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Making small loans work

Siddique Ahmed of microfinance organisation FINCA explains the need for auditors to rethink the standard audit conceptions when working with low-income entrepreneurs

Like any bank, a microfinance institution is only useful so long as it meets the needs of its customers. In the Middle East and South Asia (MESA) region, that means both the obvious (such as adapting to economic and political trends and technological advances) and the specific (such as creating products that respond to religious principles). But above all, clients must be confident in the quality of the services they are being offered.

CV

Siddique Ahmed, 38, joined KPMG Pakistan in 2000 and worked there until 2004. After a brief stint as chief accountant for Afghan Wireless Communications Company, he took over as FINCA's country audit manager in Afghanistan in 2005. Three years later, he was promoted to audit manager for the Middle East and South Asia region, with his portfolio expanding to include Africa in 2012. He is a certified fraud examiner, professional internal auditor and financial consultant.

The overall goals of the auditing department are the same as for any organisation. However, determining the best way to audit a constantly evolving suite of microfinance services – and assure customers of that consistent quality – has been a new frontier entirely, says Siddique Ahmed, FINCA's regional audit manager for Africa and MESA. It is a process he has helped pioneer over the past decade.

Based in Washington DC, FINCA is one of the leaders in the microfinance industry, which provides financial services, especially microloans, to the world's poorest people. Ahmed, who works out of Islamabad, Pakistan, has been with the institution since 2005, only 18 months after it entered the MESA region. Its MESA operation now boasts more than 347,000 clients across three countries with a loan portfolio of approximately US$84m.

Despite operating in an 'industry where inherent risk is relatively higher', Ahmed is confident that his team has 'been able to develop an auditing methodology which suits the industry' and the regions where he works.

> 'The risks are actually in the field, not in the files sitting at the head office or branch offices'

At a time when there is a growing expectation that microfinance companies will be more than just lending institutions, the challenge is how to securely guide that evolution, he tells *Accounting and Business* during a business trip he is making to Kampala, Uganda.

A different world

Auditing in microfinance is 'a different world', Ahmed says. 'For every new auditor that we hire, their first question is, why do you have so many auditors? You see big companies who have an internal audit department of a few people and the balance sheet runs into billions of dollars. But then you see a microfinance institution, which may be small in dollar terms, with a large team of auditors.'

It is the nature of the industry, he explains. The clients that microfinance institutions recruit 'may not have a proper ID or a registered business address or anything material to offer as collateral', but the industry's philosophy is that the absence of those things shouldn't exclude them from loans or other banking services. So microfinance institutions have developed models for addressing these gaps, especially the group loan that has become the hallmark of the industry.

The auditor is responsible for evaluating and improving the effectiveness of three key processes – governance, controls and risk management. And given the group loan model, the microfinance institution is likely to have a lot more clients than a conventional bank. That means auditing an unbiased sample can require substantial travel – often over unpaved roads – tracking down clients, many of whom do not have proper addresses.

Though microfinance auditors face a 'challenging task', Ahmed says that they see 'that the risks are actually in the field, not in the files sitting at the head office or branch offices'.

There have been other surprises in the job as well, including the need to rethink – and redefine – standard industry conceptions. As a certified fraud manager, Ahmed might become suspicious of a microfinance client who, upon receiving a loan, turns around and pays a dowry to get his son married. But for many microfinance clients, he says, 'cashflows are complicated. They do not keep the cashflows of the business separate from the cashflows of their personal account.' Therefore, the funds used for payment of a dowry might be from a central fungible pool generated by business income and loan funds.

As long as clients continue to invest in and grow their business, Ahmed may determine that what initially appeared to be fraud was actually not. 'If the client has been transparent and the loan officer has documented everything, we should be fine.'

Even the accounting sector, which Ahmed audits, requires some unexpected considerations. While the microfinance sector adheres to global standards, including International Financial Reporting Standards, the work still raises some surprising questions, including deciding who the loan recipient is.

For instance, if the loan is going to a group of people, should it be recorded once or is each recipient listed separately? Auditing in these cases calls for flexibility, Ahmed says, based on country regulations and the risk within the portfolio.

Ahmed's role in FINCA has grown alongside the institution's expansion in the MESA region. He took over as audit manager of MESA in 2008 and was part of the due diligence team that guided the institution's expansion into Jordan in 2007 and Pakistan in 2013.

Now he manages nearly 40 people across nine countries, ensuring that auditing methodology is implemented consistently in each – while taking into account individual country policies and cultural requirements.

Islamic-friendly

In two MESA countries – Jordan and Afghanistan – that includes Islamic-friendly banking services, where customers can access a sale-and-purchase agreement. The microfinance institution will buy a product, usually inventory, for a client and allow the client to pay for it over a series of instalments.

Because extra work is required of staff, such products may be more expensive than a conventional microloan, but Ahmed says it actually makes the auditor's work easier. Since no money changes hands, there is no opportunity for a client to spend on non-business purposes. More importantly, 'you're giving clients the comfort that they're taking a loan which is in line with their religious beliefs'.

In crafting their products, microfinance institutions operating in MESA must also take into account the variety of industries in which potential clients are involved. Ahmed offers Afghanistan's Jalalabad province, where the economy is largely driven by agriculture, as an example. Because farmers have irregular income, depending on harvests, successfully expanding to that region means 'you have to align your cashflows with the client's cashflows'. That may require a 'bullet loan', for example, with repayment made in one lump sum at the end of the term after the harvest has come in.

It also means remaining attuned to evolving geopolitical conditions. One of the biggest changes Ahmed has witnessed in the region is the influx of refugees from Syria and Iraq. 'There »

are more jobless people, there are more small businesses.' But the response should be the same: 'A need to develop your products or modify your products to answer the needs of those people.'

Over the past decade, that has meant more than just changing the structure of the loans on offer, but also introducing completely new services.

In 2013, FINCA bought a bank in Pakistan to take micro deposits in the country. It now offers micro-insurance services in some places. And it is exploring ways of digitally collecting loan repayments, which could save loan officers hours – even days – of travel.

'It's becoming more efficient and complicated,' Ahmed says. 'Complicated at first and then it can become more efficient.' For his team, the complication is figuring out how to properly safeguard each new product or service. It is critical, he says, that audit is involved in the process from the beginning, so auditors have input over the governance, risk management, controls and the overall design of any new product.

And then there are the changes that are driven by unforeseeable events. Many microfinance institutions are still not-for-profits and depend on donor funding to sustain their operations. The global recession dried up a lot of donor funding to the sector, resulting in a 'lack of free or cheap money for microfinance to grow'.

That has spurred efforts to make microfinance institutions more efficient, including a rise in express lending, heightening the risk that 'loan officers or the branch staff are not going to follow the policy as they're supposed to because they are under pressure to expand'.

Ahmed says that before any efficiencies are introduced, it is an auditor's job to discuss any potential changes with the institution's managers to see if there are other ways to improve performance without sacrificing essential financial controls.

The bottom line is this: 'You have to be proactive in mitigating the risks.' ■

Andrew Green, journalist based in Kampala

Basics

* FINCA is a leading international microfinance institution, offering financial services and products to small-scale businesses that have been turned down by traditional banks, so that these businesses can start, grow and diversify with resulting increases in family income, nutrition, employment and well-being.
* FINCA pioneered the 'village banking' method of credit delivery, now used by hundreds of organisations worldwide.
* It operates subsidiaries in 23 countries across Africa, Eurasia, the Middle East, South Asia and Latin America, serving over one and a half million people.

For more information:

www.finca.org