# *MicroSave* Briefing Note # 72

## Internal Controls in Small/Medium MFIs

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**Background**

The COSO framework[1] defines internal control as "a process, effected by an entity's board of directors, managements, and other personnel, designed to provide reasonable assurance for the achievement of organisational objectives under: *Effectiveness* and efficiency of operations; *Reliability* in financial reporting and *Compliance* with applicable rules and procedures".

For microfinance institutions (MFIs), audit and internal control should cover: (a) financial transactions, (b) operations, and (c) adherence to mission. Financial controls and transactions are reviewed to ensure their accuracy, completeness and compliance to statutory norms. At the operational level adherence to organisational policies and procedures are the main areas of review. For MFIs with poverty alleviation as a key objective, verification of mission adherence may also be made through the audit process.

These functional areas have a direct relationship with different types of risks for a MFI, broadly categorised as: (a) Institutional Risk, (b) Operational Risk, (c) Financial Management Risk and (d) External Risk[2].

For small and medium MFIs managing risk becomes more complex as systems are still evolving. Moreover, these MFIs are led by an individual or built around a few trusted employees. In the initial phase there is also a tendency to sideline procedures because (a) they appear to slow down the speed of decision making and business expansion; and (b) they appear to be costly. However, ignoring internal controls exposes an MFI to risks that can have deep and debilitating impacts on operations. Affordability and human resource constraints are other reasons why small and medium MFIs do not set up internal control systems. Though, in the long run, incremental costs of poor internal controls become much higher than anticipated initial savings.

**Basics of Risk Management**

Risk management does not mean removing all risks but rather optimising the risk-reward or risk-efficiency trade-off. Risk management activities broadly take place simultaneously at different hierarchical levels:

- ***Strategic level***: Encompasses risk management functions performed by senior management and Board of Directors. Risk management function at this level includes approval of policies, monitoring risk indicators and assessing compliance.
- ***Senior/Middle Management Level***: Encompasses risk management within a business area or across business lines. Risk management at this level includes identification of risks, developing policies, assigning responsibilities, implementing policies and monitoring compliance.
- ***Junior staff Level***: Involves risk management activities performed by individuals where risks actually occur. Risk management in these areas includes implementing and compliance with polices and procedures, and providing suggestions and feedback to further improve the policies and processes.

> In addition to its internal control department which periodically tests and reports on the effectiveness of internal controls, Equity Bank in East Africa has a Compliance Department that supplements Internal Audit by continuously assisting the bank's functional units and Branch outlets to assess process risks and efficiencies and refine or reengineer them through process mapping.

Thus risk management is not an individual function but is carried out by employees throughout the organisation.

**How to Setup Effective Control**

The COSO framework says that for effective control, the following five components work to achieve organisation's mission, strategy and related business objectives:

1. Control environment
2. Risk Assessment
3. Control Activities
4. Information and Communication
5. Monitoring

However, for upcoming MFIs it is often difficult to understand where to start from, and how to set up a control environment that would make these components work together to establish a system of sound internal control. There is no single answer to this question and different organisations practice different methods for establishing a system of internal controls.

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[1] In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed a model for evaluating internal controls. Ref URL: *http://www.coso.org,13/12/07.*

[2] See Internal Audit and Control Toolkit of *MicroSave* – available on www.*MicroSave*.net

Nevertheless, some MFIs find it is useful to start with the identification of fundamental processes and the risks involved in each step of a process – usually through "Process Mapping[3]". Once such risks have been identified a monitoring tool for internal control can be developed to measure these risks. One of the tools most commonly used by MFIs is a checklist covering the identified risks. Any deviation from performance indicators is a cause of concern requiring correction. In addition, process maps analyse what controls should be in place to encourage the desired results. Some of the controls used by MFIs include - putting check points in processes, segregation of duties, incentives, penalties, written warnings, etc.

DRISHTEE which is working through village-based IT kiosks to deliver microfinance services to its clients found non compliance issues with some of its key organisational procedures. To further probe into the risk associated with their systems, they carried out a Process Mapping exercise for all their major processes.

The identification of the risk was the starting point in understanding issues related to internal control for DRISHTEE. This further helped them in developing a monitoring tool to manage risk in their operations.

While setting up controls it is also important to ensure compliance by regular monitoring follow ups so that there are no surprises at the end of the year. Most small/medium organisations fail to do this, often because of resource constraints or for the want of monitoring systems. However, these are relatively easy to do; most of the MFIs use shadowing of field staff and non participatory observance of processes at the Branch as a tool to understand non-compliance of organisational policies and procedures. The observer for these activities is taken up on a rotation basis from a pool experienced field staff. For compliance with accounting polices it is often the Branch Accountant of different Branch or an Accountant at the Head Office who visits the Branch on a regular basis. To facilitate the process as well as to bring standardisation in monitoring procedure monitoring staff is often provided with a checklist of things to observe and a reporting format. The reports generated through regular monitoring checks then need to be communicated to the senior management for corrective action.

It is also important to understand the difference between regular audits and monitoring especially in the context of auditors' independence and reporting to the Board. Monitoring is a continuous process and deals primarily with operational issues whereas internal audit is carried out as per the audit plan and covers activities related to all aspects of MFI operations and finance. Again, reporting on a monitoring report is usually made to the Operations Manager or the Regional Managers overseeing the operations so that corrective action is taken almost immediately. The reporting of the internal audit should be directly to the Board, though reports may also have references to the monitoring report on important compliance related issues.

AROHAN, a microfinance institution working in Kolkata (India), is in an expansion phase. An expansion in operations for Arohan means setting up new Branches and adding more services to its present offering. Promoters of Arohan felt that setting up new Branches without strong monitoring and control systems runs the risk of dilution of operational processes and procedures. As a precaution they have setup a monitoring unit within Arohan which regularly visits its Branches and monitor various Branch level processes and the performance of employees. The monitoring team at Arohan comprises of senior staff from different Branches who work on a rotation basis.

Reports of Monitoring officers' are updated on a weekly basis by the Manager Operations and necessary corrective action is taken almost immediately.

Another important point to consider in terms of reporting is that in upcoming MFIs there is usually no internal audit department. In such a case, some MFIs outsource this activity to external auditors who schedule their audits as per the agreement with the MFI. However, in such a case: (a) the TOR must be clearly defined, particularly in terms of objective of the audit, sample size and frequency of audit (b) internal audit is not carried out by the auditor who performs the statutory annual audit to prevent any bias.

In terms of compliance it is equally important to ensure that the staff of the MFI also understand issues to take necessary corrective measures. Mechanisms for sharing such information could be through monthly meetings, or more simply by having compliance registers at the Branches. To further facilitate the process a track of previous compliance issues should be maintained listing out what has been complied with and what work still needs to be completed

**Conclusion:** It is essential to have system of sound internal audit and control at every stage of institutional growth. Though setting up such a system may appear complex and costly but there are innovative and cost effective ways though which such a system could be built based on the elements of proper internal control and ownership at all levels within the organisation.

[3] See *MicroSave's* Toolkit on Process Mapping

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