COMMISSIONED BY SADP AS FOLLOW UP TO DUE DILIGENCE WORKING PAPER 1 "NGO GOVERNANCE IN CAMBODIA: SERVICE AND SUPPORT OPTIONS FOR IMPROVING FINANCIAL MANAGEMENT"

Improving Due Diligence Tools

External Financial Audits, Financial System Assessments & Finance Monitoring visits

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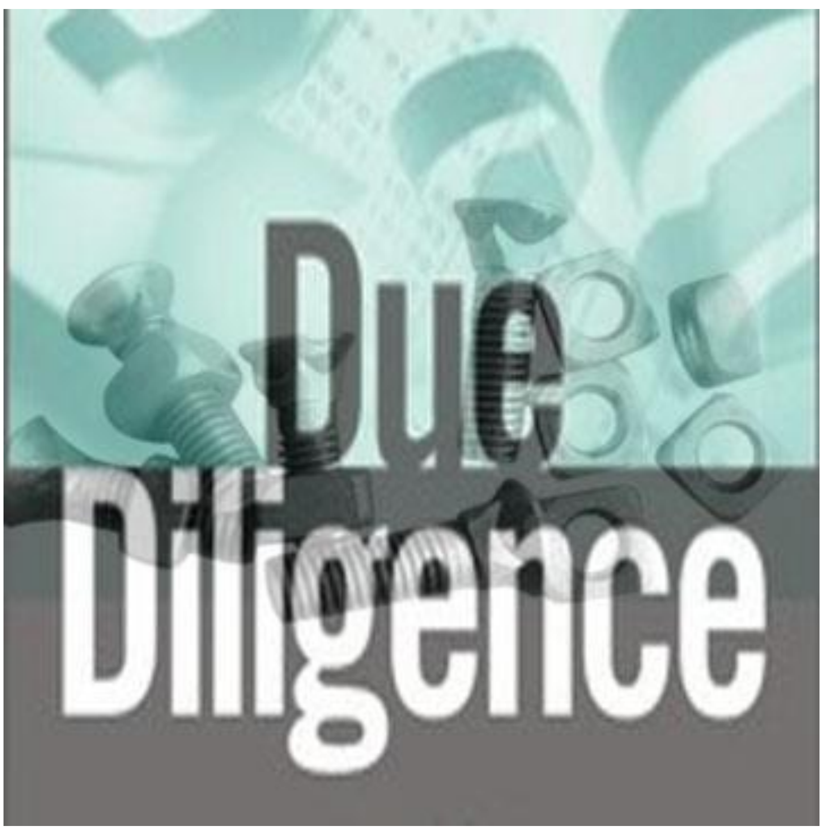

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Table of Contents

List of Acronyms ... 3

Acknowledgements ... 3

Executive Summary ... 4

Introduction ... 9

External Financial Audits ... 13

- The specific functions of external financial statement audits ... 14
- Issues with external auditing of LNGOs identified by the due diligence research project ... 15
  - The professional quality of the Cambodian audit sector ... 15
  - The uptake of external auditing by the Cambodian NGO sector ... 16
  - The quality of external audits ... 17
  - The fraud risk of conducting only project audits ... 17
- More effective external financial statement auditing ... 17
  - The theory of action underlying the guidelines ... 18
  - The Guidelines ... 20
  - Creating the right setting for a process to improve external audits ... 20
  - Choosing the right auditor to include in the process ... 22
  - Working with the auditor toward a more effective external audit ... 26

Financial System Assessments and Periodic Monitoring ... 39

- Quick scan of Financial System Assessment and monitoring instruments and practices of funding agencies ... 40

Piloting the integrated use of the three tools of external oversight ... 42

Some concluding thoughts ... 44

Epilogue and next step in this due diligence project ... 49

List of funding agencies that shared info about Financial System Assessment & monitoring ... 52

References ... 53

Annexes ... 55

Annex 1: Frequently Asked Questions about funding agencies' duly diligent approach to the financial management of their NGO partners 56

Annex 2: Selected passages from Michael Power's The Audit Society. Rituals of Verification 65

Annex 3: On having the assumption that bureaucracy is by definition pernicious 71

Annex 4: Accountability requirements, NGOs and the need for alternatives 73

Annex 5: Mango's work on International financial management standards for NGOs 75

Annex 6: Mango on the basics of good financial management and how to check on it 77

Annex 7: the issue of social norms – partnership and accountability 91

Due Diligence Working Papers

This series of Working Papers is based on fieldwork commissioned by SADP, initially as part of a CEPF funded project on the provision of appropriate support to Cambodian NGOs and peoples groups working on sustainable resource management. For that project, governance issues were identified as the core focus. However, in the course of the fieldwork, to avoid overlap with other ongoing work on LNGO governance, this focus was narrowed to governance and other issues related to financial management. The fact-finding for this initial phase of the due diligence investigation included a limited survey of grantmakers and audit companies. The results of the CEPF phase of the project were documented in Due Diligence **Working Paper 1** *NGO Governance in Cambodia: Service and Support Options for Improving Financial Management*.

With continued support from SADP, the survey was repeated, successfully aiming at broadened participation of grantmakers and audit companies. Parallel to the survey data collection, information was gathered on three tools of external oversight of the financial management of Cambodian LNGOs: financial statement audit practices, Financial System Assessments, and periodic finance monitoring. The results of the follow up survey were documented in

Due Diligence **Working Paper 2** *Financial Management of Cambodian NGOs: 2nd Survey of Grantmakers and Audit Firms*. The results of the information gathering on tools of external oversight are documented in **Working Paper 3** *Improving Due Diligence Tools: External Financial Audits, Financial System Assessments & Finance Monitoring visits.*

Besides documenting fieldwork findings, this series of Working Papers documents an ongoing thinking process on what underlies the issues brought to light by the fieldwork, why they have proven so intractable to change, what assumptions the recommendations for improving the situation are based on, why the entry point of financial management holds promise for broader organizational and sectoral change, and what risks for harm that entry point comes with. The documentation of this conceptual analysis, often in the form of annexes to the main text, makes these Working Papers very much a work in progress, that to date lacks an overarching, well-structured narrative. **Working Paper 4** *Why, How, and When Improving Financial Management is an Entry Point to Dealing with many NGO Sector Issues in Countries like Cambodia* will be an effort to take stock of this thinking process.

The Working Papers will be referred to in the text as **WP**, followed by the appropriate number.

List of Acronyms

CCC	Cooperation Committee for Cambodia
FAQ	Frequently Asked Questions
FM	Finance Manager
IASB	International Accounting Standards Board
ICFR	Internal Control over Financial Reporting
IFRS	International Financial Reporting Standards
INGO	International Non-Governmental Organization
GFGP	Good Financial Grant Practice
LNGO	Local Non-Governmental Organization
NFP	Not For profit
NGO	Non-Governmental Organization
SADP	Southeast Asia Development Program
ToR	Terms of Reference
WP	Working Paper

Acknowledgements

This report would have been impossible to write without several audit companies sharing their opinions, and professional expertise. One company – you know who you are – went way beyond what one can reasonably expect for free, and graciously mentored me in audit profession basics. Without that assistance I would never have been able to systematize much of what I argue for here. However, all participating companies opted to remain anonymous. Equally important were the many funding agencies that willingly shared information about their external audit, Financial System Assessment, and periodic monitoring practices and procedures, and gave their time to explain their rationale, and the constraints they face. Several financial management consultants enlightened me with practice stories and provided a sounding board for half-formed ideas. It deserves specific mention that the work of Mango, all easily available online, has been hugely beneficial. The former coordinator, current advisor of SADP, Graeme Brown, has been invaluable to getting this work to the finish. Without his constant prodding, active support, and intellectual contributions, I would have given up quite some time ago.

However, none of the above can or should be blamed for any specifics in the report. Full responsibility, especially for the mistakes, misunderstandings, and otherwise misinformed factual statements, opinions, and suggestions, rests with the author alone.

Executive Summary

The original due diligence research described in *NGO Governance in Cambodia: service and support options for improving financial management*[1] brought to light that the Cambodian LNGO sector has structural, seemingly intractable problems with financial management. The subsequent second grantmaker survey reinforced the credibility of the original estimates of the incidence of these problems, and of the high correlations between weak governance, weak finance systems and fraud.

A core premise underlying this work is that the persistence of financial management issues, given the substantial and ongoing capacity building efforts of LNGOs, and the self-regulating efforts of the sector, is intimately connected with funding agencies *in the aggregate* not being diligent enough regarding their oversight role. There are not enough funding agencies applying sufficient diligence, and there is a lack of collaboration/collective action by funding agencies. This includes the way funding agencies deal with the financial statement audits that they rely on heavily.

This working paper suggests a practical way in which three aspects of due diligence by funding agencies can be improved: more effective external auditing, better financial system assessments and smarter financial monitoring, which are best conceived of as intimately connected and interdependent.

The aspirational benchmark for those responsibilities is the board of a large publicly listed company. For such boards, ensuring a high quality external audit is the primary vehicle for providing the company's stakeholders with the required assurance in the company's financials. Using this benchmark thus makes the external audit a primary *thinking tool* for exploring ways to improve oversight instruments/approaches in the NGO sector. That financial statement audits and Financial System Assessments show substantial overlap (any proper audit will include testing the existence and effectiveness of management controls) only strengthens the usefulness of the external audit as a thinking tool.

To set the stage for the recommendations for improvement, the most relevant findings of what the due diligence investigation to date has brought to light are summarized below:

1. Problems with respect to external auditing of Cambodian LNGOs

1.1 In general, the track record of the crucial accountability mechanism of external audits is certainly not beyond reproach. But the situation in Cambodia is worse: Cambodia's auditing sector does not live up to international standards.

1.2 Only about half of Cambodian NGOs are externally audited. Unless required by one or more of the agencies funding an NGO, there is generally no external audit.

1.3 When NGOs are audited, those audits often do not mention systemic weaknesses, while research data clearly show that the longer NGOs (are able to) avoid proper scrutiny of their systems and the longer they operate without the presence of checks and balances provided by such proper systems, the greater the likelihood of the opportunity for fraud turning into actual fraud.

[1] WP1 (2015)

1.4 This is especially worrying because it indicates very low quality organization wide/global audits, which is the primary tool to detect double billing, the biggest fraud risks in the NGO sector. That a substantial number of funding agencies are only interested in an audit of their own project (and not in a global audit) makes for an even more disturbing situation.

2. Problems with Financial System Assessments and finance monitoring practices of funding agencies

2.1 A hugely diverse resource investment of funding agencies in these two oversight tools, which is directly related to, but certainly not fully determined by, funding agency efforts to keep "overhead" at a "defensible" level.

2.2 The large majority of grantmakers totally rely on self-reporting of their partner and refrain from applying even the most basic audit procedures[2], let alone those experienced as invasive, that any external audit company would have to apply to be able to express an acceptable level of confidence in its assessment results.

2.3 Although there is wide acknowledgement by funding agencies of the interdependence of Financial System Assessment findings and what needs specific attention during monitoring visits, there is no shared/LNGO sector understanding of what makes for minimum requirements that LNGO financial management needs to live up to for making a grant-receiving LNGO an "acceptable risk", and thus no shared understanding of what it means for grant providers to live up to (one core aspect of) their due diligence responsibility.

Working Paper 1 (WP1) suggested a due diligence Community of Practice approach for figuring out smart solutions to practical difficulties that block change of the status quo (formulating a ToR, dealing with agencies requiring project audits, etc.). This report provides practical guidelines for how to go about this.

The theory of action in which these guidelines are rooted is that:

1. Oversight cannot be outsourced. The responsible accountholders need to be in the driving seat.

2. The particular details of practical constraints are going to vary between different funding agencies, and across specific funding recipients and contexts. Only agency insiders are really able to figure out how particular barriers to change within their own agency can be overcome.

3. Arguably the most fruitful conversations between agencies for identifying barriers and ways to overcome them are those between (all) co-funders of one particular LNGO. They hold the most potential because their barrier-solving (or circumventing) findings can be implemented immediately, making for collective good practice vis-à-vis this one co-funded partner (and any others that they co-fund).

[2] See box above for an overview of audit procedures.

4. Given that the three tools of external oversight – financial statement audit, Financial System Assessment, and periodic monitoring - should be seen as an integrated package, the conversations are best designed from the start as aiming at a collective, integrated use of all three tools as their outcome.

The guidelines

The master guideline: the design of effective external oversight requires LNGO and context specific solutions

Creating the right setting for a process to improve external oversight

A1: Pilots of agencies co-funding the same LNGO.

The core recommendation for improving the effectiveness of external financial statement audits (and the connected tools of Financial System Assessment and periodic monitoring) is for funding agencies to identify responsive and "non-problematic" LNGO partners that they share with other grant providers with which they are on good terms

A2: Accepting audit profession standards as a benchmark for all external oversight.

Taking the integrated external audit as a benchmark for optimal external oversight cannot limit itself to the types of audit subject matter that "integrated" stands for, but implies an acceptance of the kinds of audit procedures that the audit profession sees as necessary for the level of assurance an audit is assumed to provide.

A3: Pilots need the partner LNGO as a fully involved participant.

Changing co-created realities needs all participants around the table.

Choosing the right auditor to include in the process

B1: One auditor contracted on a ToR that is agreed by/with funding agencies.

In Cambodia, a context lacking both properly functioning boards and proper audit sector oversight, it seems a sensible and defensible risk management strategy to let funding agencies (as one of the account-holding 'principals' of an NGO) select and contract the external auditor, and thus avoid the perverse incentives of the auditor being financially dependent upon the auditee.

B2: Ensure that the auditor is up to the task.

Currently, within the NGO sector little, if any, due diligence is done regarding the reputation and competence of the audit companies it relies on. This is unacceptable.

B3: Determine the available budget for funding agency external oversight.

External oversight ultimately translates into costs. Without a ballpark figure for the available (inter-agency) budget to start with, the conversations cannot get down to business.

B4: Ensure the auditor is willing to fully engage in the pilot process.

For an audit company, engaging in a pilot like this is not going to be business as usual. The expectations that they will have to fulfill are far beyond what is currently considered normal. The auditor is a crucial participant in the pilot. Most of what the pilot needs is going to depend on what the auditor is willing and able to deliver.

Working with the auditor toward a more effective external oversight

C1: More systems/internal control attention to improve financial statement audits.

The "integrated audit", which combines a financial statement audit with a full-fledged Financial System Assessment, is proposed as the *aspirational* benchmark for external oversight only; for practical reasons.

C2: Specify what an audit company looks at during an audit.

Funding agencies actively engage the auditor of their (shared) partner in a conversation that results in *detailed and explicit* ToR for *what the auditor is will examine* to form an opinion on the quality of the financial system/internal controls of the auditee.

C3: Specify a more investigative approach to evidence gathering.

Any good audit is an "investigation". A "forensic" investigation applies the tools of the audit profession to the detection of crime, but the tools (procedures) used are all part of the *normal* audit toolkit. The conversation should be about the proper compromise between the reliability of the evidence that an audit procedure generates, the reliance on auditee systems and assurances, and the resource costs for the auditor of applying the procedures required.

C4: Ask for explicit post-audit confirmation that, and how, all that was contractually agreed to be included was actually covered.

Guidelines C2 and C3 combined should ensure that those commissioning an audit know in a hands-on detailed manner *what* the audit is going to assess, and *how* the audit is going to do it. Given the status quo, in which this is not the case for most audit principals, a specific guideline to highlight the required level of transparency and level of involvement of the audit principal seems necessary.

C5: Explicitly ask for anything noteworthy that came to light.

This guideline sounds even more superfluous, but unless it is actually done, those commissioning the audit are not taking seriously enough their responsibility to *explicitly* state *everything* that they expect in the ToR.

D1: Working with the auditor toward more effective Financial System Assessments and periodic monitoring.

Given the central role of the external auditors in the pilot, and the integrated audit as the aspirational benchmark, the financial statement audit is going to be at the heart of the pilot conversations. However throughout the auditor is engaged in discussions about what is best dealt with by implementing a separate Financial System Assessment and what risks should be addressed by periodic finance monitoring. Mostly, these other tools of external oversight are not going to be outsourced to the audit company participating in the pilot. Nevertheless, the auditor is expected to recommend which procedures should be used in applying these other oversight tools to provide the necessary confidence, and it is important to ensure that whoever is going to use these other tools should be subjected to the same reporting standards as the audit company is for the financial statement audit.

The report ends with some **concluding reflections** on (1) the kind of bureaucratic professionalism expected of partner organization that the oversight argued for assumes; (2) the in-built tendency of (any kind of) auditing to come with risk of unwanted consequences; (3) the relationship and contribution that this due diligence project makes to, the broader development sector debates about overhead, currently often discussed under the label ‘nonprofit starvation cycle’; and (4) its potential to make a difference in addressing the even broader and more essential difficulty of the NGO sector (including the NGO grantmakers) to coordinate and collaborate on many issues that are evidently best served by collective action.

Structure of the main text

The structure of the main report is not fully aligned with that of the summary. The main text first deals with issues around financial statement audits, and formulates guidelines for pilots to improve them, then deals with issues regarding Financial System Assessments and periodic finance monitoring, and formulates some additional guidelines to make for pilots that deal with all three oversight tools in a properly integrated manner. This structure reflects the way these practical recommendations follow up from suggestions made for improving external auditing in Working Paper 1, and the focus on an “integrated” audit as an overall benchmark for proper external oversight. However, the narrative flow of the summary should make for easier understanding of the overarching problem analysis and the proposed pilots as a solution to improve all three tools of external oversight.

Introduction

The original due diligence research described in *NGO Governance in Cambodia: service and support options for improving financial management*[3] brought to light that the Cambodian LNGO sector has structural, seemingly intractable problems with financial management. The subsequent second grantmaker survey with information from 18 grant-makers and covering 95 local NGOS reinforced the credibility of the original estimates of the incidence of these problems, and of the high correlations between weak governance, weak finance systems and fraud.[4]

A core premise underlying the due diligence research is that the persistence of financial management issues, given the substantial and ongoing capacity building efforts of LNGOs, and the self-regulating efforts of the sector, indicates the need for a closer look at the quality of the external oversight mechanisms. With LNGO board oversight largely ineffective, and oversight by communities non-existent, this means the due diligence directly exerted by the sector's funders, including the independent financial audits that they rely on.[5]

The research findings presented here indicate that funding agencies *in the aggregate* are not diligent enough regarding their oversight role[6]. There are not enough funding agencies applying sufficient diligence, and there is a lack of collaboration/collective action by funding agencies.

Despite widespread rhetorical agreement on the importance of due diligence by funding agencies, practical implementation of proper external oversight, commonly discussed under the label "vertical accountability", remains largely unaddressed in the NGO sector[7].

The research to date shows that while there is a real and serious problem, none of the many arguments against either the principled rationale for improving funding agency due diligence, or the practical feasibility thereof, seem to have major traction.

Organizational financial management can be looked at from many angles, framed by different perspectives. Each frame highlights certain aspects, and ignores or even obscures others. No single frame can deliver 'full coverage' of everything that matters[8]. This due diligence project takes thinking in terms of incentives as its 'dominant frame'[9].

A core argument of this working paper is that due diligence requires that funding agencies actively engage with the choice of procedures and routines by setting explicit Terms of Reference (ToRs) for the auditors they work with.

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[3] WP1 (2015)
[4] WP2 (2015), p.4-5 for the summary of the evidence
[5] This is not to argue that the possible external oversight by other stakeholders, especially individuals/communities that LNGOs work with and for, is not important! It simply means that this research project focuses on funding agencies and external auditors.
[6] The deficit in sufficient duly diligent funding agencies is described in WP2 (see pages 21-25). A summary of the collective action argument is to be found in this guest post: GAB, 16-06-2016
[7] This is described in WP1 (see pages 25-27). A summary is to be found in this guest post: GAB, 02-06-2016
[8] For an interesting argument for 'multiperspectival' analysis of social and institutional phenomena: see Morgan (1997)
[9] See Morgan (1997), p.355-373

Framing financial management of Cambodian LNGOs -Think institutional incentives[10]

Like much of basic social science, thinking in terms of incentives is very close to common sense and understood by everyone: people are motivated to act in ways that offer rewards and avoid behaviors associated with sanctions. The same is true for organized collectives of people that have particular organizational goals. What counts as reward and sanction can vary, but universally recognized rewards would be money/material rewards, and social esteem, while sanctions like fines, jail/social exclusion, and loss of reputation are also universal. To be effective, incentives require being 'realistic' possibilities. Thus: sanction effectiveness is strongly influenced by the risk of something sanctionable ever being detected, and when detected, sanction being enforced. Incentives often have a strong socio-cultural component. It is this kind of thinking that underlies common sense heuristics that make sense of social life, like "follow the money".

The label 'common sense' has two major connotations: understandable by all (the above use) and sound and prudent judgment based on a simple perception of the situation or facts. We use thinking in terms of incentives in this latter sense. If institutional arrangements are clearly, i.e. even upon superficial inspection of easily accessible facts, set up so as to generate perverse incentives, identifying what needs change is indeed 'common sense'. Eliminating them may not be enough and may fail to (fully) turn around the situation, but it is obvious that leaving perverse incentives in place will invite intractable problems.

The aspects of due diligence by funding agencies discussed in this Working Paper fit into a larger picture of what needs to be in place to enable sound financial management of Cambodian NGOs[11]:

- The NGO must have a proper financial management system (which in most circumstances would include checks and balances involving its governing board).
- The capacity to operate such a system needs to be in place.
- The existence and actual functioning of such a system must be a precondition for receiving (larger) funds, and, if pre-grant award due diligence finds it not yet in place, but the assessment shows evidence of serious efforts to put it in place, fund management needs closer outside scrutiny than otherwise.
- The existence and actual functioning of such a system, when in place, needs periodic and astute outside assessment, to increase the chances that wrongdoing will be quickly detected.
- When things do go seriously wrong, despite having a proper system in place (fraud or other serious integrity infringements), the response by the NGO and its donors must (be able to) decisively deal with it.
- The consequences for wrongdoers in case of detection must constitute (real) deterrents.

Most of the above requires due diligence by those holding the NGO to account. Insufficient diligence allows incentives for financial mismanagement to stay in place. This working paper suggests a practical way in which three aspects of due diligence by funding agencies can be improved: more effective external auditing, better Financial System Assessments (Financial System Assessments), and smarter financial monitoring . These are generally conceived of as playing different but complementary roles,

[10] WP1, an edited version of p. 28 (excluding footnotes)
[11] WP1, p. 29

but this paper argues for looking at them as considerably more connected and interdependent than the term ‘complementarity’ suggests.

Traditionally, audits are performed by external professional audit firms. Financial systems assessments are very occasionally conducted by such firms, sometimesby a financial consultant, and mostly by staff from a funding agency. Post-grant monitoring visits are near exclusively done by funding agency staff.[12]

The recommendations in this paper try to give practical answers to a basic question about using effective oversight to improve, sustain and guarantee proper financial management of Cambodian NGOs: what are practically feasible ways for funding agencies, as core account-holders of LNGOs, to live up to their financial oversight responsibilities?

The aspirational benchmark for those responsibilities is the board of a large publicly listed company[13]. For such boards, ensuring a high quality external audit[14] is the primary vehicle for providing the company’s stakeholders with the required assurance in the company’s financials. Using this benchmark thus makes the external audit a primary *thinking tool* for exploring ways to improve oversight instruments/approaches in the NGO sector[15].

The purpose of this paper is to provide actionable guidance to funding agencies willing to improve their oversight tools.

It is all about judgment and the most important aspects are those that all can understand
Assessment of the quality of financial management relies by necessity on judgment (see **Annex 2** for more background on this core aspect of auditing). The value of an external audit ultimately rests on the trust users can have in the professional judgment of the auditor, and that judgment, in turn, relies oheavily on the trust that the auditor has in the financial system/internal controls of the auditee. Having said that, the judgment also expresses itself in the choice of specific technical procedures and routines (for conducting audits and financial systems assessments), which auditors, for understandable business and legal protection reasons, keep at what they can minimally get away with (given the standards that they need to uphold).

Often that is not enough. In a previous working paper, the following was situation was discovered:

- one in five to one in seven Cambodian NGOs was affected by fraud
- one in four Cambodian NGOs had serious financial system weaknesses;
- one in four Cambodian NGOs had weak governance;
- weak financial management increases fraud risk at least sixfold; and
- weak governance increases fraud risk at least fourfold.
- There was a 98% incidence of fraud if BOTH problematic governance and weak financial systems were present.

[12] Different agencies co-funding the same NGO normally do not coordinate Financial System Assessments and/or monitoring visits.
[13] In practice, this responsibility is delegated to such a board’s account committee
[14] What this means and implies is legally regulated and for large companies a whole different ball game from the standards an NGO audit needs to comply with.
[15] To avoid misunderstanding: this doesn’t imply that external audits are ever going to play the role they play for large corporates.

- In 68% of cases, serious financial management issues were not raised in previous external audits
- In 82% of cases Fraud susceptibility was not raised in previous external audits

A core argument of this working paper is that due diligence requires that funding agencies actively engage with the choice of procedures and routines by setting explicit Terms of Reference (ToRs) for the auditors they work with. This engagement only requires a moderate level of understanding of what auditing and other financial assessments are about[16]. The major input is paying attention and recognizing that unless the 'reasonable client/stakeholder' (e.g. funder, NGO Board) explicitly negotiates the most effective scope for the audit/assessment, they will tend to end up with a report that might fulfill legal requirements but is more a token than an effective tool of oversight.

This working paper is written for that 'reasonable' stakeholder, and doesn't assume technical expertise.

Funding agencies taking on these suggestions are bound to be confronted with 'vertical accountability' blowback. **Annex 1** is an effort to provide a communication tool for answering questions about increased funding agency attention to their due diligence obligations. Its Frequently Asked Questions (FAQ) format aims to help funding agencies deal with the kinds of questions they can expect in a sensitive and hopefully persuasive manner.

My intensive engagement with this issue for the last three years put the need for such a communication tool[17] beyond dispute. This in itself shows how contentious, and how riddled with (mutual) misunderstandings, vertical accountability is. However, the need to face unease and misunderstanding head on requires going beyond the practical questions addressed in Annex 1.

Annex 3 addresses the widely held aversion to, and fears about, bureaucracy. When designing effective financial oversight *bureaucracy cannot be avoided* (**Annex 2** about the fundamentals of auditing makes it amply clear that external auditing *cannot do otherwise* than partially rely on the financial management systems of the auditee and these are inherently *bureaucratic*).

Annex 4 addresses a corollary: the *urgent need to explore alternatives to the NGO 'form'* for dealing with the necessary bureaucratic requirements. Not all mission driven groups can (ever) or should (in principle) try to fulfill their mission by organizing themselves as a professional (bureaucratic) NGO. Bureaucratic organization comes with fairly universal operational tendencies that may inherently conflict with particular missions.

To avoid misunderstanding about claims made in this paper about what funding agencies are currently doing to improve their due diligence responsibility, **Annex 5** describes Mango's work on International financial management standards for NGOs. Their work is directly relevant but should not be seen as really addressing the issues focused on by this due diligence project.

None of the content of the annexes is going to end up in the executive summary of this report, and the executive summary is going to be the only part of the report that readers assessing its merits for their

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[16] See the Merriam-Webster explanation of 'doing your due diligence': http://www.merriam-webster.com/dictionary/due%20diligence

[17] This is not to claim this tool is going to deal with all disagreement and misunderstandings. Suggestions for improvement and/or more effective alternatives are very welcome!

purposes are going to consult. However, I hope that *if you find merit* in the substantive suggestions for more effective external auditing and better financial system assessments and monitoring, and decide to delve into the main text, you also *read these annexes*. Properly assessing the proposals, *including their potential for unintended harm*, is impossible without reflecting on the assumptions and underlying arguments described in these annexes.

From assurance by authority to assurance by evidence

One way to look at the arguments made in this paper is that they all share the assumption that external audits, Financial System Assessments, and monitoring visits of Cambodian NGOs can only be fully effective tools for oversight if funding agencies take *adequate responsibility* for them. This means that the mere existence of something called external audit, system assessment, or monitoring is not enough. Referring to the professional authority of an audit firm is insufficient. Stating one has done or commissioned an Financial System Assessment or monitoring visit is insufficient. As the buck stops with funding agencies as account holders, they need to be able to *explain* why they think that the subject matter covered by the audit/assessment/visit and the procedures used have generated sufficient oversight *evidence* to satisfy *reasonable* expectations. One cannot outsource that judgment to others. As argued above, this judgment doesn't require technical auditing expertise. It requires active engagement with framing the objectives for audits/assessments/visits. The discrepancy between the (legal) oversight responsibilities of company boards, especially those of large listed companies, and what these mean for their role in the audit process and other aspects of the financial management of the company, and the predominance of totally relying on auditor authority (and standard tools, mostly gathering only information provided by the NGO partner), in the Cambodian NGO sector, is huge.

This working paper focuses on recommendations for what is needed for agencies funding LNGOs to be able to take their oversight responsibility equally seriously[18].

External Financial Audits

This section describes suggestions on ways to improve the effectiveness of external financial audits as instruments of oversight for Cambodian LNGOs and the agencies funding them. The section is structured as follows:

- What specific functions do external financial statement audits play?
- What problems has research to date brought to light?
- How to solve these problems?

A policy and practice focused working paper is not the place to delve into the philosophical, historical, and sociological underpinnings of the practices it recommends. Having said that, without a basic

[18] Admittedly, legal responsibilities of big corporates don't guarantee effective auditing either. Any system can be beaten, and both big corporates and the audit profession struggle with many perverse incentives (see below: A recap of the basic argument of external audits as tools of oversight). But, as **Annex 2** shows, the history of audit regulation can be understood as a history of failure, followed by further attempts at control, followed by more failure, in an endless spiral. And in this game of 'cops and robbers' or 'network managers and hackers' or whatever your favorite metaphor for this dynamic may be, NGO sector account holders as a collective stand out as being comfortable with assurances that in other parts of society have long since lost credibility.

awareness of the many (often erroneous) assumptions that users of audit expertise tend to hold, and of the very real risks of unintended consequences unfolding when auditing is implemented unreflexively and without constant monitoring of what it results in, well-intentioned suggestions may end up causing more harm than good. **Annex 2** provides a selection of passages (i.e. not a summary of the argument) taken from what I consider a must-read classic on auditing. The passages are meant to alert the reader to the often surprising/unexpected/non-intuitive of what underlies the demand for, and the use and built-in limitations of, auditing. It is meant as a teaser that hopefully entices readers to follow up themselves so as to be better able to apply auditing with the required sensitivity to what it implies, to what it can and cannot do, and to what its dark sides[19] are.

The specific functions of external financial statement audits

External financial statement audits can play many important roles for Local Non-Governmental Organizations (LNGOs) in Cambodia and their account-holders.

A good audit of financial statements "provides assurance that management has presented a 'true and fair' view of a company's financial performance and position. An audit underpins the trust and obligation of stewardship between those who manage a company and those who … have a need for a 'true and fair' view, the stakeholders"[20]. In other words, they can provide confidence to LNGO management, board, funders, and other stakeholders that their financial reports are trustworthy.

Although a *financial statement audit* is a considerably less comprehensive assessment of an organization's financial system and procedures than an *audit specifically looking at its internal controls over financial reporting*, any proper financial statement audit will include testing the existence and effectiveness of management controls. "A well-run [organization] will have its own systems and controls in place to operate efficiently, safeguard its assets, and to provide reasonable assurance that its transactions are properly reported and that its financial statements are complete and accurate. The auditors assess the effectiveness of these controls in preventing and mitigating the possible risk of material misstatement in those areas where the auditor plans to use such controls to adjust the nature, timing and extent of their [own] testing"[21]. Financial statement audits can thus be a periodic check on the health of an organization's financial systems, and tell management and other stakeholders if systems are theoretically strong enough to provide the safeguards they are meant to provide, and practically enforced so as to be effective.

Even a comprehensive and well implemented financial statement audit is not able to detect all fraud. Auditors of LNGOs in Cambodia contacted for the second grantmaker survey estimated that their normal work would only bring an estimated 50% of all existing fraud to light[22] (the rest would require specific and well-guided investigative audits). On top of that, a properly executed assessment of the existence and the effectiveness of management control (see above) is a core element of the fraud risk analysis that any organization should subject itself to. The data of the second grantmaker survey indicate very high correlations between weak governance, weak financial management, and fraud[23]. In

[19] Power's analysis of these dark sides also uses a 'incentives' approach.
[20] PWC (2013), p.2
[21] PWC (2013), p.8
[22] WP2 (2015), Annex 6, p.61
[23] See WP2 (2015), p.5 for a summary of the evidence

other words, although the financial statement audit is not meant to be a fraud investigation (and will thus miss out on half of existing fraud), it can bring the most important organizational facilitators of fraud to light and thus alert management and other stakeholders to fraud risk. Also, "[t]he knowledge that an independent external audit will be conducted generally has a deterrent effect against fraud"[24].

Lastly, a periodic, trustworthy, independent, comprehensive, *organization-wide/global*, external audit is a tangible indication of an organization's commitment to the importance of accountability to its stakeholders (as noted below, *project* audits are far less reliable).

Issues with external auditing of LNGOs identified by the due diligence research project

Over the course of the due diligence research to date the following issues regarding the external auditing of LNGOs became evident:

The professional quality of the Cambodian audit sector

Financial scandals of the corporate and financial world regularly involve the underperformance and/or collusion of audit firms, and the track record of the crucial accountability mechanism of an external audit is thus certainly not beyond reproach. That is true in general. This report will revisit this (see below: a recap of the basic argument of external audits as tools of oversight) when looking at the need for active involvement in the auditing process by those commissioning the external audit. But the situation in Cambodia is (even) worse: Cambodia's auditing sector does not live up to international standards and the problem is structural. It hasn't improved much[25] since the release of a 2007 World Bank commissioned report[26] on the accounting and auditing sector which gave this description of the state of affairs:

Accounting and auditing in Cambodia

Cambodia is putting in place an institutional framework with regard to accounting, auditing, and financial reporting practices. However, institutional weaknesses in regulation, compliance, and enforcement of standards and rules still exist. The accounting and auditing statutory framework suffers from inconsistencies among different laws. Although the national accounting standards and auditing standards are based on IFRS, and ISA, respectively, they appear outmoded and have gaps in comparison with the international equivalents. There are varying compliance gaps in both accounting and auditing practices. These gaps could primarily stem from lack of clearer understanding by professional accountants, inadequate technical capacities of the regulators, absence of implementation guidance, lack of independent oversight of the auditing profession, and shortcomings in professional education and training. There is little awareness of the importance of quality financial information in Cambodia. Financial reporting is driven primarily by compliance requirements of shareholders, obtaining bank loans, and satisfying the taxation regime. Auditing in Cambodia is perceived as an exercise of little value. The law does not outline which standards should be followed in conducting audits.

[24] PWC (2013), p.8
[25] Interview with auditing company director
[26] World Bank (May 2007)

The big companies charge considerably more than the small ones; quality of the smaller ones is far more diverse and includes the criminal end of the scale[27]. But the higher rates of the big companies don't guarantee quality (albeit assumed to exclude collusion with fraud). Field auditors are usually junior, and often without much if any experience assessing NGOs[28]. All audit companies, big and small, have an interest in continued relationships with their clients and tend to refrain from pursuing leads if not contractually bound to do so. Big firms also sometimes only consult admin staff and the ED, while it is common knowledge that checks with program staff and community people/groups regularly bring proof of mismanagement to light[29].

The uptake of external auditing by the Cambodian NGO sector

Two decades of Cambodian NGO sector assessments[30] on the quantitative difference in uptake of external financial statement audits show little change in NGOs that are audited by auditing firms. About half of Cambodian NGOs are externally audited. Unless required by one or more of the agencies funding an NGO there is generally no external audit.

Little change in the uptake of external audits over the last decade[31]

Of the 32 completed profiles [on PACT NGO partners], 13 organizations (41%) have regular external audits by [private] firms... Six other NGOs (19%) indicated their donors regularly audit them. Ten more (31%) are not audited and we lack information on the remaining four. The presence of external audit appears to be directly related to the policies of the donor agency. In-country funding agencies with adequate financial staff usually conduct their own financial reviews of partners. Donors with no in-country presence are more likely to require an audit by a private firm and include the cost of the audit in the budget. During the course of the survey, the researchers examined a number of audit reports.

Although the audits are said to be expensive, the reports we examined were thin and did not include income statements. In at least one case, the audit firm did not visit the NGO office. Therefore, while external audits are a good idea, if they are guided by excessively vague terms of reference, donors and other agencies will cease to perceive audited NGOs as being held to a high standard of accounting practices and audits will lose their credibility. **2001**[32]

In 2005, around 27% of local NGOs and about 39% of INGOs got audited by external auditing firms. **2010**[33]

54% of LNGOs in their sample has independent financial audits (not all of those will be done by an accounting firm, some will be done by (one of their) donors. **2012**[34]

[27] Based on anecdotal evidence only. No data are available to make an estimate, and this phrasing should not be read as if stating the presence of *many* criminal audit companies on the Cambodian market!
[28] Sector experience is relevant for doing a proper audit in practice. In theory lack of sector knowledge can be compensated for by spending (much) more time, but that would mean either even higher costs or less profit
[29] Interview with Financial management consultant
[30] Our working definition of an NGO sector assessment is broad: any evaluation of a sample of Cambodian NGOs using at least some systematic information gathering technique
[31] WP1, p. 76-77
[32] Mansfield, et al (January 2001), p.17-18
[33] CCC (August 2010)

The quality of external audits[35]

The grantmaker surveys conducted as part of this due diligence project generated quite worrying data on audit quality:

"One of the more disturbing findings of the 2014 [grantmaker] survey was *the incidence of serious financial management issues* encountered by the data sharing audit firm which had *not been brought to light by previous external audits*. The 2015 results provide a disturbingly similar picture:

- Nearly two-thirds of serious Financial Management issues (61.9%) were not brought to light by previous external audits. This implies that the 2014 conclusion that *given that we are talking systemic weaknesses here*, *at least some of those weaknesses were present already during the time of the previous (sloppy and/or colluding/fraudulent?) audit.*

- For fraud cases the proportion was even higher: 81.8% of the LNGO fraud cases that also had serious Financial management issues did not have those systemic issues pointed out by previous audits[36]. Again, the 2014 conclusion can be repeated verbatim: *This again can be understood as indicating that the longer NGOs (are able to) avoid proper scrutiny of their systems and are able to operate for a longer duration of time without the presence of checks and balances provided by such proper systems, the greater the likelihood of the opportunity for fraud turning into actual fraud".*[37]

The fraud risk of conducting only project audits

"One of the biggest fraud risks of NGOs receiving funding from various donors is double-billing. The obvious way of preventing this is a global audit. A theoretical alternative is that all grantmakers funding one NGO agree on the time period covered by the audit of 'their' project and compare the results. But that seems an unnecessarily cumbersome and practically unfeasible way to achieve what a properly conducted global audit would deliver".[38]

"Many grantmakers' internal regulations and/or back-donor requirements ask for project audits. They may subscribe to requiring a global audit too, but cannot do so without a project audit".[39]

More effective external financial statement auditing

The working paper on service and support options for improving financial management[40] recommended practical collective action by funding agencies for dealing with the provably pernicious effect of some of them still requesting project audits without also requiring an organizational (global) audit. It also recommended that funding agencies take a much more active role in specifying their expectations for

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[34] Sua´rez, D. & Marshall, J. (2012). Unfortunately the results of the 2012 NGO survey on being externally audited (52%, of which half conducted both organizational and project audits, a quarter only organizational audits and a fifth only project audits) commissioned by CCC (May 2013) are not separately tabulated for LNGOs, INGOs and Associations and thus cannot be compared with these results. However, other data from the same survey strongly suggest serious over-reporting of practices that are known to be considered important by funding agencies (see WP1, p. 76)

[35] WP2, p.20

[36] This particular figure is not included in Table 6

[37] One may even assume that not only some of the system weaknesses but probably also some of the fraud was already present during the time of the earlier (sloppy) audit.

[38] WP1, p.33

[39] WP1, p.51

[40] WP1

financial statement audits. Complaining about quality after the fact is easy but in contractual relationships the onus is on those buying a service to specify the terms and ensure that the service provider sticks to them. The report suggested a due diligence Community of Practice (CoP) for figuring out smart solutions to practical difficulties blocking change of the status quo[41]. To do so, it suggested that such a CoP shoults should look at the following issues.

Given that many funding agencies have internal regulations and/or back-donor requirements that ask for project audits:

- What Terms of Reference (ToR) specifications for a global audit would cover most, maybe all requirements[42]?
- What requirements, if any, would not be solvable within the context of a global audit and would require a separate report[43]?
- Can project donors requiring project audits (legally) wait for the global audit when the project ends early in a financial year, and if not, how can their in-between project audit be financially figured into a collective donor agreement around how to share audit costs?
- What would be the added costs of the global audit ToR specifications[44]?
- What would be the costs of the separate project audit reporting?[45]

More broadly regarding solid ToRs:

- What system audit expectations should be included in any NGO financial statement audit to ensure that the external audit doubles up as a periodic check on the systemic soundness of an NGO's financial management?
- What would adding those specifications mean in terms of added costs?

And finally about cost sharing:

- What would be a fair and feasible basis for sharing the costs of a global ToR audit?

This section provides additional background to these suggestions so as to provide funding agency conversations with some practical guidance about what their agreements for improved external auditing of their partner NGOs would need to address.

The theory of action underlying the guidelines

The particular details of practical constraints are going to vary between different funding agencies, and across specific funding recipients and contexts.

[41] WP1, p.51

[42] Ultimately, as long as an NGO's finances are organized in a matrix form with projects/activities/expense categories as (nested) rows, and donor income covering them as columns, project finances can easily be made separately visible in a global audit.

[43] Some internal regulations/back-donor requirements will legally require a separate financial statement for the project

[44] This is bound to be higher than a normal audit; on the other hand, it is can also be expected to be less than the total of all audit costs covered by the various funding agencies.

[45] As long as the actual auditing work doesn't require additional work beyond producing the project audit report, the costs for this requirement should be relatively minor compared with the costs of an audit conducted separate from a global audit.

Not only is it practically impossible for any consultant to inventory this variety it, also seems optimistic to assume that any translation of this variety into one best practice ToR would be possible[46]. It is practically impossible for a consultant to do this because only agency insiders are really able to figure out how particular barriers to change within their own agency can be overcome. Interviewing them is not a feasible information collection strategy because very often "figuring out" has to be taken literally: they do not know until they actively try.

Consolidation of solutions in one good practice ToR seems optimistic because the *kinds of constraints* may be limited but what it takes to overcome a particular kind for a particular funding agency, within a particular funding situation, can be expected to show variation. The more variation, the less one good practice ToR is going to be of much help.

Potentially the most fruitful conversations between agencies, for identifying barriers and ways to overcome them are those between (all) co-funders of a particular LNGO. They hold the most potential because their barrier-solving (or circumventing) findings can be implemented immediately, making for collective good practice vis-à-vis this one co-funded partner (and any others that they co-fund).

A multitude of such conversations around shared partners would result in a set of good practices. Such a set may look very alike regarding the financial statement audit ToRs, timing and cost-sharing agreements that they result in, or they may show considerable variation. Ultimately, that doesn't matter because collectively (assuming they are properly documented and compiled in a way that is easily accessible to any group of co-funders of the same LNGO) they are going to provide:

- Solid evidence that when co-funders make a serious effort they can succeed in making the external auditing of their shared partner way more effective.
- A growing set of "templates" that others can choose from and that is going to offer ready-made solutions for an increasing number of "funding agencies – specific funding recipient/setting" combinations.
- An increasingly critical mass of good practice that is going to put pressure on those not yet participating to join the conversations.

Given the 'limited' number of funding agencies (an involvement of 50 grant providers would probably[47] cover a substantial share of the funding going to LNGOs) active in the Cambodian NGO sector, and the substantial overlap in NGO portfolios of funding agencies[48], hope for a 'build-up of critical mass strategy seems realistic.

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[46] In WP1 I still assumed it would be possible but argued for a funding agency Community of Practice approach on the basis of a "user involvement" perspective (which is going to increase chances of uptake). My thinking has evolved since then.

[47] Information on who funds what in Cambodia is sketchy and contradictory. Annex 5 of WP 2 (p.53-57) contains estimates. Systematic information about co-funding is not available but a third grantmaker survey would start delivering such an overview (assuming that its coverage would be good).

[48] Of the limited number of 13 funding agencies sharing partner-level data in the second grantmaker survey 11 were in co-funding relationships with one or more of the others. Of the total of 93 NGOs that received funding from them, half received funding from two or more of the grant providers surveyed.

The Guidelines

This section translates this theory of action into practical recommendations regarding what funding agencies need to do when taking collective action to improve their external oversight. The recommendations are phrased as guidelines covering three aspects requiring attention. Which funding agency – LNGO setting offers most promise? What auditor to involve in the process? And what to work on during the process.

Creating the right setting for a process to improve external audits

Guideline A1: pilots of agencies co-funding the same LNGO

The core recommendation for improving the effectiveness of external financial statement audits is for funding agencies to identify responsive and non-problematic LNGO partners that they share with other grant providers with which they are on good terms; initiate a conversation with all co-funders about smart solutions to practical difficulties that block change of the status quo; implement any solutions discovered; and document them properly.

This recommendation assumes that:

- Nothing is going to change unless pilots start to deliver solutions, and solutions are actually implemented.
- Therefore it is important to start with what seems most feasible. Thus the recommendation to start pilots with 'easy' NGO partners (no big issues, a history of open and honest communication) with all/most of which co-funders one is already on good terms.

This recommendation implies that:

- There is a 'template' for documenting solutions that ensures that other funding agencies looking for ways to improve the effectiveness of the external auditing of one or more of their partners can easily access all the relevant information to assess if this solution fits their situation. There is a 'platform' for storing and sharing these solutions. I am going to return to this in the concluding section of this report.

From pilots to changing NGO sector practice

Despite the optimism shown above, a theory is exactly that and nothing more. To actually move from pilots to something that makes a sector-wide difference, even if only in one country, is much easier theorized than done. Pilots in and of themselves simply show that something is possible and does the job one is after. Storing properly documented examples and lobbying the NGO community to access them, follow them, and over time create a new normal that makes ignoring their good practice increasingly difficult, takes a concerted effort and needs a core group of champion funding agencies and LNGOs that push the agenda beyond their own limited corner of the sector. Such a group could provide the (in themselves very limited resources required for) a platform and take care of formulating a workable template for documenting the pilots[49]. This report does not address the 'how' of getting such a group of champions together and effectively active. How to make change happen is a hot topic[50] that goes beyond this specific topic of improving financial management in the NGO sector. I do not have anything to offer other than the conviction that, *without* positive examples that others can learn from and follow, if a group of committed agencies and LNGOs would come together, it would have little to work with.

Potential spoilers of pilots (confidentiality and project audits) and how to deal with them

Working paper 1 already identified several conditions that need to be fulfilled for any proper pilot to become possible.[51] One is that all agencies provide access to all relevant information they have to the others. The research to date has shown that this is still a hurdle for a sizable proportion of funding agencies. The major argument put forward against sharing with others is that this can only be done after informing, or in a more extreme version, receiving the consent of the partner NGO.[52] Some explain that this is the morally proper standpoint; some have formalized it by contractually committing themselves to informing/prior consent.

The big advantage of starting with pilots around one shared partner NGO is that informing or asking consent of *one* NGO[53] is such a small hurdle that a refusal to do so can only be construed as deliberate obstruction, especially if requested by group of peers with whom one is supposedly on good terms.

Another condition is that all agencies participating in a pilot agree that their due diligence responsibilities (also) require an organizational/global overview of partner NGO finances. If, for whatever reason, they have decided that on top of a global audit, they want the specific project/program that their funding pays for also audited, this cannot in any way replace the need for a global overview. Again, refusal to agree on the absolute necessity of an organizational overview cannot

[49] Obvious parts of the documentation would be 1. A description of the situation before the co-funding agencies coordinated their external oversight activities (what did each agency individually do? What resources – money, staff-time – did it invest in each? What were the results?, 2. The changes due to organizing the oversight collectively (what do they do now? What resources do they invest in each activity? How do they share costs? What are the results?), 3. Specific hurdles any of the agency had to overcome and/or specific constraints that they needed to take into account (e.g. back-donor requirements, legal requirements, etc. 4. Any advice they would give to others interested to follow their example.

[50] A recent effort to theorize this core question of much/most development work and come up with some practical thinking tools and suggestions for entry points is Duncan Green, 2016.

[51] WP1, p.32-33

[52] See WP2, p.68-70

[53] As opposed e.g. to asking to share detailed info about *all* one's partners. But see WP1, p.32-33

be construed as anything other as deliberate obstruction of the collective effort to improve NGO financial management.

In the extreme case of several agencies co-funding one partner, and *all* of them requiring project audits, without any financial leeway to (also, collectively) ensure a proper global audit, such an agreement would have to translate in:

- The need to ensure that they are certain that they are aware of *all* grant providers that fund their partner
- The need to find a way ensure that all project audits are compiled into a kind of 'quasi global audit'

Especially the second requirement looks very difficult to fulfill because project/program audits are very unlikely to have aligned timeframes. In that case, a fallback option is:

- To agree with each other to align the timeframes of the financial reporting arrangements with the partner
- To agree to request the partner to not only produce project/program financial reports but also one organizational financial report
- To (have one of them) compile their separate reports and check them against the one organizational overview

Obviously, the fallback option would still imply the lack of a proper independent global audit (which would e.g. include basic system checks) and thus be second best. But one might argue that the fallback option of periodically checking if program reports and organization report match requires a level of attention to detail that would in itself offer reasonable confidence that potential problems are detected.[54]

However, it seems evident that collaborating to ensure a proper global audit will be much easier and less burdensome than the fallback option.

Choosing the right auditor to include in the process

Guideline B1: one auditor contracted on a ToR that is agreed by/with funding agencies

Obviously, funding agency pilots for improved financial statement audits only make sense when they co-determine the ToR for the audit with the LNGO partner. Weirdly enough, the grant provider setting the terms of an external audit is often standard practice when a funding agency requests a project/program audit, but often not when it accepts an organizational/global audit. The reason is that project audits are normally a back-donor requirement, and the funding agency ensures its own compliance by enforcing the required format on its partner. This may or may not imply that the funding agency chooses and/or directly contracts the auditor. Those accepting global audits normally leave the choice of auditor and the ToR of his engagement to their partner (which has led to many inadequate and even fraudulent audits). Whatever kind of audit a funding agency requires, with or without specifying a ToR, nearly all[55] see

[54] Especially if accompanied by agreed upon collective attention to financial system/internal control issues during monitoring. See section C below

[55] With the exception of those that see their LNGO partners as subcontractors, and commission their audit company of choice to do the yearly (mostly project) audit.

auditing as the responsibility of the partner, and funding agency 'interference' as overstepping the boundaries of propriety.

Given the general issues with audit quality in Cambodia (described above), interference cannot be avoided, at least not regarding the Terms of Reference, and vetting the choice of auditor. Setting conditions on what the ToR needs to include doesn't imply that the NGO partner has to use a ToR provided by its grant providers. It only means that the ToR they choose to use includes a list of requirements that the grant providers have specified. However, as the following sections show, these conditions must include that the auditor (also) directly reports to the funding agencies.

It is foreseeable that some funding agencies will have issues with this for the same 'partnership' reasons that make them hesitant to share relevant information with co-funders. However, not setting conditions means accepting a substantial risk that the external audit is of substandard quality and/or too limited in scope for the role it is supposed to play as a tool for external oversight.

It also doesn't imply that the choice of auditor should *necessarily* be in the hands of the funding agencies (although it would include the need to agree to the LNGO partner's choice). However, in case both a global audit and one or more project audits are required, pilots require that all audits are done by the same firm. Otherwise the combined auditing expense is going to seriously increase. This, again, doesn't *necessarily* imply that the choice of auditor should not be in the hands of the partner NGO anymore, but in case (one of) the grant provider(s) requesting a project audit directly contract a particular firm for the auditing of all its partners, a group implementing a pilot will find it easiest to go along with that choice. This may mean in practice that the partner NGO loses say over who does its global audit.

Incentives: who best selects and contracts the audit firm
It is grant money that pays for external audits but most global audits are commissioned and contracted by the NGO being audited. The anecdotal evidence about NGOs with financial management problems contracting firms willing to give them a clean sheet (presumably in exchange for easy money and return business) makes one wonder about how such a contractual relationship can be expected to properly incentivize an audit firm to live up to its professional standards.

Conceptually, auditing presupposes independence. Historically, the emergence of modern financial auditing ties in with the emergence of corporate entities in which ownership and control were separated with the attendant need for owners to have an independent check on the accounting of their management.[56] But even in the best of contexts (auditees having functioning boards as contractual partners of the auditors, and a regulatory and legal environment that effectively[57] sanctions fraudulent auditors) "[t]he history of auditing reads like the history of regulation more generally: as a history of failure".[58]

[56] See **Annex 2**
[57] There is no black and white, only shades of grey here: even in the best of institutional environments the sanctioning of 'white collar' crime is a big problem.
[58] See **Annex 2,** see also below: A recap of the basic argument of external audits as tools of oversight

In Cambodia, a context lacking both properly functioning boards and proper audit sector oversight, it seems a sensible and defensible risk management strategy to let funding agencies (as one of the account-holding 'principals' of an NGO) select and contract the external auditor, and thus avoid the perverse incentives of the auditor being financially dependent upon the auditee.

This, however, must be matched by the funding agency taking its role seriously. Trying to backstop ineffective oversight by an LNGO's board by ineffective oversight by its funding agency wouldn't make any sense.

An even more complicated situation arises when there are two grant providers that require project audits but normally work with different audit firms and time frames. In many cases, it doesn't require more than the willingness of one or the other to prioritize the importance of the pilot over their preferred choice of auditor, but in general, the more compromises are needed for any stakeholder involved, the more risks for friction.

Much of the above provides additional reason for the recommendation to start pilots with 'easy' NGO partners whose co-funders are all already on good terms.

Guideline B2: ensure that the auditor is up to the task

All that follows assumes that the audit firm is up to the tasks one engages it for. As described earlier, the quality of audit firms in Cambodia is very uneven. This section assumes that funding agencies are (at the very least) actively involved in the engagement of the audit firm of their shared LNGO partner.

Currently, agencies looking for a competent audit firm rely largely on past experience and word of mouth. Assuming these sources result in a shortlist of potential firms to work with, there are several issues that require attention when considering potential auditors:

(1) Is the firm willing to engage in a pilot process? As the below makes amply clear, this involves having to be *more transparent* about the audit process than they would normally have to be within the Cambodian NGO sector; *actively thinking along* with the funding agencies about the merits of particular choices, both for the financial statement audit proper, as for the other tools of oversight (which assumes substantial involvement of the senior most auditor of the team). Experience to date suggests that there are indeed some willing audit firms.

(2) Does the auditor show evidence of doing its own risk analysis by asking the right questions about the auditee and its situation? Using auditing practices as customary in Big Business as a "benchmark"[59], one would expect audit firms approached with the request to be the partner in such a pilot, to do their own risk analysis. LNGO and funding agencies thus need to be prepared to provide the audit company with quite some preliminary information, probably substantially more than current standard practice in the Cambodian NGO sector. To engage productively in ToR conversations, the audit company will need real understanding of what the NGO does and how that translates into its budget/expenditures (and associated mismanagement risks), the general issues with governance and financial management that the sector struggles with, the regulatory regime LNGOs operates within, etc. Unlike much of the pilot substance, funding agencies have the upper

[59] As this report does repeatedly

hand here; they (should) know this operational reality inside out. This means that an initial conversation should already allow them to judge if an auditor asks the right questions.

(3) Even if the firm has the required NGO sector specific expertise, is that expertise made available to the audit? "[A]udit quality largely depends on *the individuals who conduct the audit*, the [principal] could assess whether the primary members of the audit team demonstrated the skills and experience necessary to address the company's areas of greatest financial reporting risk and had access to appropriate specialists and/or resources in the audit firm that are responsible for audit quality, standards, and methodology, during the audit."[60]

(4) How strong is the internal oversight of the audit process itself? The benchmark here would be audits of large listed companies: "The audit process includes quality control procedures prior to the audit firm's issuance of its report, among them a review of audit procedures that is performed by another professional within or outside of the audit firm—also known as an *engagement quality review*. The objective of the engagement quality reviewer is to evaluate the significant judgments and conclusions made by the engagement team in forming the overall conclusion on the engagement and in preparing the independent auditor's report in order to determine whether to provide concurring approval on issuing the report."[61] One major reason to explore this is that the engagement quality review presupposes that the whole process has been documented in such detail that *an auditor who was not otherwise involved in the audit*[62] can assess its quality. An auditor agreeing that such documentation indeed indicates good quality, also will agree that all the details that guidelines 6-9 require/request do not imply extra work beyond some extra writing (and thus only minimal additional charge).

(5) Can the firm be trusted enough not to abuse the many possibilities to prioritize (only) self-interest? This is a crucial consideration but one that is going to be impossible to assess for the very first pilots. One might hope that conducting and documenting several pilots will result in the required benchmarking experience about how "reasonable" particular auditor costings are. It should thus be a temporary risk for especially the first pilots that an overall/ongoing process of piloting can mitigate.

Guideline B3: determine the available budget for funding agency external oversight

Before a funding agency collective can engage with any auditors they need to figure out amongst themselves what their budgetary possibilities are for external auditing. As the below is going to argue, the external audit is one of three oversight tools that funding agencies have, the others being Financial System analyses, and periodic monitoring of partner finances. These tools should be applied in an interconnected way.

This implies that determining the budgetary possibilities for external audits requires sharing information about the resources for all three tools. The concluding section of this paper explores this in more detail, because looking at external oversight in this 'integrated' way has implications that go beyond agreeing on shared external auditing (which after all is an 'outsourced' tool of oversight).

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[60] Center for Audit Quality (June 2015), p. 2

[61] Center for Audit Quality (January 2013), p. 15

[62] From the perspective of the NGO sector this is a Big Business benchmark because SOP in the Cambodian NGO sector is that the auditor in charge of the quality review is also the senior most auditor of the team, and has thus been involved in planning it.

However, all the following guidelines about funding agency engagement with the external audit assume that there is at least a tentative and shared agreement on what the agencies collectively are able to invest in external auditing, which covers the costs of a good global audit and any required project audits.

As the concluding section emphasizes, it makes a (potentially big) difference how much else the funding agencies are willing and able to coordinate, also for the budget they (can) allot to the external audit. Some of this potential may only emerge during the actual conversations with the selected audit firm. So a rethink on the budget allocation for the external audit on the basis of what comes up during such conversations may be necessary, but without a reasonable ballpark figure to frame the conversation the auditor will have trouble constructively engaging on a good ToR for the audit. ToR choices translate into the cost an auditor is going to incur and thus charge to the client. Exploring the consequences of various choices for the ToR is therefore not really possible without some frame of what is available.

The above doesn't necessarily preclude a choice of auditor (also) based on some form of competitive bidding, but given the limited number of audit firms with a positive reputation on the Cambodian market, and the importance of quality considerations, it seems realistic to assume that pilot are best served by choosing an auditor that all involved are comfortable with .

Working with the auditor toward a more effective external audit

The conceptual universe of financial audits

To productively think about the questions that need to be answered in pilots, it is helpful to start with what is at the heart of improving the effectiveness of external financial statement audits as tools of oversight:

- When a partner is financially audited by an external auditor the primary output[63] is an organizational/global audit, including a management letter.
- Organizational/global financial statement audits provide substantially more confidence than what is currently deemed acceptable by many.
- Ensuring such improved effectiveness is within the financial possibilities of what the collective of co-funding grant providers is able to devote to external auditing.

To translate these objectives into practical guidance for pilots three issues need further clarification:

- What does an auditor need to *look at/do* more to be able to provide more confidence in the audit report?
- What does the auditor need to *share*, about the audit findings, and about themselves, to provide more confidence?
- The current conundrum of *overhead* as a barrier to sensible thinking about the costs of external audits

This section looks at the first of these: *What does an external financial auditor need to look at/do more*?

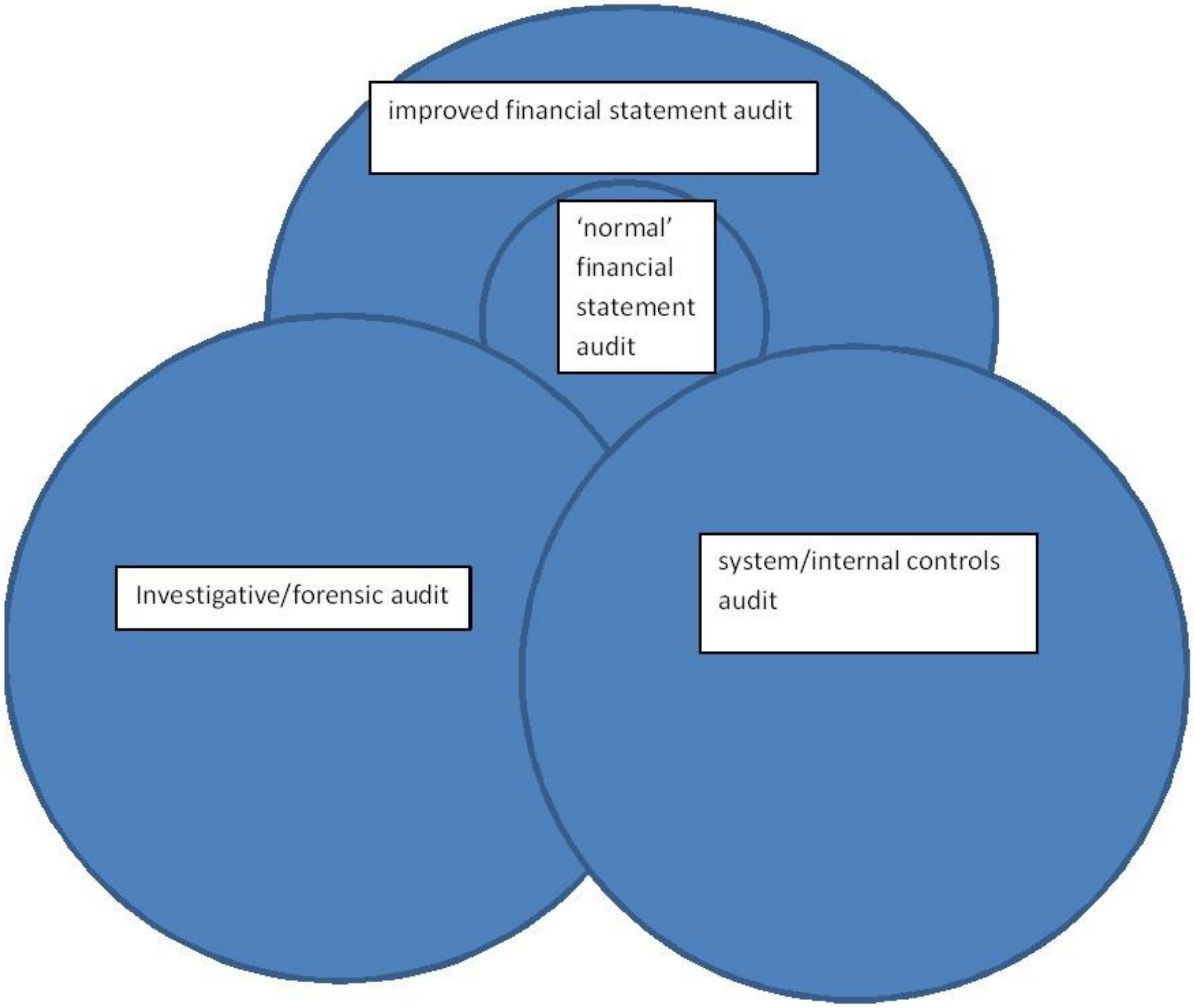
[63] This implies that the minimum commitment funding agencies that require project audits must be willing to make is to agree that getting a project audit without also getting a comprehensive overview of the organizational finances, preferably in the form of a proper external global audit, is unacceptable.

To answer this question it makes sense to start with what they currently look at and do when doing a financial statement audit, and how that relates to what they *in principle could* do. **Figure 1** below is one way of visualizing this. The figure is not meant to "technically" depict kinds/types of audits ("evaluation of a subject matter with a view to express an opinion on whether the subject matter is fairly presented"[64]) if that would be possible at all, because it doesn't take much researching to realize that the cake can be cut in many different ways.[65] It is also not meant to depict types of audits that are based on different kinds of procedures, something that the overlap between 'sets' in the below venn diagram already suggests. Rather, Figure 1 is an effort to represent the universe of auditing the financial management of Cambodian NGOs that combines both the perspectives of the *types of audit subject matter* that funding agencies are normally familiar with, and the perspective of *kinds of audit procedures* that are the foundation for the assurance an audit is assumed to provide.

[64] PWC (2013), p.2; a more elaborate definition: "Audit is an appraisal activity undertaken by an independent practitioner (e.g. an external auditor) to provide assurance to a principal (e.g. shareholders) over a subject matter (e.g. financial statements) which is the primary responsibility of another person (e.g. directors) against a given criteria or framework (e.g. IFRS and GAAP)" - See more at: http://accounting-simplified.com/audit/introduction/types-of-audits.html#sthash.2WjhYCJw.dpuf

[65] Non-experts tend always tend to assume more consensus in any professional/technical 'field' than is actually present. So it really does help to have a quick look at just a couple of easily accessible sources targeting the non-expert:
https://en.wikipedia.org/wiki/Audit
http://www.accountingtools.com/questions-and-answers/types-of-audits.html
http://accounting-simplified.com/audit/introduction/types-of-audits.html
https://finance.columbia.edu/content/types-audits

Figure 1: the universe of financial auditing



The first thing this figure shows is that the normal external financial statement audit already includes aspects of all subject matter and procedures required by its improved version. Whether that is really the case for many existing financial statement audits of Cambodian LNGOs is questionable, but conceptually, the improved version doesn't require anything new.

The overlap of the financial statement audit and the system/internal control audit represents a core aspect of auditing: the external auditor has to rely to a substantial extent on the financial system, including the crucial aspect of internal controls, of the auditee.

The overlap between the investigative audit and the financial statement audit points to the hot potato of the audit profession: the public expectation that external audits bring any existing fraud and other problems to light. The profession even has a specific label for the discrepancy between what the public thinks an audit is mainly for and its actual potential: the 'expectation gap'.[66]

[66] E.g. see: Saladrigues, R. & Grañó, M. (2014)

Guideline C1: More systems/internal control attention to improve financial statement audits

Understanding financial audits is no rocket science: a short reading guide

As described in the introduction, this working paper doesn't assume technical expertise. It is premised on the assumption that funding agencies' *unquestioned* reliance on audit expertise is a major reason that in Cambodia external audits fail to be the effective tools of oversight for LNGOs that they are supposed to be. For proper 'questioning' common sense suffices.

The translation of common sense ('think in terms of incentives') oversight objectives of financial audits into the technical procedures that are required to fulfill them for any particular auditee, given the legal/regulatory requirements that need to be taken into account because of the jurisdictions involved and the particular group of funding agencies, does requires technical expertise. But setting the objectives should be done by the clients of that expertise. And that doesn't require anything like an auditing qualification.

In general, what it requires doesn't go beyond an understanding of the principles and some other basics as described in guides that audit companies and/or their professional associations and Mango make freely available.

For understanding external auditing I found the below three guides very helpful, and recommend anyone who is not a financial professional and wants to follow up on the arguments made in this working paper to take the (small) effort to read through these three in the order below.

- PWC (January 2013) Understanding a financial statement audit
- Center for Audit Quality (January 2013) In-Depth Guide to Public Company Auditing: The Financial Statement Audit
- Center for Audit Quality (March 2013) Guide to Internal Control Over Financial Reporting

Specifically for the Cambodian context, setting the objectives also requires common sense thinking about what can give clients/stakeholders (more) assurance that auditors actually do what they say they do, and share everything that they should share. This aspect is discussed below.

To understand the recommendation of this section, it is important to emphasize some underlying basics:

- Weak financial management/system/internal control is rampant in the Cambodian NGO sector.
- Any audit/assessment needs to be tailored to fit the characteristics of the specific auditee. Some of this tailoring can realistically only happen during the audit/assessment process itself.
- Most audit management letters have a hierarchy of issues from "indications of fraud" to "material weaknesses" to "significant deficiencies", down to "other matters". It is not the small issues that matter; it is the larger systems issues that matter.
- The best indicator of the recognized importance of testing internal controls, which are a core element of sound financial systems, is that in the US large publicly listed companies are legally required to integrate a full audit of the internal controls on financial reporting with the financial statement audit.

The "**integrated audit**" of the last bullet point is the **benchmark for proper oversight** referred to earlier in the introduction. The following quote explains why the fully integrated audit – in which all internal controls are actually tested – is an *aspirational* benchmark only, even for most private sector entities:

"Because of concerns about the cost of an ICFR [Internal Control over Financial Reporting] audit for companies with more limited resources, Congress has exempted smaller public companies, and certain newly-public companies, from the requirement that the company's auditor express an opinion on the effectiveness of ICFR. However, even in a financial statement-only audit, the auditor is still required, as part of assessing audit risk, to obtain an understanding of each component of the company's ICFR. While the auditor is not required to test internal controls in these audits, if he or she concludes that there are material weaknesses or significant deficiencies in the controls, the weaknesses or deficiencies must be reported in writing to management and the audit committee."[67]

The quote highlights the mundane fact of life that the more one asks an auditor to do, the more expensive the audit is going to become. Guideline C1 points toward what using an integrated audit as a benchmark for oversight implies for the funding agencies participating in a pilot:

- Negotiate with the audit firm what attention up and above the "normal" to the financial system/internal controls can be covered in the financial statement audit based on the available resources.
- Negotiate with the audit firm *how* those features of the system/internal controls are going to be included: what procedures is the auditor going to use to form an opinion on the quality of these system aspects?

Guideline C2 is a follow up on the first bullet point, guideline C3 follows up on the second bullet point.

Having made this strong claim of the integrated audit as a benchmark, it is important to realize that *internal controls are not all that matters for the oversight of the financial systems of NGOs*. Using the integrated audit as a benchmark must thus be embedded within a broader conception of what makes for good financial management. Given its deservedly prominent place in the NGO sector I propose to use Mango's perspective on this for that purpose (see **annex 5**).

Guideline C2: specify what an audit company looks at during an audit

It is obvious that one cannot implement guideline C1 without knowing what an audit firm would *normally* look at when forming an opinion on the quality of the financial system/internal controls of the auditee. The curious thing is that those engaging the auditor will have a hard time specifying that[68]. Customary practice is that the audit firm sends an engagement letter[69], which tend to contain only very generic and non-specific clause(s) about the system of financial management/internal controls. By way of random examples:

[67] Center for Audit Quality (March 2013), p. 10

[68] Anyone intimately involved with a particular financial statement audit (e.g. the Finance Manager – FM - of the NGO) may post hoc "mine" the auditing experience for what their auditor did to form his opinion but will have a hard time predicting what he is going to do. Experienced FMs will obviously be able to make a good guess.

[69] See e.g. https://www.mango.org.uk/guide/externalaudit accessed 02-12-2016

> *"To examine the propriety of accounting operations and their conformity with the national regulations"*
>
> *"To examine the tools and procedures of internal controls"*
>
> *"Review the accounting system and procedures to ensure propriety of transactions and adequacy of the internal accounting controls"*

The limitation of the "integrated audit" to only the largest listed companies *because of its costs* shows that the reality of what an accountant actually does underlying these statements can only be a very limited version of what a full ICFR/Financial System Assessment would do.

An integrated audit as a *benchmark* doesn't imply that NGO auditing should aim for integrated audits as their 'gold standard'. In contrast to the corporate sector, NGOs and their funding agencies have more than only the external audit as tools of independent oversight. They have periodic monitoring by funding agency staff and they have (the possibility of) sepate Financial System Assessments, basically a stand-alone system/internal controls only "audit", mostly conducted early on within a funding relationship (before a large/multi-year grant is awarded).

Many funding agencies do not go beyond some very weak versions of an Financial System Assessment (which includes an assessment of the internal controls on financial reporting) during their pre-grant awarding partner assessment, often requesting/assisting the (prospective) partner to apply Mango's Health Check, but the point is that an Financial System Assessment is part of the regular/customary tool box. Calling the Mango Health Check a "very weak version" of an Financial System Assessment is not implying any criticism of Mango's tool. The NGO sector can praise itself fortunate to have a dedicated service provider like Mango, and its general promotion of good financial management, its practical instruments and tools, its training materials, and its advocacy[70] are exemplary. It is precisely for this reason that **Annex 6** summarizes Mango's position on what makes for good financial management.

Therefore, it would be a misreading of the recommendations made in this paper as rooted in an understanding of what makes for good financial management, what makes for effective audits, etc. that is *different* from what in many ways can be seen as the "industry standards" set by Mango. They are meant to improve the effectiveness of tools of oversight, *given the specific conditions of country settings like those of Cambodia*. As argued before, these conditions dramatically enhance the importance of the external oversight role played by funding agencies, including their role in holding external auditors to account for what they do.

The Mango Health Check instrument as an *overview of what matters* for financial management is a great tool (see **Annex 6**), but its utility is limited to the primary purpose for which it was developed, i.e. *a self-assessment tool*, *basically inadequate as tool of oversight*. This is the reason for classifying it as a "very weak version". The next section focuses on what is required to translate attention to financial systems/internal controls into *oversight*.

Guideline C2 recommends that funding agencies actively engage the auditor of their (shared) partner in a conversation that results in *detailed and explicit* ToR for *what the auditor is going to look at* to form an opinion on the quality of the financial system/internal controls of the auditee. It is important to keep in

[70] See **Annex 5** for the background on one of Mango's advocacy themes

mind that even detailed and explicit ToRs should[71] and will leave room for adjustments during the actual auditing process. Current practice of only including very generic and non-specific clauses gives audit users no clue about what was done during an audit, and the point of guideline C2 is to replace this with ToRs that gives users a "pretty good idea" of what aspects of financial management were actually assessed.

For a variety of reasons, some legitimate, some less so, professionals in the business of "assurance provision" like financial auditors are generally unwilling/hesitant to let you into their kitchen. Unless the client pushes, the room is going to remain firmly closed. So it up to the client!

Conceptually, the conversation with the auditor should:

- take a detailed list of what makes for good financial management as its basis,
- assess (possibly in collaboration with the auditor) what has already been/can be/is best "covered" by a separate financial systems assessment and by periodic financial monitoring (see section on "an integrated use of the three tools of external oversight"),
- assess which elements on the list can be included within the budgetary constraints the audit is subject to.

Guideline C3: specify a more investigative approach to evidence gathering

Look again at Figure 1 and notice the considerable overlap between investigative/forensic audits and financial statement audits. One of the main messages of that overlap is that there is no *principled* difference between "normal" audits and "fraud-investigating" audits. There are differences in the scope of what they focus on and the balance of procedures used to gather evidence, but those differences are driven by practical considerations of what provides the auditor with sufficient confidence to base the audit conclusions on, not by a fundamentally different intention underlying the audit.

Any good audit is an "investigation". A "forensic" investigation applies the tools of the audit profession to the detection of crime, but the tools (procedures) used are not special tools, but all part of the normal audit toolkit.

[71] "For purposes of efficiency and convenience, the testing of controls and substantive testing of transactions will often occur simultaneously. In such situations the independent auditor will make an assumption about the results of tests of controls. If these tests do not confirm that the controls operate as intended, the audit strategy will be reconsidered and the level (nature, timing and extent) of substantive procedures modified". Center for Audit Quality (January 2013), p.13-14

Types of Audit Procedures[72]

Independent auditors can perform a wide variety of procedures and combinations of procedures to gather the evidence needed to support their opinion on the financial statements.

Inspection

The examination of records or documents, whether internal or external, in paper form, electronic or other media, or physically examining an asset. For example, inspecting a sample of invoices.

Observation

Observing a process or procedure being performed by company personnel or others. For example, observing a company's physical inventory count, and re-performing counts on a test basis.

Inquiry

Seeking information from knowledgeable persons in financial or nonfinancial roles within or outside the company.

Confirmation

Obtaining information or representation of an existing condition directly from a knowledgeable third party.

Recalculation

Checking the mathematical accuracy of documents or records.

Analytical procedures

Comparison of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the independent auditor.

Reperformance

The auditor's independent execution of procedures or controls that originally were performed as part of the company's internal control over financial reporting.

A proper financial statement audit makes use of all of the types of audit procedures listed above. When an auditor is requested to do a "forensic" audit, there tend to be (often specific) suspicions of mismanagement/wrongdoing and the choice of procedures will be tailored to suit the investigation of those suspicions, but the options are all part of the regular toolkit. "[C]hoosing an audit procedure that most directly addresses the identified risk is arguably the most important factor in designing effective audit procedures. The independent auditor also recognizes that some audit procedures result in more reliable audit evidence than other audit procedures. For example, the independent auditor's confirmation of account balances from third parties may be more reliable evidence than inspection of internally generated company documents."[73]

In practice this means that auditors, *when doing a forensic audit*, tend to include/choose *audit procedures that result in the most reliable audit evidence* because they want to minimize the risk of being wrong when dis/confirming the presence of criminal acts.

There is a *strong correlation* between the *reliability* of the evidence that an audit procedure generates, the *lack of influence the auditee has on that procedure*, and the *resource costs of applying the procedure for the auditor*. A procedure that assumes that specific internal control mechanisms of the auditee's

[72] Center for Audit Quality (January 2013), p.12
[73] Center for Audit Quality (January 2013), p.12-13

financial system are effective, and thus allow an auditor to rely on the output of that system, are comparatively resource-light for the auditor (because the assumption eliminates thorough checks/tests of the controil mechanisms), but is only as reliable as the assumption is trustworthy. The auditee's potential influence on the evidence is huge because the internal control mechanisms may have been tampered with.

Guideline C3 recommends that funding agencies actively engage the auditor of their (shared) partner in a conversation that results in *detailed and explicit* ToR for *which procedures the auditor is going to use when investigating the agreed upon aspects* to form an opinion on the quality of the financial system/internal controls of the auditee.

The caveat mentioned above under guideline C2 also applies to guideline C3. It is important to keep in mind that even detailed and explicit ToRs should and will leave room for adjustments during the actual auditing process (as they should). Current practice of only including very generic and non-specific clause(s) gives audit users no clue about what was done during an audit, and the point of guideline C3 is to replace that with ToRs that gives users a "pretty good idea" of how the agreed upon aspects of financial management were actually assessed.

Guideline C3 implies that the conceptual objectives for the conversation between funding agencies and auditor need to include the procedural choices. Both what an auditor investigates and how it is being investigated is ultimately a matter of available resources. Unlimited resources would allow for evidence gathering using the most reliable procedures for all aspects of financial management. The purpose of the conversation is to find the most informative compromise between what is being investigated, and in what way, within the financial means available.

Some of these procedures, the prototypical example being the *unannounced* cash check, are often experienced as very "invasive", indicators of "distrust", etc.[74] Procedures like *Inquiry* and *Confirmation*, especially if they include outside informants (e.g. members of the communities served by the NGO) are also often contentious. Even auditors in Cambodia face these sentiments, let alone funding agencies that include some of this in financial systems assessments that they conduct/commission, and, even "worse", their periodic finance monitoring. But if anyone is seen as entitled *and recognized as such*, even by Cambodian NGOs, to use such procedures it is professional auditors.

[74] As described in the introduction, our analysis is that the *partnership paradigm* that frames the grant provider – grant recipient relationship is the major reason for these sentiments. **Annex 7** speculates on ways to mitigate the risk of external oversight creating bad blood between "development partners".

"**Professional skepticism** is fundamental to an independent auditor's objectivity and includes a questioning mind and an objective assessment of audit evidence. It requires an emphasis on the importance of maintaining the proper state of mind throughout the audit. The independent auditor uses his or her knowledge, skill, and ability to diligently perform, in good faith and with integrity, the gathering and objective evaluation of audit evidence. Given that evidence is gathered and evaluated throughout the audit, professional skepticism is exercised throughout the entire audit process."[75]

"Independent auditors…cannot hesitate to challenge management's assertions whenever those assertions run counter to the audit evidence and the auditor's own judgment. It is not uncommon for independent auditors and company management to have different views, for example, over the accounting treatment of a particular transaction, the disclosure of certain information, or the reasonableness of an accounting estimate. However, **at all times the independent auditor is called upon to act in a way that serves the public's interest, not the interest of company management**."[76]

Thus, conceptually, the conversation with the auditor should:

- take a detailed list of what makes for good financial management as its basis,
- add the possible (more and less reliable) procedures for investigating each item on that list
- assess (possibly in collaboration with the auditor) what has already been/can be/is best "covered" by a separate Financial System Assessment and by periodic financial monitoring (see section on "an integrated use of the three tools of external oversight"),
- assess which package of elements, investigated using which procedures, would make the financial statement audit the most informative as an oversight tool within the budgetary constraints the audit is subject to.

Guideline C4: ask for explicit post-audit confirmation that and how the contractually agreed terms were fulfilled?

Guidelines C2 and C3 combined should ensure that those commissioning an audit know in a hands-on detailed manner *what* the audit is going to assess, and *how* the audit is going to do it.

Given the status quo, where this is not the case for most audit principals, one may ask if there is something amiss with the assumptions underlying these guidelines. Are these guidelines aiming for an unnecessary/impractical level of transparency and/or requiring a level of involvement of the audit principal that is unrealistic?

At a practical level, the objectives certainly ask for far more transparency and involvement than is current Standard Operating Procedure in LNGO audit engagements, but it is important to highlight that *the objectives of guidelines C2 and C3 are fully aligned with the way that the audit profession itself presents good practice.*

This is what the Center for Audit Quality has to say on documentation of the audit process: "Independent auditors document the procedures performed, evidence obtained, and conclusions reached. This documentation is intended to include sufficient information to enable an experienced auditor with no previous connection with the engagement to understand the nature, timing, extent, and

[75] Center for Audit Quality (January 2013), p.14
[76] Center for Audit Quality (January 2013), p.4

results of the procedures performed, evidence obtained, and conclusions reached as well as who performed the work, the date such work was completed, who reviewed the work, and the date of such reviews."[77]

Some funding agencies, on behalf of their HQ internal audit department and/or back donors, request auditors to produce a statement[78] that covers what they consider the important details, including all the noteworthy findings (guideline C5). Asking for such a statement to ensure that those commissioning the audit receive all relevant information that it generates, is thus for some funding agencies already standard operating procedure.

This is not to say that the audit ToRs used by these agencies are necessarily "best practice" in the sense of this report: some actually do this for project audits, without defining the absence of an organizational/global audit as a deal breaker, thus making for an odd mix of "best" and "worst" practice.

However, the point is that funding agencies taking an active role in ensuring they get all the assurance and information that they have paid for in the most explicitly stated manner is a practice that already exists, and is accepted by the auditors that they work with.

Guideline C5: explicitly ask for anything noteworthy that came to light

This guideline seems superfluous but its importance is in the active role it assumes for those commissioning the audit. This role does not end with the planning (ToR) of the audit but should continue throughout the process, and this guideline emphasizes active engagement when the audit results are shared with those funding the auditee. The external audit is a *tool* of oversight, the implementation of which is outsourced to a professional service provider. The funding agencies are the *users of the tool*, and those actually *entrusted with the oversight.* Their oversight responsibility includes *oversight of the auditor*. To live up to that responsibility, they need to ensure that anything that could possibly/ potentially be of interest is brought to their attention. Due diligence regarding this implies that they cannot fully outsource the assessment of what is of interest to the professional service provider. It implies they engage the auditor in a conversation that informs them not only about why the auditor assessed particular aspects of the auditee's financial management as requiring improvement, but also why others were deemed adequate. They essentially need to be talked through all important aspects of the auditee's financial management and understand the auditor's assessments, in order to make their own.

To avoid any misunderstandings: the default scenario is that the auditor's assessments are accepted. The point of this recommendation is that those actually entrusted with the oversight have to fully understand these assessments – which includes the assessments of all that is adequate.

This may read like an extremely laborious and intensive process that posits way too many expectations regarding the involvement and the capacity of those commissioning the audit. However, taking Big Business standards as our benchmark, this level of involvement is what is *expected* to make the external audit work as the tool of oversight it is meant to be. The role equivalent to that of the 'funding agencies' would be the audit committee of the board of a company: "Among other important duties, audit committees of publicly listed companies generally have responsibility for overseeing the integrity of a

[77] Center for Audit Quality (January 2013), p. 15
[78] sometimes called an "audit questionnaire"

company’s financial statements and, in many jurisdictions, engaging and overseeing the external auditor.”[79]

The Center for Audit Quality has produced a (12 page!) external auditor assessment tool[80] for use by audit committees, and coordinates efforts to develop audit quality indicators, covering audit firm leadership and ‘tone’ at the top, audit team knowledge, experience and workload, audit team monitoring and auditor reporting, all for use by audit committees[81].

As with other references to Big Business benchmarks: the point of the above is not to argue that each NGO audit needs an oversight body that functions like an “audit committee”. It is to emphasize that *the audit profession itself* claims that for an external audit to play its role as a tool of auditee oversight, its implementation requires very active involvement of those responsible for that oversight. It is in this spirit that the implications for the communication between the auditor and those whom he/she works for make for relevant reading for those interested in improving the value of external audits as tools of oversight of Cambodian NGOs:

Audit Committee Communications[82]

“[T]he independent auditor is expected to share information regarding the scope and results of the audit that may assist the audit committee in its role of overseeing the financial reporting process for which management is responsible. These communications may be either written or oral and can take place at any time throughout the audit. While discussions between the independent auditor and the audit committee frequently go beyond these examples, matters the independent auditor is expected to discuss with the audit committee include:

- Significant accounting policies, especially the effect of those policies in controversial or emerging areas for which proper accounting treatment has yet to be established.
- The process used by management to make significant accounting estimates and how the independent auditor determined that those estimates were reasonable.
- The independent auditor’s judgment about the quality, not just the acceptability, of the company’s accounting policies.
- Difficulties encountered in dealing with management related to the performance of the audit.
- Uncorrected misstatements and corrected material misstatements.
- Any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity’s financial statements or the independent auditor’s report.
- Significant matters that were the subject of consultation when the independent auditor is aware of management’s consultation with other accountants about auditing and accounting matters.
- Other matters arising from the audit that the auditor believes to be significant to the oversight of the financial reporting process.

[79] Center for Audit Quality (June 2015), p. 1
[80] Center for Audit Quality (June 2015)
[81] Center for Audit Quality (January 2016)
[82] Center for Audit Quality (January 2013), p. 17

Discussions with the independent auditor are vital to the audit committee fulfilling its responsibility to company shareholders and others to oversee the integrity of a company's financial statements and the financial reporting process. An audit committee that is well-informed about accounting and disclosure matters relevant to the audit will be better able to carry out its responsibilities."

A recap of the basic argument of external audits as tools of oversight

With the risk of starting to irritate the reader: the core of the argument so far, and the point of most of the guidelines, is that *oversight cannot be outsourced*.

As I have shown above, the audit profession itself is very clear about this. For a profession the legitimacy of which is based on being accepted as trustworthy, such explicit positioning as a service provider that itself requires oversight by its principal makes perfect sense as a risk management strategy. When failure happens, as it is bound to do (see Annex 2), sharing blame with the client safeguards the service provider against erosion of legitimacy.

As described in **Annex 2**, the audit profession only really took off with company management and ownership increasingly being in different hands and the associated need for management oversight by the owners. The practices regarding client oversight of the audit process recommended by the audit profession for large listed companies (and required by many jurisdictions) can all be read as responses to previous spectacular failures of external audits as tools of oversight. More implicitly, they can also be read as an admission by the audit profession that its claims to independence are often undermined by its financial dependence on the auditee.

Despite my efforts, the write up so far about external auditing in this report may have left the reader with the impression that the core issue of external audits as tools of oversight is the state of the auditing sector in Cambodia. Let me repeat again: *the core is issue is that oversight itself cannot be outsourced*.

My home country, **The Netherlands, makes for an interesting illustrative case**. In terms of nearly all (relevant) country rankings it places in the top quintile indicating a strong (trustworthy, predictable, economically enabling, reasonably fair, etc.) institutional environment; in other words, a country that qualifies for the label 'the best of contexts' when one thinks about the performance of an audit sector. Part of this environment is a governmental regulator/oversight agency of auditors (AFM) that checks the quality delivered by audit firms.

AFM's 2014 report *on the big four* (in general perceived as those setting the standards for the rest of the sector) concluded, admittedly based on a random sample too small to be representative, that 45% (18 out of a sample of 40) of their audits were of insufficient quality. It is important to be clear what was investigated here. AFM's research was not about the dereliction of professional duty, or audit company financial benefits compromising professional independence that is often at work in the spectacular failures that make for front page news (think Enron and Arthur Andersen), but about the quality of run of the mill big four audits. *Insufficient quality* means that the audit conclusions were based on evidence that did not live up to the *audit profession's codified requirements* for what is needed to have confidence in the truthfulness of a company's financial statement. AFM made 53 recommendations for improvement of audit company practices. The professional association of accountants (NBA) published an analysis of the problems the first sentence of which reads: "To provide confidence one must be trusted first. The accountancy profession has not always lived up to the trust invested in it, and sometimes blatantly betrayed it"[83] (translation RH). Where are we now? AFM recently published a follow up to its 2014 report[84] and 18 of the 32 (56%) external audits they looked at were of insufficient quality….

Thus, also 'in the best of contexts' the external audit in itself doesn't guarantee proper oversight. It is an important tool for oversight but itself requires oversight of its process to be a trustworthy tool.

Financial System Assessments and Periodic Monitoring

The introduction to this section can be much shorter than to the external auditing section. The due diligence research to date didn't come across any assessments of the effectiveness of funding agency Financial System Assessments and periodic monitoring. One can find some outlines for Financial System Assessments on the internet, but nothing that actually looks at how Financial System Assessments are being implemented in practice. It seems telling that a practice that is *fully the responsibility of funding agencies* themselves (as opposed to external auditing which is a shared responsibility) hasn't received any research attention. What funding agency representatives actually do when monitoring their partners' financial management (and program implementation) is equally unstudied.

The research to date makes it quite evident that funding agencies differ substantially in the information they have about the quality of the financial management of their LNGO partners, and/or the importance they attach to having detailed, trustworthy information. Working Paper 1 observes "NGO grantmakers vary considerably in their capacity for due diligence. In the survey sample the number of partners per Program Officer may be as small as 3 or as large as 20. Obviously geographic spread, professionalism of the partner, nature of activities and other factors play into the ability and the need to assess and monitor, but the bottom-line is that *some grantmakers allocate much more staff time to due diligence than others*"[85].

Keeping tabs on partner financial management, other than through partner provided financial reports and independent financial statement audits, normally has two components: a more or less comprehensive systems assessment, aka a Financial System Assessment, and periodic monitoring.

[83] Werkgroep Toekomst Accountancyberoep (2014), p7.
[84] AFM (2017)
[85] WP1, p.53

Proper monitoring is only possible with sufficient understanding of the strengths and weaknesses of partner's financial management (and, if applicable, ongoing efforts to improve particular weaknesses). This makes Financial System Assessments the primary tool for funding agencies to be able to live up to their due diligence responsibilities.

Quick scan of Financial System Assessment and monitoring instruments and practices of funding agencies

One of the follow ups to this has been a more elaborate exploration[86] of Financial System Assessment and monitoring instruments and practices of grantmakers funding Cambodian LNGOs. The sample size and the diversity in detail of the information shared by the funding agencies that participated in this scan of the assessment and monitoring instruments and practices don't allow for much more than statements about general characteristics of this oversight landscape.

The **first** and foremost **finding** of this exploration is that the impression of a hugely diverse resource investment of funding agencies in these two oversight tools documented in WP1 is substantiated by a closer look. Regarding Financial System Assessments, the spectrum runs from consulting some trusted key informants, usually staff from other grantmakers funding the same (potential) partner, to contracting an independent audit company to conduct a formal comprehensive Financial System Assessment, using the full spectrum of audit procedures, including those 'investigative' ones (unannounced spot checks, unaccompanied visits to communities, checks with suppliers, etc.) perceived as 'invasive' and indicators of lack of trust.

The **second finding**, again substantiating an impression from WP1, is that this diversity in resource investment is directly related to, but certainly not fully determined by, funding agency efforts to keep "overhead" at a defensible level. The overhead issue deserves separate attention (see below) but it is obvious that there is a minimum of resources required, however deployed (as own staff, as money,…), to live up to due diligence responsibilities. This exploration doesn't in any way allow for a quantitative estimate of what proportion of grantmakers funding Cambodian LNGOs don't allocate that minimum[87], but it is a non-negligible share.

The **third finding** is that the large majority of grantmakers refrain from applying even the most basic audit procedures[88], let alone those experienced as invasive, that any external audit company would have to apply to be able to express an acceptable level of confidence in its assessment results. The reasoning is that only audit companies are seen as legitimated to go beyond reliance on self-reporting when mapping the financial management of an NGO. Nearly all use assessment tools that rely on self-reporting (Mango's instruments or customized versions dominating the tool box) and their main objective is to the extent possible framed as supporting capacity building.

The **fourth finding** is that many grantmakers acknowledge the interdependence of Financial System Assessment findings and what needs specific attention during monitoring visits, including the required frequency of visits and/or other ways of engagement with their partner, and translate that

[86] As compared to the information collected for WP1

[87] But beware: allocation of sufficient resources is in no way a guarantee for due diligence!

[88] for an overview of audit procedures: see box above

acknowledgement into practical procedures. However, none explicitly and consistently include the external audit in this set of interdependent tools of oversight[89].

The **fifth finding** is that the availability of Mango materials (see **Annex 6**) and their wide use by LNGOs and funding agencies, has not resulted in a shared/LNGO sector understanding of what makes for minimum requirements that LNGO financial management need to live up to for making a grant-receiving LNGO an "acceptable risk". And thus no shared understanding of what it means for grant providers to live up to (one core aspect of) their due diligence responsibility. In itself, given the huge diversity in LNGOs[90] , the nature of identified financial mismanagement risks they pose, and the possible consequences for monitoring[91], this may be expected. But there also doesn't seem to be any inter-agency discussion about the broad outlines of what would be appropriate under what conditions. Nor, even, much intra-agency reflection (let alone documentation) on how one deals with risk management in practice, given this diversity[92].

The **first conclusion** is that, given the interdependence of the three main tools of oversight in how they are best applied in the case of (the specific characteristics of) a particular grantee, adding to the existing available lists and guidelines of Mango doesn't make much sense. We don't need another template of what needs 'looking at' when doing a Financial System Assessment. That is widely available from a universally respected source.

However, the **second conclusion** is that the *procedures* used to establish the quality of a grantee's financial management require immediate attention. The wide-spread but indefensible acceptance within the LNGO sector that only one tool, the external audit, may use procedures that go beyond self-reporting seriously hampers the effectiveness of Financial System Assessments and periodic monitoring.

The **third conclusion** is that the way forward for improving Financial System Assessments and periodic monitoring doesn't require much creativity, given that one:

(1) accepts that a comprehensive (integrated) external audit is an appropriate aspirational benchmark for oversight in general, and
(2) accepts the theory of action underlying the recommendations above for improving the effectiveness of external financial statement audits (resulting in 'core' guideline A1), and
(3) specifically accepts guidelines C2 and C3 and their recommendations to figure out optimal external audit ToRs within the broader context of all available tools of oversight (i.e. taking Financial System Assessments and periodic monitoring into account)

It directly follows from the perspective embedded in the above that the three tools of external oversight should be seen as an integrated package. If figuring out ways to improve one of them is best done

[89] To avoid misunderstanding: this implies some funding agencies sometimes and/or implicitly include external audits. None do so in principle and 'structurally', which would be the approach argued for in this report.
[90] The scale (turn-over, geographic coverage, etc.), kinds of service delivery or other core activities, level/sophistication of organizational development - and the interdependence of these specificities
[91] and possibly other more grantee and/or situation specific risk management strategies
[92] This is not to argue all agencies manage their risks badly, but that their risk management as actually implemented only becomes transparent when someone else probes their practices regarding various partners. It is not an explicit intra-agency issue of discussion and none have a process for linking tools of oversight, the way they are being implemented, and LNGO grantee specificities, that is explicit and detailed enough to share and/or benchmark against the process used by peers.

through a set of pilots by collectives of funding agencies financing the same interested and non-problematic LNGO partner, and if the conversations between co-funders about smart solutions to practical difficulties that block change of the status quo regarding *that one tool* include coordination regarding the other two tools of oversight *anyway*, the pilots are best designed *from the start* as aiming at a *collective integrated use of all three tools* as their outcome.

The next section develops this concept in terms of guidelines that can be added to those specific to external auditing formulated above.

Piloting the integrated use of the three tools of external oversight

Anything formulated in terms of 'guidelines' or similar 'manualese' runs the risk of being taken as fully prescriptive and used/applied (if at all….) as a tick-box tool for 'good practice'. This is certainly not my intention, very likely ineffective (thus a waste of time), and possibly even does harm. I'm not saying anything original here, just repeating what Mango emphasizes in all their communications about the tools they make available. Each situation is different and requires serious discussion among those involved about which, if any, parts of a manual/instrument/rule-book are applicable, how they are best applied, and whether there is a need to add something to the generic tool used. Unfortunately, this is a message that in practice often falls on deaf ears and needs constant repetition. So, before adding a couple of additional guidelines, let me add another warning, a 'master' guideline; let's label it guideline zero:

Guideline 0: the design of effective external oversight requires LNGO and context specific solutions
Guidelines are only supportive process suggestions. This report recommends a particular *process* for designing an effective oversight mechanism for a particular LNGO, and the guidelines are meant to inform those designing that mechanism about what to take into account and discuss. The actual design is the intended outcome of that discussion (a ToR for an external audit, agreements about the what and how of a Financial System Assessment and periodic monitoring). To repeat a core principle underlying this report: *oversight responsibility cannot be outsourced*. There is no rulebook that can be blindly followed to guarantee proper oversight.

With this in the back of our minds: what needs adding to the above guidelines when the objective of the pilots broadens from just more effective external audits to more effective overall external oversight?

Guideline A2: accepting audit profession standards as a benchmark for all external oversight

As the sections about external auditing repeatedly emphasize, an integrated perspective on the application of all three tools of external oversight implies taking what is already being done/could be done in terms of Financial System Assessment and periodic monitoring into account when discussing the ToR for the external audit. What has remained implicit so far, but should be self-evident, is that taking the integrated external audit as a benchmark for optimal external oversight cannot limit itself to the *types of audit subject matter* that "integrated" stands for, but implies an acceptance of the *kinds of audit procedures* that the audit profession sees as necessary for the level of assurance an audit is assumed to provide. Proper oversight implies the same level of assurance, whether its fact finding is outsourced to an audit company (be it in total, or as part of an improved, more comprehensive external financial statement audit) or done by funding agency staff (as part of a Financial System Assessment or periodic monitoring). Given the heavy reliance on self-reporting, and very limited application of more independent audit procedures during Financial System Assessments and periodic monitoring this implication is far from accepted in the funding agency world. Creating the right setting cannot ignore this hot potato and will have to take it on at the start of the pilot process. The group of funding agencies participating in a particular pilot need to explicitly agree that responsible oversight means the use of procedures more 'invasive' than self-reporting, whoever does the fact-finding. **Annex 7** is an effort to support this kick-off conversation by providing some arguments for addressing some known core worries and doubts.

Guideline A3: Pilots need the partner LNGO as a fully involved participant

When one thinks through the importance of sharing basic convictions like the need to go beyond self-reporting in Financial System Assessments and periodic monitoring for making a pilot successful, implications for the partner LNGO soon become evident. Imagining pilots that exclusively focus on the external audit, which are normally conducted by an independent audit company widely perceived by LNGOs as the only actor to legitimately use 'forensic' procedures, one could envision that the LNGO partner only needs to be around the table during a kick-off phase. But it is difficult to do so when funding agency implemented Financial System Assessments and periodic monitoring are integrally included.

A core underlying axiom of the approach advocated in this project is that the issues LNGOs have with financial management are a result of a dysfunctional grant provider – grant recipient relationship. They have proven insolvable by interventions that do not include substantial behavior change of grant providers. However, as argued in **Annex 7**, the behavior of grant providers themselves is intimately connected with that of their recipients. If one accepts that striving for a grant provider – grant recipient relationship as a partnership is important (as opposed to defining it as basically a contract-based market exchange of funds), change becomes difficult to imagine other than in close collaboration.

The natural implication is that the LNGO partner that is the "subject" of a pilot is best seen and treated as a full participant in the whole pilot process. This is undoubtedly going to result in some complications, but it also avoids some by visibly practicing the partnership.

Guideline B4: ensure that the auditor is willing to fully engage in the pilot process

As should be obvious by now, for an audit company, engaging in a pilot like this is not going to be business as usual. The expectations that they will have to fulfill are way beyond what is currently considered normal. The auditor is a crucial participant in the pilot. Most of what the pilot needs is going to depend on what the auditor is willing and able to deliver. On top of that, this expertise is expected to advise on parts of the external oversight that it is not going to implement itself. This can and should legitimately be seen as "additional" to financial statement auditing. On top of that: the auditor, as the representative of recognized oversight expertise, can be expected to not only be sharing that expertise, but also facilitate the conversation between the funding agencies and LNGO participating in the pilot. Facilitating used in the sense of being the most authoritative voice in the room whose judgment cannot be ignored.

This is quite something to expect any company to sign up for, in terms of expertise, competence, time, and frankly, risk. Because if the process in one way or the other doesn't deliver, disappoints , or even worse creates irreparable frictions, and other harm, it is likely the auditor involved will at least partially suffer reputational and/or financial damage. Audit companies are the only participants that can and will largely frame their relationship with the other two in contractual market exchange terms. Assuming an audit firm wants to consider a pilot assignment, those paying the bill will have to be realistic about their expectations to be paid for work that goes beyond what can reasonably be defined as doing a proper financial statement audit.

This is not to say that audit clients cannot make a good argument for at least some of what is recommended in section C (on working with the auditor toward a more effective external audit) to be part of what current audit costings should cover, because the NGO sector, given its leave-it-all-to-the-audit-company attitude is generally and predictably being underserved at this moment. But the reality of the matter is that many NGO clients are also in a different bracket from much of the private sector as far as the costing of their audits is concerned. And more time somewhere has to translate in higher costs. On the other hand, audit companies successfully participating in pilots can be expected to both set standards that others are thereafter going to have to follow, and build a strong reputation for NGO sector expertise and understanding that should serve them well in the future. Some of their initial time can and should thus be seen as an investment in future business.

Guideline D1: Working with the auditor toward more effective Financial System Assessments and periodic monitoring

Section C addresses the core of the pilot – the external audit – but throughout, the guidelines for that section mention engaging the auditor in a conversation about what can/is best dealt with by implementing a separate Financial System Assessment and/or what risks can/should be addressed by periodic finance monitoring. Mostly, these other tools of external oversight are not going to be outsourced to the audit company participating in the pilot but implemented by funding agency staff, or other consultants (although commissioning this or another audit company to do a full Financial System Assessment can, depending on the LNGO in question and circumstances, be an interesting/the best option). It needs emphasizing that these conversations need to cover auditor recommendations regarding what procedures should be used in applying these other oversight tools to provide the necessary confidence, and to keep in mind that whoever is going to use these other tools should be subjected to the same reporting standards as the audit company is for the financial statement audit; not necessarily in terms of format – as these are at least partly external audit specific and are subject to legal requirements – but certainly in terms of ensuring that all involved know and understand what exactly has been looked at, using which procedures, with which results.

Some concluding thoughts

Throughout this report, and the grantmaker due diligence investigation that it is part of, the focus has been on the grantmaker-grantee co-creation of the LNGO financial management problems and the role the partnership frame plays in upholding that co-creation. The reasons for this focus are multiple.

Anyone applying a ‘system’ perspective in an exploratory investigation (like I did) is bound to start focusing on some aspects more than others. Literature review and informant interviews will make some themes more evident than others, which then makes for a certain measure of attention bias, reinforcing the confirmatory feedback loop.

Such a loop doesn't necessarily reinforce the most important themes and one thus needs regular stepping back and assessing if one hasn't overlooked or downplayed crucial aspects. 'Crucial' here means aspects that, if not taken into account, are going to make the analysis not only so incomplete as to result in a distorted, myopic understanding, but also useless as a basis for practical interventions (if that is one's ultimate aim, which it obviously was in this case), because the overlooked/ignored aspects will make for such problems that they incapacitate the interventions.

The remainder of this concluding section describes/reiterates the crucial aspects that I have come across so far, explains why I have decided to stick to the course set out in WP1, and tells you what's going to be next.

NGOs are by definition professional bureaucratic service providers

Some such aspects are best understood as limiting the applicability of the interventions to certain contexts. One such limiting condition that became evident quite early on is the kind of organization required to be able to live up to financial accountability standards *and* properly perform the mission it exists for. Many current Cambodian LNGOs structures operate at a scale and/or (seemingly) pursue missions that do not sit well with the professional bureaucratic organization requirements that come with proper financial accountability. This report explicitly addresses this caveat to its suggestions for NGO sector practices in **Annex 4**.

Auditing has in-built tendencies to create unwanted consequences

Other aspects constitute risks for the practical interventions because they make for consequences that can totally derail the process and/or the organizations involved. One such aspect explicitly referred to in the reporting on this funding agency due diligence investigation is the potentially perverse consequences of 'auditing'. **Annex 2** specifically describes the built-in tendency of audit cultures to incentivize the auditee to ensure compliance in form, rather than in substance, and/or re-orient the organizational mission toward the *indicators* of the audit system rather than the 'spirit' it is meant to assess. One can interpret the tendency of Cambodian civil society tendency to 'NGOize'[93] any initiative that receives foreign funding support as (largely) a response to this process, linking this aspect to the one described above, but its risks also require constant attention when the grantee has legitimately chosen the NGO form as the best organizational expression for its mission and operates it professionally.

Anyone arguing for compliance and oversight processes using indicator-based tools needs to be permanently aware that the balancing act they're performing may start generating unintended consequences. However many times such risks, that are basically built into particular approaches and thus cannot be designed away, are highlighted, it is never enough. Keeping the balance is an ongoing process, and should be considered part and parcel of what 'auditing' is ultimately about. That one is going to stumble somewhere along the line is fully predictable; one can only try to notice it before it is too late, have the flexibility and drive to change course in time, and be willing to mitigate any harm arising.

[93] See **Annex 4**

This may sound defeatist, place the whole emphasis on funding agency due diligence in a questionable light, and can be expected to **play into the aversion of many NGO sector actors to go down this route**. My core argument against this is the following. You're in the money business, maybe in a specific version of it, one that seeks to combine partnership with financial relations, but if you want to go down another route than *everyone else* in the money business, you'll have to at least argue your case convincingly, not just point to the problems. Everyone else is aware of those problems too, and apparently draws a different conclusion. You'll especially have to argue your case convincingly as the track record of the NGO sector's 'alternative approach' – the starting point of this whole investigation – is unimpressive to say the least.

The overhead conundrum

Again other aspects are potential alternative foci for an analysis. One such aspect is best known under the label 'overhead', and a topic currently receiving some (admittedly still limited) specific policy research and campaigning attention in the NGO sector. It's one of those topics of the sector, and the development industry in general, that throughout their history has been subjected to what might be described as 'cyclic attention'[94]. The most recent wave of interest seems to have gathered steam with the introduction of the catchy concept of the 'Nonprofit Starvation Cycle'[95]. Mango is hands-on involved in this recent recurrence of the theme[96]. The argument here is that "[a] vicious cycle is leaving nonprofits so hungry for decent infrastructure that they can barely function as organizations—let alone serve their beneficiaries. The cycle starts with funders' unrealistic expectations about how much running a nonprofit costs, and results in nonprofits' misrepresenting their costs while skimping on vital systems—acts that feed funders' skewed beliefs."[97]

Everyone in the NGO sector will recognize the reality of unrealistic overhead expectations. A low overhead rate is widely seen as the "institutionalized metric of NGO quality"[98], and one could make this the core focus of a project arguing for improving funding agency due diligence and LNGO financial management. All that this report recommends so far requires staff time beyond what is currently invested in due diligence, and probably some additional financial resources too. Financial oversight is as "overheady" as it gets, and as long as funding agency and LNGO resources devoted to it are held to a less-is-better standard, interest to follow up on such recommendations seems too much to expect. One can make a legitimate argument that this, rather than partnership, is the big worry and should therefore be focal.

[94] Interest is triggered, the topic becomes an 'agenda item', whatever conceptual and practical work results from this isn't apparently able to make much difference, interest wanes, until the trigger comes along. To avoid any misunderstandings: much of social science has a similar cyclic character, this is not something specific to the development industry.
[95] See Goggins Gregory, A & Howard, D. (2009)
[96] See: https://www.mango.org.uk/campaigns/costbenchmarking
[97] Goggins Gregory, A & Howard, D. (2009), p.49. One may note the structural similarity to the damaging feedback loop risk of an indicator culture described in the previous paragraph.
[98] A phrase used in a 2015 presentation by World Vision International on Treasury Shared Services, a Community of Practice project of WVI, Care, Save the Children, Childfund, CRS, and Compassion International for INGOs.

The theory of action underlying the focus on funding agency due diligence

I've nevertheless chosen to focus on the partnership 'hurdle', for the following reasons.

Without in any way claiming that back-donor expectations are not a hard reality in the universe of NGO funders, it is evasive to argue that funders cannot be expected to take their due diligence responsibility vis-à-vis their partner seriously until and unless they themselves are treated "better" by these back-donors. The argument would only be valid if back-donor overhead expectations would make efforts to improve due diligence impossible, which is certainly not the case for most funding agencies.

It may be true that investing in collective oversight may initially require more staff and financial resources that the status quo. However, once the start-up costs of figuring out what needs to be done and who is best placed to do it have been taken care of, collectively well-organized oversight cannot be but cheaper for both the co-funding agencies and for their partner, than the adding up of what each individual agency used to invest in staff and financial resources on the one hand, and what responding to the uncoordinated accountability requests of its various grant providers costs the partner. The proof of this pudding is in the eating but the absolute minimum one would expect is vastly improved oversight and thus much sounder financial management for the same cost as in the status quo. Participating in pilots as lobbied for in this report is something that many funding agencies are well able to do if they prioritize this issue. Given their annual expenditures, the effect on their overhead percentage would be anywhere from acceptable to negligible.

Furthermore, as Goggins Gregory and Howard say, "[t]o break the nonprofit starvation cycle, funders must take the lead".[99] For the links in the aid chain that we are talking about here, "funders" means "back-donors" (of NGO grantmakers). These back-donors are not going to change course by themselves. They would need to be lobbied, put under political and/or public pressure, etc. etc. Unless one denies there is a problem with funding agency due diligence and its effects on LNGO financial (mis)management, arguing for making overhead/the nonprofit starvation cycle the focal point, thus means arguing that, in the short-term, funding agencies should invest resources in participating in an overhead campaign. These resources would also result in additional overhead, so as an argument against the possibility of, at this moment in time, spending temporarily a bit more on overhead, it doesn't make sense.

A very different issue, however, is that collectively cheaper doesn't mean cheaper for each individual agency. One of the corollaries of the starvation cycle is an inter-agency race to the bottom, everyone scrambling to beat the competition for back-donor funds by improving the "institutional metric for NGO quality", i.e. lowering their overhead. Agencies prioritize different aspects of overhead in this scramble, which results in wildly different investment in finance (and other types of) oversight. Those spending too little, in practice largely get away with doing so by piggy-backing on the due diligence exerted by the others funding their LNGO partner[100]. Within pilots, to implement collective due diligence disparate investment of time and resources is going to be openly discussed, and while I would not expect that agencies that currently underinvest will immediately and/or fully rectify this, I would expect that as a

[99] P.49

[100] Obviously, this statement should be understood against a background of overall deficient external oversight, and overlooks the fact that this "getting away" can and should be interpreted as actively contributing to a dysfunctional status quo.

group, the co-funders can come to workable solutions in which under-investors start contributing a bit more, in whatever way, even if by way of in-kind paybacks regarding unrelated collective interests, and those that invest what it takes get recognition for what they do.

From this perspective, the pilots are interesting practical laboratories that can generate valuable information about what it takes to be duly diligent, which can contribute to an evidence base that Mango is currently trying to build for donor advocacy (see below).

The goals of the Mango UK and European NGO cost benchmarking study[101]

- Gather cost benchmarking data from NGOs so that each NGO can understand its cost structure better and compare this to its peer NGOs.
- Benchmark indirect costs by proposing a standardized method for cost allocation
- Understand and compare the extent of cost recovery being achieved with common donors and use this to build an evidence base for donor advocacy
- Enable NGOs to see how their cost recovery practice compares with others and offer advice for NGOs to improve their practice.

Thus, the approach recommended in this report recognizes the importance of the broader "overhead" issue, and produces evidence that is useful to the ongoing campaign.

But the pilots might pave the way for more fundamentally significant contributions to a general overhead/fight-the-nonprofit-starvation-cycle campaign. One of the factors in overhead being a recurring issue of debate is that, whatever at any moment in time the current benchmark for legitimate/optimal overhead may be, individual funding agencies and LNGOs, given the competition for funding, and the inescapable drive for efficiency of modern economies, will always be tempted to distinguish themselves by lowering their overhead. This restarts the race toward unsustainable levels, until the problems become evident and overhead returns as an issue of debate and efforts to recalibrate the benchmark.

The pilots are based on the rationale that a proper/adequate benchmark for overhead costs necessary to be duly diligent regarding finance can only be determined when funding agencies organize their due diligence work *collectivel*y, in the most practical of terms, i.e. in the actual implementation of this work. If anything makes for resilience against the temptation to compete on overhead (for finance oversight) it is such collective organization.

Obviously, finance oversight is not the only overhead item that would undisputedly be best, i.e. most efficiently and effectively, be implemented collectively. Program monitoring and evaluation, capacity building, program relevant research – there is little to be funded that wouldn't profit from a more coordinated/collective approach[102]. That we quickly move from overhead into program expenditure terrain is immaterial, because overhead as a metric of NGO quality/effectiveness is a textbook example of the perverse effects of metrics, and what really matters if relevant, efficient, and effective expenditure overall.

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[101] See: https://www.mango.org.uk/campaigns/costbenchmarking

[102] The claim is benefit from *more* coordination, not *all* program related work can be (fully) coordinated.

But now we're really crossing over from "overhead" issues to the even (much) broader issue of NGO coordination and collaboration (and I am referring here to both INGOs, funding agencies and LNGOs), which has proven as intractable an issue as they come. This is not the place to even try a cursory analysis of why that is the case but the theory of action underlying the piloting approach of this due diligence project is based on the assumption that given the proven difficulty of NGOs to act collectively, coordinate, collaborate, share resources, etc., of all possible areas, financial management should be the easiest nut to crack[103]. The expertise required for this particular area is the only one that is universally recognized (does/can anyone argue against external audits, or against the principles of sound bookkeeping that auditors check for?), is not seen as 'ideological' but 'technical'[104], and its judgments and advice is generally not challenged.

As described in the section on the theory of action underlying the guidelines for the pilots, the assumption is that cooperation breeds more cooperation. The first step is the most difficult to take. Thus it is important to identify a first step that has some chance of actually happening and has a reasonable chance of being successful.

Obviously, at this stage, I am still talking potentialities, but assuming some successful pilots would happen, the above described impact they might have on a core deficiency of the NGO sector, its inability to overcome practical and ideological difficulties that currently block more coordination, collaboration and other collective action, seems worthwhile enough. This should also be true for those who upon first sight would judge the focus of the proposed pilots not significant enough, too much about an overhead issue rather than the programmatic impact that matters to them[105].

Epilogue and next step in this due diligence project

This report has become available a year later than its planned release. The main reason for that is the author.

The response to the first two Working Papers has been lackluster. The grantmaker survey, a core part of WP1, and the focal topic of WP2, hasn't attracted the funding necessary (yet) to be done for a third time using a much improved instrument (able to deliver much more detail and allowing a much more in-depth description of the financial management reality of Cambodian LNGOs and the quality of the oversight exerted by those funding them). It also hasn't (yet?) attracted a group of funding agencies willing to support its implementation by lobbying their peers to participate and share information (increasing chances that the survey coverage would allow for representative statements about the Cambodian LNGO sector and about the universe of grantmakers operating in Cambodia). This is despite what I naively thought was more than sufficient proof (as evidenced by the results of the second round of the survey) that it is able to produce information that is undoubtedly and hugely relevant[106] at the level of their own NGO portfolio in Cambodia. Moreover, the survey is demonstrably by far the most

[103] See e.g. WP1, p.16

[104] This in itself can be analyzed as the result of ideology, but what matters here for now is the widely shared understanding of accountancy/audit expertise by development practitioners as technocratic and legitimate.

[105] Obviously, I would dispute such assessment but that is not the point

[106] If a grantmaker is truly interested in the quality of its partners' financial management (and governance)

cost-effective data-gathering tool for that. None of the other suggestions/recommendations of WP1 have been taken up by any funding agency working in Cambodia.

The information for this WP on external audits, Financial System Assessments and periodic monitoring was mostly gathered during the same time and from the same funding agencies and audit companies that contributed to the second grantmaker survey. The above described reception of the problem and data-analyses and the recommendations based on them was disheartening to say the least, and made me question why I should spend my time flogging a dead horse even more.

Even though, by now, I am the least objective judge of the situation, those that do support the project confirm that the reception of the data-based arguments of the previous reports is at least partly due to the general inertia of the funding agency world, and a reluctance to admit to/recognize its active role in supporting a dysfunctional status quo by not taking its due diligence responsibility serious enough.[107] It would also be naïve to expect reports alone to make much immediate[108] difference[109], especially if they are the kind that I delivered (technical reports, dominated by efforts at methodological and analytic accountability, jargon-heavy, not well-structured, overly verbose, and very much 'working papers' in the true sense of that term, i.e. work in progress, anyone who has made it this far will confirm), and if they lack the backing of champions that are good at the 'political' work required for a successful lobby.

But all of that, nothing of which is specific to the development industry, let alone the NGO sector[110] , is probably less important than the focus on impact/results that dominates the development agenda. Within the current ideological climate, there isn't much leeway to devote staff-time and resources to an 'administrative' agenda. The major debates in the development sector are about working adaptively and politically, etc., not about the 'bureaucratic' management of the money involved. And who could object to that? To borrow the terminology of one voice in this debate: who would object to 'results not receipts'.[111] The partnership paradigm that the argument of this Working Paper series has made much fuss about can be interpreted as related to that focus, but has other roots too, and, more importantly, the focus on impact has a much broader reach.

It took time to overcome the 'why bother' mood, but when actually compiling everything gathered about external auditing, Financial System Assessments and periodic monitoring, thinking through its implications, and pushed by the few who were truly interested in the results, the writing of this report turned out to be very much worth the time invested. The work of getting my head around what the

[107] At worst by just not being duly diligent, at best by doing a good job, by doing it alone which overlooks the systemic issues that can only be addressed collectively.

[108] In the longer term (policy) research that initially doesn't generate much response may in many indirect ways contribute to changing agendas, but such indirect impact is nearly impossible to convincingly attribute to any particular research output. The impact/use of research on policy and practice is one of those social science themes receiving cyclic attention, although the evidence-based 'movement' has managed to make it a more or less permanent agenda item, through the lobby for insertion of impact metrics in the evaluation of academic research, directly tying funding to very dubious impact indicators. However, the interactional basics at work at the interface of research and policy and practice have been first and astutely described several decades ago by authors like Carol Weiss, and despite the many research programs on this topic, nothing much groundbreaking has been added.

[109] Unless they happen to appear at a time when their message is directly useful to the 'political' agenda of specific policymaking or practitioners' interests.

[110] Which established industry/sector embraces change? Which social research has guaranteed impact?

[111] Kenny, C. (2016)

issues are, what is contributing to keep them as they are, and what might help to make for a real change has certainly made progress with writing this third WP. This includes, maybe most importantly, more clarity on the conceptual and practical dichotomy of results versus receipts.

I sincerely hope the suggestions in this paper for pilots on improving the finance oversight of LNGOs will be taken up by some funding agencies, and I hope that a third grantmaker survey finds the required support and manages to deliver upon its promises in such a way that it becomes a periodic feature on the NGO sector calendar. But these matters are not in my hands. The one thing that is under my own control is to make an effort to bring the core insights, analyses, assumptions and recommendation of the three working papers together in one, hopefully better structured narrative. Work in progress in combination with each WP so far having a specific, thus also limited focus, has meant that some of what ended up in the main text is actually less important than some that ended up in an annex, quite some arguments have somewhat changed over time, links between arguments have become much clearer, and the many recommendations made across three papers may profit from a summarizing and prioritizing rehash. **Annex 1** of this paper is actually an early and very limited version at such an effort, aimed at LNGOs. The next Working paper in this series may or may not take the same format (of a FAQ) but it is certainly going to be based on the same intention of being more persuasive to practitioners of both funding agencies and LNGOs.

List of funding agencies that shared info about Financial System Assessment & monitoring

1	Action Aid Cambodia
2	HBF
3	Diakonia
4	SADP
5	World Renew
6	Danmission
7	CARE
8	AJWS
9	DCA/CA
10	Forum Syd
11	NPA
12	Misereor
13	Fin Church Aid
14	Oxfam Aus
15	Oxfam US
16	Pro Victimis
17	The Asia Foundation
18	Brot fuer die Welt
19	ICCO
20	CEPF
21	PACT

The contacted audit Firms were guaranteed full confidentiality, including non-disclosure of their being contacted for participating in the survey.

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Annexes

Annex 1: Frequently Asked Questions about funding agencies' duly diligent approach to the financial management of their NGO partners

Annex 2: Selected passages from Michael Power's The Audit Society. Rituals of Verification

Annex 3: On having the assumption that bureaucracy is by definition pernicious

Annex 4: Accountability requirements, NGOs and the need for alternatives

Annex 5: Mango's work on International financial management standards for NGOs

Annex 6: Mango on the basics of good financial management and how to check on it

Annex 7: the cost of social norms – partnership and vertical accountability

Annex 1: Frequently Asked Questions about funding agencies' duly diligent approach to the financial management of their NGO partners

Nearly all development money is ultimately public money, coming from tax payers or charitable individuals who give this money in the trust that it is efficiently and effectively used for the improvement of people's well-being in countries like Cambodia. Both funding agencies and their partners are part of this value chain of aid[112] that includes those that provide the money, those that allocate it to specific places and objectives and those that utilize it, designing and implementing the actual work to make a difference in people's lives. Both funding agencies and the LNGOs that they provide funds to are voluntary, independent, Not for Profit organizations that *are not self-serving in aims and values*[113]. At the core of what we are is the principle that we do not exist for ourselves, we are custodians of public money with a responsibility to ensure that money is used in the best possible way for its ultimate "beneficiaries". Each of us plays a different role in that chain: NGOs mostly implement activities, funding agencies provide money and organizational strengthening support to NGOs.

There is broad consensus in the Cambodian NGO sector about what constitutes good organizational practice. Sound financial management is an integral part of this understanding[114]. The reasons for this are both moral and practical:

Obviously, financial integrity and the systems required to minimize fraud risks are important, and their absence is thus serious. It's a moral imperative: public funds shouldn't be wasted, let alone diverted into private pockets. Also, NGOs demand Good Governance from authorities. Practicing what one preaches and applying the levels of transparency and accountability demanded from government to oneself is the foundation of the NGO sector's legitimacy to make such demands in the public's name (don't be a toad selling skin medicine - Cambodian proverb). It is also a practical imperative, because weak systems are bound to result in inefficiencies, deprive management of operationally and programmatically important input for decision-making, and decrease chances of raising (more) funds.

However, despite this, problematic financial management is a widespread, seemingly intractable phenomenon[115].

1. **Do funding agencies consider good financial management a necessary condition for achieving impact?**

Proper financial management is not *by itself* going to result in the impact an NGO is seeking to make. Funding agencies' mission is to support NGOs working on positive change. The quality of their financial management is about the efficiency and effectiveness they can achieve in working toward that change. Bad financial management constitutes a serious risk and can result in positive harm. Funding agencies' role is supporting NGOs that aim for change impact to create the best possible organizational conditions for being successful. That means providing funding, supporting relevant OD, and playing their role as

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[112] For some background on this perspective on development aid: Schnabbel, C. (2007)
[113] For these defining characteristics of NGOs see: VBNK (2005) Management Tool Series 2: Introduction to boards and governance, p.7-10
[114] E.g. see: CCC (2014) The Code and Voluntary Certification System for NGO Good Governance & Professional Practice
[115] For the factual evidence and a more in-depth analysis of this bold statement, see: WP1. The quote is from p.18

one of the NGOs accountholders diligently. *The quality of a NGOs work comes first*, good financial management is about risk management (prevent harm), effectiveness and efficiency.

2. Can attention to proper financial management interfere with an NGO's focus on impact?

Yes, an unbalanced focus on financial management can inhibit change by focusing NGO management on administrative issues and leading them to be subsumed by bureaucratic requirements and to be risk adverse. Funding agencies' engagement with partners always includes attention to the NGO's program work and to be sensitive to and openly discuss any possible negative consequences of their due diligence regarding financial management (and other administrative functions).

One major strategy to avoid negative consequences it to work on administrative systems that are as simple as they can be. *Proper financial management does not require complex systems*. Unfortunately, current mainstream NGO practice in Cambodia includes quite some unnecessary elements (per diems, a plethora of allowances, etc.) that are a source of conflict between working flexibly and minimizing risk. Challenging mainstream assumptions and expected "perks" is not easy, can only be done after a relationship of trust has developed, and takes time to have impact.

Another strategy is to lobby for, and actively engage in funding agency collaboration around shared partners, so as to decrease the administrative load resulting from their current uncoordinated engagement with them (see also 19)

3. What role do funding agencies' play in the safeguarding of proper financial management by their partners?

NGOs *exist to improve the circumstances and prospects of disadvantaged people and/or act on concerns and issues that are detrimental to the well-being, circumstances or prospects of people or society as a whole*[116]. Good NGO practice implies proper accountability to all stakeholders. As a grant providers and OD supporters funding agencies are core account-holders and need to play their part in that (vertical) accountability relationship in a proper way.

This includes:

- Engaging the NGO partner on the quality of its systems (its ability to provide an audit trail in a timely manner), its procedures (having proper checks and balances: separation of duties, independence of the finance function, internal oversight, which includes the role of the board), and transparency (both internally and externally).
- Supporting the partner in improving areas of weakness.
- Providing external oversight

Funding agencies see the application of due diligence regarding their role as account-holders as an important responsibility. Although this is only occasionally perceived as such by partner NGOs[117],

[116] WP1, p.14

[117] Obviously the onus is on funding agencies to explain this as clearly as possible to partner NGOs. So far, we have only had very partial success. This FAQ is part of our communication strategy regarding our due diligence responsibility.

besides other functions, funding agencies' due diligence plays a direct role in ensuring that their partner NGOs' financial management is properly safeguarded. A proper control framework for finances consists of three elements[118]:

(1) policies, procedures and systems

(2) management oversight

(3) independent review of (1) and (2)

External audits are a crucial component of (3) but even when these are high quality they do not suffice. For most Cambodian NGOs, policies, procedures and systems are adequate at best, management oversight (which includes the board, and ideally, but hardly ever in practice, an internal independent audit function) ditto, and external audits are of varying and regularly questionable quality. The need for other forms of "independent review" is therefore crucial to better safeguard the NGO against fraud and corruption. *Funding agencies being duly diligent fills that gap, and should thus be seen as providing an indispensable service to their NGO partner.*

4. Why seem so many funding agencies not so concerned about partner NGO financial management? How can you be so sure about the correctness and properness of its approach?

Unfortunately, the NGO perception that funding agencies differ greatly in their emphasis on the importance of their due diligence responsibility, in the resources they invest in their due diligence, and in the extent to which they go beyond solely relying on NGO reporting and/or external audits is true. Understandably, that strengthens the tendency to see the approach of those that focus on that responsibility as overstepping boundaries (see also 14), and makes it much less likely that proper due diligence is seen as helping NGOs properly managing their organizations (see also 3).

Until very recently the NGO sector lacked an authoritative analysis of the need for development agencies to take fraud and corruption in their own sector seriously. It also lacked a "straightforward application of the best counter-fraud practice, from the public and private sectors"[119]. But Oliver May's (2016) *Fighting Fraud and Corruption in the Humanitarian and Global Development Sector* has taken care of that lacuna. Whoever is not satisfied with the arguments put forward in this FAQ can now consult a much more elaborate, well-documented treatment of these issues.

[118] See Oliver May (2016), p.60-66
[119] May (2016), p.2

5. When does financial due diligence come into play in funding agencies engagement with NGOs?

The two most important moments are:

- o When considering a funding application of an NGO that does work that a funding agency is interested to support. Unless a recent proper Financial Systems Analysis is available due diligence requires arranging for one, either implemented by their own staff or by a consultant. This often is a two-stage process: if funding agencies don't yet know the NGO, a first grant is often only a one-year getting-to-know- each-other-grant and the pre-grant award Financial System Assessment is likely to not be a full-fledged assessment. However, continued longer-term institutional funding is going to require such an in-depth assessment (which can happen during the get-to-know-each-other period).
- o When monitoring an NGO that receives funding.

6. What are the aspects of financial management that funding agencies look at during a proper Financial System Assessment?

An Financial System Assessment looks at the quality of the systems, the procedures and the transparency regarding finances (see 2 for our understanding of these terms). It assesses the finance understanding (capacity) of the NGO and its management, their openness to recognize (possible) issues with the current situation and willingness to work on necessary improvements.

7. How do funding agencies gather the information needed for a Financial System Assessment?

Normally, funding agency staff or the consultant requests the NGO to provide financial reports, external audits, and financial and other policies. They also (should) request access to some underlying documentation and data from the bookkeeping system. They interview the NGO director, finance staff, and others who interact with the finance administration. They (should) include spot checks on relevant parts of the administration (e.g. petty cash management).

Unfortunately many, or even most agencies do not go beyond (enough) gathering self-reported information about their partner's financial management (the only exception being the latest external audit report, if available). However, a Financial System Assessment and an external financial statement audit are in principle very similar. External audits also look at the quality of the systems, the procedures and the transparency regarding finances, the main difference being that Financial System Assessments are more comprehensive. This means that the information gathering procedures that an external auditor deems necessary to have enough confidence in these aspects of an auditee's financial management should also be the standard for funding agencies if they conduct a Financial System Assessment. It is difficult to explain why funding agencies in general accept the audit profession as the standard setting expertise regarding external oversight but shy away from these standards when they are do not outsource a Financial System Assessment to an audit company (which only some do) but do it themselves.

8. Is a detailed overview of what an Financial System Assessment looks at publicly available?

Yes, it can be accessed here:………………..

9. What happens with the results of a Financial System Assessment?

The results should be fully shared and discussed with the NGO. When the NGO receives funding, when applicable, this is going to be accompanied with a plan, developed together, for improving financial management. This may include capacity building, often funded by a separate grant. In the best possible scenario, Financial System Assessments are shared between funding agencies, ensuring that the administrative burden on the NGO is minimal, and ensuring that once they have subjected themselves to a proper Financial System Assessment (periodically updated by a lean version, that focuses on continued enforcement by NGO management of good practice, and progress on improving specific weaknesses) all funders, including new ones, accept it as providing sufficient confidence in their partners' financial processes. Obviously, this ideal scenario is difficult to envision without hands-on agreements between funding agencies about coordinated or delegated monitoring.

10. What are the aspects of financial management that funding agencies look at during monitoring?

This depends on the outcome of the Financial System Assessment, the subsequent interaction history of the funding agency and the NGO, and, equally important, the coordination between the various co-funders of the NGO. Those aspects of the existing financial management which the NGO and the funding agency/ies have identified as in need of attention and/or improvement will receive extra attention during monitoring visits. *There is not one size that fits all*. Monitoring is also going to be used to look at the continued implementation of sound financial policies and procedures. It may include spot checks and may not always be announced.

11. Why do funding agencies think that existing internal financial reports and external audits are insufficient to judge the quality of financial management?

The purpose of external audits is an independent check on the accuracy of the internal reports. Good external audits also come with management letters that reflect on financial system issues that need attention or improvement. However, even if external audits would be high quality and could be fully trusted, their frequency is insufficient to stop serious mismanagement in a timely manner. And the financial system assessment component that is part of a normal audit is too limited for a solid picture (obviously, external auditors can be contracted to do a *proper* Financial System Assessment but that requires a specific Terms of Reference and comes with additional cost). A skilled "lone wolf" staff member can defraud an NGO of substantial sums in-between two external audits, without NGO management or its funders becoming aware of this. But more importantly, the quality of external audits in Cambodia is problematic. Funding agency experience as well as research clearly show that relying on external audits is not good enough for anyone aiming for proper due diligence[120].

12. Why do funding agencies consider the use financial self-assessments tools (e.g. Mango) insufficient?

Self-assessment is a very good *internal* tool for NGOs, but it lacks the independent checks and balances required for *external* accounting. **We are very aware that some funding agencies rely on self-assessments but consider this bad practice (see also box above).** We are also very aware that arguing for higher standards, especially when accompanied by the implementation of necessary due diligence procedures is often interpreted as mistrust (not proper for a 'partnership'), a denial of NGO

[120] For the research evidence, seeWP1, p.20-21

independence, and an expression of an unbalanced power relation between NGO and its donors. However, for the credibility and legitimacy of NGOs this is an unwarranted and potentially harmful attitude. It is a serious problem to unconditionally view NGOs as the "conscience of society," and there is a need to hold NGOs as accountable as the governments and other institutions they critique. One of the seven "myths and misconceptions" that Oliver May describes as clouding the debate about fraud and corruption in the (I)NGO scene speaks directly to this issue: *NGO staff are not less likely to commit fraud than those in other sectors*[121]. There is no reason to interpret the independently verified accountability requirements that everyone fully accepts as appropriate for governments and the corporate sector, as unnecessary, even improper and detrimental, for the relationship between funding provider and funding recipient[122].

It is important to emphasize that this moral argument has a very practical side to it. The first beneficiary of proper oversight, in other words oversight that is based on the use of fact-finding procedures that the recognized expertise regarding this, the audit profession, considers adequate, are (1) a LNGO's board (responsible for the oversight of management), and (2) a LNGO's management (responsible for the oversight of operational staff, some of whom may be looking for ways to commit fraud, or have found them already). There is a reason that external audits are supposed to be commissioned by an organization's board. The audit company hired to do so provides a service to the board that they are supposed to be interested in because it directly serves their purpose (the audit profession's institutional take-off is rooted in the days that company owners started hiring managers to run their operations and the owners wanted assurance that they were not being defrauded). And management, unless themselves involved in fraud, had a direct interest in supporting a periodic thorough independent check because in any larger operation management is always partly in the dark about what goes on. They are heavily reliant on the assumed quality of their internal systems and the honesty of their staff. As the prevention of fraud, and the optimization of organizational effectiveness and efficiency is their responsibility, and their board will look at management when things have gone offrail, they should welcome any help they can get in assessing the systems and individuals they have to rely on but cannot assess themselves.

13. How much weight do funding agencies give to good professional financial management in their decision-making about grants?

The quality of financial management in itself is normally not a decisive criterion in funding agency decision-making. *The aspects of financial management that are taken into account are*:

- Is the (potential) grantee willing to honestly discuss the any issues regarding financial management?
- Are funding agency and grantee able to agree on improvements and/or status-appropriate monitoring arrangements?
- Are agreements taken seriously?

14. Do funding agencies run a risk of overstepping their boundaries when playing their external oversight role?

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[121] May (2016), p.17

[122] This is not to claim that in practice governments and businesses are always as accountable as they should be!

Yes. When partners complain about a funding agency meddling in internal affairs, feeling ”controlled”, inappropriately “ investigated” (rather than “assessed”) and mistrusted, these are all possible indications that the grant provider is overstepping its boundaries. *Risk management always needs to look both ways*. Funding agencies may be committed to the principles described in the points above but the properness of their practical implementation requires constant attention. The behaviour of funding agency staff members and consultants needs to stay impeccable, missteps need to be acknowledged, and apologized for, and possible more structural problems with aspects of how these principles are being implemented need to be adequately dealt with.

Funding agencies normally have several mechanisms in place to ensure that their own faults become visible and are properly responded to:

- Yearly partner workshops that include opportunities for grantees to disclose inappropriate behavior (this part of the workshop should be independently facilitated)
- A whistleblowing policy that outlines procedures for partners to bring inappropriate staff/consultant behavior and/or inappropriate organizational behavior to the attention of a designated funding agency complaints/ombudsman official, or, in the absence of such a designated position, its board (with an obligation for either to respond)
- …….

15. Does funding agency due diligence run a risk of making its partners more “donor-centric”, and hampering their downward accountability to the communities that they work with?

Yes, the risk certainly exists. The financial dependency that is inherent in a grant provider – grant recipient relationship comes with the risk that the grant provider pushes its agenda and that the grant recipient operates overly donor-centric, rather than prioritizing the agendas and interaction with the communities it works with. Both grant provider and grant recipient have a responsibility to prevent this from happening. However, we think that ignoring our grant provider due diligence responsibilities would be a wrong strategy to promote downward accountability of its NGO partners. Programmatic downward accountability is a feasible objective, but the technical capacity required for accountability regarding the integrity of the full spectrum of an NGO’s financial management is hardly ever available at community level.

Currently, and foreseeably for some time into the future, many Cambodian NGOs can be expected to have insufficient internal oversight by management and board, and to lack external oversight by communities. *So, while the donor-centrism risk is real, and needs constant attention, for the time being, properly implemented vertical accountability is going to remain the only feasible mechanism for effective oversight.* And all organizations require effective oversight.

16. Doesn’t the importance that a funding agency attaches to its due diligence responsibility regarding financial management give it an overly bureaucratic focus, hampering innovation and flexibility?

It is certainly true that “frontloading” due diligence requirements comes with a focus on compliance and a certain measure of bureaucracy. However, experience shows that neglecting them later on results in serious problems that require way more of a funding agency’s resources, and come with way more bureaucracy. We would argue that a serious due diligence approach creates the space for innovation and flexibility.

Having said that: it is up to funding agencies to show that they indeed respond flexibly when the situation requires it, and that they invest in sensible innovation.

17. If even elaborate Financial System Assessment's and close monitoring of financial management cannot prevent fraud. Why bother?

It is true that even very strong systems and procedures cannot prevent the occurrence of fraud. But they certainly make it more difficult for malevolent individuals to find loopholes. They thus protect NGOs much better against "lone wolf" perpetrators[123], and they dramatically increase chances that fraud is caught early on. Furthermore, good internal oversight (an aspect of governance that is an integral part of good financial management) dramatically increases chances that the NGO can properly deal with an incidence of fraud and suffer no longer-term consequences, or even emerge a stronger organization. For funding agencies, identifying and adequately addressing fraud indicates that an NGO is well-organized, well-managed, and well-governed.

18. Do funding agencies have a zero tolerance policy regarding fraud/corruption?

- No, in the sense that most funding agencies do not believe that zero occurrence of fraud is a realistic objective. *Reducing fraud and corruption to an absolute minimum is a realistic objective.*
- Yes, in the sense of expecting the NGO partner to follow up on any indication or evidence of fraud and corruption, without exception, even if it seems "minor", is "uncomfortable", risks putting some strain on relationships, or happens at an "inconvenient" (e.g. very busy) time.
- No, in the sense that evidence of fraud/corruption in itself is not a reason to discontinue a funding relationship. That normally depends on how the NGO deals with the fraud once it has come to light.
- No, in the sense that the policies of most funding agencies do not make involvement of the police and the judiciary mandatory.

Many Cambodian NGOs have successfully dealt with fraud/corruption within their organization, without losing the financial support of those funding them.

19. Not all funding agencies give equal attention to their due diligence responsibility. Isn't that confusing for NGOs?

Yes, this is undeniably confusing. Many funding agencies are convinced that "going it alone" is not very effective. Unless we *collectively* take due diligence regarding financial management more seriously, nothing much will change. Therefore we supports fact finding policy research regarding this issue, actively participate in discussions on NGO governance, and engage with other grant providers on the need for better and better coordinated due diligence. Cambodian NGOs have little influence here (they have complained for two decades about the administrative burden and other problems created by the inability and/or unwillingness of funding agencies to coordinate their engagement with partners, see 20). The ball is clearly in the funding agency court.

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[123] Oliver May (2016): "…studies imply that around 90 per cent of fraud could be prevented by appropriate internal controls." P.61

20. Do funding agencies' due diligence requirements increase the administrative burden of NGOs?

Our analysis is that the *unnecessary* administrative burden of NGOs is due to the uncoordinated nature of the requirements of the grant providers funding them. We are convinced that better coordination, from pre-grant award Financial System Assessment, through monitoring, reporting, external audits, to evaluations, can result in less administrative requirements and less time needed to facilitate funding agency visits while at the same time allowing for better Financial System Assessments, better monitoring, better reporting, better external audits and better evaluations. Coordination would result in a win-win situation.

Annex 2: Selected passages from Michael Power's The Audit Society. Rituals of Verification

This annex provides a selection of passages (i.e. not a summary of the argument) taken from what I consider a must-read classic on auditing. The passages are meant to alert the reader to the often surprising/unexpected/non-intuitive of what underlies the demand for, the use of and the in-build limitations of auditing. It is meant as a teaser enticing readers to investigate for themselves so as to be better able to apply auditing with the required sensitivity to what it implies, to what it can and cannot do, and to what its dark sides are.

Auditing is a universal of human interaction

People are constantly checking up on each other, constantly monitoring the ongoing stream of communicative exchanges and accounts that make up daily life. Normally, this process is unconscious and we do not feel that we are really doing it...It is through the giving and monitoring of the accounts that we and others provide of ourselves, and of our actions, that the fabric of normal human exchange is sustained. These accounts only become objects of explicit checking in situations of doubt, conflict, mistrust, and danger...Methods of checking and verification are diverse, sometimes perverse, sometimes burdensome, and always costly...Trust releases us from the need for checking. Nevertheless, a certain kind of accounting goes on between us, albeit implicitly and in the background...Could one imagine a society, or even a group of people, where *nothing* was trusted and where explicit checking and monitoring were more or less constant?...Of course, some societies have tried to institutionalize checking on a grand scale. These systems have slowly crumbled because of the weight of their information demands, the senseless allocation of scarce resources to surveillance activities and the sheer human exhaustion of existing under such conditions...In the end checking itself requires trust: the two concepts are not mutually exclusive...Having said this, could one imagine a society without any checking at all, a society of pure trust where all accounts are taken at face value? This is equally difficult to conceptualize. What we need to decide, as individuals, organizations, and societies, is how to combine checking and trusting. (p.1-2)

Auditing is a fuzzy concept

"...[D]espite the general references to account giving and checking above, there is no precise agreement about what auditing really is, as compared with other types of evaluative practice, such as inspection or assessment...[T]he most general conceptual ingredients of an audit practice: *independence* from the matter being audited; technical work in the form of *evidence* gathering and the examination of documentation; the expression of a *view* based on this evidence; a clearly defined *object* of the audit process...[T]he conditions under which auditing is demanded. First there must be a relation of accountability, i.e. the requirements for one party (the agent) to give an account of his actions to another party (the principal). Second, the relation of accountability must be complex such that the principals are distant from the actions of agents and are unable personally to verify them. On this view audit is a form of checking which is demanded when agents expose principals to 'moral hazards', because they may act against the principals' interests, and to 'information asymmetries', because they know more than the principals. Audit is a risk reduction practice which benefits principals because it inhibits the value reducing actions by agents...the categories of principal and agent can be filled in a variety of ways. Who are the relevant principals: shareholders, local residents, taxpayers, future generations? Such relativization of the idea of audit is important and provides a reminder that definitions are attempts to fix a practice within a particular set of norms or ideals." (p.4-5)

Auditing is both a practice and an expression of a normative ideology

"The ambiguity of auditing is not a methodological problem but a substantive fact...[T]he word is not used simply descriptively to refer to particular practices, but normatively in the context of demands and aspirations for accountability and control...Auditing may be a collection of tests and an evidence gathering task, but it is also a system of values and goals which are inscribed in the official programmes which demand it." (p.6-7)

"All practices give accounts of themselves which are aspirational rather than descriptive. These accounts exist at the collective, or what can be called the 'official' , level and for many years sociologists and others have been interested in digging into these accounts, showing what they leave out and demonstrating how a certain ideal and institutionally acceptable 'front stage' account of practice is only produced after much 'back stage' work, which is rendered invisible...It is particularly attractive to apply some of these ideas to financial accounting and auditing since they are institutionalized forms of account giving in general. Like every other institutionalized field they produce official accounts of their account giving, rationalized meta-accounts of themselves and their potential. This meta-accounting is not simply a cynical public relations exercise but an intermediate and necessary aspect of the programmatic [normative] side of practice which connects concrete technical routines to the ideals which give them value. However, meta-accounting for the technical dimensions of a practice is not necessarily a neat and consistent matter. It is often loosely coupled to programmatic ideals on the one hand and technical operations on the other." (p.7-8)

"Ideal accounts of the financial audit described above function as a kind of paradigm and...survive at a time when the practice itself has undergone a crisis...Large scale corporate collapses constantly generate inquiry and concern about the financial audit function..." (p.8-9)

Learning from the history of financial auditing

"[T]he history of financial auditing...draws attention to the uneasy and shifting relationship between auditing practice and the programmatic goal of detecting fraud. If official meta-accounts of auditing overemphasize the goal of detecting fraud, then programmatic expectations may be created in excess of those that it can really satisfy. Practitioners refer to this as an 'expectations gap'. On the other hand, if these stories of financial auditing reject the goal of detecting fraud, then it will be asked whether auditing has any value at all...The history of financial auditing, and of the development of official guidance on the auditors' responsibility for the detection of fraud, reveals a complex process of constructing a credible, if fragile, role for the auditor, between the high and the low expectations." (p.9-10)

The history

"Auditing in one form or another has existed as long as commercial life itself; even the earliest forms of writing seem to have been accounting documents...The earliest financial audits seem to have been oral in form and judicial in structure. The auditor would stand in judgment over a party giving the account...the aim was to establish the trustworthiness of agents...Over time, audit practice co-evolved with the development of accounting records and statements which acquired evidential status as a supplement to oral traditions of proof...[M]odern financial auditing, as a discreet practice distinguishable from accounting, began to take shape from the middle of the nineteenth century. The emergence of corporate entities in which ownership and control were separated provided a natural stimulus...The modern external audit has been described as an independent examination of, and expression of opinion on, the financial statements of an enterprise by a qualified auditor...This brief history of auditing is somewhat sanitized. Auditing was a practice long before it was able to give an 'account' of itself in anything approaching a conceptual fashion...[A]s the judgments of the amateur auditor became displaced by those of the professional, justificatory discourses and technical innovations have emerged - often in the wake of crisis and scandal. Furthermore, when one looks more closely at the history of auditing and compares it with present day discussions, it is striking that many of the problems and preoccupations are the same. It is as if certain difficulties are endemic to auditing, not least in terms of programmatic expectations about its scope and whether this includes the requirement to detect fraud" (p.16-18)

Auditing and fraud

"...[T]he detection of fraud seems to have been a primary objective of auditing until well into the twentieth century when it became a derived or secondary objective...Today it remains true that most people, when asked about auditing, will tend to associate it with the search for fraud.. And when auditors fail to uncover fraud which subsequently comes to light, these same people will assume that the audit process has failed in some way...The [expecations] gap is between what the public expects...and what auditors claim to be delivering - an opinion on the financial statements which appeals to notions such as 'fairness' or 'true and fair'...[Auditors] also argue that, on grounds of cost and technical feasibility, the primary responsibility for the detection and prevention of fraud lies with management and its systems...Fraud...generally involves the theft of assets coupled to a falsification of the books of account. Furthermore, it is important to distinguish between employee and senior management fraud. There is some agreement that responsibility for the former may be reasonably delegated to management control systems. The fundamental operational issues for external auditors arise in the context of senior management fraud and deliberate mis-statement... [i]t is acknowledged [by professional self-regulatory bodies] that the auditor must plan the audit to provide a 'reasonable expectation' of detecting material mis-statements. 'Materiality' has been interpreted qualitatively in professional guidance as the degree of tolerable or acceptable error in financial statements, but like the term 'reasonable expectation', is not precisely specified beyond this...For good philosophical reasons, no rule or system of rules can entirely control the conditions of its own applicability. Every rule requires a second-order rule which says when it applies and so on...

It is beginning to sound as if audit were mere illusions, a game of writing. This is not the case. At the operational level, auditors do indeed have an array of techniques which have some capacity for detecting large mis-statements in financial statements...Audit firms have always concerned themselves with the development of in-house procedures for detecting fraud over and above the normal ones...and there is considerable interest in the need to audit the 'integrity' of senior management, a partial return to the medieval auditing process which focused on the trustworthiness of people....[But]the official front stage of financial auditing is effectively decoupled from all these efforts. Here one encounters a more cautious style, especially on matters relating to audit scope...[T]here is no clearly defined notion of what is 'reasonably expected' of the auditor in relation to any particular act of fraud and its impact on the financial statements." (p.21-25)

[A]udit failures are almost impossible to judge because the activities of accounting and auditing are so vaguely defined...The history of auditing reads like the history of regulation more generally as a history of failure. Efforts at social control, it seems, always fail and failure is always the condition for further attempts at control...

[Moreover] there is also the interesting analytic problem [that] it is difficult to disentangle the success of auditing from the success of the auditee...corporate financial statements may be generally reliable because of good auditing *or* because of good internal company accounting policy...

There is no robust conception of 'good' auditing independent either of auditor judgments or of the system of knowledge in which those judgments are embedded and against which particular audits could be judged. Good auditing ends up as conformity to agreed procedures which have stood the test of time." (p.27-29)

Audits provide confidence but rely on trust in their procedures and routines

"[This is all] not to say that the procedures and routines through which audits are operationalized are in any way vague. Indeed, they are often very precise. The issue is how technical routines like the sampling of purchase invoices, the circularization of debtors, the assessment of inherent risk, and so on actually come to be regarded as constituting 'reasonable' practice...

Three key areas for auditing knowledge are analysed: sampling, reliance on external expertise, and the assessment of internal control systems.

- It is argued that sampling in its general sense is an essential component of auditing. Audits have value because they seek to draw general conclusions from a limited examination of the domain under investigation. But despite statistically credible foundations for sampling, audit practice is driven by economic pressures to derive more, or at least as much assurance from fewer inputs...
- Reliance on other experts enables the unauditable to be auditable by creating a chain of opinions in which the auditor distances himself from the first order judgments of experts. The knowledge of say chartered surveyors, actuaries, and management can be 'black boxed' and subject to various tests of reliability...
- This indirect relation between auditing and its object also applies in the case of internal management control systems. For many years auditors have focused upon control systems rather than directly examining large quantities of transactions; they have checked the systems which allow direct checking...['control of control']

What emerges...is a view of auditing as a collection of pragmatic and humble routines which may add to confidence about the veracity of statements made by the auditee but not in a way that can be easily quantified. Verification emerges as a more negotiated and interactive practice than is commonly imagined." (p.11-12)

"...[B]elow the wealth of technical procedure, the epistemic foundation of financial auditing, i.e. the relation between its inputs and the production of assurance is essentially obscure. Ultimately financial auditing requires that the judgments of auditing experts are trusted" (p.15)

Auditing shapes organizational realities

"...[A]uditing works by virtue of actively *creating* the external organizational environment in which it operates...Audit is never purely neutral in its operations; it will operationalize accountability relations in distinctive ways, not all of which may be desired or intended. New motivational structures emerge as auditees develop strategies to cope with being audited; it is important to be seen to comply with performance measurement systems while retaining as much autonomy as possible...[T]he [unwanted] consequences of auditing can be analysed schematically in terms of [two extremes:] *decoupling*, where audits are rendered ineffective, and *colonization*, where they are effective in unintended ways." (p.13)

"The key question is not just whether there are intended gains to be weighed against unintended side-effects, but whether elements of decoupling and colonization lead to 'reverse effects' in which original goals of financial control and effectiveness are actually frustrated and undermined..[T]here is a need to recognize these 'regulatory paradoxes' which surround audit and a need [to be] sensitive to the incentive effects through which micro-rationalities can subvert macro-rationality" (p.120-121)

The model of auditing colonizing the accountability about other aspects than finance

"The abstract system tends to become the primary external auditable object, rather than the output of the organization itself, and this adds to the obscurity of the audit as a process which provides assurance about systems elements and little else." (p.85)

"Existing structures of self-reflection on practice, which have traditionally been *ad hoc*, local, and under the control of practitioners themselves, have been harnessed to regulatory initiatives in the environment. Despite explicit pleas to differentiate learning and accountability, internal and external auditing, one can discern the steady transformation of internal control cultures into externally auditable objects. Auditees have adopted strategies to deal with these developments but, formally at least, systems with very similar general features are being developed in diverse contexts to provide an auditable surface for the organization...[T]he actual mechanics of constructing measures which conform to ideals of replicability, calculability, visibility, portability, and legitimacy can be done in many different and contestable ways...Where the specialist knowledge base of the practice itself is complex...and/or internally controversial...these problems are compounded...It is widely accepted that such factors should play some role in an evaluation of the organization. But as 'measures of the measurable' in abstraction from local complexity, there are problems...[P]erformance measurement gravititates towards outputs and the systems for producing them; it is around these measures that a certain style of management control can be exercised unencumbered by the contingencies of how such outputs might relate to desired outcomes...And where these outputs are also problematic, there is a further tendency to drift towards inputs, such as costs, which are readily auditable." (p.114-115)

Acceptance of auditing as an instrument of oversight and control

"Assurance and comfort are passed upwards between internal and external auditors. Whether such arrangements really do build on existing consensual cultures of self-auditing, thereby growing from the bottom up, or whether auditing is perceived as externally and crudely imposed is a fundamental issue..." (p.104)

"...[A]uditing practice in all its guises is still the best option available for achieving cost-effective incremental assurance about a wide range of activities. The knowledge base of audit may be obscure and professional institutes may invest extensively in defensive guidance documents but, in the final analysis, audit represents a form of pragmatic 'muddling through' with experienced professionals giving it their best shot. There can be no guarantees of assurance or control, nor can assurance be tightly quantified in a manner that would give it an appropriate aura of objectivity. There is much to be said for this pragmatic modesty and, quietly, this is the view of most practitioners...The politics of regulatory failure...must become reflexive if it is not to reproduce itself in ever increasing structures of regulatory complexity with ever greater demands for monitoring." (p.143-145)

Annex 3: On having the assumption that bureaucracy is by definition pernicious[124]

If anything, due diligence evokes the image of a bureaucratic audit culture of endless paper work and control routines. Bureaucracy has a bad reputation, among those of all political persuasions. One can argue that that bad reputation is actually a more recent phenomenon than we imagine, but weirdly enough, bureaucracy as a phenomenon of academic reflection seems to have moved out of fashion, after the 'market model' acquired ideological hegemony. The bureaucracy critique of the political right rules the debate and doesn't need to prove itself anymore, and the political left, on the defensive everywhere in the West, trying to salvage as much of its (inherently bureaucratic) welfare state institutions from the new ideological winds as possible, is left without any persuasive analysis of bureaucracy to replace its earlier 1960s flower power and anarchist critiques. So what we currently have is overtly anti-bureaucratic rhetoric of the neo-liberal right that doesn't match empirical reality at all, and nothing much by way of a more evidence-based alternative from the other end of the political spectrum.

Graeber's summarizes his reading of actual empirical reality in his Iron Law of Liberalism:

Any market reform, any government initiative intended to reduce red tape and promote market forces will have the ultimate effect of increasing the total number of regulations, the total amount of paperwork, and the total number of bureaucrats the government employs. (p.9)

Graeber argues that to understand this rule:

[a] critique of bureaucracy fit for the times would have to show how all these threads - financialization, violence, technology, the fusion of public and private - knit together into a single, self-sustaining web. (p.42)

The point here is not to elaborate Graeber's own analytic take on this 'self-sustaining web. What matters for thinking through one's underlying assumptions regarding bureaucracy is some of his empirical observations, which ground his 'iron law':

(1) That the law goes beyond what most would understand to be the economic sphere of society:

It was [also] a cultural transformation. And it set the stage for the process whereby the bureaucratic techniques (performance reviews, focus groups, time allocation surveys...) developed in financial and corporate circles came to invade the rest of society - education, science, government - and eventually, to pervade almost every aspect of everyday life. (p.21)

(2) That, despite the universally shared aversion to bureaucracy, tellingly, the dominant academic theorizing on bureaucracy is based on the assumption that bureaucracy really works:

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[124] The reflections in this paragraph are taken from and/or based upon American anarchist, anthropologist and activist David Graeber's new book The utopia of rules (2015). They are also part of the Annex 1 on assumptions of WP1.

Weber saw bureaucratic forms of organization as the very embodiment of Reason in human affairs, so obviously superior to any alternative form of organization that they threatened to engulf everything, locking humanity in a joyless "iron cage", bereft of spirit and charisma. Foucault was more subversive, but he was subversive in a way that only endowed bureaucratic power with more effectiveness, not less...Through concepts like governmentality and biopower, he argued that state bureaucracies end up shaping the parameters of human existence in ways far more intimate than anything Weber would have imagined. (p.55)

(3) And that despite the universal aversion, nearly all of us fear the absence of bureaucracy:

[T]he experience of operating within a system of formalized rules and regulations, under hierarchies of impersonal officials, actually does hold - for many of us much of the time, for all of us at least some of the time - a kind of covert appeal. (p.149)...*Cold, impersonal, bureaucratic relations are much like cash transactions, and both offer similar advantages and disadvantages. On the one hand they are soulless. On the other, they are simple, predictable, and - within certain parameters - treat everyone more or less the same...it's hard to imagine how, even if we do achieve some utopian communal society, some impersonal (dare I say, bureaucratic) institutions would not still be necessary, and just for this reason.* (p.152)

Graeber also gives plenty of fodder for the universal unease and aversion with bureaucracy. Just a couple of examples:

- The observation that bureaucracies seem to have an inescapable inner logic of expansion.
- The observation that once one creates a bureaucracy it is almost impossible to get rid of (because it is both indispensible to rulers, and holds a genuine appeal to those it administers - see above)
- Bureaucratic rationality tends, even if installed as a means, to become an end in itself.

Given Graeber's extremely critical reflections on bureaucracy, the analytical agenda he sets out for himself recognizes that neither gut aversion, nor uncritical eulogizing of bureaucratic 'rationality' is going to help us much in dealing with bureaucracy:

We need to find a way to talk about what it is we actually object to in this process, to speak honestly about the violence it entails, but at the same time, to understand what is appealing about it, what sustains it, which elements carry within them some potential for redemption in a truly free society, which are best considered the inevitable price to pay for living in any complex society, which can and should be entirely eliminated. (p.44)

Like anyone else, I share a deep-seated aversion against bureaucracy, but am equally deeply convinced that accountability of NGOs and donors, their organizational partnerships, and the due diligence required cannot do without bureaucracy. My assumption is that one needs to question every specific manifestation of it, always ask the question, what specific end any regulation is meant to serve, resist acceptance of its internal logic as sufficient rationale for any measure, and always be on the look-out for the underlying power-inequalities. But, as an unavoidable instrument of social control, it has its place, and our effort should thus go into figuring out as best as we can, its proper application.

Annex 4: Accountability requirements, NGOs and the need for alternatives[125]

"A huge issue is the apparent trade-off between governance structures and administrative bureaucracy required to responsibly, accountably, and transparently handle large amounts of other people's money and the flexibility, time outside the office, freedom from having to spend time on covering substantial institutional costs, etc. etc., required by at least part of the work that NGOs exist for and are funded for….

In other settings there are more organizational forms available, some without bureaucracies. But they are then often/normally assisted by specialized service providers when money is involved, allowing them to remain overhead-light and concentrate on their mission rather than having to invest increasing amounts of time into organizational processes. There is a serious argument to make that NGOs are not the right vehicle for some of the tasks that are taken up by NGOs. But every initiative to organize things differently (networks, etc.) over time NGO-izes in Cambodia. Nevertheless, it seems evident that not all "missions" should be given an NGO form.

When the NGO form is chosen, it should be chosen with the objective to live up to the accountability standards that (should) go with that. When that form and its requirements don't mesh well with the mission to be accomplished, organizational solutions other than the NGO form should be sought; which might very well involve an NGO in a particular support role.

The argument throughout this report has been that if one channels money through an NGO, the accountability required to ensure proper organizational functioning, at least with respect to finances, cannot do without X, Y and Z. The argument throughout has been that, given the experience over the last two decades, efforts to get away with toned-down versions of X, Y and Z fail". [126]

One consequence of [taking] upward financial accountability seriously is that the limitations of the NGO form are going to become even more evident. Not all, perhaps only some development activities currently channeled through NGOs sit well with the requirements and/or the in-build tendencies of the properly professional bureaucratic NGO form. Giving primacy to development objectives means that there is a serious need to find feasible alternatives to the NGO form.

Some obvious assumptions about the failure of alternatives to take proper root in Cambodia are that:

- The NGO form is more attractive than alternatives for the individuals managing them[127]
- Alternatives normally have associational characteristics, making for a structural need for internal democracy, and/or legitimate processes of representation. Both are 'intractable problems' of NGOs (see e.g. WP1, annex 3)[128].
- Donor requirements are most easily met by the NGO form"[129].

[125] This annex brings together the relevant bits and pieces about this core issue that are to be found in WP 1
[126] WP1, p. 46-47
[127] And/or employed by them
[128] There is thus an overlap between problems of downward accountability of NGOs and this issue
[129] WP1, p.54-55

However that may be, given the failure to avoid NGO-ization of all alternatives that have tried to fulfill the financial accountability requirements *in-house*, the most promising direction to explore is their *outsourcing* (beyond the most basic documentation of expenditure).

The only outsourcing model practiced in the Cambodian NGO sector (on a limited scale) is of a funding agency taking care of the financial administration of small, local NGOs (and NGOs doing it for CBO partners). This model is in practice only applied when the funding agency/NGO is the sole source of funding of its partner.

Outsourcing to an entity that is specifically equipped to do just that: take care of LNGO administrations seems an obvious alternative. “For the private sector, consultancy firms offer outsourced financial accounting services to small and even medium-sized enterprises. It is somewhat of a mystery to the author why this service doesn't exist for NGOs and/or why NGOs don't look for it[130]. The box below reproduces a typical sales rap[131] for such services and it is difficult not to see the potential for the NGO sector.

Outsourcing financial administration

[Company X's] accounting services are being performed by experienced CPA’s (Certified Public Accountants) in a professional, correct and timely manner. While we collaborate closely with your team to safeguard smooth communication and best performance of all accounting and reporting processes and tasks, you can focus on your core competences, activities, and other business priorities more effectively without the need of having an own accounting department. In the standard case, our monthly accounting service fees are significantly lower than the cost of our clients having and managing an own accounting team... Not only will this spare you from the hassles of recruiting, managing and retaining own accounting personnel but also helps you saving costs and expenses for office equipment, accounting software, materials and rent.

Obviously, the NGO sector does have specifics that would need further exploration”.[132]

“This is a core issue, and it is a mystery to me that it attracts so little, if any reflection and practical experimentation with possible alternatives for the situations where NGO requirements do harm to the mission. This is not the place to pursue it further but one cannot make an argument for systems, structures, and office-professionalism without making this big caveat”.[133]

[130] This question is beyond the mandate of this study and is thus not pursued here.
[131] Taken from the website of one such provider offering services on the Cambodian market.
[132] WP1, p.44-45
[133] WP1, p.47

Annex 5: Mango's work on International financial management standards for NGOs

Mango (standing for Management Accounting for NGOs) presents itself as "the only NGO focused on strengthening the financial management and accountability of other NGOs around the world".[134] They have build a solid reputation and their tools are widely used, also in the Cambodian NGO sector.

The acceptance of their expertise has allowed them to extend their objectives from service provision to (I)NGOs and donors to improving the operational playing field of its clients, the not-for-profit sector, by leading "the development of internationally recognised not-for-profit (NFP) financial management standards."[135] Their advocacy "led to a key study by the CCAB[136], a partnership of key accounting bodies in the UK and Ireland (Mango was on the technical steering group), for which the project brief acknowledged that:

"Charities and other non-governmental organisations (NGOs) increasingly work internationally with grants from government funding their development and relief activities, while private donors and international foundations are increasingly taking a global approach to their work. As a result, charities and other NGOs face a multiplicity of international grant regimes, often made more complex by the lack of an agreed approach to financial planning and reporting."[137]

"[O]n 29 January 2016, Mango and the African Academy of Sciences (AAS) launched a partnership to develop the [Good Financial Grant Practice] GFGP standard. The initiative will be led by AAS and the African Organisation for Standardisation, who will work with funders from across the world and grant recipients in Africa to develop this new, pan-African quality standard by August 2017."[138]

They have also lobbied the International Financial Reporting Standards (IFRS) Foundation to have the International Accounting Standards Board (IASB)[139] extend its remit to develop standards for the not-for-profit sector. Mango feels that only with officially recognized accountancy standards for the NFP sector, "initiatives like GFGP gain the longer-term traction they need to succeed."[140]

But their lobby has not succeeded. Development of a NFP standard was not included in the IASB work program for the coming five years (2017-2021): "The [IFRS] Trustees concluded that the Board should not expand its remit at this time, but recommended that the Board should be involved in any initiatives or working groups on this topic."[141]

The ultimate objectives of international standards in financial management of grant funds are to:

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134 https://www.mango.org.uk/aboutus, accessed 24-11-2016

135 https://www.mango.org.uk/getconnected/mangocampaigns/internationalfinancialmanagementstandardsforngos accessed 24-11-2016

136 Crawford, L. et al. (2014)

137 Crawford, L. et al. (2014), p.7

138 https://www.mango.org.uk/getconnected/mangocampaigns/internationalfinancialmanagementstandardsforngos/gfgp accessed 24-11-2016

139 The IFRS is the oversight body of the IASB and its trustees determine what is included in the IASB working program

140 http://www.mango.org.uk/news/722 accessed 24-11-2016

141 IASB (2016), p.35

- “provide better assurance for donors - and build the trust needed so that a higher proportion of funding is channelled directly to local and national NGOs
- simplify financial reporting and stop the waste of resources caused by the lack of harmonisation between donor requirements - this leads to multiple audits and assurance visits, and a high administrative burden for grant recipients.”[142]

It is obvious that Mango’s work and aims here are crucially relevant to improving the due diligence of funding agencies, but also that it is a *derivative relevance*. The best way to conceptualize it is that this work aims to improve the financial management of funding agencies themselves, which undoubtedly will include aspects of their account-holder responsibilities toward the money that they sub-grant to LNGOs. But these aimed for standards can only be expected to frame but not flesh out the nitty-gritty detail of the ‘standards of oversight for sub-grants to LNGOs’ which is the level that our due diligence research is looking at.

This due diligence work and that of Mango target different links in the chain of aid.

142 https://www.mango.org.uk/getconnected/mangocampaigns/internationalfinancialmanagementstandardsforngos accessed 24-11-2016. Grant recipients in this quote refers to INGOs and other NFPs who directly implement and/or sub-grant to LNGOs

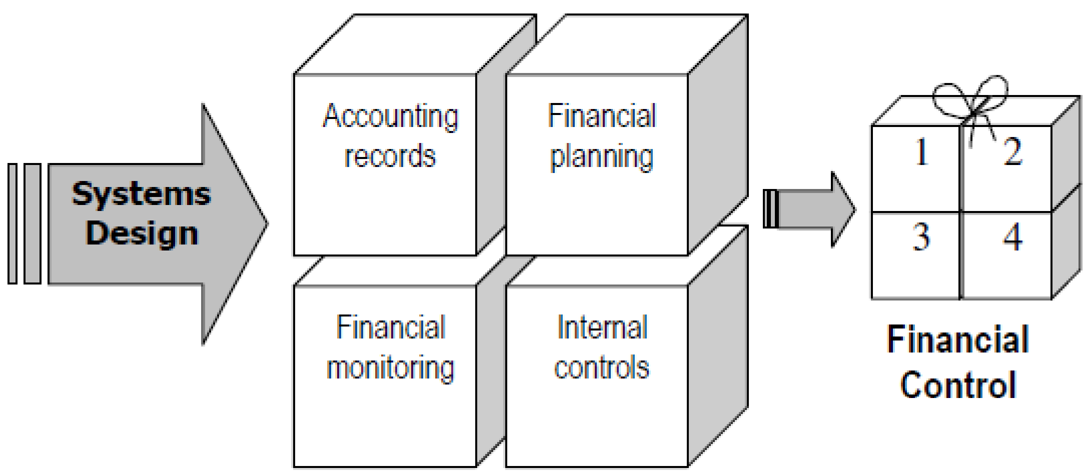
Annex 6: Mango on the basics of good financial management and how to check on it

Mango (standing for Management Accounting for NGOs) rightly presents itself as "the only NGO focused on strengthening the financial management and accountability of other NGOs around the world".[143] They build a solid reputation and their tools are widely used, also in the Cambodian NGO sector. Mango doesn't focus on funding agency due diligence but many funding agencies rely on its widely used and best known tool, the (financial) Health Check as their primary Financial System Assessment tool. The health check is developed as a *self-assessment tool*, but is often applied with the assistance of funding agency staff or consultant. Mango should and cannot be blamed for that, but self-assessed health is unfortunately not an adequate tool of oversight.

This annex summarizes mango's perspective on sound financial management. The whole package is available in its Guide to financial management for NGOs[144] . The purpose of this summary is to emphasize that whatever is recommended in this working paper isn't after something new or different. There is no disagreement whatsoever about what is sound financial management.

The basics of financial management[145]

Financial control is at the heart of financial management. The key to good practice in financial management: robust systems. There are four building blocks in a strong financial management system. When all the building blocks are set up and working effectively, we achieve financial control.



The basics include proper internal oversight

What needs emphasizing is that financial management cannot be assessed without looking at governance issues. As a minimum requirement for funding agency assessment Mango suggests finding

[143] https://www.mango.org.uk/aboutus, accessed 24-11-2016
[144] http://www.mango.org.uk/guide
[145] http://www.mango.org.uk/Pool/T_Primer-FM1.pdf & http://www.slideshare.net/tlewis_mango/t-mango-primercareslideshow

out "whether the Board meet regularly? Do they review budgets and financial reports? Is there anyone on the Board with financial knowledge or experience? Are there any conflicts of interest?" [146]

Minimum requirements, good, and best practices

One way of looking at Mango's publicly available explanations[147] of what needs to be checked and in place is to understand them as "risk levels": starting with "minimum requirements", more comprehensive "good practice", and what for lack of a better term one might label "best practice". However, given an unfortunate overlap between the level of descriptive detail of what an assessor actually needs to find out and these "risk levels", the "minimum requirement" description doesn't really provide practically usable checklists. The "minimum requirement" list both selects *and summarizes* what needs to be in place to make an NGO a "reasonable" risk for any grant provider. This means that for proper understanding of what Mango considers necessary, one needs to take the "best practice" detail as one's starting point, and keep in mind that the summarizing "minumum requirements" should be understood as including much of that detail when used in practice. Again, unfortunately, but for very understandable reasons, *not all of the detail*. One of its top ten tips for funding agencies that assess their partners' finances is to "[a]void relying solely on checklists, tools or numbers to make an assessment decision. They all help you to gain an understanding, but it is important to consider each organisation in its own context."[148]

The point of the above is that to really understand any particular "minimum requirement" one needs to:

(1) fully digest the most comprehensive detailed description of how this requirement can look like in a ("best practice") NGO, while
(2) realizing that any specific NGO may go for alternative ways to reach the same objectives, and,
(3) realizing that not necessarily all of the detailed aspects need to be present to make for very "good practice"

Keeping this in mind, I share:

(1) Mango's Minimum Standards Checklist
(2) To illustrate the level of detail underlying these minimum standards: "Clear delegation of authority" between board and the chief executive (obviously a detail that is core to "internal oversight")
(3) By way of one more illustration, a comprehensive list of issues for doing an Financial System Assessment (for a small NGO), an example of what would make for "good practice"

Two caveats

(1) Mango's material/resources are very clear that the purpose of these levels is primarily to identify the existing quality of financial control, so as to support improvement. They are moot about the limits of what is realistically improvable and what the consequences for oversight of such limits might be.
(2) Mango's position can be summarized as the "minimum requirements" making an NGO a "reasonable" risk for any grant provider. This does not imply that an NGO that doesn not (yet) live up to them should not/never be funded. Funding would however require "beyond regular" monitoring to compensate for the high risk of financial mismanagement.

[146] http://www.mango.org.uk/toptips/tt17partnerassess

[147] Again, this is not to imply criticism of Mango, because full-fledged understanding of this material assumes one participates in a training.

[148] http://www.mango.org.uk/toptips/tt17partnerassess

Minimum Standards for Financial Management in NGOs[149]

Mango has a list of minimum standards and a list of some additional areas of good practice that give a quick and dirty overview of what is required for these building blocks to make for good financial control.

A. Minimum Requirements	
Standard	**Why**
1. A valid supporting document for every transaction, (securely filed and stored for the minimum period required.)	Protection for staff, evidence and details of transaction.
2. A cash book for every bank account, reconciled every month.	To organise and summarise transaction information; check for errors and omissions.
3. A Chart of Accounts – used consistently in the accounting records and budgets	Principle of consistency; to facilitate production of financial reports.
4. A budget detailing costs and anticipated income for all operations.	Planning, fundraising, control and reporting.
5. Clear delegation of authority – from governing body through the line management structure.	To know who is responsible for what and within what limits.
6. Separation of duties – sharing finance duties between at least two people.	To prevent temptation to steal and reduce opportunity to commit fraud; to share the load.
7. Annual financial statements – preferably audited by an independent person.	Accountability to stakeholders; transparency.

B. Good Practice	
8. Additional accounting records when staff are employed (wages book) or assets owned (assets register).	To meet statutory and audit requirements; for control purposes.
9. Budgets based on real activity plans, which include the full cost of running a project.	Realistic, more likely to meet targets.
10. Budgets with clear calculations and notes.	Easy to read and make adjustments. Easy to justify calculations.
11. Separate core costs budget.	Encourages active management and financing strategy for core costs.
12. Monthly cash flow forecast.	Helps to identify and take action to avoid short-term cash flow problems.
13. Use of Cost Centres when working with	To separate restricted funds and related

[149] http://www.mango.org.uk/guide/minstandards

multiple donors and/or projects.	transactions; to facilitate reporting to managers and donors.
14. Funding grids, if more than one donor is funding an organisation or project.	To avoid double-funding situations and identify areas of shortfall.
15. Budget monitoring reports at least monthly to managers (and also regularly to beneficiaries).	To monitor progress; control purposes.
16. Written policies and procedures, including a code of conduct for staff & board members.	To prevent confusion about organisation rules and expected practice.
17. Diversified funding base – mix of restricted and unrestricted funds.	Less vulnerable to financial shocks; helps to build up reserves.
18. A reasonable level of reserves.	Less vulnerable to financial shocks; helps overcome cashflow problems

What underlies the standard of "Clear delegation of authority" between board and the chief executive

The point of this section is to show what an independent assessor would actually have to figure out if a certain requirement is optimally met (is this in place as a policy? Does this actually happen in practice? How can I know this with sufficient confidence?)

Who does what in financial management?[150]

The Board of Trustees

- Discuss and approve the annual budget
- Approve the organisation's financial policies, including delegated authority
- Review quarterly and annual financial reports, including budget monitoring, cashflow and the balance sheet
- Monitor progress in generating funds to ensure that the organisation has adequate resources to carry out its objectives
- Review and approve the audited financial statements
- Ensure accountability and transparency
- Periodically assess the financial risks facing the organisation.

The Chief Executive Officer (CEO)

- Appointing financial staff
- Managing the budgeting process
- Ensuring income is generated as set out in the financing strategy and budget
- Reviewing donor agreements to be aware of conditions attached to grants
- Making decisions about large expenditures (within the limits set by the Board)
- Ensuring that proper financial records and accurate books of account are kept

[150] http://www.mango.org.uk/toptips/tt13rolesfm

- Ensuring that financial reports are produced on time, in the correct format and delivered to the right people
- Monitoring that programme activities are in line with the budget
- Checking financial reports and drawing the attention of staff/Board to problems
- Ensuring control of cash, stocks and equipment.
- Note: The CEO may delegate some of the activities required to fulfil these obligations to senior managers, such as the Finance Manager or Programme Managers, but the responsibility remains with him/her.

Financial Governance of boards[151]

The above description of the role of boards is still a summary. Focusing on the role of boards, mango's resources include an even more detailed checklist:

1. Making sure funds are used to help beneficiaries effectively

- Making sure the organisation has practical strategies for analysing and responding to social problems
- Monitoring that the organisation is actually doing a good job, putting its strategy into practice and achieving value-for-money
- Making sure the organisation has appropriate internal procedures (such as internal controls and accounting systems) to empower front-line staff to make good judgements
- Regularly checking that internal procedures are followed in practice (eg carrying out internal audits)
- Taking an active role in internal controls as necessary (eg authorising large payments)
- Regularly monitoring financial reports, including the income and expenditure statement and the balance sheet
- Monitoring whether the organisation is being accountable to its beneficiaries (eg presenting financial reports to them).

2. Making sure the organisation has enough funding

- Approving a realistic annual budget and fundraising plans
- Monitoring the amount of income received
- Actively working out how to ensure the organisation will be sustainable, including approving a financing strategy
- Monitoring relationships with donors (eg if reports are submitted on time)
- Monitoring fund balances including general reserves (if any fund balances are negative, this could have serious implications for your credibility.)

3. Making sure the organisation has effective senior management

- Recruiting a Chief Executive with financial management skills for their role (or supporting the Chief Executive to develop these skills)
- Supporting the Chief Executive to develop a culture of good financial management (eg leading by example and encouraging finance and programme staff to work together)

[151] http://www.mango.org.uk/toptips/tt20gov

- Making sure that the most senior finance manager is a member of the most senior management team
- Encouraging an open culture that recognises problems and aims to learn from them; and holding senior managers to account for the results of the decisions that they take and the initiatives they launch.

4. Making sure that the organisation operates within the law

- Understanding the organisation's legal requirements, including Labour laws, Tax laws and Health & Safety legislation
- Making sure that the management team meets legal requirements (eg paying taxes, filing annual reports)
- Appointing external auditors, overseeing the audit and approving the audited accounts and annual reports
- Filing reports with government departments.

5. Making sure the board can handle its responsibilities effectively

- Appointing a Honorary Treasurer, with specific responsibilities for financial management and the skills to carry them out
- Making sure that all board members understand their financial management responsibilities and supporting them to develop appropriate skills
- Making sure there are no conflicts of interest between the organisation’s operations and board members work or business interests
- Making time at board meetings to discuss the financial management aspect of all major decisions.

Internal Audit Review Checklist

Mango recommends a more comprehensive list of issues for doing an Financial System Assessment (for a small NGO)[152]

A. General

Ref	Checklist Item	Y/N N/A	Notes
A1	**Does the organisation have an up-to-date Organisation Chart which shows the staffing and committee structure?** *If not, they should describe the staff and Board set-up to help you draft an organogram.*		
A2	**How many staff and/or Trustees are involved in financial administration for the organisation?** *It is useful to note the job titles and approx. how many hours they spend on finance admin work.*		
A3	**Have any of the staff received finance-related training and/or possess accountancy qualifications?** *Note details of qualifications/duration of training.*		
A4	**Does the organisation have a Finance Manual – i.e. written down procedures which cover financial rules, routines and processes?** **If yes, who has access to the manual?** *Try to get sight of the manual or other written procedures to establish how recently it was written/updated.*		
A5	**Does the organisation use a computer to store its accounting records? If yes, which program(s)?** **Does the organisation use a computer to produce financial reports? If yes, which program(s)?**		
A6	**What are the NGO's main sources of income?**		
A7	**What financial trends are apparent (e.g. funding growing or drying up)?**		

[152] https://www.mango.org.uk/guide/internalauditchecklist

Ref	Checklist Item	Y/N N/A	Notes
B1	**Which of the following budgets does the organisation have:** project budgets? (e.g. those relating to one activity or donor-funded project) core costs (administration/overheads) budget organisation-wide budgets (i.e. consolidating all activities)? cash budgets or cash flow forecast? Others? [specify] *Try to get copies or sight of the most recent budgets available, noting the period they refer to.*		
B2	**What process is used to produce the organisation's budgets?** *Find out who is involved, when they are produced, what method is used. Is there a link to the organisation's mission and objectives?*		
B3	**Is the organisation's annual budget formally approved by the Board and entered in the minutes?** **Are significant changes to the budget approved by the Board?** *This could be verified by sight of the Minutes book.*		

B. Budgeting and Planning

Ref	Checklist Item	Y/N N/A	Notes
C1	**Which of the following basic accounting records does the NGO keep:** Cashbook? Analysed cashbook? Petty cash book? A file of invoices/receipts for all expenditures? A file of receipts/vouchers for incoming funds? A file of bank statements for each bank account held? A fixed assets register?		

C2	**Which of the following additional accounting records does the NGO keep:** Payroll records? General ledger/nominal ledger? Journal book? Accounts Payable/Purchase Ledger? Accounts Receivable/Sales Ledger? Others:		
C3	**How recently were the books updated?** within the last 7 days? within the last 14 days? within the last 30 days? more than 30 days ago? more than 60 days ago?		
C4	**Were the accounting records available for your inspection?** **If not, why?**		
C5	**Is the organisation aware of and complying with the accounting requirements of:** the NGO's governing document? Statutory regulations?		
C6	**Are the annual financial statements formally approved by Board members at an annual meeting?** *This could be verified by sight of the Minutes book*		
C7	**If relevant, what arrangements are made for accounting for and managing foreign exchange?**		

C. Accounting Records

Ref	Checklist Item	Y/N N/A	Notes
D1	**Which of the following policy and procedures are written down:** Delegation of authority (i.e. who signs what on behalf of the organisation and within what limits – cheques, purchase orders, leases, contracts, etc.) Cash handling and banking? Procurement and payment (i.e. how to order/purchase goods and services) Use and control of vehicles **Are these communicated to all staff and trustees?**		
D2	**Is there any segregation of tasks to provide automatic 'double check'?** *Need to establish whether the financial admin tasks are shared by staff or concentrated in the hands of one or two people.*		
D3	**Which of the following controls over incoming funds are followed:** Numbered duplicate receipts issued for all incoming cash and cheques? Cash received and counted in the presence of more than one person? Cash coming in and petty cash floats kept separate at all times? Incoming receipts banked promptly and regularly? (at least weekly)? All incoming money banked and no amounts held over for petty cash "feeding"? *Variations should be explained*		

D4	**What controls are in place over receipt books issued by the NGO?** *For example, numbered duplicate books signed for and checked.*		
D5	**What precautions are taken to ensure that cash, cheque books and other valuables held on the premises are safeguarded?** **Are keys of safe or cash box signed for?** **Is insurance held to cover contents of safe or cash box?**		

D. Internal Controls

Ref	Checklist Item	Y/N N/A	Notes
D6	**Which of the following controls over purchases are followed:** Supporting documentation held for all items of expenditure (i.e. invoices, vouchers, receipts)? All expenditure properly authorised on a Payment Voucher? Invoices checked against orders made? Records kept of orders placed but not carried out? The quality and quantity of goods supplied checked against orders made? Payments only made against original invoices (i.e. not on monthly statements or photocopies)? Regular stock-taking undertaken?		
D7	**Which of the following controls over payments by cheque are followed:** Conditions set down in the governing document about who can sign cheques complied with? At least 2 signatories on the bank mandate? Cheques and never signed in blank? A nominated signatory may not sign a cheque made payable to themselves? All cheque expenditure is recorded in the cashbook and noted with the relevant cheque number?		

	Cheque stubs completed at time of payment? Cheques signed only with proper documentary evidence of the nature of the payment?		
D8	**Which of the following controls over payments by petty cash are followed:** Every effort made to minimise cash payments? All payments by cash made from a cash float? The cash float drawn from the bank and not from incoming money? All petty cash payments have supporting documentation? Supporting documentation authorised by someone other than the cashier or claimant? Amounts of claim entered on a petty cash voucher? All payments noted in a petty cash book? All topping up withdrawals from bank noted in the petty cash book? Regular checks made of petty cash records by someone other than the cashier?		

Ref	Checklist Item	Y/N N/A	Notes
D9	**Which of the following controls over the NGO's bank accounts are complied with:** All bank accounts held in the name of the NGO, not individuals? Instructions to open or close accounts properly authorised and / or reported to Trustees? Secure records held for all bank accounts? Regular bank reconciliations carried out? Bank statements regularly inspected by the Trustees?		
D10	**Which of the following checks on accounting records are made:** Cross checks made between bank statements and income and expenditure records to ensure no discrepancies between records? Checks made by someone other than the original recording officer (e.g. Internal Auditor)? Any restrictions placed on donated income identified and observed?		

D11	**If the organisation has paid employees:** Are personnel records kept and held separately from wages records? Are salary levels properly authorised and recorded? Are checks made to verify existence of employees? Are cash payments for wages and salaries avoided whenever possible? If cash payments made, are they paid out by someone other than the payroll clerk and signed for? Are staff employed under a proper contract of employment? Is compliance with statutory tax regulations ensured?		
D12	**If the organisation owns fixed assets (vehicles, office equipment, buildings, etc.):** Is an Assets Register/inventory held and updated regularly? Are assets checked regularly to ensure that they are still in good repair and in the proper location? Has insurance cover been considered? Is the use of fixed assets reviewed annually to ensure they are put to best use and serving the NGO's interest? Are vehicles fitted with appropriate security and kept in a safe place overnight? Are buildings properly safeguarded?		

E. Financial Reporting and Monitoring

Ref	Checklist Item	Y/N N/A	Notes
E1	**Does the organisation produce financial statements (including a Balance Sheet and Profit & Loss or Income & Expenditure account)? If yes:** How often? Period covered by the most recent statements? Who receives copies of the financial statements? *Obtain copies of the latest set of statements if available..*		
E2	**Are the annual financial statements subjected to an independent audit by a qualified professional?** **If yes:** When was the last external audit conducted and by whom? Was the audit report qualified or unqualified? *Obtain a copy of the latest audited statements if available*		
E3	**Does the organisation produce periodic reports for MANAGERS which compare performance against budgets? If yes:** How often? Period covered by the most recent report? Who prepares the reports? Who receives copies of the reports? *Obtain copies of the latest budget comparison reports if available.*		
E4	**Does the organisation produce periodic reports for DONORS which compare performance against budgets? If yes:** which donors? how often? who prepares the reports?		

Annex 7: the issue of social norms – partnership and accountability

The partnership paradigm customarily framing the grant giver – grant recipient relationship seriously complicates vertical accountability and the external oversight role of the grant provider. This annex describes

Why that is the case

Why it is inescapable

And, *given that it cannot be avoided*, some speculation about if and how its complications can be mitigated.

Dan Ariely on social and market exchanges

A well-known popularizer of behavioural economics, Dan Ariely, devotes a chapter of his *Predictably irrational, The hidden forces that shape our decisions*[153] to the psychological mechanisms that underlie these problems.

This annex extracts some insightful passages from that chapter (the cost of social norms), and speculates on the implications for the partnership paradigm in NGO funding.

As much social science, the below explanatory framework uses common sense terminology in a specific technical way in which its meaning is more defined/restricted. In this case, the analysis contrasts 'social' norms and 'market' norms, which in other technical treatments would be conceptualized as being hierarchically related concepts with market norms being a specific kind of social norms. The reader is kindly requested to not make too much of these sorts of debatable choices and focus on the (non-technical) substance of the argument.

Social exchanges and market exchanges don't mix well

"As Margaret Clark, Judson Mills, and Alan Fiske suggested a long time ago[154]…we simultaneously live in two different worlds – one where social norms prevail, and the other where market norms make the rules. The social norms include the friendly requests that people make of one another. Could you help me move this couch? Could you help me change this tire? Social norms are wrapped up in our social nature and our need for community. They are usually warm and fuzzy. Instant paybacks are not required; you may help move your neighbor's couch, but this doesn't mean he has to come right over and move yours. It's like opening a door for someone: it provides pleasure for both of you, and reciprocity is not immediately required.

The second world, the one governed by market norms, is very different. There's nothing warm and fuzzy about it. The exchanges are sharp-edged: wages, prices, rents, interest, and costs-and-benefits. Such market relationships are not necessarily evil or mean – in fact, they also include self-reliance, inventiveness, and individualism – but they do imply comparable benefits and prompt payments. When you are in the domain of market norms, you get what you pay for – that's just the way it is.

[153] Ariely (2008)

[154] E.g. see: Fiske, A. (1992) The four elementary forms of sociality: framework for a unified theory of social relations. Psychological Review

When we keep social norms and market norms on their separate paths, life hums along pretty well….". (p. 68)

"So we live in two worlds: one characterized by social exchanges and the other characterized by market exchanges. And we apply different norms to these two kinds of relationships. Moreover, introducing market norms into social exchanges…violates the social norms and hurts the relationships. Once this type of mistake has been committed, recovering a social relationship is difficult.

Ariely illustrates this imagining you've been invited by your in-laws for Thanksgiving. What would happen if by the end of the sumptuous meal you draw your wallet and ask your mother-in-law for the bill? "Once you've offered to pay for the delightful Thanksgiving dinner she will remember the incident for years to come"….

A few years ago [my good friends Uri and Aldo] studied a day care center in Israel to determine whether imposing a fine on parents who arrived late to pick up their children was a useful deterrent. Uri and Aldo concluded that the fine didn't work well, and in fact it had long-term negative effects. Why? Before the fine was introduced, the teachers and parents had a social contract, with social norms about being late. Thus, if parents were late – as they occasionally were – they felt guilty about it – and their guilt compelled them to be more prompt in picking up their kids in the future. (In Israel, guilt seems to be an effective way to get compliance)[155] But once the fine was imposed, the day care center had inadvertently replaced the social norms with market norms. Now that the parents were paying for their tardiness, they interpreted the situation in terms of market norms. In other words, since they were being fined, they could decide for themselves whether to be late or not, and they frequently chose to be late."

Once the fine was removed, the behavior of the parents didn't change. They continued to pick up their kids late…

This experiment illustrates an unfortunate fact: when a social norm collides with a market norm, the social norm goes away for a long time. In other words, social relationships are not easy to reestablish. Once the bloom is off the rose – once a social norm is trumped by a market norm – it will rarely return." (p. 76-77)

"The delicate balance between social norms and market norms is also evident in the business world. In the last few decades companies have tried to market themselves as social companions – that is, they'd like us to think that they and we are family, or at least are friends…If you're a company, my advice is to remember that you can't have it both ways. You can't treat your customers like family one moment and then treat them impersonally – or, even worse, as a nuisance or a competitor – a moment later when this becomes more convenient or profitable. This is not how social relationships work. If you want a social relationship, go for it, but remember that you have to maintain it under all circumstances.

On the other hand, if you think you may have to play tough from time to time – charging extra for additional services or rapping knuckles swiftly to keep consumers in line – you might not want to waste money in the first place on making your company the fuzzy feel-good choice. In that case stick to the

[155] In other places/cultures shame is more effective [RH]

simple value proposition: state what you give and what you expect in return. Since you're not setting up any social norms, or expectations, you also can't violate any – after all, it's just business (p. 78-80)

So what?

Obviously, Ariely's analytic lens is overly simplistic. The diversity in normative expectations *within* the very broad category of "social exchanges" is enormous. Think e.g. cultural differences (dimensions like equality/hierarchy, and individualist/collectivist[156]), but also within one place and time there is huge variety in the specific expectations attached to particular "social exchange" relationships. Nevertheless, the broad dichotomy is immediately recognizable, or phrased differently: makes (common) sense.

Part of that common sense understanding (within all market economy societies) is that money tends to evoke market norms, unless exchanged between family or close friends, or explicitly framed as a "gift". Therefore*, the partnership frame that dominates the LNGO sector is in most cases inherently unstable*. In the aid business, generally, even when a LNGO receives "organizational" funding (as opposed to the situation of LNGOs hired as subcontractors to implement funding agency initiated and supervised projects, which is much easier recognizable as a market exchange, although in practice often times still rhetorically framed as a partnership), money needs to be accounted for (as opposed to gifts that do not need some explicit, formalized form of accounting)[157].

LNGOs as subcontractors: a caveat

Obviously, there is nothing inherently wrong with grant providers entering into a subcontracting relationship with a CSO. So it is important to emphasize that what is discussed in this report only applies to those relationships/situations that are not intentionally and mutually structured as a subcontracting arrangement.

The partnership frame is as inherently unstable as the corporate sector example Ariely uses of companies presenting themselves as social companions. Inherently unstable means that the party that introduces the tension, the company, respectively the grant-giver, needs to work especially hard at keeping the frame intact. That means displaying behavior that is compatible with the social exchange frame and refraining from actions that the other party experiences as incompatible, and as an indication of a frame switch. Switching between frames confuses and creates mistrust and other negative feelings. As the partnership frame, because of the rhetorically white-washed, but practically enforced financial (and often program) accountability expectations, was never the "natural" frame for most of these exchanges in the first place, the "partners" tend to be hyper-sensitive to any frame-incompatible behavior.

[156] All such terms are ideologically tainted and within academic debates may be hotly contested. They specific choices made here do not represent any particular ideological choice but should be seen as placeholders for a "general idea".

[157] This makes for one major but not very common exception to the general picture: money channeled to civil society organizations that are (largely, often indirect) fronts for political work, at least in the earlier days of the NGO era (1970s and 80s), is often granted without much accountability expectations. For these relations the term "partnership" is way less ambiguous because the money is more a contribution to a cause, comparable to contributions to a political parties, and what the money is going to be used for is really/exclusively and fully the prerogative of the recipient.

Ariely's recommendation is to stick to either market exchange or social exchange expectations and avoid anything suggestive of frame-switching. If one accepts this recommendation, the core question to ask is: *is there a way to salvage the partnership frame without giving up on proper financial accountability*? The alternative, explicitly framing the grantgiver-grantee relationship as a market exchange, would imply giving up on a core tenet of what makes for effective development CSOs: that they pursue equitable partnerships and solidarity[158].

Why is financial dependence an inherently fragile basis for grant-giver grant recipient partnership?
The intimately related twin core problems that need to be overcome to salvage the relationship frame is that (1) *money is power*, often misused by funding agencies to exert programmatic control, making LNGOs either wary of anything reeking of grant providers overstepping their boundaries, anything breaching LNGO autonomy; and (2) that *proper financial accountability*[159] *requires independent external oversight*, that lives up to the professional standards and partly *quite invasive/forensic procedures* to reach those standards that are widely accepted as appropriate for such oversight: those of the audit profession. These procedures are seen as breaching LNGO autonomy, when applied by anyone other than external auditors, and even then are only grudgingly accepted as unavoidable (many grant providers stipulate an external audit as a non-negotiable condition).

These problems are to some extent unavoidable. At the most fundamental level because ending a funding relationship is always going to cause more issues for the money recipient than for the money-giver (and more so to the extent the recipient is more dependent upon this particular giver) a funding relationship is inherently unequal. This inequality does not *necessarily* compromise the programmatic autonomy of the recipient, but it is undeniably real, and makes for negative incentives for both grant-providers and grant-recipients: there is no magic wand that can make the temptation for funding agencies of misusing the power of their money for programmatically self-interested reasons (i.e. not based on/rooted in partnership with the LNGO) disappear. And there is no magic want that can make the temptation for LNGOs to turn from mission-driven CSOs to chasing-the-money driven consultancy firms go away.

What stands out is that these temptations are in a sense mirror images of each other. LNGOs fear a loss of programmatic take-over by those funding them and the grant-providers fear partnering with supposedly autonomous mission-driven CSOs that turn out to consultancy body-shops. The shared image is that of an equal engagement between autonomous organizations on the basis of shared values, and programmatic goals.

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[158] One of the Open Forum for CSO Development Effectiveness Istanbul principles: "CSOs are effective as development actors when they … commit to transparent relationships with CSOs and other development actors, freely and as equals, based on shared development goals and values, mutual respect, trust, organizational autonomy, long-term accompaniment, solidarity and global citizenship" (see: Working party on Aid effectiveness, OECD/DAC, 2010).

[159] It merits emphasizing that the need for proper accountability is not disputed in NGO land: another of the Open Forum for CSO Development Effectiveness Istanbul principles states: "CSOs are effective as development actors when they … demonstrate a sustained organizational commitment to transparency, multiple accountability, and integrity in their internal operations." (see: Working party on Aid effectiveness, OECD/DAC, 2010)

Programmatic accountability, financial accountability, and autonomy

If that is so, what exactly makes external *financial* oversight using invasive fact-finding techniques such a contentious process, such a deal breaker for trust between grant-provider and grantee? Is the perception/understanding that the invasive procedures that are necessary for proper external oversight breach the LNGO's autonomy accurate?

One way to think about this is to look at financial accountability's three components: relevance, effectiveness and efficiency of the organizational use of resources. *Relevance* (given our mission do we spend our resources doing the right things? Is the impact our interventions can have the impact we want?), and *effectiveness* (assuming we spend them on the right things, do we spend them in the right way, a way that actually works and optimizes results?) are directly *programmatic* aspects of financial management. *Efficiency* (assuming we spend them on the right things in an optimally effective manner, do we do it in the most cost-benefitting way? Do we ensure that we don't waste[160] resources?) is not directly programmatic.

To the extent that external financial oversight includes the directly programmatic components the its understanding as a breach of LNGO autonomy makes sense but even a cursory look at which of these components of financial accountability are assessed when using any of the three tools of external oversight (financial statement audit, Financial System Assessment and periodic financial monitoring) that this report focuses on reveals that relevance and effectiveness are not really in play. In other words, the perception that financial oversight conflicts with programmatic autonomy is conceptually[161] difficult to uphold.

It is also telling that the corporate sector may regularly complain about specific time consuming external audit and other compliance processes, may often lobby for self-regulation as an alternative to independent assessment procedures for specific (mostly non-financial) compliance areas, and is very creative in undermining the independence of its external auditors (e.g. by hiring the same firm for all kinds of lucrative consultancy gigs) and/or challenging external audit criticisms of particular legally questionable financial management practices through in-house or insourced audit expertise, but none of this grumbling, lobbying, negotiating etc. uses arguments of external oversight being an infringement of organizational autonomy[162]. The need for such oversight and the need for the kinds of standards and procedures that it is based upon are not disputed. In fact, is there any other sector apart from LNGOs where arguments against independent financial oversight as infringement of autonomy are common currency?

[160] This obviously includes "waste" through fraud and other financial mismanagement

[161] Obviously, this is not to claim that some/many funding agencies do not sometimes/regularly overstep the boundaries and ignore the programmatic autonomy of their LNGO partners; it is just to claim that external financial oversight does not in itself breach that autonomy.

[162] This is not to claim that companies do not present themselves as to be trusted in their promises that self-regulation is going to do the job and/or will not use legal arguments/means that are about their rights as legal personas (which define their autonomy), but the underlying rationale is pragmatic and results-oriented at core – things work better this way – while the autonomy claim of NGO is moral and relationship-oriented.

An inconsistent understanding of audit standards and procedures

If breach of autonomy is not a legitimate argument against the kind of financial oversight that this report argues for, what else remains as arguments against the appropriateness of external checks on LNGO financial management within a partnership relationship? Next to autonomy, another term central to the partnership discourse is trust, and within the context of external oversight, its opposite: mistrust. Oversight using invasive/forensic procedures is construed as indicating mistrust and inconsistent with partnership. However, at the same time, as referred to above (see note 158), the NGO sector self-presents as aiming for" sustained organizational commitment to transparency, multiple accountability, and integrity in their internal operations".

Of the multiple aspects of organizational "performance" that NGOs are expected to "account" for, only financial management has a recognized history of systematic performance judgment by external professionals whose standards, procedures and other operational processes are the result of at least two centuries of continuous adaptations to what they encountered in practice (and this is ongoing); the standards are globally accepted, and sector independent[163] , and the tightly regulated profession holds a monopoly on the legally recognized performance judgments against these standards. Not that there are no debates and disagreements and quite spectacular failures, but all-in-all financial audits are as undisputedly accepted as "best practice" as it gets. This is something that program performance assessment doesn't have any equivalent for that would come even remotely close.

I have never come across any sensible argument that this may be best practice for judging the quality of financial management of any organization *but not* NGOs. From the perspective of an organization's financially efficient use of resources, NGOs undoubtedly have some specific characteristics, but are certainly not such outliers that the rationale of audit profession standards and procedures doesn't apply to them. Thus anyone arguing for *organizational commitment to transparency, multiple accountability, and integrity in their internal operations* by definition argues for something judged against those standards and procedures.

Thus, perceiving/understanding the application of such standards and procedures as an indication of mistrust and a breach of partnership conventions is not consistent with LNGO claims to aim for transparency, accountability and integrity. To the extent that this claim is trustworthy, the resistance against audit standards and procedures become unintelligible.

Goes hand in hand with an inconsistent understanding of partnership

As Ariely argues, this inconsistency is rooted in the partnership frame itself, because that comes with in-build expectations of how money should be dealt with. NGO claims to strive for full accountability and partnership frame normative expectations that money exchange is understood in gift rather than market economy terms conflict with each other. As argued above, the partnership frame for the grant provider – grant recipient relationship is already inherently fragile, and this inconsistency only adds to that. Or maybe better phrased, partnership's inherent fragility, its in-build temptations to be misused

[163] If one concentrates on the underlying principles and important basics and ignores relatively superficial differences between various specific standards and what applies in different jurisdictions to different kinds of companies (listed versus unlisted, etc.) etc.

grant providers[164], actively reinforces the LNGOs inconsistent engagement with accountability (rhetorical support, practical resistance).

Obviously, most grant providers/funding agencies are more or less aware of this in-build instability and the understandable (experience-based) fears underlying their partners' engagement with accountability, and lots of their own actions as account-holders can be understood as "relationship work" to keep the partnership frame intact[165]. As has been the underlying argument in all of the problem analysis of this due diligence project, the normative framing of the grant provider grant recipient relationship is really a *co-creation* of funding agencies and LNGOs. It is a *NGO sector* norm. Funding agency unwillingness to be duly diligent actively supports and enables current LNGO understanding of what is appropriate within a "partnership".

Why partnership in the first place?
Something underlying this whole discussion is why the NGO sector is so eager to frame the grant provider – grant recipient relationship as a partnership. When that comes with so many seemingly intrinsic problems, why not just go for a market exchange frame? Why try to salvage that frame in the first place.

This question opens up a whole new can of worms that is way too contentious for even a superficial effort to deal with within this context[166]. For our purposes here, it seems sufficient to acknowledge that framing this relationship as a market exchange would come with its own can of worms, and that the sector has valid ideological and practical reasons to value partnership rather above contract.

So what?
The way forward that I would argue for is to embrace rather than avoid the in-build contradictions of the current use of the frame. If we want to both salvage the frame and have an accountable NGO sector we need to face the issues head on. The issues emerge and affect the relationship anyway, however careful one balances the tightrope. The current co-creation makes for strained relationships and a sector that is not really financially accountable. In line with the basic argument underlying the whole due diligence project: it is time to do something different. In this case, that difference would be for grant providers/funding agencies to change their "relationship work" from avoiding[167] all external oversight that is perceived as inconsistent with the partnership frame to orienting it toward overcoming the resistance of their partner. This implies explicitly addressing that resistance, acknowledging the importance of autonomy and trust, acknowledging the reality of grant providers being tempted to ignore the programmatic autonomy of their partners, but taking a strong and principled stand on the need for proper external oversight.

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[164] And grant recipients, but for the current argument, what counts is misuse by grant providers.
[165] One can look upon the reasoning here as answering some of my own questions about the weirder aspects of this relationship in Annex 9 of WP2.
[166] Annex 12 of WP1 touches on some of it.
[167] to the extent possible…most cannot avoid requesting an external audit but the outsourced nature/involvement of audit companies mitigates the effect that has on the relationship, especially if the funding agency doesn't involve itself at all in what is expected of the external audit.

As the analysis above shows, proper independent oversight of LNGO financial management is compatible with partnership between equals who are entitled to autonomous control over their mission and program, and with LNGO acceptance of the need for integrity of internal operations. But LNGO trust that this is indeed the case is not going to come out of thin air. It is going to require honest conversations, in which everything is talked through in such a way that all questions, worries, doubts, etc., are explicitly addressed. This annex is an effort to support such conversations by providing a couple of arguments for addressing some known core worries and doubts.