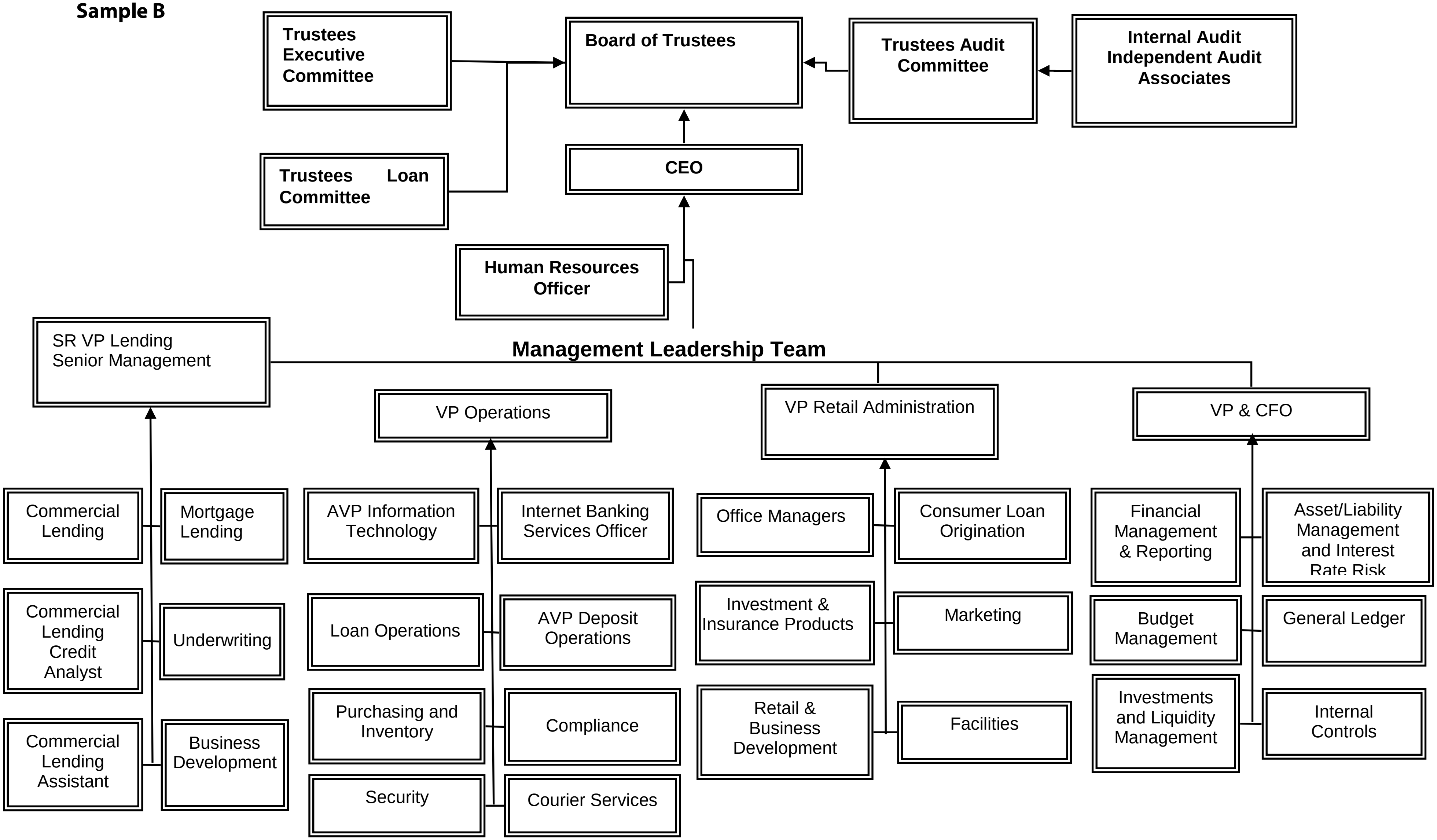
Sample B



Trustees Executive Committee
Board of Trustees
Trustees Audit Committee
Internal Audit Independent Audit Associates
Trustees Loan Committee
CEO
Human Resources Officer
Management Leadership Team
SR VP Lending Senior Management
VP Operations
VP Retail Administration
VP & CFO
Commercial Lending
Mortgage Lending
AVP Information Technology
Internet Banking Services Officer
Office Managers
Consumer Loan Origination
Financial Management & Reporting
Asset/Liability Management and Interest Rate Risk
Commercial Lending Credit Analyst
Underwriting
Loan Operations
AVP Deposit Operations
Investment & Insurance Products
Marketing
Budget Management
General Ledger
Commercial Lending Assistant
Business Development
Purchasing and Inventory
Compliance
Retail & Business Development
Facilities
Investments and Liquidity Management
Internal Controls
Security
Courier Services

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Annex 3: Sample Risk Assessment Tools

Sample A: Basic Risk Assessment Tool

This approach is adapted from a *MicroSave* toolkit."[39] 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.

[39] Pikholz et al., 2005, "Institutional and Product Development Risk Management Toolkit." Additional resources for risk assessment are also available in that toolkit 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.)

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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.

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 • ATM systems, POS • Information technology • Human resources • Management • Governance • Fraud	Risks vary, depending on specific examples from the 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					

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Sample C: Excel Spreadsheet Risk Assessment Tool

The attached Excel spreadsheet, “MFI Risk Assessment Ranking Tool,” 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 4: Sample MFI Internal Audit Charter

Introduction

The internal audit is an independent appraisal function established within the organization to evaluate the adequacy, effectiveness, and efficiency of the systems controls and quality of ongoing operations and initiatives.

The internal audit function is separate, distinct, and independent of the MFI's external financial statement audits.

Pursuant to regulations and standards published by local regulatory bodies, the national board of accountants and auditors, as well as international audit standards, the internal auditor should report to a level within the organization that allows the internal audit function to fulfill its responsibilities. In this regard, the internal auditor shall consult the executive director for guidance in establishing assignments and direction, and shall report to the audit committee of the board of directors for strategic direction, reinforcement, and accountability.

Mission and Purpose

The internal audit function will provide independent, objective assurance, and consulting services designed to add value and improve the MFI's operations. It endeavors to help the organization accomplish its objectives by bringing a systematic, disciplined approach to the evaluation of MFI risk management and improve its effectiveness, internal controls, and governance processes.

Internal audit activities relate to assessing the quality and integrity of the MFI control structure, assessing potential or actual business risks throughout the organization, and providing suggestions for process enhancements.

The principal components of this activity are to determine that control systems, operating procedures, and management processes in select areas are reviewed effectively in order to safeguard the interest of the organization and are consistent with the policies, laws, regulations, and guidelines set forth by senior management, the board of directors, the audit committee, the central bank, the government, and other appropriate regulatory agents.

To achieve its purposes, the internal audit function will:

- review and appraise the soundness, adequacy, and application of accounting and management procedures to determine that these procedures provide adequate controls, expected results, and appropriate levels of operating efficiency

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- perform sufficient tests during the course of review to determine compliance with established policies, plan, procedures, laws, and regulations
- review the management and financial information systems and determine the reliability and timeliness of management information
- appraise the quality, efficiency, and effectiveness of ongoing processes, initiatives, and business activities
- review the application and effectiveness of risk management procedures and risk assessment methodologies
- coordinate auditing efforts with other risk assessment functions (e.g., quality control, security, risk, and compliance), external auditors, regulators, external consultants, and other government agencies

Authority and Scope of Activity

The internal audit department or the internal auditor is authorized to initiate, without advance notice, audits and reviews of any and all MFI-related entities, functions, initiatives, processes, and activities. The results will be reported to the applicable managers, senior management, and the audit committee.

In carrying out their duties, internal auditors and employees performing internal audit activities shall have full, free, and unrestricted access to any and all documents, books, records, files, personnel, and organizational activities necessary to fulfill their duties. However, such access shall not apply in the case of privileged attorney-client communication and/or attorney work products.

The internal audit department or internal auditor specifically does not have the authority to initiate or approve accounting transactions of any nature or administer or supervise any MFI operational function. Impartiality requires that the internal audit department not be involved in operations that select or implement internal control measures. The department must also be independent of everyday internal control processes. However, the department may give recommendations for strengthening internal controls and can also give opinions on specific matters related to internal control procedures, as per the request of senior management.

Internal audit authority is derived directly from the board of directors. The internal audit department reports on a directional and accountability basis to the audit committee, which means, among other things, that the audit committee:

- approves the internal audit charter
- approves the internal audit department's audit plan and budget

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- receives regular communications from the internal audit department on the results of its activities or other matters set forth herein or that the internal audit department determines necessary
- approves the appointment, removal, evaluation, and compensation of internal audit staff
- determines whether scope or budgetary limitations impede the ability of the internal audit department to execute its responsibilities
- reviews internal audit reports and risk assessments

The internal audit department reports administratively to the executive director, who reviews and approves the department's

- budgeting and management accounting
- human resource administration
- internal communication and information flow
- administration of internal audit policies and procedures (such as expense approvals, leave approvals, requests for office space)

Auditing Standards

The standards of the internal audit enable the MFI to meet its requirement to have an internal audit function that is supervised by the audit committee. These standards are segregated into three categories: organization, personnel, and performance.

Organization

The MFI shall:

- have an internal audit function responsible for identifying and assessing business risk and evaluating the adequacy, effectiveness, and practicality of its systems and of ongoing activities and initiatives
- maintain an environment within which the internal audit department has the freedom to act
- allocate sufficient resources to the internal audit department to enable it to conform to the principles and standards of modern internal auditing
- provide, as part of its management control structure, a measurement of the effectiveness of the internal audit department
- ensure that the internal audit department has unrestricted access to all departments, offices, activities, documents, records, information, properties, and personnel relevant to the performance of the internal audit function

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Personnel

The internal audit department and the employees performing internal audit activities are expected to comply with the MFI's established code of ethics and the spirit and principles set forth in the code of ethics that are established by relevant regulators, national accounting bodies, and international auditing standards. In substance, internal auditors shall:

- perform in an honest, objective, and diligent manner
- hold the trust of the MFI and not knowingly take part in any known illegal or improper activity
- refrain from activities that are in conflict with the interest of the MFI or that would interfere with his or her ability to be objective or ability to appear objective
- not accept personal fees or gifts or benefit personally from his or her employment, other than as agreed in his or her employment contract or with management
- maintain confidentiality
- exercise due professional diligence and care
- maintain adequate technical proficiency
- adhere to conduct that enhances the professional status of internal auditing, as defined by national accounting bodies

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Performance

The internal audit department shall be effectively organized and administered, as specified below.

- The internal audit department and employees performing internal audit activities will receive proper supervision, direction, and training.
- A formal internal audit plan for an appropriate cycle of time is required and will cover the functions, activities, initiatives, and processes identified as exhibiting high risk or importance to the MFI.
- The scope of internal audit activities conducted will include determination of the level of business risk to the MFI: an appraisal of the adequacy, effectiveness, and practicality of the system of internal controls; and an evaluation of the quality of execution.
- Procedures utilized shall be efficient, up to date, and provide sufficient, evidential documentation to support audit conclusions.
- Audit working papers shall be complete; identify the audit work performed and the samples chosen; provide sufficient evidence to justify the auditor's findings and conclusions; and document the audit work performed, as well as the findings, conclusions, and recommendations reported.
- Findings shall be communicated to the appropriate management levels, and audit reports will be forwarded in a timely manner to the manager responsible for appropriate action, the audit committee, and the executive director.
- The internal audit department shall comply with sound internal auditing principles and best practices.

Summary reports of internal audit activities, conclusions, significant findings, and recommendations will be prepared and forwarded to the applicable manager, the executive director, and the audit committee.

Responsibilities of Auditing

The responsibility for the effective conduct of internal auditing rests with the board of directors. This responsibility is executed through the audit committee. Implementation of internal audits shall be fulfilled by the internal audit department.

Internal Audit Department

The internal audit department is responsible for the implementation, direction, and accomplishment of the internal audit program for the MFI. The department will:

- institute special investigations, reviews, audits, or studies of any matter at the direction of the board of directors, audit committee, executive director, or its own volition and make a complete report thereof

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- inform, on an immediate basis and in writing, the executive director, audit committee, and the board of directors of the results of any audit that identifies unusual losses, potential losses, management deficiencies, control deficiencies, or other matters that may lead to significant harm or embarrassment to the MFI
- inform executive management and the audit committee of new audit concepts and regulatory developments and report significant risks related to proposed actual changes in the activities, initiatives, and processes of the MFI
- budget sufficient resources to discharge the responsibilities of the internal audit department
- support management as it monitors the implementation of actions to respond to the result of regulatory reports, external financial statement auditors, or consultants to ensure that appropriate corrective action is taken and to report at each scheduled audit committee meeting (or more frequently, if necessary) the progress of the action taken
- maintain an informative contact and a cooperative working relationship with the external financial statement auditors
- with the assistance of management, develop and present an annual internal audit plan to the audit committee for its approval
- monitor and report to the executive director and the audit committee on the adequacy and timeliness of management response and the corrective action taken on all significant weaknesses reported by internal audit department or identified by MFI regulatory authorities

Management

For internal auditing activity to be effective, management at all levels of the MFI is expected to inform the internal audit department and the audit committee in a timely manner of significant planned developments and activities considered important and that present potential risks to the organization. The following are examples of such conditions and circumstances;

- initiatives related to new departments, functions, activities, processes, or products
- major changes in existing operating and control procedures or methods, including new computer-based applications and e-commerce activities
- significant or continuing out-of-balance conditions, regulatory violations, and other matters that may directly or indirectly result in loss to the MFI
- instances of officer and/or employee dishonesty or propensity thereto that involve loss or risk to the MFI
- discovery of unsafe or unsound practices
- major customer or employee complaints
- threats, acts of extortion, or robberies

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Annex 5: Sample Job Descriptions for an Internal Audit Department

Sample Chief Internal Auditor Job Description: Template A

Job Title: Chief Internal Auditor
Immediate Supervisor: Board Audit Committee Chairperson
Location: Head Office
Occupational category: Managerial
Department/Service: Internal Audit Department

Purpose of Position

To lead the entire internal audit function of the MFI, to support management in its risk identification and prioritization activities; to test the adequacy and effectiveness of internal control systems; to test for compliance with systems, policies, and procedures in all operational areas; and to report to the MFI board audit committee the findings from such tests, the MFI's exposure to risk, and recommended steps to mitigate risks.

Major Responsibilities

Planning and systems development:

1. Prepare and develop the strategic and annual internal audit work plan according to existing risk profiles and MFI business plans. Develop department operational budgets, including estimates for staff resources, training, travel, and support of audit work.
2. Develop, update, and maintain an internal audit manual with appropriate files (permanent and temporary), working papers, checklists, client reports, and audit resources.
3. Prepare the annual audit schedule for conducting an internal audit or evaluation of all areas of MFI operations and branches, including adequate planning for internal control assessments, development of audit procedures, fieldwork, file review, special assignments, surprise audits, meetings, and report writing.

Organizing and implementing:

4. Conduct field work according to work plans with department staff.
5. Manage, supervise, and review the work of internal audit staff.
6. Ensure all operational and other risks are continually reviewed in the course of internal audit work to ensure adherence to professional auditing standards.

`

7. Plan and perform spot-check/cross-checking of cash and/or loan meeting processes (disbursements and collections).
8. Perform special examinations, procedures, and assignments at the request of management, board, or staff.
9. Provide technical and administrative support (e.g., research and guidelines) to the board audit committee, as needed.

Monitoring, follow-up, evaluation, and reporting:

10. Monitor previous audit recommendations.
11. Provide recommendations to strengthen internal control systems, improve policies and procedures, and support the MFI's risk management strategy.
12. Provide audit reports to management and the board that document audit work conducted, in accordance with professional standards of communication.
13. Provide quarterly updates to the board audit committee on the status of audit recommendations and any areas that could be the cause of increasing risk to the MFI.
14. Conduct regular audit performance evaluations to ensure that audit activities add value to the work and activities of the MFI.
15. Submit an annual internal audit department report to the board that outlines the major accomplishments, issues, and challenges of the department and recommends actions to strengthen audit activity.

Staff management:

16. Plan, recruit, motivate, and manage internal audit department staff, ensuring the efficiency and adequacy of internal audit skills.
17. Provide orientation and annual trainings for staff to ensure the development of professional skills in the department.
18. Conduct performance appraisal evaluations for internal audit staff of the department, including setting performance objectives and regular monitoring.

Relationship with stakeholders:

19. Coordinate with external auditors, bank supervisors, and other external assessors and evaluators.
20. Communicate with government entities (e.g., central bank, tax department, labor ministry, etc) and other private entities.

<u>Required Knowledge, Skills, and Experience</u>

Education:

`

- Bachelor's degree in accounting or finance; certification in the field auditing or accounting is an added advantage.
- Master of Business Administration or equivalent degree in the field in accounting and finance or related field; CPA/ACCA graduate preferable.

Work experience and skills:

- 10 years financial management or auditing experience; at least 4 years in a middle management /supervisory position, preferably in financial institutions. Previous audit experience preferred.
- Extensive audit experience (at least 3 years) with a reputable auditing firm, commercial bank, or microfinance institution.
- Comprehensive knowledge of microfinance institutions and banking.
- Strong knowledge of internal control structures.
- Good understanding of the national legal framework, including taxation of and legal compliance by banking and financial institutions.
- Experience with statistical sampling and related software is an advantage.

Personal skills and characteristics:

- Understands and agrees with the MFI's mission, goals, core values, and systems.
- Determined personality with initiative and perseverance.
- High personal integrity and honest, principled individual.
- Able to make sound conclusions and relevant recommendations.
- Objective, professional, and able to communicate well both verbally and in writing.
- Capability and willingness to take responsibility; highly developed sense of rectitude.
- Good interpersonal skills, including the ability to coach and train others.
- Good conflict management skills.
- Computer literacy (Word, Excel, PowerPoint, etc).
- Willingness to travel to local provinces for audit, evaluation work, and other assignments.

Signature/Name	Position	Date
Prepared by: ___________	________________	_______
Reviewed by: __________________	__________________	_______________
Approved by: _________________________	__________________	_______________

`

Sample Chief Internal Auditor Job Description: Template B

Job Summary:

The MFI's internal auditor is responsible for verifying that the MFI's operational processes are in compliance with its policies and procedures, that the policies adhere to government regulations and laws, and that there a robust risk management program and internal controls are incorporated into the daily activities of the institution. The internal auditor position is independent of the executive director and reports directly to the board audit committee.

Job Description:

1. Develop and maintain an internal audit program that provides for observation, monitoring, testing, and reporting on the status of the MFI's adherence to its policies and procedures.
2. Establish auditing schedules to visit all retail MFI locations, operations, MIS departments, administration offices, and other areas where business is conducted.
3. Develop auditing standards for all MFI policies and applicable government regulations. Maintain records of all testing and audit results.
4. Report all findings to senior management and the board of directors. Coordinate with senior management and track their actions and responses to audit reports. Follow up with the board on the status of management responses.
5. Coordinate with external auditors and bank regulators during examinations.
6. Maintain all internal audit reports according to the MFI's retention policies.
7. Conduct customer account verifications.
8. Report any serious weaknesses in the control system to the board of directors.
9. Maintain the highest confidentiality standards regarding the MFI, its operations, security measures, customer information, account information, and all employee data.
10. Perform any other job functions as directed by the board audit committee.

`

Sample Field Auditor Job Description

Job Title:	Internal Auditor—Field Operations
Reports to:	Head of Internal Audit Department or Chief Internal Auditor
Status:	Full-time
Job Summary:	This position is responsible for internal audit functions related to field lending operations of the MFI. It requires continually verifying operations and transactions to confirm that operating and portfolio reports are reliable. Job duties include the testing of controls in lending activities for compliance with management-approved policies and procedures.

Responsibilities:

- Execute detailed field audits, including review of loan applications, verification of borrowers, verification of loan balances, assessment of delinquent clients, and general assessment of borrowers and their business capacity.
- Prepare detailed field audit reports for the head of the internal audit department (or chief internal auditor).
- Assist the operations department in developing corrective actions.
- Advise senior management on how to improve systems of internal control.
- Follow up to determine the adequacy of corrective actions by loan officers, loan supervisors, and members of the operations team.
- Participate in studies and projects as assigned.
- Work with the chief internal auditor, general manager, deputy general manager, operations manager, and credit manager of the MFI to enhance control and verification systems throughout operational activities.

Approval and Dates

Management: ____ **Date:** ____________

Audit Committee: _____________________________________ **Date:** ____________

`

Sample Financial Internal Auditor Job Description

Job Title:	Financial Internal Auditor
Reports to:	Chief Internal Auditor
Status:	Part-time
Job Description:	This position is responsible for the financial internal audit function of the MFI. It continually reviews operations for any weaknesses in internal controls and tests transactions and reports for compliance with approved financial and accounting policies and procedures. Auditing of financial activities and financial reporting also ensures that the MFI adheres to current legislation, legal norms, and regulations. The overall objective of financial auditing is to assure management of the reliability of the MFI's financial reports and to follow up on the findings of external audit reports to resolve outstanding issues and ensure corrective actions are taken to address issues.

Responsibilities:

- Ensure that all MFI policies and procedures are executed in accordance with the regulations issued by senior management as well as by the central bank and other supervisory entities.
- Verify and evaluate the efficiency and sufficiency of internal, financial, and accounting controls to provide a working environment appropriate for the safeguarding of assets and the reliability of transactions and reports.
- Advise senior management how to improve systems of internal control.
- Present final audit reports to operating departments and division managers in order to identify problems and recommend corrective measures.
- Verify the follow-up of recommendations issued by external and internal audits.
- Continuously analyze and evaluate the systems of internal control of the MFI that apply to financial transactions through audit activities.
- Review the accounts and the economic events that affect the MFI's financial statements.
- Review and verify the adequate valuation and qualification of assets, especially the loan portfolio and the estimation of loan-loss provisions and reserves in accordance with current regulations.
- Review the MFI's annual financial statements that will be published by official authorities.
- Conduct surprise reviews of petty cash on a regular basis, as well as regularly confirm balances of the main accounts in the balance sheet (especially for bank accounts).
- Remain appraised of all legislation in force that applies to the MFI, including changes to company law, the fiscal code, and labor laws.

Approval and Dates

Management: ____ **Date:** _____________

`

Audit Committee: ______________________________________ **Date:** ____________

`

Annex 6: Sample Internal Audit Timesheet

Name of audit:										
	Planned	**Actual**	**Auditor 1**		**Auditor 2**		**Auditor 3**		**Supervision**	
Planning	Hours:	Hours:								
	Dead-line:	Last date:								
Evaluation of internal controls	Hours:	Hours:								
	Dead-line:	Last date:								
Testing	Hours:	Hours:								
	Dead-line:	Last date:								
Visiting clients	Hours:	Hours:								
	Dead-line:	Last date:								
Evaluation and documentation	Hours:	Hours:								
	Dead-line:	Last date:								
Developing draft report	Hours:	Hours:								
	Dead-line”	Last date:								
Developing final report	Hours:	Hours:								
	Dead-line:	Last date:								
Audit file closure/admin	Hours:	Hours:								
	Dead-line:	Last date:								
Comments on variance from budget/ recommended future changes										

Reviewed by: ______________________________ Date________________________

`

(Note: The audit team might want to add further categories, such as keeping track of time spent on deposits, credit and operations, when conducting branch audits).

Annex 7: Sample Internal Audit Performance Evaluation

INTERNAL AUDIT PERFORMANCE EVALUATION FORM

This form is used to provide input from the auditee for the quality assurance program of the internal audit department. Please respond to these evaluation questions openly and honestly, as we use this form throughout the year to make improvements to our process and organization. Thank you for your time and input.

Audit number and Title : ____

Auditor(s) : ____________________________________

Audit Process	Strongly agree	Agree	Disagree	Strongly disagree	Did not observe
1. The audit process and timeline were clearly explained at the start of the audit.					
2. The audit objectives and scope were discussed prior to the start of the audit.					
3. Management's concerns and suggestions were obtained and incorporated or considered throughout the audit.					
4. Management was kept informed throughout the audit regarding the audit status and potential audit issues.					
5. The audit resulted in minimal disruption of the operations of the department.					
6. The audit was completed within a reasonable time frame. Any delays in completing the audit were explained to management.					
7. The audit issues noted were relevant to my operations.					
8. All relevant parties had the opportunity to provide input regarding potential audit issues.					
9. Audit recommendations were constructive and reasonable.					

Provide any additional comments that would assist the internal audit department in improving future audit services.

Please email or transmit this form to the senior auditor within one week. Thank you.

`

Annex 8A: Sampling Calculation Tools: Poisson Sampling Table

See attached Excel spreadsheet (“Annex 8_fnl.xls”).

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Annex 8B: Sampling Calculation Tools: Attribute Sampling Worksheet

See attached Excel spreadsheet ("Annex 8_fnl.xls").

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Annex 9: Statistical Sampling Supplement

If you have a 2003 or later version of the Excel software program, you can use its "Data Analysis" function to help you conduct sampling.[40] Under the "Tools'"' menu you will find "Data Analysis." If you don't see it in under your "Tools'"' menu, click on "Add-ins" under the Tools menu, select "Data Analysis" and follow the Excel instructions to upload it to the Tools menu. You do not need to be connected to the Internet to upload the menu function for Data Analysis.

Data Analysis can be used for:

- random number generation
- selecting a sample
- interpreting results of variable sampling

Most of the above menu options are self-explanatory when you start to use them. Data Analysis cannot, however, be used to determine sample size.

Prior to using Data Analysis, convert any formula in the input range data into a number (choose the "Edit" Menu, "Paste Special," "Values"). To have Excel choose the sample, select "Data Analysis," click on "Descriptive Statistical," then "Sampling". When prompted to choose an input range, choose the unique numbers for the sample items (for example, choose the loan identifier codes), then type in the sample size or the interval and the new worksheet or output range in the population's worksheet. Since using random numbers for choosing a sample is the most valid methodology in statistical sampling and is easily done as "interval sampling" using Excel, this is the recommended method.

Prior to having Excel calculate your results for variable sampling, as well as converting all input data from formulas as described in the paragraph above, delete any non-numerical cells in the input range (e.g., "n/a"). To conduct the calculation, click on "Descriptive Statistics," then choose "Sampling." Fill in the input range (i.e., the numbers to be analyzed) and the output range (i.e., where the results will go) and then check "Summary Statistics." The significant figure is the standard deviation.

The standard deviation can also be calculated using the "STDEVA" function (under the "Insert" menu.) You need type in only the relevant range of figures.

[40] All explanations included in the whole sampling section are for Excel XP. *Note:* do not use the "Data Analysis" function in an Excel program that predates 2003. Earlier versions of Excel had hidden calculation errors that were only corrected for the 2003 version.

`

Annex 10: Sample Strategic Plan for an Internal Audit Department

Long-term audit planning is important regardless of what stage of development the internal audit department has reached. In order to ensure that the internal audit function is incorporated into the core plans and activities of an MFI, and not simply "bolted on" as an addition, it is useful to look at its work as a strategic and integral part of an MFI's risk management feedback loop. An MFI's growth, expansion, fraud prevention, risk assessment, strategic planning, and transformation all need to be incorporated into long-term, strategic internal audit planning.

A sample strategic plan, illustrated below, would be updated on a "rolling forward" basis each year.

STRATEGIC AUDIT PLAN 20xx/20xx

Audit area	*Risk score*	*Yr1 20xx*	*Yr2 20xx*	*Yr3 20xx*	*Total years*
Administration					
Branch x	H	2	2	1	5
Branch y	M	1		1	2
Branch z	L		1		1
Accounting and finance	L		1	1	2
Head office operations	M	1	1	1	3
Human resources	L	1		1	2
Procurement and expenditures	H	2	1	2	5
Risk management	L		1		1
System review and other IT	H	2	1	1	4
Other (define)					
Total audits/yr		9	8	8	25

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

The key aspects of this strategic plan (related to the methodological issues of its formation) are:

Changes from the 20xx/xx (preceding period) strategic plan and the reasons for these changes:

Approval and Dates

Senior Management: ____

`

Audit Committee:____

`

Annex 11: 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
- 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.

Comments:

Approval and Dates

Audit Committee Representative: ____

Management:____

`

Annex 12: Sample Engagement Letter/Entrance Email for an Internal Audit

AUDIT ENTRANCE EMAIL

TO: Auditee Management
FROM: Auditor
DATE:
SUBJECT: Internal Audit of [Name of Audit]

The Internal Audit Department (IAD) will be conducting an audit of [Name of Audit and state period to be audited.] The objectives of the audit are as follows:

- [Objective #1]
- [Objective #2]
- [Objective #3]
- [Objective #n]

The IAD expects the timeline of the audit to be as follows:

Fieldwork begins	[Date]
Fieldwork ends	[Date]
Report Draft with Management Responses	[Date]

It is the internal audit department's goal to provide recommendations that will result in the maximum and most efficient use of the institution's resources. We will keep you apprised of findings and recommendations as they develop, and will seek your responses during the audit.

In order for the audit to proceed efficiently and produce as little disruption as possible to your operations, I and other department staff will need your assistance and that of your staff. We will need your help to gather the information necessary to complete audit procedures and to answer relevant questions and provide explanations regarding issues encountered during audit testing. I would greatly appreciate your commitment to providing the following information by the date indicated so that I may adhere to the above timeline:

- [type of information required] [date required]
- [type of information required] [date required]
- [type of information required] [date required]
- [type of information required] [date required]

Copies of the audit report will be distributed to you and senior management for a formal response to audit findings and recommendations. The final report will then be distributed to you, senior management, and the board audit committee.

`

I will be contacting you soon in order to arrange an opening meeting to discuss the various aspects of the audit. Should you have any questions or concerns during the course of the audit, please do not hesitate to contact me at:

`

Annex 13: Sample Internal Audit Opening Meeting Memo

INTERNAL AUDIT OPENING MEETING OF [DATE]	
Name of the audit:	Audited period:
Scheduled date of audit:	
Prepared by:	Date:
Reviewed by:	Date:

Objective: [opening meeting minutes]

Participants:

Name	Position	Department/ Service

Summary of the issues discussed:

Updates and changes to the planned internal audit objectives:

`

`

Annex 14: Sample Internal Control Self-assessment Questionnaire

Pre audit stage. The best internal auditing results come when all parties—management, staff, auditees, and auditors—work together toward the achievement of organizational objectives. Operational staff and managers should be given the opportunity to provide feedback and to conduct a self-assessment exercise by looking at their own internal control system. This exercise will strengthen their commitment and buy-in to a strong internal control system.

Purpose. As a member of the management team of the MFI, it is your responsibility to design, adhere to, and monitor the significant operating and financial controls of the ______________ department/area. This short self-assessment has been designed to obtain input from you so that the internal audit department can effectively determine the correct level and areas of focus of its activity in the upcoming review of this department. Your input is important and appreciated. It should take approximately 20 minutes to complete this form.

Area: ________________________________

Responsible Person: __________________

Please describe **the key business objectives** of your department/area (i.e., what is the mission of your department/area?).

____

____

____

____

Are the **policies and procedures** in your department/area **documented**? (circle one) Yes No
Comments:

____

____

Are the **policies and procedures** in your department/area **up-to-date**? (circle one) Yes No

`

Comments:

Please describe the ***key business processes*** that occur in your department/area (i.e., what activities are completed in your department/area?)

Please describe the ***key internal controls*** that you believe exist in your department/area (i.e., how do you control major activities, output, etc., in your department/area?)

What are the ***key information systems utilized*** in your department/area?

Please describe ***the key performance measures*** you obtain and utilize to monitor the effectiveness and efficiency of your business processes.

Please describe ***the key means of communication*** you utilize to inform other departments of activities and issues occurring in your department/area.

`

Which departments would benefit from communication with your department/area?

____

____

Which departments do you currently communicate with?

____

____

Are there any areas that you would like the upcoming internal audit to specifically review (e.g., areas of immediate control concern or inefficient processes)?

____

____

____

____

Overall, how would you rate the following in your department/area? (1=Bad, 5=Excellent)

Effectiveness of internal controls	1	2	3	4	5
Quality of output	1	2	3	4	5
Efficiency of your business processes	1	2	3	4	5

Do you have any suggestions or ideas to strengthen internal controls that you or your staff think would be helpful to your department/area of operations?

____

____

____

If there is any additional information you feel that the internal auditing department (or internal auditor) should have prior to the audit (e.g., such as organizational charts, policies, reports, etc.)? If so, please attach it to this questionnaire. Please return this questionnaire and any attachments to [name] by [date].

`

Annex 15: Internal Control Questionnaires

An existing *MicroSave* toolkit includes excellent internal control questionnaires.[41] The following MFI operational areas are addressed by those questionnaires:

- Cash
- ATMs and PINs
- Inter-office and inter-branch transactions
- Due from bank accounts (clearing account)
- Credit products
- Collateral/securities
- Interest and fees
- Loan losses
- Fixed assets
- Savings deposits
- Fixed deposits
- Security
- Emergency preparedness
- Insurance
- Computer processing

The full 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.)

The questionnaires that follow have been expanded, based on other sample internal control questionnaires.

[41] See Attachment 7 of MicroSave's "Institutional and Product Development Risk Management Toolkit" (Pikholz et al. 2005).

Sample MFI Internal Control Questionnaire for Governance

(Note: This template should be tailored to the individual MFI.)

Completed by:_______________________________ Date:________________________
Reviewed by_________________________________ Date:________________________
Meeting with_________________________________ Date:________________________
Other information reviewed____
Branch/Office:_________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the branch. Many Internal Audit Departments do not conduct work on governance or institutional management unless the institution is relatively mature and the department is highly experienced and professional.

Note: Questions about the internal audit department are more appropriate for an external assessment of the MFI's internal control system.

INTERNAL CONTROL QUESTIONNAIRE FOR GOVERNANCE			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Does the mission statement balance the social and commercial objectives of the institution?		
	Is there a statement of institutional core values?		
	Is there an independent governing body that provides direction for the institution?		
	Does the composition of the board reflect the dual mission of microfinance?		
	Are there minutes reflecting regular board meetings?		
	Are board decisions made according to an agreed-upon strategic or business plan?		
	Does the board provide an environment conducive to transparency and internal controls?		
	Does the board approve an annual budget that guides operating decisions?		
	Is there an annual external audit by a reliable audit firm?		
	Does the board lead policy development and the monitoring of institutional performance?		
	Does the board lead the risk management process in the institution, setting risk appetite and conducting regular monitoring of risk indicators?		
	Does the board adequately manage its own performance, meetings, evaluations, and ongoing development?		
	Does the board have a Code of Ethics for its members		

INTERNAL CONTROL QUESTIONNAIRE FOR GOVERNANCE			
	Internal Control Question	Yes/ No	Controls or Comments
	and require members to sign a Conflict of Interest Certificate?		
	Does the board relate effectively to management and the executive director, supporting, communicating, and holding him or her accountable for results and oversight?		
	Is there an independent internal audit function?		
	Are internal audits conducted regularly?		
	Does the internal auditor report directly to the board of directors?		
	Does the scope of the internal audit include central office functions?		
	How are internal auditors assigned to branches and audit areas?		
	Is the internal audit department managed by professional and qualified staff?		
	Are internal audit practices (e.g. rotation, planning, review, etc.) in line with professional standards of practice and conduct?		
	Is the internal audit department reviewed regularly (e.g., by external auditors, evaluators, board committee)?		
	Is there an established process for management or board response to internal audit reports?		
	Does the institution have access to legal counsel and for what purposes?		

Sample MFI Internal Control Questionnaire for Financial Independence

(Note: This template should be tailored to the individual MFI.)

Completed by:______________________________ Date:_______________________
Reviewed by________________________________ Date:_______________________
Meeting with________________________________ Date:_______________________
Other information reviewed____
Branch/Office:________________________________Date:______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the MFI.

INTERNAL CONTROL QUESTIONNAIRE FOR FINANCIAL INDEPENDENCE			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Has the organization developed its own business plan?		
	Is the organization building the capacity to operate independent of ongoing technical assistance?		
	What percentage of total operating costs is covered by financial income?		
	Is there a policy that determines the procedure for setting interest rates?		
	Is there proper accounting for subsidies and in-kind donations?		
	Is there an agreement with the central office that fees are to be charged for services provided?		
	Does the organization have a plan to establish itself as an independent legal structure?		
	Does the organizational culture and operating mode reflect a business culture?		

Sample MFI Internal Control Questionnaire for Petty Cash

(Note: This template should be tailored to the individual MFI.)

Completed by:______________________________ Date:_______________________
Reviewed by________________________________ Date:_______________________
Meeting with________________________________ Date:_______________________
Other information reviewed____
Branch/Office:________________________________Date:______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR PETTY CASH			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Are there written policies and procedures for handling cash?		
	Are there written policies and procedures for cash transactions and record keeping?		
	Is there an appropriate segregation of duties between cash handling, accounting, and reporting functions?		
	Are appropriate approval levels clearly outlined in the MFI's policies?		
	Are cash funds adequately secured during non-working hours (e.g., locked, fireproof, fixed vault)?		
	Are cash funds verified by an independent party?		
	Is a source document required for all cash transactions?		
	Is there a designated cashier or custodian of petty cash?		

Sample MFI Internal Control Questionnaire for Operating Cash

(Note: This template should be tailored to the individual MFI.)

Completed by:_______________________________ Date:________________________
Reviewed by_________________________________ Date:________________________
Meeting with_________________________________ Date:________________________
Other information reviewed____
Branch/Office:_________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR OPERATING CASH/CASH ON HAND			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Does the institution have written policies regarding the handling of cash for operations?		
	Is cash physically secured at all times?		
	Is the vault cash under dual control?		
	Is the vault fireproof and immoveable?		
	Are cash funds verified by an independent party? Daily? How often?		
	Is there a vault register that records the physical cash count? How often is it verified with financial records or a cash book?		
	Is cash in the safe or vault organized by denomination, appropriately sealed, and labeled?		
	Is there an appropriate policy to determine the limit of appropriate cash on hand?		
	Is there a policy for cash transfers to the bank? Is it effective and appropriate?		
	Is a source document required for all cash transactions?		
	Is there an adequate segregation of duties between cash handling, recording, and approvals?		
	Are all cash movements to and from the safe and/ or vault recorded in a cash book?		
	Are there policies and procedures for cash discrepancies?		
	Please refer to MicroSave reference on page 1 of this annex for questionnaires related to cash in retail banking.		

Sample MFI Internal Control Questionnaire for Cash Receipts

(Note: This template should be tailored to the individual MFI.)

Completed by:________________________________ Date:_________________________
Reviewed by__________________________________ Date:_________________________
Meeting with__________________________________ Date:_________________________
Other information reviewed____
Branch/Office:__________________________________Date:________________________
To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR CASH RECEIPTS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Are all cash receipts acknowledged with an official receipt to the payer?		
	Are all cash receipts deposited immediately and intact to the bank?		
	Are receipts printed in multiple copies (at least 3) and serially pre-numbered, with the stamp or logo of the institution or branch?		
	Are receipts in the receipt book in ascending numerical order?		
	Is there a document control record that registers all receipt books in stock, those in circulation, and completed receipt books returned?		
	Are all cash receipts recorded daily in the cash journal?		
	Is there adequate segregation of duties between receiving cash, recording cash in the book of accounts, and depositing cash in the bank?		
	Are there appropriate policies for handling cash in loan disbursements and collections?		

Sample MFI Internal Control Questionnaire for Disbursements

(Note: This template should be tailored to the individual MFI.)

Completed by:________________________________ Date:________________________
Reviewed by__________________________________ Date:________________________
Meeting with__________________________________ Date:________________________
Other information reviewed____
Branch/Office:__________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR DISBURSEMENTS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Cash		
	Are there policies for cash disbursements? Are policies adequate and do they address approvals and supporting documentation?		
	Are cash disbursements used for most activities or for very few activities?		
	Does the MFI use payment vouchers to request and document the approval of cash disbursements?		
	Are loan disbursements made by cash? Are disbursements made in the branch, office, or in the field?		
	Is there adequate segregation of duties between the handling of cash disbursements, approvals of cash disbursements, and their recording in client and financial records?		
	Checks		
	Are there policies for check disbursements? Are policies adequate and do they address approvals and supporting documentation?		
	Are check disbursements used for most activities or for very few activities?		
	Is there adequate segregation of duties between the handling of check disbursements, their approval, and their recording in client and financial records?		
	Are checks stored under lock and key and accessible only to the clerk assigned to prepare checks?		
	Is there a document control record that registers checks issued per bank account?		
	Are voided checks appropriately cancelled or voided and stored with the check stubs?		

INTERNAL CONTROL QUESTIONNAIRE FOR DISBURSEMENTS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Is there a policy preventing the signing of blank checks?		
	Does the MFI use payment vouchers to request and document the approval of check disbursements?		

Sample MFI Internal Control Questionnaire for Opening, Maintaining, and Closing Bank Accounts

(Note: This template should be tailored to the individual MFI.)

Completed by:_______________________________ Date:________________________
Reviewed by_________________________________ Date:________________________
Meeting with________________________________ Date:________________________
Other information reviewed____
Branch/Office:______________________________Date:________________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR OPENING, MAINTAINING, AND CLOSING BANK ACCOUNTS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Is the opening of new bank accounts adequately documented? Is the purpose clear and reasonable?		
	Does the donor or investor require separate bank accounts for loan funds? Is this adequately managed?		
	Are the appropriate board resolutions to open new bank accounts in place?		
	Are the criteria for selecting a bank in place and documented?		
	Are there periodic reviews of bank services, relationships, efficiency, and risks?		
	Are bank signatories clearly defined and approved by board resolution and policies?		
	Do bank signatories or panels of signatories reflect adequate segregation of duties related to approvals of expenditures?		
	Are bank reconciliations performed and independently reviewed monthly?		
	Are outstanding items followed up with the bank or MFI staff immediately?		
	Are deposits in transits cleared in the following month?		
	Is it usual to have a long list of outstanding checks?		
	Is follow-up and communication with the bank documented?		
	Are bank officials advised of signatory changes promptly?		

INTERNAL CONTROL QUESTIONNAIRE FOR OPENING, MAINTAINING, AND CLOSING BANK ACCOUNTS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Has there been a change of signatories during the audit period?		
	Is there periodic review of all bank accounts to ensure relevance, efficiency, and demand?		
	Are bank accounts closed if deemed necessary?		
	Are account closures approved and adequately documented?		
	Are all bank accounts under the legally registered name of the MFI?		
	Are any dormant or unusual accounts held?		

Sample MFI Internal Control Questionnaire for Bank Deposits

(Note: This template should be tailored to the individual MFI.)

Completed by:______________________________ Date:_______________________
Reviewed by________________________________ Date:_______________________
Meeting with________________________________ Date:_______________________
Other information reviewed____
Branch/Office:_________________________________Date:______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR BANK DEPOSITS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Checks		
	Are all check receipts acknowledged with a written receipt?		
	Does policy require that all checks received be stamped "for deposit only"?		
	Is there adequate segregation of duties between opening mail or receiving checks, recording checks, and making deposits?		
	Are all deposits of checks made promptly?		
	Cash		
	Are there policies for the deposit of cash receipts in a timely manner?		
	Is cash deposited intact?		
	Are cash deposits supported by source documents (e.g., receipts, collection registers, etc.)?		
	Are supporting documents of each deposit verified, cross-referenced if necessary, and approved or subtotaled if necessary?		
	Are all movements of cash between the safe, vault, or office and the bank recorded in a cash book or other record?		
	Is cash in transit recorded as such?		

Sample MFI Internal Control Questionnaire for Online Banking and Fund Transfers

(Note: This template should be tailored to the individual MFI.)

Completed by:______________________________ Date:_______________________
Reviewed by________________________________ Date:_______________________
Meeting with________________________________ Date:_______________________
Other information reviewed____
Branch/Office:________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR ONLINE BANKING AND FUND TRANSFERS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Online Banking		
	Are there policies and procedures for online banking, if it is used?		
	Is there adequate segregation of duties between access to electronic accounts and electronic disbursements or transactions?		
	Do the policies for electronic banking adequately address the need for supporting documentation and approvals?		
	Are printouts of electronic transactions required?		
	External Fund Transfers		
	Are there policies and procedures for fund transfers?		
	Is there adequate segregation of duties between the approval and handling of fund transfers?		
	Do the policies for fund transfers adequately address the need for supporting documentation and approvals?		
	Is anti-terrorism policy applicable, and if so, are policies in place and adequate?		
	Are the mechanisms to monitor compliance with anti-terrorism policies in place and effective?		
	Is the documentation to support anti-terrorism compliance appropriate and adequate?		
	Internal Fund Transfers		
	Are there policies and procedures in place for transfers to and from various branches?		
	Are there policies in place for appropriate levels of		

INTERNAL CONTROL QUESTIONNAIRE FOR ONLINE BANKING AND FUND TRANSFERS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	cash and bank balances in the branches for the purposes of both efficiency and risk mitigation?		
	Are there effective controls over the transfer of funds related to request for funds, approvals of transfers, and actual transfers?		
	Are there periodic reviews of cash and bank volumes and demand to ensure effective cash management?		

Sample MFI Internal Control Questionnaire for Financial Management

(Note: This template should be tailored to the individual MFI.)

Completed by:_______________________________ Date:________________________
Reviewed by_________________________________ Date:________________________
Meeting with_________________________________ Date:________________________
Other information reviewed____
Branch/Office:_________________________________Date:______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR FINANCIAL MANAGEMENT			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Are there written financial management policies and procedures?		
	Are financial reports and indicators used in decision making and financial projections?		
	Is there assigned responsibility for asset/liability management?		
	Is the MFI operating in a highly inflationary environment?		
	Is there a regular calculation of effective interest rates?		
	What is the net interest rate margin?		
	Are appropriate control mechanisms in place to mitigate foreign exchange risk?		
	Is there a relevant and useful forecast of cash needs? Is it regularly updated and useful to managers?		
	Is the annual budget used and updated regularly?		
	Are actual results compared to the budget and cost over-runs identified?		
	Does the MFI actively monitor operating efficiency through ratio analysis?		
	Does the MFI have a mechanism to identify and document common errors and reporting issues?		
	Are there approved policies and guidelines for investments?		

Sample MFI Internal Control Questionnaire for Accounting Policies and Procedures

(Note: This template should be tailored to the individual MFI.)

Completed by:______________________________ Date:_______________________
Reviewed by________________________________ Date:_______________________
Meeting with________________________________ Date:_______________________
Other information reviewed____
Branch/Office:________________________________Date:______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR ACCOUNTING POLICIES AND PROCEDURES			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Are there written policies controlling all transactions? Are they adequate and current?		
	Are there clear and relevant accounting procedures for handling transactions at all levels of operations?		
	Is there an appropriate segregation of duties between accounting and reporting functions?		
	Are appropriate approval levels clearly outlined in the MFI's policies?		
	Is a document storage and control system in place?		
	Have all obsolete forms been destroyed?		
	Are there written policies regarding the purchase, use, and sale of fixed assets?		
	Are purchases and sales appropriately authorized?		
	Are MFI assets physically secure?		
	Is the inventory of assets fully documented (e.g., via a fixed asset register), labeled, and physically verified (at a minimum, annually)?		
	Are there clear guidelines regarding personal use of company fixed assets?		
	Are depreciation policies in place and reviewed from time to time?		
	Are there appropriate procurement policies for goods and services that meet necessary requirements?		
	Are there clear levels of authority for procurement and purchases for branch-level operations?		
	Is there a written policy for loan loss provisions and write-offs?		
	Are the provision policies reasonable?		

INTERNAL CONTROL QUESTIONNAIRE FOR ACCOUNTING POLICIES AND PROCEDURES			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Are loan tracking records reconciled with accounting records on a regular basis?		
	Is the aging account prepared accurately and in a timely manner?		

Sample MFI Internal Control Questionnaire for Financial Reporting

(Note: This template should be tailored to the individual MFI.)

Completed by:________________________________ Date:________________________
Reviewed by__________________________________ Date:________________________
Meeting with_________________________________ Date:________________________
Other information reviewed____
Branch/Office:__________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR FINANCIAL REPORTING			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Is there a master list of all financial reporting requirements specifying their purpose, due dates, responsible person, etc?		
	Are reporting responsibilities included in staff performance objectives?		
	Do the reports present relevant information in a clear format?		
	Is there a "forms book" kept up to date with examples of all forms in current use?		
	Is the current MIS capable of handling the volume of transactions?		
	Are reports accurate and prepared in a timely manner? Are they available to relevant users of the information?		
	Do financial reports follow international accounting standards, as applicable?		
	Are financial indicators prepared and used in management decisions?		
	Is the MIS fully integrated with the accounting system, or is the latter a separate module?		
	Are there effective controls over the reconciliation of data entry and reports from different systems?		
	Is there sufficient security over financial information and system access?		
	Have future system needs, including costs, been analyzed and planned for?		
	Is the general ledger adequate for basic financial reporting (e.g., balance sheet, income and expense		

INTERNAL CONTROL QUESTIONNAIRE FOR FINANCIAL REPORTING			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	statement, cash flow statement)?		
	Is the general ledger reporting system sufficiently robust for relevant branch reporting and monitoring?		
	Are financial transactions processed in a centralized head office or in decentralized branches? Are there adequate controls for accuracy and timing of reports?		
	Are financial reports consolidated regularly?		
	Are there adequate controls and verification of consolidation processes?		
	Do internal financial statements agree with donor reports or other reports for external users?		
	Is there effective reporting from the finance department to senior management about the results, implications, and interpretation of financial reports?		
	Does the system allow for the extraction of supplemental financial data for internal management purposes?		

Sample MFI Internal Control Questionnaire for MIS System and Reporting

(Note: This template should be tailored to the individual MFI.)

Completed by:________________________________ Date:________________________
Reviewed by__________________________________ Date:________________________
Meeting with__________________________________ Date:________________________
Other information reviewed____
Branch/Office:__________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR MIS SYSTEM AND REPORTING			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Is there a master list of all MIS reporting requirements that specifies their purpose, due dates, responsible person, etc?		
	Are reporting responsibilities included in staff performance objectives?		
	Is the current MIS capable of handling the volume of transactions?		
	Are reports accurate and prepared in a timely manner? Are they available to relevant users of the information?		
	Is the MIS used for reporting impact indicators in addition to financial indicators? Do staff clearly understand the importance of these different types of information?		
	Is there adequate control over data entry to ensure accuracy, timeliness, cut-off routines, and verification and/or approval of the data entered?		
	Is there adequate reconciliation between bank deposits, financial reports, and source documentation to ensure integrity of data entry?		
	Is there regular verification of the integrity of the system's internal computations for repayment schedules, loan histories, aging schedule, and loan portfolio reports?		
	Is the MIS fully integrated with the accounting system, or is the latter a separate module?		
	Is there sufficient security of financial information, system access, and passwords for various functions to		

INTERNAL CONTROL QUESTIONNAIRE FOR MIS SYSTEM AND REPORTING			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	ensure segregation of duties?		
	Have future system needs, including costs, been analyzed and planned for?		
	Are transactions processed in a centralized head office or in decentralized branches? Are there adequate controls for accuracy and timing of both reports and data entry?		
	Are consolidations of the database regularly conducted with appropriate IT security, reliability, and integrity?		
	Is there effective reporting and interpretation of the results, implications, and interpretation of MIS reports?		
	Is staff and management understanding of the information in MIS reports adequate for additional analysis and calculations, if necessary?		

Sample MFI Internal Control Questionnaire for Human Resources

(Note: This template should be tailored to the individual MFI.)

Completed by:________________________________ Date:________________________

Reviewed by__________________________________ Date:________________________

Meeting with__________________________________ Date:________________________

Other information reviewed____

Branch/Office:_________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR HUMAN RESOURCES			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Is a human resource policy manual distributed to all employees?		
	Are human resource policies reviewed for compliance with national employment standards?		
	When was the most recent version of the human resource policy manual issued?		
	Is the hiring process clearly defined?		
	Are internal promotions considered first?		
	Are hiring procedures designed to attract honest, competent, and well-motivated individuals?		
	When did the MFI conduct its most recent salary survey of similar organizations?		
	Are termination policies consistent with governmental legal requirements?		
	Are termination procedures consistently followed?		
	Is the MFI's mission statement and statement of core values visible in all offices?		
	Do employees know the organization's mission statement and use it to help guide their actions?		
	Is there an employee code of conduct?		
	Is there a policy of immediate termination for staff fraud or dishonesty?		
	Are clients informed of the communication channels for voicing complaints?		
	Are clients visited on a sample basis to confirm loan balances?		
	Are new staff formally oriented to MFI expectations, policies, and procedures?		
	Are new employees oriented to the MFI culture of		

INTERNAL CONTROL QUESTIONNAIRE FOR HUMAN RESOURCES			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	honesty and zero-tolerance for corruption?		
	Is there a full personnel performance management system for all levels?		
	Does each staff member have objective performance targets?		
	How are the targets monitored and their achievement rewarded?		
	Is there an organizational chart available that clearly shows reporting channels for all staff?		
	Is there a succession policy for all staff?		
	Are confidential and complete personnel files maintained for each employee?		
	Does the policy clearly outline the minimum content of each file?		
	Are exit interviews conducted with departing staff members to determine the reasons for their leaving?		
	Are vacation or termination pay accruals properly recorded?		
	Is there a staff development policy?		
	Are loan officers held responsible for the quality of their own portfolios?		
	Is there a salary incentive plan for loan officers?		
	Do these incentives reward desired behavior?		
	Are there incentive plans for administrative and managerial staff that incorporate portfolio performance?		
	Are incentives adequate to reward positive performance and discourage negative performance?		

Sample MFI Internal Control Questionnaire for General Operations and Controls

(Note: This template should be tailored to the individual MFI.)

Completed by:________________________________ Date:________________________
Reviewed by__________________________________ Date:________________________
Meeting with_________________________________ Date:________________________
Other information reviewed____
Branch/Office:_________________________________Date:______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR GENERAL OPERATIONS AND CONTROLS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Has the organization experienced fraud?		
	What were the conditions that made it vulnerable to fraud?		
	Is there a contingency plan in place to quickly mitigate the damage if fraud occurs?		
	Has the organization experienced theft from external sources?		
	What was done to mitigate the risk of reoccurrence?		
	Has there been an analysis of security needs for each location or branch?		
	Are contracts and agreements for services current and in place? Is there a regular market review of service options and prices?		
	Are all rental leases current and renewed with adequate review and time to plan options?		
	Are documents, contracts, and agreements periodically legally reviewed to ensure their adequacy?		
	Are adequate property and fixed asset insurance in place with a reputable company for all properties? Are the policies periodically reviewed for adequacy and appropriateness?		
	Are physical MFI branches and offices clearly identified, easy to locate, and of basic soundness?		
	Are properties secure against crime (i.e., do they have permanent, solid walls, ceilings, and floors)? Are they located in low-crime districts?		
	Is the gate locked overnight, with adequate security		

INTERNAL CONTROL QUESTIONNAIRE FOR GENERAL OPERATIONS AND CONTROLS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	personnel on site?		
	Are all doors and windows well secured to prohibit forced entry?		
	Are natural disasters rare at the location(s)?		
	Are at least two different keys required to unlock the doors of each building?		
	Are at least two different keys required to unlock the strong room (safe room) door?		
	Is the strong room secured to prohibit forced entry?		

Sample MFI Internal Control Questionnaire for Credit Operations

(Note: This template should be tailored to the individual MFI.)

Completed by:______________________________ Date:_______________________

Reviewed by________________________________ Date:_______________________

Meeting with_______________________________ Date:_______________________

Other information reviewed____

Branch/Office:_______________________________Date:______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR CREDIT OPERATIONS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Does the MFI's mission statement clearly identify its target market and delivery philosophy?		
	Has market research documented that sufficient demand exists for appropriate services?		
	Are loan policies and procedures developed and maintained?		
	Are changes in MFI loan policies appropriately documented and communicated?		
	Do MFI policies define the required content of client files? Is there a checklist?		
	Are the requirements for client eligibility clearly defined?		
	Do the policies outline a method for determining client character?		
	Is there a prohibition against lending to related parties?		
	Is financial analysis conducted for each loan applicant?		
	Do loan sizes automatically increase with each cycle, regardless of the results of financial analysis?		
	Is the financial analysis methodology simple and consistently applied?		
	Are the MFI's loan products designed to meet the needs of the target market?		
	Are its loan products designed to ensure that the best clients do not grow out of the program?		
	Is client training appropriate and effectively delivered?		
	How does the MFI ensure that clients understand all		

INTERNAL CONTROL QUESTIONNAIRE FOR CREDIT OPERATIONS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	loan terms and conditions?		
	Do sufficient guidelines exist for valuing collateral, if applicable?		
	Is the process for seizing collateral consistent with the requirements of local law?		
	Are there adequate policies and procedures for control and disposition of seized collateral?		
	Are clients aware of their rights?		
	Are there established channels for client complaints?		
	Is there a zero-tolerance culture for delinquency in loan repayments?		
	Is there a sharing of client delinquency information among MFIs?		
	Are exit interviews conducted with clients who discontinue the use of the MFI's services?		
	Do at least two people meet all loan applicants and approve all applications?		
	Do loan officers have any discretion in setting loan terms for specific clients?		
	Are the expectations for accurate and timely portfolio reports clearly stated?		
	Is portfolio quality information available by branch and loan officer?		
	Are there standard procedures for collecting delinquent loans?		
	Are loan write-off and rescheduling policies applied on a consistent basis?		

Sample MFI Internal Control Questionnaire for Client Service and Loan Products

(Note: This template should be tailored to the individual MFI.)

Completed by:________________________________ Date:________________________
Reviewed by__________________________________ Date:________________________
Meeting with__________________________________ Date:________________________
Other information reviewed____
Branch/Office:__________________________________Date:________________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR CLIENT SERVICE AND LOAN PRODUCTS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	What percentage of time do loan officers spend in the field?		
	What percentage of clients was visited by someone other than the credit officers?		
	What percentage of clients visit the office on a regular basis?		
	Were any new training products for clients developed during the audit period?		
	Were all new clients visited by more than one person after their loans were distributed?		
	What is the average length of time between loan application and disbursement of funds?		
	How is credit officer time tracked and recorded?		
	Is there an open-door policy for clients to make complaints to managers?		
	Have any customer service surveys or interviews ever been conducted?		
	Loan Products		
	Were any new client loans issued to persons in a new geographic location?		
	Were any new client loans issued to persons in a new business sector?		
	Were any new client loans issued to persons outside the target market?		
	Were any new loan products introduced?		
	Were any loans issued to new or former clients with discretionary terms?		

INTERNAL CONTROL QUESTIONNAIRE FOR CLIENT SERVICE AND LOAN PRODUCTS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Were any loans issued to new or former clients for purposes other than income-producing activities?		
	Are policies and procedures available for new products and were staff clear on how to handle new products?		
	When was the most recent update to loan products made? Were new training materials developed on the new product(s)?		
	Does market research inform new product development?		
	How are new products tested, piloted, and evaluated? Does the process adequately evaluate risks?		

Sample MFI Internal Control Questionnaire for IT Operations

(Note: This template should be tailored to the individual MFI.)

Completed by:______________________________ Date:_______________________
Reviewed by________________________________ Date:_______________________
Meeting with________________________________ Date:_______________________
Other information reviewed____
Branch/Office:________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR IT OPERATIONS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Is a procedure for off-site backup followed at least daily and in a reliable manner?		
	If Microsoft Windows is used, is it updated automatically?		
	Is there a robust and constantly updated anti-virus software, a firewall, and anti-spyware for all computers?		
	Are all employees using the IT system aware of the risks of downloading other software, phishing, and other virus risks from the Internet?		
	Does the institution have a contingency plan in the event of a political event or natural disaster?		
	Is there limited physical access to the IT network and server rooms?		
	Are all network computers password protected?		
	Is there sufficient climate control in the server room?		
	Are all computers reasonably protected from flooding, overheating, or freezing?		
	Are there sufficient procedures or equipment to stop the loss of data or damage to electronic equipment, including computers, from blackouts?		
	Is the IT system sufficiently designed to allow for long periods of loss of connectivity?		
	Are there requirements that all passwords be difficult		

INTERNAL CONTROL QUESTIONNAIRE FOR IT OPERATIONS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	to decipher (e.g., no birthdays, names, etc), kept sufficiently secret, and changed regularly?		
	Is there a hierarchy of access to IT databases (e.g., read, input, authorization, program change access)?		
	Are standard authorization, dual control, segregation of duties, and other internal controls maintained with respect to the IT system?		
	Are there special authorizations for write-offs, exceptions, or corrections in the IT system?		
	Is there sufficient support for the IT system?		
	Does the IT Department sufficiently document its programming and the IT system in general?		
	Are sufficient and easy-to-understand manuals available to all employees? Are they updated regularly?		
	Is the data in the IT systems regularly reconciled and reviewed by a person not responsible for IT, data input, or input authorization?		
	Is there a succession plan for IT staff?		

Sample MFI Internal Control Questionnaire for Changes to IT Systems

(Note: This template should be tailored to the individual MFI.)

Completed by:________________________________ Date:________________________

Reviewed by__________________________________ Date:________________________

Meeting with_________________________________ Date:________________________

Other information reviewed____

Branch/Office:_________________________________Date:_______________________

To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR CHANGES TO IT SYSTEMS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Has the price structure for the supplier's software updates been investigated?		
	Are there sufficient guarantees for any hardware purchased?		
	Is the post-purchase service agreement for the software sufficient?		
	Have the institution's procurement procedures been respected?		
	Was the system sufficiently tested before introduction?		
	Was there a parallel run before the previous system was stopped?		
	Is the new system flexible enough? What controls are there to ensure that hard coding is kept to a minimum?		
	Is the system appropriate for the physical geographic environment and level of competence of staff?		
	Are the new system's report and inquiry capabilities sufficient for the MFI?		
	Does the new system meet any regulatory requirements?		
	Is the new system capable of producing any regulatory reports?		

INTERNAL CONTROL QUESTIONNAIRE FOR CHANGES TO IT SYSTEMS			
	Internal Control Question	**Yes/ No**	**Controls or Comments**
	Will the system be robust and flexible enough to deal with growth, changes in the MFI's strategy, and the introduction of new products or business activities within its lifespan?		
	Does the system include sufficient computer-assisted audit techniques (CAAT's)?		
	Can the system deal with all languages and alphabets used by the MFI?		

Internal Control Questionnaire for Branches—Other

(Note: This template must be tailored to the individual MFI, based on the level of MFI decentralization and assignment of responsibilities to the branches.)

Completed by________________________________Date:______________________

Reviewed by ________________________________Date:______________________

Meeting with ________________________________Date:______________________

Other information reviewed ____

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To be completed by the Internal Audit Department based on a well thought-out review of actual procedures implemented in the relevant branch.

INTERNAL CONTROL QUESTIONNAIRE FOR BRANCHES—OTHER			
	Internal Control Question	**Yes/No**	**Controls/Comments**
	General		
	Is the branch's appearance presentable?		
	Are documents filed in an organized manner?		
	Is there sufficient security at the branch?		
	Fixed Assets		
	Are inventory numbers promptly affixed to the fixed assets themselves?		
	Do the control procedures for fixed assets provide sufficient control to avoid theft or misuse of assets, including assets that have been fully depreciated?		
	Are branch employees aware of the guidelines regarding personal use of company fixed assets and repayment of any damages?		
	Accounting and Administration		
	Are written policies and procedures that cover all branch transactions available to all relevant branch employees?		
	Are there appropriate approval levels in the branch?		
	Does the branch prepare its own budget or does it participate sufficiently in the overall MFI budget process?		
	Are actuals for the branch monitored against the budget and significant variances between budget and actuals		

INTERNAL CONTROL QUESTIONNAIRE FOR BRANCHES—OTHER			
	Internal Control Question	**Yes/No**	**Controls/Comments**
	investigated?		
	Are there sufficient controls over petty cash?		
	Are there sufficient systems to ensure that the branch manager and offices are aware of all legal and internal requirements concerning documents that must be kept in the branch or posted on the wall or provided to the head office?		
	Human Resources		
	Are the procedures for advertising, interviewing, and hiring employees sufficient and fair and will they result in the best employees for the MFI?		
	Are IT regulations respected?		
	Is the system of authorizing, calculating, recording, and documenting employee leave (sick and vacation) sufficient?		
	When employees leave, is there sufficient and timely notification to the head office operational, payroll, and human resources departments?		
	Are employees aware of the head office departments and whom they can contact there if a problem arises that cannot be solved in the regional or branch department?		
	Are all regional employees familiar with the MFI mission statement?		

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Annex 16: Typical Control Objectives of Financial Transactions

Financial transaction procedures are developed and implemented to ensure the fulfillment of the following objectives of MFI operational financial control. Internal audit objectives and procedures are developed to test and verify that the following financial reporting objectives are met.

a. **Transactions and activities shall demonstrate overall reasonableness.** This requires an internal auditor to understand the business operations, context, and environment in which he or she works. The test simply looks at what is logical and reasonable to expect from specific transactions and activities.

b. **Transactions and activities shall be valid.** The operating system must not permit the inclusion of fictitious or non-existent transactions in journals, databases, or other records. This prohibition applies to all valid operating activities that offer financial services.

- All pre-printed forms shall be pre-numbered and kept under the control of the head accountant.
- All transactions entered in the journals must be recorded in numerical order.
- All transactions must be fully substantiated by supporting source documents
- Any changes made to transaction entries must be made by first reversing the incorrect entry and then entering the new one. Entries that have already been posted should not be altered.

c. **Transactions and activities shall be properly authorized. All transactions and activities must be supported by adequate and appropriate documents that justify and support payments.**

Upon approval of the annual budget, the assigned staff person authorizes specific expenditures. These expenditures should remain within the budget by classified categories unless approvals are received for any changes. Supporting documentation and vouchers for transactions that have been paid shall be stamped "Paid" and dated. An MFI's assets can be wasted or destroyed by incorrect or fraudulent transactions.

d. **Transaction records shall be complete.** The system must prevent the omission of transactions from the records. All pre-numbered forms must be accounted for in numerical order, including forms that have been mutilated or otherwise voided due to error.

e. **Transactions shall be properly valued.** Expense reports, invoices, receipts, and other transactions shall be checked for accuracy and initialled by someone other than the person

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preparing the payment documentation. Values should be checked for consistency throughout the recording process.

f. **Transactions shall be properly classified in the records.** The transactions must be entered into the journals with the proper account categories according to the chart of accounts.

g. **Transactions shall be recorded at the proper time.**

- Recording transactions before or after they occur will increase the likelihood of error.
- All transactions occurring in any given month must be recorded in the books during that month.
- Proper cut-off procedures shall be maintained at month end to ensure consistent reporting from month to month.

h. **Transactions and financial reports shall be correctly summarized and aggregated.** Whether the accounting system is manual or automated, adequate controls must be in place to make sure that classification, posting, and summarization is correct.

i. **Financial reports and statements shall fully disclose the relevant information and details** so that readers may make informed decisions and understand organizational risks.

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Annex 17A: Typical Internal Audit Procedures, Definitions, and Illustrations

The following chart defines common audit procedure terms, categorizes the type of evidence that they represent, and illustrates the procedures in a microfinance context.[42]

Terms, definitions, and type of evidence	*Illustrative audit procedure for an MFI*
Analysis means to break down into components and consider in detail. The elements of analysis can then be isolated, identified, and quantified. Quantification may require an auditor to perform detailed calculations and computations. Furthermore, an auditor can document ratios and trends, make comparisons and isolate unusual transactions or contradictions. *(Analytical)*	***Analyze*** budget variances from year to year. ***Analyze*** delinquency trends between branches, loan officers, and loan products to isolate problem areas and issues.
Compare. A comparison of information in two different locations or sources. The instruction should state which information is being compared in as much detail as practical. *(Documentary and Physical)*	***Select*** a sample of expense invoices or receipts and **compare** the unit price in the invoices to those in related service or supply contracts, the supplier's website, or the purchase order details. Compare past operations and past month and trends for expenses, loan interest revenue, disbursements, etc.
Compute. A calculation done by the auditor independent of the client. Normally this is done as part of analytical tests. *(Analytical)*	***Compute*** the ratios for various operating indicators based on the data provided.
Examine. A reasonably detailed study of a document or record to determine specific facts about it. *(Documentary)*	***Examine*** a photocopy of an ID document to decide whether or not it is legitimate. Sample a loan application file to determine whether the supporting documentation and information meets eligibility criteria for clients.
Inquire. The act of inquiry should be associated with the type of evidence defined as inquiry evidence. *(Testimonial)*	***Inquire*** of management and staff whether there are any problem areas, for example, delinquency, client death, or fraud. ***Inquire*** of management whether there are any changes in policies or any new identified risks or problems.
Observe. The act of observation (using the senses—that is, sight and sound) should be associated with the type of evidence defined as inquiry. *(Physical)*	***Observe*** whether staff—operational and administrative—actually implement and conduct processes and procedures as defined and required.
Read. An examination of written information to determine facts pertinent to the audit. *(Documentary and Analytical)*	***Read*** the minutes of a board of directors' meeting to understand key operational decisions and changes. ***Read*** credit and savings policies and procedures to

[42] Adapted from Alvin A. Aerns, James K. Loebbecke, and W. Morley Lemon, 1997, *Auditing: An Integrated Approach*, 5th edition (Scarborough, Canada: Prentice Hall Canada, Inc.).

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Terms, definitions, and type of evidence	*Illustrative audit procedure for an MFI*
	understand the basic operational processes, changes, and controls that have been put in place.

Terms, definitions, and type of evidence	*Illustrative audit procedure for an MFI*
Re-compute. A calculation done to determine whether a client or system's calculation is correct. *(Analytical)*	***Re-compute*** and calculate the reports produced by the MIS to confirm its accuracy. Check the calculations of manually produced reports. ***Re-calculate*** the loan portfolio aging schedule and the allowance account for accuracy. ***Re-compute*** and calculate basic ratios from portfolio reports to confirm their accuracy. ***Re-compute*** a loan repayment schedule to confirm accuracy of the MIS and the schedule's consistency with MFI policies and procedures.
Reconcile. The process of matching two independent sets of records in order to show mathematically, with the use of supporting documentation, that any difference between the two records is justified. For example, the reconciliation of a bank statement balance at the end of the month with the cash balances in the general ledger. *(Analytical)*	***Reconcile*** the balance of loans receivable from the general ledger with loans receivable on MIS reports. ***Reconcile*** the loan principal collected in the general ledger with that recorded in the bank accounts and the MIS reports.
Scan. A less detailed examination of a document or record to determine if there is something unusual that warrants further examination. *(Documentary)*	***Scan*** the portfolio reports and cash or bank journals, looking for large and unusual transactions.
Trace. An instruction normally associated with documentation and correct calculations. The procedure should state what the auditor is tracing and where it is being traced from and to. Tracing usually includes some form of other procedure, such as compare, recalculate, or verify. *(Physical)*	***Trace*** a sample of loan repayments from client receipts to the collection register to the general ledger posting to the MIS loan tracking system posting to the bank deposit slip. ***Trace*** a sample of a savings receipts from client records and passbooks to the MFI accounting records, liability accounts, and individual client accounts. ***Trace*** a sample of loan disbursements from the check in the general ledger to the MIS disbursement list.
Verify or confirm. Confirm with an external party or customer the specifics of a transaction. *(Testimonial)*	***Verify or confirm*** with a client the amount of a loan actually received and the amount of the balance remaining.

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Annex 17B: Sample Audit Procedures and Work Plans

I. SAMPLE INTERNAL AUDIT STEPS FOR PETTY CASH

Sample objectives of the petty cash audit program:

- Verification that policies and procedures for petty cash disbursement and replenishment are in place and followed
- Verification that petty cash transactions are recorded in a cash book
- Verification that the petty cash balance is counted and agrees with the cash book balance by an independent supervisor at the times identified in the petty cash policy
- Verification that petty cash is physically secure, with access restricted to all staff other than the cashier
- Verification that only authorized payments are issued from petty cash
- Verification that valid and genuine transactions are effected with petty cash
- Verification that the petty cash imprest level is appropriate and adequate for the volume of weekly transactions
- Verification that accounting entries to replenish petty cash are accurate

Sample Individual Audit Steps: Petty Cash Verification	Auditor and Date	Reviewer and Date	Comments	WP Reference
1. Verify and confirm that petty cash transactions are authorized according to policy and procedures (amount, type of expense, etc.) and maintained on an imprest basis. 2. Verify and confirm that petty cash disbursements are recorded in the cash book correctly and in a timely manner. 3. Trace a sample of transactions and supporting documents to verify the authenticity of petty cash transactions. 4. Analyze the frequency of petty cash replenishment to verify the adequacy and reasonableness of the petty cash imprest level. *Under normal circumstances, a "reasonable" petty cash level will require replenishment approximately twice a month. This should be weighed against efficiency and*				

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Sample Individual Audit Steps: Petty Cash Verification	Auditor and Date	Reviewer and Date	Comments	WP Reference
the safety of the custodian and the funds. 5. Observe the petty cash custodian conduct transactions and administer the fund. 6. Examine the accounting transactions entered when replenishing petty cash. 7. Confirm that petty cash is kept in a locked, physically secure place (fireproofed and immovable to the extent possible) with restricted access for everyone except the custodian. 8. Verify the procedures and practices that ensure funds are never left unattended or unsecured. 9. Confirm that the petty cash balance on hand is physically counted and compared with the cash book record periodically and in surprise audits. Verify that the reconciliation is signed off and dated by the independent reviewer conducting the count. 10. Verify the process for a change in custodianship. Verify that a cash count, handover, and fund reconciliation are performed and independently reviewed when a change of custodian occurs (e.g., for cases of leave, vacation, new hires, etc.) 11. Confirm that procedures and processes address the matter of lost or stolen petty cash, who should be contacted, and how a loss or theft should be handled. 12. Trace accounting entries to the petty cash account in the general ledger to note unusual patterns or amounts being passed through the accounts.				

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II. SAMPLE INTERNAL AUDIT STEPS FOR CASH ON HAND

Sample objectives of the cash-on-hand audit program:

- Verification that policies and procedures of cash-on-hand disbursement, handling, and deposits are in place and current
- Verification that there is adequate segregation of duties between handling, recording, and approving cash transactions
- Verification that the cash-on-hand balance is counted and agrees with the cash book balance by an independent supervisor at the times identified in the policy for cash on hand (e.g., daily, weekly)
- Verification that there is a cash-on-hand currency record and that it is maintained on a regular basis
- Verification that cash on hand is physically secure, under dual control, and has restricted access
- Verification that there is an approved limit to how much cash on hand is held
- Verification that excess cash on hand is deposited in a bank account
- Verification that the approved limits on cash on hand are adequate for operating purposes, yet efficient and minimal for security purposes
- Verification that valid, authorized, and genuine transactions are effected with cash on hand

Sample Individual Audit Steps: Cash on Hand	Auditor and Date	Reviewer and Date	Comments	WP Reference
1. Verify and confirm that cash-on-hand transactions are authorized according to policy and procedures (e.g., amounts, physical count, type of transactions, transfers, etc.) and that these are current.				
2. Verify that vault cash is under dual control and kept in a secured device that is: o always locked o fireproof *(to the extent possible)* o immovable *(to the extent possible)*				
3. Verify and confirm that cash-on-hand transfers, transactions, and movements to and from the safe are recorded in the cash book correctly and in a timely manner.				
4. Review documents to obtain reasonable assurance that: a. entries in the cash book and on receipts are recorded				

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both in numbers and words

b. figures and words in all entries agree

5. Trace a sample of transactions and supporting documents to verify the authenticity, authorization, and classification of cash-on-hand transactions.

6. Confirm cash-on-hand balances from the records to verify compliance with policies that establish the level of cash held.

7. Observe the cashier conduct a series of transactions with cash at hand.

8. Confirm that the cash on hand is physically counted and compared with the cash book record, both periodically and in surprise counts by an independent reviewer. Verify that the reconciliation is signed off and dated by the person conducting the count.

9. Verify the process for a change in custodianship. Verify that a cash count, handover, and fund reconciliation are performed and independently reviewed when a change in custodian occurs (e,g., leave, vacation, new hire, etc.).

10. Conduct a cash count to verify the physical existence of cash.

11. Verify that all cash in the safe is arranged by denomination, appropriately sealed, and the amount labeled on each bundle.

12. Perform a random check of __% of all cash transactions in the cashbook to confirm that the entries are correct.

13. Trace accounting entries to the cash-on-hand account in the general ledger to note unusual patterns or amounts being passed through the accounts.

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III. SAMPLE INTERNAL AUDIT STEPS FOR CASH RECEIPTS, CHECKS, AND BANK DEPOSITS

Sample objectives of an audit program for cash receipts, checks, and bank deposits:

- Verification that cash paid to the MFI is duly receipted, safeguarded, and recorded in the books of accounts
- Verification that cash receipts are not lost or stolen
- Verification that client repayments are duly receipted and credited to their accounts
- Verification that cash receipts are deposited intact in a bank account
- Verification that cash receipts are recorded daily in the cash journal
- Verification that receipt books are printed in triplicate and sequentially pre-numbered
- Verification that the stock of receipt books is controlled, under lock and key, and that the release of new books and return of filled books are documented in a control register
- Verification that all checks received are stamped "for deposit only"
- Verification that all checks received are deposited promptly in the MFI's bank account

Sample Individual Audit Steps: Cash Receipts, Checks, and Bank Deposits	Auditor and Date	Reviewer and Date	Comments	WP Reference
1. Confirm that all cash receipts are deposited immediately intact and correctly recorded in the cash journal and books of account. 2. Verify that cash receipts are stamped with the branch/organization logo and sequentially pre-numbered. 3. Scan the document control register to analyze the release of new receipt books and return of full receipt books. 4. Examine the sequence of pre-numbered receipt books used in the current period. 5. (If manually issuing receipts), verify whether: a. receipts for cash received and placed in the safe are prepared in multiple copies, with the final copy remaining in the receipt book or filed sequentially				

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Sample Individual Audit Steps: Cash Receipts, Checks, and Bank Deposits	Auditor and Date	Reviewer and Date	Comments	WP Reference
b. receipts in the receipt book are in ascending numerical order 6. Confirm that all currency received is acknowledged with a pre-numbered receipt issued to the payee. 7. Confirm that all checks received are stamped "for deposit only" 8. Confirm that all cash receipts (currency and checks) are recorded daily in the cash journal and the total agrees to a completed deposit slip. 9. Analyze and review the general ledger accounts for unusual amounts, patterns, or trends in transactions and accounts. **On a test basis** 1. Compare the date on a pre-numbered receipt to the date of the corresponding entry in the cash receipts journal and the date of the corresponding bank deposit. 2. Trace cash receipts to the accounting records to confirm accurate accounting treatment in a client's individual account and in the general ledger.				

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IV. SAMPLE INTERNAL AUDIT STEPS FOR DISBURSEMENTS

Sample objectives of disbursements audit program:

- Verification that policies and procedures for cash and check disbursements are in place and current
- Verification that there is adequate segregation of duties between authorizing, making, and recording disbursements
- Verification that appropriate and adequate limits of authority and responsibility are in place for procurement and operating activities
- Verification that valid, authorized, and genuine transactions are effected with cash and bank resources
- Verification that all disbursements are supported by adequate documentation identifying specifications, unit cost, unit order, and total cost
- Verification that controls are in place to prevent fictitious or unauthorized disbursements

Sample Individual Audit Steps: Disbursements	Auditor and Date	Reviewer and Date	Comments	WP Reference
1. Examine disbursement policies and procedures and confirm that they are current and relevant.				
Disbursements by check 2. Examine the sequence of the pre-numbered vouchers used during the period; verify that the document control record for vouchers is updated. 3. Examine the document control record for check stubs; verify that voided checks during the period are documented. Inquire about any sequential check numbers that are unaccounted for. 4. Determine if there has been a change of check signature policy during the period. 5. Analyze any unusual disbursements during the period by reviewing the general ledger and examining supporting documentation and approvals concerning unusual activity.				

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6. Examine the transactions and withdrawals from inactive accounts.				
7. On a test basis, determine whether disbursements from checks: a. have appropriate payment vouchers, original receipts, or supporting documentation b. are in accordance with approved procedures c. are approved by the authorizing individual d. are properly classified for accounting purposes e. invoices are stamped “paid” and dated; signatures for recipients of hand-delivered checks are indicated on loan contracts, payment vouchers, or the dispatch book f. the mailing date is recorded, if applicable				
Disbursements by cash				
1. Examine a sample of transactions from the cash disbursements journal and determine whether: a. cash disbursements have appropriate payment vouchers, original receipts, or supporting documentation b. cash disbursements are in accordance with approved procedures c. cash disbursements are approved by the authorizing individual d. cash disbursements are properly classified for accounting purposes e. invoices are stamped “paid”				
Online banking and fund transfers				
1. Read the policies and procedures concerning online banking for any accounts in the organization; evaluate the relevance, adequacy, and clarity of authorizations and segregation of duties.				
2. Observe staff conducting online banking transactions to confirm that adequate internal controls and segregation of duties are practiced (e.g., administrator of access rights should not be able to disburse funds, one individual should never be able to initiate *and* approve an electronic				

disbursement, electronic transactions should always be supported by proper documentation, etc.).

3. Read the policies and procedures concerning electronic fund transfers, wire transfers, etc.

12 Select a sample of electronic transactions and examine, trace and confirm:

a. authorization was made for all transactions

b. full supporting documentation and approvals accompany each transaction

c. appropriate classification of transactions has been made in the accounting records

d. transactions have cleared the bank accounts as recorded and by the date documented

Compliance with Anti-Money Laundering and Countering the Financing of Terrorism (AML-CFT) guidelines

1. Review the organization's AML-CFT policy, if it exists. Review compliance and other reports related to AML-CFT.

2. Examine contracts and agreements to confirm whether AML-CFT expectations are fulfilled.

3. Evaluate how the organization ensures compliance with the policy (e.g., list checking using a third-party list-checking tool).

1. Review the terms of reference and responsibilities of the compliance officer.

5. Select a sample of transactions to verify whether compliance has been met, tracing from transaction origin to the final checks and balances and reports.

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V. SAMPLE INTERNAL AUDIT STEPS FOR OPENING, MAINTAINING, AND CLOSING BANK ACCOUNTS

Sample objectives of audit program for opening, maintaining, and closing bank accounts:

- Verification of all current bank accounts, names, and balances
- Verification that policies and procedures for opening, maintaining, and closing bank accounts exist, are current, and adhered to
- Verify that criteria for selecting a bank in which to open an account is adequately documented
- Verify that bank services and financial strength are periodically reviewed to identify any new risks
- Verification that changes in bank signatories are made as personnel or responsibilities change
- Confirmation that bank signatories are properly identified to ensure segregation of duties
- Verification that board resolutions or standing orders are in place for the opening, maintenance, and closing of bank accounts
- Verification that communication with banks concerning accounts is clearly documented and maintained

Sample Individual Audit Steps: Opening, Maintaining, and Closing Bank Accounts	Auditor and Date	Reviewer and Date	Comments	WP Reference
1. Verify that all bank accounts of the MFI are recorded in the books of accounts, and that names, account numbers, and balances are confirmed with the bank itself.				
2. Verify that policies and procedures concerning bank accounts are in place and current.				
3. Verify that board policies and resolutions for the operating of bank accounts are in place and guide the opening and closing of accounts and changes in signatories.				
4. Read board minutes to confirm board authorization of the operating of bank accounts.				
5. Analyze the panel of signatories for various accounts to ensure adequate segregation of duties between various areas of responsibility.				

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6. Examine the notices to the bank updating signatories when personnel or responsibilities change to ensure notice, minimized exposure to loss or abuse, and documentation. 7. Read the bank communications file to analyze the adequacy and timeliness of same. 8. Confirm whether loan funds must be banked separately from donor or investment contracts or agreements. 9. Ascertain if the purpose and use of a new bank account is clear and adequately documented. 10. Verify whether criteria for selecting the bank in which to open an account are adequately documented. 11. Verify if ongoing evaluation of the financial condition of the bank is done to assess the bank's stability and minimize organizational risk. 12. Verify if bank services and the MFI's relationship with the bank are periodically reviewed to increase operational efficiency and reduce risks. 13. Inquire and verify whether certain bank accounts that are no longer needed (e.g., due to changes in location, purpose, or use) are closed to reduce unnecessary risk and cost to the organization.				

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VI. SAMPLE INTERNAL AUDIT STEPS FOR BANK RECONCILIATIONS

Sample objectives of the bank reconciliation audit program:

- Verification that policies, procedures, and processes are in place for regular bank reconciliation and that they are adhered to
- Verification that bank reconciliations for all bank accounts are performed monthly in a timely manner
- Verification that bank reconciliations effectively identify unrecorded transactions, errors in recording transactions, errors in bank records, outstanding deposits, and uncleared checks
- Verification that bank issues are duly handled and communicated with the bank
- Verification that there is adequate segregation of duties between the staff performing banking functions (e.g., making deposits, writing checks, signing checks) and performing reconciliations or reviewing and approving reconciliations

Sample Individual Audit Steps: Bank Reconciliations	**Auditor and Date**	**Reviewer and Date**	**Comments**	**WP Reference**
1. Verify that bank reconciliations correctly assure that transactions affecting cash are properly recorded and ensure that unauthorized disbursements are detected promptly.				
2. Verify that bank reconciliations are prepared monthly for every bank account in a timely manner.				
3. Confirm that there is a segregation of staff duties in performing banking functions (e.g., signature authority, deposits, reconciliations, etc.).				
4. Confirm that all deposits in transit cleared the following month.				
5. Confirm whether reviews are conducted of the outstanding check list to detect items more than one month old				
6. Review bank correspondence regarding the clearing and follow-up of outstanding items, bank errors, missing deposits, etc.				
7. Sample a selection of bank reconciliations and examine, calculate, and analyze each one. Compare				

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and confirm bank balances from the general ledger with the bank reconciliations.				

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VII. SAMPLE INTERNAL AUDIT STEPS FOR CREDIT OPERATIONS

A. Internal Audit Steps for Credit Committee and Loan Files

Objectives of the credit committee audit program:

- Verification that the credit committee operates effectively
- Verification of the security of credit data, loan files, and security files
- Verification that loan applications are correctly followed up
- Verification that clients for whom a loan has been rejected are notified promptly and professionally
- Verification that loans granted are registered in the information technology (IT) system and that the filing of the physical loan files is up to date[43]

Sample Individual Audit Steps: Credit Committee and Loan Files	Auditor and Date	Reviewer and Date	Comments	WP Reference

[43] The sample of loans to be audited is taken from the database, then a sample is taken from the physical files to check for loans that exist but are not in the database (i.e., a check for the completeness of the database).

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1. Attend two credit committee meetings to ensure that they are properly run, with the correct members (all of whom are encouraged to participate), and that sufficient analysis has been performed. 2. Verify that there is correct restricted access to the loan files, security files, and the IT system. 3. Verify that the security and loan files are protected against destruction from fire, water, etc. 4. Take a sample of loan applications from credit committee meetings and verify that clients for whom a loan has been rejected were professionally notified within the official time frame. 5. Evaluate whether the rejection of the audited loans was justified. 6. Select a sample of 1 application from 10 different days from the loan application registration and verify that all applications were followed up. Verify that loans that were authorized were registered in the IT system.				
7. From the physical loan files, haphazardly choose 5 of each type of loan and verify that they are correctly listed in the IT database (e.g., client name and loan account number.)				

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VIII. SAMPLE INTERNAL AUDIT STEPS FOR CREDIT OPERATIONS

B. Internal Audit Steps for Individual Loans

Sample overall objectives of the individual loan audit program:

- Verification that only loans with a high likelihood of repayment are granted
- Verification that the MFI has financially and legally protected itself in the event of non-payment of loans
- Verification that the MFI has met its legal responsibilities
- Verification that only loans to legitimate clients are granted
- Verification that the accounting for credit loans and loan-related income is true and fair
- Verification that clients are dealt with in a professional manner
- Verification that the MFI's client credit histories are correctly reflected in the national credit registry

Sample control objectives of the individual loan audit program:

- Verification that only authorized loans are disbursed
- Verification that loans and security have been correctly researched prior to granting loans
- Verification that once disbursed, loans are being reasonably monitored
- Verification that the MFI's policies and procedures are implemented correctly

Sample Individual Audit Steps: Individual Loans	Auditor and Date	Reviewer and Date	Comments	WP Reference

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Sample Individual Audit Steps: Individual Loans	Auditor and Date	Reviewer and Date	Comments	WP Reference
Using interval sampling, choose a sample from the IT loan database.				
Loan File Review				
A. Loan application				
1. Verify that the purpose of the loan in the loan application is the same as in the loan assessment and loan contract.				
2. Verify that the application was dealt with promptly and properly registered.				
3. Verify that the loan application is dated and has been signed by the client and the loan officer.				
B. Loan assessment form				
1. Verify that the amount of the loan is reasonable after analyzing the loan assessment and the loan officer's comments.				
2. Verify that the client, loan officer, and loan supervisor have signed the loan assessment form.				
3. Recalculate the financial information and ratios *(if this process is not automated)*.				
4. Cross check the security in the loan assessment form against the security documents.				
5. Match the credit history and personal details in the loan assessment to the registry's credit report.				
C. Loan contract				
1. Verify that the contract has been signed by the client, loan supervisor, and branch				

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Sample Individual Audit Steps: Individual Loans	Auditor and Date	Reviewer and Date	Comments	WP Reference
manager within their approval limits and stamped by the MFI.				
2. Match the amount, term, security, interest rate, and commissions and fees to the loan assessment and the credit committee meeting minutes.				
3. Verify that the loan amount, location, purpose, and term comply with the MFI's policies and procedures. In particular, verify that the client has met loan criteria.				
4. Verify that the contract is professional and covers the relevant legal bases.				
D. Visit report				
1. Verify that the visit report is up to date, the loan officer has followed the visit policy schedule, and the loan supervisor has been correctly reviewing the visit reports (i.e., at least monthly). Note any variances from the MFI's visit policy.				
2. Verify that the loan officer has made relevant comments and his or her visits to the client have been reasonable under the repayment risk circumstances. Verify that the loan officer and/or branch have reacted correctly to any conditions noted in the report.				
E. Other				
1. Match the client's name, ID number, and signature from the photocopy of the ID card to the contract, loan assessment, loan application, security documents, repayment schedule, and loan agreement terms.				
2. Check that the repayment schedule is signed by the client and loan officer and that the principal amount, installments, interest, commission, insurance, and dates match the loan contract.				
3. Trace the transfer of the net loan principal				

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Sample Individual Audit Steps: Individual Loans	Auditor and Date	Reviewer and Date	Comments	WP Reference
amount (minus commissions and insurance fees) to the MFI's bank statement. Verify the client and his/her bank details against the application form.				
4. Check if a client's business license details are compatible with the loan purpose. Scan the business license photocopy for authenticity. If there is no copy of the business license, evaluate whether this document is expected for this type/size of customer.				
5. If the loan was funded by investor Z, evaluate the environmental impact assessment for reasonableness. Verify that it is properly signed.				
6. Verify that there is a signed, completed checklist.				
7. Interview the loan officer to ensure that he/she is familiar with the client.				
Security File Review				
1. Check that there are legally valid collateral/guarantee documents and that they have been correctly signed and notarized. For jointly owned houses that are held as security, ensure that there is a signed consent form.				
2. Check whether the collateral/ guarantees are reasonable and sufficient to protect the MFI and comply with its policies.				
3. Ensure that collateral has been correctly registered in the MFI's security register and, if held by the MFI, is secured and protected.				
Verification with the IT System/ Database *(will vary depending on the IT system)*				

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Sample Individual Audit Steps: Individual Loans	Auditor and Date	Reviewer and Date	Comments	WP Reference
1. Match the loan account number, principal and installment amounts, interest rate, commission, insurance, and term in the loan contract to the credit database.				
2. Match personal details and the client's credit history with this MFI to the loan assessment. Match the credit history with the client's national credit registry history.				
3. Verify that correct penalty fees have been charged if loan repayments have been overdue.				
4. Verify that the loan is recorded in the correct portfolio at risk (PAR) category.				
Visit to the Client				
1. Check the actual use of the loan with the purpose in the loan contract.				
2. Check the existence of the borrower and that he/she is the actual owner of the business and that the client's most recent address and phone number are correct.				

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3. Confirm the dates of the loan officer's visits and any pertinent comments in the visit report with the client.				
4. Check that financial information in the loan assessment and the environmental assessment (if required) are compatible with the client's situation.				
5. Verify the existence of the collateral (if applicable), its ownership, and that it is reasonably valued, sufficient, and protected.				
6. Interview the spouse or other co-owners to ensure that he/she/they agree to the pledging of assets.				
7. Interview guarantors to verify that their guarantee is bona fide and that they have the capacity to repay arrears if necessary.				
8. Check that the client feels that the loan officer has acted in a professional manner and that no extra payments were requested. If the loan is in arrears, check whether the loan officer has made an unofficial agreement for late or partial repayment of the loan.				
9. Evaluate whether it is likely that the loan's status will change (e.g., be assigned to PAR or begin to be repaid if in PAR). Discuss with loan officer, branch manager.				

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IX. INTERNAL AUDIT STEPS FOR SAVINGS

Sample objectives of the savings audit program:

- Verification that current and relevant savings policies and procedures are in place and adhered to
- Verification that savings transactions are duly recorded in passbooks and MFI records
- Verification that the MFI has met its legal responsibilities with respect to protecting savings by maintaining adequate liquidity balances
- Verification that the accounting for savings and interest expenses related to savings are true and fair
- Verification that clients are dealt with in a professional manner
- Verification that reporting for savings is correctly recorded in detailed accounts and accurately summarized in the financial statements
- Verification that interest is correctly calculated, reported, and accounted for in the financial records

Sample Individual Audit Steps: Savings	**Auditor and Date**	**Reviewer and Date**	**Comments**	**WP Reference**
1. Confirm if there were any formal changes to savings policies, procedures, or interest policies during the audit period.				
2. Verify if the changes were communicated to members and staff. If yes, how was it done? Interview a sample of staff to test comprehension and understanding of updated policies and procedures.				
3. Interview a sample of clients to verify that: a. changes to savings policies and procedures were made b. clients understood the changes				
4. Verify and confirm that client ledger files contain savings AND loan transactions and balances.				
5. Take a sample number of client ledger cards and calculate interest amounts, transactions, and updated balances. Test mathematical accuracy.				
6. Visit a sample of clients and review their				

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Sample Individual Audit Steps: Savings	Auditor and Date	Reviewer and Date	Comments	WP Reference
passbooks, transactions, and updated balances. Determine if they agree with the intermediary's ledger cards.				

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7. If the MFI serves groups, determine if their savings are kept in the group or in the MFI's bank account.				
8. Confirm the policy of liquidity for client savings. Verify that the established amount has been maintained. Identify any increases or decreases in savings liquidity and analyze the cause of changes and any unusual items.				
9. Review a monthly or quarterly savings report. Determine whether there is a detailed list of client savings that agrees with the total provided by the report.				
10. Review the reports submitted to the board audit committee and its members. Determine if these reports are substantiated by detailed lists and correct numbers. Match the amounts in the reports with the trial balances/balance sheets.				

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X. SAMPLE INTERNAL AUDIT STEPS FOR FINANCIAL MANAGEMENT

Sample overall objectives of the financial management audit program:

- Verification that financial resources are used efficiently and effectively
- Verification that asset and liability management (ALM) policies and procedures ensure that resources are on hand to meet obligations
- Verification that ALM policies and procedures ensure that excess liquidity is invested to maximize returns
- Verification that cash planning and forecasting is regularly done and identifies any cash shortfalls well in advance
- Verification that cash balances are monitored on a regular basis
- Verification that the MFI effectively manages its foreign exchange risk, if any
- Verification that the board and senior management has paid adequate attention to financial operations strategy and the monitoring of the MFI's debt and equity mix

Sample Individual Audit Steps: Financial Management	Auditor and Date	Reviewer and Date	Comments	WP Reference
1. Evaluate the organization's ability to reasonably forecast cash flow based on receipts and disbursement needs. Review and examine any tools and spreadsheets used for this purpose. 2. At a minimum, the process of generating a cash forecast should: a. predict the monthly cash position of the organization b. identify short-term cash needs and excess available cash c. minimize potential delays in project implementation due to cash flow problems 3. Determine the organization's skills in: a. knowing the best time to call forward funds from the main office or other donors b. moving excess cash to higher-interest investments c. reducing the risk of loss of funds due to currency devaluation or bank failure				

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4. Review and evaluate the MFI's policies and procedures for financial management, investments, borrowing, foreign exchange risk, interest rate risk, liquidity, and asset and liability management (ALM). Confirm that these policies are current. Verify staff understanding of the policies and their actual practice in financial management. 5. Confirm whether there is an official Asset Liability Committee (ALCO) of the board or among senior management. Confirm the lead committee person's role in asset and liability management. 6. Review and evaluate the indicators, measures, frequency, and adequacy of ALM used by the finance manager or risk officer. 7. Review ALM reports submitted to the board or senior management and evaluate their adequacy. 8. Confirm whether the MFI is affected by foreign exchange risk through borrowing, investment, or other activities. 9. Evaluate whether the MFI monitors its interest rate risk on a periodic basis. Review all reports, indicators, and measurements used to evaluate and assess this risk.				

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XI. SAMPLE INTERNAL AUDIT STEPS FOR ACCOUNTING AND FINANCIAL REPORTING

Sample overall objectives of the audit program for accounting and financial reporting:

- Verification that financial reports are reliable and accurate within reason
- Verification that financial reports are prepared in a timely manner in order to be relevant
- Verification that financial reports are useful and understandable by management
- Verification that operating and financial information and reports are obtained and prepared in an efficient manner
- Verification that financial staff are qualified and competent to prepare and analyze financial information
- Verification that policies and procedures governing the preparation, frequency, and distribution of financial reports are in place, relevant, and current
- Verification that financial reporting to external parties agrees with internal reports generated from the general ledger
- Verification that accounting policies, processes, and procedures are in place, relevant, and current
- Verification that accounting policies and procedures are adhered to consistently
- Verification that accounting procedures and processes are independently reviewed and monitored

Sample Individual Audit Steps: Accounting and Financial Reporting	Auditor and Date	Reviewer and Date	Comments	WP Reference

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Accounting Policies and Procedures 1. Review and examine the MFI's accounting policies and procedures. Interview and observe staff as they conduct their activities to confirm adherence to procedures and their capacity to fulfill their responsibilities. 2. On a test, sample basis: a. Verify that the financial reports and statement balances are supported by and agree with schedules and account analysis. b. Trace selected transactions from source documents, vouchers, and bank transactions through to journals and accounts in the general ledger. Verify that authorization approvals were adhered to and that the account classification is correct.				

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3. Verify that branch managers reconcile all entries with the interest-earned account. Verify that bank account deposits agree with MIS entries for revenue recognition. 4. Verify that a register or passbook is maintained that records all interest earned by clients and/or by the MFI's savings account. 5. Verify whether accrued interest receivable has been recorded in the accounting records. Compare this amount to client loan records. Confirm whether interest is also accrued on delinquent loans and, if so, whether there is a provision established for doing so. Evaluate whether policy and practice are conservative enough to fairly present the receivable as a collectible item. 6. Trace and examine investment transactions to verify that interest is recognized in the books and agrees with investment certificate calculations. 7. Verify that investment documents are physically secure. Verify that only authorized persons make investment decisions and that investment transactions follow policy. 8. Cross-reference and agree the detailed list of prepaid expenses agrees with the MFI's balance sheet. Review prepaid expense account transactions to identify unusual activity and patterns. 9. Sample a selection of prepaid transactions and test for accuracy in making adjustments and expensing various items. 10. Cross-reference and agree the detailed list of staff advances with the associated balance sheet account. 11. Determine (through a sample) if new advances are approved and recorded according to established policies.				

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12. Confirm that staff advances are retired by expense reports or through repayments according to established schedules and/or policy. Confirm that cash is repaid as agreed upon in the policy.				
13. Cross-reference and agree the detailed list of accounts receivable with the balance sheet. Inquire about overdue invoices and follow-up practice. Confirm the follow-up of invoices.				
14. Review and analyze invoices issued during a specific period or take a sample. Trace the original entry, review the approvals on source documents, and evaluate repayment patterns and frequency.				
15. Cross-reference and agree the detailed list of accounts payable with the balance sheet. Inquire about overdue payables and credit terms. Investigate late charges on delinquent payments to vendors.				
16. Review and analyze invoices received during a specific period or take a sample. Trace the original entries, review the approvals on source documents for goods or services rendered, and evaluate repayment patterns and frequency.				
17. Review and recompute deferred grant revenues. Reconcile receipts of deferred grants and the recognition of grant revenue on the MFI's income statement.				
18. Verify and confirm that journal entries are independently reviewed and approved.				
19. Inspect a sample of journal entries to ensure that adequate description of transactions is made, supporting documentation is in place, approvals are verified, and the entries are signed.				
20. Review and examine the payroll voucher and payment details. Re-compute deductions, net payments, and cross-reference with the relevant journal entry and accounting records.				

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21. Confirm that the MFI's payroll is regularly prepared and authorized by the human resources department; verify that changes are promptly updated. 22. Determine if an annual procurement plan is in place, and whether it is monitored and adjusted to ensure the best value when procuring goods and services. 23. Confirm that procedures and controls are in place for the order, control, storage, and disbursement of office supplies. Evaluate whether segregation of duties is adequate. 24. Trace a sample of transactions for office supplies to ensure that goods ordered are received, recorded, and paid as invoiced. 25. Review the system of receiving and storing goods. Evaluate the adequacy of stock. Confirm that stock is locked and safeguarded. 26. Review and evaluate the system of staff access to stationery and supplies. Trace a sample of stationery supplies disbursed to staff, any accompanying documentation, and evaluate the reasonableness of the system. 27. Inquire about off-balance sheet items, contingencies, and other possible items that the organization may be accountable or liable for. **Portfolio Aging Report, Portfolio at Risk ,and Write-offs** 1. Confirm that aging percentages are in accordance with policy. 2. Describe the organization's collection strategy, particularly for delinquent loans. 3. Verify and compute the number and value of loans that comprise the "portfolio at risk." Note: A loan is considered at risk immediately after repayment				

falls into arrears. *(Please list)*				
4. Confirm at what point the organization provides for bad debts (loan loss provision).				
5. Recalculate loan loss allowance and reconcile with balance sheet.				
6. Recalculate current loan loss provision and compare with income statement.				
7. Verify that appropriate approvals have been obtained for all loan write-offs. If write-offs have been made, verify the following: a. cause of the write-off b. write-off authorization and that MFI policy was followed c. write-off was adequately accounted for and reflected in the accounts d. the number and value of loans written-off				
8. Trace and verify the collections of loan write-offs—that is, how they are handled and tracked. Analyze and evaluate whether procedures, supervision, and reporting of collections on written-off loans are adequate.				
Financial reporting				
1. Examine the policies and procedures governing internal and external financial reporting; analyze the adequacy of reporting frequency and its relevance and usefulness.				
2. Confirm that a calendar of required statutory and donor reports is maintained to ensure that reports are filed and/or provided in a timely manner.				
3. Compare and confirm the reliability and integrity of data (i.e., where information in the financial reports came from). a. select sample transactions and trace them from original disbursement or revenue receipt				

to the general ledger to the trial balance to the financial statements (i.e., balance sheet / profit & loss statement)

b. verify how financial information reflected in donor reports and internal management reports was generated. Select sample donor reports and trace figures back to the general ledger and accounts.

4. Confirm that only one set of accounting books is kept by the organization. Investigate whether there is reason(s) to believe that more than one set of accounting books is maintained.

5. Observe and analyze the competence and capacity of finance department staff to manage and control the accounting process and the preparation of financial statements.

6. Interview report users and decision makers about the reliability, usefulness, and adequacy of financial reporting. Analyze any gaps in expectations, capacity, or needs.

Balance Sheet, Income Statements, Portfolio Reports

On a test sample basis:

1. Verify that reports are prepared in proper and understandable formats.

2. Confirm that reports are prepared in a timely manner.

3. Validate and verify the following:

   Assets = Liabilities + Equity (balance sheet)

   Current Year Surplus (income statement) agrees with balance sheet

   Accumulated Surplus / Deficit (income statement) agrees with balance sheet

   All subaccounts total correctly in the balance sheet and income statement

   Branch consolidations—if any—are made correctly

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and inter-company accounts eliminated Portfolio data reports are current and information is detailed to support correct calculation of ratios Aging schedules are provided, accurate, and correctly used to calculate portfolio at risk and a loan loss allowance SEEP or other financial performance ratios for microfinance institutions are prepared and accurate				

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XII. SAMPLE INTERNAL AUDIT STEPS FOR MIS AND MIS REPORTING

Sample objectives of the audit program for management information system (MIS) and MIS reports:

- Verification that the MIS database for the client portfolio is robust, well used, well understood, and produces reliable information
- Verification that the MIS processes data correctly
- Verification that reports are produced correctly as per specifications
- Verification that data entry controls are effective and ensure that transactions are entered accurately and for the correct period in their entirety, and that batch entries are cross-totaled and controlled
- Verification that MIS reports are relevant and useful

Sample Individual Audit Steps: MIS and MIS Reporting	**Auditor and Date**	**Reviewer and Date**	**Comments**	**WP Reference**
1. Confirm the method of tracking loan portfolio transactions—manual, spreadsheet, database. Evaluate whether systems are efficient and secured, and whether they produce timely reports.				
2. Confirm how the loan portfolio tracking system links/reconciles with the official accounting books of the organization.				
3. Cross-reference ending balances of principal outstanding for a selected sample of dates.				
4. Confirm that the system captures the following information: a. identity of client b. amount of loan disbursed c. loan terms d. repayment schedule e. amount and timing of payment received f. amounts and aging of delinquent loan payment g. outstanding balance				
5. Confirm whether the MFI conducts regular checks of the MIS system for integrity and				

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Sample Individual Audit Steps: MIS and MIS Reporting	Auditor and Date	Reviewer and Date	Comments	WP Reference
reasonableness and to ensure accuracy of the portfolio system.				

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6. Interview users about their knowledge of and satisfaction with the MIS and its reports. Observe users during analysis and review of reports.				
7. Confirm the security control features of the MIS system in terms of software, access, back-up procedures, etc. Evaluate the effectiveness of these controls.				
8. Verify the MFI's archiving and records retention policy. Evaluate whether it is reasonable. Confirm whether and how it is followed.				
9. Confirm and examine the types of reports generated by the MIS. Verify who reviews, uses, and approves reports.				
10. Verify whether the database makes adequate segmentation of loans by product, branch, loan officer, re-financing, etc.				
11. Verify the distribution and monitoring of client performance and loan delinquency, other than the loan officers and collectors.				
12. Examine and evaluate how rescheduled and/or restructured loans are monitored in the portfolio tracking system.				
13. Verify how the MFI tracks and uses client credit histories. Confirm how credit histories are used in ongoing credit service and delivery.				

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XIII. SAMPLE INTERNAL AUDIT STEPS FOR HUMAN RESOURCES

Sample overall objectives of the audit program for human resources:

- Verification that human resource policies and procedures are in place, updated, and current
- Verification that human resource management is effective in recruiting, developing, and retaining capable and motivated staff
- Verification that there is a clear policy and relevant disciplinary action with respect to fraud and abuse of office
- Verification that remuneration procedures are competitive and fair
- Verification that staff development and training is effective in building the human resource assets of the organization
- Verification that a performance management process is in place and followed

Sample Individual Audit Steps: Human Resources	Auditor and Date	Reviewer and Date	Comments	WP Reference
1. Interview staff and management to evaluate level of staff satisfaction, participation, and commitment to the organization. 2. List staff actually seen and interviewed during this audit, including: a. titles b. number of persons c. branch manager d. credit manager e. credit agent f. bookkeeper g. cashier 3. Verify that the number of branch staff seen agrees with the head office records for staff at the branch. Identify any discrepancies. 4. Verify whether all employees are aware and in receipt of a human resources policy manual. 5. Compare the MFI's human resources policies with the national employment standard. Confirm any discrepancies in compliance. Highlight areas where				

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organizational policy errs on the side of generosity. 6. Confirm that the hiring process clearly and transparently defines available openings, qualifications, and application processes. 7. Confirm whether internal promotions are considered first. 8. Evaluate whether hiring procedures are designed to attract honest, competent, and well-motivated individuals. 9. Confirm when the MFI conducted its most recent salary survey of similar organizations. Evaluate how the data was used. Review the organization's salary scale. 10. Confirm that termination policies and disciplinary measures are consistent with governmental legal requirements. 11. Select a sample number of files and incidents to determine whether termination procedures were consistently followed. 12. Verify whether the MFI's mission statement and statement of core values are visible in its offices. Interview staff to gauge their understanding of the mission and how it affects their work. 13. Verify and review the employee code of conduct, if available. Review employee-signed copies of the code of conduct. Verify the frequency of employees signing the code. 14. Verify and review whether new staff are given a formal orientation to MFI staff expectations, policies, and procedures. Observe an orientation session and evaluate the adequacy of its content and delivery. 15. Determine how new employees are oriented to the MFI's culture of honesty and zero-tolerance for corruption. Interview recently hired staff and review training and orientation materials to				

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confirm appropriateness and adequacy of the messages.				
16. Verify whether a full personnel performance management system exists at all levels. Select a sample of staff files and review documented steps of the performance management system.				
17. Confirm whether each staff member has established objective performance targets. Evaluate whether they understand and take these targets seriously.				
18. Verify how performance targets are monitored and achievement is rewarded. Interview staff for anecdotal feedback and experiences and compare with management responses.				
19. Review the available organizational chart to verify whether it clearly shows reporting channels for all staff. Identify any incongruent or duplicate reporting relationships.				
20. Confirm whether a succession policy exists for all staff. In case of unexpected absence, confirm that there are alternate individuals on staff to fulfill the individual's work.				
21. Verify that confidential and complete personnel files are maintained for each employee. Confirm the minimum content of each file.				
22. Confirm whether exit interviews are conducted with departing staff members to determine their reasons for leaving. Compute staff turnover during the current and past audit periods.				
23. Verify that there is a policy requiring all staff to take vacations.				
24. Verify whether a complimentary procedure or process exists that is performed by someone outside the group to prevent collusion.				
25. Confirm whether a staff and branch management rotation of duties and responsibilities is in place.				

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Evaluate whether the process is effective, efficient, or confusing. 26. Evaluate whether the current staffing structure and number is appropriate. Highlight areas that should be reduced or augmented. 27. Observe staff and management and the general tone of the office. Describe staff morale. 28. Observe staff in a number of job activities and assignments. Evaluate the adequacy and capacity of staff to perform their job functions. 29. Observe staff and management in a number of activities, meetings, and work assignments. Evaluate whether training or management is the issue in non-performance. 30. Confirm whether a staff and management training program is in place. Review past participation in various trainings and interview staff as to the appropriateness and effectiveness of training opportunities.				

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XIV. SAMPLE INTERNAL AUDIT STEPS FOR GENERAL OPERATIONS AND CONTROLS

Sample overall objectives of the audit program for general operations and controls:

- Verification that assests are safe and secure and that proper conduct in operations is practiced
- Verification that assets and contents are adequately insured against loss and theft
- Verification that the organization has a policy that only loans with a high likelihood of repayment are granted

Sample Individual Audit Steps: General Operations and Controls	Auditor and Date	Reviewer and Date	Comments	WP Reference
Building and premises				
1. Verify that the MFI's offices are physically safe and secure and in low-risk environments.				
2. Confirm that the buildings are secure against crime. (Verify that they have permanent, solid walls, ceiling and floors; and are located in low-crime districts.)				
3. Confirm that the gate is locked overnight, with adequate security personnel on site. Observe staff entering and departing the office to verify that they comply with MFI policy.				
4. Inspect doors and windows to verify that they are well secured to prohibit forced entry.				
5. Confirm that there are at least two different keys required to unlock the door to any MFI building.				
6. Confirm that there are at least two different keys required to unlock the strong room (safe room) door. Verify that the strong room is secured to prohibit forced entry.				
Safe				
1. Review and verify the procedures related to the				

safe or vault, including access, dual control, duplicate safe keys and combinations, access to duplicates, etc. 2. Confirm that the safe is affixed to a wall or floor to prevent its removal. 3. Confirm that safe custodians issue receipts for all cash received and that copies of same are kept in the safe. 4. Confirm that all changes of custodian for the key to the safe and its combination, and the date and time of each change, are recorded in a register. 5. Observe and confirm that there are more than one custodian present when the safe is opened. 6. Confirm the security procedures regarding the opening of the safe (e.g., the main door and the door to the strong room are locked). **Insurance** 1. Review all insurance policies for the MFI's fixed assets, bonds, and buildings. Evaluate the adequacy of coverage. 2. Evaluate whether insurance is used appropriately to transfer risk from the MFI to external parties. 3. Review and confirm the process for obtaining insurance, the service experience of firms, and alternatives for more effective service. 4. Trace the insurance premium payments for correct and accurate accounting and amortization of annual charges. **Fraud** 1. Verify whether the organization has a stated policy on fraud and how it is handled and addressed with clients and staff.				

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2. Interview staff and managers to confirm the number of times that fraud has occurred in their area of operations. Confirm whether and how fraud was handled and reported. 3. Confirm how fraud was identified or brought to the attention of senior management. 4. Verify whether policies or procedures were adjusted effectively after an incident of fraud to reduce its likelihood in the future. **Security** 1. Inspect the physical premises to evaluate the strength of security and any risk thereto. 2. Observe traffic flows through the offices and/or branches, near the offices, and the location of any secured assets (e.g., documents, vault, etc.). Evaluate the risks related to security of the same. 3. Review any security arrangements the MFI has in place for its buildings, staff, or property. **Other** 1. Confirm whether the MFI has any agency agreement with other service providers (e.g., remittance agencies, insurance companies, banks). If so, verify that agreements are current and fully disclosed. 2. Verify that the fees are collected per agreement for these services. Confirm that they are reported and disclosed correctly and adequately. 3. Examine and review the process of updating and entering agency transactions in the MFI's financial records and its MIS client transaction files. 4. Verify whether the MFI issues, restocks, or controls any cards issued to customers (e.g., membership passes, smart cards, ATM cards, etc.). Confirm that adequate procedures and controls are in place and adhered to.				

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Physical Records 1. Inspect and verify that the branch's privileged records (e.g., loan and staff files) are locked in a fireproof cabinet to which only authorized personnel can gain access. 2. Inspect and review the system established to ensure that all loan and personnel files withdrawn are returned. 3. Inspect records and check that they are kept in good condition, and in an orderly manner, to facilitate their easy retrieval. 4. Confirm the MFI's records retention policy and compare it with its contractual requirements or national statutory requirements. Verify that retained records are stored in a secure location to protect them from moisture, dust, and destruction.				

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XV. SAMPLE INTERNAL AUDIT STEPS FOR FIXED ASSETS

Sample overall objectives of audit program for fixed assets:

- Verification that fixed asset policies and procedures are adequate and in place and responsibly safeguard the acquisition, use, and disposal of fixed assets
- Verification that fixed assets are purchased, recorded, and classified with proper approvals and authorization
- Verification that adequate bids and tenders are used in the acquisition of fixed assets
- Verification that disposals of fixed assets follow transparent and fair procedures
- Verification that assets are periodically physically inspected
- Verification that assets are labeled and tracked by location within the organization
- Verification that a fixed asset register is maintained and agrees with the general ledger
- Verification that depreciation policies are in place and adhered to
- Verification that net book value of the MFI's fixed assets is accurately and fairly presented in the financial statements

Sample Individual Audit Steps: Fixed Assets	**Auditor and Date**	**Reviewer and Date**	**Comments**	**WP Reference**
1. Review all policies and procedures regarding the purchase, maintenance, accounting, and disposal of fixed assets and confirm that they are current, relevant, and adequate.				
2. Review and cross-reference the detailed fixed asset schedule or register, agreed total cost, accumulated depreciation, and net book value with the MFI's general ledger and financial statements.				
3. Review invoices for acquisitions of fixed assets and verify that authorizations were made as per policy, and that the assets were capitalized as per policy.				
4. Re-compute the depreciation charges made and verify that depreciation and accumulated deprecation balances are accurate.				
5. Review and analyze the list of fixed assets for inventory verification; confirm condition, location,				

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and existence of fixed assets. 6. Inspect and confirm that assets are labeled. 7. Examine the vehicle and motorcycle log books to determine if all use of fixed assets is documented and utilized by approved persons for approved purposes. 8. Examine and review the maintenance records of vehicles and motorcycles. Cross-reference service records with invoices paid and charged to vehicle repair accounts. 9. Sample invoices for fixed asset purchases and verify that the procurement process was followed, specifications for each purchase were made, and adequate quotations obtained. Confirm that assets were capitalized as per policy. 10. Trace a sample of fixed asset disposals in the general ledger to verify accuracy of the accounting entries. Review the disposal process, including communications, bid process, final paperwork, and disposition of assets. 11. Confirm whether any fixed assets have been lost or stolen during the period of the audit. Review the adequacy of the policy addressing fixed asset losses.				

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XVI. INTERNAL AUDIT STEPS FOR CLIENT SERVICES AND LOAN PRODUCTS

Sample objectives of the audit program for client services and loan products:

- Verification that approved credit policies and procedures are understood and adhered to by credit staff
- Verification that customers are satisfied with the MFI's services and staff
- Verification that adequate client care takes place in order to build loyalty and minimize credit risk
- Verification that adequate market research and planning takes place for new product development
- Verification that the MFI is reaching its targeted clientele
- Verification that the MFI is achieving its mission and objectives

Sample Individual Audit Steps: Client Services and Loan Products	**Auditor and Date**	**Reviewer and Date**	**Comments**	**WP Reference**
Client Services				
1. Inspect and analyze loan officer time records, if available. Identify inefficiencies in time management and opportunities for increasing time with clients.				
2 Interview loan officers about the use of their time to understand the amount of time spent with clients.				
3. Review all training and marketing materials provided to clients to determine tone, adequacy, and frequency of messaging.				
4. Observe a client training session to verify the adequacy of MFI communication with clients and their understanding of MFI messages.				
5. Interview a sample of clients to: a. analyze feedback on the MFI's customer service b. confirm and gauge their loyalty and likelihood of repeat business				
6. Interview clients to determine the frequency of MFI visits, by whom, and post-loan follow-up.				
7. Confirm with clients and client				

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Sample Individual Audit Steps: Client Services and Loan Products	Auditor and Date	Reviewer and Date	Comments	WP Reference
documentation the length of time between loan application and disbursement of loans.				
8. Review any supervisory logs documenting client visits by supervisors or branch managers.				
Markets and Products				
1. Interview staff in order to understand and determine their understanding of market research and its overall adequacy, as well as planning for expansion and/or new products.				
2. Review updates to credit policies and procedures to verify their relevance and staff understanding of same.				
3. Review all new product processes and policies to verify staff understanding of same.				
4. Observe staff training sessions or materials to determine the adequacy and details of new product orientation and processes.				
5. Verify whether loans issued to clients in new geographic locations were within approved policies.				
6. Interview a sample of clients to identify and understand their product needs and preferences.				
7. Interview a sample of clients to determine that MFI product processes and procedures were followed.				
8. Interview a sample of clients to determine whether loans reasonably meet the capacity to repay criteria.				
9. Interview a sample of clients to determine whether loans were used as intended, as per their loan applications.				
10. Interview a sample of clients to determine				

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Sample Individual Audit Steps: Client Services and Loan Products	**Auditor and Date**	**Reviewer and Date**	**Comments**	**WP Reference**
the socioeconomic impact of MFI services and products.				

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XVII. INTERNAL AUDIT STEPS FOR INFORMATION TECHNOLOGY

Sample objectives of the audit program for information technology (IT):

- Verification that policies and procedures for IT maintenance and management are in place and functioning
- Verification that backups are made and stored as scheduled
- Verification that access to hardware is limited, as per policies and procedures
- Verification that the system configuration for IT is mapped and updated throughout the MFI
- Verification of the adequacy of the physical environment for IT equipment
- Verification of system security from viruses, hacking, and spyware
- Verification that segregation of duties and internal controls are in place for approving, accessing, and updating hardware and software
- Verification of competent management, staff adequacy, and succession planning

Sample Individual Audit Steps: Information Technology (IT)	**Auditor and Date**	**Reviewer and Date**	**Comments**	**WP Reference**
1. Review the MFI's IT policies and procedures, and any updates thereto.				
2. Interview staff to determine their role in the IT department and their understanding of its policies and procedures.				
3. Observe department activities and operations to verify staff understanding of procedures.				
4. Review backup logs, schedules, and registers to verify frequency of backups, signatories, and approvals.				
5. Inspect onsite storage of backups to verify and cross-reference with the log.				
6. Review the system configuration map of all IT in the institution and verify when it was last updated.				
7. Inspect the physical environment to ensure that dust, moisture, and temperature are controlled.				
8. Inspect power and electricity sources to				

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Sample Individual Audit Steps: Information Technology (IT)	Auditor and Date	Reviewer and Date	Comments	WP Reference
ensure adequacy of uninterrupted power.				
9. Interview staff to understand their roles within the department and verify adequate segregation of duties.				

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10. Review documents and procedures outlining the system by which passwords are allocated, how the system is maintained, and verify if these procedures are implemented and up to date.				
11. Verify that passwords are difficult to decipher, kept sufficiently secret, and changed regularly.				
12. Verify that there is a hierarchy of access to databases and IT system controls (e.g., with respect to read, input, authorization, and program change functions).				
13. Interview staff to understand the system of planning updates to databases, servers, and systems.				
14. Analyze the adequacy of planning processes, pilot periods, parallel runs, and full implementation of any IT changes.				
15. Inspect anti-virus, firewall, and spyware documentation and verify the frequency of updates.				
16. Review the incident log to determine the frequency of problems, outages, and/or system failures.				
17. Review all IT support agreements to verify the adequacy and relevance of support.				
18. Verify the operating system used and frequency of updates thereto.				
19. Evaluate the adequacy of system protection, given its activity and use.				
20. Interview staff to evaluate their capacity and competence to manage their work.				
21. Review staff succession plans for the IT department, if available.				
22. Interview staff and review documents to verify levels of authority during staff absences.				

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Annex 18: Internal Audit Working Papers Template

Note:

- All audit work and evidence must be clearly documented. A "**permanent**" file is usually kept on hand to record information that does not change frequently. It includes the MFI and branch profiles and key information. This includes the strategic plans, policies and procedures, regulatory guidelines, and other relevant policy documents that do not change from year to year.
- A **"current working file"** contains a record of actual work done, samples collected, findings, interview notes, questionnaires, and conclusions. The table samples and illustrations that follow should be prepared using the table function in Excel or Word for Windows software. These tables track the samples collected and information on the selection that is necessary to draw conclusions. The individual cells should be filled in, ticked off (okayed), or referenced to a working paper (e.g., photocopies, scanned articles, findings etc.). Numerical values are useful for quantifying results of audit work. The auditor and reviewer should date and sign off a worksheet when it is completed. Documentation of the internal audit is critical—without a record of the audit, there will be no trace of the work that has been done. The external auditor or other internal audit team members should be able to follow the work very clearly.
- The columns in the illustrations below should be adapted, depending on the purpose and procedures of a given internal audit.
- Any and all audit findings should first of all be clearly understood, clarified, and explained by operational staff. Many times a "finding" may not be a finding at all. Rather, ot may be a misunderstanding, a detail requiring clarification, or a well-justified item.

`

Illustration A: Sample Template for Detailing an Internal Audit Sample

Audit title – Audit #: ____________________________ **Document Ref. #:**____________________________

MFI: _________________________

Audit Area: __________________

Branch: ______________________

Dates: _______________________

Table A18.1 Sample details

Sample #	*Client or ref #*	*Name / description*	*Amount*	*Date of transaction*	*MFI staff*	*MFI staff approved*	*Comments*	*Date of Review*

`

Auditor:___________________

Reviewer:_________________

`

Illustration B: Sample Template for Internal Audit of Individual Loans

	Document Ref. #:
Audit title – Audit #:	Period under review :
Prepared by:	Date :
Reviewed by:	Date :

Table A18.2 Individual Loan Audit Checklist

Audit Steps /Loan Account Number	**346897**	**789378**	**878979**	**159382**	**564303**	**487387**	**129830**	**302983**	**912039**	**872093**	**756908**	**198390**	**653873**
Loan application (steps 1–3 below)	OK												
Loan sssessment													
1. Reasonable	OK												
2. Financial ratios	OK												
3. Signed	OK												
4. Security agrees	OK												
5. Credit report	OK												
Loan contract													
1. Signed, dated, stamped	OK												
2. Agrees with CC minutes	OK												
3. Agrees with policies	OK WO												
4. Professional	OK												
Visit report													
Timeliness, review	1)												
Reasonable	1)												
Other													
1. ID details match	OK												
2. Repayment sheet	OK												
3. Bank transfer	OK												
4. Government docs	OK												
5. Environmental	n/a												

`

Audit Steps /Loan Account Number	**346897**	**789378**	**878979**	**159382**	**564303**	**487387**	**129830**	**302983**	**912039**	**872093**	**756908**	**198390**	**653873**
impact													
6. Checklist	OK												

`

7. Loan officer familairity	OK												
Security file													
1. Correct docs	OK												
2. Reasonable	OK												
3. Correctly registered	OK												
IT system													
Agrees with loan contract	OK												
History and personal details	OK												
PAR and penalty	OK												
Client visits													
Steps 1—3 below	OK												
Financial compatibility	OK												
Collateral	OK												
Spouse agrees	OK												
Guarantors	OK												
Loan officer has prof. manner	OK												
Evaluation	OK												

Notes: WO – Women only, LO – loan officer; n/a – not applicable.

Note: Some related steps are grouped together in the above table so that the table did not become too unwieldy. The most important steps (such as evaluating the reasonableness of a loan) should always be shown separately.

The above steps can be supplemented by tests that do not apply to individual loans. Once again, these should be customized to the procedures of the credit department of the MFI being audited.

`

Illustration C: Internal Audit Steps for Loan Criteria Evaluation

Date: ______________________________ **Prepared by:** ____________________

Audit title – Audit #: _________________ **Approved by:** ____________________

Document Ref. #: ___________________

Table A18.3 Loan Criteria as of Sept. 1, 2008 (see Auditor XXX if any problems)

Type of loan	*Max/ min amount*	*Max/ min term*	*Authoriztn. signing*	*Annual Interest Rate*	*Fee*	*Collateral/ guarantee*	*Policy Ref.*	*Other*
Group Type A	1,000–5,000	6 mos–2 yrs	LO, LS	12	n/a	Group guarantee	3.2, 3.5, 3.7 (pgs 20-22)	Funded by NGO X, for women only
Group Type B	1,000–5,000	6 mos–2 yrs	LO, LS	18	1%	Min 50% coll. (see CrPol pg 26. 4.4.1)	4.2, 4.4, 4.8 (pg 25-27)	
Individual Type A	3,000–10,000	6 mos–2 yrs	BM	15–18	2%	150%	5.1, 5.3 (pg 30-35)	
Indiv Type A > 10,000	10,000–30,000	1 yr–3 yrs	BM, Deputy, HOCM	15–18	2%	150%,	6.1, 6.3 (pgs 39-41)	Only after first loan cycle successfully completed
Individual Type B	20,000–50,000	1 yr–3 yrs	BM, Deputy HOCM	14–20	1%	*details*	7.1, 7.3 (pgs 43-45)	
Business	20,000–100,000	3 mos–5 yrs	BM, HOCM	12–20	1%	*details*	8.1, 8.3 (pgs 47-49)	

Note: LO – Loan Officer, LS – Loan Supervisor, BM – Branch Manager, HO – Head Office, CM –Credit Manager; CrPol – Credit Policy.

This table is intended for auditors to use as a handy reference. It can be used for a variety of audit procedures, including internal audit steps undertaken for the Credit Committee, as well as many audit procedures for credit operations. It is important to put the date on the sheet, as criteria and policies will change over time. One auditor should be assigned responsibility for updating the reference sheet. If reference sheets are used only intermittently, they can be included as a regular part of the permanent file.

`

Reminder: All lists in the left-hand columns of the tables and completion of the cells below the top row are examples only. The audit steps and tables should be customized by the audit team to match a given MFI's credit procedures.

`

Annex 19: Sample Internal Audit Findings Form

Document Ref. #: ________________

Finding No.____

<table>
<tr><td>Date:</td><td colspan="2"></td></tr>
<tr><td>Auditor:</td><td colspan="2"></td></tr>
<tr><td>Findings:</td><td colspan="2">This section should contain a clear and concise statement of the condition.</td></tr>
<tr><td>Causes:</td><td colspan="2">Who ? What? Why ?</td></tr>
<tr><td>Consequences:</td><td colspan="2">In terms of cost, adverse performance, or other factors. What is the impact on services, money, or people?
The auditor should document analysis of the problem in this section. References to applicable standards and/or procedures should be included. This section should not contain information that is redundant to that found in the working papers.</td></tr>
<tr><td>Recommendations:</td><td colspan="2">This section should include the corrective action(s) to be recommended to the auditee and answer the following questions :
• What should be done?
• Who should do it?
• When should it be done?
Recommendations should also be classified by level of priority: major, intermediate, minor
• "Major" qualifies mandatory actions to be implemented immediately
• "Intermediate" qualifies mandatory actions to be implemented within 30 days
• "Minor" qualifies operational and administrative improvements to be implemented within 60 days</td></tr>
<tr><td>WP reference or method of identification of the finding:</td><td colspan="2"></td></tr>
<tr><td>Responsible Dept.:</td><td colspan="2"></td></tr>
<tr><td>Management Response</td><td>Acknowledgement of finding</td><td>Dept.
Date:</td></tr>
<tr><td>Comments:</td><td colspan="2"></td></tr>
</table>

<table>
<tr><td colspan="3">Disposition of this finding :</td></tr>
<tr><td>DATE</td><td>STATUS OF FINDING</td><td>COMMENTS</td></tr>
<tr><td></td><td>Dropped for lack of materiality</td><td></td></tr>
<tr><td></td><td>Dropped due to time constraints</td><td></td></tr>
</table>

`

	Dropped as a result of additional information being developed	
	Deferred for future development	
	Included in draft report	
	Included in final report	

`

Annex 20: Sample Internal Audit Exit Meeting Memo

Document Ref. #: ________________

Table A20.1 Exit Meeting Findings, Management Responses, and Agreed Action Table

Audit	**Branch or City, Date***			
Finding No.	*Finding*	*Recommendation*	*Agreed action/ ** Management response*	*Audit action/ Follow-up date***
xx*	Insurance for collateral/security has expired	Table be prepared to remind credit department when insurance must be renewed	*Table to be prepared by DATE*	*DATE*
xx*	Security risk from holders of ATM cards and PINs	Guardian of ATM PINs should be moved to credit area	*Rejected: would be too cumbersome for clients to go to two buildings.*	*To be discussed with senior management*
xx*	No permanent key register	Branch should have permanent key register (policy no. xxx)	*Permanent key register does exist.*	*Agreed, finding removed.*

Notes: * Suggestions for how the table should be filled out.
** Italics denote examples that would be noted in writing at the exit meeting.

Date____________________

________________________________ ________________________

`

Signature Branch/Department Manager

Signature Lead Auditor

`

Annex 21: Sample Internal Audit Report Templates

Writing the Internal Audit Report and Making Recommendations

This annex provides two clear and concise formats for writing an internal audit report. The purpose of writing the report is to ensure that people read it—and the report style and following format do just that. The report outlines the time period of the audit, the areas covered, and the samples and transactions tested. It goes on to highlight key findings in the area concerned, the risks that those findings reveal, and recommended steps to correct the situation.

The report is signed by the person who writes it and by the person who receives it. This procedure ensures that the communication of the audit work and recommendations is complete and that accountability is clear.

Writers are urged to remember that a written audit report should contain no surprises or uncertainties regarding information. Branch and operational staff should already been verbally debriefed and all outstanding questions and issues clarified. Management should have reviewed the report and incorporated their comments and responses. This is a normal process, it reflects the ownership and participation of senior management in the internal audit process. Some MFIs include this section in the audit report itself as a response from the branch management team.

Follow-up on Previous Reports

The follow-up component of an internal audit is important from a risk management perspective (i.e., it is a risk management feedback loop) and as a communications channel in the overall internal control system. Both internal audit work and an internal audit report include a component regarding follow-up on previous audits and recommendations. The auditor files his or her report with senior management and the board audit committee; who, by virtue of their communication with the executive director, ensure that operational recommendations are made to correct the problems and risks identified in the audit. The executive director is ultimately responsible for ensuring that branch and operational staff implement changes and improvements to policies and procedures in order to strengthen internal controls.

In subsequent audit work, the internal auditor verifies the progress toward implementing these changes. This is a critical part of the risk management feedback loop and an independent check and verification for the board that risk management efforts are implemented in the MFI.

The final section of the audit report provides an opportunity for reporting on previous reports and recommendations. Recommendations or changes that have not been implemented should be included in this section and highlighted to senior management and the board audit committee. Many MFI internal audit departments provide a quarterly report on their activities (including recommendations made) to the board and senior management.

`

SAMPLE INTERNAL AUDIT REPORT: TEMPLATE A

Branch/Office: ______________________ **Date(s) of Audit:** ______________
Office: _______________________ **Auditor:** _____________________

Document Ref. #:_______________

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 ______________ ______________

4) Loan files ______________ ______________

5) Savings ______________ ______________

List other audit work programs:

`

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
Management Comments:			
Management Comments:			

<table>
<tr><th>KEY ISSUES</th><th>FINDINGS</th><th>RISK</th><th>RECOMMENDATIONS</th></tr>
<tr><td colspan="4"></td></tr>
<tr><td></td><td></td><td></td><td></td></tr>
<tr><td colspan="4">Management Comments:</td></tr>
<tr><td></td><td></td><td></td><td></td></tr>
<tr><td colspan="4">Management Comments:</td></tr>
<tr><td></td><td></td><td></td><td></td></tr>
</table>

<table>
<tr><th>KEY ISSUES</th><th>FINDINGS</th><th>RISK</th><th>RECOMMENDATIONS</th></tr>
<tr><td></td><td></td><td></td><td></td></tr>
<tr><td colspan="4">Management Comments:</td></tr>
<tr><td></td><td></td><td></td><td></td></tr>
<tr><td colspan="4">Management Comments:</td></tr>
</table>

`

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

`

SAMPLE INTERNAL AUDIT REPORT: TEMPLATE B

Document Ref. #:_____________

NAME OF AUDIT

MONTH YEAR

DISTRIBUTED TO

`

Document Ref. #: ________________

AUDIT NAME
AUDIT REPORT

TABLE OF CONTENTS

`

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.

`

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:

`

- 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

`

Annex 22: Sample Internal Audit Management Responses

A management response assumes 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: _____________________________

`

Annex 23: Sample Transmittal Cover Letter/Email for Internal Audit Distribution

AUDIT REPORT TRANSMISSION EMAIL

(NAME OF AUDIT) –.

Dear ___________:

The Internal Audit Department has completed an audit of the _______________ (account no., if applicable) of the (department/branch/location) on (date).

The audit's objective was:

-
-
-
-

The report, attached for your review, concludes that ________ (e.g., the internal controls over the ___________ are adequate/inadequate to provide management with reasonable assurance that ____________ and that procedures as prescribed in the _____ manual are correctly implemented) except for the findings presented in the body of the report.

Copies of the report are being provided to the executive director and the relevant senior manager in order to enable them to implement concurrently the recommendations made by the report. The views of the branch manager/senior manager on individual recommendations and the actions to be taken, together with time limits for the latter, are attached in annex ____.

`

Annex 24: Sample Internal Audit Recommendations Follow-up Report

MFI Internal Audit Follow-up Tool: 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 TOOL: TEMPLATE B

Document Ref. #: ________________________

Audit Name: ________________________________

Prepared by: _______________

<table>
<tr><td colspan="2">MFI – INTERNAL AUDIT DEPARTMENT

AUDIT RECOMMENDATION STATUS REPORT</td><td colspan="3">MFI Department/Branch:

Audit Report No.</td><td>Quarter Ending:</td></tr>
<tr><td rowspan="2">Rec.No.</td><td rowspan="2">RECOMMENDATION/RESPONSE
Print/Type Recommendation, if response is required, place directly below applicable recommendation

Enter audit recommendations number as shown in the audit report</td><td colspan="3">STATUS

Check appropriate column</td><td rowspan="2">IMPLEMENT. OR TARGET DATE
Enter date implemented or the target date for implementation</td></tr>
<tr><td>Implemented</td><td>Partly Imple-mented</td><td>Not Imple-mented.</td></tr>
<tr><td></td><td></td><td></td><td></td><td></td><td></td></tr>
</table>

`

Annex 25: Sample Internal Control and Audit Steps Targeting the Prevention and Detection of MFI Fraud

Note: This list does not include all possible frauds, but concentrates on those that are harder to detect or prevent or are specific to a microfinance institution.

Fraud risk	What to look for and where (detective)	What MFIs and banks can do (preventive)
Loan Fraud		
Loan officer creates ghost clients; uses new loans to repay loan installments	• Conduct spot checks and surprise visits to clients to verify that they exist and to verify their loan balances • Regular analytical review in the case of any increase or sudden delinquency in one area, follow up unusual patterns with extra client visits • Regular analytical review of loan officer's portfolio for any unusual increase, extra client visits • Analyze and investigate any delinquency, particularly clients that pay well in the beginning of the loan, but not toward the end • Verify copy of ID in loan files • Check that all client signatures match each other and ID cards	• Require copies of ID cards • Periodically ensure that the administrative assistant deals with and/or meets clients • Branch manager should meet the client (note that the operations department admits that implementation of this control is not strong) • Branch manager occasionally and in secret visits clients unannounced
Loan officer makes loans to family members, which is not allowed under MFI loan policy	• Check ID cards and addresses • During spot check client visits, check on relationships	• Branch manager should meet the client (note that the operations department admits that implementation of this control is not strong)
• Loan officer requires payment from client before granting loan	• During visits to or contact with clients, check on quality of service	• During branch manager visits or contact with clients, check on quality of service

`

Fraud risk	What to look for and where (detective)	What MFIs and banks can do (preventive)
	• Contact a sample of loan applicants that were not granted loans and query them about the quality of service	
• Client is a "front" for the loan officer or another client	• Investigate any client that is not at a business during a spot check • Check that the branch manager's visits are really in secret	• Branch manager occasionally visits clients unannounced and in secret
• Client pledges collateral to several financial institutions	• Comparison between loan granted and expenditures when visiting client	• Comparison between loan granted and actual home improvements undertaken or business investments, etc., when visiting client • Note: there is no collateral registry
• Client uses someone else's goods as collateral	• Surprise spot checks during and immediately after disbursement, including photographs of stock	• Unannounced visits by loan officers/branch managers to "check how client is doing"
• Client presents false home ownership papers/ false letter from refugee camp manager or ownership papers from local authorities are unreliable	• Unannounced visits • Ask neighbors • During audit, check ownership with databases of local authorities for a sample of clients	• Check papers for quality, irregularities • Ask neighbors • Require supporting documentation when local council documentation is unreliable • Unannounced visits
• Client takes credit from several financial institutions	• Review of loan application for reasonableness • During spot check, check improvements, business investments, etc., compared to loan granted	• Comparison with loan granted and expenditure when visiting client
• Client uses loan for another purpose	• Spot checks • Check loan application for reasonableness, care	• Spot checks • Check loan application for reasonableness, care

`

Fraud Involving Administration		
Purchase of equipment at higher-than-market prices, receiving a kickback	• Check all fixed asset invoices for reasonableness • Do occasional independent market checks of fixed assets, recurring operating costs • Verify quote system and procurement committee authorization for purchases	• Purchases are reviewed by an independent employee for reasonableness • Procurement committee must approve purchases • Payment by bank transfer or check
• An employee "borrows" from the cash fund for the week-end, intending to repay it on Monday morning	• Conduct regular and surprise cash counts of the petty cash fund	• Restricted access • Periodic checks by supervisor
MFI Financial Statement Manipulations or Fraud		
Fictitious revenues: • Recording interest payments that have not been received • Creating or manipulating transactions to enhance reported earnings (e.g., adjustments of client savings to repayments, improper recording of prepayments, interest accruals without proper provisions, etc.) • Fabricating revenue by creating fictitious or phantom clients and loans	• Know the business and the industry • Utilize skepticism • Examine documentation (especially around reporting period dates – check all journal adjustments and entries to interest revenue, all loans disbursed around reporting period end, ensure documents are genuine originals, and have not been tampered with) • Verify client disbursements through physical checks and client receipts around the reporting dates	• Ensure clear accounting and recording procedures are in place for every type of revenue adjustment, principal adjustments, and all receipts • Ensure all accounting adjustments have supporting documentation and are approved by appropriate authority
Timing differences: • Recording revenue and/or expenses in improper period • Early revenue recognition • Delayed reporting of expenses • Holding the books open after the reporting date If the MIS and the general ledger are not linked or	• Determine whether the books were left open • Check all invoices and transactions in the months immediately before and after the reporting date • Check whether transactions were treated consistently around the reporting period end • Check to make sure that any	• Ensure clear accounting and recording procedures are in place for every type of adjustment, capital purchase, depreciation, and expense payment • Search for unrecorded liabilities and examine payment activity • Ensure all accounting transactions have supporting documentation and are regularly reviewed and adjustments are approved by

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integrated, entries can be made to one system in one period, and in another system in the second period • Capitalizing expenditures that should be expensed • Depreciating or amortizing too slowly • Premature expense recognition	and all unusual adjustments or transactions are fully supported by documentation • Observation and enquiry • Review document sequence; vouching • Expense and payment analysis • Examine capitalization and depreciation policies; recalculate depreciation	appropriate authority
Concealed liabilities or expenses: • Unrecorded liabilities that inflate the equity position on the balance sheet or increase net earnings • Understand the actual liability • Failure to record or disclose contingent liabilities and guarantees, including third-party guarantees • Reporting revenue rather than liability when cash is received	• Perform a search for unrecorded liabilities—go through files or follow month transactions and disbursements • Trace amounts to accounts payable sub-ledger on the balance sheet date • Examine open invoice files to see that all invoices are recorded • Confirm liabilities with vendors and third parties	• Ensure clear accounting and recording procedures are in place for every type of adjustment, capital purchase, depreciation, and expense payment • Search for unrecorded liabilities and examine payment activity • Ensure all accounting transactions have supporting documentation and are regularly reviewed and adjustments are approved by appropriate authority
Failure to disclose contingencies or post-balance sheet events • The MFI is fearful that contingencies or post-balance sheet events have created negative events (e.g., fraud, legal action or lawsuit, merger, due diligence, staff departures, natural disasters, huge rise in delinquency)	• Management enquiry • Review of board meeting minutes, management meeting minutes • Make confirmations with legal counsel • Examine legal or professional expense accounts • Perform litigation search	• Create a risk management committee of the board • Establish policies and practices of good board governance and management that promote transparency and accountability
Improper disclosure Improper disclosure of accounting methods and policies, or changes in	• Examine board minutes • Management and board inquiry • Examine details of all loans, agreements, memoranda of	• Board must establish policies and practices of transparency, accountability, and good governance • Internal auditor must have clear

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policy • Inadequate disclosure of relevant information – both in the financial statements and the notes to the financial statements (e.g., significant events, liability omissions, contingent liabilities) • Improper disclosure of related-party transactions related to share or dividend transactions, liabilities, or inter-company transactions (e.g., a holding company, parent NGO, etc.)	understanding, related-party agreements and transactions • Examine large and unusual year-end or near year-end transactions	reporting lines to the board audit committee and submit regular internal audit reports, management responses, and follow-up of recommendations and issues
Improper asset valuation • Over-valuing loans receivable—the largest asset of an MFI (highest risk for an MFI) • Understating the allowance for loan losses by having a policy that is not related to the quality of the portfolio or the history of write-offs • Reluctance to write-off loan losses, thereby overstating gross portfolio • Overstating accrued interest receivable without adequate provisions	• Examine all portfolio policies, including allowance, provisions, and write-offs • Review all year-end aging reports; recalculate and verify aging categories and the amount recorded as the allowance • Review all write-offs made during the year • Review all accrued interest entries; ensure adequate provisions are in place for accrued interest on late loans • Select a sampling of clients by loan size and area and verify amounts disbursed and loan balances with clients	• Ensure all policies in place are appropriate, adequately conservative, reviewed regularly, and implemented in the accounting for the loan portfolio • Risk management committee or appropriately designated management should lead annual review to ascertain whether policies are adequate and reflect operating experience, historical trends, and current environmental issues
Over-inflated assets / Loans receivable Assets appear higher than reasonable • Portfolio at risk appears lower than it actually is because a high volume of	• Review all monthly disbursements by budget to observe both over- and underbudgeted activities	• Prepare monthly and quarterly disbursement plans for all branches; monitor the actual monthly amounts for unusual trends and patterns

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new loans (without any delinquency) have been issued just before the reporting period • Possibility exists that the allowance for loan losses is understated because of an unusually high number of recently disbursed loans		

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Additional Resources

Websites (accessed March 2009)

AuditNet, www.auditnet.org

offers many auditing resources free of charge

CGAP (Consultative Group to Assist the Poor), www.cgap.org

- *External Audits of Microfinance Institutions: A Handbook*

  Volume 1 is geared towards the boards of directors, managers, donors, creditors, and investors of MFIs. It reviews the difference between internal and external audits, details specific audit issues associated with MFI loan portfolios, and provides concrete suggestions on how to commission an external audit, including writing the terms of reference and selecting the auditor.

  Volume 2 is geared towards external auditors. It furnishes an overview of the microfinance industry for auditors unfamiliar with these financial institutions and offers guidance on a range of audit issues specific to MFIs.

COSO (Committee of Sponsoring Organizations of the Treadway Commission), http://www.coso.org

- publications (for sale):
  - o *Internal Control Framework*
  - o *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*
  - o *Enterprise Risk Management—Integrated Framework*
  - o *Report of the National Commission on Fraudulent Financial Reporting*

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

International Federation of Accountants, www.ifac.org

KnowledgeLeader, www.knowledgeleader.org

A subscription-based website that provides audit programs, checklists, tools, resources and best practices. Its goal is to help internal auditors and risk management professionals save time, manage risk, and add value. Subscription fees range between $20 and $600, depending on the size of the user group.

MicroSave, www. microsave.org

Toolkits: www.microsave.org /toolkits

- Loan Portfolio Audit toolkit

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- Institutional and Loan Product Risk Management Toolkit

World Council of Credit Unions, www.woccu.org

Useful online materials:

Excel

- "Using Excel for statistical sampling"
  MeadinKent Co. website
  http://www.meadinkent.co.uk/excel-statistics1.htm

- "Descriptive Statistics and Confidence Interval from Excel"
  Website of Dr. Muhammed Fahad Al-Salamah, Industrial Engineering Department, King Faud University of Petroleum and Minerals
  http://faculty.kfupm.edu.sa/SE/salamah/StatsExcel/statsitics_
  from_Excel.htm

Statistics and sampling

- Random Number Generator
  Random.org website, www.random.org

- "Statistics Glossary," University of Glasgow, Statistics Department
  http://www.stats.gla.ac.uk/steps/glossary/presenting_data.html#disp

- "Statistics Explained," SySurvey website
  http://www.sysurvey.com/tips/statistics/contents.htm

- Statistical sampling package (free but academic)
  The R-Project for Statistical Computing website
  www.r-project.org

- "T tests"
  RobertNyles.com website
  http://www.robertniles.com/stats/tscore.shtml

- "T Distribution Calculator: Online Statistical Table"
  Stat Trek website
  http://stattrek.com/Tables/t.aspx

- Training material on sampling and other audit training
  City Government of Seattle

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www.seattle.gov/audit/celt.htm