



Risk-based Process Audits

Strategically advancing MFIs and banks in emerging economies



Making internal audit work more effectively for you

A rapidly changing environment is only one hurdle that microfinance institutions and banks active in emerging economies have to overcome; they also face formidable challenges and risks that are inherent to the economies and business practices in the countries in which they operate. At the same time, the shareholders of these institutions are eager to see the business grow within acceptable risk-tolerance limits and establish a solid governance framework.

As one of the main pillars in the governance structure, internal auditors need to make sure their methods provide useful, actionable feedback that adds value to the business and thus helps the institutions meet the high expectations of their boards, management and respective committees.

However, in many financial institutions the audit methods in use today are no longer effective enough – and in critical need of an update. We strongly recommend that BoDs and Audit Committees review and overhaul the methods employed by their audit teams before their institutions are overwhelmed by accumulated risks.

Discovering risks in a systematic way

A common grievance we hear from our clients is that they are repeatedly presented with the *same* audit findings and have to go through the *same* debates, e-mail exchanges and meetings over

and over again – without achieving a satisfactory outcome. Many institutions only use compliance-check audit models, which are no longer sufficient to capture the types of risks they face – an approach that is repeatedly critiqued by the Institute of Internal Auditors (IIA), which states that auditors need to move beyond the corporate policing, box-ticking mind-set. Boards and management would like to see their audit teams zero in on the core risks that the institutions face and provide practical, value-adding recommendations to mitigate negative findings in a systematic way. One approach to doing this is to focus on *processes* to reveal core risks so that the resulting losses, errors or inefficiencies can be corrected and the institution can grow in a healthy manner.

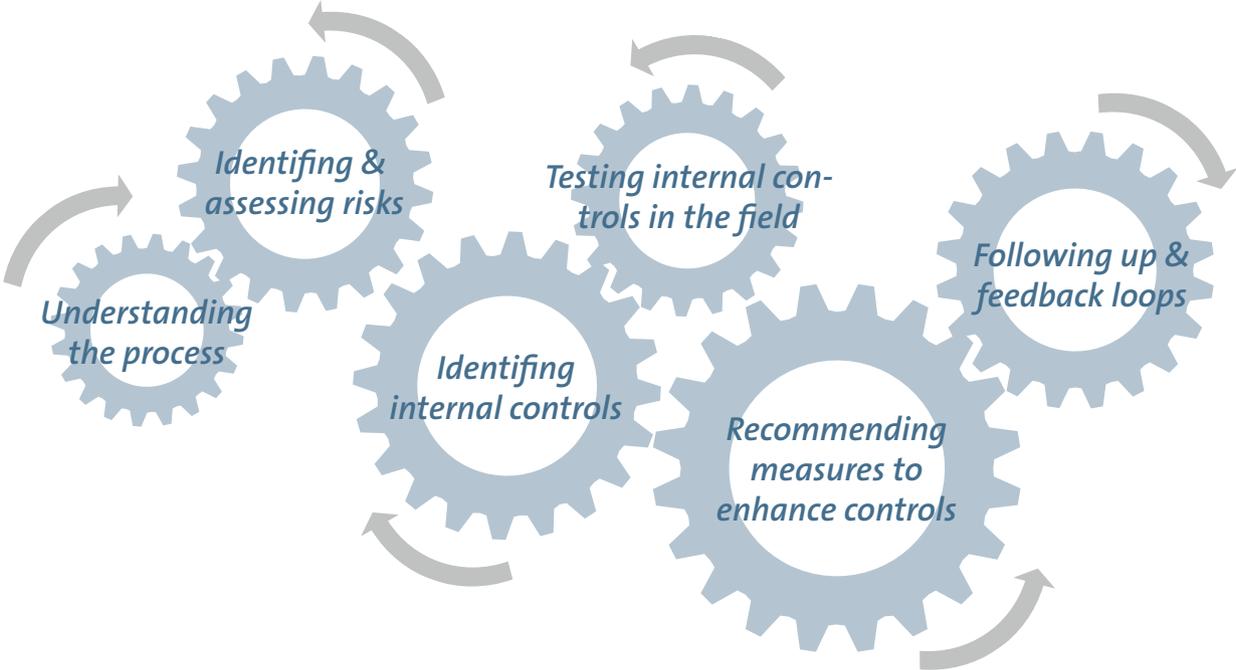
Thinking out of the box

Risk-based Process Audit is an audit methodology that uses critical out-of-the-box thinking to recommend improvements to an institution's stagnant risk-management problems and ensure that processes are functioning as they should.

Risk-based Process Audit allows auditors to delve into the root causes of all types of risks, which, once resolved, enable institutions to make significant improvements in their operations, create a more solid risk profile, and ultimately benefit from focused and solutions-oriented audit reports.

In fact, the IIA endorses the main techniques of the Risk-based Process Audit approach, such as process mapping and risk and internal control assessments, in line with its stance that internal auditors should possess the ability to understand the governance framework, effectively assess risks and internal controls, and utilise proper audit field

work techniques. Risk-based Process Audits can substantially improve risk management; we are convinced that it is therefore a must-have weapon in the arsenal of internal audit toolkits – particularly for MFIs and banks operating in the challenging environments of emerging economies.



Major advantages of Risk-based Process Audits

Eliminating process inefficiencies and weaknesses in control mechanisms

With their emphasis on compliance checks, traditional internal audit methodologies are no longer sufficient for banks and MFIs in transition economies. While such methodologies are good for extracting a snapshot of the current level of non-compliance with policies and procedures, periods of rapid institutional growth and other internal and external factors will certainly give rise to risks that can render the existing processes inefficient. Only a methodology such as that used in Risk-based Process Audits can highlight inherent inefficiencies and weaknesses in control mechanisms. There are a number of other significant reasons why financial institutions can specifically benefit from the introduction of Risk-based Process Audit methodology:

Addressing the root cause of a problem instead of auditing only outputs

Institutions face inherent risks arising from business growth situations in largely informal emerging markets, such as increasing numbers of branches and staff, high numbers of manual transactions, and high staff turnover; in addition, business opportunities are often located in remote geographical areas. Process audits can greatly improve an institution's success in navigating through these challenges, as the key focus of the audit is on the processes themselves, not

just the outputs. This means that once risks and internal control weaknesses in the process have been identified and the auditor's recommendations are implemented, the root cause of the problem will have been addressed. In other words, regardless of transaction volumes, numbers of branches or staff changes, the enhanced processes will function exactly as they should.

Effective support for continuous improvement of policies and procedures

Institutions, particularly those that are relatively new or rapidly growing, regularly need to make significant improvements to policies and procedures, as these quickly become outdated or inefficient and often overlap. By definition, process audits uncover deficiencies in processes, and therefore effectively support improvements in procedures.

Significant strengthening of a sense of process ownership among middle managers

Too many middle managers of banks and MFIs in emerging economies have a weak sense of process ownership and often lack the skills needed to design effective processes. Working with internal auditors who focus on the importance of efficient processes and applying them correctly, over time, such managers will inevitably develop a much stronger sense of ownership of the processes they are responsible for. The result will not only be an

increased level of procedural compliance among staff, but practices will be standardised across the branch network.

Higher quality of internal training through direct feedback loops

Feedback loops in institutions between auditors and training units or relevant heads of departments tend to be weak. For example, communication of compliance audit findings to the branch primarily results in well-intended efforts to “not

make the same mistakes again”. However, unlike compliance audits, process audits can unveil the root cause of these mistakes: perhaps staff are not following procedures as expected, due to logical errors in procedural design and/or a lack of understanding or simply weak skills. In such cases, specific and clear feedback from auditors will be of very high value for the training unit, which can then design and conduct the necessary courses in a targeted manner so that these errors are far less likely to be repeated.



IPC's implementation and training approach

Our easy-to-implement plan for the introduction of risk-based audit methodology at MFIs and banks in emerging markets is split into two phases – the Control Environment Review and Process Audit Training and its institutionalisation.

1. Control environment review

IPC experts will initially assess the current internal control systems (ICS) by performing a Control Environment Review. The aim is to comprehensively analyse the institution's existing ICS against the key elements of a healthy ICS in order to determine the institution's current risk profile and create strategies to strengthen it.

This systematic assessment is accomplished during the first phase of the project by means of desk reviews as well as on-site assessments and analysis. The desk review results in a SWOT analysis for the institution, enabling IPC to effectively prepare and carry out the subsequent on-site analysis, which entails:

- A review of the risk-related reporting system
- Interviews/discussions with key operational staff, middle and upper management
- Walkthroughs, i.e. close observations of real-time operations as they are being carried out by staff

This allows us to prepare a Gap Analysis Report, which serves as the basis for tailoring the training and institutionalisation plans to ensure that Risk-based Process Audits are successfully embedded in the institution's workflow.

2. Training and institutionalisation

This phase accounts for the bulk of the project. The process audit methodology training for IA staff involves on-location visits by the short-term expert team combined with ongoing distance learning sessions between visits. The content is modelled on IPC's process audit toolkit as well as on our standard training guidelines and implementation materials.

The on-location visits are comprised of four two-week modules over several months to introduce auditors to the concept and hone their skills to enable them to successfully perform full process audits. The training sessions are a mixture of classroom discussions, interactive workshops, intensive coaching and hands-on fieldwork. This ensures that the concepts and materials are fully understood and that subsequent audits can be carried out efficiently and independently, giving the auditors a real sense of ownership.

Between on-location visits, four distance learning modules will help to anchor the concepts and pave the way for the on-location training sessions.

The distance learning modules include practice-based learning with guided homework and feedback support.

Throughout the training implementation process, IPC will work continuously to ensure that the approach is successfully embedded in the institution's standard work procedures. We will hold regular discussions – both on- and off-site – with the management and the audit commit-

tee to keep them fully informed of the project's progress. They will be encouraged to see process auditing as an ongoing project and to support their audit teams over time by enabling them to develop their process audit skills further. It may be that certain structural and organisational matters will have to be ironed out in order to facilitate the implementation of process audits; if so, IPC will analyse the situation and make concrete recommendations on how to resolve the issues at hand.

Traditional audits

Focus is on compliance with existing policies and procedures

Focus is on detection of errors and omissions

Control know-how is restricted to internal audit

Restricted by function boundaries

Auditors are perceived as investigators

Substantive approach to testing controls

Reactive "mistake finder"

Underlying risks are left undetected

Findings in audit reports re-appear in subsequent reports

Risk-based Process Audits

Focus is on factors that hinder successful performance of tasks

Risk identification and process optimisation in addition to ongoing compliance checks

Internal audit shares control knowledge with the organisation

Process-oriented, across functions

Auditors are perceived as facilitators

Control environment and key controls in place

Proactive agent of change

One audit can resolve many issues

Increased efficiency of process and internal controls eliminates repeated findings

Our audit training: Blocks 1-4

Block 1

Module 1 – Process mapping

IPC will train the IAD to map processes using flowcharts and best practice mapping standards. In this way, auditors will gain the skills they need to identify staff responsibilities in processes, process overlaps and inefficiencies, and critically, learn to identify where risk events are likely to occur and where internal controls exist for risk mitigation.

Module 2 – Process analysis

During this module, the IAD will learn to use the process flowcharts to create a risk matrix in order to identify and assess risks and internal controls in processes. Such skills are at the heart of the process audit methodology and are critical for auditors to be able to carry out process audits effectively.

Distance learning – Session A

During this session, the IAD will finalise the process flowcharts and the Risk Assessment Table while receiving remote feedback and support from IPC experts. By enabling auditors to apply the learned techniques themselves, the critical objective of enhancing the IAD's ownership of the produced matrices will be achieved.

Block 2

Module 3 – Audit techniques

While several of the audit techniques, such as using checklists and interviews, will be familiar to auditors, IPC will introduce ways to improve the current use of these techniques. In the process, the IAD will develop a solid risk-based audit approach and learn how to integrate the techniques into the overall process audit methodology. Other process audit instruments, such as walkthroughs and client visits, may be new to audit teams; IPC will demonstrate these tools to carry out the field work more effectively.

Module 4 – Audit programme design

An audit programme is an essential component of an IAD's toolkit. It not only documents the work processes that the auditors expect to see being practiced, it presents the audit steps that should be performed in order to determine whether internal controls are functioning as designed. Given the importance of this tool, we will coach IAD staff to create their own audit programmes in a very hands-on way. Auditors will learn the skills to design a programme for any process to be audited.

Distance learning – Session B

During this session, auditors will continue to develop their skills in audit programme design by learning to enhance audit programmes for other sub-processes. In this way, auditors will have the opportunity to work through the steps themselves, yet still have IPC's support and detailed feedback, both in written and oral form.

Block 3

Module 5 – Risk-based sampling

Risk-based sampling is used to select documents, clients, loans, or other elements that are the subject of the audit. This approach channels the IAD's resources to where potential problems may lie in the process and allows for greater efficiency in detecting systemic problems.

Module 6 – Practice audit

With the fundamentals of process audit methodology laid out, IPC will conduct a limited process audit side by side with the audit team. Although not as detailed as a "full" process audit, this exercise will provide the audit team with the valuable real-life experience of conducting a process audit.

Module 7 – Effective reporting

High-quality, well-organised, and value-adding reporting helps to make sound decisions. IPC experts will ensure that all elements of effective audit reporting are understood and integrated by the IAD. This includes setting up objective risk-ranking metrics, laying out the root causes of findings so that value-added recommendations can be made, and linking these to improvements in the internal control structure of the process.

Distance learning – Session C

During this session, the audit team will complete the practice audit initiated earlier with IPC experts on location. To strengthen their report writing skills, the IAD team will draft the process audit report with the help of distance coaching. IPC will be highly involved in these steps, providing instructive feedback and support as the team finalises their first process audit and report.

Block 4

Module 8 – Follow-up tracking

To ensure that audit findings are not endlessly repeated audit after audit, it is critical for an effective follow-up process to be in place and used by the IAD. To this end, IPC's training links the reporting structure to the follow-up process, providing tools and guidance to ensure the implementation and effectiveness of the agreed actions.

Module 9 – Analysis of audit results

This segment focuses on how to use the cumulative results of audit reports each quarter to analyse the data across key parameters in order to provide a more complete picture of the overall risk situation to management, audit committees and supervisory boards in order to support their strategic decision-making capacity.

Module 10 – Annual audit planning

Annual audit planning is based on an assessment of risks and exposures that may affect the institution across all auditable areas. Therefore, a risk-prioritised schedule of audits (annual audit plan) should be determined and approved by the audit committee in order to reflect the most current strategies and direction of the institution given the current risk environment.

Distance learning – Session D

During the final distance learning session, auditors will continue to develop their ability to analyse audit results as presented during the on-site training. At the same time, audit managers or designated staff will continue to develop the annual audit plan, all with close support from IPC.

Our training set-up

Skills gained during each block

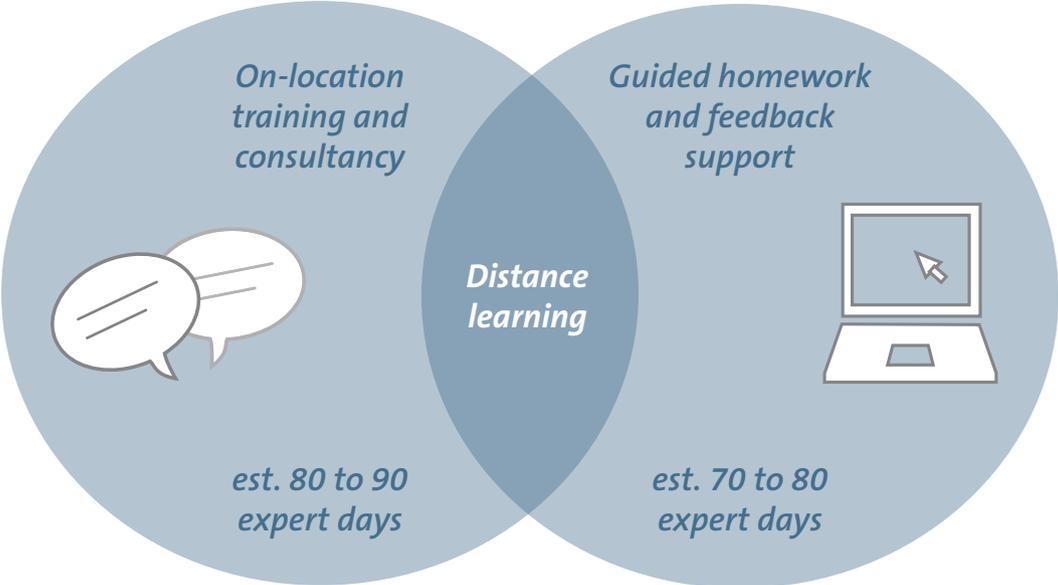
Block 1	On-site	Module 1 – Process mapping Module 2 – Process analysis	<ul style="list-style-type: none"> Ability to map processes in flowchart format Risks identification and assessment Creation of a risk matrix
	Off-site	Distance learning – Session A	
Block 2	On-site	Module 3 – Audit techniques Module 4 – Audit programme design	<ul style="list-style-type: none"> Ability to perform walkthroughs, interviews, client visits Creation of risk-based checklists for audit field work Ability to create audit programmes
	Off-site	Distance learning – Session B	
Block 3	On-site	Module 5 – Risk-based sampling Module 6 – Practice audit Module 7 – Effective reporting	<ul style="list-style-type: none"> Selection of samples for audit engagements Practical on-site application of learned audit techniques Risk-ranking of findings and recommendations of corrective actions based on analysis of root problems
	Off-site	Distance learning – Session C	
Block 4	On-site	Module 8 – Follow-up tracking Module 9 – Analysis of audit results Module 10 – Annual audit planning	<ul style="list-style-type: none"> Establishment of an effective follow-up framework Ability to analyse results to provide valuable advice Update the audit charter to account for learned methodologies
	Off-site	Distance learning – Session D	

IPC – the right partner for your process audit

IPC aims to transform internal audit departments from inspection-focused and box-ticking “mistake finders” into “solution providers” that can provide invaluable assistance to the owners and managers of any financial institution. IPC’s strong track record includes 35 years in development finance and financial institution-building, practical expertise in helping institutions operating in transition economies transform traditional compliance-

focused audits into value-adding full process audits, and strong experience in creating mutual understanding between BoDs, management and auditors on risk identification, assessment and mitigation mechanisms.

Our expert team consists of process audit consultants with extensive internal audit experience across the globe.



IPC - Internationale Projekt Consult GmbH

Falkensteiner Str. 77
60322 Frankfurt am Main
Germany
Tel: + 49 69 90 50 188-0
E-mail: ipc@ipcgbh.com
www.ipcgbh.com

