



microNOTE # 36

From Social Rating to Social Auditing

* The performance rating is similar to the financial (or credit) rating for private sector firms. It differs from the latter in that it combines an assessment of the MFI's key financial risk with an assessment of institutional performance particular to microfinance. It asks, for example, "How good is this MFI at providing microfinance services?" Or "If we lend money to this MFI, will it be effectively used?"

Over the past two years, USAID has been working with Chemonics under the Accelerated Microenterprise Advancement Project - Knowledge Generation (AMAP KG) to develop and test a social rating tool for microfinance institutions (MFIs). Since April 2005, the AMAP KG research team has implemented three pilot tests of the social rating, including a stand-alone social rating in Albania and two integrated social and performance ratings in Bolivia in collaboration with PlanetRating and MicroRate.*

The social rating has proven to be a useful social performance assessment (SPA) tool targeted primarily to external users. Its usefulness for informing and guiding institutional reform, however, is limited, for a variety of reasons (as discussed below). The social audit is a complementary SPA tool designed to compensate for the gaps in the social rating. In contrast to the social rating, the social audit is targeted primarily to internal users; the primary purpose of the social audit tool is to inform and guide institutional reform in the area of social performance. Ideally, the social audit constitutes an important component of the MFI's overall social performance management (SPM) system.

This MicroNOTE describes and contrasts the social rating and social audit demonstrating why the latter is a necessary complement to the former. In doing so, it summarizes the key lessons learned from the USAID social rating initiative and how these are relevant to the development of the social audit.

The Social Rating

Social Rating Defined

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A social rating is defined in the SEEP *Social Performance Glossary* as: “An independent assessment of an organization’s social performance using a standardized rating scale. The social rating process and rating scale may parallel those used for financial rating.”¹ The social rating tool developed by the AMAP KG research team examines six key internal processes to determine the degree to which they align policies, behaviors, and outcomes within the MFI to its social mission. The six internal processes are: (1) mission statement and management leadership, (2) hiring and training, (3) incentive systems, (4) monitoring systems, (5) customer service and (6) strategic planning.

In addition to assessing the above six internal processes, the AMAP KG social rating includes an assessment of the MFI’s “social accounts.”² The social rating assesses not only the quality and credibility of the social accounts but also their implications for the MFI’s overall social performance.

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¹ See <http://www.seepnetwork.org/content/library/detail/4728>.

² Social accounts refer to the information on social performance gathered by the MFI through the variety of assessment tools it uses. The process of gathering social accounts (information) is referred to as “social accounting.”

The social rating is designed to be implemented in tandem with the standard performance rating carried out by an independent rating agency. The social rating examines many of the same aspects of institutional design, systems, policies, etc. that a performance rating does, albeit from a social perspective.

From a financial perspective, for example, a shift from rural to urban lending may suggest a greater volume and value of lending, more rapid loan turnover, and lower operational costs, all with important implications for both short-term and long-term financial performance. From a social perspective, however, a shift from rural to urban lending might suggest a shift from less-well-off to more-well-off clients or a shift from underserved markets to more saturated markets. Moreover, if the MFI’s mission includes supporting rural-based enterprises, this move from rural to urban markets may indicate possible mission drift.

The social rating also examines other aspects of institutional performance relevant solely, or mostly, to social performance, such as the MFI’s social responsibility to the community, employees, and other stakeholders. Due to the large overlap between the financial assessment in the performance rating and the social assessment in the social rating, the latter can be

integrated into the former at a relatively small marginal cost.

Financial Risk vs. Social Risk

The performance rating is also similar to the social rating in that an aim of both is to assess risk; financial risk in the first case and social risk in the second. Financial risk is the risk that the MFI will not fulfill its financial obligations. Social risk is the risk that the MFI will not fulfill its social mission. Financial risk is a well-established concept. Social risk is a new concept introduced by the USAID AMAP project into the microfinance, as well as the broader social performance, lexicon.

Social risk is relevant for socially responsible investors looking to maximize financial and social returns. Information on social risk enables investors to make reasonable estimates of the expected social return across different investment options and expected financial returns. This in turn allows the investors to make more informed investment decisions and thereby increase their overall expected returns from investment.

Limitations of the Social Rating and the Need for a Complementary Assessment Tool

The social rating is targeted to audiences for whom information on social risk is appropriate, which includes principally

socially responsible investors and donors. This is not to say that the social rating is not useful for internal audiences; in fact, a well-done social rating will provide the MFI management and Board with useful information relative to organizational strengths and weaknesses as well as concrete ideas for operational, policy, or other reforms. For example, a finding that the MFI's incentive system encourages loan officers to move up market from the core target market tells management that the incentive system needs to be fixed, and it provides insights on how to fix it.

Notwithstanding what useful lessons the social rating generates for MFI management and governance, this is not its primary purpose. The financial rating is not in principle a collaborative exercise between the rating agency and the MFI. The opportunities for rater-management consultations are limited both by time and the scope of the activity.

Thus, there appears to be a need for a further complementary product targeted specifically to internal audiences that builds in more opportunities for dialogue and consultation with MFI management and board. This complementary product is the social audit.

The Social Audit

Social Audit Defined

The SEEP *Social Performance Glossary* defines the social audit as follows: "An examination of the records, statements, internal processes, and procedures of an organization related to its social performance. It is undertaken with a view to providing assurance as to the quality and meaningfulness of the organization's claimed social performance."

The concept of the social audit in microfinance is relatively new, although it has a rich background outside of microfinance where it goes by a variety of labels, such as social and ethical accounting, auditing, and reporting (SEAAR); social accounting; or sustainability reporting. Although such terms may have different technical definitions, they broadly describe the same process of assessing and validating an organization's social performance. Each shares, to varying degrees, the following seven characteristics:

1. Planning: Understanding mission and values and identifying stakeholders and issues.
2. Stakeholder engagement and dialogue: Understanding what matters about social performance.
3. Measurement: Building comparable, understandable, and reliable information.
4. Reporting and disclosure: Finding ways to

communicate and gather feedback.

5. Auditing, verification, and quality assurance: Building credibility and trust with stakeholders.
6. Commitment to improve performance: Making real change in social performance.
7. Embedding: Building social accounting into mainstream operations, systems, and planning.

The social audit shares items 1-5 from the above list with the social rating, but it diverges from the social rating in terms of items 6-7. In other words, the social audit is more than an independent, objective assessment of social performance, it is also part of an ongoing social performance management (SPM) system by which the MFI reaffirms its commitment to its social mission and strives to embed this social mission into governance, operations, systems, and planning.

From Social Rating to Social Auditing

Lessons from the Social Rating

Over the course of developing and testing the social rating, AMAP KG researchers and their collaboration partners have identified several lessons that are relevant for the development of the social audit.

1. The focus on internal processes to assess social performance is both justified and effective.

In all pilot tests performed, the examination team was able to assemble a reasonably comprehensive and accurate portrait of social performance at the MFI.

2. The six key internal processes assessed are sufficiently broad in scope that they enable examiners to address issues critical to understanding social performance.
3. There was significant variation in the six key internal processes across the three MFIs assessed. We can be confident, therefore, that the approach allows auditors to differentiate between MFIs and establish credible social performance baselines.
4. The integration of financial and social assessment during the social rating allowed sufficient depth to understand and assess social performance, but it did not allow sufficient depth to make substantive and detailed assessment in terms of areas for reform and corresponding recommendations. This is not to suggest that the social rating needs be a separate, stand-alone activity (it could be), but rather to point out there are informational benefits to focusing on social issues alone. (These benefits are up

to a point only once costs are considered. Cost-effectiveness remains an important criterion in designing the social audit.)

5. The management meeting at the end of the social rating did not provide an adequate forum for reviewing social issues and findings in depth. This was due both to time limitations and the relative importance placed on financial issues and findings during the management meeting.
6. The context of the social rating makes it both difficult and inappropriate for the raters to offer specific and detailed recommendations related to organizational, policy, or governance reform.
7. The social rating does not spend much time looking at issues more traditionally associated with Corporate Social Responsibility (CSR) or corporate governance. CSR refers to a company's obligation to be accountable to all of its stakeholders in all its operations and activities. It encompasses a multi-dimensional and global set of issues all with strategic implications for business and policymakers, such as health, safety, diversity, gender equity, human resource policies, human rights, supply chain,

the environment, and sustainable development. Corporate governance refers to the processes by which corporate entities are governed, including the way in which power is exercised over the management and direction of the entity; the supervision of executive actions; accountability to owners and other stakeholders; and the regulation of corporate bodies by the state. It will be necessary to revisit these issues to determine whether and how to integrate CSR and governance issues into the audit process.

8. Both the social rating and social audit involve MFI stakeholders as an integral part of the assessment process. The social audit differs, however, in that its purpose is precisely to understand social performance from the perspectives of diverse stakeholders. This distinction, however, may be greater in concept than actual practice depending on how either is implemented. Stakeholders to be consulted include, at a minimum, MFI management and staff, board members, and clients.
9. Not every MFI has the same inclination or need to undergo a performance rating, and the timing of internal in-

formation needs does not always coincide with the timing of a performance rating. There is, therefore, a need for a more flexible social assessment tool not tied to performance rating cycles.

10. MFIs and/or MFI networks may want to develop their own social performance assessment capabilities; something they cannot do if they are dependent on rating agencies for information on social performance.

Developing a Social Audit

In light of the above-identified gaps in the social rating, there exists a need for a social audit tool to complement the social rating. Given the similarities between the social audit and social rating, a good starting point for the social audit is the approach used for the AMAP KG social rating. Similar to the social rating, the AMAP KG social audit (1) assesses six key internal processes and their consistency with the MFI's social mission and (2) assesses the credibility and implications of the MFI's social accounts.

In contrast to the social rating, the AMAP KG social audit:

1. Targets primarily internal audiences, particularly management and the board.
2. Focuses solely on social performance.

3. Goes into greater depth on social issues.
4. Involves a wider array of stakeholders.
5. Is more prescriptive in terms of offering specific recommendations for reform.
6. Addresses governance and CSR issues in greater depth.

It is expected, however, that the form and content of the social audit will evolve as a result of development and field testing. The end product may be similar to the starting point, but it may also be quite different.

Questions to be Addressed in Developing a Social Audit

Four important questions to be addressed in developing the social audit are:

1. Who will carry out the social audit?
2. Who will use the social audit?
3. Who will pay for the social audit?
4. What is the cost of the audit?

With regards to the first question, there are a few options. One option is for the MFI to create an internal social auditor (or audit unit) or, alternatively, to add social auditing responsibilities to the existing internal auditor (or audit unit). This option is appropriate for MFIs that want to integrate social performance management into their routine operations. Another option is for microfinance networks to offer a social audit-

ing service to network members. This option is particularly attractive for networks that want to develop their members' SPM capacities or to create common standards around social performance. It also offers networks another potential source of revenue generation.

Yet another option is to develop a social audit industry in which independent social auditors contract with MFIs, MFI networks, or MFI stakeholders to carry out independent social audits or to train MFIs or MFI networks in social auditing. This option is appropriate if an end objective is to scale-up social auditing across the microfinance sector.

Regardless of who carries out the social audit, establishing its credibility requires that the social auditor(s) be independent of MFI management. In the case of the internal social audit, this implies that the internal social auditor(s) report directly to the Board of Directors.

Regarding who will use and pay for the social audit, there are again a number of possibilities. It is anticipated that the MFI will be both primary user and purchaser. In addition, MFI networks may also use social audits to establish and track social performance standards among network members. In this capacity, the networks may cover the cost of the social audits or work out cost sharing arrangements with MFIs. Donors might

also pay for all or part of social audits, whether to support internal capacity development of MFIs or to assess the MFIs' social performance.

The cost of the social audit will depend on whether it is done by internal or external auditors, how in-depth it is, and the price structure of the environment in which the MFI operates. Development of the social audit will need to work out the cost implications of the different alternatives. In the case of internal social audits, the relevant costs to be considered include not only the actual implementation cost but also the cost of integrating the social audit function into routine operational systems.

As with the social rating, an objective is to drive down the costs of the social audit to the point where it is financially feasible for the MFI. What this entails in terms of time, resources, and scope and depth of coverage is to be determined over time via a process of field testing, reflection, and stakeholder engagement.

Implied by the discussion above is the need to develop social auditing capacity within the microfinance sector. This in turn implies the corresponding need to develop training resources and standards around social auditing, including standards over content, implementation, training, and reporting. Donors

and microfinance networks are expected to play a major role in funding and supporting social audit capacity development within the sector.

Conclusion

Assessing and managing the social performance of microfinance institutions is an important but challenging task. The social rating is one SPA tool that has demonstrated its value to the microfinance sector. The social audit is another SPA tool that has demonstrated its value. Although developed outside of the microfinance sector, the general concept and methodology of the social audit are equally appropriate to microfinance.

The AMAP KG social rating and social audit are similar in purpose and design. Nonetheless, they serve different, albeit complementary, roles. Whereas the social rating is a tool for assessing social risk and is targeted primarily to external users, the social audit is a tool for engaging stakeholders in assessing and improving social performance and is targeted primarily to internal users.

Further development of the social audit by the AMAP KG

team and other researchers is necessary to answer key questions related to, among other things, social audit design, implementation, cost, use, standards, and capacity development.

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