

MICROFINANCE INSTITUTIONS DISCLOSURE AUDIT
CHART OF ACCOUNTS BOOKKEEPING JOURNAL LEDGER
INVOICE TRIAL BALANCE CREDIT DEBIT FINANCIAL
STATEMENTS BALANCE SHEET ASSETS LIABILITY
EQUITY NET WORTH CORPUS LOAN OUTSTANDING
PAST DUE LOANS RESTRUCTURED LOANS LOAN LOSS
RESERVE BAD DEBT WRITE OFF CAPITAL FIXED ASSET
BOOK VALUE DEPRECIATION RESERVE INCOME
STATEMENT REVENUES EXPENDITURES COMPOUND
INTEREST SIMPLE INTEREST ACCRUED INTEREST
SURPLUS LOAN LOSS PROVISION HISTORICAL COST
PRINCIPAL INVESTMENTS OPERATING EXPENSES ADMINISTRATIVE EXPENSES GROSS FINANCIAL MARGINS
GRANTS CASH FLOW DEFAULT DELINQUENCY COLLATERAL PORTFOLIO REPORT SUSTAINABILITY
PROFITABILITY OPERATING EFFICIENCY LIQUIDITY ASSET QUALITY REPAYMENT SCHEDULE AGING
SCHEDULE INSTALLMENTS RESERVE RATE PORTFOLIO AT RISK CURRENT REPAYMENT RATE OPERATING COST
RATIO TOTAL COST RATIO PRODUCTIVITY RATIO OPERATIONAL SELF-SUFFICIENCY FINANCIAL SELF-
SUFFICIENCY AUDIT MICROFINANCE INSTITUTION DISCLOSURE AUDIT CHART OF ACCOUNTS BOOKKEEPING
JOURNAL LEDGER INVOICE TRIAL BALANCE CREDIT DEBIT FINANCIAL STATEMENTS BALANCE SHEET ASSETS

Tracking Financial Performance Standards of Microfinance Institutions AN OPERATIONAL MANUAL



Sa-Dhan

The Association of
Community Development
Finance Institutions

TECHNICAL TOOL SERIES

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TRACKING FINANCIAL
PERFORMANCE STANDARDS OF
MICROFINANCE INSTITUTIONS :
AN OPERATIONAL MANNUAL



Sa - Dhan

**The Association of
Community Development
Finance Institutions**

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INTRODUCTION TO MICROFINANCE STANDARDS

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FOREWORD

The recent emerging trend in the Microfinance industry in India has led to a greater emphasis on transparency and financial viability of Microfinance Institutions (MFIs). This trend is not uncommon for any nascent and growing industry. An important aspect of this trend has been greater focus on financial and institutional indicators to measure the impact and performance of MFIs. However, it is hard to achieve transparency and viability sans standard (uniform) measures to assess financial condition, impact and performance. It is also recognised that the development of standards also contributes in building ground to take the sector towards self-regulation.

A variety of measurements have been used globally to measure MFIs' performance, many of which have been recognized as standard indicators. A closer look at these measures reveal that these indicators are being calculated and applied in many different ways. To overcome this issue, Sa-Dhan – The Association of Community Development Finance Institutions initiated the process of development of minimum sectoral standards for the Indian Microfinance industry, ever since its inception (1998). Sa-Dhan, through its sub-group on standards has finally arrived at financial performance standards for Indian MFIs, through a series of consultative meetings.

Setting standard indicators and procedures is quite a complex and uphill task, especially when it comes to arriving at standards through the consensus mode. Much of that had been experienced by Sa-Dhan, which had followed the same route of consensus building to get wider acceptability. Given the diversity in operating models, geographical features, local economy & infrastructure and over the top – the ideologue, all these factors combined, provide an even more strong reason, to develop common indicators among different stakeholders through the consensus building process.

Though establishing minimum financial performance standards by Sa-Dhan, is a path breaking move towards promoting transparency in MFI reporting and making comparisons between MFIs more meaningful, however, appropriate skills set and information gap among microfinance practitioners remains a major roadblock towards wide scale use of standards by MFIs.

The preparation of this operational manual is certainly a great attempt towards addressing the skill and information gap among practitioners. It will be of great help in building awareness and adoption of standards as more and more MFIs are going for commercial funding sources and investments to support their growth. Within its carefully defined purpose, I trust this manual will make valuable contribution to the Indian Microfinance sector in moving towards transparency and self-regulation.

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(Chair Standards Sub-Group, Sa-Dhan)
Managing Director, SHARE Microfin Ltd.
August 2003

ACKNOWLEDGMENTS

The need of the operational manual to track financial performance of Microfinance Institutions (MFIs) was triggered during the field-testing of financial performance standards suggested by Sa-Dhan Standards Sub-Group. It was found that state of data management system and understanding of financial concepts among MFIs is rather poor and hence, objective of building large number of strong MFIs will not be achieved until and unless financial systems of MFIs are not in place. The issue was taken-up before the Standards Sub-Group, which suggested to develop an operational manual to facilitate Microfinance practitioners in adopting financial standards in their respective organisations.

This first draft of the manual was prepared by Mr. Ramesh S. Arunachalam (*Microfinance Consulting Group, Chennai*) under a specific task assigned by Sa-Dhan. We wish to place on records our sincere thanks to him for compiling the manual. We would also like to acknowledge that many of the conceptual and operational definitions of financial terms and concepts in the manual were taken from several documents of CGAP, SEEP Network and other publications that are mentioned at the end of this manual.

The contributions of the Sa-Dhan Standards Sub-Group (headed by Mr. Udaia Kumar and equally supported by key members – Mr. Sanjay Sinha, Prof. David Gibbons, Mr. R. K. Mukherjee and Mr. V. Satyamurti) are gratefully acknowledged for the strategic guidance provided by them during the course of development of this manual.

Our special thanks are due to all who had generously contributed their comments on the draft that helped in further refinement of the manual. Among them, Mr. R. K. Mukherjee, and Mr. B. C. S. Baliga had worked further on the manual to enrich its presentation by incorporating the comments received on the draft version.

We owe sincere gratitude to Mrs. Samyukta Rao, Mr. Bikram Duggal and Ms. Bindu Ananth at ICICI Bank for providing their generous moral and financial support for the process of development of Microfinance standards in India and more specifically for the production of this manual.

Last but not the least, a lot of appreciation to Sa-Dhan team – Mrs. Achla Savyasachi, Mr. L. T. Mate, Mr. Nilesh Arya, and Mr. Niraj Kumar who provided their valuable support in various forms in giving the final shape to the manual.

We encourage readers to share their comments and suggestions on any aspect of this manual.

Mathew Titus
Executive Director
Sa-Dhan
August 2003

PREFACE

The financial sector has been a pioneer in evolving good practices and standards. Microfinance has emerged as a sector in its own standing. In only a couple of decades, the microfinance sector has attracted international attention, largely driven by the uniqueness of its approach, focus and perhaps part-failure of other sectors to operate in consonance to the complex challenges of poverty.

While the financial sector as a whole has financial practices and standards in place, the microfinance sector within, remain an uncharted domain in this aspect. Sa-Dhan - The Association of Community Development Finance Institutions in India, found it justified to take the lead in taking up the challenge – of suggesting the broadly accepted global standards, testing contextual applicability and suitability of the standards through a longitudinal process, and finally this operational manual as one significant contribution to professional development of the sector.

This manual is intended for microfinance practitioners having some basic familiarity with accounting terms and financial statements. The primary objective of this document is to put forward recommended financial standards, keeping in mind the professionals in the sector who may need introduction to the depth and implications of standards.

Finally, it is important to clarify upfront what the manual isn't or doesn't do. It isn't intended to be a complete how to manual for appraising microfinance institutions. Further it doesn't discuss financial adjustments for distinct accounting practices, subsidies and inflation. To make it clear, this manual should not be used as a substitute for a chart of accounts or accounting policies. It is also not intended to be a financial analysis guide, as analysts normally use additional financial indicators and information beyond what is contained in this manual. There are many reference materials for MFIs and analysts, several of which are listed at the end of this manual.

The scope of the manual is therefore limited to Sa-Dhan recommended Financial Performance Standards for self-administration purpose for MFIs.

Focus of the manual is to:

- 1) Conceptually define the various generic financial performance constructs like asset quality, viability and sustainability, productivity, efficiency, and related aspects.
- 2) Identify reliable and valid indicators for measuring these and to provide operational definitions for these indicators.
- 3) Document procedures by which these indicators could be calculated including records required, methodological aspects and the like.
- 4) Provide illustrative calculations of these indicators using a hand book type approach, and
- 5) To suggest a minimum set of performance standard for Sa-Dhan's members and the Indian micro-finance sector.

Sa-Dhan believes that professional horizons are wide and a continuous process. This manual is the first attempt to broaden the objective to bring forth practitioner-led best practices and standards as the reference point for all concerned.

STRUCTURE OF THE MANUAL

Understanding of financial performance standards is essential for every Microfinance manager irrespective of their institutional priority. The best way to bring them in the fold of financial standards is to unveil its utility/application in most basic form. The attempt to demystifying financial standards contributes both to the length of this manual and to the order in which the things are presented.

CHAPTER 1 provides a basic introduction to importance of standards and how they are developed with a specific mention of Sa-Dhan's approach towards building standards.

CHAPTER 2 describes the characteristics & components of Financial Performance Standards and at the end it provides summary of financial performance standards suggested by Sa-Dhan.

The technical contents of the manual are structured as follows:

CHAPTER 3 provides a basic introduction to financial statements for Microfinance Institutions - their categories, utilities, components, conceptual definition of terms, construction (*only Balance Sheet and Income Statement*) and finally it deals with key issues in cost allocation while preparing financial statements.

CHAPTER 4 goes into specific step-by-step details to prepare loan repayment schedule and calculating age of loans from it, concepts & rationale of loan loss allowances, its calculation based on aging analysis of loans and related accounting entries. Finally, construction of portfolio report with conceptual definition of terms associated with it

Chapter 3 & 4 come early in the technical section of the manual because the following chapter is based on clear understanding of financial statements, repayment schedule, aging analysis and portfolio report. The data required for calculation of different ratios dealt in subsequent chapter, come from these three financial statements viz. Balance sheet, Income statement and Portfolio Report.

CHAPTER 5 provides the conceptual framework where the broad standards/constructs of *Asset (Portfolio) Quality, Efficiency, Productivity, and Viability* are discussed with specific indicators. It further goes into details for each indicator, providing conceptual definition along with a discussion on their utility/limitations and identification of key methodological issues with regard to their calculation. For each indicator, the details are structured as:

1. Formula with numerator and denominator
2. Trends and the interpretation
3. Sa-Dhan suggested Benchmark
4. What the indicator means? – Simple Definition
5. What the ratio measures?
6. Minimum records to be maintained
7. Step-by-step illustration of how to calculate each indicator
8. What events/activities distort the indicator
9. Some examples, where required and appropriate

The Technical Appendix containing annexes, given below:

- Annex 1 Financial Performance Assessment for MFIs: Some Popular Tools used worldwide
Annex 2 Glossary of Financial Terms

Chapter

1

INTRODUCTION TO MICROFINANCE STANDARDS**1.1 BACKGROUND**

After more than a decade of experimentation, the Microfinance sector in India has graduated to take-off stage and has begun to scale up rapidly, attracting substantial attention and resources. In the context of sustained growth of Microfinance in India and given the twin imperatives of enhanced sustainability and expanded outreach, there is growing emphasis on professional growth of the sector. ‘Standards setting’ is one of the tested means to achieve professionalism. Several global initiatives have been undertaken to promote development of reliable financial standards (including performance, accounting and governance standards) to compare Microfinance Institutions (MFIs) operating in different environments and across the world. In addition, MFIs themselves have together attempted (especially, on a regional and/or national basis) to define a conceptual framework for assessment – using commonly agreed indicators and standards.

1.2 WHY IS THERE SO MUCH TALK ABOUT STANDARDS?

In the recent few years, micro-finance has experienced a significant shift from being an “intervention” made up of short-term development programmes to being a full-fledged “industry” composed of permanent institutions. This push, by donors, bankers and practitioners alike, towards organisational sustainability has led to professionalisation of the sector, wherein micro-finance institutions strive to apply commercial principles to their context and uniqueness of operations in order to become sustainable and self-sufficient.

Earlier impact and outreach (i.e. disbursing credit to large numbers of poor) used to be the main goals for a Microfinance programme, but now-a-days portfolio quality and institutional viability have also gained due importance as indicators of success. Microfinance is now being seen as an industry whose objective is to provide a wide range of financial services to poor households, the informal sector, micro-enterprises, and others with no or little access to the formal banking system.

Consequently, wholesale bank/donor-funded projects are increasingly geared towards strengthening the foundation and infrastructure of the overall industry, in addition to the traditional provision of one-on-one technical assistance to the Microfinance institution itself. These “industry-wide” initiatives usually have two end goals:

1. To increase transparency in the system through information sharing and reporting mechanisms including development of standards and their use by MFIs; and
2. To integrate Microfinance institutions into the overall financial system.

The second reason for the importance of standards comes from the institutional level. Despite the fact that micro-finance has evolved to a greater level of sophistication and experienced constant growth, a simple fact remains—there still exists a wide gap between the number of clients served by MFIs and the potential market of poor people lacking access to credit, savings and other financial services. To start bridging this gap, MFIs would need to do two things:

- Make better (optimal) use of the resources at hand (i.e. become more efficient and reach more people with the same amount of resources/funding);
- Attract other (eclectic) sources of funding besides traditional donor funds in order to be able to grow further and expand outreach.

As outlined below, Microfinance performance standards provide a critical tool in helping MFIs achieve both of these goals.

1. First of all, by providing across- industry common performance measures, standards initiatives can provide micro-finance institutions with a cheap and readily available tool to see how their institutions compare with peers within the industry. (Comparative Analysis).
2. Standards initiatives such as the 'Microfinance Information Exchange'¹ (MIX) give MFIs a one-stop access to a wide range of comparative performance indicators, based on figures from a peer group of leading international MFIs using common calculation methods and accounting principles.
3. MFIs can utilise this data not only to monitor their institution's progress against the rest of the industry, but also to identify key areas of their operations that require attention or need improvement. (Self-Assessment and Diagnosis)
4. Microfinance standards can facilitate MFIs' access to new sources of funds by providing objective evidence to lenders, investors, and donors that particular MFIs are in consonance with international and national standards. (Rating Benefits)
5. As donors focus on the initial phases of institutional sustainability, MFIs need to access commercial funds as a logical step forward. Accessing the market- sources of funds requires more than just demonstrating an ability to offer services to the poor. Commercial bankers and private investors base their financing decision not only on "social criteria" but also on the level of return and their risk exposure. Thus, MFIs must demonstrate that they are earning a rate of return on their operations where they are able to pay for the real cost of commercial funds (financial self-sufficiency).
6. The MFIs need to demonstrate their ability to manage their lending portfolio systematically and effectively by keeping delinquency and portfolio at risk within an acceptable level.
7. Many donors are increasingly adopting emphasis on MFI sustainability in making funding decisions. The Consulting Group on Assistance to the Poorest (CGAP) at the World Bank, for example, requires that MFIs who apply for funding present financial statements using a common framework that includes issues of effect of in-kind subsidies, below-market rate refinancing and reductions in the real value of equity through inflation.
8. Some other international standards efforts offer MFI evaluations that are not linked to any specific financing request, but are made public to enhance the confidence levels of potential donors and investors.

The fact that a variety of actors are involved in this standardisation process—MFIs, networks, donors, private sector—clearly highlights the extent of "buy-in" to the process and aspect of having comparable (standard) measures of performance.

¹ See *Microfinance Information Exchange* web site at <http://www.mixmbb.org>. It should be noted that its publication - *Micro-Banking Bulletin* publishes only aggregate statistics and not information on specific MFIs.

1.3 HOW ARE MICROFINANCE STANDARDS DEVELOPED?

The process for developing microfinance standards depends on the type of institution that spearheads the effort, the overall objective of the exercise, and the ways in which the standards will be used. Current standards initiatives can be broken down into three major categories - those led by donor organisations, those led by private sector companies, and those led by MFIs.

1.3.1 Donor-led efforts

Donor-led multi-country comparative standards efforts, such as the Micro-Banking Bulletin and Women's World Banking (WWB) are essentially defined by the sponsoring organisation who then seek to convince MFIs to participate and supply functional data for feedback and wider dissemination. The Micro-Banking Bulletin was constituted on a pro-bono basis and has always been fully funded by donors, with CGAP being the primary funder at this date. Institutions send in questionnaires, evaluations and audited financial statements. In return, they receive a detailed financial performance report from the Micro-Banking Bulletin team at no cost. WWB and NCCA use the data also to periodically assess the partner-MFIs.

1.3.2 Private sector-led efforts

Private sector standards initiatives resemble donor efforts in that the MFIs are being rated or evaluated on a pre-selected set of indicators. The main difference, however, lies in the fact that the organisations involved in these efforts are striving to become a commercial rating company similar to Standard & Poor's or Moody's, where institutions willingly pay a fee to be included in a formal network of certified institutions. The ratings that are given by Standard & Poor's or Moody's tend to be the barometer by which private investors judge the soundness and quality of a company. Because the data reported in the MicroBanking Bulletin are self-reported, with less than 20 percent of respondents submitting information that have been independently analysed and verified, a niche market exists for the development of an autonomous rating company to whom potential investors in microfinance could turn to as an arbiter of quality. Among the principal actors currently in this market are – M-CRIL, ACCION, Planet Finance and MicroRate.

Planet Finance, through its programme Planet Rating, provides evaluation and rating services to microfinance institutions using the GIRAFE methodology. The GIRAFE evaluation examines six major institutional areas and includes a total of 26 quantitative and qualitative indicators. The six areas are governance and decision making process; information and management tools; risk analysis and control; activities and loan portfolio; financing (liabilities and equity); and efficiency and profitability. The evaluator utilises a grid to rank each indicator, from which a final score is derived based on the weighting that is assigned to that indicator.

MicroRate's methodology is "risk driven," focusing on enterprise-critical risk factors such as portfolio at risk, return on equity, and debt to equity ratio. MicroRate's evaluation and supervision missions examine the following categories of performance measure: portfolio quality, information systems, internal controls, market environment, financial health of the MFI, and operational efficiency.

Based on the conceptual framework of the original CAMEL, ACCION developed its own instrument, although it reviews the same five areas as the original CAMEL. ACCION use its CAMEL primarily as an internal assessment tool, which has contributed to setting performance standards both for the ACCION Network and for the microfinance industry as a whole. The ACCION CAMEL analyzes and rates 21 key indicators, with each indicator given an individual weighting. Eight quantitative indicators account for 47% of the rating, and 13 qualitative indicators make up the remaining 53%. The final CAMEL composite rating is a number on a scale of zero to five, with five as the measure of excellence.

1.3.3 MFI-led efforts

Standards initiatives that are led by MFIs usually aim to establish prescriptive norms and a common vision. These standards are arrived at through a lengthy and reiterative consultation process at the international level among MFIs adhering to a common network (such as Women's World Banking) or at the national level. The following examples show how two different organisations have approached the standard setting process.

The Philippine Microfinance Coalition for Standards (PMCS), a group of NGOs came together in 1996 to begin the process of developing nation-wide microfinance standards. The impetus for this initiative came from a core group of MFI directors from two different Philippine networks, who saw that Philippine MFIs were not achieving significant impact in terms of outreach or poverty alleviation.

The standards development process used by the PMCS consisted of four key steps: (1) formation of the Coalition itself, which ultimately brought together 69 MFIs, the Central Bank, several commercial banks, research organisations and donors; (2) conducting a national inventory of microfinance institutions along with an in-depth survey of a smaller number of selected MFIs in order to build a database for benchmarking and standards definition; (3) having working groups develop proposals for standards based on international best practices and the results of the PMCS's investigations; and (4) meetings to discuss the propositions and arrive at an overall consensus. In August 1998, this two-year process culminated in the adoption of a basic standard framework.

The framework adopted by the PMCS has two levels. The first is comprised of "Minimum Standards" to which all members must adhere in order to *join* the Coalition. These are not meant to rate or compare different MFIs but are meant to be the minimum prerequisites for being considered a "serious microfinance NGO." The second level consists of a series of eight performance indicators for which a scoring system is applied to assign numerical scores and attribute weights to arrive at a single overall institutional rating.

During the past few years, the Small Enterprise Education and Promotion Network (SEEP), a network of US-based NGOs working in enterprise development and microfinance, has been working with three MFI networks to develop, test, and produce a toolkit for MFI data collection and benchmarking. The purpose of the toolkit is to facilitate MFI networks in their efforts to establish performance standards and benchmarking tools for their members.

Development of the toolkit will contribute to building the supervisory capacity of MFI networks by providing them with a management tool for evaluating strengths and weaknesses, and a roadmap for improving MFI performance.

Three networks are involved in this initiative: Ghana Microfinance Institutions Network (GHAMFIN) in Ghana, Credit and Development Forum (CDF) in Bangladesh, and the Center for Microfinance for NIS/CEE¹ in Poland. With the technical assistance of the Micro-Banking Bulletin and the USAID Microenterprise Best Practices project, the following tools are being developed:

- A standardized format for financial statements;
- A questionnaire for collecting data on performance; and
- A database that contains forms for data input, enables automatic adjustments of financial statements, and produces a variety of reports.

² Newly Independent States/Central and Eastern Europe.

1.4 SA-DHAN'S APPROACH TOWARDS BUILDING STANDARDS

In India, Sa-Dhan, The Association of Community Development Finance Institutions, has been involved in establishing standards for the Microfinance sector in India. To take this task forward, Sa-Dhan has adopted a seminal approach towards standards setting.

1.4.1 Process Governing the Development of Standards

Given the diversity of operating models, legal forms, regional features and cultural aspects, Sa-Dhan has, as part of the standard setting process, strategically focused on providing platforms for collective action that are required in a nascent but growing sector. Sa-Dhan has adopted the *participatory diagnostic process* to safeguard the interests of all stakeholders and develop camaraderie within the Microfinance sector. It also brings clarity, transparency and ownership in the very process of formalising standards.

To steer the task of development of standards, a core-group of key Sa-Dhan members was then formed and this group periodically met to take stock of progress made by the Sa-Dhan Secretariat and also to provide future direction. The primary task of the Sa-Dhan Secretariat is to build consensus among the diverse set of stakeholders on common minimum standards and facilitate the adoption of practices that promote good governance, effective management, transparent reporting and enhanced accountability within the Microfinance sector in India.

To begin with, Sa-Dhan held a series of consultative workshops, involving wider stakeholders to develop a broad framework of standards for Micro-finance sector. Thereafter, a series of workshops were organised across regions to define and arrive at broader agreement on the specifics. Simultaneously, Educative and Awareness Generation workshops on Standards were also held by Sa-Dhan covering different regions (zones).

1.4.2 Strategy for Development of Standards

- ☞ Identifying basic thematic areas of standards that are neutral, relevant/appropriate and objectively verifiable
- ☞ Undertaking confidence building measures to establish an open and constructive environment to facilitate examination of controversial issues
- ☞ Adopting a twin track approach whereby, at this stage, a minimum set of standards (irrespective of MFI age, model and scale of operations) will be used for the entire sector; further a comprehensive set of standards could be developed as the sector matures
- ☞ While MFIs should be given a reasonable time frame to adopt standards as an inherent part of their organisational systems and procedures, they should show consistent and substantial improvement in performance during the gestation period
- ☞ To continue the consultation process with other stakeholders as well to enhance the credibility of the sector
- ☞ Standards building process to be supplemented by the enforcement process
- ☞ Helping MFIs to adopt standards through transfer of knowledge, skills and various capacity building initiatives

1.4.3 Process Agreed for the Introduction of Standards for Indian MFIs

1. Draft Minimum Standards at Sub-Group meeting
2. Ask for response from stakeholders
3. Field-testing of draft standards
4. Based on the result of field-testing and responses from the stakeholders, finalize the standards
5. Introduce standards on a trial basis
6. Request six-monthly report on progress towards achieving the standards
7. After one year, review the standards and make changes (if required) based on the experience of the past year

After the first round of field-testing the minimum standards for financial performance measures are being finalised now by the Sub-Group on Standards.

1.5 CONCLUSION

One of the interesting aspects of evolution of Microfinance in India or elsewhere is that it has not evolved from mainstream financial sector, neither the majority of institutions providing such services are structured as financial institutions. The sector originated from development sector and still it is dominated by Non-Governmental Organisations (NGOs). These set of institutions are largely run by managers with no or little background of finance.

However, the emergence of Microfinance standards as a major topic of discussion reflects the evolution of microfinance into a more sophisticated and formalised industry, composed of institutions committed to operate along principles consistent with those governing formal financial institutions, without losing the focus that they have to serve the financial need of poor. The fact that a variety of actors are involved in this standardisation process - MFIs, networks, donors, private sector - seems to underscore the extent to which "buy-in" about the importance of having comparable measures of performance has been spread.

A major challenge for standards initiatives seems to lie at the practical level of data collection. As the Philippine Coalition found out through their efforts, it was easier to get philosophical agreement on the value of standards than to generate the information necessary to rate the MFIs. For the majority of institutions, some substantial "housecleaning" will need to be done before reliable data could be gathered and made available to the public.

In addition, the existence of standards is also expected to facilitate MFIs to access to capital markets. An increasing number of MFIs are beginning to access non-donor private financing and are paying the market rate. However, very few MFIs are ready to access international capital markets. Having access to performance information may reduce some of the transaction uncertainty.

Nevertheless, the first big step has been made and there is now widespread recognition that the industry is heading towards more standardisation, transparency, and openness. The foundation has been laid and it is now up to the individual MFIs to build on the existing structure.

FINANCIAL PERFORMANCE STANDARDS

Chapter

2

FINANCIAL PERFORMANCE STANDARDS

An MFI can deduce its financial performance in terms of ratios and indicators from its operations and financial position. “Standards” is a step forward; it represents *the ideal* level for each indicator.

Financial Performance Standards are drawn from experience of *analysing* the indicators that are derived from financial ratios. Analysis of indicators are done in two ways (a) starting with ratios and the resultant indicators of a *particular date* say March 31, 2003 or (b) starting with ratios and indicators of different periods (March 31, 2003 as *compared* to March 31, 2002).

Application of financial performance standards can be made (a) by an MFI *within itself, driven by its own experience* and (b) *Across MFIs driven by experience of the industry*. This manual entirely focuses on the latter i.e financial performance standards applicable to MFIs across the *industry*.

The financial performance standards given in the manual therefore incorporate the experience and practices within a large number of microfinance institutions and tries to add refinements wherever found necessary. The emphasis is therefore into sharing the *industry-level financial standards* in the microfinance industry, irrespective of the microfinance model, geographical location, size or age of institutions. As the result, the financial performance standards are applicable to all microfinance institutions. This also defines the choice of select few financial standards contained in the manual.

Financial performance standards for the Microfinance industry is characterised by the following four features:

- ☞ Specific financial aspects of an MFI that *together* define financial performance
- ☞ A *common set* of performance indicators for measurement and comparison,
- ☞ A *uniform methodology* for calculating the selected indicators, and
- ☞ A *benchmark* for each indicator leading to standard

2.1 SPECIFIC FINANCIAL ASPECTS THAT TOGETHER DEFINE FINANCIAL PERFORMANCE

The first step in the process of developing standards is to identify the broad financial aspects of an MFI. This task is made easy by the fact that there is general agreement in the financial sector about the broad aspects that are:

(1) Outreach; (2) Assets (Portfolio) Quality; (3) Productivity; (4) Efficiency; (5) Viability (Sustainability); (6) Profitability; (7) Capital Adequacy; and (8) Liquidity.

Having outlined the specific financial aspects above, the next steps are to decide on the indicators within each of the above broad aspects and work further deep into deriving the financial ratios.

2.2 FINANCIAL PERFORMANCE INDICATORS

Having the broad aspects (2.1 above) in place, the crucial step is to make choice among wide numbers of indicators available for each of the broad aspects of financial performance.

Table-I below lists the indicators adopted by some of the international agencies. It is important here to understand that for each broad aspect, some indicators need to be prioritised i.e. using *all* available indicators for each aspect would be a huge task; some indicators are also complimentary so a choice of either/or becomes necessary.

Table 1 - Common measures of Financial Performance used by different agencies

INDICATOR	NAME OF INSTITUTION					
	ACCION	Microfinance Information Exchange	PlaNetRating	SEEP Network	WOCCU	Women's World Banking
Outreach						
▪ Number of active borrowers		✓		✓	✓	✓
▪ Number of women borrowers		✓				✓
Portfolio (Asset) Quality						
▪ Repayment rate						✓
▪ Portfolio at risk	✓	✓	✓	✓	✓	✓
▪ Arrears rate				✓	✓	
▪ Loan loss rate	✓		✓	✓		
▪ Loan loss provision (or Reserve) rate	✓	✓		✓	✓	✓
Productivity						
▪ Number of loans per credit officer		✓		✓		✓
▪ Amount of loans per credit officer				✓		✓
▪ Ratio of credit officers to total staff	✓	✓	✓			
Efficiency						
▪ Cost per loan (or borrower)		✓		✓		✓
▪ Cost per unit of money lent	✓	✓		✓		✓
▪ Operational efficiency	✓	✓	✓	✓	✓	
▪ Administrative efficiency		✓	✓			
Sustainability/Viability						
▪ Operational sustainability		✓	✓	✓		✓
▪ Financial sustainability		✓	✓	✓		✓
Profitability						
▪ Return on assets (adjusted & unadjusted)	✓	✓	✓	✓	✓	✓
▪ Return on equity (adjusted & unadjusted)	✓	✓	✓		✓	
▪ Yield on portfolio		✓			✓	✓
Capital Adequacy						
▪ Leverage	✓	✓			✓	✓
Liquidity						
▪ Current/Quick Ratio	✓				✓	

2.3 UNIFORM METHODOLOGY FOR CALCULATING INDICATORS

Performance indicators require a reliable calculation *method* in order to be comparable. This requires that the exact formula for each indicator is detailed for uniform interpretation and that there is an agreement on how necessary adjustments/re-grouping of financial data is made so that every financial data would have a universally common meaning.

The latter aspect is critical if a true “level playing field” is to be established on which to measure financial performance, since un-adjusted measures may be ambiguous, reflect differences in interpretation; they may also reflect differences in accounting practices and access to subsidies. The key aspect here is that unless accounting practices are adjusted to reflect a normal position across MFIs, establishing actual financial performance comparisons is not feasible.

The basic issues to consider here are the following:

- Norms for provisioning for loan loss
- Charging depreciation on fixed assets and
- Accounting for *accrued* interest - income & expense

There are other issues for consideration, namely

- Adjustments for the effect of inflation on equity.
- Adjustments for subsidies including cost allocation of unrecognised and/or hidden subsidies

2.4 BENCHMARKS FOR FINANCIAL PERFORMANCE INDICATORS, LEADING TO STANDARDS

The fourth step in standards-setting involves elaboration of chosen benchmarks for *each* indicator. Finally, the standards are set, based on practical observation of indicators evolving from MFIs and evaluating them for comprehensive application across the industry. A look at benchmarking, first.

Benchmarking is achieved in two steps – (a) making choice of *suitability* of specific indicators from the universal list of indicators and then (b) *elaborating* the appropriate financial ratios for each indicator.

Benchmarking provides MFIs with “milestone” to drive their institution to optimal financial performance. More important, it helps to pinpoint potential trouble spots / areas where MFIs need to focus.

The microfinance industry represents a *range* of institutions and different operating environments. Benchmarking is meaningful only if an MFI is compared with *similar* other MFIs. One simple method is by comparison *among peer* group of MFIs – peers by location, size and operational models. The Micro Banking Bulletin, for example, forms their peer groups using three main criteria: region, scale of operation, and target market. Table 2 below lists the criteria for these peer groups.

Table 2 - Micro Banking Bulletin Peer Group Criteria

Region	Scale of Operations Total Loan Portfolio (US\$)	Target Market Average loan balance/GNP per capita
Africa	Large: > 5 million	Low-end: < 20% OR Avg. Loan Balance = US\$150
Middle East/North Africa	Medium: 800,000 to 5 million	
Central Asia	Small: < 800,000	
Asia (Pacific)	Large: > 8 million	Broad: 20% to 149% High-end: 150 to 249% Small Businesses: = 250%
Asia (South)	Medium: 1 to 8 million	
	Small: < 1 million	
Eastern Europe	Large: > 12.5 million	
Latin America	Medium: 1.5 to 12.5 million	
	Small: < 1.5 million	

Source: Micro Banking Bulletin, November 2002.

Several practitioner networks such as Women's World Banking and ACCION establish a specific target to reach, or a set of reference values within whose range their affiliates will need to fall.

Table 3 illustrates some performance benchmarks that are in use in the international microfinance sector today.

Table 3 - Some Illustrative Performance Benchmarks
(Women's World Banking & ACCION)

Indicator	Target	Trend
Monthly reimbursement rate	>90%, >95%	Increasing
Cost per unit lent	35%, 15%	Decreasing
Portfolio at risk (> 31 days)	<10%, <9-5%	Decreasing
Portfolio at risk (>1 day)	< 15%	Decreasing
Loan loss	<4%, < 2%	Decreasing
Operational self-sufficiency	90-100%	Increasing
Financial self-sufficiency	70-100%	Increasing

The graduation from 'benchmark' to 'standard' needs attention. Benchmarking is a road *route* where an MFI can compare (benchmark itself) with a *similar* MFI. Standard denotes the *optimal* position, to use the same example, the *destination* that the road leads to, is the standard.

Within MFIs, interpretation of standards may cause some *initial* hitches. Financial ratios and indicators are deduced *within* MFIs and comparisons made with similar other MFIs. This achieves important milestone i.e. benchmarking. However benchmarking is a step forward to achieving standard; benchmarking is a critical tool for self-evaluation and monitoring but at the same time, it should not be construed as the *end* in itself; the aim is to achieve industry level optimal performance – that is denoted by standards for each aspect of financial performance.

2.5 SA-DHAN RECOMMENDED MINIMUM FINANCIAL PERFORMANCE STANDARDS

Sa-Dhan Sub-Group on standards has proposed a set of financial performance standards. It calls the set as *minimum* in the sense that the *specific* standards are found acceptable and practically applicable among *all* MFIs, free from considerations of model, age, location and size. This is also the building block to research on further additions to the set of standards for the microfinance industry.

The minimum standards proposed by Sa-Dhan for financial performance of MFIs, the definitions and values are given in Table 4 next page :

³ What to include (in the numerator and denominator of the formula) and what to exclude have been dealt in chapter 5.

Table 4 – Sa-Dhan’s Minimum Standards with Indicators and Values

1. SUSTAINABILITY PERFORMANCE STANDARDS	
Indicator # 1 Proposed	
Name	Operational Self-Sufficiency
Formula ³	$\frac{\text{Operating Income (from Loans + Investments)}}{\text{Operating Costs + Loan Loss Provisions + Financing Costs}}$
Standard	Operational Self-Sufficiency at 100%
2. ASSET QUALITY PERFORMANCE STANDARD	
Indicator # 1 Proposed	
Name	Portfolio at Risk > 60 Days Past Due
Formula	$\frac{\text{Unpaid Principal Balance of Past Due Loans (with overdue > 60 days of age)}}{\text{Total Gross Outstanding Portfolio}}$
Standard	PAR > 60 Days at <u>less</u> than 10%
Indicator # 2 Proposed	
Name	Current Repayment Rate
Formula	$\frac{\text{Total Amount (Principal) Collected for the Period - Prepayments}}{\text{Total Amount (Principal) Due}^4 \text{ (to be collected during period)}}$
Standard	Current Repayment Rate at <u>greater</u> than 90%
3. EFFICIENCY PERFORMANCE STANDARDS	
Indicator # 1 Proposed	
Name	Operating Cost Ratio ⁵
Formula ⁶	$\frac{\text{Total Operating Costs}}{\text{Average Outstanding Portfolio}}$
Standard	Operating Cost Ratio at less than 20%
Indicator # 2 Proposed	
Name	Total Cost Ratio ⁷
Formula	$\frac{\text{Total Costs (Operational Costs + Loan Loss Provision + Cost of Funds)}}{\text{Average Outstanding Portfolio}}$
Standard	Total Cost Ratio at <u>less</u> than 30%
Indicator # 3 Proposed	
Name	Active Borrowers Per Credit Officers ⁸
Formula	$\frac{\text{Average Number of Active Borrowers}}{\text{Average Number of Credit Officers}}$
Standard	Active Borrowers Per Credit Officer at <u>between</u> 250-350 clients

To summarise, Sa-Dhan through its sub-group on standards, adopted a intensive participative methodology to identify performance standards; define and apply them, outline a common methodology for their calculation and establish benchmarks for a minimum set of standards given in the Table above. In effect, this operational manual is result of this entire process of practice-led standard setting by Sa-Dhan.

⁴ Some MFIs include past dues from previous period to track past due payments that were to be collected

⁵ Also called as Administrative Efficiency Ratio

⁶ What to include in the numerator and denominator of the formula and what to exclude have been dealt with extensively in Chapter 5 as also other methodological issues

⁷ Includes Operating Costs + Cost of Funds + Loan Loss Provision

⁸ Also called as client to staff ratio with staff being loan officers primarily

FINANCIAL STATEMENTS OF A MICROFINANCE INSTITUTION

Chapter

3

FINANCIAL STATEMENTS OF A MICROFINANCE INSTITUTION**3.1 INTRODUCTION**

Financial Statements are summary of quantitative data depicting overall financial health of an organisation. Therefore, they not only enable an assessment of how well an organisation is doing but also provide clues of the specific areas that require management attention.

In the Indian context, the financial statements most widely understood are the balance sheet and income & expenditure statement. The standard forms used by MFI and the auditors for the balance sheet and income & expenditure statement are drawn from schedule-VI of the Indian Companies Act 1956. MFIs add some annexure to both these main statements as supplementary information for details. The annexure are often not common across but MFI specific. Most of the annexure are also found to be explaining accounting break-up like sub-heads of the broad head 'salaries and allowances' and therefore not of much help in the context of the financial performance of an MFI.

The four financial statements that together provide data for assessing financial performance of an MFI are:

- Balance sheet
- Income and Expenditure Statement
- Cash Flow Statement, and
- Portfolio Report.

The first two statements are statutory and hence widely available statements from MFIs though not complete with required details; the latter two, in most cases, need to be specially prepared.

Additionally, policy of the MFI in regard to accounting such as depreciation, provisioning norms, income recognition and accrued expenses would be required for complete understanding.

In the Table below, for each statement, there is a corresponding column that lists the key strategic issues that have to be culled out.

Table 5 – Financial Statements and what does it conveys

Financial Statement	Key Issues required as information
Balance Sheet	• What is the overall financial position of the MFI? • What asset does it own and types? • How does it finance these assets - through liabilities (obligations to others) and through equity (shares/stocks)? • What assets and liabilities are short term or long term
Income and Expenditure Statement	• What income is being generated by the MFI? • How much of this income is from operations? • Income from investments? • Income from other activities and sources? • Recurring and non-recurring income and expenses • What expenses are required to earn the income? • How much is incurred as financial expenses? • What are the operational expenses?
Cash Flow Statement	• What are the MFI's regular sources of cash? • How does it spend / use that cash?
Portfolio Report	• What portion of the MFI's portfolio is good? • What portion is bad and how much bad?

Importance of Timely and Accurate Financial Statements

Timely production of financial records is critical. If financial information is not produced accurately and punctually, financial ratios and assessment would not be of much use. This would lead to poor management of the organisation and inaccurate response to operational problems leading to institutional failure.

Each of the four financial statements has specific contribution to the objective of analysis of financial performance.

Table 6 – Financial Statements and Possible Analysis

Financial Statements		Possible Analysis
Statement	Specific Analysis in regard to	Utility to MFI Manager
Balance Sheet	- Asset Liquidity Matching - Asset Quality	Overall, how are the assets being funded? Is the financing pattern adequate? What portion of the loan portfolio (asset) is good or bad? Are there reserves to cover these?
Income and Expenditure Statement	- Sustainability - Profitability - Operating Efficiency	Is the MFI meeting all its expenses from its income? What are the trends? Is it generating a surplus and providing returns to its stakeholders? Are loans being provided in a cost-effective manner? Are resources being used in an optimal fashion?
Cash Flow Statement	Liquidity	Is enough cash available to cover all cash obligations?
Portfolio Report	Asset Quality	What portion of the loan portfolio (asset) is good or bad? What is the nature of bad loans?

The main statements i.e. the balance sheet and income & expenditure statements are taken as the base for the discussions in this chapter. A sample of traditional financial statements (*Table 7 a & 7 b*) in the Indian context is being re-produced here in the beginning to familiarise Indian Microfinance practitioners. However, for the purpose of building the discussion on the financial statement that captures the specific features of an MFI and requirement of different stakeholders, a more representative sample of financial statement (*Table 8 a & 8 b*) by expanding conventional financial statements are also presented in this chapter for reference. This example will be referred for all discussions in this chapter.

Table 7 (A) – Conventional Income & Expense Statement of an MFI

INCOME AND EXPENDITURE STATEMENT FOR THE YEAR ENDED MARCH 31, 2003

Figures of previous year (Rs.)	Particulars	Current year figures (Rs.)
	INCOME	
13,56,000	Interest	17,40,000
12,000	Service charges	48,000
1,04,000	Operational grant	
11,000	Miscellaneous income	23,000
14,83,000	Total	18,11,000
	EXPENDITURE	
5,38,000	Salaries and allowances	6,08,000
98,000	Rent, electricity and taxes	1,16,000
1,32,000	Office Expenses	1,45,000
2,02,000	Conveyance and travel	2,34,000
3,78,000	Interest on loans	4,90,000
63,000	Miscellaneous expenses	54,000
72,000	Depreciation	62,000
14,83,000	Total	17,09,000
	Excess of income over expenditure Transferred to reserve	1,02,000

Table 7 (B) – Conventional Balance Sheet of an MFI

BALANCE SHEET AS ON MARCH 31, 2003

Figures of previous year (Rs.)	Particulars	Current year figures (Rs.)
	SOURCES OF FUND	
8,00,000	Corpus	8,00,000
98,000	Reserve and Surplus	2,00,000
48,69,000	Loans	84,00,000
2,13,000	Current Liabilities	3,50,000
59,80,000	Total	97,50,000
	APPLICATION OF FUND	
3,60,000	Fixed Assets	2,90,000
1,00,000	Investments	4,00,000
54,67,000	Loans	86,25,000
53,000	Current Assets	4,35,000
59,80,000	Total	97,50,000

Table 8 (a) – Sample Income & Expenditure Statement of an MFI

I	II	III	IV	V
Sl. No.	Description	Year Ending 31 st March		
		2001	2002	2003
	INCOME			
	Income from loan Portfolio			
IS 1	Interest on Current and Past Due Loans	18,000	24,100	31,000
IS 2	Loan Fees and Service Charges	7,700	10,000	10,600
IS 3	Late Fees on Loans	700	600	400
IS 4	<i>Total Income from Loan Portfolio</i>	<i>26,400</i>	<i>34,700</i>	<i>42,000</i>
IS 5	Investment Income (Interest on Investment)	800	3,000	1,000
IS 6	TOTAL OPERATING INCOME	27,200	37,700	43,000
	EXPENSES			
	Financial Expenses			
IS 7	Interest On Debt	2,400	7,000	7,400
IS 8	Interest Paid on Deposits			
IS 9	<i>Total Financial Expenses</i>	<i>2,400</i>	<i>7,000</i>	<i>7,400</i>
IS 10	Gross Financial Margin (IS 6 – IS 9)	24,800	30,700	35,600
IS 11	<i>Provision for Loan Losses</i>	<i>10,000</i>	<i>6,000</i>	<i>5,000</i>
IS 12	Net Financial Margin (IS 10 – IS 11)	14,800	24,700	30,600
	Operating Expenses			
IS 14	Salaries and Benefits	8,000	10,000	12,000
IS 15	Administrative Expenses	4,600	5,000	5,200
IS 16	Occupancy Expenses	4,300	5,000	5,000
IS 17	Travel	4,000	5,000	5,000
IS 18	Depreciation	400	600	800
IS 19	Miscellaneous	500	600	600
IS 20	<i>Total Operating Expenses</i>	<i>21,800</i>	<i>26,200</i>	<i>28,600</i>
IS 21	Gross Surplus/Deficit from Operations	-7,000	-1,500	2,000
IS 22	Grant Revenue for Operations	7,000	1,900	0
IS 23	Net Surplus/Deficit from Operation	0	400	2,000

3.2 INCOME AND EXPENDITURE STATEMENT – KEY DEFINITIONS & INTERPRETATIONS

The Income and Expenditure statement is also known as the profit and loss statement. It is a flow statement that summarises all financial activity during a stated period of time, usually a month, quarter or year. It displays all revenues and expenses for a stated period of time. The bottom line of an income statement is the net income (or net profit or surplus) for the period.

There may be need to analyse and distinguish between other services from MFI that are directly connected to microfinance (hence to be included in costs) and services that are independent of microfinance and hence to be excluded for consideration in this context.

There are instances that an MFI is providing other services in addition to microfinance services. These services and their costs, ranging from shared facilities to staff and other costs need to be bifurcated to arrive at true and fair costs assignable to microfinance operations. The guidelines for cost allocation are also provided at the end of this chapter (see section 3.4)

It needs emphasis that the conventional Income statement (see Table 7 a) is as per statutory disclosure norms. For the purpose of evaluating financial performance and standards, the statutory information is expanded to greater details (see Table 8 a). In light of the above, explanation of a sample income and expenditure statement, expanded to needs of evaluation is presented further in this section.

Using the expanded format (Table 8 a) helps in several ways:

- One can analyse where its income is coming from and accordingly adjust its strategic direction so as to achieve long term sustainability
- Subsidies can be ascertained and the true financial picture of the MFI can be understood
- The existence of prudential accounting norms can be ascertained (like loan loss provision) and this will enable both the MFI and the wholesaler (donor) to take necessary action for safeguarding the portfolio
- The extent to which increase in operational (cash and non-cash) expenses are justified by an increase in portfolio size, quality and income can also be determined. This will help, both the MFI and the wholesaler (or Donor), make better decisions aimed at enhancing the outreach and sustainability of the organisation.

3.2.1 Income

Income for an MFI can be received from three basic sources

- Income from Loan Portfolio
- Investment Income
- Other Income

INCOME		2001	2002	2003
	Income from loan Portfolio			
IS 1	Interest on Current and Past Due Loans	18,000	24,100	31,000
IS 2	Loan Fees and Service Charges	7,700	10,000	10,600
IS 3	Late Fees on Loans	700	600	400
IS 4	<i>Total Income from Loan Portfolio</i>	<i>26,400</i>	<i>34,700</i>	<i>42,000</i>
IS 5	Investment Income (Interest on Investment)	800	3000	1000
IS 6	TOTAL OPERATING INCOME	27,200	37,700	43,000

Each of these aspects are described below

3.2.1.1 Operational Income

Income from loan Portfolio is income that an MFI derives from its lending operations (refer IS 4, Table 8 a). This would include interest and fee income. Interest income can be further divided into interest on current, past and re-structured loans outstanding.

Interest Income on Current, Past-Due and Re-Structured Loans – consists of the amount collected from clients on loans. The issues are:

1. The interest rate is always stated as a percentage of the loan amount for a period (generally monthly or annually)
2. It is the balance sheet accounts that are affected by the principal portion of the loan repayment, i.e., the Loan Outstanding decrease and Cash increases, until another loan is made and then the reverse is true.

Apart from interest income, the MFI can also get income from fees/service charges. Fees could be of two types - stated as a percentage of the loan amount or as a flat fee, for loans provided by the organisation.

Fees are however usually stated as a percentage of the loan disbursed (or loan outstanding) and they increase the effective interest rate for the client. The impact of the fee however varies across loan terms, with fees having a greater impact on the effective interest rate for loans with shorter rather than longer loan terms. Sometimes, an MFI charges late fees on the loans. This is the amount collected, as a penalty, from borrowers who have had loans with payments in arrears.

3.2.1.2 Investment Income

A second income for an MFI is its investments (refer IS 5, Table 8 a). Investments are usually excess (idle) cash invested by the MFI (into fixed deposits, savings bank accounts, marketable securities etc.) from its revolving loan fund.

Thus, the amount of interest earned by the organisation on its investments such as term deposits, securities, treasury bills, savings bank accounts etc. comprise its investment income.

There are usually two forms of investments that can be made by MFIs

- 1) Short-term investments (maturity date is less than a year)
- 2) Long-Term Investments (maturity date is more than a year)

Several aspects about investment income require clarification:

- 1) They are getting be a legitimised source of income for MFIs
- 2) However, only some legal forms have the scope for investing in a variety of investments
- 3) Investment requires a special fund manager who can attend to the task of investing prudently - i.e. ensure the right balance between safety, liquidity and returns

3.2.1.3 Other Income

Grant Income is the main form of other income for MFI (refer IS 22, Table 8 a). This generally includes two types of grants:

1. Grants for provision of credit services – this includes grants (or donations) provided by donors, wholesalers and others towards salaries and other operational expenses.
2. Grants for loan fund capital – this typically encompasses donations (or contributions) to an MFIs revolving loan fund capital.

Either way, grants are better brought into the income statement and through this taken into the net worth (Net worth) side of the balance sheet.

- a. Income from Grants for Credit Services - funds donated to the organisation to cover programme and operating expenses.
- b. Income from Grants for Loan Fund Capital - funds donated to the organisation to capitalise the loan fund, which are restricted to use for lending and can't be spent on operating expenses.

Miscellaneous income can also be a source of other income. For example, when loans that have been written-off are collected, the cash coming in (back to the organisation) is treated as miscellaneous income. This is because, the loan loss provision was treated as an expense in the first place and therefore, when the written-off loan is collected, it should be treated as an income.

The key reasons for bifurcating the income in this manner (3 sources) is to see where an MFI is really getting its income from - operations or investments or grants? This aspect is crucial because ultimately, an MFI that gets most of its income from grants cannot be expected to sustainable. In terms of best practices recommendations, it can be said that operational income should constitute 60 percent, investment income 30 percent, and miscellaneous income around 10 percent.

3.2.2 Expenses

Expenses of an MFI can be categorised into two broad heads:

- Financial Expenses
- Operational Expenses

EXPENSES		2001	2002	2003
	Financial Expenses			
IS 7	Interest On Debt	2,400	7,000	7,400
IS 8	Interest Paid on Deposits			
IS 9	<i>Total Financial Expenses</i>	<i>2,400</i>	<i>7,000</i>	<i>7,400</i>
IS 10	Gross Financial Margin (IS 6 – IS 9)	24,800	30,700	35,600
IS 11	<i>Provision for Loan Losses</i>	<i>10,000</i>	<i>6,000</i>	<i>5,000</i>
IS 12	Net Financial Margin (IS 10 – IS 11)	14,800	24,700	30,600
	Operating Expenses			
IS 14	Salaries and Benefits	8,000	10,000	12,000
IS 15	Administrative Expenses	4,600	5,000	5,200
IS 16	Occupancy Expenses	4,300	5,000	5,000
IS 17	Travel	4,000	5,000	5,000
IS 18	Depreciation	400	600	800
IS 19	Miscellaneous	500	600	600
IS 20	<i>Total Operating Expenses</i>	<i>21,800</i>	<i>26,200</i>	<i>28,600</i>

Each of these aspects are described below

3.2.2.1 Financial Expenses

There are two kinds of financial expenses for an MFI. There are:

1. **Interest on Debt or borrowings** - interest paid to banks and other financial institutions for money loaned (by them) to the MFI (*refer IS 7, Table 8 a*).

This interest is stated as a percentage figure on an annual basis and depending on the loan term it is worked out. Different lenders usually have different methods of calculating interest – i.e. on a declining balance, flat, simple or compound basis.

In most cases, financial institutions do not use the flat rate of interest. Rather, they use the declining balance interest method in conjunction with simple or compound interest⁹.

Please note that the principal repayment of a bank loan is not included as a financial cost.

2. **Interest Paid on Deposits** - interest payments earned by clients who deposit savings in the organisation (*refer IS 8, Table 8 a*).

Please note that, in a technical sense, interest should be paid on savings, which is debt and not equity. While some MFIs do this, most do not and this is certainly a legal violation as savings is a liability on which interest must be paid to the borrower. Also, not all MFIs are allowed to mobilise savings

3.2.2.2 Operational Expenses

There are two kinds of operational expenses:

- 1) One that involves an outflow of cash, which are called as cash operational expenses. This includes salaries, administrative expenses, travel, occupancy and miscellaneous expenses. Please see the box for definitions.

Operating Cash Expenses - Some Definitions

1. Operating Expenses are related to the management of the loan fund, whether it is held as outstanding loans or investments/deposits. For a single - purpose financial institution, all costs should be included.
2. For multi-purpose institutions, all direct costs of financial operations and an appropriate portion of the institution's overhead should be included.

The main categories are:

1. Salaries and benefits - amounts earned by staff for services rendered (*refer IS 14, Table 8 a*).
2. Administrative expenses - costs incurred in administering the organisation such as stationary, insurance, legal fees, etc (*refer IS 15, Table 8 a*).
3. Occupancy expenses - expenses made for (1) lease of land and/or buildings for the purposes of loan fund management over a specified time period, and (2) expenses for utilities, such as electricity, water, and telephone (*refer IS 16, Table 8 a*).
4. Travel - expenses for transportation, room and board, etc., of staff members working on behalf of the organisation (*refer IS 17, Table 8 a*).
5. Other Expenses - other expenses related to the loan fund's operations, such as training costs, loss on currency conversion, etc (*refer IS 19, Table 8 a*).

⁹ While banks predominantly use compound, other wholesalers and donors use simple interest

- 2) The other, which doesn't involve an outflow of cash, which is called as non-cash operational expenses

EXPENSES
Non-Cash Operational Expenses
Depreciation
Loan Loss Provision
Total Non-Cash Operational Expenses

The major non-cash operational expenses for an MFI are

1) **Provision for Loan Losses** – The loan loss provision (*refer IS 11, Table 8 a*) is the allowance made for expected defaults on the loan fund (*See section 4.2.1 in next chapter for further detail*). This is usually based on an aging analysis of loan accounts and allocation of risk rates based on historical default rate or best practices (*explained in detail in sec 4.2.2 in chapter 4*).

The loan loss provision is the (non-cash) amount expensed in a period to increase the loan loss reserve (*See section 3.3.2 (c)*) to an adequate level to cover probable defaults of the loan portfolio. Although a loan loss provision (a non-cash expense) is treated as a direct expense of the credit programme when the provision is made, the loans will not yet have been written off as actual loss. Some organisations include the loan loss expense with the operating costs. It is important to separate the loan loss expense from other operating costs, as an indicator of portfolio quality.

2) **Depreciation Expenses** – Depreciation (*refer IS 18, Table 8 a*) is an annual, non-cash expense that is determined by estimating the useful life of each asset. Using the most common method, called straight-line depreciation, an asset with an estimated useful life of five years would have one-fifth of its purchase price reflected as an expense in each of five years. Depreciation represents a decrease in the value of property and equipment to account for that portion of their useful life that is used up during each accounting period. Land theoretically does not lose value over time and therefore is not depreciated. Legal aspects also sometimes curtail the maximum depreciation amounts based on a slab rate classification for each depreciable item such as cars, computers etc.

3.2.2.3 Gross Surplus/Deficit from the Operation

Gross Surplus/Deficit from the Operation (*refer IS 21, Table 8 a*) is derived after Total operating income (*refer IS 6, Table 8 a*) less all expenses related to the MFI's core financial service operations, including total operating expenses (*refer IS 20, Table 8 a*), total financial expenses (*refer IS 9, Table 8 a*), and loan loss provision expense (*refer IS 11, Table 8 a*). It does not include donations, revenues expenses from non-financial services. Many MFIs choose not to deduct taxes on revenues or profits from the net operating income; rather they are included as a separate category. MFIs are encouraged to indicate if taxes are included in this account.

3.2.2.4 Net Surplus/Deficit from the Operation

Net Surplus/Deficit from the Operation (*refer IS 23, Table 8 a*) is derived after total income (operating and non-operating, including all donations) less total expenses and taxes (if any). Some MFIs prefer to present net income before donations and taxes. If so, the MFI should label it as such (such as *net income before donations*).

The issue of treatment of grant income (received for acquisition of assets and meeting operational cost) as non-operational income is dealt ahead. They are reported below the line (after gross surplus deficit from operation) in the income statement.

3.2.3 Treatment of Donor Grants

1. Funds donated to cover operational cost are a direct subsidy to the MFI.
2. The value of the subsidy is, therefore, equal to the amount donated to cover expenses incurred in the period reported.
3. Some donations are provided to cover operating shortfalls over a period greater than one year. Only the amount “spent” in the year is recorded (as per conventional method) on the income statement as revenue.
4. Any amount still to be used in subsequent years remains as a liability (as per conventional method) on the balance sheet (referred to as deferred revenue). This occurs because, theoretically, if an MFI stopped operations in the middle of a multi-year operating grant, they would have to return the unused donations to the donor. Therefore, the unused amount is considered a liability.
5. However, prudent norms suggest that Donated funds for operations should be reported on the income statement separately from revenue generated by lending and investment activities to accurately report the earned revenue of the MFI.
6. These funds should be deducted from revenue or net income prior to any financial performance analysis, because they do not represent revenue earned from operations. Theoretically, any costs incurred to obtain donor funds – “funding costs” should – should also be separated from other operating expenses, because the benefit of receiving the funds is not included.
7. To make the adjustments, if an MFI has recorded donations to cover operational costs on the income statement as revenue earned, the amount should be reported below the net income line, resulting in a reduction in operational revenue and, therefore, a reduction in the amount transferred to the balance sheet as current year net surplus (deficit). An offsetting credit entry is made to the balance sheet in the accumulated capital – subsidy account (equity).

Analysing Changes in Income Statement

One of the key tasks for the analyst is to isolate changes in the structure of the various income and expenses items across two years. This trend analysis is a very useful technique for understanding where the MFI is today and where it is headed tomorrow. In turn, such analysis will facilitate what on-course corrections are required and also enable MFI management to take suitable decisions that will enable the MFI to enhance its sustainability and expand out reach. Basically, such analysis involves calculating the proportion of income and expense items as a measure of the total income and expenses respectively.

Table 8 (b) – Sample Balance Sheet of an MFI

I	II	III	IV	V
Sl. No.	Description	Year Ending 31 st March		
		2001	2002	2003
	ASSETS			
	Current Assets			
	<i>Cash and Deposit</i>			
BS 1	Cash and bank current accounts	10,000	5,000	10,000
BS 2	Interest-bearing deposits	4,000	14,000	16,000
BS 3	<i>Total Cash and Deposit</i>	<i>14,000</i>	<i>19,000</i>	<i>26,000</i>
	<i>Loan Outstanding</i>			
BS 4	Regular	64,000	100,000	132,000
BS 5	Past Due	40,000	39,000	34,000
BS 6	Restructured	0	1,000	2,000
BS 7	<i>Gross Loans Outstanding</i>	<i>104,000</i>	<i>140,000</i>	<i>168,000</i>
BS 8	<i>(Loan Loss Reserve)</i>	<i>-10,000</i>	<i>-10,000</i>	<i>-14,000</i>
BS 9	<i>Net Loans Outstanding</i>	<i>94,000</i>	<i>130,000</i>	<i>154,000</i>
BS 10	Other Current Assets	1,000	2,000	1,000
BS 11	Total Current Assets	109,000	151,000	181,000
	Long-Term Assets			
BS 12	Long Term Investments	16,000	22,000	25,000
BS 13	Fixed Assets (Movable & Immovable) At Cost	6,000	8,000	8,000
BS 14	<i>(Accumulated Depreciation)</i>	<i>-400</i>	<i>-600</i>	<i>-1,400</i>
BS 15	<i>Net Fixed Assets</i>	<i>5,600</i>	<i>7,400</i>	<i>6,600</i>
BS 16	Total Long Term Assets	21,600	29,400	31,600
BS 17	TOTAL ASSETS	130,600	180,400	212,600
	LIABILITIES AND NET WORTH			
	Current Liabilities			
BS 18	Short-Term Borrowing (Commercial)	12,000	24,000	36,000
BS 19	Short-Term Borrowing (Concessional)	0	0	0
BS 20	Client Savings	0	0	0
BS 21	<i>Total Current Liabilities</i>	<i>12,000</i>	<i>24,000</i>	<i>36,000</i>
	Long Term Liabilities			
BS 22	Long Term Debt (Commercial)	15,000	30,000	24,000
BS 23	Long Term Debt (Concessional)	37,600	60,000	70,000
BS 24	Restricted or Deferred Revenue & Expenses	0	0	0
BS 25	<i>Total Long Term Liabilities</i>	<i>52,600</i>	<i>90,000</i>	<i>94,000</i>
BS 26	Total Liabilities	64,600	114,000	130,000
	NET WORTH			
BS 27	Equity/Corpus/Loan Fund Capital	66,000	66,000	80,200
BS 28	Retained Net Surplus/Deficit prior years	0	0	400
BS 29	Net Surplus/Deficit current year	0	400	2,000
BS 30	Total Net Worth	66,000	66,400	82,600
BS 31	TOTAL LIABILITIES AND NETWORTH	130,600	180,400	212,600

3.3 BALANCE SHEET – KEY DEFINITIONS AND INTERPRETATIONS

The balance sheet is a stock statement, which is a snapshot of the MFI at a moment in time. The statement reflects what the MFI owns and what is owed to it (assets), what it owes others (liabilities), and the difference between the two (equity or net assets).

The Balance Sheet provides an *instant* picture of an organisation financial position in terms of where all funds have been obtained from (sources of funds) and where all the funds have been used for (application of funds).

The balance sheet uses the fundamental accounting equation

$$\begin{aligned} \text{SOURCES OF FUNDS} &= \text{APPLICATION OF FUNDS} \\ &\text{and} \\ \text{ASSETS} &= \text{OWN FUND} + \text{EXTERNAL LIABILITIES} \end{aligned}$$

The Balance Sheet items would now be elaborated to look into possible components under each head.

3.3.1 Sources of Fund - Liabilities and Net Worth

3.3.1.1 Liabilities

Liabilities represent what is owed by the organisation to others either in the form of a cash commitment or as an obligation by the organisation to provide goods and services in the future.

Current Liabilities

1. Short-term Borrowing (commercial) – the outstanding amount, that the organisation owes to banks or other lenders for which it is paying a market rate of interest, and are due to be repaid within one year (*refer BS 18, Table 8 b*).
2. Short-term Borrowing (concessional) – the outstanding amount that the organisation owes to banks or other lenders for which it is paying the lender a rate of interest below the market rate, and are due to be repaid within one year (*refer BS 19, Table 8 b*).
3. Client Deposits (Group Savings Deposits, Trust Fund, etc.) - both voluntary and forced client savings that are deposited with the organisation that it must return (*refer BS 20, Table 8 b*).

LIABILITIES		2001	2002	2003
	Current Liabilities			
BS 18	Short-Term Borrowing (Commercial)	12,000	24,000	36,000
BS 19	Short-Term Borrowing (Concessional Rate)	0	0	0
BS 20	Client Savings	0	0	0
BS 21	<i>Total Current Liabilities</i>	<i>12,000</i>	<i>24,000</i>	<i>36,000</i>

Although a liability for the organisation, deposits are different from funds borrowed from a financial institution because there is normally no due date or amortisation schedule - fixed and recurring deposits, while they have a maturity date, are not structured by MFIs in the same manner as in banks. Therefore, while technically, they have to be returned on the date of maturity, they are often (required to be) extended for another term on a sequential basis. This, in effect is a double-edged sword that has an advantage as well as disadvantage.

Long-Term Liabilities

1. Long-term Debts (commercial rate) - The outstanding amount that the organisation owes to banks or other lenders for which it is paying a market rate of interest. Long-term debt is that portion which is due to be repaid in more than one year's time (*refer BS 22, Table 8 b*).
2. Long-term Debt (concessional rate) - the outstanding amount that the organisation owes to banks or other lenders for which it is paying the lender a rate of interest below the market rate (*refer BS 23, Table 8 b*).
3. Other Liabilities include: Restricted Deferred Revenue, which are funds received, but restricted for use in future years, are classified as a liability on the balance sheet, because they would have to be returned to the funding organisations if the specified programmes were not carried out. The funds are not recorded as revenue until the service or product is delivered. When the organisation receives restricted or deferred funds, it incurs an obligation (liability) to provide the services described in the grant agreement. As the organisation provides the services (i.e., technical assistance or training to micro entrepreneurs) it incurs expenses. Deferred revenue is then reflected as grant revenue and used to cover those expenses.

Deferred expenditure - Likewise, outstanding expenses like salaries payable, providence fund payable, insurance payable are treated as liabilities, as the organisation will have to pay for such expenses in the future (*refer BS 24, Table 8 b*).

LIABILITIES		2001	2002	2003
	Long Term Liabilities			
BS 22	Long Term Debt (Commercial)	15,000	30,000	24,000
BS 23	Long Term Debt (Concessional)	37,600	60,000	70,000
BS 24	Restricted or Deferred Revenue & Expenses	0	0	0
BS 25	<i>Total Long Term Liabilities</i>	<i>52,600</i>	<i>90,000</i>	<i>94,000</i>

Several key issues need to be articulated here and these are outlined below:

- 1) Not all MFIs can acquire savings from clientele, as there is a legal restriction on savings deposits by the RBI. Another aspect here is that most MFIs treat savings not as a liability but rather as equity. This is not correct as savings deposits are strictly returnable to clients and hence, they ought to be treated as liability.
- 2) MFIs must distinguish between long-term debt as commercial and subsidised, for this enable an analyst to understand its financial position, from a sustainability perspective. Interest rates less than the prime-lending rate can be considered as subsidised and those equal to or greater than this rate (set by the RBI) can be regarded as commercial debt. In India, this cut-off rate often fluctuates but for the purpose of Microfinance this can be taken as 12 percent annualised rate.
- 3) Disclosure of the outstanding expenses is also very crucial because it tells an analyst about the future commitments of the MFI and makes the balance sheet more transparent
- 4) In summary, all of the above are required as part of increasing the transparency and accountability of MFIs and they must acquire the culture to provide balance sheets in such fashion, which are based on international (global) best practices.

3.3.1.2 Net Worth

Net Worth is equal to the assets less the organisation's liabilities. Net Worth is sometimes referred to as Equity, Fund Balance, or Net Assets. Unlike liabilities, the net worth of an organisation does not have to be repaid. It therefore represents the value of the organisation. Net worth might include capital contributions of investors or donors, retained earnings, and current year surplus.

1. Equity/Corpus/Capital – Equity represents what the investor has contributed. Corpus denotes the “capital” of the MFI. While MFIs registered as company would show capital in its proper name, corpus is the synonymous nomenclature used for MFIs registered as society or trust. For purpose of accounting and measurement of financial performance, corpus is equated with permanent capital. Sources of Capital include grants restricted and designated to be taken as capital, investor contributions, the proceeds of fund raising activities, and/or membership fees (*refer BS 27, Table 8 b*).
2. Net Retained Surplus/Deficit prior years - the amount of income (or loss) accumulated since the formation of the organisation. It may also be referred to as undistributed profits or earned surplus (*refer BS 28, Table 8 b*).
3. Net Surplus/Deficit current year - the amount of income (or loss) generated in the current year (*refer BS 29, Table 8 b*).

NET WORTH		2001	2002	2003
BS 27	Equity/Corpus/Loan Fund Capital	66,000	66,000	80,200
BS 28	Retained Net Surplus/Deficit prior years	0	0	400
BS 29	Net Surplus/Deficit current year	0	400	2,000
BS 30	Total Net Worth	66,000	66,400	82,600

Ideally reserve also is part of Net Worth, but for fairer representation of the balance sheet, it is taken as a negative asset. In MFI, generally two types of Reserves are created: (i) Specific reserves -created for some special purpose (loan loss reserve is most common reserve for an MFI), whereas, (ii) General reserve - created for any nature of future use.

Any impact of delinquency/other losses will directly affect the net worth of an MFI. Therefore, if de-capitalisation is occurring one must look at the causes and attempt to control or mitigate or eradicate these.

3.3.2 Application of Fund - Assets

In the previous section we discuss about representation of “sources of fund” in the balance sheet, in this section we will discuss about “*application of funds*”, the other part of balance sheet, i.e. ‘Assets’.

Assets represent what is owned by the organisation or owed to it. They are those items in which an organisation has invested its funds for the purpose of generating future receipts of resources. They may be either current (short term) or long term by nature of their life and utility within the organisation. Assets are divided into two categories, namely (1) Current, and (2) Long-Term.

3.3.2.1 Current Assets

Current assets include cash and deposits (marketable securities), accounts receivable, and inventories i.e. assets, *which in the normal course of business will be turned into cash within a year*. As per best practices norms, *between 75% - 77% of the total assets in current assets is considered as optimal*.

The components of Current Assets are dealt below:

a) **Cash in Hand and Bank Current Accounts**

All balances available with the MFI instantly/on demand such as cash in safe or with bank in current account or any non- interest bearing deposit are classified under this head. (*refer BS 1, Table 8 b*).

b) **Interest bearing deposits**

Funds on deposit with any financial institution, with a term of less than one year, which are earning interest income for the MFI (*refer BS 2, Table 8 b*).

c) **Loans outstanding**

This is the most important income-generating asset for an MFI. It is also called as 'loan portfolio'. This is because, in common parlance of Microfinance, the main source of revenue comes from 'lending' to clients. Greater the micro-loans provided by the MFI, the higher its income (all other things being equal) and the greater the loans provided, the higher the loans outstanding.

As in case of sources of funds, loans given by the MFI need careful examination. In the sense that some loans may have repayment portion exceeding next one year and hence need to be treated separately as long term. All other loan-portions falling due for collection in next one year are "current".

For convenience of understanding, if all loans are short term in nature, there are three sub-categories within this broad category of loans outstanding – Namely, Regular loans outstanding, Past due loans outstanding and Re-structured loans outstanding. Let's take a look into the details of each of these sub-categories.

▪ **Regular Loans Outstanding** - the total amount of loans outstanding at a point in time that are *regular*, i.e., with no late payments or defaults (*refer BS 4, Table 8 b*).

▪ **Past-Due Loans Outstanding** - the total amount of loans outstanding which have amount past due. In other words, it represents outstanding balance of all overdue loans (*refer BS 5, Table 8 b*).

There is another aspect that requires clarification with regard to past due loans. In strict accounting parlance, any loan, which has even a single (installment) payment over due for (just) a day, should be classified as a past due loan

However, MFIs may have their own norms with regard to this aspect and consequently, this could vary on a case-by-case basis. But, best practices recommend that, if a payment on a loan due on a certain date is not paid by that date, then that loan should be classified as a past due loan.

▪ **Restructured Loans outstanding** - Outstanding loans in which original terms are re-negotiated (*refer BS 6, Table 8 b*). There are two cases here: loans can be either refinanced or rescheduled.

Current Assets		2001	2002	2003
	<i>Cash and Deposit</i>			
BS 1	Cash and bank current accounts	10,000	5,000	10,000
BS 2	Interest-bearing deposits	4,000	14,000	16,000
BS 3	<i>Total Cash and Deposit</i>	<i>14,000</i>	<i>19,000</i>	<i>26,000</i>
	<i>Loan Outstanding</i>			
BS 4	Regular	64,000	100,000	132,000
BS 5	Past Due	40,000	39,000	34,000
BS 6	Restructured	0	1,000	2,000
BS 7	<i>Gross Loans Outstanding</i>	<i>104,000</i>	<i>140,000</i>	<i>168,000</i>

Rescheduling an outstanding loan involves changing the payment period and/or the size of payments.

Refinancing a loan involves developing a new loan agreement before a previous one is completed. It can include increases in the principal amount, extension of the loan term, etc.

Restructuring of loan is usually done so that a borrower is no longer in *arrears*. Best practices suggest that such restructuring of loans is better avoided and discouraged as it results in the appearance of a “healthy” portfolio when in fact, restructured loans (*and portfolio*) indeed remain risky.

Best practices strongly recommend this bifurcation to ensure transparency with regard to level of risk in an MFI.

d) Loan Loss Reserve

To offset the risk (of loss) in loan portfolio, best practices recommend that MFI should establish a loan loss reserve. (See section 4.2.1 in chapter 4 for further detail). Hence, Loan Loss Reserve is the amount set aside through accounting entry to recognise probable future loan losses in an MFI’s loan portfolio so that the true value of the loan portfolio is fairly stated (refer BS 8, Table 8 b).

e) Net Loans Outstanding

The amount of loan loss expense is recorded on the Balance Sheet as a negative asset (Loan Loss Reserve), reducing the gross outstanding loan balance. It results in a figure called as the Net Loans Outstanding. It is the sum of all loan balances still owed to the organisation, that is, all loans disbursed and not yet repaid or written off, net of any loan loss reserve. Best practices suggest that the net loans outstanding should account for at least two-third of the total assets.

Loan Outstanding		2001	2002	2003
BS 4	Regular	64,000	100,000	132,000
BS 5	Past Due	40,000	39,000	34,000
BS 6	Restructured	0	1,000	2,000
BS 7	<i>Gross Loans Outstanding</i>	<i>104,000</i>	<i>140,000</i>	<i>168,000</i>
BS 8	<i>(Loan Loss Reserve)</i>	<i>-10,000</i>	<i>-10,000</i>	<i>-14,000</i>
BS 9	<i>Net Loans Outstanding</i>	<i>94,000</i>	<i>130,000</i>	<i>154,000</i>

Rationale for creating Loan Loss Reserve – When the Reserve is created (or adjusted), a loan loss expense (referred to as the Provision for Loan Losses) is recorded on the Income Statement as an expense. The amount of loan loss provision is then recorded as the negative asset - loan loss reserve and each year the amount provisioned under loan loss gets accumulated under loan loss reserve. This negative asset reduces the net outstanding loan portfolio. (Process of accounting entries for provisioning, reserve and write-offs is given in details in section 4.2.3 in chapter 4).

In case of actual loan losses, or write-offs, it gets reflected as a reduction of the Loan Loss reserve and the Gross Loans Outstanding on the Balance Sheet (and not on the Income Statement). The resultant effect is to leave the Net Portfolio on the Balance Sheet unchanged since the reserve has already been made (see graphical representation given at the end of section 4.2.3 in chapter 4).

- If the Loan loss reserve is too low relative to the value of loans to be written off, then both the Loan Loss Reserve and the Provision for Loan Losses (on the Income Statement) first need to be increased and then the loans can be written off.

- It is to be noted here that all of the loans outstanding amounts reflect only the principal due, not the interest (which is generally income statement item).
- When interest is due but not received, there is a procedure by which this (due) interest is accrued and reflected on the balance sheet under accounts receivable (*as accrued interest*) as shown below.

f) Other Current Assets

Items, such as accounts receivable (accrued interest, fees, etc.) and prepaid expenses (rent, insurance, salary advances, etc.) are clubbed under other current assets. Accrued interest (receivable) is one item that deserves attention from a best practices perspective.

Consider an MFI, following accrual system of accounting also applies the accrual principle to interest income. So the interest is accounted as income irrespective of whether it has been received or not. But the interest that is due and has not been received, if it gets into the income statement, it should be accounted for in the Balance Sheet as well. *This is because when interest that is due is received, the accounting entries are:*

- Credit - Income
- Debit - Cash

However, when interest due is not received but recorded in the income statement, the accounting entries will be:

- Credit - Income
- Debit - ???????? (Cash can't be debited, as interest has not been received)

As per fundamental accounting equation (Assets = Liabilities + Equity)

Now, when interest due is not received but it has been recorded in the income statement, this entry gets into the balance sheet on the equity side through net surplus (or deficit).

And according to the fundamental accounting, there must be a balancing entry on the asset side. Therefore, this balancing entry in the balance sheet (when interest is due and has not been received and is also recorded in the income statement) is called as accrued interest.

Thus, when interest is due and not received and also when it is recorded in the income statement as income, the entries are:

- Credit - Income
- Debit - Accrued Interest (asset under accounts receivable)

And when this income is realized, the corresponding entries are:

- Credit - Accrued Interest
- Debit - Cash

And when Accrued Interest is Written-off along with principal outstanding, the corresponding entries are:

- Credit - Accrued Interest (*reduces asset*)
- Debit - Capital Reserve or Corpus (*reduces equity*)

If written-off accrued interest is collected, then, the corresponding accounting entries are:

- Credit - Miscellaneous Income
- Debit - Cash

3.3.2.2 Long-Term Assets

Long-term assets represent those assets not readily redeemable as cash. Basically, there are two kinds of long-term assets – (a) investments or receivables held for *longer than one year*, and (b) fixed assets, such as land, buildings, machinery, equipment, furniture, automobiles, etc.

a) Long-term Investments

Investments not intended as a ready source of cash such as long term fixed deposits, stocks, bonds and promissory notes that are held for more than one year are classified as long-term investments.

b) Fixed Assets

Fixed assets usually refer to property and equipment, such as land, buildings, machinery, furniture, automobiles, etc. They are recorded at their acquisition cost – i.e., the historical cost at which they were bought.

c) Accumulated Depreciation

This represents the sum of depreciation expenses recorded in the current and previous fiscal periods. Depreciation represents gradual decrease in value of fixed assets. The common methods for calculating depreciation are the straight-line method and the declining balance method. For financial analysis any frequent change in depreciation method is an area of concern.

Long-Term Assets		2001	2002	2003
BS 12	Long Term Investments	16,000	22,000	25,000
BS 13	Fixed Assets (Movable & Immovable) At Cost	6,000	8,000	8,000
BS 14	(Accumulated Depreciation)	-400	-600	-1,400
BS 15	Net Fixed Assets	5,600	7,400	6,600
BS 16	Total Long Term Assets	21,600	29,400	31,600

Analysing changes in the Balance Sheet Structure

One of the key tasks for the analyst is to isolate changes in the structure of the various asset and liability items across two years. This trend analysis is a very useful technique for understanding where the MFI is today and where it is headed tomorrow. In turn, such analysis will facilitate what on-course corrections are required and also enable MFI management to take suitable decisions that will enable the MFI to enhance its sustainability and expand out reach.

Basically, such analysis involves calculating the proportion of asset and liability items as a measure of the total assets and liabilities respectively.

3.4 COST ALLOCATION – KEY ISSUES FOR PREPARING FINANCIAL STATEMENTS

A number of institutions that provide Microfinance services also offer a range of non-financial services, such as business development services (training & technical assistance to micro entrepreneurs) and training in areas like literacy, health, natural resource management etc. Usually the consolidated financial statements of such multi-service organisations contain financial data pertaining to all activities undertaken by the organisation.

Assessing financial performance and sustainability of Microfinance operation of a multi-service organisation from its consolidated financial statements would become rather difficult. Though Microfinance is being carried out with developmental agenda, the activity per se is commercial. Unlike other traditional developmental programme, in this activity, there is two-way flow of money – money is given or taken as credit or deposit to or from the poor and also it is repaid in the form of money. Therefore, the financial services should be treated as distinct cost centres vis-à-vis non-financial services in an MFI's accounts.

The following points provides a summary of the key issues in preparing financial statements for multi-service organisations who also undertake Microfinance programme:

- Before embarking on a cost allocation exercise, MFI managers must first decide which services offered, if any, can be considered functionally separate from the provision of financial services. In other words, they must answer the question of *“to what extent are the non-financial services integral to the success of the Microfinance programme?”*
- In some Microfinance programmes, the provision of skills and literacy training, for instance, is considered vital to core elements of the Microfinance methodology, such as group development and cohesion. In these cases, non-financial services may be seen as directly contributing to good credit/savings behaviour, particularly in programmes serving extremely poor clients. This sense of “non-separability” may pertain particularly in cases where credit officers are charged with providing training and where on-site technical assistance is inseparable from credit supervision.
- Cost allocation is appropriate for MFIs that offer non-financial services on a voluntary basis. Therefore, *if non-financial services are considered an integral part of the Microfinance or lending methodology, then cost allocation between financial & non-financial services may not be warranted* since the MFI implicitly or explicitly considers these services as part of the Microfinance methodology and cost. *On the other hand, if non-financial services are thought to be complementary (but not necessary) to the successful delivery of financial services, cost allocation is recommended.* However, MFIs interested in exploring the possibility of changing their approach and offering these services on a voluntary basis may wish to conduct a cost allocation exercise to guide their planning process.
- Some MFIs recognise that the provision of non-financial services may require ongoing subsidies, particularly those services with a “social” character like health and literacy training. They often approach international donors or national funding agencies for separate financing of these services. This financing may or may not be combined with a fee charged to clients to help cover the costs of delivering the service. Other MFIs expect that these social activities will be financed with income and fees earned from the provision of financial services. Such MFIs may charge a separate commission on loans or otherwise integrate the cost of providing non-financial services into the effective interest rate on financial services.
- MFIs that fund their non-financial services separately, either through donations or fees or some combination of the two, are likely to view these services as separate “cost centers”. These MFIs are good candidates for cost allocation.

- MFIs that expect their financial services to cross-subsidise their non-financial services may see the value in cost allocation so they can understand exactly what portion of their income from financial services goes toward covering the costs of non-financial services. Similarly, MFIs that charge a dedicated fee on their loans to cover a specific non-financial service may wish to verify that the fee actually covers the relevant costs.
- Non-financial services may represent a marginal activity to MFIs. If non-financial services make up a very small proportion of total costs and institutional effort, a complicated cost allocation exercise is probably not necessary. No fixed standard of materiality can be applied to all cases. However, MFIs with less than 10 percent of their costs attributable to non-financial services should consider whether they need anything beyond the simplest cost allocation exercise.

When costs related to non-financial services have to be allocated, the SIMPLE procedure given below is suggested to be followed. Complicated cost allocation exercises are avoided because, as experience indicates, the additionality of such an exercise is really minimal.

1. First, identify what the non-financial services are and ask the question as to whether they are compulsory and an inevitable part of Microfinance.
2. If they are integral (compulsory) part of Microfinance services, then NO cost allocation is necessary.
3. If they are not an integral part of Microfinance services (i.e., not compulsory) then determine what costs can be attributed to them?
4. If they exceed 10 percent then a Simple cost allocation may be warranted
5. Assuming that cost allocation is to be done, first determine, what are the resources used to the various activities that constitute Microfinance?

The major resources are:

- (a) Fixed Assets – Immovables (land and building)
 - (b) Fixed Assets – Movables (vehicles)
 - (c) Fixed Assets – Equipment (computers etc)
 - (d) Human Resources – Staff
 - (e) Financial Resources
 - (f) Other Resources
6. This requires that the MFI identify all activities related to Microfinance – which of course would vary with the methodology. An example is given in the Box below
 7. For each activity, determine, if any resource, not part of the Microfinance programme, is used. If yes, identify the resource and attribute a cost value to it.
 8. For fixed assets (immovables), like shared office space, some MFIs use the square feet approach to allocate rental costs (based on the going market rate in the area). This is fairly simple and accurate.
 9. Steps for this would include:
 - (a) Identifying the actual measurement of office space in Square Feet
 - (b) Multiplying it by the rental per square feet per month for all months in a year based on the local market conditions
 - (c) Adding the cost of borrowing money to make the deposit that would have been paid, if it were actually a rental

- (d) Adding utilities as per usage based on the square feet, of course taking into account the actual usage. Some MFI have even added a sub-metres to track utilities like electricity and make accurate payments with regard to these.
10. For fixed asset movables, like motorcycles, the actual usage could be discussed from a log book of travel records kept with regard to the vehicles.
 11. A fair rental value, (based on local market) and actual fuel costs based on the log of usage could be allocated. The normal going mileage per litre of fuel can be assumed here.
 12. For equipment like computers, again fair rental value (based on local market) could be allocated.
 13. The key issue is that when ownership of fixed assets lies with other (non-financial service providers) legal entities/projects, then, allocating costs based on fair market rental value is what is appropriate.
 14. Likewise, human resources (staff) costs could be allocated on the time that these non-microfinance staff spend for Microfinance activity
 15. This entails that these staff track their time spent on Microfinance in terms of hours/day and the monthwise total time spent by them can then be obtained by summing up each day's total. Then, one as outlined below can allocate accurate staff indirect costs. This is done in the following manner.
 16. For each staff determine their gross remuneration per hour or day (8 hours in a day) and multiply this by the number of hours allocated to Microfinance. While calculating the cost/hour, please use a consistent standard appropriate to the staff position and also to the organisations' human resources policies.
 17. For instance if the human resources policy states that working 8 hours/day for 25 days a month entitles them to a gross monthly compensation of Y Rupees, then per hour costs would be:

$$\begin{array}{lcl} 25 \text{ days} \times 8 \text{ hours} & \longrightarrow & Y \text{ Rupees} \\ 1 \text{ hour} & \longrightarrow & \frac{Y \text{ Rupees}}{200} \end{array}$$
 18. If this standard varies by position, then the appropriate figures must be used.
 19. Once the per hour cost is determined for all staff positions, then allocating indirect staff costs is fairly easy as shown below.

Sl. No.	Staff position	Actual time spent during month	Cost per hour	Total monthly cost (in Rs)
1	A_1	B_1 Hours	C_1 Rs	$B_1 C_1$
2	A_2	B_2 Hours	C_2 Rs	$B_2 C_2$
3	A_3	B_3 Hours	C_3 Rs	$B_3 C_3$
.				
.				
.				
n	A_n	B_n Hours	C_n Rs	$B_n C_n$
Total	All Positions	NA	NA	$B_1 C_1 + B_2 C_2 + B_3 C_3 + \dots + B_n C_n$

20. The same can be done for all months and brought into the income statement. Indirect staff costs allocated, which, if not tracked is akin to a hidden/unreported subsidy.
21. If any financial resources are borrowed or received as a grant from non-financial service departments, the same adjustments as made for concessional borrowings and/or grants for loan fund capital must be done here.
22. Once all these adjustments are done, then the cost allocation is complete and helps present a more accurate financial picture of the MFI.

It is to be noted that while cost allocation may seem to be a tedious exercise, it is very necessary, especially, if non-financial services constitute > 10% of the total turnover.

CONSTRUCTING LOAN REPAYMENT
SCHEDULE, AGING SCHEDULE AND
LOAN PORTFOLIO REPORT FOR AN MFI

Chapter

4

CONSTRUCTING LOAN REPAYMENT SCHEDULE, AGING SCHEDULE AND LOAN PORTFOLIO REPORT FOR AN MFI

The two statutory financial statements viz. Balance Sheet and Income & Expenditure Statement have been understood in detail in the earlier chapter. Now the other dimensions need to be discussed in same spirit. In this chapter, we will deal with construction of Loan Ledger, classifying the loans as per their performance and based on that construction of Loan Portfolio Report of an MFI.

4.1 LOAN LEDGER AND REPAYMENT SCHEDULE

For an MFI, (a) Individual Loan Ledger, (see Table 9, 10 & 11) and (b) Aggregated Loan Ledger (see Table 12) are the backbone of all financial transaction recorded in the organisation. These two are among the most important documents in any MFI and their proper and timely maintenance is must.

Loan ledger of an MFI is basically repayment schedule of loan outstanding that keeps record of repayment of loan and its various status. Before disbursement of loan, the terms must be finalised (and recorded) and made very clear to the client with regard to:

- (a) Loan Disbursed Amount
- (b) Disbursement Date
- (c) Loan Term in Number of Installments – 10, 20, 30 etc.
- (d) Frequency of Repayment of Installment – Weekly, Monthly etc. must be clearly stated
- (e) Due Date for 1st Installment – exactly 1 week or month from date of disbursement OR any specified date in a month (like on the day of group meeting or last/first day of each month) OR if any grace/moratorium period exists it needs to be mentioned upfront (for example, an MFI is following a policy where month end is considered as due date of loan repayment. A loan was disbursed on January 21, 2002. As per the policy of MFI, the first installment should be due on January 31, 2002, which is only 10 days after the disbursement. However, in this case, the MFI give a grace period of one month to the borrower. It means that the first installment is now due on the last date of February 2002, instead of end of January 2002).
- (f) Sequence of Payment – which is to be taken first. The suggested sequence is Interest Overdues, Interest Due, Principal Overdues and Principal
- (g) Definition of Overdues - When does a loan become overdue or pastdue is an aspect that must be clearly specified. It is suggested that the day after an amount is due, the amount if not paid becomes overdue. Such as, if on April 30, 2002, an amount of Rs. 100 is due and it is not paid, then, on May 1, 2002, this amount is in arrears or overdue

Having understood that loan terms need to be defined upfront, now we will try to understand the process of construction of individual loan ledger through an illustrative example. Please look at the Key data/facts given below:

Loan Amount Disbursed (Rs.)	1000
Disbursement Date	23/7/2002
Number of Installments	50
Weeks in a Year	52
Interest	15% per annum
Method of Interest Calculation	Flat
Total Interest (Rs.)	144.23 {1000 * (15/100) * (50/52)}
Interest per Installment	2.88 (144.23/50)
Interest Rounded-off to nearest whole no. (Rs.)	3.00
Principal to be paid per Installment (Rs.)	20 (1000/50)

Now, based on the above information, a repayment schedule is drawn – See Table 9 (next 2 pages).

Table 9 - Loan Repayment Schedule with FLAT Rate of Interest

I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	XIII	XIV	XV	XVI	XVII	XVIII
Instl. No.	Prin. Due	Cum Prin. Due	Int. Due as Per Schedule	Date Due	Int. Due as per payment	Amount Paid	Int. Paid	Prin. Paid	Date Paid	OD Process Date	Cum Prin. Paid	Prin. Prepaid	Prin. Outstanding	Interest OD	Prin. OD	Age of OD	OD Settled
1	20.00	20	3.00	7/30/2002	3.00	23.00	3.0	20.00	7/30/2002	7/31/2002	20.00	0	980.00	0.00	0.00	0	No OD
2	20.00	40	3.00	8/6/2002	3.00	23.00	3.0	20.00	8/6/2002	8/7/2002	40.00	0	960.00	0.00	0.00	0	No OD
3	20.00	60	3.00	8/13/2002	3.00	23.00	3.0	20.00	8/13/2002	8/14/2002	60.00	0	940.00	0.00	0.00	0	No OD
4	20.00	80	3.00	8/20/2002	3.00	23.00	3.0	20.00	8/20/2002	8/21/2002	80.00	0	920.00	0.00	0.00	0	No OD
5	20.00	100	3.00	8/27/2002	3.00	23.00	3.0	20.00	8/27/2002	8/28/2002	100.00	0	900.00	0.00	0.00	0	No OD
6	20.00	120	3.00	9/3/2002	3.00	23.00	3.0	20.00	9/3/2002	9/4/2002	120.00	0	880.00	0.00	0.00	0	No OD
7	20.00	140	3.00	9/10/2002	3.00	23.00	3.0	20.00	9/10/2002	9/11/2002	140.00	0	860.00	0.00	0.00	0	No OD
8	20.00	160	3.00	9/17/2002	3.00	23.00	3.0	20.00	9/17/2002	9/18/2002	160.00	0	840.00	0.00	0.00	0	No OD
9	20.00	180	3.00	9/24/2002	3.00	23.00	3.0	20.00	9/24/2002	9/25/2002	180.00	0	820.00	0.00	0.00	0	No OD
10	20.00	200	3.00	10/1/2002	3.00	23.00	3.0	20.00	10/1/2002	10/2/2002	200.00	0	800.00	0.00	0.00	0	No OD
11	20.00	220	3.00	10/8/2002	3.00	23.00	3.0	20.00	10/8/2002	10/9/2002	220.00	0	780.00	0.00	0.00	0	No OD
12	20.00	240	3.00	10/15/2002	3.00	23.00	3.0	20.00	10/15/2002	10/16/2002	240.00	0	760.00	0.00	0.00	0	No OD
13	20.00	260	3.00	10/22/2002	3.00	23.00	3.0	20.00	10/22/2002	10/23/2002	260.00	0	740.00	0.00	0.00	0	No OD
14	20.00	280	3.00	10/29/2002	3.00	23.00	3.0	20.00	10/29/2002	10/30/2002	280.00	0	720.00	0.00	0.00	0	No OD
15	20.00	300	3.00	11/5/2002	3.00	23.00	3.0	20.00	11/5/2002	11/6/2002	300.00	0	700.00	0.00	0.00	0	No OD
16	20.00	320	3.00	11/12/2002	3.00	23.00	3.0	20.00	11/12/2002	11/13/2002	320.00	0	680.00	0.00	0.00	0	No OD
17	20.00	340	3.00	11/19/2002	3.00	23.00	3.0	20.00	11/19/2002	11/20/2002	340.00	0	660.00	0.00	0.00	0	No OD
18	20.00	360	3.00	11/26/2002	3.00	23.00	3.0	20.00	11/26/2002	11/27/2002	360.00	0	640.00	0.00	0.00	0	No OD
19	20.00	380	3.00	12/3/2002	3.00	23.00	3.0	20.00	12/3/2002	12/4/2002	380.00	0	620.00	0.00	0.00	0	No OD
20	20.00	400	3.00	12/10/2002	3.00	23.00	3.0	20.00	12/10/2002	12/11/2002	400.00	0	600.00	0.00	0.00	0	No OD
21	20.00	420	3.00	12/17/2002	3.00	23.00	3.0	20.00	12/17/2002	12/18/2002	420.00	0	580.00	0.00	0.00	0	No OD
22	20.00	440	3.00	12/24/2002	3.00	23.00	3.0	20.00	12/24/2002	12/25/2002	440.00	0	560.00	0.00	0.00	0	No OD
23	20.00	460	3.00	12/31/2002	3.00	23.00	3.0	20.00	12/31/2002	1/1/2003	460.00	0	540.00	0.00	0.00	0	No OD
24	20.00	480	3.00	1/7/2003	3.00	23.00	3.0	20.00	1/7/2003	1/8/2003	480.00	0	520.00	0.00	0.00	0	No OD
25	20.00	500	3.00	1/14/2003	3.00	23.00	3.0	20.00	1/14/2003	1/15/2003	500.00	0	500.00	0.00	0.00	0	No OD
26	20.00	520	3.00	1/21/2003	3.00	23.00	3.0	20.00	1/21/2003	1/22/2003	520.00	0	480.00	0.00	0.00	0	No OD
27	20.00	540	3.00	1/28/2003	3.00	23.00	3.0	20.00	1/28/2003	1/29/2003	540.00	0	460.00	0.00	0.00	0	No OD
28	20.00	560	3.00	2/4/2003	3.00	23.00	3.0	20.00	2/4/2003	2/5/2003	560.00	0	440.00	0.00	0.00	0	No OD

Contd. next page

Table 9 - Loan Repayment Schedule with FLAT Rate of Interest

I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	XIII	XIV	XV	XVI	XVII	XVIII
Instl. No.	Prin. Due	Cum Prin. Due	Int. Due as Per Schedule	Date Due	Int. Due as per payment	Amount Paid	Int. Paid	Prin. Paid	Date Paid	OD Process Date	Cum Prin. Paid	Prin. Prepaid	Prin. Outstanding	Interest OD	Prin. OD	Age of OD	OD Settled
29	20.00	580	3.00	2/11/2003	3.00	23.00	3.0	20.00	2/11/2003	2/12/2003	580.00	0	420.00	0.00	0.00	0	No OD
30	20.00	600	3.00	2/18/2003	3.00	23.00	3.0	20.00	2/18/2003	2/19/2003	600.00	0	400.00	0.00	0.00	0	No OD
31	20.00	620	3.00	2/25/2003	3.00	23.00	3.0	20.00	2/25/2003	2/26/2003	620.00	0	380.00	0.00	0.00	0	No OD
32	20.00	640	3.00	3/4/2003	3.00	23.00	3.0	20.00	3/4/2003	3/5/2003	640.00	0	360.00	0.00	0.00	0	No OD
33	20.00	660	3.00	3/11/2003	3.00	23.00	3.0	20.00	3/11/2003	3/12/2003	660.00	0	340.00	0.00	0.00	0	No OD
34	20.00	680	3.00	3/18/2003	3.00	23.00	3.0	20.00	3/18/2003	3/19/2003	680.00	0	320.00	0.00	0.00	0	No OD
35	20.00	700	3.00	3/25/2003	3.00	23.00	3.0	20.00	3/25/2003	3/26/2003	700.00	0	300.00	0.00	0.00	0	No OD
36	20.00	720	3.00	4/1/2003	3.00	23.00	3.0	20.00	4/1/2003	4/2/2003	720.00	0	280.00	0.00	0.00	0	No OD
37	20.00	740	3.00	4/8/2003	3.00	23.00	3.0	20.00	4/8/2003	4/9/2003	740.00	0	260.00	0.00	0.00	0	No OD
38	20.00	760	3.00	4/15/2003	3.00	23.00	3.0	20.00	4/15/2003	4/16/2003	760.00	0	240.00	0.00	0.00	0	No OD
39	20.00	780	3.00	4/22/2003	3.00	23.00	3.0	20.00	4/22/2003	4/23/2003	780.00	0	220.00	0.00	0.00	0	No OD
40	20.00	800	3.00	4/29/2003	3.00	0.00	0.0	0.00	Not Paid	4/30/2003	780.00	0	220.00	3.00	20.00	1	OD Not Paid
41	20.00	820	3.00	5/6/2003	3.00	0.00	0.0	0.00	Not Paid	5/7/2003	780.00	0	220.00	6.00	40.00	8	OD Not Paid
42	20.00	840	3.00	5/13/2003	3.00	0.00	0.0	0.00	Not Paid	5/14/2003	780.00	0	220.00	9.00	60.00	15	OD Not Paid
43	20.00	860	3.00	5/20/2003	3.00	0.00	0.0	0.00	Not Paid	5/21/2003	780.00	0	220.00	12.00	80.00	22	OD Not Paid
44	20.00	880	3.00	5/27/2003	3.00	0.00	0.0	0.00	Not Paid	5/28/2003	780.00	0	220.00	15.00	100.00	29	OD Not Paid
45	20.00	900	3.00	6/3/2003	3.00	0.00	0.0	0.00	Not Paid	6/4/2003	780.00	0	220.00	18.00	120.00	36	OD Not Paid
46	20.00	920	3.00	6/10/2003	3.00	0.00	0.0	0.00	Not Paid	6/11/2003	780.00	0	220.00	21.00	140.00	43	OD Not Paid
47	20.00	940	3.00	6/17/2003	3.00	0.00	0.0	0.00	Not Paid	6/18/2003	780.00	0	220.00	24.00	160.00	50	OD Not Paid
48	20.00	960	3.00	6/24/2003	3.00	0.00	0.0	0.00	Not Paid	6/25/2003	780.00	0	220.00	27.00	180.00	57	OD Not Paid
49	20.00	980	3.00	7/1/2003	3.00	0.00	0.0	0.00	Not Paid	7/2/2003	780.00	0	220.00	30.00	200.00	64	OD Not Paid
50	20.00	1000	3.00	7/8/2003	3.00	0.00	0.0	0.00	Not Paid	7/9/2003	780.00	0	220.00	33.00	220.00	71	OD Not Paid
Total	1000.00		150.00	NA	150.00	897.00	117.0	780.00									

Explanation of the Repayment Schedule (table-9) is given below:

1. Column I of the schedule gives the installment number from 1 to 50
2. Column II is the principal due as per loan agreement – Rs. 20 per week
3. Column III is the cumulative principal due. Take for example, Installment No 5. When the 5th installment is due, 5 weeks X 20 principal per week would have become due. The cumulative principal due is 100 as given in column III corresponding to installment 5.
4. The Interest due as per schedule is 3.00 per week and it is given in Column IV.
5. Column V is an important column; it gives the date on which each specific installment becomes due. For example, the 1st installment becomes due 1 week after disbursement (as per loan agreement). i.e., 23/7/2002 + 7 days = 30/7/2002. This is given in Column V corresponding to 1st installment.
6. Sometimes, MFIs may offer a moratorium period. In such cases, the 1st installment would become immediately due after the moratorium period.
7. Column VI gives the interest due as per payment. While significance of this column is reduced for MFIs charging 'Flat' rates of interest, for others which use the 'declining' balance (Table 10) or 'EMI' method (Table 11), this is very relevant, especially if the client makes the repayment after the scheduled installment date. MFIs could use this information to calculate 'Penalties' or 'Late Fees'.
8. All payments coming in from clients are adjusted as per loan agreement of MFI, which stipulates the following:

(a) First Towards	-	Interest Overdues
(b) Second Towards	-	Interest Due
(c) Third Towards	-	Principal Overdues
(d) Fourth Towards	-	Principal Due
9. Now, as can be observed from the schedule given in Table 9, the client in the example has promptly paid all installments upto installment no 39. Hence, data in columns VII (*amount paid*), VIII (*Int. Paid*), IX (*Prin. Paid*) and X (*Date Paid*) correspond to the original schedule.
10. This is also reflected by the data in column XII (*Cumulative Prin. Paid*) which matches the data in Column III (*Cumulative Prin. Due*).
11. Accordingly, columns XV (*Interest Overdue*) and XVI (*Principal Overdue*) report a value of '0' for each installment till installment number 39.
12. Column XVI (*Prin. Overdue*) = Column III (*Cum. Prin. Due*) – Column XII (*Cum. Prin. Paid*)
13. Likewise, Column XV (*Interest Overdue*) = Column VI (*Int. due*) – Column VIII (*Int. Paid*).
14. Column XIII represents any amounts prepaid – i.e., after the using sequence of
 - I. *Interest Overdue*,
 - II. *Interest Due*,
 - III. *Principal Overdue*, and
 - IV. *Principal Due*,
 and deducting amounts from clients as such, any amount (that) is left, goes to this column.

15. Column XIV is the Principal Outstanding column and it represents the difference of Loan Amount – Cum. Prin. Repaid (Column XII).
16. Column XI is the Overdue Processing date, which is 1 day after the installment due date (Column V). The essence of this is that, if 20 is principal due on a specific date and repayment of principal is less than the 20 due, then the difference of principal due (minus) – principal paid becomes Principal Overdue, one day after the due date.
17. For example, in installment number 40, as on 30/4/2003, the principal overdue is 20 with an age of 1 day as principal of 20 has not been paid on even on 30/4/2003. Likewise, in the same manner, 220 is the principal overdue and 33 is the interest overdue as of 9/7/2003. The age of this overdue loan is 71 days, as shown in Column XVII.
18. To calculate accurate age of an overdue loan, the following method should be followed:
[Date of calculating Overdue (or Today) – (minus) Earliest Overdue Date with unpaid overdue]
 It is also to be noted that when overdues from several past installments exist, to calculate age of overdue it is important to take the date on which the earliest installment (among several installments) first fell overdue. However, this must be done only if amounts from that installment are still unpaid. If amounts from that installment have been paid, then the next earliest installment for which unpaid overdues exist must be taken as the basis for calculating age. Here, the earliest when the overdue occurred was in the 39th installment when Rs. 20 was not paid that fallen due on 29/4/2003. It remains unpaid as on 9/7/2003 (last installment). Therefore, the age is = (9/7/2003) – (29/4/2003) = 71 days.
19. Please see the box below on how not to calculate the age of an overdue loan using the installment method of aging (which is an incorrect procedure).

Example of Incorrect Aging

☞ Let us assume that 1032 has not been paid (part of it is overdue from August 2001).

☞ The loan term ends in January 2002.

☞ The value per monthly installment is 180

☞ The age is sometimes calculated as:

$$\text{Age} = \frac{\text{Overdue Amount}}{\text{Installment amount}}$$

☞ As per the above formula, the age, as at end January 2002 would be

$$\text{Age (End January 2002)} = \frac{1032}{180} = 5.96 \text{ Months}$$

☞ This is correct, as 6 months intervene between August 2001 & January 2002 (inclusive of both months)

☞ Let us now assume that we are in July 2002.

☞ The age as per above method of calculation is still 6 months.

☞ But actual age is 6 months till January 2002 + 5 months till July 2002 or 11 months.

☞ So what is considered 180 days past due is actually 330 days past due

☞ This incorrect aging impacts ability of MFI to collect money (the further the borrower in age of overdue, less likely to get it back). Also, it distorts provisioning, income and finally, sustainability

20. While the method to arrive at aging was done using data with the Flat rate of interest method, the same generic principles apply to loans terms using 'Reducing Balance Method' and/or 'EMI Method'. The schedules for these are given in Tables 10 and 11.
21. As long as borrowers pay according to their schedule, interest payments will mirror what needs to be paid as per schedule. But the moment borrowers deviate from the schedule, interest payments will also change based on the principal outstanding.
22. For example, Rs15 is the interest due per month and has to be paid on the last day of the month for Rs1000 loan, payable in 10 equal months with interest at 15% declining balance annualised. The principal and interest payments as per schedule are as follows:

No. of Installment	Principal Due as per Schedule	Interest Due as per Schedule	Principal Paid	Principal Outstanding at end of installment
1	100	15.00	100	900
2	100	13.50	100	800
3	100	12.00	100	700
4	100	10.50	100	600
5	100	9.00	100	500
6	100	7.50	100	400
7	100	6.00	100	300
8	100	4.50	100	200
9	100	3.00	100	100
10	100	1.50	100	0

Now assume that the client does not pay the 1st installment on time and in fact pays it one installment late. Then interest to be charged changes and is as follows:

This installment interest is 15 and not 13.50 because Principal Outstanding is still 1000 before the borrower makes the payment

No. of Installment	Principal Due	Interest Due	Principal	Paid Principal Outstanding at end of Installment	Interest Paid
1	100	15	0	1000	0
2	100	15	100	900	15 (Interest Overdue) + 15 (this installment Interest)
3	100	13.50	100	800	13.50
4	100	12.00	100	700	12.00
5	100	10.50	100	600	10.50
6	100	9.00	100	500	9.00
7	100	7.50	100	400	7.50
8	100	6.00	100	300	6.00
9	100	4.50	100	200	4.50
10	100	3.00	100	100	3.00
11	100	1.50	100	0	1.50

So, MFIs must re-work their calculations at the time of repayment to account for such aspects.

23. Also, MFIs must have clear-cut norms on dealing with interest issues after the loan term. For example, when the flat rate of interest is used, an equal interest amount gets charged per installment from the borrower based on the original loan conditions. Now, after the loan term is over and principal amounts are still unpaid by the borrower, charging the same interest may be erroneous. How to deal with such aspects also needs to be clarified upfront. Further, penalties and penal interest (if any) and their rates thereof must be specified and used consistently.
24. Interest Rate should always be expressed as an 'Annualised Percentage Rate' and the following formula will help in doing so:

To annualise a number, the formula is: $AA = [A \times (12/M)]$

Where

AA = Annualised amount

A = Amount for the period

M = Number of months in the period

25. Interest Calculation Aspects – whether until date of payment or month End is followed should be clarified. Often times, when last date of month is the due date, MFIs still take the full month's interest even if the borrower repays 7 days before the scheduled date. Some others calculate interest until the date of payment only. Among the latter, while some adjust for the interest on principal outstanding for the 7 days balance, others just forget about it. The key aspect is that all of these have an impact on aging, portfolio analysis, ratios and sustainability and hence, information on what is done as part of the loan protocol is very necessary.
26. Also, the method of Interest Calculation – whether EMI or Regular Diminishing or Flat – should not be changed during the course of a loan.

Table 10- Loan Repayment Schedule with Declining Interest

I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	XIII	XIV	XV	XVI	XVII	XVIII
Instl. No.	Prin. Due	Cum Prin. Due	Int. Due as Per Schedule	Date Due	Int. Due as per payment	Amount Paid	Int. Paid	Prin. Paid	Date Paid	OD Process Date	Cum Prin. Paid	Prin. Prepaid	Prin. Outstanding	Interest OD	Prin. OD	Age of OD	OD Settled
1	100	100	15.00	8/31/2002	15.0	115.00	15.0	100.00	8/31/2002	9/1/2002	100.00	0	900.00	0.00	0.00	0	No OD
2	100	200	13.50	9/30/2002	13.5	113.50	13.5	100.00	10/2/2002	10/1/2002	200.00	0	800.00	0.00	0.00	2	Yes
3	100	300	12.00	10/31/2002	12.0	112.00	12.0	100.00	11/5/2002	11/1/2002	300.00	0	700.00	0.00	0.00	5	Yes
4	100	400	10.50	11/30/2002	10.5	110.50	10.5	100.00	11/25/2002	12/1/2002	400.00	0	600.00	0.00	0.00	0	No OD
5	100	500	9.00	12/31/2002	9.0	109.00	9.0	100.00	12/25/2002	1/1/2003	500.00	0	500.00	0.00	0.00	0	No OD
6	100	600	7.50	1/31/2003	7.5	107.50	7.5	100.00	2/6/2003	2/1/2003	600.00	0	400.00	0.00	0.00	6	Yes
7	100	700	6.00	2/28/2003	6.0	0.00	0.0	0.00	Not Paid	3/1/2003	600.00	0	400.00	6.00	100.00	1	OD Not Paid
8	100	800	4.50	3/31/2003	6.0	0.00	0.0	0.00	Not Paid	4/1/2003	600.00	0	400.00	12.00	200.00	32	OD Not Paid
9	100	900	3.00	4/30/2003	6.0	0.00	0.0	0.00	Not Paid	5/1/2003	600.00	0	400.00	18.00	300.00	62	OD Not Paid
10	100	1000	1.50	5/31/2003	6.0	0.00	0.0	0.00	Not Paid	6/1/2003	600.00	0	400.00	24.00	400.00	93	OD Not Paid
Total	1000		82.50	NA	91.5	667.50	67.5	600.00			600.00	0	400.00				

Table 11 - Loan Repayment Schedule using EMI Method

I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	XIII	XIV	XV	XVI	XVII	XVIII	XIX
Instl. No.	Amount Due	Prin. Due	Cum Prin. Due	Int. Due as Per Schedule	Date Due	Int. Due as per payment	Amount Paid	Int. Paid	Prin. Paid	Date Paid	OD Process Date	Cum Prin. Paid	Prin. Prepaid	Prin. Outstanding	Interest OD	Prin. OD	Age of OD	OD Settled
1	108.43	93.43	93.43	15.00	8/31/2002	15.00	108.43	15.00	93.43	8/31/2002	9/1/2002	93.43	0	906.57	0.00	0.00	0	No OD
2	108.43	94.84	188.27	13.60	9/30/2002	13.60	108.43	13.60	94.84	9/30/2002	10/1/2002	188.27	0	811.73	0.00	0.00	0	No OD
3	108.43	96.26	284.53	12.18	10/31/2002	12.18	108.43	12.18	96.26	10/31/2002	11/1/2002	284.53	0	715.47	0.00	0.00	0	No OD
4	108.43	97.70	382.23	10.73	11/30/2002	10.73	108.43	10.73	97.70	11/30/2002	12/1/2002	382.23	0	617.77	0.00	0.00	0	No OD
5	108.43	99.17	481.40	9.27	12/31/2002	9.27	108.43	9.27	99.17	12/31/2002	1/1/2003	481.40	0	518.60	0.00	0.00	0	No OD
6	108.43	100.66	582.05	7.78	1/31/2003	7.78	108.43	7.78	100.66	1/31/2003	2/1/2003	582.05	0	417.95	0.00	0.00	0	No OD
7	108.43	102.16	684.22	6.27	2/28/2003	6.27	108.43	6.27	102.16	2/28/2003	3/1/2003	684.22	0	315.78	0.00	0.00	0	No OD
8	108.43	103.70	787.92	4.74	3/31/2003	4.74	0.00	0.00	0.00	Not Paid	4/1/2003	684.22	0	315.78	4.74	103.70	1	OD Not Paid
9	108.43	105.25	893.17	3.18	4/30/2003	4.74	0.00	0.00	0.00	Not Paid	5/1/2003	684.22	0	315.78	9.47	208.95	31	OD Not Paid
10	108.43	106.83	1000.00	1.60	5/31/2003	4.74	0.00	0.00	0.00	Not Paid	6/1/2003	684.22	0	315.78	14.21	315.78	62	OD Not Paid
Total	1,084.34	1,000.00		84.34	NA	89.03	759.04	74.82	684.22									

Table 12 - Summary Format of Repayment Schedule

I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII	XIII
Sl. No	Loan Disbursed	No of Installments	Current Installment	Due per Installment	Cumulative Due So Far	Cumulative Paid On-Time So Far	Cumulative Paid as Overdue So Far	Cumulative Paid So Far	Cumulative Overdue or Arrears	Cumulative Prepayments	Cumulative Prin. Outstanding	Cumulative Prin. Outstanding for OD Loans
1	20,000	10	9	2,000	18,000	15,000	3,000	18,000	0	0	2,000	0
2	30,000	10	7	3,000	21,000	20,000	3,000	23,000	0	2,000	7,000	0
3	45,000	10	9	4,500	40,500	32,000	10,000	42,000	0	1,500	3,000	0
4	2,00,000	10	10	20,000	2,00,000	2,00,000	0	2,00,000	0	0	0	0
5	20,000	10	4	2,000	8,000	8,000	3,000	11,000	0	3,000	9,000	0
6	4,00,000	10	1	40,000	40,000	39,000	700	39,700	300	0	3,60,300	3,60,300
7	20,000	10	4	2,000	8,000	2,000	6,000	8,000	0	0	12,000	0
8	30,000	10	4	3,000	12,000	12,000	0	12,000	0	0	18,000	0
9	20,000	10	4	2,000	8,000	8,000	0	8,000	0	0	12,000	0
10	20,000	10	6	2,000	12,000	12,000	0	12,000	0	0	8,000	0
11	20,000	10	5	2,000	10,000	2,000	7,000	9,000	1,000	0	11,000	11,000
12	20,000	10	2	2,000	4,000	2,000	3,000	5,000	0	1,000	15,000	0
13	2,50,000	10	0	25,000	0	0	0	0	0	0	2,50,000	0
14	2,50,000	10	0	25,000	0	0	0	0	0	0	2,50,000	0
Total/Avg	1,345,000	11.67	NA	NA	381,500	352,000	35,700	3,87,700	1,300	7,500	9,57,300	3,71,300

4.2. ACCOUNTING FOR LOAN LOSSES – KEY ISSUES FOR STANDARD SETTING

4.2.1 Allowances for Loan Losses

For an MFI the loan portfolio is the main business and asset. The values of this asset i.e. loans is therefore a key issue for good management and income and thus for setting standards for financial performance. This issue needs to be understood by two dimensions viz.

- A.) The institutional policy of an MFI should be in place to consider and account for change in quality of its loan portfolio
- B.) Change in quality of loans has substantial effect on MFI's balance sheet and income statement.

The reasons for having a *system* for accounting for change in quality of loan portfolio are:

- *Maintaining loans on the books that are unlikely to be repaid in normal course overstates the size of loan portfolio.*
- *A well-defined policy that establishes a loan loss reserve and periodically declares loans non-recoverable saves a programme from declaring a large amount unrecoverable all at once and thereby drastically reducing assets.*

While the accounting systems are based on 'historical' costs, the accounting for quality of loans is a change in itself – it is a shift from traditional system that hinges on only historical costs (i.e. keeping an asset at its *original* value for all times).

How does the asset – loan portfolio – perform? For an MFI, as lender, loan performs by *repayment* of the principal amount and the interest (and other fees, if any levied on loan). Since repayment of loan is over a *future* period, the present status of a loan and estimation of its future performance are the core issues. Maintaining loan portfolio at the realistic level helps MFI project the actual picture. This removes that portion of the asset that is found not to be 'performing'.

Here it is also interesting to understand that evaluating loan portfolio is *not* always a negative aspect i.e. issue for loss only. A low/non-performing loan can *revive* and therefore become performing. This gives a *positive* effect to an MFI's balance sheet and income. But practically such chances of revival are much less than loans turning worse to bad, so the elaborations here will centre around most happening chances – that of losses in loan portfolio.

Accounting for change in loan portfolio, has two steps. (a) Periodic review of all loans are made and 'loan loss provision' is made to bring the real picture of performance of loans; (b) The provision is given effect into specific 'loan loss reserve' for loan portfolio (*also see section 3.2.2.2 & 3.3.2.1 in chapter 3*).

Though Loan loss provision is a non-cash expense in anticipation of possible loss in value of loan outstanding, whereas, *actual loan losses or write-offs occur when it is recognised (only for accounting purpose) that loans are unrecoverable*. The process of recognising an uncollectable loan is called a *write-off*.

Because the possibility that some loans would be unrecoverable has been provided for in the books of accounts through reserves, loan losses are written off against loan loss reserves and are also removed from the outstanding portfolio. In other words, *they decrease the reserve and the outstanding portfolio*.

Loan write-off is a significant policy decision that requires attention to several aspects related to loan recovery. In normal course, loans are written-off only after the loan term expires. However, in exceptional circumstances, like death or permanent migration of the borrower, the loan is written-offs even before the loan term is over.

Loan losses or write-offs occur only as an accounting entry. They do not mean that loan recovery should not be pursued. In fact, it should be identified.

4.2.2 Calculating Loan Loss using Aging Analysis

Now we have understood that MFIs should have clear allowances for loan losses. However, some questions still haunts the mind of a manager of an MFI, as to what amount would be appropriate to set aside as loan loss provision and what should be the basis to arrive at that figure. This section is focused around addressing the above questions, where we will try to understand the basis of making loan loss provision and the process of calculating the amount to be provisioned.

A practical approach to arrive at amount to be provisioned for loan loss is based on “aging analysis” of all loan outstanding. In ‘aging analysis’, all loans are reviewed for their present position in relation to the repayment schedule as decided when each of the loans was sanctioned. Given below is the step-wise method to calculate loan loss provision based on aging analysis.

1. The first step towards aging analysis is to draw an ‘aging schedule’ with following categories:

Loan Category	Explanation
Regular Loans	Loans where repayments have been made as per the due dates or all repayments (that are due) have been paid
Loans overdue for < 30 days	Loans with payments overdue for less than 30 days (from the scheduled date)
Loans overdue between 31-60 days	Loans with payments overdue for between 31 – 60 days (from the scheduled date)
Loans overdue between 61-90 days	Loans with payments overdue for between 61 – 90 days (from the scheduled date)
Loans overdue between 91-180 days	Loans with payments overdue for between 91 – 180 days (from the scheduled date)
Loans overdue between 181-365 days	Loans with payments overdue for between 181 – 365 days (from the scheduled date)
Loans overdue for above 365 days	Loans with payments overdue for over 365 days (from the scheduled date)

Here each category depicts a range of quality of loans. At the same time, each category also depicts the range of risk (probability) of losing money (loan may not come back from borrower). However, the level of risk or probability of loan loss in each category will differ from context to context.

2. Having understood the method of deriving age of an overdue loan from repayment schedule in section 4.2 (18) of this chapter, now calculate the age of all outstanding loans and club them under appropriate category (as given above) based on their age.
3. After classifying all the loans under age group, now sum up the outstanding figure of all loan accounts for each age group.
4. Establish rate of provisioning (% of loan outstanding that need to be kept aside) for each age group, based on risk perspective (of default) attached to each category. An historical precedence of client behavior is the best guidance mechanism towards establishing rate of provisioning. Especially, if there is a cause to believe that there could be something that is specific to the context that requires the establishment of risk rates unique to that context.

However, in the absence of adequate historical data on default by borrowers, MFI can resort to following guidelines to assign provisioning rate:

- a) National statutory bodies have their own norms for setting the provisioning rate – The Reserve Bank of India has stipulated norms for classification of loans in NBFCs.
- b) International best practices recommend values for various loans categories which are as follows:

Status of Loans	Reserve Rate
Regular	0%
1-30 days past due	10%
31-60 days past due	25%
61-90 days past due	50%
91-180 days past due	75%
181-365 days past	90%
> 365 days past due	100%

- c) Sometimes, as in the beginning of an MFI operation, it may not be possible to have an aging schedule, as loans may still not have become due. In such circumstances, when having an aging analysis is rather not applicable or not possible (due to lack of data), using the internationally recommended norm of 3 percent of loans outstanding as the allowance could be implemented.
5. After assigning provisioning rate for each age (risk) category, now multiply the volume of loan outstanding in each category with corresponding provisioning rate. This will give the amount to be provisioned (for loan loss) under each risk category.
 6. Now add up all provision amounts under each age category to get the overall provision amount. To get the overall provision rate, divide the overall provision amount by total outstanding portfolio

The entire process calculating loan loss provision is summarized below with an illustrative example.

Calculating loan loss provision requires an *aging schedule*, allocating *probabilities* (reserve rates) for likely loan losses for each category of loans and then multiplying the volume of loan outstanding in each category by the probability and adding it all to get the provision amount (or even the overall provision/reserve rate for which one would have to divide by the outstanding portfolio).

I	II	III	IV = (II*III)
Description	Loan Outstanding	Provision Rate	Provision Amount Adding to Reserve
Regular Loans	100,000	0%	-
Loans with overdue for < 30 days	10,000	10%	1,000
Loans with overdue between 31-60 days	10,000	25%	2,500
Loans with overdue between 61-90 days	3,000	50%	1,500
Loans with overdue between 91-180 days	1,000	75%	750
Loans with overdue between 181-365 days	4,000	90%	3,600
Loans with overdue for >365 days	5,000	100%	5,000
Total	133,000	-	14,350

The Total Provision Amount is in the last row of column IV and it equals to Rs. 14,350

$$\text{The Provision Rate} = \frac{\text{Column V Total}}{\text{Column II Total}} = \frac{14,350 \times 100}{133,000} = 10.789 \% = 11\% \text{ (approx.)}$$

Let us assume that this is provision rate for the most recent years and also consider that the provision rates for the previous two years (before this year) are 10 percent and 11 percent respectively. Now, using the data of three consecutive years, average provision rate could be calculated that can be applied for the next year (for projection or otherwise)

$$\text{Average Provision Rate} = \frac{11\% + 10\% + 9\%}{3 \text{ (years)}} = \frac{30\%}{3} = 10\%.$$

In other words, a reference provision rate is now available based on a historical analysis of the data over a three-year period. While one may want to question, the appropriate number of years to choose for calculating the provision rate, it must be clarified that there is really no concrete scientific guideline. However, one may argue that the last 3 years (being most representative of the current situation) are perhaps best used in calculating the average.

The provision rate increases as loans have been overdue for a longer period – the farther a loan is from the originally scheduled repayment, the likelihood or probability of the loan being repaid (or recovered) is lower. Therefore, as the age of the loan, in terms of its overdue status increases, the provision rate (or risk factor) also increases. Obviously, such a risk is minimal in loans that are regular – i.e., they have no overdue. Therefore, the provision rate is listed as 0 percent. However, MFIs following more prudent norms also make provision for regular loans (in the range of 1% - 3%).

While the above are intuitively appealing arguments, several key aspects need to be considered while establishing the provision rate on historical data:

- a) Take for the example an MFI, where during a particular season (monsoons or otherwise), repayments may not come in for 3 months or so – this is true of weaving and fishing (where clients go to sea). Under such circumstances, < 90 days overdue loans would not be at great risk because of the seasonality aspect. Clients normally repay the entire amount when they get back to work, often over 2/3 installments, as both examples given above are high value (low volume) trades.
- b) Likewise, for crop loans, the same is true as crops are harvested after 90 days or so (many a time) and the argument that repayment will occur from the household income or other livelihoods has often not happened. In such cases, the very nature of livelihoods sometimes causes over dues in payment but the risk may not be high after all. Therefore, it seems prudent to tailor the risk rates to the context and change it, if there is enough justification.
- c) If there is insurance for calamities and other aspects, the provision (risk) rate again could be lowered but this must be justified.

4.2.3 Accounting Entries for Loan Loss Provision, Loan Loss Reserve and Write-offs

In the previous section, we learnt to calculate Loan Loss Provision, now the next step would be to make appropriate accounting entries for the provision. In this section, we will try to learn the relevant accounting treatment of loan loss provision and its bearing on loan loss reserve.

Before we move to accounting entries, let's take a quick re-look at the key concepts related to loan loss provision and reserve and write-off.

- The loan loss provision in the current period, a non-cash (operating) expense appears on the income statement, which is a cushion against likely loan losses from loans outstanding in that period and is based on an aging of all types of loans that are outstanding during the period. It is an amount added to the existing loan loss reserve, given the present loan aging position.
- Loan Loss Reserve appears as a negative asset on the Balance Sheet. In the first year of operation of an MFI, the loan loss reserve = loan loss provision because that is the 1st time a provision is being made. However, in the subsequent years, loan loss provision adds to the existing loan loss reserve.
- On the other hand, actual loan losses (often defined by the write-off policy) reduce the existing loan loss reserve (as well as the outstanding portfolio) and usually (but not compulsorily) correspond to earlier loans (for which provisions have already been made in an earlier period based on an aging schedule then available).

Now, let's recall the fundamental accounting principle.

Assets and Expenses		Liabilities, Equity and Income	
Debit (Dr)	Credit (Cr)	Debit (Dr)	Credit (Cr)
INCREASES	DECREASES	DECREASES	INCREASES

Refer to the table calculating provision amount in Sec. 4.2.2

Loan Loss Provision Expense is added (increased) by Rs. 14,350

Therefore, the corresponding accounting entry will be - DEBIT Loan Loss Provision (increase of expense and gets to the equity side of the Balance sheet via retained net surplus/deficit)

Since provision amount is added to Loan Loss Reserve, hence,

Loan Loss Reserve is increased by the same amount – Rs. 14,350

The corresponding accounting entry will be - CREDIT loan Loss Reserve (increase of a negative asset that reduces the net portfolio outstanding and hence, total assets or increase of a liability)

The summary of accounting entries of Loan loss provision and Reserve:

Particulars	Entries	Amount
Loan Loss Provision Expense (<i>Increase of Expense</i>)	DEBIT	Rs. 14,350
Loan Loss Reserve (<i>Increase of –ve asset or Increase of liability</i>)	CREDIT	Rs. 14,350

Processing the Loan Write-offs

Suppose that Rs. 3,000 is written off (declared as bad debt by the MFI)

It reduces (decreases) the Loan Loss Reserve by write-off amount of Rs. 3,000

The corresponding accounting entry will be - DEBIT Loan Loss Reserve (Decrease of a negative asset or a liability)

At the same time it also reduces (decreases) the Outstanding Portfolio by write-off amount.

The corresponding accounting entry will be - CREDIT Loans Outstanding (Decrease of an asset)

The summary of accounting entries of Write-off:

Particulars	Entries	Amount
Loan Loss Reserve (<i>Decrease of –ve asset or decrease of liability</i>)	DEBIT	Rs. 3,000
Outstanding Portfolio (<i>Decrease of an asset</i>)	CREDIT	Rs. 3,000

Here we need to understand that loan write-offs are reduced from the loan loss reserve because provisions for these 'overdue' loans must have already been made earlier and also already added to the reserve. Therefore, charging these write-offs to the loan loss reserve is most appropriate.

Now what happens, when already written off loans are collected?

The norm is to increase income as the loan loss provision made *earlier* was charged as an expense. Thus, when written off loans are collected, then accounting entries would be as follows (taking the same example, let us say Rs 1,000 is collected from the loan that was written off earlier)

CREDIT Miscellaneous Income (Increase of Income)

DEBIT Cash (Increase of an Asset)

The summary of accounting entries of amount recovered from written-off loans:

Particulars	Entries	Amount
Miscellaneous Income (Increase of Income)	CREDIT	Rs 1,000
Cash (Increase of an Asset)	DEBIT	Rs 1,000

In summary, the following procedure is adopted while accounting for loan loss reserve.

Loan Loss Reserve at the beginning of the Period
 + (PLUS)
 Loan Loss Provision for the Period
 - (MINUS)
 Loan Write-offs during the period
 = (EQUAL TO)
 Loan Loss Reserve at the end of the period.

Summary of concepts and accounting norms for Loan Loss Provision, Reserve and Write-offs

A provision records the *possibility* that the outstanding loan portfolio of an MFI is not 100% realisable and it treats the anticipated loss in the value of loan portfolio as a business expense during the period.

Loan loss reserve represents the amount of loan outstanding that is expected to turn bad.

Provision is mere accounting entry and doesn't involve cash movement like savings for rainy day

Loan loss provision charged is an expense for the period, thus, it affects the Income and Expenditure Statement. Since the corresponding credit accumulates over time under reserve, it also affects the Balance sheet where it is shown as a negative asset (alternatively as a liability)

Dr - Loan loss provision
Cr - Loan loss reserve

Provisioning for loan loss, however, doesn't affect the loan ledger.

Loan losses or write-offs occur when it is determined that loans are no more recoverable.

A write-off is an accounting procedure that removes the outstanding balance of the loan from the gross loan portfolio and from the loan loss reserve, thus, produce changes in the asset side of the balance sheet.

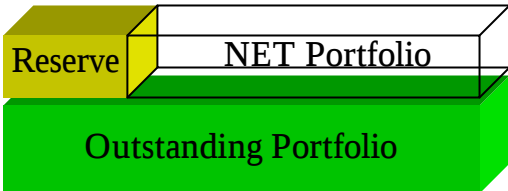
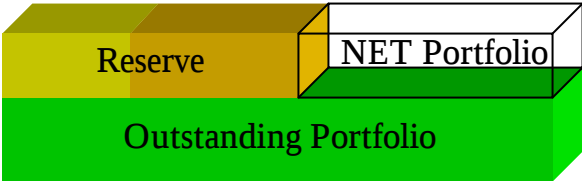
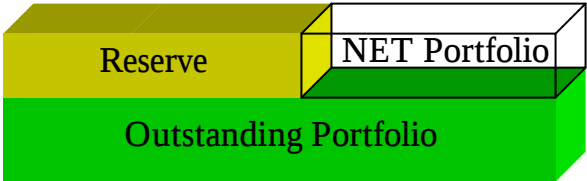
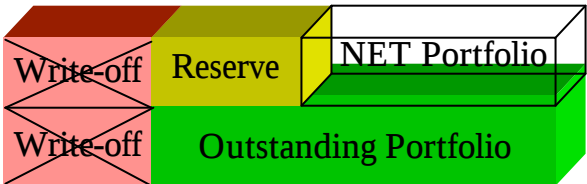
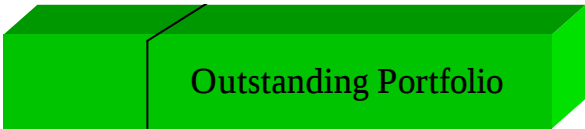
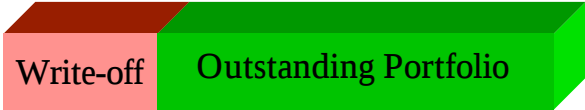
Dr - Loans Loss Reserve
Cr - Outstanding Loans

However, write-offs do not affect the balance of the net loan portfolio, total assets, or any equity account unless the write-off amount is less than or equal to the reserve, OR an increase in the loan reserve is made.

Write-offs do not affect the income statement, if provisions are made at appropriate times, however, it does affect the loan ledger.

When write-offs are recovered, they are booked in the income and expenses statement as miscellaneous income

Effect of Reserves and Losses on Balance Sheet value of Outstanding Portfolio

	Loan Loss Provision (recorded as expense in Income Statement)	Loan Loss Reserve (reduces total portfolio in Balance Sheet)
1st Year		
2nd Year		 
		
NO PROVISIONING		
1st Year	(Overstated Income)	(Overstated Assets) 
2nd Year		  (Sudden Decrease)

4.3 LOAN PORTFOLIO REPORT – KEY DEFINITIONS & INTERPRETATIONS

In Chapter 3, we learn about construction of two statutory financial statement (Balance Sheet and Income Statement) of MFI. Till now in this chapter, we learn about aging analysis. In this section, we will learn to prepare another important (non statutory) financial statement called Portfolio Report.

The portfolio report provides an overview of performance of the most significant asset of an MFI, its loan portfolio. Therefore, a separate report is required to track the most important portfolio. The report become very crucial in a sense that safeguarding the quality of loan portfolio is primary responsibility of MFI's management. The complete portfolio report with an aging analysis provides the desired information about the micro-credit operations. Like Income Statement, Portfolio report is also prepared for a particular period. A sample Loan Portfolio Report is presented below (Table 13). The following discussion uses the sample report given below to explain the various aspects pertaining to the loan portfolio report.

Table 13 – Sample Portfolio Report

Portfolio related Data for the Year ending March 31, 2001, March 31, 2002 & March 31, 2003						
I	II	III	IV	V		
Sl.	Description	2001	2002	2003		
P1	Total value of loans disbursed during period	176,000	260,000	320,000		
P2	Total number of loans disbursed during period	2,200	2,600	3,200		
P3	Number of Active Borrowers (End of Period)	2,640	3,100	3,600		
P4	Average number of Active Borrowers	2,170	2,870	3,350		
P5	Value of loans outstanding (End of period)	104,000	140,000	168,000		
P6	Average outstanding balance of loans	90,000	122,000	150,000		
P7	Value of payments in arrears (End of period)	20,000	18,000	140,00		
P8	Value of outstanding balance of loans in arrears (End of period)	40,000	40,000	40,000		
P9	Value of loans written off during period	0	6,000	1,000		
P10	Average loan size	160	200	200		
P11	Average loan term (months)	24	24	24		
P12	Average number of loans officers during period	8	12	12		
P13	Value of Re-Scheduled Loans Outstanding	0	0	0		
P14	Value of Re-Financed Loans Outstanding	0	0	0		
P15	Value of Loan Outstanding for which Repayment is yet to begin	0	0	0		
Aging Analysis of Outstanding Loans for Year Ending March 2003						
Sl. No	Type of Loan	Outstanding		(IV) as a % of Total Loan Outstanding	Provision Rate	Provision Amount
		No. of Loans	Value of Loans			
I	II	III	IV	V	VI	VII
P16	Regular Loans	2810	128,000	76.19 %	0%	-
P17	Less than 30 Days past due	400	17,500	10.42 %	10%	1,750
P18	Between 31- 60 days past due	150	10,000	5.95 %	25%	2,500
P19	Between 61- 90 days past due	120	5,000	2.98 %	50%	2,500
P20	Between 91- 180 days past due	50	3,500	2.08 %	75%	2,625
P21	Between 181- 365 days past due	40	2,500	1.49 %	90%	2,250
P22	> 365 days past due	30	1,500	0.89 %	100%	1,500
P23	Total	3,600	168,000	100.00%	-	13,125

Explanation of Portfolio Report (Table 13) is given below

Explanation of each row (1 to 15) of Portfolio related Data for the Year ending March 31, 2001, March 31, 2002 & March 31, 2003, is provided here

1. Total Value of Loans Disbursed during the Period – Refers to the total value (in currency) of loans disbursed in a specific time period regardless of whether they are performing, non-performing or written off. This value should not be confused with gross loan portfolio, which can be several times less than the value disbursed. (See Column II, Row P1).
2. Total Number of Loans Disbursed during the Period – Refers to the total number of loans disbursed in a specific time period. For MFIs using a group lending methodology, the number of loans should refer to the number of individuals receiving part of a group loan, unless the MFI specifies a different definition. (See Column II, Row P2).
3. Number of Active Borrower (end of period) - Refers to the number of borrowers with one or more loan in force that have neither been fully repaid nor written-off. Borrowers, who have repaid their loan in full, are not considered in this number. The number of active borrowers will be lower than the number of loan outstanding, if some borrowers have more than one loan. (See Column II, Row P3).
4. Average Number of Active Borrower – Refers to the average no. of active borrowers (as defined above) over a period. Average number of active borrowers can be estimated by taking the no. of active borrowers at the first date of the period and adding the no. of active borrower at the last date of the period and dividing the sum by two. (See Column II, Row P4).
5. Value of Loans Outstanding (end of period) - Refers to the current value (in currency) of loans still not paid at a specific date. It differs from the “Total Value of Loans disbursed during the period” and it consider just the amount that is currently owed to the organisation. In other words, only unpaid principal balance of loan disbursed is included in Value of Loans Outstanding. (See Column II, Row P5) {for details see section 3.3.2.1 (c) in chapter 3}.
6. Average Outstanding Balance of Loans - Refers to the average value (in currency) of loans outstanding over a period. Average Outstanding Balance can be estimated by taking the opening balance of loans outstanding at the first date of the period and adding the closing balance of loans outstanding at the last date of the period and dividing the sum by two. (See Column II, Row P6)

In order to increase the accuracy of this calculation, the balance of loans at the end of any given interval (midway through the period, end of each month, etc.) can be used, provided, the total figure is divided by the number of intervals used.

For example, to determine the Average Outstanding Balance for a 12-month period using monthly intervals, the outstanding balance at the end of each month would be added together and the total figure divided by 13.

As per our example, for year 2002, the average outstanding balance of loans (as the approximate formula) is $(104,000 + 140,000)/2 = 122,000$. (Row P5 and Column IV). While for cursory analysis, one may use the approximate formula of opening balance plus closing balance and dividing this by 2, it is imperative that from a best practices perspective, the accurate formula of adding all month end balances with the opening balance and dividing by 13 is followed.

7. Value of Payments in Arrears (end of period) - Refers to the value (in currency) of payments in arrears – payments that have been due and not paid. This figure includes principal only that has become due but has not been received as of the end of the period. (See Column II, Row P7)

8. **Value of Outstanding Balance of Loans in Arrears (end of period)** - Refers to the total value (in currency) of loans that have one or more payments in arrears. Includes principal amount only, but covers the total loan amount outstanding, not just the amount of principal that has fallen due and not been received. Also referred to as “Portfolio at Risk” (*for details see section 5.1.1 in chapter 5*) when this is divided by the outstanding portfolio. (See Column II, Row P8).
9. **Value of Loans Written-Off during the Period** - Refers to the value (in currency) of loans that have been recognised for accounting purposes as non-recoverable and is removed from the outstanding balance of the loan from the gross loan portfolio and from the loan loss reserve in the Balance Sheet, without affecting balance of the net loan portfolio, total assets, or any equity account. (See Column II, Row P9)

Writing off loans is always a difficult decision and it must be carefully taken (*refer the bottom part of section 4.2.1 in this chapter*)

Writing off loans too rapidly can make an organisation’s loan portfolio look much healthier than it may be, as the Portfolio at Risk appears small.

By the same token, past due loans, which should be written off but are still included in an organisation’s outstanding loan figure overstate the size of the organisation’s healthy portfolio and consequently distort the financial picture.

10. **Average Loan Size** - Refers to the average size of loans at the time of disbursement. (See Column II, Row P10)

This would normally be determined in the following manner:

$$\frac{\text{Value of Loans Disbursed during the period (P1)}}{\text{Number of Loans Disbursed during the period (P2)}}$$

Using the above formula, we get the average loan sizes for years ending March 2002 as 100 (260,000/2,600) and March 2003 as 100 (320,000/3,200).

11. **Average Loan Term** - Refers to the amount of time that loans, on average, are outstanding. In other words, it’s the average period in which borrowers are supposed to pay back the entire sum of money lent by the MFI. (See Column II, Row P11)
12. **Average Number of Loan Officers during Period** - The term “loan officer” refers to *field personnel* or *line officers* who deal directly with clients in disbursing loans and collecting loan payments (i.e., employees who are part of the Microfinance programme). Though ‘loan officer’ directly interact with the client, but not with administrative staff or analysts who process loans without direct client contact. Loan officers include contract employees who may not be part of permanent staff, but are contracted on a regular basis in the capacity of loan officer.

Number of loan officers is reported on a full-time-equivalent basis. In cases where a staff member manages some loans, but also has other duties (for instance, a supervisor), this indicator should include a fraction < 1 that represents the amount of time spent doing loan officer duties. For instance, an MFI that has 5 loan officers and one supervisor that manages some loans may report 5 ½ as the number of loan officers. The average (rather than the absolute number) is taken because there could be a turnover of the employees. (See Column II, Row P12).

Apart from the above, best practices recommendations suggest that the following additional information should be a part of Portfolio Report in order to ensure greater transparency and accuracy in the risk estimates

13. Value of Re-Scheduled Loans outstanding - Refers to the value of loans that have been re-scheduled – all outstanding loans, whose terms have been changed but no new amounts have been given (additionally) (See Column II, Row P13).
14. Value of Re-Financed Loans outstanding - Refers to the value of loans that have been re-financed – all outstanding loans, whose terms have been changed and also new amounts have been given additionally (See Column II, Row P14).
15. Value of Loans outstanding for which repayment is yet to begin - Refers to the value of loans outstanding for which the repayment schedule is yet begin. These could include loans that have a longer moratorium period as well as loans that have been recently disbursed. (See Column II, Row P15).

- ♦ The reason for obtaining this information is that, inclusion of such loans (outstanding) in the total outstanding portfolio will understate the risk inherited in portfolio.
- ♦ In some cases, clients' repayment behaviour is not observable (as repayment has not yet started), hence, the Portfolio risk will remain understated. Therefore, to present the true picture of the risk, it is fair and accurate to make proper adjustment by deducting these amounts from the outstanding portfolio (*also see section 5.1.1.6, 5.1.1.7 and 5.1.1.8 in chapter 5*).
- ♦ Of course, these amounts would have to be automatically included in the total outstanding portfolio, once the repayment schedule begins.

The rows 16 to 23 of portfolio report is aging analysis of all outstanding loans for year ending March 31, 2003. It is similar as aging analysis table explained earlier in this chapter in section 4.2.2. A brief explanation of each column of aging analysis is given below:

- ♦ Column I gives the row identification number,
- ♦ Column II is the description of the type of loans classified as regular and various days past due.
- ♦ Column III provides the number of such loans in the various categories, as mentioned above.
- ♦ Column IV gives the value of unpaid principal balance (or loan outstanding) for the respective category of loans (both current and past due by different days). This total should equal the amount given in row P5, *Column V*.
- ♦ Column V shows the percentage of loans outstanding in each of the categories (as a proportion of the total loans outstanding). The total here should equal 100%. It also highlights the Portfolio at risk for loans in each of the categories of past due loans (*for details see section 5.1.1 in chapter 5*).
- ♦ Column VI gives the risk factor in terms of the percentage of the loan outstanding that will (perhaps) be not recovered. This is available for each of the categories of loans (regular and past due loans by different days).
- ♦ Column VIII provides the amount at risk for the different types of loans, taking into account the loan outstanding and the risk factor.



PERFORMANCE STANDARDS-CONCEPT,
DEFINITIONS, CALCULATION AND
METHODOLOGICAL ISSUES

Chapter

5

PERFORMANCE STANDARDS - CONCEPT, DEFINITIONS, CALCULATION AND METHODOLOGICAL ISSUES

In chapter 2 we learn about the conceptual framework of financial performance standards and their basic features. Also, we learnt about the broad thematic areas of financial performance of an MFI and standards recommended by Sa-Dhan under each thematic area of financial performance.

In this chapter we will try to define each of the broad areas of financial performance standards suggested by Sa-Dhan, identify specific indicator(s) for each performance area, provide conceptual & operational definitions of these indicators along with a discussion of their strengths/weaknesses and identify key methodological issues with regard to their calculation.

5.1 ASSET QUALITY STANDARDS

1. Asset Quality Standards signify the performance level of the most important asset (loan portfolio) of an MFI. It helps management and other stakeholders to know whether the institution is doing a responsible job of managing its portfolio. More specifically, it tells that what portion of loan portfolio (asset) is good or bad.
2. This group of ratios are very crucial for an MFI because the “loan portfolio” is the primary income generating asset of a micro-finance institution
3. The risk that some of the loans will not earn expected revenue and may not be paid back (at all) is very real and must be anticipated as business risks.
4. Management of the twin risks of repayment of principal amount and of interest income are crucial because of their impact on overall viability of the micro-credit operation.
5. Therefore, timely and periodic monitoring of this group of ratios would enable MFIs to detect delinquency on performance of loans given by the MFI.
6. The key Asset Quality Ratios to be monitored¹⁰ are Portfolio at Risk and the traditionally used Current Repayment Rate, despite it not being a genuine measure of portfolio quality.
7. The various statements/reports/records required for calculating Asset Quality Ratio are given below

Statements/Reports Required for Calculation of Assets Quality Ratios	
Statement/Reports / Records	Requirements
Portfolio Report with Aging Schedule	Yes, this alone is required and sufficient. But, the aging of loans must be done in an accurate manner.
Balance Sheet	Could be used if appropriately structured, especially to include information on past due and restructured loans
Loan Ledger (Individual & Aggregated)	Yes, required and very important

¹⁰ These are generally calculated for Principal Amounts but most of the same concepts can be applied for interest payments as well.

5.1.1 Portfolio At Risk

$$\frac{\text{Sum of Unpaid Principal Balance of All Loans with Payments Past Due}}{\text{Total Gross Outstanding Loan Portfolio (Sum of Principal Outstanding of All Loans)}}$$

Trend - A decreasing "Portfolio at Risk" is positive but this trend can be misleading because a lower ratio can be obtained by simply increasing the denominator (the size of loan portfolio). In other words, sudden and large disbursements of loans could mask the actual delinquency risk. Alternatively, in a growing MFI that is fast expanding in terms of loan disbursements, the same limitation applies. (*Limitation of this measure is discussed in detail in section 5.1.1.5 in this chapter ahead.*)

Standard Proposed by Sa-Dhan – Portfolio at Risk > 60 Days should be <10%

5.1.1.1 What is meant by Portfolio at Risk (PAR)? - Simple Definition

- ☞ Portfolio at Risk (also called as "PAR") is a percentage (%).
- ☞ It represents the "proportion of an MFI's total gross outstanding loan portfolio that is at (default) risk"
- ☞ It is perhaps the most important measure of an MFI's asset quality

5.1.1.2 What does it measure?

- ☞ PAR attempts to measure the default risk in a portfolio by using past as well as future data.
- ☞ Its estimation is based on the key question that, if all delinquent borrowers are to completely default, then how much (money) would the MFI stand to lose?
- ☞ From this perspective, Portfolio at Risk (PAR) provides a pessimistic estimate of the default risk in an MFI's portfolio.

5.1.1.3 What minimum records are required for calculating PAR?

- ☞ Loan ledger with disbursement, schedule and repayment data on each individual loan backed-up a comprehensive credit policy outlining various terms and conditions.
- ☞ Aggregation of the loan ledger data with regard to delinquent and current loans – either a simple aging table or comprehensive portfolio report

5.1.1.4 How to calculate PAR?

Some generalised mandatory steps to calculate PAR are given below:

Step 1: Using the loan policy and business rules, please clearly identify the following for each and every (outstanding) loan:

1. Loan Amount Disbursed
2. Number of Installments
3. Frequency of Installments
4. Interest Rate (Annual)

5. Interest Computation Method
6. Repayment Assumptions (including grace/moratorium period, whether equal installments for principal are there etc.)

Step 2: Using the above, fill out the Principal and Interest Amounts Due with Dates Due for each installment of every loan (*see table 9*).

Step 3: Write down the total amounts paid by clients along with dates of payments (these are transactions of repayments made by clients)

Step 4: Calculate interest due as per payment date for each installment. If due date of installment and payment date are one and the same, then interest due as per payment date will be the same as interest due as per schedule. Otherwise, it will differ. This is a very crucial aspect that should not be ignored.

Step 5: Once the transaction amounts are available, allocate or distribute these total amounts as per the following norms

1st towards Fines/penalties (1st)

2nd towards Interest Overdue (2nd)

3rd towards Interest Due if it is actually due on the date of payment (3rd)

4th towards Principal Overdue (4th)

5th towards Principal (5th)

If there are no fines, it will first go towards Interest Overdue, then Interest Due if it is actually due on that date, then Principal Overdue and Last towards Principal

Step 6: Now, at end of each installment, check whether total amount paid = Fines Paid + Interest O/D Paid + Interest Paid + Principle O/D Paid + Principle Paid.

Step 7: At end of each installment also get the following totals

- Principle Outstanding,
- Principle Overdue,
- Interest Overdue
- Principle Paid
- Interest Paid
- Fines Paid, and
- Prepayments

Prepayments will occur when a client makes payment in excess of principal + interest due (including over dues) plus fines to be paid till that installment

Step 8: Check if Principle or Interest O/D > 0 and if so, then determine age of the overdue loan as of a particular date or installment.

Step 9: To calculate age as at end of any installment, check for unpaid over dues (principle or interest) and also ascertain when they occurred.

Step 10: Age at end of installment can be calculated as follows:

Age of Overdue Loan

= Date at which age is being calculated (i.e., today or date at end of installment)

–(Minus)

Date at which earliest UNPAID Overdue occurred

= “Y” Days.

Here unpaid is as of the reference date of calculating the age.

Step 11: After identifying age of all the loans, aggregate repayment schedules for all loan accounts and summarise them in the form of an aging schedule as given below. (See section 4.2.2 in chapter 4)

- Regular Loans (Loans with No Over Dues)
- Loans $\leq$ 30 Days Past Due
- Loans between 31-60 Days Past Due
- Loans between 61-90 Days Past Due
- Loans between 91-180 Days Past Due
- Loans between 181- 365 Days Past Due
- Loans $>$ 365 Days Past Due

Step 12: Calculating Portfolio at Risk

Using either of the reports (loan loss provision table or aggregated loan repayment format), sum the unpaid principal balance of all loans with payments past due (or overdue or arrears) and divide it by the Total Gross Outstanding Portfolio (which is the *sum of the outstanding principal amounts of all loans*). This is the Total Portfolio at Risk or PAR $\geq$ 1 Day. (The procedure is outlined in aging analysis Table – 13)

Arrive at the Portfolio at Risk (PAR) for past due loans with different ages. PAR is usually calculated for several categories

- ☞ $PAR \geq 1 \text{ Day} = \text{Sum of } PAR \text{ 1-30 Days} + 31-60 \text{ Days} + \dots PAR > 365 \text{ Days}$
- ☞ $PAR > 30 \text{ Days} = \text{Sum of } PAR \text{ 31-60 Days} + 61-90 \text{ Days} + \dots PAR > 365 \text{ Days}$
- ☞ $PAR > 60 \text{ Days} = \text{Sum of } PAR \text{ 61-90 Days} + 91-120 \text{ Days} + \dots PAR > 365 \text{ Days}$
- ☞ $PAR > 90 \text{ Days} = \text{Sum of } PAR \text{ 91-120 Days} + 121-180 \text{ Days} + \dots PAR > 365 \text{ Days}$
- ☞ $PAR > 180 \text{ Days} = \text{Sum of } PAR \text{ 181-365 Days} + PAR > 365 \text{ Days}$
- ☞ $PAR > 365 \text{ Days (1 Year)} = \text{Sum of } PAR > 365 \text{ Days}$

Calculation of Portfolio at Risk from Portfolio Report:

Step 1 – The formula is

$\frac{\text{Sum of Unpaid Principal Balance of All Loans with Payments Past Due}}{\text{Total Gross Outstanding Loan Portfolio (Sum of Principal Outstanding of All Loans)}}$
--

Step 2 - Take the Unpaid Principal Balance of Past Due Loans for Year 2003 – it is 40,000 (Please refer to Portfolio Report - Table 13, Row P8, Column III for Unpaid Principal Balance of Past Due Loans for Year 2003)

Sl.	Description	2001	2002	2003
P8	Value of outstanding balance of loans in arrears (End of period)	40,000	40,000	40,000

Numerator of Formula

Step 3 - Take the Total Gross Outstanding Loan Portfolio for Year 2003 – it is 168,000 (Please refer to Portfolio Report, Row P5, Column III for total gross outstanding loan portfolio for Year 2003)

Sl.	Description	2001	2002	2003
P5	Value of loans outstanding (End of period)	104,000	140,000	168,000

Denominator of Formula

Step 4 - Divide Unpaid Principal Balance of Past Due Loans by Total Gross Outstanding Loan Portfolio as shown below and, we get Portfolio at Risk as 23.81% for year 2003

Sl.	Portfolio at Risk	2001	2002	2003
P8	Value of outstanding balance of loans in arrears (End of period) (A)	40,000	40,000	40,000
P5	Value of loans outstanding (End of period) (B)	104,000	140,000	168,000
	Portfolio at Risk Value = A / B =	38.46%	28.57%	23.81%

Likewise, the portfolio at risk for Years 2001 & 2002 are respectively 38.46% & 28.57%

Trend Analysis

The trend in portfolio at risk is decreasing, which is positive. During the period 2001-2003, Portfolio at Risk has come down by nearly 14.65% (38.46% - 23.81%) While the Total Outstanding Loan Portfolio has grown by 62% $\{(168,000 - 104,000) / 104,000\}$ from 2001 to 2003, Portfolio at Risk is reduced only by 38% $\{(38.46\% - 23.81\%) / 38.46\\}$ during the same period (there is no change in terms of absolute value of Portfolio at Risk). However, there have been loan write-offs as well during this period. Hence, reduction in PAR appears to be due to some collection of arrears, increase in total outstanding loan portfolio and loan write-offs.

Calculation of Portfolio at Risk by Age

Look at the aging analysis of loans in the table below (*bottom part of Table 13*)

Aging Analysis of Outstanding Loans for Year Ending March 2003

Sl. No	Type of Loan	Outstanding		(IV) as a % of Total Loan Outstanding	Provision Rate	Provision Amount
		No. of Loans	Value of Loans			
I	II	III	IV	V	VI	VII
P16	Regular Loans	2810	128,000	76.19 %	0%	-
P17	Less than 30 Days past due	400	17,500	10.42 %	10%	1,750
P18	Between 31- 60 days past due	150	10,000	5.95 %	25%	2,500
P19	Between 61- 90 days past due	120	5,000	2.98 %	50%	2,500
P20	Between 91- 180 days past due	50	3,500	2.08 %	75%	2,625
P21	Between 181- 365 days past due	40	2,500	1.49 %	90%	2,250
P22	> 365 days past due	30	1,500	0.89 %	100%	1,500
P23	Total	3,600	168,000	100.00%	-	13,125

PAR $\geq$ 1 day (past due) is sum of

PAR < 30 days (past due) – 10.42% (Row P 17, Column V) PLUS (+)
 PAR 31 – 60 days (past due) – 5.95% (Row P 18, Column V) PLUS (+)
 PAR 61 – 90 days (past due) – 2.98% (Row P 19, Column V) PLUS (+)
 PAR 91 – 180 days (past due) – 2.08% (Row P 20, Column V) PLUS (+)
 PAR 181 – 365 days (past due) – 1.49% (Row P 21, Column V) PLUS (+)
 PAR > 365 days (past due) – 0.89% (Row P 22, Column V)

= 10.42% + 5.95% + 2.98% + 2.08% + 1.49% + 0.89% = 23.81% for the year 2003

Similarly, PAR > 30 days (past due) is sum of

PAR 31 – 60 days (past due) – 5.95% (Row P 18, Column V) PLUS (+)
 PAR 61 – 90 days (past due) – 2.98% (Row P 19, Column V) PLUS (+)
 PAR 91 – 180 days (past due) – 2.08% (Row P 20, Column V) PLUS (+)
 PAR 181 – 365 days (past due) – 1.49% (Row P 21, Column V) PLUS (+)
 PAR > 365 days (past due) – 0.89% (Row P 22, Column V)

= 5.95% + 2.98% + 2.08% + 1.49% + 0.89% = 13.39%

Likewise, PAR > 60 days (past due) is sum of

PAR 61 – 90 days (past due) – 2.98% (Row P 19, Column V) PLUS (+)
 PAR 91 – 180 days (past due) – 2.08% (Row P 20, Column V) PLUS (+)
 PAR 181 – 365 days (past due) – 1.49% (Row P 21, Column V) PLUS (+)
 PAR > 365 days (past due) – 0.89% (Row P 22, Column V)

= 2.98% + 2.08% + 1.49% + 0.89% = 7.44%

Similarly, PAR > 90 days (past due) is 4.46%

Similarly, PAR > 180 days (past due) is 2.38%

Similarly, PAR > 365 days (past due) is 0.89%

5.1.1.5 What events/activities affect (distort) PAR?

Sl. No.	Events/Activities that affect PAR	Impact on Numerator	Impact on Denominator	Impact on PAR
1	Rescheduling	Decreases Numerator	None	Reduces the whole PAR Ratio, while default risk still exists
2	Refinancing	Decreases, assuming overdue amounts are rescheduled	Increases, if additional amounts are given to same client	Reduces the whole PAR Ratio, while default risk still exists
3	Write-offs	Decreases Numerator	Decreases Denominator	Reduces the whole PAR Ratio, while default risk still exists
4	Fresh Loan disbursements for which repayments are yet to begin (including those with a long grace / moratorium period)	None	Increases Denominator	Reduces the whole PAR Ratio, while default risk still exists
5	Incorrect ageing of past dues, based on the installment method of aging (<i>see Box next page</i>)	None	None	Distorts the age of past dues and affects provisioning, reserve and sustainability
6	Sequence of payments, Principal first and interest next	Decreases the numerator	None	- Reduces the whole PAR Ratio, while default risk still exists - Distorts the age of past dues and affects provisioning, reserve and sustainability and through reduction of interest payments (yield)
7	Weekly Repayments	None	None	- Distorts the age of past dues and affects provisioning, reserve and sustainability - Here, PAR > 30 days will have to interpreted differently as for a loan with weekly repayments, it means that at least 4 installments have become past due and are at risk. This is very different from the conventional PAR > 30 days used for loans with monthly repayments
8	Balloon Repayments, as in case of agriculture loans (> 90 Days or equal to a quarter)	None	None	- Distorts the age of past dues (over dues) and affects provisioning, reserve and sustainability - Here, PAR > 30 Days, > 60 Days, > 90 Days, etc. have to be redefined and interpreted accordingly

Example of Incorrect Aging and Implications for using PAR as a Standard

Consider the following example

- ☞ The loan term finishes on January 31, 2002
- ☞ The amount overdue is 400 (part of which is overdue since December 2001)
- ☞ The amount per monthly installment is 200
- ☞ As per the installment method of calculation of age:

$$\text{Age} = \frac{\text{Overdue Amount}}{\text{Installment Amount}}$$

- ☞ The age as on January 31, 2002 is

= 400 Divided by 200 = 2.0 Months

This is correct.

- ☞ Now, assume that we are in end May 2002. The age as per the installment aging formula is still 2 months (assuming that the client has not paid back any further amounts), which is not correct
- ☞ But the actual age is 2 months till January + February + March + April + May = 6 months
- ☞ Now, assume that PAR > 60 Days or PAR > 90 Days is used as a standard.
- ☞ Thus, if the aging done by the MFI is based on the installment (incorrect) method, such loans, which are actually 6 months past due WILL never come into the fold of PAR > 60 Days or PAR > 90 Days. And if there are a large number of such loans, because of the erroneous method of aging, the reported PAR values will also portray an incorrect picture and hence, the standard of using PAR based on age would also become ineffective.
- ☞ In fact, after a loan is passed its scheduled loan term, if this incorrect method of aging is used, PAR by Age will always be under reported. Consider that there are several loans that are actually more than 180 days past due. While individually they may constitute a small percentage and contribute accordingly to PAR, cumulatively, if a large number of such loans exist, their impact on PAR would become significant. And this becomes even more serious when their age is distorted and PAR by age is used as a standard. This aspect is highlighted sequentially.

5.1.1.6 Adjusting the Portfolio at Risk Measure

As noted earlier, PAR has a serious limitation in that it is affected by sudden and large increases in outstanding portfolio and/or decreases in the unpaid principal balance, which can be caused in any of the following ways:

- Disbursement of loans (increases outstanding portfolio but will not have an impact on the unpaid principal balance of past due loans, especially, if the repayment schedule has not begun)
- Rescheduling of past due loans (reduces the unpaid principal balance of past due loans by making them current; there is no impact on outstanding portfolio)
- Re-financing of past due loans (reduces the unpaid principal balance of past due loans by making them current and also increases the outstanding portfolio)
- Loan write-offs (reduces the unpaid principal balance of past due loans and also reduces the outstanding portfolio)

When the outstanding portfolio increases, then the ratio *appears* lower and so does the risk. Likewise, when the unpaid principal balance of past due loans decreases, the ratio becomes smaller and the risk appears less. *But actually, the risk is still high.*

Thus, one has to look at alternative ways of measuring PAR, to adjust for re-scheduling/re-financing /write-offs and also recent loan disbursements, to get the true picture of default risk in the portfolio

PAR (without adjustments for rescheduling) + Rescheduling Ratio = PAR (Adjusted for rescheduling). This is given in box below

Portfolio at risk (PAR) = (Adjusted for Rescheduling)	Unpaid Principal Balance of Loans with Payments Past Due + Unpaid Principal Balance of re-scheduled loans (when Rescheduled)
	Outstanding Portfolio

Likewise, one can adjust the PAR for re-scheduling and re-financing

Portfolio at risk (PAR) = (Adjusted for Rescheduling and Re-financing)	Unpaid Principal Balance of Loans with Payments Past Due + Unpaid principal balance of re-scheduled and re-financed loans
	Outstanding Portfolio

Similarly, one can adjust the PAR for new loan disbursements for which repayment is yet to begin

Portfolio at risk (PAR) = (Adjusted for recent disbursements)	Unpaid Principal Balance of Loans with Payments Past Due
	Outstanding for Loans for which the repayment is yet to begin)

Finally, one can also adjust for write-offs, especially, if they have been huge.

Portfolio at risk (PAR) = (Adjusted for Write-Offs)	Unpaid Principal Balance of Loans with Payments Past Due + Write-Off Amounts
	Outstanding Portfolio + Write-Off Amounts

The impact of sudden and large increases in outstanding portfolio and/or decreases in the unpaid principal balance, on PAR is illustrated ahead with examples.

5.1.1.7 Impact on Various Scenarios on PAR

Situation 1 – Base Case					
Type of Loans	Value of Loans Outstanding	Percentage of Portfolio	Portfolio at Risk	Provision Rate	Provision Amount
Current Loans	100,000	59.17%	-	0%	-
Loans < 30 Days Due	10,000	5.92%	5.92%	10%	1,000
Loans 31 - 60 Days Due	10,000	5.92%	5.92%	25%	2,500
Loans 61 - 90 Days Due	10,000	5.92%	5.92%	50%	5,000
Loans 91 - 180 Days Due	10,000	5.92%	5.92%	75%	7,500
Loans 181 - 365 Days Due	20,000	11.83%	11.83%	90%	18,000
Loans > 365 Days Due	9,000	5.33%	5.33%	100%	9,000
Total	169,000	100.00%	40.83%	-	43,000

PAR (Unadjusted)	40.83%
Provision Amount	43,000.
PAR (Adjusted)	40.83%

Situation 2 - Loans greater than 365 days over due Re-scheduled					
Type of Loans	Value of Loans Outstanding	Percentage of Portfolio	Portfolio at Risk	Provision Rate	Provision Amount
Current Loans	109,000	64.50%	-	0%	-
Loans < 30 Days Due	10,000	5.92%	5.92%	10%	1,000
Loans 31 - 60 Days Due	10,000	5.92%	5.92%	25%	2,500
Loans 61 - 90 Days Due	10,000	5.92%	5.92%	50%	5,000
Loans 91 - 180 Days Due	10,000	5.92%	5.92%	75%	7,500
Loans 181 - 365 Days Due	20,000	11.83%	11.83%	90%	18,000
Loans > 365 Days Due	-	0.00%	0.00%	100%	-
Total	169,000	100.00%	35.50%	-	34,000

PAR (Unadjusted)	35.50%
Provision Amount	34,000
Re-scheduled Amount	9,000
PAR (Adjusted)	40.83%

Situation 3 - Re-Scheduled Loans > 365 days over due and Re-Financed them Rs 10,000 more					
Type of Loans	Value of Loans Outstanding	Percentage of Portfolio	Portfolio at Risk	Provision Rate	Provision Amount
Current Loans	119,000	66.48%	-	0%	-
Loans < 30 Days Due	10,000	5.59%	5.59%	10%	1,000
Loans 31 - 60 Days Due	10,000	5.59%	5.59%	25%	2,500
Loans 61 - 90 Days Due	10,000	5.59%	5.59%	50%	5,000
Loans 91 - 180 Days Due	10,000	5.59%	5.59%	75%	7,500
Loans 181 - 365 Days Due	20,000	11.17%	11.17%	90%	18,000
Loans > 365 Days Due	-	0.00%	0.00%	100%	-
Total	179,000	100.00%	33.52%	-	34,000

PAR (Unadjusted)	33.52%
Provision Amount	34,000
Re-scheduled Amount	9,000
Re-Financed Amount	10,000
PAR (Adjusted)	44.13%

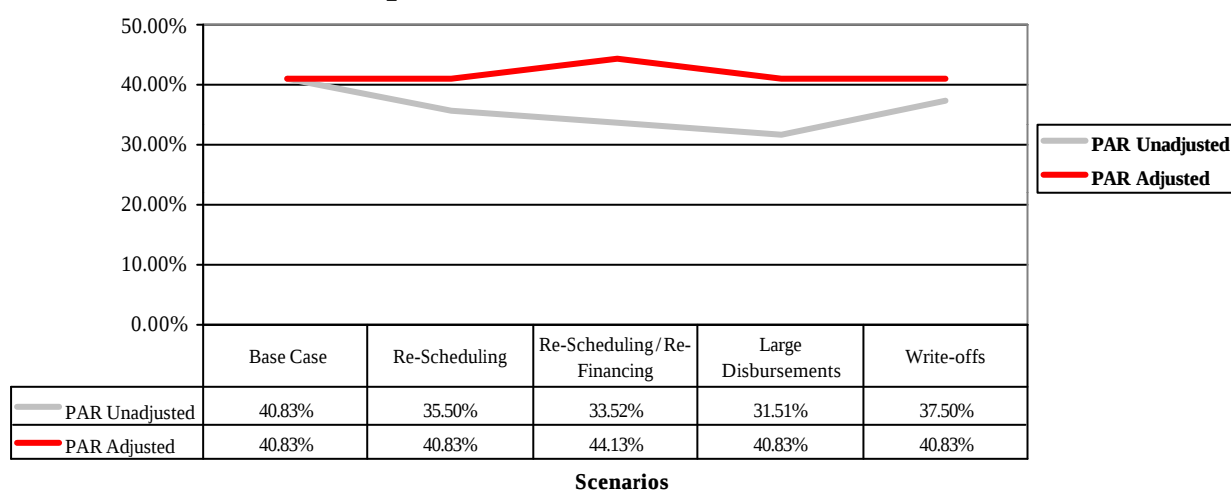
Situation 4 - New disbursements of Rs 50,000 for which repayment is yet to begin					
Type of Loans	Value of Loans Outstanding	Percentage of Portfolio	Portfolio at Risk	Provision Rate	Provision Amount
Current Loans	150,000	68.49%	-	0%	-
Loans < 30 Days Due	10,000	4.57%	4.57%	10%	1,000
Loans 31 - 60 Days Due	10,000	4.57%	4.57%	25%	2,500
Loans 61 - 90 Days Due	10,000	4.57%	4.57%	50%	5,000
Loans 91 - 180 Days Due	10,000	4.57%	4.57%	75%	7,500
Loans 181 - 365 Days Due	20,000	9.13%	9.13%	90%	18,000
Loans > 365 Days Due	9,000	4.11%	4.11%	100%	9,000
Total	219,000	100.00%	31.51%	-	43,000

PAR (Unadjusted)	31.51%
Provision Amount	43,000
Fresh disbursement (Repayment yet to begin)	50,000
Unpaid Principal Balance	69,000
Outstanding Portfolio (Unadjusted)	219,000
Adjusted Outstanding Portfolio	169,000
PAR Adjusted	40.83%

Situation 5 - Write-Off Loans > 365 Days Due					
Type of Loans	Value of Loans Outstanding	Percentage of Portfolio	Portfolio at Risk	Provision Rate	Provision Amount
Current Loans	100,000	62.50%	-	0%	-
Loans < 30 Days Due	10,000	6.25%	6.25%	10%	1,000
Loans 31 - 60 Days Due	10,000	6.25%	6.25%	25%	2,500
Loans 61 - 90 Days Due	10,000	6.25%	6.25%	50%	5,000
Loans 91 - 180 Days Due	10,000	6.25%	6.25%	75%	7,500
Loans 181 - 365 Days Due	20,000	12.50%	12.50%	90%	18,000
Loans > 365 Days Due	-	0.00%	0.00%	100%	-
Total	160,000	100.00%	37.50%	-	34,000

PAR (Unadjusted)	37.50%
Provision Amount (Unadjusted)	34,000
Write-Offs	9,000
Unpaid Principal Balance	60,000
Adjusted Principal Balance	69,000
Outstanding Portfolio (Unadjusted)	160,000
Adjusted Outstanding Portfolio	169,000
PAR Adjusted	40.83%

Impact of Various Scenarios on PAR



5.1.1.8 Loan Re-Scheduling and Re-Financing

MFI should have a clear policy on re-scheduling and re-financing, as they have the potential to decapitalise the RLF portfolio at all levels. They could also result in the ‘multiplier effect’ whereby, after re-scheduling and re-financing of some (clients’) loans, other clients also feel that they could get their loans re-scheduled/re-financed {also see section 4.3 (13), (14) and (15) in chapter 4}.

In the discussion, re-scheduling stands for revision in repayment terms at a time after the terms were originally set at time of sanction. Re-financing stands for sanctioning another loan while earlier loan is still outstanding, with inherent understanding that apportion /full amount of the second loan would be applied in full adjustment of the earlier loan.

Therefore, unless, the situation mandates, rescheduling and refinancing are better avoided as

1. If they are used to reduce delinquency, they can spell disaster for the portfolio
2. They make a risky portfolio appear less risky
3. Can result in causing clients to develop a mind set that in the event of not making loan repayments, their loans will also be automatically rescheduled/re-financed

Only in cases where natural factors such as earthquakes, fires, cyclones, floods, drought wreak havoc on economies and the activities of micro-entrepreneurs, can rescheduling and/or re-financing be thought of as alternatives. Please refer Box below for impact of Rescheduling, Refinancing and Write-off on loan loss reserve. The key point to note here is that apart from camouflaging the level of risk in a portfolio, such actions also reduce the loan loss provisions and reserves. This particularly, is not good, as the level of risk still remains the same.

The following calculations (please refer to various scenarios in section 5.1.1.7) illustrate the impact of rescheduling, re-financing and write-off on loan portfolio quality

Scenario Base Case	Loan Loss Reserve Rate in %	% change from	Comments
Base Case	12.72	Not Applicable	Correct Representation
Re-Scheduled Option	5.87	50% Decrease	Further Reduction in Loan Loss Reserve (LLR)
Write-Off Option	6.31	54 % Decrease	Significant Reduction in LLR (by 50%)
Re-Scheduled and	5.24	59 % Decrease	Further Reduction in LLR
Re-Financed Option			

5.1.2 Current Repayment Rate

$$= \frac{\text{Total Amount Received during period} - \text{Prepayments}}{\text{Total Amount Due}^{11} \text{ (to be collected during period)}} \times 100$$

Trend – An increasing Current Repayment Rate is positive

Standard Proposed by Sa-Dhan – Current Repayment Rate should exceed 90%

5.1.2.1 What does it measure?

- ☞ Current period repayment rate helps in understanding the behaviour of clients and performance of the institution in the on-going period.
- ☞ This can be especially useful when the institution has several years of micro-finance experience and a large overall disbursement, which can usually camouflage 'poor' performance in the current period.
- ☞ In other words, an excellent repayment track record in the past can shroud current poor repayment performance, especially if the volume of money lent in the current period is quite small in comparison to that lent cumulatively. Having the current period repayment rate is useful in such cases.

5.1.2.2 What minimum records are required for calculating the Current Repayment Rate?

- ☞ Loan ledger with disbursement, schedule and repayment data on each individual loan backed-up a comprehensive credit policy outlining various terms and conditions
- ☞ Aggregation of the loan ledger data with regard to delinquent and current loans – either a simple ageing table or comprehensive portfolio report
- ☞ Key financial statements like the Balance Sheet and Income Statement, appropriately constructed

5.1.2.3 How to calculate the Current Repayment Rate?

- ☞ Create a loan repayment schedule, identify whether the loan is delinquent and age the loan in days with regard to past dues (refer Table 9)
- ☞ Aggregate loan repayments schedules for all loans and summarise these in the form of a simple table (refer Table 12)
- ☞ Define the current period for calculating the repayment rates
- ☞ Sum the total principal amount paid so far by clients in current period (see table 12, last row, col. IX).
- ☞ Sum the prepayments, if any made by them so far. Prepayment would have occurred if the total amount paid by the client exceeds the amount due from the client (see table 12, last row, col. XI).
- ☞ Sum the total amounts due from the client till date in the current period - today or date of aggregation etc (see table 12, last row, col. VI).
- ☞ Then do the following calculation to get the Current Repayment Rate

¹¹ Some MFIs include past dues from previous period to track past due payments that were to be collected

$$\frac{\text{Total amounts paid so far by Clients in Current Period} - \text{Prepayments} \times 100\%}{\text{Total amounts due* from Clients till date in Current Period}}$$

* - Some MFIs include past dues that need to be collected from a previous period

Given the data in the Table 12, let's calculate the current repayment rate as per the method suggested

1. Total principal amount paid so far by clients (*Table 12 – last row, col. IX*) = Rs. 387,700
2. Prepayment amount as on the date of calculation (*Table 12 – last row, col. XI*) = Rs. 7,500
3. Total amounts due till date from client in current period (*Table 12 – last row, col. VI*) = Rs. 381,500

Now, as per the suggested method of calculation:

$$\frac{(1) - (2)}{(2)} = \frac{387,700 - 7,500}{381,500} = \frac{380,200}{381,500} = 99.66\%$$

5.1.2.4 What aspects affect Current Repayment Rate?

- ☞ The sequence of allocating client repayments – interest first versus principal first – has an impact on repayment rates. It is suggested that client repayments should be allocated in the following sequence - first to interest overdue, then to interest due, then to principal overdue and finally to principal due
- ☞ When aggregating repayments from various clients, prepayments of some clients could smoothen the non-repayment by other clients. Hence, prepayments should always be subtracted while calculating repayments rates
- ☞ Current period needs to be defined precisely and consistency maintained with regard to this

5.1.2.5 What is the utility of Current Repayment Rate?

- ☞ Monitoring current period delinquency. Can be extremely useful in doing the above if the MFI has been in operation for a long period of time
- ☞ Current period repayment rate provides a reflection of “how much” of the amount due in the current period is being paid by the clients.
- ☞ It provides an insight regarding what proportion of the amount due in current period is still overdue.
- ☞ In other words, it is a surrogate measure of the effectiveness of the programme in the current period. It is crucial to have current period repayment rates especially when an MFI has been operating for a large number of years.
- ☞ In such cases, the cumulative repayment rates, based on a large volume of loans disbursed, will offer little insight into immediate/programme performance.
- ☞ For example, it is quite possible that a programme, which has done very well for over 10 years, could suddenly be performing poorly.
- ☞ When cumulative disbursements are large, it would be almost impossible to find this out. Current period repayment rate is required for this.

5.1.2.6 Are Repayment Rates indeed reliable and valid indicators of asset quality?

- ☞ While they are indeed useful, repayment rates are not reliable and valid indicators of asset (portfolio) quality.
- ☞ As evident from the example given in Table 12, it is possible to have a very high repayment rate and yet a very high portfolio at risk - in excess of 80% (*illustration is given at end of this section*).
- ☞ While many MFIs use repayment rates to measure default risk in a portfolio, it must be remembered that repayment rates primarily express the amount paid by clients as a percentage of the amounts due from them.
- ☞ They do not measure default risk in a portfolio.
- ☞ In fact, the portfolio outstanding does not appear in the numerator or denominator in the repayment rate formula. Therefore, using repayment rates to get a measure of the default risk is inappropriate.

Calculation from Table 12 (see table below) demonstrates as to why Repayment Rates are not a Reliable/Valid Indicator of Portfolio Quality

Indicator	Formula	Value (in %)
Cumulative Repayment Rate (CRR)	$\frac{\text{Column IX Total} - \text{Column XI Total}}{\text{Column VI Total}}$	99.66%
PAR (Portfolio at Risk)	$\frac{\text{Column XIII Total}}{\text{Column XII Total}}$	38.79%
Portfolio at Risk Adjusted	$\frac{\text{Column XIII Total}}{\text{Column XII Total} - (\text{Sum of Row 13+14, Column XII})}$	81.19%

5.2 EFFICIENCY AND PRODUCTIVITY STANDARDS

Efficiency Ratios

1. Efficiency ratios help answer the question as to whether the institution serves as many people as possible with its resources for the lowest possible cost
2. They measure the cost of providing services (loans) to generate revenue. These costs are referred to as operating costs and should include neither financing costs nor loan loss provisions
3. Total operating costs can be stated as percentage of three amounts to measure the efficiency of the MFI: the average portfolio outstanding or average performing assets or total assets. For a more detailed analysis, operating costs can also be broken down to measure efficiency of specific cost elements such as salaries and benefits, occupational expenses such as rent and utilities, or travel
4. For MFIs that mobilise deposits, efficiency ratios will be somewhat different because additional operating costs are incurred to collect deposits. Therefore, efficiency ratios of MFIs that collect deposits should not be compared to MFIs that do not collect deposits. This analysis focuses only on the credit operations

In MFIs, three key factors influence the level of activities and hence operating costs:

1. Turnover of the loan portfolio (related to loan term)
2. Average loan size
3. Maturity (or experience) of the institution.¹²

The impact of these three factors and the corresponding efficiency of operations can be analysed by looking at operating costs as a percentage of portfolio outstanding and at the costs associated with lending on a per unit of currency basis or a per loan basis. All of these ratios have important implications for the cost of capital for the ultimate client - the rural and urban poor. These two efficiency ratios are:

1. Operating cost ratio
2. Total Cost Ratio

Utility of Efficiency Ratios

1. Efficiency ratios provide information about the rate at which MFIs generate revenue to cover their expenses
2. By calculating and comparing *efficiency ratios* over time, MFIs can determine whether they are indeed maximizing (optimising) the use of their resources
3. Efficiency ratios can be used to compare performance over time as well as measure improvements in an MFI's operations across an extended time period. *This is the descriptive part where one can understand, "how the MFIs performance has changed over time?"*
4. By taking the performance of the MFI as a whole, branches, credit officers, or other operating units (as appropriate), an MFI can begin to determine the "optimum" relationships between key operating factors (including inputs and outputs).

¹² The maturity of the institution refers to how long the programme has been operating: are systems well developed? are staff fully trained? has a reasonable scale been reached? In short, is the institution well advanced along the learning curve? does it have a good experience curve?

5. While such relationships could often be specific to the model of Microfinance adopted by the MFI, its strategic context and other issues germane to its existence, the key issue here is that such a longitudinal comparative analysis provides a sound historical basis for understanding the relationships and arriving at an “optimum”.
6. If applicable and necessary and without confounding the levels of analysis that may exist, managers could compare operating units and determine where they might need to minimise costs, maximise revenues and/or do both to increase profitability. *This is the diagnostic issue where the MFI management can attempt to analyse various relationships and attempt to answer questions such as, “how to reduce costs and/or increase revenues to ensure higher profitability?”*

The various statements/reports/records required for calculating EFFICIENCY RATIOS are given below

Statements/Reports Required for Calculation of Efficiency Ratios	
Statement/Reports / Records	Requirements
Portfolio Report with Aging Analysis	Yes, this is required
Balance Sheet	Could be used if appropriately structured, especially to include information on past due and restructured loans
Income Statement	Yes, this is required
Loan Ledger (Individual)	Yes, required and very important

5.2.1 Operating Cost Ratio

$\frac{\text{Operating Costs during period}}{\text{Average Outstanding Loan Portfolio}}$
--

Trend - A decreasing Operating Cost Ratio is positive

Standard Proposed by Sa-Dhan – Operating Cost Ratio should <u>not</u> exceed 20%
--

5.2.1.1 What is meant by the Operating Cost Ratio? - Simple Definition

- ☞ Operating Cost Ratio is a percentage (%)
- ☞ This ratio is perhaps the best indicator of the overall efficiency of a lending institution. For this reason, the ratio is also commonly referred to as Administrative Efficiency ratio: it measures the institutional cost of delivering loan services. The lower the Operating Cost Ratio, the higher the efficiency of an institution.
- ☞ This ratio is affected by increasing or decreasing operational costs relative to the average loan portfolio outstanding.

5.2.1.2 What does it measure?

- ☞ It is the key measure of the efficiency of the lending operations. If the performing assets are primarily loans funds, this ratio shows how much the institution must spend on all operating costs (salaries, rent, office, vehicles, etc.) to keep a unit of money loaned out for one year's time.
- ☞ If an institution selects an efficient methodology and employs a highly productive staff, the operating cost ratio will drop, resulting in a more sustainable institution. In an organisation, a downward trend in this ratio highlights the increasing efficiency of the organisation.

5.2.1.3 What minimum records are required for calculating the ratio?

- ☞ Loan ledger with disbursement, schedule and repayment data on each individual loan backed-up a comprehensive credit policy outlining various terms and conditions
- ☞ Aggregation of the loan ledger data with regard to delinquent and current loans – either a simple aging table or comprehensive portfolio report
- ☞ Key financial statements like the Balance Sheet and Income Statement, appropriately constructed

5.2.1.4 What events/activities affect (distort) the Operating Cost Ratio?

- ☞ Portfolio size, loan size, methodology and salary incentives have an impact on this ratio. Portfolio size matters and while small MFIs can become more efficient by growing, beyond a point, the importance of economics of scale diminishes rapidly and other factors become crucial.
- ☞ Loan size certainly has a much stronger impact on efficiency.
- ☞ Also, the operating expenses of rural MFIs are much higher since their clients are more widely dispersed. Hence, rural programmes tend to have higher operating cost ratios
- ☞ Standardisation of Microfinance operations should also help in a reduced operating cost ratio
- ☞ This ratio is also affected by unreported and/or hidden subsidies
- ☞ Organisations providing micro-credit as well as other services can allocate costs in such a way that their credit operations look more efficient than they really are
- ☞ When MFIs allocate costs to subsidiaries or do not carry them on the books at all, for instance when donors meet certain costs, such as paying for consultants or health workers collect loans/savings – this ratio is affected

5.2.1.5 How to calculate the ratio?

1. From the income statement, sum all expenses {refer Table 8 (a), IS 20)} related to the operations of the MFI. These typically would included:
 1. Salaries and Benefits {refer Table 8 (a), IS 14)}
 2. Administrative Expenses {refer Table 8 (a), IS 15)}
 3. Occupancy Expenses {refer Table 8 (a), IS 16)}
 4. Travel {refer Table 8 (a), IS 17)}
 5. Depreciation {refer Table 8 (a), IS 18)}
 6. Other {refer Table 8 (a), IS 19)}

Interest and provision expenses and extraordinary expenses should not be included

2. From the portfolio report, calculate the average outstanding portfolio during the period (for instance, a year) using the following procedure:

- ☞ Divide the period (year) into appropriate sub-periods – for example, a year could be divided into 12 sub-periods of a month each (*see Table 14 below*)
- ☞ Take the actual loans outstanding at the beginning of the period (say April 1, 2001)
- ☞ Add to this the sum of loans outstanding at the end of each sub-period (i.e., month)
- ☞ Then compute Average Loan Outstanding as follows

$$\text{Average Loan Outstanding (During Period)} = \frac{B + E1 + E2 + E3 + \dots + E12}{13}$$

3. Divide Operating Costs during period by Average Loans Outstanding to get the Operating Cost Ratio

Table – 14 Process for Computing Average Loan Outstanding

April 1, 2002	Actual Loan Outstanding at Beginning of Period	B1
April 30, 2002	Actual Loan Outstanding at End of Sub-Period 1	E 1
May 31, 2002	Actual Loan Outstanding at End of Sub-Period 2	E 2
June 30, 2002	Actual Loan Outstanding at End of Sub-Period 3	E 3
July 31, 2002	Actual Loan Outstanding at End of Sub-Period 4	E 4
August 31, 2002	Actual Loan Outstanding at End of Sub-Period 5	E 5
September 30, 2002	Actual Loan Outstanding at End of Sub-Period 6	E 6
October 31, 2002	Actual Loan Outstanding at End of Sub-Period 7	E 7
November 30, 2002	Actual Loan Outstanding at End of Sub-Period 8	E 8
December 31, 2002	Actual Loan Outstanding at End of Sub-Period 9	E 9
January 31, 2003	Actual Loan Outstanding at End of Sub-Period 10	E 10
February 28, 2003	Actual Loan Outstanding at End of Sub-Period 11	E 11
March 31, 2003	Actual Loan Outstanding at End of Sub-Period 12	E 12
13 Data Points	Actual Loan Outstanding Amount	Sum of B1 + E1 + E2 + ... E12

The calculation of *Operating Cost Ratio* from financial statements is illustrated below:

Step 1 – Use the formula given below

$$\frac{\text{Operating Costs}}{\text{Average Loan Portfolio Outstanding}}$$

Step 2 - Take the Operating Cost for Year 2001 – it is 21,800 {refer Table 8 (a), IS 20} for Year 2001}

Sl.	Description	2001	2002	2003
IS 20	Total Operating Costs (A)	21,800	26,200	28,600

Numerator of Formula

Step 3 - Take the Average Loan Portfolio Outstanding for Year 2001 – it is 90,000 (refer to Portfolio Report – Table 13, P6 for Year 2001)

Sl.	Description	2001	2002	2003
P6	Average Loan Portfolio Outstanding (B)	90,000	122,000	150,000

Denominator of Formula

Step 4 - Divide Operating Cost by Average Loan Portfolio Outstanding and as shown below, we get Operating Cost Ratio as 24.22% for year 2001

Operating Cost Ratio	2001	2001	2002
Operating Cost (A)	21,800	26,200	28,600
Average Loan Portfolio Outstanding (B)	90,000	122,000	150,000
Operating Cost Ratio Value = A/B =	24.22%	21.48%	19.07%

Step 5 - Likewise, as given above, Operating Cost Ratio for Years 2002 and 2003 are 21.48% and 19.07% respectively.

5.2.2 Total Cost Ratio

$\frac{\text{Operating Costs during period} + \text{Cost of Funds} + \text{Loan Loss Provision}}{\text{Average Outstanding Loan Portfolio}}$
--

Trend - A decreasing Total Cost Ratio is positive but sufficient attention must be given to the cost of funds aspects and also loan loss provision created

Standard Proposed by Sa-Dhan – Total Cost Ratio should <u>not</u> exceed 30%
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5.2.2.1 What is meant by the Total Cost Ratio? - Simple Definition

- ☞ Total Cost Ratio is a percentage (%)
- ☞ Like the operating cost ratio, this ratio is an indicator of the overall efficiency of a lending institution. The lower the total Cost Ratio, the higher the efficiency of an institution
- ☞ However, because costs of funds and loan loss provision are included here, greater care must be exercised while interpreting the ratio

5.2.2.2 What does it measure?

- ☞ If the performing assets are primarily loans funds, this ratio shows how much the institution must spend on all costs (salaries, rent, office, vehicles, sourcing capital and making provisions etc.) to keep a unit of money loaned out for one year's time.
- ☞ If an institution selects an efficient methodology and employs a highly productive staff, the total cost ratio will drop, resulting in a more sustainable institution. In an organisation, a downward trend in this ratio highlights the increasing efficiency of the organisation. But, again because the cost of funds and loan loss provision are included, a decreasing ratio may not necessarily be good (or positive) because the numerator can be decreased by accessing subsidised funds as well as having lower provisions than mandated by the portfolio quality.

5.2.2.3 What minimum records are required for calculating the ratio?

- ☞ Loan ledger with disbursement, schedule and repayment data on each individual loan backed-up a comprehensive credit policy outlining various terms and conditions
- ☞ Aggregation of the loan ledger data with regard to delinquent and current loans – either a simple aging table or comprehensive portfolio report
- ☞ Key financial statements like the Balance Sheet and Income Statement, appropriately constructed

5.2.2.4 What events/activities affect (distort) the Total Cost Ratio?

- ☞ Portfolio size, loan size, methodology and salary incentives have an impact on this ratio. Portfolio size matters and while small MFIs can become more efficient by growing, beyond a point, the importance of economics of scale diminishes rapidly and other factors become crucial.
- ☞ Loan size certainly has a much stronger impact on efficiency.

- ☞ Also, the operating expenses of rural MFIs are much higher since their clients are more widely dispersed. Hence, rural programmes tend to have higher total cost ratios
- ☞ Standardisation of micro-finance operations should also help in a reduced total cost ratio
- ☞ This ratio is also affected by unreported and/or hidden subsidies
- ☞ Organisations providing micro-credit as well as other services can allocate costs in such a way that their credit operations look more efficient than they really are
- ☞ When MFIs allocate costs to subsidiaries or do not carry them on the books at all, for instance when donors meet certain costs, such as paying for consultants or health workers collect loans/savings – this ratio is affected
- ☞ Finally, because the cost of funds and loan loss provision are included, a decreasing ratio may not necessarily be good (or positive) because the numerator can be decreased by accessing subsidized funds as well as having lower provisions than mandated by the portfolio quality

5.2.2.5 How to calculate the ratio?

1. From the income statement {refer Table 8 (a)}, sum all expenses related to micro-financing, including cost of fund and loan loss provision. These typically would included:
 - I. Operational Costs {refer Table 8 (a), IS 20)}
 - a) Salaries and Benefits {refer Table 8 (a), IS 14)}
 - b) Administrative Expenses {refer Table 8 (a), IS 15)}
 - c) Occupancy Expenses {refer Table 8 (a), IS 16)}
 - d) Travel {refer Table 8 (a), IS 17)}
 - e) Depreciation {refer Table 8 (a), IS 18)}
 - f) Other {refer Table 8 (a), IS 19)}
 - II. Cost of Funds {refer Table 8 (a), IS 9)}
 - III. Loan Loss Provisions {refer Table 8 (a), IS 11)}
2. From the portfolio report (refer Table 13 - row P6), calculate the average outstanding portfolio during the period (for instance, a year) using the following procedure:
 - a) Divide the period (year) into appropriate sub-periods – for example, a year could be divided into 12 sub-periods of a month each (see Table 14)
 - b) Take the actual loans outstanding at the beginning of the period (say April 1st, 2001)
 - c) Add to this the sum of loans outstanding at the end of each sub-period (i.e., month)
 - d) Then compute Average Loan Outstanding as follows
 - e) Average Loan Outstanding (During Period) =
$$\frac{B + E1 + E2 + E3 + \dots + E12}{13}$$
3. Divide Total Costs during period by Avg. Loans Outstanding to get Total Cost Ratio

The calculation of *Total Cost Ratio* from financial statements is illustrated below :

Step 1 – Use the formula given below

$$\frac{\text{Operating Costs + Cost of Funds + Loan Loss Provision}}{\text{Average Loan Portfolio Outstanding}}$$

Step 2 - Take the Operating Cost, Financial Expenses, and Loan loss Provision amount for Year 2001 – it is 34,200=(21800+2,400+10,000) {refer Table 8 (a), IS 20, IS 09 & IS 11) for Year 2001}

Sl.	Description	2001	2002	2003
IS 20	Total Operating Costs (A)	21,800	26,200	28,600
IS 09	Total Financial Expenses (B)	2,400	7,000	7,400
IS 11	Provision for loan Losses (C)	10,000	6,000	5,000
	TOTAL	34,200	39,200	41,000

Numerator of Formula

Step 3 - Take the Average Loan Portfolio Outstanding for Year 2001 – it is 90,000 (refer to Portfolio Report – Table 13, row P6 for Year 2001)

Sl.	Description	2001	2002	2003
P6	Average Loan Portfolio Outstanding (D)	90,000	122,000	150,000

Denominator of Formula

Step 4 - Divide (Operating Cost + Cost of Funds + Loan loss provision) by Average Loan Portfolio Outstanding and as shown below, we get Total Cost Ratio as 38.00% for year 2001

Total Cost Ratio	2001	2001	2002
Operating Cost (A) + Cost of Funds (B) + Loan loss provision (C)	34,200	39,200	41,000
Average Loan Portfolio Outstanding (D)	90,000	122,000	150,000
Total Cost Ratio Value = (A+B+C) / D =	38.00%	32.13%	27.33%

Step 5 - Likewise, as given above, Total Cost Ratio for Years 2002 and 2003 are 32.13% and 27.33% respectively.

Productivity Ratio

1. By calculating and comparing productivity ratios over time, MFIs can determine whether they are indeed maximizing (optimizing) the use of their resources
2. Productivity refers to the volume of business (output) that is generated for a given resource (input) – e.g. 20 field workers (input), managing 7,000 clients (output) that are generating income for MFI.
3. These ratios focus on the productivity of the credit officers {see section 4.3 (12) for definition}, because, they are the primary generators of revenue. In fact, increasingly, credit officers are getting to be viewed as profit centers (by MFIs), whereby they are expected to generate revenue in excess of all their expenses (direct and allocated to them).

5.2.3 Active Borrowers Per Credit Officer

$\frac{\text{Average Number of Active Borrowers}}{\text{Average Number of Credit Officers}}$
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Trend – An increasing number of active borrowers {see section 4.3 (3) for definition} per Credit Officer is positive. This again is based on the experience curve phenomenon according to which, with passage of time, the staff get more efficient at what they have been doing and therefore, will be able to do more of this work without (negatively) affecting quality.

Standard Proposed by Sa-Dhan – Active borrowers/credit officer should be 250-350 Clients

5.2.3.1 What does the ratio Active borrowers Per Credit Officer mean? - Simple Definition

- ☞ Active borrowers per credit officer is a number (#) ratio
- ☞ In simple terms, it highlights the “*number of active clients serviced by a credit officer*”
- ☞ It measures the overall productivity of the MFI’s total human resources in managing clients who have an outstanding loan balance and are thereby contributing to the financial revenue of MFI.
- ☞ This indicator is valuable for monitoring staff productivity and for determining institutional operating efficiency. The caseload is determined by the methodological aspects of the institution, with well-designed institutions capable of reaching higher numbers of borrowers per loan officer.

5.2.3.2 What does it measure?

- ☞ It captures the productivity of staff – the higher the ratio the more productive the institution.
- ☞ Indirectly, the ratio says a fair amount about how well the MFI has adapted its processes and procedures to its business purpose of lending to micro-finance clients
- ☞ Low staff productivity usually does not mean that staff work less, but that they are tied up in excessive and time-consuming paperwork and procedures (like filling-up of SHG records etc)
- ☞ The no. of active borrowers per credit officer varies depending on the method of credit delivery and whether or not loans are made to individuals, to individuals as group members, or to groups
- ☞ For each MFI there is an optimal no. of clients that each credit officer can manage effectively
- ☞ While salary costs may appear lower when credit officers carry a large no. of clients, too many clients may result in higher loan losses, which can be more than offsetting lower administrative costs.

5.2.3.3 What minimum records are required for calculating the ratio?

- ☞ Loan ledger with disbursement, schedule and repayment data on each individual loan backed-up a comprehensive credit policy outlining various terms and conditions
- ☞ Aggregation of the loan ledger data with regard to delinquent and current loans – either a simple ageing table or comprehensive portfolio report
- ☞ Key financial statements like the Balance Sheet and Income Statement, appropriately constructed
- ☞ Staffing details including portfolio and other data disaggregated by credit officers

5.2.3.4 What strategic issues affect (distort) the ratio?

- ☞ Defining a credit officer is very crucial - A credit officer is a full-time employee whom the MFI acknowledges as such and it is normally understood that the person works at least for 8 hours a day and minimum of 5 days a week.
- ☞ Given the various methodological and other problems associated with productivity ratios, using average amounts (both in the numerator and denominator) is preferable.
- ☞ The distinction of active borrowers is also important to avoid possible confusion with (1) number of active loans, when a single loan goes to a group of individuals, and (2) cumulative loans disbursed during the period as opposed to “active “ borrowers who currently have outstanding loans.
- ☞ For the purpose of this manual, it is assumed that each loan reported is held by one borrower. Where that is not the case, borrowers would have to be counted separately.
- ☞ When comparing this ratio with other MFIs (or between different branches or different lending products within the same MFI), it is also necessary to take into account the average loan term because this greatly affects the number of borrowers a credit officer need not spend as much time processing renewals as she would if the loan terms were shorter. If this is the case, a credit officer should in theory be able to carry more active borrowers than a credit officer working with shorter loan terms (assuming all other factors are the same).
- ☞ Some MFIs lend only to groups (SHGs) and here the conceptual decision of whether, the group should be treated as the borrower or if the members of the group should be so considered, is a difficult choice. In either case, there are advantages and disadvantages but the key issue is that it would be fair and appropriate to discern and determine the correct level of analysis with regard to who should be taken as the borrower. This aspect gets particularly complicated as illustrated by the following example - consider that an MFI lends to a group with 23 members but loans are in turn taken only by 7 members. For the purpose of computing this ratio, should we say that this loan was given to a group of 23 members or it was distributed among 7 members. It is a tough situation and arguments can be made for both cases. Therefore, it is imperative that when comparisons are made across MFIs with different methodologies, this aspect of the unit of analysis (in terms of who is the borrower) must be conceptually clarified upfront.
- ☞ A key aspect for this and other productivity ratios is that while credit officers could indeed be efficient, there could be a whole lot of other staff contributing to inefficiency. Hence, all measures that use credit officers in the denominator should be interpreted with caution

5.2.3.5 How to calculate the ratio?

- 1) Have clear and upfront definitions of active borrowers and credit officers
- 2) Calculate the average number of active borrowers during the period (for instance, a year) – *this should be available in the portfolio report or aggregated loan ledger or other reporting formats*
- 3) Calculate the average number of credit officers during the period (for instance, a year) - *this should also be available in the portfolio report*
- 4) Divide the average number of active borrowers by the average number of credit officers to obtain the ratio value

As noted earlier, period averages are much more meaningful when they are computed on a monthly or at least a quarterly basis. When using such sub-period averages, the numerator is the opening balance plus the sum of the balance at the end of each sub-period, while the denominator is the number of sub-periods plus one.

As an example, a quarterly average would be calculated as:

$$P^{avg} = \frac{(P^0 + P^1 + P^2 + P^3 + P^4)}{(4+1)}$$

The calculation of *Active Borrowers Per Credit Officer* from Portfolio Report is illustrated below:

Step 1 – Use the formula given below

Average Number of Active Borrowers	
Average Number of Credit Officers	

Step 2 - Take the Average Number of Active Borrowers for Year 2001 – it is 2,170 (Please refer to Portfolio Report, Table 13, Row P4, Column III for Average No. of Active Borrowers for Year 2001)

Sl.	Description	2001	2002	2003
P4	Average Number of Active Borrowers (A)	2,170	2,870	3,350

Numerator of Formula

Step 3 - Take the Average Number of Credit Officers for Year 2001 – it is 8 (Please refer to Table 13, Row P12, Column III for Average Number of Credit Officers for Year 2001)

Sl.	Description	2001	2002	2003
P12	Average Number of Credit Officers (B)	8	12	12

Denominator of Formula

Step 4 - Divide Average Number of Active Borrowers by Average Number of Credit Officers and as shown below, we get Active Borrowers Per Credit Officer as 271 for year 2001

Average Number of Active Borrowers (A)	2170	2870	3350
Average Number of Credit Officers (B)	8	12	12
Active Borrowers Per Credit Officer Value = A/B =	271	239	279

Step 5 - Likewise, as given above, the average number of active borrowers per credit officer for Years 2002 and 2003 are 239 and 279 respectively.

5.3 FINANCIAL VIABILITY STANDARDS

1. Financial viability refers to the ability of an MFI to cover its expenses with earned revenue.
2. Revenue is generated when the assets of an MFI are invested or put to productive use.
3. Expenses are incurred to earn that revenue.
4. Thus, to determine financial viability, revenue is compared to expenses through self-sufficiency indicators.
5. If revenue is greater than expenses, the MFI is self-sufficient. Some of the commonly used indicators of self-sufficiency are:

☞ Operational Self-Sufficiency

☞ Financial Self-Sufficiency

Levels of Self-Sufficiency – From Four to Two

- As the microfinance industry matures, the definition of self-sufficiency has begun to narrow
- A few years ago people spoke about four levels of self-sufficiency that an MFI should progressively aim to achieve.
- Some analysts considered an MFI to be operationally self-sufficiency (level one) if the revenue it generated from operations covered its operating costs; level 2 self-sufficiency meant that the MFI covered its operational costs plus loan loss provisions from operating revenue
- Reaching level three meant that an MFI generated enough revenue to cover financing costs, operating expenses, and loan provisions.
- Level four (financial self-sufficiency) referred to revenue that covered non-financial and financial expenses calculated on a commercial basis- “profit without subsidy” (Christen and others 1995).
- Currently, however, most people in the microfinance industry refer to only two levels of self-sufficiency: *operational self-sufficiency* and *financial self-sufficiency*.

The various statements/reports/records required for calculating Viability Ratio are given below

Statements/Reports Required for Calculation of Viability Ratios
Portfolio Report with Ageing Analysis
Balance Sheet
Income Statement
Loan Ledger (Individual loan account details)

5.3.1 Operating Self-Sufficiency

$\frac{\text{Operating Income (Loans + Investments)}}{\text{Operating Costs + Loan Loss Provisions + Financing Costs}}$

Trend – An increasing Operating Self-Sufficiency ratio is positive

Standard Proposed by Sa-Dhan – Operating Self-Sufficiency should equal 100%

5.3.1.1 What is meant by Operating Self-Sufficiency? - Simple Definition

- ☞ Operating self-sufficiency is a percentage (%)
- ☞ Operating Self-Sufficiency indicates whether or not enough revenue has been earned to cover the MFI's total costs – operational expenses, loan loss provisions and financial costs.

5.3.1.2 What does it measure?

- ☞ It is an important measure of sustainability of the lending operations
- ☞ Looking at the ratio as a self-sufficiency figure allows determination of the extent to which operations are becoming (increasingly) self-sustaining.
- ☞ Operational self-sufficiency thus indicates whether or not enough revenue has been earned to cover the MFI's direct costs, excluding the (adjusted) cost of capital but including any actual financing costs incurred.
- ☞ If an MFI does not reach operational self-sufficiency, eventually its equity (loan fund capital) will be reduced by losses (unless additional grants can be raised to cover operating shortfalls). This means that there will be a smaller amount of funds to loan to borrowers, (which could lead to closing the MFI once the funds run out).
- ☞ To increase its self-sufficiency, the MFI must either increase its yield (return on assets) or decrease its expenses (financing costs, provisions for loan losses, or operating costs).

5.3.1.3 What minimum records are required for calculating the Ratio?

- ☞ Loan ledger with disbursement, schedule and repayment data on each individual loan backed-up a comprehensive credit policy outlining various terms and conditions
- ☞ Aggregation of the loan ledger data with regard to delinquent and current loans – either a simple ageing table or comprehensive portfolio report
- ☞ Key financial statements like the Balance Sheet and Income Statement, adjusted for loan losses, depreciation & accrued interest

Defining Operational Self- Sufficiency – Alternative View Points

- The definition of operational self-sufficiency varies among different MFIs and donors.
- The difference centres on the inclusion of financing costs. Whereas actual financing costs used to be included only in levels three and four (as mentioned earlier), some analysts include them in calculating both operational and financial self-sufficiency and some only in calculating financial self-sufficiency.
- Some MFIs argue that operational self-sufficiency should not include financing costs, because not all MFIs incur financing costs equally, which thus makes the comparison of self-sufficiency ratios between institutions less relevant.
- While some MFIs fund all of their loans with grants or concessional loans and do not need to borrow funds—or collect savings—and thus either do not incur any financing costs or incur minimal costs.
- Other MFIs, as they move progressively toward financial viability, are able to access concessional or commercial borrowings and thus incur financing costs.
- However, all MFIs incur operating expenses and the cost of making loan loss provisions, and they should be measured on the management of these costs alone.
- Furthermore, these MFIs argue that they should not be penalised for accessing commercial funding sources (through the inclusion of financing costs in the formula), nor should MFIs that are able to finance all of their loans with donor funds be rewarded.
- The choice of which formula to use is personal, because both are correct. However, it is important that when comparing institutions, the analyst determine that the same formula has been used, because no standard definition has yet been established.

5.3.1.4 What events/activities affect (distort) the ratio?

- ☞ This ratio is also affected by unaccounted, unreported and/or hidden subsidies with regard to operations
- ☞ Organisations providing micro-credit as well as other services can allocate costs in such a way that their credit operations look more sustainable than they really are
- ☞ When MFIs allocate costs to subsidiaries or do not carry them on the books at all, for instance when donors meet certain costs, such as paying for consultants or health workers collect loans/savings – this ratio is affected

5.3.1.5 How to calculate the ratio?

1. From the income statement, sum up all operating income. This would include:
 - ☞ Interest on Current and Past Due Loans {refer Table 8 (a), IS 1}
 - ☞ Loan Fees and Service Charges {refer Table 8 (a), IS 2}
 - ☞ Late Fees on Loans {refer Table 8 (a), IS 3}
 - ☞ Interest on Investment {refer Table 8 (a), IS 5}

GRANT INCOME SHOULD NOT BE INCLUDED

2. From the income statement {refer Table 8 (a)}, sum all expenses related Microfinancing, including cost of fund and loan loss provision. These typically would included:
 - I. Operational Costs¹³ {refer Table 8 (a), IS 20}
 - a) Salaries and Benefits {refer Table 8 (a), IS 14}
 - b) Administrative Expenses {refer Table 8 (a), IS 15}

¹³ The cost of promotion of SHGs should be treated as an expense for the period

- c) Occupancy Expenses {refer Table 8 (a), IS 16}
 - d) Travel {refer Table 8 (a), IS 17}
 - e) Depreciation {refer Table 8 (a), IS 18}
 - f) Other {refer Table 8 (a), IS 19}
 - II. Cost of Funds {refer Table 8 (a), IS 9}
 - III. Loan Loss Provisions {refer Table 8 (a), IS 11}
3. Divide Total Operating Income by Total Direct Expenses (Operating + Loan Loss Provision + Financing Costs) to get Operational Self-Sufficiency.

The calculation of Operational Self-Sufficiency from Income Statement is illustrated below:

Step 1 – Use the formula given below

$$\frac{\text{Operating Income (Loans + Investments)}}{\text{Operating Costs + Financing Costs + Loan Loss Provision}}$$

Step 2 - Take the Operating Income (Loans + Investments) for Year 2001 – it is 27,200 {refer to Income Statement - Table 8 (a), IS 6, for Year 2001}

Sl.	Description	2001	2002	2003
IS 6	Total Operating Income (A)	27,200	37,700	43,000

Numerator of Formula

Step 3 - Take the Operating Cost, Financial Expenses, and Loan loss Provision amount for Year 2001 – it is 34,200=(21800+2,400+10,000) {refer Table 8 (a), IS 20, IS 09 & IS 11} for Year 2001}

Sl.	Description	2001	2002	2003
IS 20	Total Operating Costs (B)	21,800	26,200	28,600
IS 09	Total Financial Expenses (C)	2,400	7,000	7,400
IS 11	Provision for loan Losses (D)	10,000	6,000	5,000
	TOTAL	34,200	39,200	41,000

Denominator of Formula

Step 4 - Divide Operating Income (Loans + Investments) by Operating Costs + Financing Costs + Loan Loss Provision as shown below, we get Operational Self-Sufficiency as 79.53% for year 2001

Operational Self-Sufficiency	2001	2002	2003
Total Operating Income (A)	27,200	37,700	43,000
Operating Costs (A) + Financing Costs (C) + Loan Loss Provision (D)	34,200	39,200	41,000
Operational Self-Sufficiency Value = A/(B+C+D) =	79.53%	96.17%	104.88%

Step 5 - Likewise, as given above, Operational Self-Sufficiency for Years 2001 and 2002 are 96.17% and 104.88% respectively.

ANNEXURES

Annex

1

PERFORMANCE INDICATORS FOR MICROFINANCE INSTITUTIONS : SOME POPULAR TOOLS USED WORLDWIDE

Sl. No.	Name of Tool/Institution	Broad performance area	Indicators to measure performance
1.	CAMEL, ACCION CAMEL analyses the five traditional aspects considered to be most important in the operation of a financial intermediary. These five areas reflect the financial condition and general operational strength of the MFI and are briefly summarised in the next column.	1. <i>C-Capital adequacy.</i> The capital position of the institution and its capacity to support growth of the loan portfolio as well as a potential deterioration in assets are assessed. The CAMEL analysis looks at the institution's ability to raise additional equity in the case of losses and its ability and policies to establish reserves against the inherent risk in its operations. 2. <i>A-Asset quality.</i> The overall quality of the loan portfolio and other assets, including infrastructure (for example, officer location and environment), is examined. This requires analysing the level of portfolio at risk and write-offs, as well as the appropriateness of the portfolio classification system, collection procedures, and write-off policies. 3. <i>M-Management.</i> Human resource policy, the general management of the institution, management information systems, internal control and auditing, and strategic planning and budgeting are examined as distinct areas that reflects the overall quality of management. 4. <i>E-Earning.</i> The key components of revenues and expense are analysed, including the level of operational efficiency and the institution's interest rate policy as well as the overall results as measured by return on equity and return on assets. 4. <i>L-Liquidity.</i> This component of the analysis looks at the institution's ability to project funding needs in general and credit demand in particular. The liability structure of the institution, as well as the productivity of its current assets, is also an important aspect of the overall assessment of an institution's liquidity management.	<i>Quantitative</i> ▪ Leverage ▪ Reserve adequacy <i>Qualitative</i> ▪ Ability to raise equity <i>Quantitative</i> ▪ Portfolio at Risk (> 30 days past due) ▪ Write-offs <i>Qualitative</i> ▪ Portfolio classification system ▪ Productivity of long-term assets ▪ Infrastructure <i>Qualitative</i> ▪ Governance/Management ▪ Human resources ▪ Processes, controls, and audit ▪ Information technology system ▪ Strategic planning and budgeting <i>Quantitative</i> ▪ Adjusted return on equity ▪ Operational efficiency ▪ Adjusted return on assets <i>Qualitative</i> ▪ Interest rate Policy <i>Quantitative</i> ▪ Productivity of other current assets <i>Qualitative</i> ▪ Liability Structure ▪ Availability of Funds to Meet Credit Demand ▪ Cash Flow Projections

Source: Saltzman, Rock and Salinger 1998

Sl. No.	Name of Tool/Institution	Broad performance area	Indicators to measure performance
2.	Microfinance Information Exchange (MIX) MIX is a not for profit private organisation that supports the growth & development of a healthy Microfinance sector. Through its publication - Micro Banking Bulletin that is one of the principal outputs of Micro banking standards project funded by CGAP, it collects financial & portfolio data provided voluntarily by MFIs, primarily to help MFI managers and board members to understand their performance vis-a-vis other MFIs. Secondary objective includes establishing industry performance standards and enhance transparency of financial reporting of MFIs world wide. To address the issue of diversity in operating environment of MFIs, while comparing the financial and portfolio data, it has adopted a peer group framework, where financial performance of MFIs are compared among peer group members on 7 broad parameters.	<i>Institutional maturity, size and outreach</i>	- Age of institution - Number of offices - Number of personnel - Number of active borrowers - Percent of women borrowers
		<i>Profitability and Sustainability</i>	- Adjusted return on Assets - Adjusted return on equity - Operational self-sufficiency - Financial self-sufficiency - Adjusted profit margin
		<i>Income and Expenses</i>	- Adjusted operating income ratio - Adjusted total expense ratio - Yield on gross portfolio - Yield on gross portfolio (real) - Adjusted financial expense ratio - Adjustment expense ratio - Loan loss provision expense ratio - Adjusted personnel expense ratio - Adjusted administrative expense ratio - Adjusted operating expense ratio
		<i>Efficiency</i>	- Adjusted operating expense / Loan portfolio - Adjusted personnel expense / Loan portfolio - Adjusted administrative expense / Loan portfolio - Average salary / GNP per capita
		<i>Productivity</i>	- Personnel productivity (No. of active clients/No. of all staff) - Loan officer productivity (No. of clients/No. of loan officer) - Personnel allocation ratio (No. of loan officer/No. of staff)
		<i>Portfolio quality</i>	- Average outstanding loan size - Depth (Avg. outstanding loan size/ GNP per capita) - Portfolio at risk (> 30 days) - Portfolio at risk (> 90 days)
		<i>Capital and Liability structure</i>	- Commercial funding liabilities ratio - Capital / Asset ratio

Source: Micro-Banking Bulletin (November 2002)

Sl. No.	Name of Tool/Institution	Broad performance area	Indicators to measure performance
3.	GIRAFE, PlaNet Finance The G.I.R.A.F.E rating and evaluation instrument was developed by PlaNet Finance. This rating evaluation is both quantitative and qualitative to cover the full range of risks faced by a potential investor. G.I.R.A.F.E focuses on six areas of assessment. The six areas of assessment are divided into 26 factors; both quantitative and qualitative. The qualitative factors cover mostly the governance, the information systems and risks coverage issues. The quantitative factors need a financial analysis and preliminary adjustments, in order to make financial information comparable between institutions.	1. G - Governance and decision making process	1. Maturity of institution 2. Balance and efficiency of the governance system 3. Technical organization of governance 4. Weight of governance in relation to expenses 5. Internal skills 6. Staff turnover ratio 7. Training efficiency
		2. I - Information and management tools	1. Technical support for information systems 2. Information management 3. Organization of technical departments
		3. R - Risk analysis and control	1. Identification of risks 2. Coverage of risks by internal control
		4. A - Activities and loan portfolio	1. Global balance of assets on balance sheet 2. Relevance of services 3. Loan portfolio management 4. Write off ratio 5. Portfolio at risk (> 31 days)
		5. F - Financing: liabilities and equity	1. Overall assessment 2. Ratio of transformation equities into assets
		6. E - Efficiency and profitability	1. Administrative efficiency ratio 2. Operating efficiency ratio 3. Staff ratio 4. Adjusted return on average assets 5. Adjusted return on average equity 6. Operating self-sufficiency 7. Financial self-sufficiency

Source: PlaNet Finance, 2000

Sl. No.	Name of Tool/Institution	Broad performance area	Indicators to measure performance
4.	Small Enterprise Education and Promotion (SEEP) This guide sets out a framework for analysing the financial condition of an MFI. The framework is divided into three groups, each of which comprises a set of ratios.	1. The first group of ratios analyses the <i>financial sustainability</i> of the MFI – or the ability of an MFI to meet the needs of its clientele without reliance on external assistance.	Return on performing assets = $\frac{\text{Financial income}}{\text{Average performing assets}}$ Financial cost ratio = $\frac{\text{Financial costs}}{\text{Average performing assets}}$ Loan loss provision ratio = $\frac{\text{Loan loss provisions}}{\text{Average performing assets}}$ Operating cost ratio = $\frac{\text{Operating expenses}}{\text{Average performing assets}}$ Adjusted cost of capital = $\frac{[(\text{Inflation} \times (\text{net worth} - \text{net fixed assets})) + ((\text{inflation} - \text{int. rate paid}) \times \text{conc. loans})]}{\text{Average performing assets}}$ Donations and grants ratio = $\frac{\text{Donations and grants}}{\text{Average performing assets}}$ Operating self-sufficiency = $\frac{\text{Financial income}}{\text{Fin. \& Opr. costs} + \text{Loan loss provision}}$ Financial self-sufficiency = $\frac{\text{Financial income}}{\text{Fin. \& Opr. costs} + \text{Loan loss provision} + \text{Imputed cost of capital}}$

Contd. next page

Sl. No.	Name of Tool/Institution	Broad performance area	Indicators to measure performance
4.	Small Enterprise Education and Promotion (SEEP)	2. The second group of ratios analyses <i>financial efficiency</i> of MFIs. They must be concerned with serving as many people as possible with their resources.	$\text{Cost per unit of money lent} = \frac{\text{Operating costs}}{\text{Total amount disbursed}}$ $\text{Cost per loan made} = \frac{\text{Operating costs}}{\text{Number of loans made}}$
		3. The third group of ratios helps MFIs monitor their <i>portfolio quality</i> . If the quality of the portfolio is poor, the MFI cannot continue to operate in the long term.	$\text{No. of active borrowers per credit officer} = \frac{\text{Average no. of active borrowers}}{\text{Average no. of credit officers}}$ $\text{Portfolio per credit officer} = \frac{\text{Average loan outstanding}}{\text{Average no. of credit officers}}$ $\text{Portfolio in arrears} = \frac{\text{Payments in arrears}}{\text{Value of loans outstanding}}$ $\text{Portfolio at risk} = \frac{\text{Balance of loans in arrears}}{\text{Value of loans outstanding}}$ $\text{Loan loss ratio} = \frac{\text{Amount written off}}{\text{Average loans outstanding}}$ $\text{Reserve ratio} = \frac{\text{Loan loss reserve}}{\text{Value of loans outstanding}}$

Source: SEEP Network, 1995

Sl. No.	Name of Tool/Institution	Broad performance area	Indicators to measure performance
5.	PEARLS, World Council of Credit Unions(WOCCU) PEARLS is a system of 45 financial ratios that the WOCCU uses worldwide to monitor the performance and credit unions. It was originally designed and implemented with Guatemalan credit unions in the late 1980s. The WOCCU now uses it to create a universal financial language that each credit union can speak and understand, to generate comparative credit union rankings, and to provide the framework for a supervisor unit at the second tier. Each ratio has a standard target or goal that each credit union should strive to achieve.	1. P - Protection (7 ratios). Refers to adequate protection of assets. Protection is measured by comparing the adequacy of the provision for loan losses against the amount of delinquent loans. Protection was deemed adequate if a credit union had sufficient provisions to cover 100 percent of all loans delinquent for more than 12 months and 35 percent of all loans delinquent for 1-12 months.	1. Allowance for loan losses / Allowances required for loans delinquent > 12 months 2. Net allowance for loan losses / Allowances required for loans delinquent < 12 months 3. Total charge-off of delinquent loans >12 months 4. Annual loan charge-offs 5. Accumulated loan recoveries/ Accumulated loan charge-offs 6. Solvency 7. Allowances for investment losses/ Non-regulated investments
		2. E - Efficiency financial structure (9 ratio). Determines growth potential, earnings capacity, and overall financial strength. Ratios measure assets, liabilities, and capital, and their associated targets constitute an ideal structure for credit unions.	1. Net loans/Total assets 2. Liquid investments / Total assets 3. Financial investments / Total assets 4. Non-financial investments / Total assets 5. Savings deposits / Total assets 6. External credit / Total assets 7. Member share capital / Total assets 8. Institutional capital / Total assets 9. Net institutional capital/ Total assets
		3. A - Asset quality (3 ratios). Ratios measure the impact of assets that do not generate income.	1. Total loan delinquency / Gross loan portfolio 2. Non-earning assets / Total assets 3. Net institutional & Transitory capital + Non interest-bearing liabilities / Non-earning assets

Contd. next page

Sl. No.	Name of Tool/Institution	Broad performance area	Indicators to measure performance
5.	PEARLS, WOCCU	4. R - Rate of return and costs (12 ratios). Disaggregates the essential components of net earnings (by investments to help management calculate investment yields and evaluate operating expense. The result more clearly indicate whether the credit union is earning and paying market rate on its assets, liabilities and capital.	1. Net loan income / Average net loan portfolio 2. Total liquid investment income / Avg. liquid investments 3. Total fin. investment income / Avg. fin. Investments 4. Total non-fin. investment income / Avg. non-fin. investments 5. Total interest cost on savings deposit / Avg. savings deposit 6. Total interest cost on external credit / Avg. external credit 7. Total dividend paid on shares / Avg. member shares 8. Total gross income margin / Avg. total assets 9. Total operating expenses / Avg. total assets 10. Total loan loss provision expense / Avg. total assets 11. Non-Recurring Income or Expense / Avg. total assets 12. Net income / Avg. total assets
		5. L - Liquidity (3 ratios). Reveals if the credit union is administering its cash to meet deposit withdrawal requirements and liquidity reserve requirements, while minimising the amount of idle funds.	1. (Short-term investments + Liquid assets - Short-term payables) / Savings deposits 2. Liquidity reserves / Savings deposits 3. Non-earning liquid assets / Total assets
		6. S - Signs of growth (11 ratios). Measures both financial and membership growth. By comparing asset growth to other key areas it is possible to detect changes in the balance sheet structure that could have a positive or negative impact on earnings. Growth of institutional capital is the indicator of profitability and success, particularly if it is proportionately greater than the growth in assets.	1. Growth in loans to members 2. Growth in liquid investments 3. Growth in financial investments 4. Growth in non-financial investments 5. Growth in savings deposits 6. Growth in external credit 7. Growth in share capital 8. Growth in institutional capital 9. Growth in net institutional capital 10. Growth in membership 11. Growth in total assets

Source: Richardson, 2001

Sl. No.	Name of Tool/Institution	Broad performance area	Indicators to measure performance
6.	Women's World Banking (WWB) WWB has been a leader in building consensus, first among leading MFIs, then with donors and policy-makers on the key indicators needed to measure performance of MFIs. The performance indicators recommended by WWB are divided into qualitative and quantitative categories The emphasis is on MFIs achieving minimum agreed performance standards and taking significant incremental steps to improve performance.	Quantitative	
		<i>Portfolio Size and Quality</i>	- Gross portfolio outstanding - at beginning and end of year - Total number of loans disbursed during the period - Repayment rate on time and/or as of 30 days - Portfolio at risk on time and/or as of 30 days
		<i>Efficiency</i>	- Cost per unit of money lent - based on amount of loans disbursed in the period based on avg. portfolio outstanding - Number of loans per credit staff person
		<i>Self-sufficiency/Profitability</i>	- Operational self-sufficiency of credit & savings operations and overall, including and excluding costs of funds - Overall financial self-sufficiency - Return on performing assets
		<i>Key Demographic Data on Clients</i>	- Average loan size - Percentage of loans below \$500 - Number of active borrowers - Percentage of borrowers below poverty line - Percentage of repeat credit clients for previous years - Number of savers - Total deposits at beginning and end of the period - Percentage of borrowers who are women - Percentage of savers who are women - Percentage of board members who are women - Percentage of total staff that are women - Positive interest rates charged to clients in relation to inflation, commercial bank price rate, and administrative costs of inflation
		<i>Interest Rates</i>	- Resource Base - Reduction in subsidies, donor dependence
		Qualitative	
		<i>Reach of client group - focus on the poor</i>	- Evidence of focus on the poor - Methodology - Use of collateral substitutes - Savings
		<i>MFI Management, Structures and Systems</i>	- Vision and mission - Governance - Financial, credit and management information systems - Legal structures - Financial reporting - Management and staff - Business plan, financial projections - Effective operating systems

Source: Women's World Banking 2001

Annex

2

GLOSSARY OF FINANCIAL TERMS

Term	Definition
Account	Formal record that represents, in words, money or other unit of measurement, certain resources, claims to such resources, transactions or other events that result in changes to those resources and claims. An individual form or record used to record and summarize information related to each asset, each liability, and each aspect of owner's equity. The form used to record additions and deductions for each individual asset, liability, capital, revenue, and expense.
Account form of Balance Sheet	A balance sheet with assets on the left-hand side and liabilities and capital on the right-hand side.
Account Payable	Amount owed to a creditor for delivered goods or completed services. A liability created by a purchase made on credit.
Account Receivable	Claim against a debtor for an uncollected amount, generally from a completed transaction of sales or services rendered.
Accountant	Person skilled in the recording and reporting of financial transactions.
Accountants' Report	Formal document that communicates an independent accountant's: (1) expression of limited assurance on Financial Statements as a result of performing inquiry and analytic procedures (Review Report); (2) results of procedures performed (Agreed-Upon Procedures Report); (3) non-expression of opinion or any form of assurance on a presentation in the form of financial statements information that is the representation of management (Compilation Report); or (4) an opinion on an assertion made by management in accordance with the Statements on Standards for Attestation Engagements (Attestation Report). An accountants' report does not result from the performance of an Audit.
Accounting	Recording and reporting of financial transactions, including the origination of the transaction, its recognition, processing, and summarisation in the Financial Statements. The process of recording, summarizing, analyzing, and interpreting financial (money-related) activities to permit individuals and organizations to make informed judgments and decisions. The process of identifying, measuring, and communicating economic information to permit informed judgments and decisions by users of the information.
Accounting Change	Change in (1) an accounting principle; (2) an accounting estimate; or (3) the reporting entity that necessitates disclosure and explanation in published financial reports.
Accounting Cycle	The steps involved in the recording and summarizing processes of accounting. The principal accounting procedures employed to process transactions during a fiscal period.
Accounting Equation	The equation that expresses the relationship between the accounting elements in a simple mathematical form: $\text{Assets} = \text{Liabilities} + \text{Owner's Equity}$.
Accounting Period	The period of time for which operating and financial statements are regularly prepared. A period that is typically one year; however, it can be any length of time for which accounting records are maintained, often for a month.

Term	Definition
Accounts Payable	The liability that results from purchasing goods or services on credit. Amounts entities owe suppliers for goods and services. Listed in the current liabilities section on the statement of financial position.
Accounts Payable Ledger	A subsidiary ledger that lists the individual accounts of creditors. Also called the creditors' ledger.
Accounts Receivable	The asset arising from selling goods or services on credit to customers. Listed in the current assets section on the statement of financial position.
Accounts Receivable Account	An asset account that shows the total currency (dollar or rupee or pound) amount due from credit customers.
Accounts Receivable Ledger	A subsidiary ledger containing only accounts of credit customers; also called the customers' (debtors) ledger.
Accounts Receivable Turnover	A measure that indicates how quickly an entity is collecting its accounts receivable. Calculated by dividing net credit sales by average net accounts receivable.
Accrual Basis	Method of accounting that recognizes revenue when earned, rather than when collected. Expenses are recognized when incurred rather than when paid. The basis of accounting that requires that revenue is recorded when earned, no matter when cash is received, and that expenses are recorded when incurred, no matter when cash is paid.
Accrual	An expense or a revenue that gradually increases with the passage of time.
Accrued Expenses	Expenses that build up or accumulate during the current period but will not be paid until the next period. Also called accrued liabilities. Unbilled amounts earned by others during a given period which are not yet due
Accrued Revenue	Revenue that has been earned in the current accounting period but will not be received until the next period. Also called accrued assets. Accrued interest is an example from the financial services and micro-finance sector
Accrued Salaries	Salaries that are unpaid (and unrecorded) at the end of an accounting period. Also called accrued wages.
Accumulated Depreciation	Total depreciation pertaining to an asset or group of assets from the time the assets were placed in services until the date of the financial statement. The total depreciation from the start of the life of a physical asset to any point in time. This total is the Contra Account to the related asset account.
Acid-Test Ratio	The ratio of the sum of cash, receivables, and marketable securities to current liabilities. The ratio of quick assets to current liabilities. A yardstick commonly used is a 1-to-1 ratio. Also called quick ratio.
Addition	A capital expenditure that literally adds on to an existing physical asset. The cost of an addition is debited to the physical asset account.
Adequate Disclosure Principle	States that financial statements or the explanatory notes and schedules that go with the statements must disclose all relevant data about the financial position of an entity
Adjusting Entries	Entries made at the end of an accounting period to bring the balances of certain accounts up to date.
Aging Schedule	A schedule in which accounts receivable are grouped into age categories and an estimated bad debts rate is applied to each age category.

Term	Definition
Aging the Receivables	A way of estimating bad debts expense when using the balance sheet approach. The process of analyzing the accounts receivable and classifying them according to various age groupings with the due date being the base point for determining age.
Allowance Method	A method of accounting for bad debts in which the amount estimated to be uncollectible is established at the end of an accounting period in an adjusting entry. Uncollectible accounts are then written off by debiting Allowance for Doubtful Accounts. The method of accounting for uncollectible receivables, by which advance provision for the uncollectibles is made.
Amortization	Gradual and periodic reduction of any amount, such as the periodic write down of a bond premium, the cost of an intangible asset or periodic payment of mortgages or other debt.
Amortization	The periodic write-off of the cost of an intangible asset. The periodic expense attributed to the decline in usefulness of an intangible asset or the allocation of bond premium or discount over the life of a bond issue.
Analytical Procedures	Substantive tests of financial information which examine relationships among data as a means of obtaining evidence. Such procedures include: (1) comparison of financial information with information of comparable prior periods; (2) comparison of financial information with anticipated results (e.g., forecasts); (3) study of relationships between elements of financial information that should conform to predictable patterns based on the entity's experience; (4) comparison of financial information with industry norms.
Annual Report	Report to the stockholders of a company which includes the company's annual, audited Balance Sheet and related statements of earnings, stockholders' or owners' equity and cash flows, as well as other financial and business information. A report a company publishes for its stockholders at the end of each fiscal year. The report includes required elements such as an auditors' report and the company's statement of earnings, statement of financial position, and statement of cash flows. The report also includes elements such as letters and articles by the company's executives, information on its financial condition, and significant events.
Annuity	Series of payments, usually payable at specified time intervals.
Apportionment	The process of dividing operating expenses among departments.
Appropriation of Retained Earnings	A portion of retained earnings earmarked for a specific purpose, such as expansion or the retirement of debt. The amount appropriated may not be used for cash or stock dividends.
Appropriations	The process of authorizing future payments from budgeted income. Only money that is appropriated can be spent.
Asset	Any item of economic value, either physical in nature (such as land or buildings) or a right to ownership, as expressed in cost or some other value, owned by an individual or entity. Anything of value. Any interest in real or personal property, which can be appropriated for the payment of debt. Anything companies own. These things might be physical assets such as buildings, trucks, inventories of products, equipment, and cash. Or these things might be intangible assets such as goodwill, trademarks, and patents. Listed as a category on the statement of financial position.

Term	Definition
Audit	A review of (1) the operating, administrative, and financial activities of an agency for conformance with all legal and administrative requirements and conformance with the principles of economy and efficiency; or (2) selected claims, cost proposals, grants, loans, or similar agreements entered into by an agency for conformance with the principles of economy and efficiency.
Audit Engagement	Agreement between an audit firm and its client to perform an audit.
Audit Risk	The risk that the auditor may unknowingly fail to modify appropriately his or her opinion on financial statements that are materially misstated.
Audit Sampling	Application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class.
Auditing Standards	Guidelines to which an auditor adheres. auditing standards encompass the auditor's professional qualities, as well as his or her judgment in performing an audit and in preparing the auditors' report.
Auditor	Person who audits financial accounts and records kept by others. a person or firm an entity hires as an independent third party to review its financial information. The auditor's main purpose is to make sure the statement of earnings, statement of financial position, and statement of cash flows fairly present the company's financial condition, and that they comply with auditing standards set forth by the various regulatory bodies
Auditors' Opinion	A summary of the findings of a firm of certified public accountants (Chartered accountants) that audits, or examines, a company's financial statements. This report is included in the company's annual report. Also called auditors' report and report of independent accountants.
Automated Data Processing	The general term applied to the processing of data by mechanical or electronic equipment that operates with a minimum of manual intervention.
Auxiliary Record	A business record that is not essential but is helpful in maintaining records that are essential; an example is the petty cash payments record.
Average Collection Period for Accounts Receivable	A rough measure of the length of time accounts receivable have been outstanding. Calculated by dividing 365 days by the accounts receivable turnover.
Backlog	The amount of a company's unfilled orders at the end of the year. When the company fills the orders the following year, it records the revenue on the statement of earnings. Frequently, a company will give its perspective on backlog in the management discussion section in the annual report.
Bad Debt	A debt that is not collectible and is therefore worthless to the creditor. All or portion of an Account, loan, or note receivable considered to be uncollectible. An account receivable that, for one reason or another, cannot be collected.
Balance	Sum of debit entries minus the sum of credit entries in an account. if positive, the difference is called a debit balance; if negative, a credit balance. The balance of an account is determined by footing (adding) the debit side, footing the credit side, and calculating the difference between the two sides.

Term	Definition
Balance Form of Account	A ledger account form with four amount columns that many businesses prefer to use because the balance is always known and it is easy to see whether the balance is a debit or a credit. Also called the four-column account form.
Balance of an Account	The amount of difference between the debits and the credits that have been entered into an account.
Balance Sheet	Financial statement presenting measures of the assets, liabilities and owner's equity or net worth of business firm or nonprofit organization as of a specific moment in time. Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation of a specified date the entity's assets, liabilities and the equity of its owners. also known as a statement of financial condition. A listing of a firm's assets, liabilities, and owner's equity at a specific point in time. Other terms used to describe the balance sheet are statement of financial position and position statement.
Balance Sheet Approach	A method of estimating the bad debts expense under the allowance method in which the expense is based on aging the accounts receivable.
Bank Checking Account	An amount of cash on deposit with a bank that the bank must pay at the written order of the depositor.
Bank Discount	Interest deducted in advance by a bank.
Bank Reconciliation	Making the bank statement balance agree with the checkbook balance. The method of analysis that details the items that are responsible for the difference between the cash balance reported in the bank statement and the balance of the cash account in the ledger.
Bank Statement	A monthly report showing the bank's record of the checking account.
Bankruptcy	A condition in which a firm does not have sufficient cash to pay its creditors. Legal process, governed by federal statute, whereby the debts of an insolvent person are liquidated after being satisfied to the greatest extent possible by the debtor's assets during bankruptcy, the debtor's assets are held and managed by a court appointed trustee.
Board of Directors	Individuals responsible for overseeing the affairs of an entity, including the election of its officers. People elected by a corporation's stockholders to oversee the business & appoint the officers.
Book of Original Entry	The journal is referred to as the book of original entry because it is the first place in which transactions are formally recorded.
Book Value	Amount, net or contra account balances, that an asset or liability shows on the balance sheet of a company. also known as carrying value. The difference between the cost of an asset and its accumulated depreciation.
Book Value of Asset.	The cost of an asset less the balance of any related contra asset account
Book Value	The value of an asset, a liability, or a stockholders' equity account. For a fixed asset, it is typically the cost of the asset minus accumulated depreciation. As companies continue to use fixed assets to generate revenue, the book values lessen, and sometimes ultimately reach zero.
Bookkeeping	The recording of business data in a prescribed manner.

Term	Definition
Break-Even Point	The point in operations where total sales exactly equal total fixed and variable costs; the point of zero profit or loss.
Bridge Loan	Short-term loan to provide temporary financing until more permanent financing is available.
Budget	Financial plan that serves as an estimate of future cost, revenues or both. A formal statement of management's financial plans for the future.
Budgeted Balance Sheet	A balance sheet that estimates each element of financial condition at a specified future time.
Budgeted Income Statement	An income statement that estimates net income for the next fiscal period, based on all income statement budgets.
Business	An organization that operates with the objective of earning a profit.
Business Entity Concept	The principle that states that, for accounting purposes, a business is a distinct economic entity or unit that is separate from its owner and from any other business.
Business Plan	A document that describes an organization's current status and plans for several years into the future. It generally projects future opportunities for the organization and maps the financial, operations, marketing and organizational strategies that will enable the organization to achieve its goals.
Business Segment	Any division of an organization authorized to operate, within prescribed or otherwise established limitations, under substantial control by its own management.
Business Transaction	The occurrence of an event or of a condition that must be recorded in the accounting records.
Bylaws	Collection of formal, written rules governing the conduct of a corporation's affairs (such as what officers it will have, what their responsibilities are, and how they are to be chosen). Bylaws are approved by a corporation's stockholders, if a stock corporation, or other owners, if a non-stock corporation. A set of policies that act as a corporation's constitution.
Cash on Delivery	Terms set by the seller that call for payment when the goods are delivered
Call Loan	Loan repayable on demand. Also known as demand loan
Canceled Checks	Checks that have been paid by the bank out of the depositor's account.
Capital	Broadly, all the money and other property of a corporation or other enterprise used in transacting its business.
Capital Expenditure	A cost that adds to the utility of an asset for more than one accounting period. Examples include additions, betterments, and extraordinary repairs. Capital expenditures increase either the value or the life of the asset and are debited to either the plant asset account or its accumulated depreciation account, depending on the type of expenditure.
Capital Expenditures Budget	A budget used for long-term planning of when physical assets will need to be replaced.
Capital Lease	A lease, which includes one or more of four provisions that result in treating the leased asset as a purchased asset in the accounts.

Term	Definition
Capital Markets	Those financial markets, including institutions and individuals, that exchange securities, especially long-term debt instruments.
Capital Statement	A summary of the changes in the capital of a business entity during a specific period of time.
Capital Stock	Ownership shares of a corporation authorized by its Articles of Incorporation. The money value assigned to a corporation's issued shares. The balance sheet account with the aggregate amount of the par value or stated value of all stock issued by a corporation. Shares of ownership in a corporation.
Capital	The rights (equity) of the owners in a business enterprise.
Capitalization	Long-term debt, preferred stock and net worth. The loan capital of a community development loan fund; includes that which has been borrowed from and is repayable to third parties as well as that which is earned or owned by the loan fund (i.e. "permanent capital").
Capitalized Cost	Expenditure identified with goods or services acquired and measured by the amount of cash paid or the market value of other property, capital stock, or services surrendered. Expenditures that are written off during two or more accounting periods.
Capitalized Interest	Interest cost incurred during the time necessary to bring an Asset to the condition and location for its intended use and included as part of the Historical Cost of acquiring the asset.
Capitalized Lease	Lease recorded as an asset acquisition accompanied by a corresponding liability by the lessee.
Cash	In its most basic meaning, cash is currency (paper money) and coin. The definition in a business context also includes checks, money orders, traveler's checks, cashier's checks, bank drafts, and receipts from credit card sales.
Cash Basis	Method of bookkeeping by which revenues and expenditures are recorded when they are received and paid. A basis of accounting where revenue is recorded only when cash is received, and expenses are recorded only when cash is paid.
Cash Budget	A budget that estimates the expected cash to be received and spent over a period of time.
Cash Equivalents	Short-term (generally less than three months), highly liquid Investments that are convertible to known amounts of cash. Highly liquid, short-term investments that can be turned to cash with little or no delay
Cash Flow Financing	Short-term loan providing additional cash to cover cash shortfalls in anticipation of revenue, such as the payment(s) of receivables.
Cash Flows	Net of cash receipts and cash disbursements relating to a particular activity during a specified accounting period. Cash receipts and cash payments from operating activities, investing activities, and financing activities.
Cash Payments Journal	A special journal used for recording all disbursements of cash. Also called the cash disbursements journal.
Cash Receipts Journal	A special journal used to record all receipts of cash, regardless of the source.

Term	Definition
Cash	Any medium of exchange that a bank will accept at face value. Currency and checks on hand and deposits in banks. Listed in the current assets section on the statement of financial position.
Certificate of Deposit (CD)	Formal instrument issued by a bank upon the deposit of funds which may not be withdrawn for a specified time period. Typically, an early withdrawal will incur a penalty.
Charges	Charges or fees by the bank that are subtracted directly from the depositor's account and appear on the bank statement. Also called bank charges.
Chart of Accounts	A directory or listing of accounts in the ledger. A listing of all the accounts used by a business enterprise.
Check	A written order directing a bank to pay a specified sum of money to a designated person or business.
Check Register	A modified form of the cash payments journal used to record all transactions paid by check.
Check Stub	Part of a check that remains in the checkbook as a permanent record of the check.
Checkbook	A bound book of checks with stubs; the depositor's record of the checking account.
Classified Balance Sheet	A balance sheet that divides the assets and liabilities sections into the following subsections: current assets and long-term assets, and current liabilities and long-term liabilities.
Classified Income Statement	An income statement divided into the following sections: revenue cost of goods sold (funds), operating expenses, and other income and expenses.
Closing Entries	Entries made at the end of an accounting period to transfer the balances of the temporary accounts to the owner's capital account. An entry necessary to eliminate the balance of a temporary account in preparation for the following accounting period.
Closing Process	The process of transferring the balances of temporary accounts to the owner's capital account.
Collateral	Assets pledged to secure the repayment of a loan. Asset provided to a creditor as security for a loan.
Combined Financial Statement	Financial Statement comprising the accounts of two or more entities.
Combined Journal	A multicolumn journal used by small businesses to help save journalizing and posting time. It has two special columns for recording debits and credits to cash, various other special columns for recording transactions that occur often, and two general columns for recording transactions that occur less often. Also called a combination journal.
Community-Based Finance Institution:	The term "Community-based finance institution" (CBFI) has been formulated to define organizations which enable low-income groups to participate fully and democratically in the development process and which have their roots in the community. Frequently, these organizations are referred to as co-operatives, but some community-based organizations are in fact not co-operatives but groups with a similar structure and objectives [UN-ESCAP (1991)].

Term	Definition
Comparative Financial Statement	Financial Statement presentation in which the current amounts and the corresponding amounts for previous periods or dates also are shown. A side-by-side comparison of a company's financial statements for two or more accounting periods.
Compliance Audit	Review of financial records to determine whether the entity is complying with specific procedures or rules.
Compound Interest Principles	Interest computed on principal plus interest earned in previous periods.
Composite-Rate Depreciation Method	A method of depreciation based on the use of a single rate that applies to entire groups of assets.
Comprehensive Income	Change in equity of a business enterprise during a period from transactions and other events and circumstances from sources not shown in the income statement. The period includes all changes in equity except those resulting from investments by owners and distributions to owners.
Conservatism	An investment strategy aimed at long-term capital appreciation with low risk; moderate; cautious; opposite of aggressive behavior; show possible losses but wait for actual profits. Concept which directs the least favorable effect on net income.
Consistency	Accounting postulate which stipulates that, except as otherwise noted in the Financial Statement, the same accounting policies and procedures have been followed from period to period by an organization in the preparation and presentation of its financial statements.
Consistency	The accounting principle that requires a firm to continue to use a method once chosen, rather than switch from method to method arbitrarily or for temporary advantage. The concept that assumes that the same generally accepted accounting principles have been applied in the preparation of successive financial statements.
Consolidated Financial Statements	Combined Financial Statements of a parent company and one or more of its subsidiaries as one economic unit.
Consolidated Statement	A financial statement resulting from combining parent and subsidiary company statements.
Contingent Liability	Potential liability arising from a past transaction or a subsequent event. A possible liability, such as on a discounted note of a customer, that may become a real liability if certain events occur. A potential obligation that will materialize only if certain events occur in the future.
Continuing Operations	Portion of a business entity expected to remain active.
Co-Operative:	A co-operative, as defined by the International Labour Organization is an association of persons, usually of limited means, who have voluntarily joined together to achieve a common economic end through the formation of a democratically controlled business organization, making equitable contributions to the capital required and accepting a fair share of the risks and benefits of the undertaking [UN-ESCAP (1991)].
Correcting Entry	An entry used to correct certain types of errors in the ledger.

Term	Definition
Cost	The financial measure of resources consumed in accomplishing a specific purpose such as performing a service, carrying out an activity, or completing a unit of work or a specific project. An input into the manufacturing of a product. There are three common inputs in manufacturing: (1) raw materials, (2) direct labor, and (3) factory overhead.
Cost Accounting	Procedures used for rationally classifying, recording, and allocating current or predicted costs that relate to a certain product or production process. The field of accounting that is used to determine the dollar value of goods that are manufactured. Accounts that are presented on the income statement; used to determine the cost of goods sold to customers.
Credit	Entry on the right side of a Double-entry bookkeeping system that represents the reduction of an Asset or expense or the addition to a liability or revenue. (See Debit.) The allowance of cash, goods, or services in the present, with payment expected in the future. To credit (Cr.) an account means to enter an amount on the right, or credit, side of the account.
Credit Balance	Balance remaining after one of a series of bookkeeping entries. This amount represents a liability or income to the entity. (See Balance.) Occurs when the amount on the credit side of an account is greater than the amount on the debit side.
Credit Period	The amount of time a seller allows a credit customer to pay for a purchase.
Credit Terms	The terms for payment set by a seller of goods or services; includes the amount of time before payment is due and the rate of discount (if any) for paying early.
Credit Union:	In the financial sector, co-operatives which enable savings to be made and loans to be taken are generally known as "credit unions" which are registered under the legislation dealing with co-operatives in each country. The basic credit union is composed of a group of people having a "common bond" who may be resident in the same neighbourhood or employed at the same place of work, or it can be a religious or ethnic grouping. The principal reason for the emphasis on a common bond is that the social pressure of the group is considered a very important condition as security for loans. It is a form of collateral which is not available in conventional finance [UN-ESCAP (1991)].
Credit	(1) The right side of an account; (2) the amount entered on the right side of an account; (3) to enter an amount on the right side of an account.
Creditor	Party that loans money or other assets to another party. A business or person to whom a debt is owed.
Current Asset	Asset that one can reasonably expect to convert into cash, sell, or consume in operations within a single operating cycle, or within a year if more than one cycle is completed each year. Cash and assets that will be sold, used up, or turned into cash within the current accounting period, usually one year. Besides cash, examples are receivables, supplies, and merchandise inventory.
Current Cost Statements	The financial statements that result when historical costs reported in conventional statements are adjusted for specific price-level changes, so that all elements of the statements are reported at their current costs.

Term	Definition
Current Liabilities	Debts that are due for payment within one year. Examples are accounts payable, salaries payable, sales tax payable, and the current portion of notes payable. Obligations a company has to others, such as creditors, suppliers, & tax authorities, payable within one year. Listed in the liabilities category on the statement of financial position. Obligation whose liquidation is expected to require the use of existing resources classified as current assets, or the creation of other current liabilities. A liability that will be due within a short time (usually one year or less) and that is to be paid out of current assets.
Current Ratio	Current assets divided by current liabilities -- a measure of liquidity. Generally, the higher the ratio, the greater the "cushion" between current obligations and a firm's ability to meet them. The ratio obtained by dividing current assets by current liabilities. It is an indicator of a firm's ability to pay its short-term debts as they become due. The ratio of current assets to current liabilities.
Current Value	(1) Value of an asset at the present time as compared with the asset's Historical Cost. (2) In finance, the amount determined by discounting the future revenue stream of an asset using compound interest principles.
Debit	Entry on the left side of a double-entry bookkeeping system that represents the addition of an Asset or expense or the reduction to a Liability or Revenue. (See Credit.) To debit (Dr.) an account means to enter an amount on the left, or debit, side of the account.
Debit Balance	Balance remaining after one or a series of bookkeeping entries. This amount represents an Asset or an expense of the entity. (See Balance.) Occurs when the amount(s) on the debit side of an account is greater than the amount(s) on the credit side.
Debt	An amount owed for funds borrowed. The debt may be owed to an organization's own reserves, individuals, banks, or other institutions. Generally, the debt is secured by a note, bond, mortgage, or other instrument that states repayment and interest provisions. The note, in turn, may be secured by a lien against property or other assets. General name for money, notes, bonds, goods or services which represent amounts owed.
Debt Service	Amount of payment due regularly to meet a debt agreement; usually a monthly, quarterly or annual obligation.
Debtor	Party owing money or other Assets to a Creditor.
Decentralized Branch Accounting	A system of accounting for branches in which each branch keeps its own records and prepares its own financial statements.
Declining-Balance Depreciation Method	A method of depreciation that provides declining periodic depreciation charges to expense over the estimated life of a asset.
Default	A failure to discharge a duty. The term is most often used to describe the occurrence of an event that cuts short the rights or remedies of one of the parties to an agreement or legal dispute, for example, the failure of the mortgagor to pay a mortgage installment, or to comply with mortgage covenants. Failure to meet any financial obligation. Default triggers a creditor's rights and remedies identified in the agreement and under the law.

Term	Definition
Deferral	A postponement of the recognition of an expense already paid or a revenue already received. Expenses and revenue that have been recorded in the current accounting period but are not incurred or earned until a future period.
Deferred Charge	Cost incurred for subsequent periods which are reflected as assets. Another name for deferred expenses, usually applying to advance payments that cover more than a year.
Deferred Credits	Another name for deferred revenue, usually applying to amounts received more than a year in advance.
Deferred Expenses	Advance payments for goods or services that benefit more than one accounting period.
Deferred Income	Income received but not earned until all events have occurred. Deferred income is reflected as a liability.
Deferred Revenue	The advance receipt of revenue that will not be earned until a future accounting period.
Deficit	Financial shortage that occurs when liabilities exceed assets. A debit balance in the Retained Earnings account.
Deflation	A period when prices in general are falling and the purchasing power of the currency (dollar or pound or rupee) is increasing.
Delinquent	In a monetary context, something that has been made payable and is overdue and unpaid,
Demand Loan	Loan repayable on demand. Also known as a Call Loan.
Depletion	Method of computing a deduction to account for a reduction in value of extractable natural resources. The expense resulting from the using up of a natural resource. The cost of metal ores and other minerals removed from the earth.
Deposit Method	Related to the sales of real estate, under this method the seller does not recognize any profits, does not record a note receivable, and continues to reflect the property and related debt in the seller's financial statements, recording the buyer's initial investment and subsequent payments as a deposit.
Deposit Slip	A form that is prepared when coin, currency, or checks are deposited in a bank account. It indicates the depositor's name and account number and summarizes the amount deposited. Also called deposit ticket.
Depositor	The business or person under whose name a checking account is opened.
Depreciation	Expense allowance made for wear and tear on an asset over its estimated useful life. (See Accelerated Depreciation and Straight-line Depreciation.) An allocation process in which the cost of a long-term asset (except land) is divided over the periods in which the asset is used in the production of the business's revenue. The periodic cost expiration of all plant assets except land. An allowance for wear or age made to the value of a fixed asset, allocating its cost over its estimated useful life. Listed in the assets category on the statement of financial position.
Depreciation Expense	The expense that results from the allocation process of depreciation.

Term	Definition
Direct Expense	An expense that is associated with a specific department; an expense that benefits only that department and that would not exist if the department did not exist.
Direct Method	A format for the statement of cash flows that discloses each major class of cash inflow and cash outflow from operating activities. It shows the amount of cash received or paid for revenues and expenses reported on the income statement. This is the method recommended by the FASB.
Direct Write-Off Method	A method of accounting for bad debts in which the expense is recorded at the time of the write-off of a customer's account. A method of accounting for uncollectible receivables, whereby an expense is recognized only when specific accounts are judged to be uncollectible.
Disbursement	Payment by cash or check. Represents the amount of checks issued and electronic fund transfers, cash or other payments made.
Disclaimer of Opinion	Statement by an auditor indicating inability to express an opinion on the fairness of the financial statements provided and the reason for the inability.
Disclosure	Process of divulging accounting information so that the content of financial statements is understood.
Discount	Reduction from the full amount of a price or debt.
Dividend	A distribution of corporate earnings to the stockholders of the company.
Dividend Yield	A measure of profitability that tells the investor the rate earned on investment. Calculated by dividing the dividend per share of stock by the market price per share.
Dividend	A distribution of earnings of a corporation to its owners (stockholders). Distribution of earnings to owners of a corporation in cash, other Assets of the corporation, or the corporation's capital stock. Cash or stock payments from a company's profits distributed to stockholders, an equal amount for each share of stock owned. Listed as dividends on the statement of stockholders' equity.
Dividends In Arrears	Passed dividends on cumulative preferred stock.
Double Declining-Balance Method	A depreciation method that allows greater depreciation in the early years of the life of a plant asset and less depreciation in later years. This is achieved by applying a constant rate to each year's decreasing book value.
Double-Entry Accounting	Each business transaction affects the accounting elements in at least two ways. Recording both effects of a transaction is called double-entry accounting. A system for recording transactions based on recording increases and decreases in accounts so that debits always equal credits.
Double-Entry Bookkeeping	Method of recording financial transactions in which each transaction is entered in two or more accounts and involves two-way, self-balancing posting. Total debits must equal total credits.
Drawee	The bank on which a check is drawn.
Drawer	The business or person who writes a check.
Drawing Account	A temporary owner's equity account that is used when an owner withdraws cash or other assets from the business for personal use.

Term	Definition
Dual Effect	The principle that states that all business transactions are recorded as having at least two effects on the basic accounting elements.
Due Date	The date on which a note must be paid. Also called the maturity date.
Earned Capital	Capital that arises from profitable operations of the corporation; usually called retained earnings.
Earned Income	Wages, salaries, professional fees, and other amounts received as compensation for services rendered.
Earnings per Share (Eps)	Measure of performance calculated by dividing the net earnings of a company by the average number of shares outstanding during a period. The portion of a company's profit assigned to each share of stock. For example, if the profit is currency (Dollar, Rupees, Pounds) 1 million and 500,000 shares are outstanding, the earnings per share would be currency (Dollar, Rupees, Pounds) $1 \text{ million} \div 500,000 \text{ shares} = \text{currency (Dollar, Rupees, Pounds) } 2$. Listed in the per share of common stock amounts category on the statement of earnings.
Earnings Report	A financial statement that reports the results of a company's business operations (revenue and expenses) for a set period, usually one year. Also called an income statement, statement of earnings, statement of operations, and statement of profit and loss.
Encumbrance	(1) Mortgage or other lien on the entity's assets; (2) Anticipated expenditure; (3) Uncompleted or undelivered portion of a purchase commitment. Expected liabilities.
Endorsement	A signature or stamp on the back of a check that transfers ownership of the check to the bank or another person.
Equipment	The physical assets needed by a business in order to operate.
Equity	The value of property in an organization greater than total debt held on it. Equity investments typically take the form of an owner's share in the business, and often, a share in the return, or profits. Equity investments carry greater risk than debt, but the potential for greater return should balance the risk. Residual interest in the assets of an entity that remains after deducting its liabilities. Also, the amount of a business' total assets less total liabilities. Also, the third section of a balance sheet, the other two being assets and liabilities. The right or claim to the properties of a business enterprise. The part of a company's assets that belongs to the stockholders. In other words, the amount that would remain if a company sold all of its assets and paid off all of its liabilities. Listed as stockholders' equity on the statement of financial position and on the statement of stockholders' equity.
Escrow	Money or property put into the custody of a third party for delivery to a grantee, only after fulfillment of specified conditions.
Exempt Organization	Organization which is generally exempt from paying income tax. Exempt organizations include religious organizations, charitable organizations, social clubs, and others.
Expenditure	Payment, either in cash, by assuming a liability, or by surrendering asset.

Term	Definition
Expense	The amount of assets consumed or services used in the process of earning revenue. The costs of operating a business. Unlike the cost of an asset, the cost of an expense does not provide a future benefit to the business. Therefore, its effect is a reduction in owner's equity. Costs such as salaries, rent, office supplies, advertising, and taxes. Listed in the operating expenses category on the statement of earnings.
External Reporting	Reporting to stockholders and the public, as opposed to internal reporting for management's benefit.
Financial Forecast	A statement indicating an enterprise's financial plans and expectations for the future.
Financial Institution	Organization engaged in any of the many aspects of finance including commercial banks, development banks, thrift institutions, investment banks, securities brokers and dealers, credit unions, investment companies, insurance companies, and real estate investment trusts.
Financial Statements	Presentation of financial data including balance sheets, income statements and statements of cash flow, or any supporting statement that is intended to communicate an entity's financial position at a point in time and its results of operations for a period then ended. Summaries of financial activities.
Financing Activities	Transactions that involve cash receipts or payments from changes in long-term liabilities and stockholders' equity--such as selling stock to stockholders and paying dividends, and borrowing from creditors and repaying these loans.
Fiscal Period	The period of time that covers a complete accounting cycle. A fiscal year is a fiscal period covering twelve months; it does not necessarily coincide with the calendar year.
Fiscal Year	Period of 12 consecutive months chosen by an entity as its accounting period which may or may not be a calendar year. A 12-month time period that may or may not be from January 1 to December 31 or April 1 to March 31. The annual accounting period adopted by an enterprise.
Fixed Assets	Any tangible asset with a life of more than one year used in an entity's operations. Anything companies use for more than one year to manufacture, display, store, and transport products. Often called "property, plant, and equipment" because that's what fixed assets usually are. Listed after current assets in the assets category on the statement of financial position.
Fixed Costs	Costs that do not change as production changes; costs that occur even without any production
Flexible Budget	A budget that is actually a series of budgets for different levels of production activity
Footing	The total of the debit column or credit column of an account.
Forecast	Prospective financial statements that are an entity's expected financial position, results of operations, and cash flows
Foreclosure	Seizure of collateral by a creditor when default under a loan agreement occurs.

Term	Definition
Franchise	Legal arrangement whereby the owner of a trade name, franchisor, contracts with a party that wants to use the name on a non-exclusive basis to sell goods or services, franchisee. Frequently, the franchise agreement grants strict supervisory powers to the franchisor over the franchisee which, nevertheless, is an independent business.
Fraud	Willful misrepresentation by one person of a fact inflicting damage on another person.
Funds Statement	The statement of changes in financial position.
Fungibility	The quality of money that makes one individual specimen indistinguishable from another. Anything used as money (gold, shells, bank notes) must have this quality. The fungibility of money makes it difficult for lenders to ensure that borrowers use the loan funds in the way lenders wish; one way they try to get round "misuse of funds" is to lend in kind. Often a person will borrow money for one stated purpose, but the effect of the loan is to finance another activity. Say, for example, that I intend to improve my house using savings but someone offers me a home improvement loan on attractive terms. The effect of the loan is not to increase quality of the housing stock, as the lender intended, but to enable me to undertake some other activity I could not otherwise have financed buying a motorcycle, taking a holiday, or perhaps partying every night. Micro finance lenders such as donors and NGOs tend to dislike this because (a) they don't think poor people should use their limited incomes on such things, and (b) it reduces the funds available for lending to other potential clients or beneficiaries.
General Expense	Expense incurred in the general operation of a business. Expenses related to (1) running a firm's office or (2) any other operating activities that do not involve the sale of merchandise. Also called administrative expenses.
General Ledger	Collection of all asset, liability, owners' equity, revenue, and expense accounts. A ledger containing the financial statement accounts. The principal ledger, when used in conjunction with subsidiary ledgers that contains all of the balance sheet and income statement accounts.
Going Concern	Assumption that a business can remain in operation long enough for all of its current plans to be carried out.
Going Concern Concept	The concept that assumes that a business entity has a reasonable expectation of continuing in business at a profit for an indefinite period of time.
Goodwill	Premium paid in the acquisition of an entity over the fair value of its identifiable tangible and intangible assets less liabilities assumed. An intangible asset made up of such factors as an excellent reputation, a fine location, a superior product line, or outstanding management skills. Used to give a partner a greater capital credit than the amount of assets invested. An intangible asset that adds value to the worth of a company; for example, the reputation of its products, services, or personnel. Listed in the assets category (sometimes as "Investments and sundry assets") on the statement of financial position.

Term	Definition
Governing Documents	Official legal documents that dictate how an entity is operated. The governing documents of a corporation include articles of incorporation and Bylaws; a partnership includes the partnership agreement; a trust includes the trust agreement or trust indenture; and an LLC includes the Articles of organization and operating agreement.
Grantee	Person to whom property is transferred.
Grantor	(1) Person who transfers property. (2) Person who creates a trust.
Guaranteed Loan	A pledge to cover the payment of debt or to perform some obligation if the person liable fails to perform. When a third party guarantees a loan, it promises to pay in the event of a default by the borrower.
Guaranty	Legal arrangement involving a promise by one person to perform the obligations of a second person to a third person, in the event the second person fails to perform.
Historical Cost	Original cost of an asset to an entity.
Horizontal Analysis	The comparison of each item in a company's financial statements in the current period with the same item from a previous accounting period or periods. The percentage analysis of increases and decreases in corresponding items in comparative financial statements.
Improvement	Expenditure directed to a particular asset to improve its performance or useful life.
Income	Inflow of revenue during a period of time. (See Net Income.)
Income from Operations	Gross profit minus operating expenses. Also called operating income. The excess of gross profit over total operating expenses.
Income Statement	Summary of the effect of revenues and expenses over a period of time. A summary of a business's revenue and expenses for a specific period of time, such as a month or a year. Other terms used to describe the income statement are earnings statement, operating statement, statement of operations, and profit and loss statement.
Independent Auditors' Report	A report accompanying financial statements, which chartered accountants (CPAs) express an opinion as to the fairness of the statements.
Indirect Expense	An expense of operating a business that is not associated with a specific department; an expense that benefits an entire business and would continue to exist even if a specific department were eliminated.
Indirect Labor	The cost of those employees who work in the company, but not on the product itself. Example - Accountants not working in the credit program
Inflation	A period when prices in general are rising and the purchasing power of the currency (dollar or rupee or pound sterling) is declining.
Informal Finance System	"Informal" refers to types of institutions. Most community-based financial institutions are formal organizations, although they are not normally targeted for a particular purpose. While every group exhibits some degree of formality, the term "informal" is used principally to describe traditional systems of savings and loans.

Term	Definition
Insolvent	When an entity's Liabilities exceed its Assets.
Intangible Asset	Asset having no physical existence such as trademarks and patents. A long-lived asset that is useful in the operations of an enterprise, is not held for sale, and is without physical qualities. Long-term assets used in a business that lack physical substance. Examples include patents, copyrights, trademarks, and franchises. Anything nonphysical, such as goodwill, trademarks, and patents, that have value for a company. Listed in the assets category (sometimes as "Investments and sundry assets") on the statement of financial position. Would positive peer pressure in micro-finance be such an intangible asset
Interest	Payment for the use or forbearance of money. The charge for credit; calculated as (principal) X (rate) X (time)
Interim Financial Statements	Financial Statements that report the operations of an entity for less than one year
Interim Financing	Short-term loan to provide temporary financing until more permanent financing is available
Interim Statement	A financial statement issued for a period covering less than a fiscal year Statements that are prepared during the fiscal year for periods of less than 12 months--such as monthly, quarterly, and semiannually
Internal Audit	Audit performed within an entity by its staff rather than an independent certified public accountant.
Internal Control	Process designed to provide reasonable assurance regarding achievement of various management objectives such as the reliability of financial reports. The procedures used within a company to protect its assets.
Internal Transactions	Transactions, such as adjustments, that occur within a company and do not affect parties outside the company
Investment	Expenditure used to purchase goods or services that could produce a return to the investor. A company's equity ownership in unconsolidated subsidiaries and affiliates. Listed in the category of assets (for example, "Investments and sundry assets") on the statement of financial position.
Invoice	A business document that contains the names and addresses of the buyer and the seller, the date and terms of the sale, a description of the goods, the price of the goods, and the mode of transportation used to ship the goods. The seller calls the invoice a sales invoice; the buyer calls it a purchase invoice. The bill provided by the seller (referred to as a sales invoice) to a purchaser (referred to as a purchase invoice) for items purchased.
Journal	Any book containing original entries of daily financial transactions. A form in which transactions are recorded in chronological order (by order of date).
Journalizing	The process of recording transactions in a journal.
Lease	Conveyance of land, buildings, equipment or other assets from one person (Lessor) to another (Lessee) for a specific period of time for monetary or other consideration, usually in the form of rent. A contractual agreement conveying the right to use an asset for a stated period of time.
Leasehold	Property interest a lessee owns in the leased property.

Term	Definition
Ledger	Any book of accounts containing the summaries of debit and credit entries. A collective grouping of accounts. The group of accounts used by an enterprise.
Legal Capital	The amount of earnings that a corporation must retain before a dividend can be paid to stockholders; usually equals the par value of the stock outstanding.
Lessee	Person or entity that has the right to use property under the terms of a lease.
Lessor	Owner of property, the temporary use of which is transferred to another (Lessee) under the terms of a lease.
Letter of Credit	Conditional bank commitment issued on behalf of a customer to pay a third party in accordance with certain terms and conditions. The two primary types are commercial letters of credit and standby letters of credit.
Leverage	Using long-term debt to secure funds for an organization. In the social investment world, often refers to financial participation by other private, public or individual sources. The use of borrowed funds to earn a greater return than the cost of the borrowed funds. The tendency of the rate earned on stockholders' equity to vary from the rate earned on total assets because the amount earned on assets acquired through the use of funds provided by creditors varies from the interest paid to these creditors. A company's use of debt, instead of its equity, to support its assets and grow.
Liabilities	Debts owed by the business. A company's debts to a lender, a supplier of goods and services, a tax authority, a landlord, and others. Listed as a category on the statement of financial position. Debts or obligations owed by one entity (debtor) to another entity (creditor) payable in money, goods, or services. A debt of a business enterprise.
Liabilities, Total Liabilities	Total value of financial claims on a firm's assets. Equals total assets minus net worth.
Limited Liability	Limitation of shareholders' losses to the amount invested means that stockholders of a corporation are not personally liable for the debts of the company
Line of Credit	Agreement by a bank that a company may borrow at any time up to an established limit.
Liquid Asset	An asset that can be quickly converted into cash. Examples include cash and marketable securities.
Liquid Assets - Cash	cash equivalents, and marketable securities.
Liquidation	Winding up an activity by distributing its assets to the appropriate parties and settling its debts. The process of winding up a business.
Liquidity	Refers to how quickly an asset can be turned into cash, used up, or expire; used in reference to assets, which are listed on the balance sheet in the order of their liquidity.
Loan Agreement	A written contract between a lender and a borrower that sets out the rights and obligations of each party regarding a specified loan.
Long-Term Debt	Debt with a maturity of more than one year from the current date. Debt a company will repay after one year. Listed in the liabilities category on the statement of financial position.

Term	Definition
Long-Term Investment	An investment that is not intended to be a ready source of cash in the normal operations of a business and that is listed in the "investments" section of the balance sheet. Investments that management intends to hold for more than one year.
Long-Term Liabilities	Debts that will not come due for payment within one year. Examples are long-term notes payable and mortgages payable. A liability that is not due for a comparatively long time (usually more than one year).
Loss	Excess of expenditures over revenue for a period or activity.
Management Accounting	Reporting designed to assist management in decision-making, planning, and control. Also known as managerial accounting.
Margin	Excess of selling price over the unit cost.
Market Rate	The rate of interest a company must pay to borrow funds currently.
Marketable Securities	Stocks and other negotiable instruments which can be easily bought and sold on either listed exchanges or over-the-counter markets. Financial assets, such as stocks and bonds, that companies can convert to cash. Listed as assets on the statement of financial position. An investment in a security that can be readily sold when cash is needed.
Matching Principle	A fundamental concept of basic accounting. In any one given accounting period, you should try to match the revenue you are reporting with the expenses it took to generate that revenue in the same time period, or over the periods in which you will be receiving benefits from that expenditure. A simple example is depreciation expense. If you buy a car that will last for many years, you don't write off the cost of that car all at once. Instead, you take depreciation deductions over the car's estimated useful life. Thus, you've "matched" the expense, or cost, of the building with the benefits it produces, over the course of the years it will be in service. A fundamental rule of basic accounting. In any one given accounting period, you should try to match the revenue you are reporting with the expenses it took. Requires that revenue earned during an accounting period be offset by the expenses that were necessary to produce that revenue, so that the accurate net income or net loss for the period can be reported
Matching	The principle of accounting that all revenues should be matched with the expenses incurred in earning those revenues during a period of time.
Maturity Date	The date on which the principal (amount) must be repaid
Maturity Value	The principal plus the interest on an instrument; the amount that must be paid to the payee on the maturity date of the instrument. The amount due at the maturity or due date of an instrument.
Monetary Items	Definite fixed amounts stated in terms of currency units, either by law or by contract agreement. Money or a claim to receive money or an obligation to pay a fixed amount of money.
Natural Business Year	A fiscal year ending at a business's lowest point of activity.
Natural Business Year	A year that ends when a business's activities have reached the lowest point in its annual operating cycle.
Negotiable	Able to be transferred by endorsement to another party.

Term	Definition
Net Assets	Excess of the value of securities owned, cash, receivables, and other assets over the liabilities of the company.
Net Earnings	A company's total revenue less total expenses, showing what a company earned (or if lost, called net loss) for a set period, usually one year. Listed often literally as the "bottom line" on the statement of earnings. Also called net income and net profit.
Net Income	Excess or deficit of total revenues and gains compared with total expenses and losses for an accounting period. Occurs when revenue earned during an accounting period exceeds the expenses of the same period. The final figure in the income statement when revenues exceed expenses. A company's total revenue less total expenses, showing what a company earned (or lost, called net loss) for a set period, usually one year. Listed often literally as the "bottom line" on the statement of earnings. Also called net earnings and net profit.
Net Loss	The final figure in the income statement when expenses exceed revenues.
Net Profit	A company's total revenue less total expenses, showing what a company earned (or lost, called net loss) for a set period, usually one year. Listed often literally as the "bottom line" on the statement of earnings. Also called net earnings and net income.
Net Realizable Value	The difference between the balance in the Accounts Receivable account and the Allowance for Doubtful Accounts account; the actual amount of receivables that the firm expects to collect.
Net Receivables	Another name for net realizable value.
Net Working Capital	Current assets minus current liabilities.
Net Worth	Similar to equity, the excess of assets over liabilities. The owner's equity in a business. The amount of a company's stockholders' equity. Listed as total stockholders' equity on the statement of financial position.
Non Current Assets	Anything of long-term value to a company, including fixed assets and intangible assets. Listed in the assets category (after current assets) on the statement of financial position.
Note Payable	A formal written promise to pay a specified amount at a definite future date. A written promise to pay, representing an amount owed by a business.
Note Receivable	A written promise to pay, representing an amount to be received by a business.
Notes	An annual report section that provides information essential to fully understanding the financial statements. Notes explain the financial statements' numbers and any significant events affecting them. Notes also provide additional detail and provide supplementary financial information. Also called footnotes.
Operating Activities	Transactions that enter into the calculation of net income; operating activities affect the income statement.
Operating Expenses	Expenses incurred in the normal operation of the business.
Operating Expenses Budget	A budget that estimates operating expenses for the next fiscal period.

Term	Definition
Operating Expenses	Costs related to a company's operations. Examples are salaries, advertising, sales commissions, travel, and entertainment. Listed as a category on the statement of earnings.
Opportunity Cost	The potential benefit that is foregone from not following the best (financially optimal) alternative course of action.
Payroll Register	Summary of the gross earnings, deductions, and net pay for all employees for a specific payroll period.
Pension	Retirement plan offered by an employer for the benefit of an employee, usually at retirement, through a trustee who controls the assets. (See employee benefit plan.)
Petty Cash Fund	A small amount of cash kept in the office for making small payments for items such as postage and office supplies. A special cash fund used to pay relatively small amounts.
Petty Cash Payments Record	An auxiliary record, one that is used to record payments from the petty cash fund. At the end of the month, the record is summarized and used as a basis for a journal entry.
Petty Cash Voucher	A voucher used when payment is made from the petty cash fund. It shows the amount of the payment, the purpose, and the account to be debited.
Petty Cashier	The person designated to disburse money from the petty cash fund.
Pledged Asset	Asset placed in a trust and used as collateral for a debt.
Portfolio	A combination of assets held for its investment benefits, including financial and non-financial returns. The asset mix is usually varied in kind and size to maintain an acceptable level of risk and return.
Posting	The process of transferring amounts from the journal to the ledger. The process of transferring debits and credits from a journal to the accounts.
Posting Errors	Errors that result from incorrect transfers from the journal to an account or from the ledger to the trial balance.
Prepaid Expense	Cost incurred to acquire economically useful goods or services that are expected to be consumed in the revenue-earning process within the operating cycle. A purchased commodity or service that has not been consumed at the end of an accounting period. Another name for deferred expenses, usually applying to advance payments that cover a year or less.
Principal	In commercial law, the principal is the amount that is received, in the case of a loan, or the amount from which flows the interest. Face amount of a security, exclusive of any premium or interest. The basis for interest computations. The amount of money borrowed or the amount of credit extended. Also called the face value.
Principle of Materiality	States that proper accounting procedures have to be strictly followed only for events and transactions that would have an effect on a business's financial statements.
Principle of Objective Evidence	States that source documents should form the foundation for recording business transactions.
Prior Period Adjustment	Correction of a material error related to a prior period or periods, excluded from the determination of net income.

Term	Definition
Profit Center	Any segment of a business that incurs expenses while producing revenue.
Profitability	The ability of a business to earn a reasonable return on the owners' investments. The ability of a firm to earn income.
Projection	Prospective financial statements that include one or more hypothetical assumptions.
Promissory Note	Promise to pay. Written contract between a borrower and a lender that is signed by the borrower and provides evidence of the borrower's indebtedness to the lender. Evidence of a debt with specific amount due and interest rate. The note may specify a maturity date or it may be payable on demand. The promissory note may or may not accompany other instruments such as a mortgage providing security for the payment thereof. (See demand loan.) A written promise to pay a sum of money at a definite time in the future. Also called a note.
Proxy	Document authorizing someone other than the shareholder to exercise the right to vote the stock owned by the shareholder.
Quick Assets	Current assets that can be converted to cash right away, such as receivables and marketable securities. The sum of cash, receivables, and marketable securities.
R&D	See Research and Development.
Rate	The annual percent charged on the principal.
Ratio	A fractional relationship of one number to another. A measure of the relative size of two numbers. Usually, financial ratios are expressed as a times multiple (x) or a percentage (%). Ratios provide a quick way to compare a company to its performance over time, to other companies in the same industry, and to the industry average.
Ratio Analysis	Comparison of actual or projected data for a particular company to other data for that company or industry in order to analyze trends or relationships.
Real Account	A balance sheet account.
Realization Principle	The principle that states that revenue should be recorded when it is earned, even though cash may not be collected until later.
Receivables	Accounts receivable; an amount that is owed the business, usually by one of its customers as a result of the ordinary extension of credit. Amounts of money due from customers or other debtors.
Reconciliation	Comparison of two numbers to demonstrate the basis for the difference between them.
Refinancing Agreement	Arrangement to provide funding to replace existing financing, the most common being a refinance of a home mortgage.
Reinsurance	Process by which an insurance company obtains insurance on its insurance claims with other insurers in order to spread the risk.
Report of Independent Accountants	A summary of the findings of a firm of independent certified public accountants that audits, or examines, a company's financial statements. This report is included in the company's annual report. Also called auditors' report and auditors' opinion.

Term	Definition
Reserve	Account used to earmark a portion of equity or fund balance to indicate that it is not available for expenditure.
Restructuring	Reorganization within an entity. Restructuring may occur in the form of changing the components of capital, renegotiating the terms of debt agreements, etc.
Revenue	Income earned from carrying out the activities of a firm. The amount charged to customers for goods sold or services rendered. The total flow of funds into a company, mostly for sales of its goods or services. Listed as the first category on the statement of earnings. Sales of products, merchandise, and services; and earnings from interest, dividend and rent.
Revenue Expenditures	An expenditure that benefits only the current period. Expenditures for a plant asset that benefit only the current accounting period. Examples include repairs and maintenance expenses. Revenue expenditures are debited to expense accounts.
Revenue Recognition	Method of determining whether or not income has met the conditions of being earned and realised or is realisable.
Reversing Entry	An entry made at the start of a new accounting period to reverse an adjusting entry made at the end of the previous period. A reversing entry is the exact opposite of the adjusting entry. An entry that reverses a specific adjusting entry to facilitate the recording of routine transactions in the subsequent period.
Salaried Employees	Individuals who work for a fixed amount for a definite period of time, such as a week, a month, or a year.
Salary	A fixed amount paid to employees for a certain period of time, such as a week or a month.
Salvage Value	Selling price assigned to retired fixed assets or merchandise unsalable through usual channels. The amount that an asset is expected to be worth at the end of its productive life. Also called scrap value, trade-in value, and residual value.
Schedule of Accounts Payable	A listing of the individual creditor balances in the accounts payable ledger.
Schedule of Accounts Receivable	A listing of the balances in the accounts receivable ledger.
Securities	Investments, including stocks and bonds. Listed as assets on the statement of financial position.
Security	A pledge made to secure the performance of a contract or the fulfillment of an obligation. Examples of securities include real estate, equipment stocks or a co-signer. Mortgages are a form of security with strong legal standing, because they are publicly registered following a formal legal procedure. A mortgage gives the lender holding a mortgage security the right to reclaim the asset being financed, if repayment is not made. Any kind of transferable certificate of ownership including equity securities and debt securities.
Self-Sufficiency:	Self-sufficiency occurs when a micro-credit programme can cover all of its operating expenses (including loan losses and the cost of capital) entirely with internally-generated sources of income.
Short-Term	Current; ordinarily due within one year.

Term	Definition
Solvency	The ability of a firm to pay its debts as they come due.
Special Journal	A journal designed to record a single type of transaction. Journals used by businesses to record transactions that are similar in nature; examples are the purchases journal and the cash payments journal. Also called special-purpose journals.
Special Report	Special report is a term applied to auditors' reports issued in connection with various types of financial presentations, including: Financial statements that are prepared in conformity with a comprehensive basis of accounting other than generally accepted accounting principles. Specified elements, accounts or items of a financial statement. Compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements. Financial presentations to comply with contractual agreements or regulatory provisions. Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's reports.
Spread	Difference between two prices, usually a buying and selling price. This happens with interest in the case of micro-finance
Statement of Cash Flows	A statement of cash flows is one of the basic financial statements that is required as part of a complete set of financial statements prepared in conformity with generally accepted accounting principles. It categorizes net cash provided or used during a period as operating, investing and financing activities, and reconciles beginning and ending cash and cash equivalents. A financial statement that provides information about the cash flows from operating activities, investing activities, and financing activities during an accounting period and the net increase or decrease in cash that occurred. A financial statement that reports the flow of cash in and out of a company for a set period, usually one year. It reports the operating activities, investing activities and financing activities of the company.
Statement of Changes in Financial Position	A basic financial statement devoted exclusively to reporting changes in financial position for a specified period of time.
Statement of Earnings	A financial statement that reports the results of a company's business operations (revenue and expenses) for a set period, usually one year. Also called an earnings report, income statement, statement of operations, and statement of profit and loss.
Statement of Financial Condition	Basic financial statement, usually accompanied by appropriate disclosures that describe the basis of accounting used in its preparation and presentation as of a specified date, the entity's assets, liabilities and the equity of its owners. Also known as balance sheet.
Statement of Financial Position	A financial statement that reports a company's assets and the claims against them - liabilities and stockholders' equity - at a set date noted on the statement. Also called the balance sheet.
Statement of Operations	A financial statement that reports the results of a company's business operations (revenue and expenses) for a set period, usually one year. Also called an earnings report, income statement, statement of earnings, and statement of profit and loss.

Term	Definition
Statement of Profit and Loss	A financial statement that reports the results of a company's business operations (revenue and expenses) for a set period, usually one year. Also called an earnings report, income statement, statement of earnings, and statement of operations.
Straight-Line Depreciation	Accounting method that reflects an equal amount of wear and tear during each period of an asset's useful life. For instance, the annual straight-line depreciation of a currency (Dollor, Rupees, Pounds) 2,500 asset expected to last five years is currency (Dollor, Rupees, Pounds) 500. (See accelerated depreciation.)
Straight-Line Depreciation Method	A method of depreciation that provides for equal periodic charges to expense over the estimated life of an asset.
Subsidiary Ledgers	Ledgers that contain only one type of account; the example in this chapter is the accounts payable ledger.
Sustainability:	Sustainability is the ability of a micro credit programme to maintain its operations and continue to provide service to its customers or clients. A Programme is sustainable when a combination of external grants, loans, and internally generated revenues are sufficient to cover all programme expenses over the long term.
Tangible	All physical assets used by a business are tangible (capable of being touched).
Tangible Asset	Assets having a physical existence, such as cash, land, buildings, machinery, or claims on property, investments or goods in process. (See intangible assets.)
Term	Refers to the maturity or length of time until final repayment on a loan, bond, sale or other contractual obligation.
Term Loan	Loan for a specified time period.
Time	The number of years, months, or days for which interest is charged. Also called the term.
Transaction	Any activity that changes the value of a firm's assets, liabilities, or owner's equity.
Trend	A pattern in a company's financial performance over time. For example, if a company's sales have been increasing over many months or years, analysts would describe this pattern as a sales growth trend.
Trial Balance	A listing of all ledger accounts with their balances to test the equality of debits and credits; it is usually prepared at the end of each month. A summary listing of the balances and the titles of the accounts.
Troubled Debt Restructuring	Agreement between debtor and creditor which amends the terms of a debt that has little chance of being paid in accordance with its contractual terms. The agreement may involve the transfer of assets in full or partial satisfaction of the debt.
Unaudited Financial Statements	Financial statements which have not undergone a detailed audit examination by an independent certified public accountant (CPA).
Uncollectible Account	Another name for bad debt.
Unearned Income	Payments received for services which have not yet been performed.

Term	Definition
Unearned Revenue	Another name for deferred revenue, usually applying to amounts received a year or less in advance. Revenue received in advance of its being earned.
Unrestricted Funds	Resources of a not-for-profit entity that have no restrictions as to use or purpose. (See Fund Accounting and Restricted Fund.)
Variable Costs	Costs that vary in total as production varies, but remain the same per unit regardless of how many units are produced.
Vertical Analysis	The expression of each item in a company's financial statement as a percent of a base figure, in order to see the relative importance of each item. For the balance sheet, the base is total assets; for the income statement, the base is net sales. The percentage analysis of component parts in relation to the total of the parts in a single financial statement.
Voucher	A method of accounting for cash payments in which all payments are authorized in advance and kept track of internally through five components: voucher, voucher register, unpaid voucher file, check register, and paid voucher file.
Voucher Register	The journal in which all vouchers are recorded.
Voucher System	A method of accounting for cash payments in which all payments are authorized in advance and kept track of internally through five components: voucher, voucher register, unpaid voucher file, check register, and paid voucher file. Records, methods, and procedures employed in verifying and recording liabilities and paying and recording cash payments.
Voucher	A document that serves as evidence of authority to pay cash.
Wage	A fixed hourly rate paid to an employee.
Working Capital	Technically, means current assets and current liabilities. The term is commonly used a synonymous with net working capital. The term often also is used to refer to all short-term funding needs for operations (excluding debt service and fixed assets). A company's investment in current assets that are used to maintain normal business operations. Net working capital, which is the excess of current assets over current liabilities, is also interchangeable with working capital. Both reflect the resources in circulation to meet operating needs and obligations as they come due. Excess of current assets over current liabilities. The excess of a firm's current assets over its current liabilities. A strong working capital means that the firm is likely to be able to carry on its current operations. The excess of total current assets over total current liabilities at some point in time.
Write off	When an investment, such as a loan, becomes seriously delinquent or in default and is determined to be uncollectible, the lender may choose to charge the outstanding investment amount as an expense or a loss.
Yield	Return on an investment an investor receives from dividends or interest expressed as a percentage of the cost of the security.

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PLUS SEVERAL INTERNAL DOCUMENTS OF SA-DHAN INCLUDING ITS STANDARDS STRATEGY FRAMEWORK, SUB-GROUP MINUTES AND OTHER REFERENCES.

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