

MicroSave

Market-led solutions for financial services

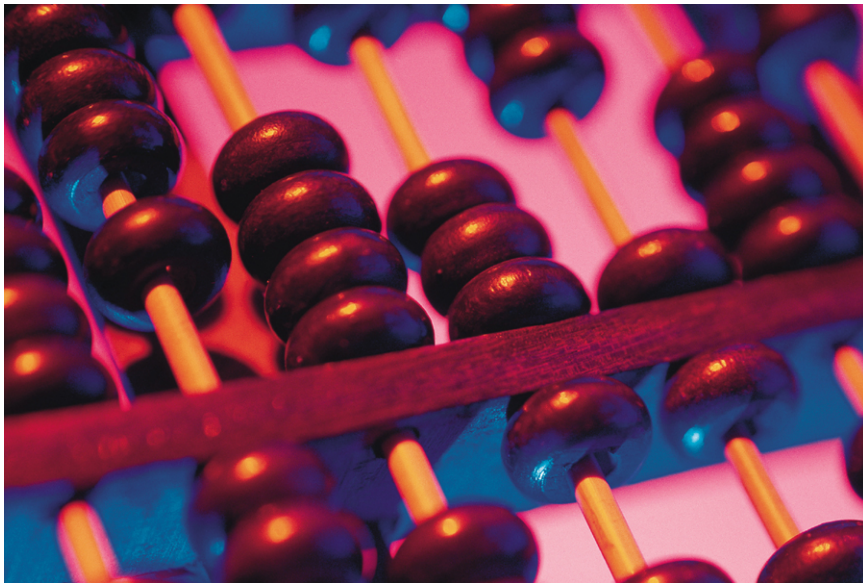
Website: www.MicroSave.net

MEDA

Website: www.meda.org

Basic Financial and Accounting Systems for MFIs

March 2008



Mennonite Economic Development Associates

Ruth Dueck Mbeba

Acknowledgements

MEDA acknowledges the contribution and input of Nandan S. Bisht, Abhishek Choudhury, Ruth Dueck Mbeba, Ruth Hoffman, V. Nagarajan, L.B. Prakash, and Vishrant Shukla in writing and development of the overall toolkit. Much of the content and application is based on Indian and international microfinance accounting practices.

Many thanks to the helpful input and support from MEDA staff in making this effort possible, especially to Trudy Rejeski.

A learning toolkit is never “final” as new techniques, tools and resources become available and are shared with one another. Both accounting standards and regulatory frameworks for microfinance are continually developing, and it is important to keep up to date with changes. Participant feedback and comments will assist to continually improve this toolkit and its resources.

Table of Contents

1. Introduction	1
What do Users Need and Why?	2
Microfinance Institutions and their Clients	5
What is Accounting?	6
Accounting Conventions or Guidelines	6
2. Overview of Microfinance Accounting Systems	11
Micro-Finance Accounting and Management Information Systems	11
Cost Accounting for Multi-Service MFIs	15
The Chart of Accounts	16
The MIS Structure for Loans and Savings	19
MFI Accounting Policies	20
3. Accounting Documents.....	22
Source Documents	22
Accounting Transaction Voucher	22
Cash and Bank Journals (Cash Book or a Journal cum ledger).....	23
General Journal	24
General Ledger.....	24
Subsidiary Ledgers.....	25
Fixed Assets Ledger.....	26
The Audit Trail	26
4. The Accounting Cycle	28
Transactions	28
Classifying Transactions.....	28
Journaling.....	29
Posting to the General Ledger.....	29
Trial Balance	29
Reconciliations.....	30
Accounting Adjustments.....	31
Draft Financial Statements and Closing	31
Why is Loan and Savings Information so Important?	31
Transaction Occurs – Client Receipt or Payment	32

Issue Receipts or Verify Receipts of Payments	32
Record and Summarise Receipts for General Ledger.....	33
Update Client Records with Individual Transactions	33
Draft MIS Reports.....	33
Reconcile MIS and General Ledger.....	33
Issue Summarised MIS Reports.....	33
5. Internal Control Procedures.....	35
Control Environment	36
Policies and Procedures	36
Qualified, Trained and Motivated Staff.....	36
External and Internal Audits	36
General Control Procedures.....	37
Specific Control Procedures	38
Segregation of Duties.....	38
Accounting for Cash	39
6. Accounting Procedures for Microfinance	42
Cash vs. Accrual Accounting.....	42
Accounting for Client Transactions.....	43
Accounting for Accrued Loan Interest Revenue	44
Accounting for Impairment Loss Allowance and Provision for Impairment Losses	45
Accounting for Loan Write-Offs and Write-Off Recoveries.....	47
Accounting for Deferred Expense on Group Formation.....	48
Accounting for Software Development and Amortisation	49
Accounting for the Purchase and Depreciation of Fixed Assets.....	49
Accounting for the Sale or Disposal of Fixed Assets	50
Accounting for Grants and Donations	50
Accounting for Fixed Asset Donations.....	51
Accounting for Donations of Loan Capital.....	52
Accounting for In-Kind Subsidies and Grants.....	53
Accounting for Financial Costs	54
Translation of Foreign Currency.....	54
Accounting for Bank Partnerships.....	55
Accounting for Applications in Technology Services.....	55
Accounting for Agency Relationships	56

7. Financial Statements and Reports	57
The Financial Statements	58
Cash Flow Statements.....	61
The Portfolio and Operational Reports	63
Disclosure of Financial Information:	64
Consolidating Financial Statements of Branches	66
Closing Entries.....	66
Other External Reports	67
Emerging Trends.....	67
Where to Go From Here	69
Resource Bibliography.....	71

Figures:

Figure 1.1: Accounting Debits and Credits.....	9
Figure 2.1: Microfinance Financial Management Information System – Accounting System and Client Portfolio System (MIS).....	11
Figure 2.2: Sample Chart of Account Structure.....	16
Figure 2.3: Sample Chart of Account Descriptions and Explanations.....	17
Figure 3.1: General Journal Sample (adjustments).....	24
Figure 4.1: Accounting Cycle	28
Figure 4.2: Sample Trial Balance	30
Figure 4.3: Accounting Cycle for Client Transactions in the MIS	32
Figure 6.1: Illustration of Accounting for the Impairment Loss Allowance and Provisions	47
Figure 6.2: Illustration of Accounting for Loan Write-offs and Write-off Recoveries.....	48
Figure 6.3: Illustration of Deferred Expense on Group Formation.....	49
Figure 6.4: Illustration of Accounting for Software Development and Amortization	49
Figure 6.5: Illustration of Accounting for Grants and Donations	51
Figure 6.6: Illustration for Donations and Grants for Fixed Assets.....	52
Figure 6.7: Illustration of Donations for Loan Capital	53
Figure 6.8: Illustration of Donations of In-kind Subsidies and Grants	54
Figure 7.1 Understanding Relationships between Financial Statements	62

List of Handouts:

Section 1: Introduction

- 1.1 Workshop Schedule
- 1.2 Financial Statement Terms and Definitions – SEEP Framework
- 1.3 List of International Financial Reporting Standards
- 1.4 List of International Accounting Standards

Section 2: Overview of Accounting Systems

- 2.1 Sample Chart of Accounts

Section 3: Accounting Documents

- 3.1 Sample Accounting Documents for MFIs
- 3.2 Sample Client Forms for MFIs
- 3.3 Sample Document Register

Section 4: The Accounting Cycle

- 4.1 Sample Accounting Cycle
- 4.2 Sample Reconciliation Schedule
- 4.3 Reconciliation Tips
- 4.4 Sample Bank Reconciliation
- 4.5 Sample Portfolio Reports
- 4.6 Sample MIS Report Schedule

Section 5: Internal Control Procedures

- 5.1 Sample Accounting Policies
- 5.2 Sample Monthly Accounting Checklist
- 5.3 Sample Manager’s Accounting Report Checklist
- 5.4 Sample Management Checklists
- 5.5 Sample Cash Count and Verification
- 5.6 Sample Vault Register

Section 6: Accounting Procedures for Microfinance

Section 7: Financial Statements and Reports

- 7.1 Sample Financial Statements
- 7.2 Sample Audited MFI Statements
- 7.3 Sample Portfolio and Non-Financial Data Reports
- 7.4 Sample Consolidated Financial Statements
- 7.5 Course Evaluation

List of Exercises

Section 1: Introduction

- 1.1 Balance Sheet Classification
- 1.2 Sample Transactions – Balance Sheet

Section 2: Overview of Accounting Systems

- 2.1 Chart of Accounts – Head Office and Branch

Section 3: Accounting Documents

- 3.1 Accounting Documents Design

Section 4: The Accounting Cycle

- 4.1 Preparation of Accounting Adjustments
- 4.2 Analysing a Trial Balance

Section 5: Internal Control Procedures

- 5.1 Sample Accounting Transactions
- 5.2 Segregation of Duties – Distance Management
- 5.3 Segregation of Duties – Loan Officers Handling Cash
- 5.4 Segregation of Duties -- Branch Personnel Problem

Section 6: Accounting Procedures for Microfinance

- 6.1 Accounting for Impairment Loss Allowance, Provisions and Write-Offs
- 6.2 Accounting for Deferred Revenue

Section 7: Financial Statements and Reports

- 7.1 Financial Statement Preparation
- 7.1 Financial Statement Preparation - Condensed
- 7.2 Loan Portfolio Quality Reports
- 7.3 Where Users Get their Information!
- 7.4 Case Study – If I Had a Million Dollars
- 7.5 MFI Accounting Action Plan

1. Introduction

“My accounting department prepares all financial statements and submits them to the investors and donors. I don’t get very involved in accounting.”

“We produce financial statements when requested by donors or statutory bodies – usually on a quarterly basis. I find it unnecessary to do it more often.”



“We have an external audit simply to satisfy regulatory requirements.”

Do these comments sound familiar? Most microfinance practitioners would agree that an MFI’s accounting system is a key component of control and reporting in the institution. However, many are not familiar with accounting and accounting terms, let alone appreciating or understanding the financial statements produced by the accounting system. Using the financial statements as management tools – the balance sheet, the income and expense statement and the cash flow statements – is often a challenge.

However, the financial reports produced by accounting systems are first and foremost important management and monitoring tools. They form the foundation for relevant measurement, reporting and performance analysis.

This toolkit is designed to provide MFIs of all types, legal structures and methodologies the core components of accounting systems needed to record, classify and summarise financial transactions and to produce meaningful, timely and accurate financial statements and reports. Key practical procedures and aspects of accounting for microfinance institutions are highlighted.

However, the toolkit is not intended to replace the extensive accounting training offered by colleges and universities that is necessary to produce certified accountants. Those courses include a strong theoretical foundation of accounting practice, and a broad range of specific applications. This toolkit covers key theoretical concepts but emphasises practical procedures, skills, and tools needed to manage accounting for microfinance. The materials draw heavily on basic accounting principles, and on other resources produced for the microfinance industry internationally. Resources and publications are cited in the bibliography at the end of this toolkit.

Your MFI’s accounting structure and system is one of the key cornerstones of good information systems in microfinance institutions. A good accounting system produces accurate, relevant and timely reports that enable:

- **meaningful analysis and monitoring of operations,**
- **are fully auditable and stand the test of external audits, and**
- **meet the requirements of external reporting needs.**

It is also important that your MFI employs **qualified and trained staff** to develop a strong accounting system, policies and procedures and carry out accounting responsibilities. **Bookkeepers, accounting clerks or data entry staff** record financial transactions and activities, and must know how to do that correctly. **Accountants** verify, reconcile and produce financial statements supported by accompanying schedules, and must know how to do that well. **Finance managers** and **CEOs** of MFIs must be able to understand financial information, analyse performance, and make the necessary decisions to improve and strengthen the institution.

Finally, information and reports produced by the accounting system must meet the needs of external users and stakeholders, including statutory regulators (e.g. the Companies Act and Registrar or the

Societies Act), Central Banks, the Income Tax Department, investors, and last but not least your Board members.

Accounting practice and reporting standards vary from country to country. It is recommended that MFIs take local standards and issues into consideration when developing their own accounting policies and procedures. Microfinance institutions should consult with **national accounting bodies** and **microfinance networks** to verify and confirm local practice. Accounting and auditing firms may be able to provide resources as well.

There is a growing trend in the world towards common accounting standards outlined in **International Accounting Standards (IAS)** and **International Financial Reporting Standards (IFRS)**. National accounting standards may or may not reflect some of the global shifts, and need to be reviewed from time to time to see how standards continue to evolve.

Reporting obligations may also vary according to the legal act governing the type of your MFI's registration. If your MFI is subject to **central bank regulations**, there will be specific accounting and reporting obligations and expectations that must be complied with. Many countries have broad legislation and frameworks under which MFIs operate, without specific or detailed reporting requirements. However, others have very specific statutory and reporting formats and requirements based on the type of legal registration, rather than a sector wide approach. This is to protect the users of financial services, investors, shareholders, and the readers of financial statements. For example, India has specific requirements for:

- Societies and Trusts (NGO's),
- Mutual Benefit Trusts (authorized to mobilize savings),
- Cooperatives and Mutual Aided Cooperatives,
- Not for Profit Companies,
- Local Area Banks,
- Non-Bank Finance Companies, and
- Commercial Banks.



This toolkit illustrates the features of a basic accounting system that is designed to provide a range of reports and information, depending on user requirements. The Handouts include a range of reporting formats and samples. The toolkit is based on International Accounting Standards and International Financial Reporting Standards.

What do Users Need and Why?

The table below illustrates the various MFI information users and report readers, what reports they need and why. Reports and schedules are generated through automated systems or manual systems, but usually a combination of both. Computerised general ledgers and client loan tracking systems (MIS) generally produce the reports and data used to prepare more specific analytical reports. Other reports – like an annual management report or a business plan are generated through other planning tools or summarising annual operational data.

User	Information Needs	Reports Needed	Frequency
Branch Managers	<ul style="list-style-type: none"> • Portfolio Status and Quality • Branch profitability • Credit Officer 	<ul style="list-style-type: none"> • Balance Sheet • Income & Expense Statement • Portfolio Reports – 	<ul style="list-style-type: none"> • Daily portfolio disbursements and collections • Weekly Portfolio

	<ul style="list-style-type: none"> • Loan Product performance • Cash Balances and Flows – projected, actual • Portfolio Growth – projected disbursements and collections 	<ul style="list-style-type: none"> • Cash Status Reports • MIS Reports – collections, disbursements, demand due reports 	<ul style="list-style-type: none"> • Daily or weekly cash status and projections • Monthly Balance Sheets and Income and Expense Statements
MFI Managers	<ul style="list-style-type: none"> • Portfolio Status and Quality • Branch profitably • Consolidated MFI performance and profitably • Cash flow status and projections – by Branch and in total • Financial performance and trends 	<ul style="list-style-type: none"> • Balance Sheet • Income & Expense Statement • Portfolio Reports, Aging Reports • Cash Status Reports • MIS Reports - disbursements and collections • Ratio Analysis • Branch liquidity and inter-Branch cash management 	<ul style="list-style-type: none"> • Weekly portfolio and cash status (daily if necessary) • Monthly Balance Sheets and Income & Expense Statements • Weekly or monthly cash flow statements or projections
Board Members	<ul style="list-style-type: none"> • MFI Profitability • Portfolio and Cash Status • MFI Risks • Reporting issues to external stakeholders • Financial performance and trends • MFI Activities and Performance • MFI future plans and strategies 	<ul style="list-style-type: none"> • Balance sheet actual and budgeted • Income & Expense Statements with full disclosure notes and comparison to budget • Portfolio Reports including Aging • Internal Auditor reports • Externally audited financial statements and Management Letter • Ratio Analysis • Annual Management Report • Business Plan – short term and long term 	<ul style="list-style-type: none"> • Monthly or Quarterly financial statements and ratio reports • Annual or semi-annual audited reports and Management Letter • Annual reports and business plans
External Auditors	<ul style="list-style-type: none"> • All accounting and portfolio reports, accounting documents and reports internally generated by the MFI's general ledger system • The MFI's internal control system, policies and environment, including any risks and findings noted by the Internal 	<ul style="list-style-type: none"> • Access and availability of all accounting source documents • Access and availability of hard copy of general ledger, financial statements, portfolio reports, portfolio transaction listings • Access to and availability of all bank 	<ul style="list-style-type: none"> • Annually or on interim basis

	Auditor	<p>reconciliations, fixed asset schedules, and other supporting schedules and information on key accounts</p> <ul style="list-style-type: none"> • The MFI’s accounting and credit policies • The MFI’s Internal Audit reports • The MFI’s Chart of Accounts – Head Office and Branch 	
Regulators and Statutory(Central Banks, Companies division, tax authorities)	<ul style="list-style-type: none"> • MFI Profitability • Portfolio and Cash Status • MFI Compliance to Cash Balances, Capital Adequacy, Write-Off policies and risk management performance • Shareholder information • Debt investor details – secured and unsecured • Differences in accounting policies from legislated tax policies and allowances 	<ul style="list-style-type: none"> • Balance Sheet • Income & Expense Statements • Cash Flow Statements • Ratio Analysis • Audited financial statements with full disclosure • Cash updates e.g. Asset and Liability Management Reports, Capital Adequacy Reports • Financial statements that are adjusted for tax laws and allowances 	<ul style="list-style-type: none"> • Weekly (in case of regulated banks) for Cash Status, Capital Adequacy • Quarterly and Annually as required
Investors	<ul style="list-style-type: none"> • MFI Profitability • Portfolio and Cash Status • MFI Compliance to Cash Balances, Capital Adequacy, Write-Off policies and risk management guidelines • Shareholder information • Debt Investor details – secured and unsecured • MFI performance and activity reports and future plans and strategies 	<ul style="list-style-type: none"> • Portfolio and Cash Status • Audited financial statements and management letter • Ratio Analysis • Rater reports, Due Diligence reports • Annual Management Report • Business Plan – short term and long term 	<ul style="list-style-type: none"> • As needed, monthly or quarterly • Annually

This toolkit will focus on the foundation of accounting and financial systems of the MFI and its Branches. However, it will also make note of the user needs of external stakeholders and regulators, since the MFI accounting system, including Branch levels, should be structured to provide information for all types of users.

“Begin with the end in mind!” Know what report and information your MFI’s stakeholders need – and then build your systems and reports to facilitate the necessary information and reports!

Microfinance Institutions and their Clients

For the purpose of this toolkit, an MFI – a Microfinance institution -- will be any type of entity or organisation that offers financial services to disadvantaged sectors of urban and rural communities that are unable to access these services from formal or commercial banks. Microfinance institutions offer various types of financial service products including savings, remittances or money transfers, and micro-insurance. This toolkit places a clear emphasis on MFIs who offer credit services, since this is often the first, and the most invested-in product in an institution. MFIs may be registered in a variety of legal forms – for-profit companies, trusts, banks, non-profit companies, federations or NGOs. The regulatory system may have different reporting expectations for the different legal forms. However, this toolkit will assume that well-designed basic accounting systems and structures can provide the needed information for MFIs of all legal forms.

Microfinance institutions serve a wide variety of clients – individuals, groups (often called Solidarity Groups or Joint Liability Groups), or Self Help Groups. **Regardless of the client served, the basic accounting process for loans and savings, Branch reporting, and MFI reporting is similar.** MFIs do need to make some basic decisions about the level of tracking for their clients, as discussed below.

Accounting for Various Methodologies and Approaches

MFI loan products vary by methodology. Some MFIs offer loans to individuals. Others lend directly to groups that co-guarantee one another's loans. Solidarity groups (SG) or Joint Liability Groups (JLG) are very popular methodologies. Many MFIs also lend to Self Help Groups (SHGs).

When lending to a Joint Liability Group or Solidarity Group, the MFI needs to decide whether it will track group transactions and payments, or individual member transactions. Most MFIs will track individual member transactions. When lending to Self Help Groups, the MFI needs to decide on the level of detail it will track on the Group. In general, SHG internal records do not get entered into the MFI financials – but are used for the MFI's assessment of the SHG's credit rating or scoring. However, the MFI tracks the loan activities and transactions with the Group. If the MFI collects and holds any SHG savings, they must also be tracked by the MFI.

Self Help Groups continue to handle their own accounting for transactions, internal savings, loan approval processes, and delinquency management.

Microfinance institutions also serve the sector through **various operating models.** For example, commercial banks in some countries are mandated by the Central Bank or economic policy to offer financial services to a priority sector in the national poverty reduction strategy. However, they are not prepared or are reluctant to offer these services directly. They may then lend operating or loan funds to existing MFIs serving the sector – and disclose these amounts as **“managed portfolio.”** This is often referred to as a **“partnership model.”** Other MFIs or banks engage in **linkage programmes** where they provide financial services to Community Based Organisations or Self Help Groups developed and promoted by NGOs in the development sector.

In both **“partnership models”** and **“linkage programmes”**, the accounting process is similar to general accounting processes and procedures outlined in this toolkit. However, the bank offering these services must segment and disclose these amounts from other financial services, and provide detail as to the quality of the asset, and any allowances for loan losses provided on the amounts. Standard microfinance assessment of asset quality and provisioning should apply. The NGO or the MFI who acts as the agent for the bank should account for these arrangements as outlined in Section 6 of this toolkit.

What is Accounting?

Accounting

- Is the process of recording, classifying, and summarising economic events, that
- Leads to the preparation of financial statements, and
- Provides essential information that allows the manager to choose actions that will redirect the enterprise's activities to be more consistent with the mission and objectives of the business plan

Accounting is often referred to as “the language of business” and like any other language, it has its own unique structure and vocabulary. Since accounting terms like assets, revenue, expenses and cash flow are used regularly, it is important that managers and those making business decisions understand basic accounting concepts. These concepts form the basis of accounting and financial management. *Handout 1.2 Financial Statements Terms and Definitions – SEEP Framework* outlines key terms used in accounting and financial statements, applying International Accounting Standards. The Handout provides a fairly broad list of terms and definitions, but it should not be considered as an exhaustive and complete resource.

Accounting falls into two broad categories: financial accounting and management accounting. Financial accounting is concerned with recording, organising and summarising the financial results of past operations. Financial accounting reports are generally prepared on a monthly basis for internal and external purposes. The annual financial statements are subject to an independent auditor's opinion to verify the fairness and reasonableness of information presented. External audits are required by statutory regulation for MFIs, but they can fulfil many other management and Board objectives, such as an independent and external review of systems, recommendations for improvements in the management letter, and investor requests, among others.

Management accounting information is tracked and presented at a much more detailed level (e.g. by activity, or by Branch or department). Management reports focus not simply on a summary of financial transactions, but on future projections, budgets, and previous period historical reports. Management reports are flexible, change as needed, and do not conform to any external standard, because they are for internal management analysis and decision making only.

Not every one in your MFI needs to understand all the details of its accounting system like the bookkeeper and the accountant. However, managers need to understand the system in order for effective monitoring and control; they must also know how to interpret the information that accounting provides. It is helpful for all to understand the conventions or guidelines that form the base of the accounting system.

A strong, effective accounting system – including a loan and saving tracking system – is an essential foundation for reporting and analysis of your MFI's performance. Without a good accounting system, your reports are not necessarily reliable. And without reliable reports, you as an MFI manager are not able to confidently understand financial reports or make reliable judgement or decisions to improve and strengthen performance.

Accounting Conventions or Guidelines

Accounting practice is based on commonly accepted “conventions” or “guidelines” that guide policies and accounting treatment of transactions. The following are commonly accepted accounting

conventions or guidelines. Their application to accounting for microfinance will be illustrated in more detail in Section 6 of this toolkit. In general, these principles form the basis for the development of accounting and reporting standards.

a. Business Entity Concept: Every business is a separate entity, distinct from its owner and from every other business. Therefore, the records and reports of a business should not include the personal transactions or assets of either its owner(s) or those of another business.

A retired banker decided to open a community microfinance organisation in the rural centre to which he retired after 35 years of banking sector experience. He invested his own retirement package as start up capital, and launched operations. He would withdraw funds from the organisation for personal use when needed, recording the withdrawals against his original investment. Occasionally he also invested the surpluses of a small business that he also initiated in his retirement. Needless to say, the annual auditors were not impressed with the retired banker's approach to the MFI's cash resources. They felt that the retired banker did not segregate his personal transactions from the MFI's transactions.



b. Fair Value vs. Historical Cost Principle: General past practice has been to record assets at their actual, historical cost. This is still the practice at the time of purchasing and recording the asset. However, over time, the historical cost might be much less than the cost to replace the asset today (e.g. A computer, a vehicle) OR a lot less than which the asset could be sold for (e.g. land, a building). **Note: International Accounting Standards and International Financial Reporting Standards recommend re-valuing assets from their historical cost to reflect current values as necessary in International Accounting Standard 16.**



An MFI purchased an office building in a lucrative deal at 100,000 in 2000. Five years later, the area was targeted for intensive business development, and new commercial construction boomed. The value of the MFI office building increased 5 times to 500,000. What is the effect on the MFI's financial statements? Under the historical cost convention? None. However, under fair value accounting, the building should be re-valued in the accounting records from its historical cost to the current market price.



c. Going Concern Concept: The records and balance sheet of an organisation and a business is developed with the assumption that the business will continue to operate indefinitely, and that the assets used in conducting business and operations will not be sold, and the liabilities will be paid as recorded.

In 2006, the auditors noted that cash flow in the community MFI was increasingly very, very difficult. A large, national MFI had opened a Branch in the community in 2005 and offered more efficient service, and better interest rates. Although not regulated, the community group did offer savings services to its clients, but clients complained about the time to withdraw funds, and how at times, funds were not available. The auditors began to evaluate whether the community based group might actually be able to operate with its cash flow problems and staff competition.

d. Consistency Principle: Organisations should consistently apply the same accounting principles from period to period. This ensures that reports from various periods may be compared to produce meaningful conclusions on the financial position of the organisation and the results of the operations. Any changes to accounting principles should always be disclosed in the notes to the financial statements. Generally, auditors will restate previous year's figures and adjust them retroactively for comparison purposes.

The community based MFI operated by the retired banker was anxious to present a favourable financial position when presenting his 2005 audited financial statements to the local government office overseeing community activities of this nature. He changed his accounting policy on setting a Provision for Loan Losses and for depreciation, resulting in a 50,000 profit for the year. However, he failed to disclose the change in the financials presented. The auditor had no choice but to make adjustments and disclosures for the change in accounting policy, highlighting the reasons for changes, and results of changes.



e. Accrual: The accrual or realisation principle requires that revenue be recognised in the accounting period it is earned, and expenses be recognised when they are incurred, rather than when there is payment or collection of cash. It is recommended that MFIs apply the accrual-based accounting method.

MFIs choose either a cash basis of accounting or an accrual basis of accounting. The community microfinance group managed by the banker operated on a cash basis. In late 2003, the group received 200,000 as donation from an international donor. However, the funds were not spent until the following year, so the March, 2003 year end reflected a very large surplus. The funds were spent in 2004, resulting in a very large loss for the year. Accrual accounting would have recorded the revenues when earned and recognised when spent for the expenses intended.



f. Matching Principle: Organisations incur expenses to earn revenues. Expenses should be reported on the Income Statement during the same period as the revenues generated as a result of incurring those expenses.

Accrual accounting would imply that the grant expenses for the approved grant would be “matched” by the related grant revenue in the same period. Revenue would be recorded and recognised as spent for the objectives of the grant agreement.



The community MFI purchases insurance on its fixed assets at the beginning of each fiscal year, in effect pre-paying a year’s insurance in advance. The payment is charged to prepaid insurance, and amortised monthly in order to match the expenses to the revenue generated in the same period.

g. Conservatism and Prudence: When presented with a choice, accountants should choose procedures and methods of recording transactions that ensure assets, revenues and gains are not OVERSTATED, and that liabilities, expenses and losses are not UNDERSTATED. This principle is intended to result in the fair presentation of information.

The local government body governing microfinance institutions in the area required that at a minimum all MFIs allocate 2% of their total portfolio as the Impairment Loss Allowance. However, the actual portfolio quality of the community based microfinance group was very poor, with delinquency as high as 20% in some months. In fact a 2% Allowance for Loan Impairments was definitely inadequate to cover the actual losses that were more realistically expected.



The community MFI kept the low allowance in an effort to make the organisation look stronger than it actually was. Assets were OVERSTATED as a result, and expenses UNDERSTATED, presenting an unfair picture of the MFI’s financial health.

h. Substance over form implies that the accounting treatment and presentation of transactions should be governed by their substance and not merely by their legal form. This has further application for

more advanced accounting topics and for specific issues related to valuations, special agency relationships or sophisticated investment vehicles.

i. Materiality implies that financial statements should disclose all items which might influence the decisions of the users of financial statements if they had knowledge of the same. Disclosure, notes to the financial statements, and errors or misstatements in the financial statements all affect the issue of materiality. The concept of materiality is in itself relative and subjective, as the size and volume of MFI activities differs greatly; therefore levels of materiality or immateriality will also vary greatly.

j. Double-Entry Accounting

- Any given transaction will affect a minimum of two accounts within assets, liabilities, or equity (including revenue and expenses).
- If the accounting equation is to remain in balance, any change in the assets must be accompanied by an equal change in the liabilities or equity, or by an equal but opposite change (increase or decrease) in another asset account.



Figure 1.1: Accounting Debits and Credits

Account	Debit	Credit
Assets	Increase	Decrease
Liabilities	Decrease	Increase
Equity	Decrease	Increase
Revenue	Decrease	Increase
Expenses	Increase	Decrease

The basic accounting equation is as follows:

$$\text{Assets} = \text{Liabilities} + \text{Equity (Revenue - Expenses)}$$

As in any mathematical or algebraic equation, this above equation can also be expressed as follows:

$$\text{Liabilities} - \text{Assets} = \text{Equity}$$

OR

$$\text{Equity} = \text{Assets} - \text{Liabilities}$$

At the end of the reporting period, revenue and expense accounts are netted out to result in a final profit or loss. This profit or loss is then transferred to the Balance Sheet as equity, thereby ensuring that the Balance sheet balances. Within the equity section of the Balance Sheet, most MFIs and organisations create and operate several funds, reserves or restricted reserves for specified purposes.

The above accounting principles form the foundation of Accounting Standards developed by both international and national bodies.

From 1973 to 2000, the International Accounting Standards Committee was the international structure for setting International Accounting Standards. In 2000, the International Accounting Standards Board (IASB) was formed to carry on the work of the previous committee. Specifically, the objectives of the Board are to:¹

- a. Develop a single set of high quality, understandable and enforceable global accounting standards to facilitate high quality, transparent and comparable information in financial statements for the global market.
- b. Promote the use and rigorous application of these standards
- c. Take into consideration the special needs of small and medium-sized entities and emerging economies, and
- d. Promote and bring about convergence of national accounting standards and International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) to high quality solutions.



International Financial Reporting Standards (IFRS) refers to a number of pronouncements issued by the IASB on accounting and reporting issues. More broadly, IFRSs refers to the entire body of the Board's pronouncements, including standards (IAS) and interpretations of the standards.

Handout 1.3 List of International Financial Reporting Standards provides a list of the current reporting standards promoted internationally. *Handout 1.4 List of International Accounting Standards* provides the list of standards adopted and promoted by international accounting bodies. These are increasingly becoming the “norm” in accounting standards around the world, and many countries are adopting these standards as their own. Further detail on these standards can be obtained at the website www.iasplus.com.

The following section looks at the basic, structural considerations and features of a financial management and information system in an MFI. For the most part, it looks at the broad framework of the accounting general ledger, the client tracking system, and the decisions that need to be made when structuring systems to meet user needs.

¹ www.iasplus.com

2. Overview of Microfinance Accounting Systems

The basic components of an accounting system are fairly universal and applicable to all organisations. Source documents form the basis of all transactions. A Chart of Accounts is a numbered system that is structured to classify and organise transactions by account. The journals – cash journals, general journals, or bank journals record each and every transaction or adjustment. They are summarised monthly, or more often, and posted to the general ledger. The general ledger holds a record for each account in the Chart of Accounts. It accumulates the totals posted from the journals to provide monthly and annual revenue and expenses. It accumulates all the accounts of the Balance Sheet.

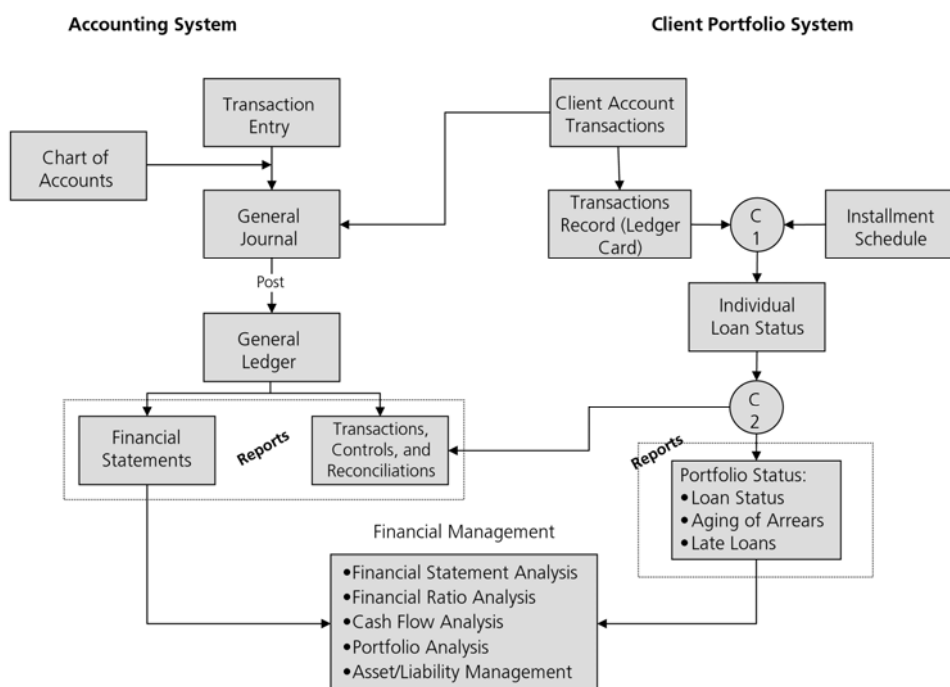
These accounting records and processes form the basis of all accounting systems. Most MFIs choose computerised accounting packages that perform many of these accounting functions automatically, for example, posting to various general ledger accounts and producing financial statements.

Micro-Finance Accounting and Management Information Systems

The following diagram illustrates a “generic” financial management information system in a microfinance institution, whether its clients are individuals, Self Help Groups, Solidarity Groups or Joint Liability Groups and regardless of the MFI’s legal structure or registration. The accounting system follows the usual flow from transaction to the preparation of financial statements.

The loan tracking system acts as a subsidiary ledger to the general ledger. Client transactions must be entered into both systems, but can be summarised in the accounting general ledger. Some loan tracking systems are manual, but it is a huge challenge to handle a large number of clients, produce reports and age loans with great efficiency in a manual system. Most MFIs prefer automated systems.

Figure 2.1: Accounting System and Client Portfolio System (MIS) Microfinance



Integrated vs. Non-integrated Information Systems

Most MFIs prefer automated systems – for both the general ledger and for the loan tracking system. In addition, it is preferable and advisable for the two systems to be “linked” or integrated, through one single software. This might imply two different modules within the software. An integrated system can be linked through either “batch posting” of transaction entries from the client accounts to the general ledger, or posting through real on-line updates with every transaction.

Non-integrated or linked systems imply that MFIs must pay closer attention to:

- greater control on data entry in both systems, since the same data is entered in two separate systems
- greater control on data entry month end processes, related to cut-offs, adjustments, etc.
- greater controls for reconciliations of outstanding balances of loan principal

Even though your system may be integrated, you may need to pay special attention to posting from the client accounts to the general ledger. Some systems are very sensitive to electricity cuts, or other disruptions to computerized processing, so reconciliations and regular monitoring are very important.

Centralised vs. De-centralised Accounting Systems

MFIs centralise or de-centralise their accounting systems depending on their size, their technological adaptations, their geographic spread and their operational activities. Most MFIs will begin operations with centralised accounting functions and decentralised operations. This means that the Head Office processes all accounting and client loan transactions in services managed and controlled at the Branch Office. Any Branch activity, transactions, and documents must be recorded at the Branch (usually manually) and sent to the Head office for processing.

This may be manageable for a small volume of activity, but over time it is likely to become challenging as volume increases and the number of distant Branches increase. The Branches need immediate and reliable financial information, particularly for loan tracking. Sometimes, Branches will handle only loan and savings transactions, while the Head Office takes care of all other finances, operating costs, salaries and accounting. If the Head Office also handles automation of loan and savings transactions, there will be some duplicity of effort and the potential of errors and discrepancies.

Over time, financial systems usually develop and evolve to fully decentralised accounting systems where all financial transactions are processed at the Branch and consolidated at Head Office. The distinction between the two can be made in the following comparisons.

Accounting Centralised at Head Office	Accounting Branch De-Centralised
<p>Accounting at the Head Office:</p> <ul style="list-style-type: none"> • The MFI maintains general ledger at Head Office that holds separate departments or cost centres by Branch. Some MFIs must also segregate reports by donor. In this case, the Chart of Accounts must facilitate both Branch and donor sub-accounting. Alternately, Head Office may open a separate general ledger for each Branch • To the extent possible, the MFI should allocate assets (e.g. fixed assets and loan portfolio) and liabilities to Branch departments. It may be difficult to establish 	<p>Accounting at the Branch:</p> <ul style="list-style-type: none"> • The Branch itself maintains a general ledger that handles all branch financial transactions. The Chart of Accounts and structure of the system must be consistent with the MFI and the Head Office’s system overall. • Branch accounting includes all transactions related to operating expenses, salaries, transportation, office rent, loan interest, interest income, bank fees, etc. • Branches need to hold their own bank accounts as needed, petty cash and

Accounting Centralised at Head Office	Accounting Branch De-Centralised
<p>Branch based balance sheets if they are not set up this way from the beginning, since operational bank accounts or cash at Head Office are often merged into a few accounts for optimum liquidity management.</p> <ul style="list-style-type: none"> • Department accounting or accounting by cost centres must record all Branch revenues (from loan interest and fees) and operating expenses in order to determine the Branch’s performance and break-even point. • Large Branch operating expenses may be handled and processed by the Head Office. Branches may operate petty cash funds for small, incidental expenses that are then also recorded by the Head Office on behalf of the Branch. The Branch must retain proper records and report to the Head Office any transactions to ensure timely entry into the accounting records. • While Branches may record inter-office transfer of funds, the Head Office generally is responsible for initiating the reconciliation of these accounts and also the elimination of accounts upon consolidation of Branch financial statements • A Head Office financial system that consolidates Branch general ledgers or cost departments will also handle various transactions that relate to the MFI overall but not to specific Branches, for example, tax remittances, interest on borrowings, amortization of MFI software development, taxation, and deferred grant revenue. 	<p>operating cash and exercise the same levels of internal control and operational guidelines stipulated in the accounting policies and procedures of the MFI.</p> <ul style="list-style-type: none"> • The Branch must structure loans and operating advances from Head Office according to established policy. Usually this is an advance to the Branch. All inter-office transfers and transactions must be recorded promptly and according to policy, including interest, new advances or retirements. • The Branch should record any deficits or surpluses generated by the Branch and monitor break-even points and trends of operating revenue over operating expenses. • The Branches must operate their accounting according to MFI policy and ensure that their records are orderly and well-kept for audit purposes • Branches must be aware of their own budgets and targets in order to effectively manage their Branch operations

Portfolio Centralised at Head Office	Portfolio De-Centralised at the Branch
<p>Loan and Savings Transactions at Head Office:</p> <ul style="list-style-type: none"> • Any MFI processing loan transactions must track the disbursement and collection of loan repayments. This involves receipts, cash collection registers, summaries, cash disbursement registers, and all documents needed in the audit trail for cash transactions. This is always conducted at the point of the transaction – e.g. with the client at the Branch or field centre. Entering and processing transactions data in the client records is the next step of the loan tracking system (often called the MIS). • MFIs that centralise client transaction processing still need to have the basic audit 	<p>Loan and Savings Transactions at the Branch:</p> <ul style="list-style-type: none"> • Any MFI processing loan transactions must track the disbursement and collection of loan repayments. This involves receipts, cash collection registers, summaries, cash disbursement registers, and all documents needed in the audit trail for cash transactions. Entering and processing transactions data in the client records is the next step of the loan tracking system (often called the MIS). • Branch MIS systems can be handled on a manual basis or through an automated system. • All Branch client accounting related to

Portfolio Centralised at Head Office	Portfolio De-Centralised at the Branch
<p>trail for cash transactions outlined above at the Branch level. However, the Head Office may have the MIS system that automates client transactions in database software. This system then produces transaction reports, late loan reports, a month end portfolio outstanding report, and a month end portfolio aging report.</p> <ul style="list-style-type: none"> • The above MIS system must be able to segment client data by Branch, by Credit Officer and by other features as needed (e.g. by area or loan product). • The most important feature in a centralised MIS for client transactions is that data is carefully reconciled to cash transactions at the Branch, and that information and reports moves between the Branch and the Head Office as efficiently and quickly as possible. In reality, THIS IS A CHALLENGE! • The Head Office MIS system may need to merge and consolidate the loan and savings transactions of several Branches. If automated, the software should facilitate this consolidation. Alternately, reports are exported to a spreadsheet and consolidated manually. 	<p>loan and savings transactions with the MFI – disbursements, repayments or collections, adjustments, etc. is entered into the Branch’s MIS system as soon as possible after it has taken place.</p> <ul style="list-style-type: none"> • In either a manual or automated loan tracking system, the Branch must produce regular late loan reports, a month end portfolio outstanding report, and a month end portfolio aging report. • Branches must make proper provisions for loan impairments as outlined by MFI policy for any portfolio at risk • Branch managers must be aware of their own targets and goals with respect to disbursements, collections and portfolio quality in order to manage their Branch effectively.

The main point is that the accounting principles, and the basic accounting cycle are the same and should be consistently applied, whether an MFI uses a centralised or a de-centralised system. A clear audit trail with good internal controls in the accounting process must be in place whether systems are centralised or de-centralised. **Finally, the purpose of the accounting system is to provide information – in the form of financial reports – that provide reliable, relevant and TIMELY information to managers. Decentralised systems in remote Branches – with appropriate internal audit and controls -- is one of the most practical and efficient ways to do that.**

Example of de-centralised Branch transactions affecting the Head Office:

Branches pay out the salaries of their staff each month and deduct withholding taxes, and account for employer portion of other government social benefits. Both withholding taxes are remitted by the Head Office to the appropriate government authority:

Debit: Salaries	1,000		
Debit: Employer Social Benefit	100		
	Credit: Bank for payment to employee	950	
	Credit: Taxes Payable – Accounts Payable Head Office		150

The amount payable for tax remittances includes the tax deductions on the employee’s salary, and the employer portion of other government social benefits. The 150 will be transferred to Head Office, who will record and pay this amount as withholding taxes to the appropriate government office. The Branch retains the full costs and accounting of its staff salaries.

Cost Accounting for Multi-Service MFIs

The principles behind cost accounting for multi-service MFIs are quite simple:

- First and foremost, accounting for business segments is a standard promoted and expected by International Accounting Standards. This applies to both geography and business activity. The application to microfinance institutions is that any activity in an MFI should be segmented from other activities in the organisation, if it is over 10% of the total volume of the MFI's revenue, assets, or profits (IAS 14).
- Secondly, microfinance is generally managed and offered as a commercial activity with a social purpose. Tracking performance of microfinance implies the need to segment other social and developmental activities separately. Setting up a separate organisational structure, a separate general ledger or a separate cost department are all ways to support segmentation of microfinance activities. However, a balance sheet that reflects only microfinance assets, liabilities and equity is very important, as much of the performance and ratio analysis is based on balance sheet information.

Separate Set of Books to be kept for Micro-Finance Activities:



Accounting standards for microfinance institutions in India have been designed to promote transparency.

- First and foremost, separate accounting books and records must be maintained for microfinance.
- Books of accounts are to be kept on accrual basis and a double entry system of accounting should be followed.
- Loan and savings tracking systems must be maintained, detailing all collections and disbursements from borrowers.
- Transactions with related agencies (Self Help Groups) who lend to individual borrowers must be detailed.
- All revenue and expenditures related to microfinance activities must be properly recorded and disclosed.
- Fixed asset transactions of the microfinance institution must be properly recorded and disclosed.
- Details of loans and advances to employees, directors, trustees or any other person managing the affairs of the MFI must be disclosed.

(Adapted from "Accounting Standards for Micro-Finance Institutions in India" V. Nagarajan & Co. SIDBI Foundation for Micro Credit)

Some MFIs prefer to keep all their activities within one accounting and reporting structure, but to segregate activities within the one system. If you take this approach, you need to make decisions as to how you will do that -- through activity based costing techniques or general allocations. For more information on the techniques and approaches in cost accounting for multi-service MFIs, refer to the *MicroSave "Costing and Pricing of Financial Services Toolkit"* (D. Cracknell 2004).

The Chart of Accounts

The accounting system is built on the chart of accounts structure. The design of the chart of accounts is a fundamental decision for every institution. It reflects the type of information desired from the system and provides a structure to do so.

It is the foundation for recording transactions into the general ledger and for presenting the accounts in the financial statements.

Using a well-designed chart of accounts structure will:

- provide a clear method to account for separate parts of the MFI
- follow cost accounting and fund accounting principles,
- provide a simple way of adding accounts and therefore allow for growth, and
- provide flexibility to adjust accounts to the individual needs of the institution.

A detailed Chart of Account structure should allow activity to be tracked by branch, by donor (account fund), by function (operating or non-operating), and by responsibility (the regions). An MFI may need to consult with local standards and regulators to determine whether there are prescribed formats for the Chart of Accounts. Management must decide the level of detail desired in the chart of accounts. Too much detail can be time-consuming, and provide irrelevant information. Too little detail does not provide enough information to make good management decisions or financial projections.

Most Microfinance institutions, are interested in Branch performance (financial statements by Branch), and some levels of donor or account fund reporting, to facilitate transparent financial activity for external reports. Further, MFI reporting is increasingly becoming standardised for international benchmarking and investors. In order to get consistent and comparable analysis, common definitions and understandings are important.

The structure described here is a multi-digit number with two or more separators: ABCC-DD-EE. This allows activity to be tracked by branch and by donor (account fund). Additional separators may be added if needed.

Note: This structure would be edited depending on whether the MFI uses decentralised accounting at the Branches, on the software specifications for consolidations, or whether accounting systems are centralised.

Figure 2.2: Sample Chart of Account Structure

A	The first digit indicates the type of account	1000 Assets 2000 Liabilities 3000 Equity 4000 Income 5000 Expenses 6000 Non-operating income & expenses
B	The second digit indicates a group of accounts with common characteristics	1100 Cash Funds Advanced to Branches 1200 Loan Portfolio 1300 Impairment Loss Allowance 1400 Interest Receivables 1500 Other Receivables 1600 Prepaid Expenses 1800 Fixed Assets

		1900	Other Assets
CC	The next two digits indicate specific accounts within the group	1005	Cash on Hand
		1010	Cash in Bank
D	Number for Branches or non-microfinance activities	-00	Head Office
		-01	Branch One
		-02	Branch Two
		-03	Branch Three
EEE	Donor/Investor	00	Unrestricted
		01	Donor #1
		02	Donor #2

How would it work in practice? Here are some examples:

Example 1: If 1010 is Cash in Bank, then

1010-00-00 is the balance of cash held in the head office bank account in unrestricted funds

1010-02-00 is the balance of cash held in the Branch Two bank account in unrestricted funds

Example 2: If 4010 is the interest income from regular loans, then

4010-01-06 is the interest income from loans from Branch 1 for donor number 6.

4010-03-00 is the interest income from loans from Branch 3 from the MFI’s own funds.

Account Explanations

The table below illustrates a general description of the use of selected account groups in the chart of accounts, up to fixed assets and accumulated depreciation. (A comprehensive sample Chart of Accounts is illustrated in *Handout 2.1 Sample Chart of Accounts*). The account groups are highlighted in bold print, and are only used as main categories for reporting purposes, and to provide a structure to the chart of accounts. Posting from journals is made to the detailed accounts in the second level. The table gives a description of the account and its possible uses. Not all of the account groups may be currently used by the MFI, but it is important to know the proper treatment in case of future need.

Figure 2.3: Sample Chart of Account Descriptions and Explanations

ASSET ACCOUNT GROUPS		
1000	Cash and Banks	To record all amounts deposited into a bank account or added to cash on hand and all amounts withdrawn from a bank account or taken out of cash on hand
1005	Cash on Hand	Cash held in the office safe for petty expenses
1010	Cash in Banks	MFI bank account that handles all MFI banking transactions – deposits and withdrawals
1100	Trade Investments	Any financial assets acquired primarily for the purpose of selling or repurchasing in the near term. These may include certificates of deposit, including interest-bearing deposits and treasury bills.
1200	Loan Portfolio – Current and Past Due	To record the principal amount of loans issued to clients and the amount of principal repaid by clients. If a loan is unpaid at the end of the month, some MFIs transfer the principal balance to “Past due loans”
1210	Loan Receivables	All loans issued to clients less the amount of principal repaid, being the balance of loans outstanding
1230	Loan Receivables – Rescheduled	All loans that are past due their repayments, and have formally negotiated a new repayment schedule, and are now current

1300	Impairment Loss Allowance	To record an allowance for potentially uncollectible loans based on an assessment of risk (usually aging). The amount of the allowance should be adjusted monthly. In some cases, an MFI will choose to adjust quarterly or annually
1310	Impairment Loss Allowance	The Allowance for potential uncollectible loans from clients as per MFI policy
1320	Allowance for Loan Losses – Rescheduled	The Allowance for potential uncollectible loans from rescheduled loans as per MFI policy
1400	Interest Receivable on Loan Portfolio	To record client loan interest that was due but not paid. The amount is cleared when payment is made or the amount is written off as a bad debt
1410	Interest Receivable – Loans	Loan interest from clients that is due, but not yet paid.
1500	Accounts Receivable and Other Assets	To record amounts due from sources other than clients.
1510	Travel advances – employees	Advances paid to staff for travel expenses before a work-related trip which must be retired with receipts for approved expenses and any remaining cash.
1520	Other employee advances	All other advances paid to staff for project expenses which will be retired with receipts for approved expenses and any remaining cash.
1530	Miscellaneous receivables	Any other items paid by the project on behalf of other parties which will be collected within a short period.
1540	Prepaid Expenses	Expenses paid in advance of the reporting period, e.g. annual vehicle insurance, prepaid rent, annual equipment insurance
1600	Other (Long Term) Investments	Include investments that have a fixed maturity or payments that the MFI intends to hold to maturity. This includes bonds or shares that the MFI plans to hold for 12 months or more, but not loans, receivables, or trade investments.
1800	Fixed Assets	To record the cost (or value, if donated) of all fixed assets owned by the MFI. Fixed assets may also include other assets, such as software. Intangible assets (e.g. Goodwill) may be included here if permitted by local accounting standards and IAS.
1810	Land and Buildings	Land and buildings that the MFI owns through direct purchase, credit or donation.
1820	Vehicles	Vehicles and motorcycles that the MFI owns through direct purchase, credit or donation
1830	Computer Equipment	Computer equipment (computers, printers, UPS) that the MFI owns through direct purchase, credit or donation.
1840	Office Furniture and equipment	Office furniture and equipment that the MFI owns through direct purchase, credit or donation
1850	Accumulated Depreciation and Amortisation	The sum of all depreciation and amortisation expenses for Fixed Assets. Accumulated depreciation represents the reduction in value of Fixed Assets corresponding to the assets' remaining useful life.

1860	Accum. Depreciation – Land and Buildings	Depreciation is charged each period for land and buildings to show the “wear and tear” of the asset, and accumulates in this account. However, land is not a depreciable asset.
1870	Accum. Depreciation – Vehicles	Depreciation is charged each period for vehicles to show the “wear and tear” of the asset, and accumulates in this account.
1880	Accum. Depreciation – Computer Equipment	Depreciation is charged each period for computer equipment to show the “wear and tear” of the asset, and accumulates in this account.
1890	Accum. Depreciation – Office Furniture and Equip.	Depreciation is charged each period for office furniture and equipment to show the “wear and tear” of the asset, and accumulates in this account.

Maintaining the Chart of Accounts

The chart of accounts is not a static document. It needs to be reviewed and revised on a regular basis as needs dictate. The Head Office Finance Manager, in consultation with the Executive Director, is generally responsible to maintain the chart of accounts for both the Head Office and the Branch Offices, and to ensure that all accounting staff throughout the institution knows which account numbers they should be using.



From time to time it may be necessary to add accounts to the chart. If the MFI receives additional operating grants or loan capital from a new donor, and is required to report to the donor for those specific activities, it is useful to open accounts with the appropriate donor code. If the MFI expands to a new Branch, accounts need to be opened to handle all the standard financial activities of the branch. If the MFI expands to offer another loan product, an account should be added for the new product in order to track performance of the new product in the financial and management reports.

If the MFI uses an automated general ledger, there may be some additional things to consider for the Chart of Accounts. They may need to be set up for Fund Accounting and the potential to post some revenues and expenses to specific capital or equity accounts. Donations and grant equity might also require special treatment. This implies that the capital or equity structure of the automated system needs careful attention on installation and planning. Careful attention and a clear audit trail are also important when closing year end transactions to the system. If not, most income and expense accounts will be automatically closed to the general retained earnings account.

Alternately, the MFI can choose to set up spreadsheets and track the historical grants and donations from various donors outside the accounting system.

Note: It is critical to plan the structure of the Chart of Accounts for the MFI, to know the limitations and requirements of software, and to ensure that Branches and Head Office are consistent and unified. Without a consistent, well-controlled Chart of Accounts, software or manual consolidation is a difficult challenge. Auditors may not be able to follow the audit trail, and comparisons between Branches are difficult if not impossible.

The MIS Structure for Loans and Savings

MFI managers and information users must think through the structure and needs of the MIS used to track client loans and savings transactions, just like they think through their Chart of Accounts. The MIS generally tracks the following on client transactions, including:

- Identity of the client
- Credit history
- Amount disbursed
- Loan terms: interest rate, fees, maturity, etc.
- Repayment schedule: dates and amounts
- Amount and timing of payments received
- Amount and aging of delinquency
- Outstanding principal balance
- Outstanding of savings balance
- Savings terms; interest rate, charges, etc.
- Savings transactions – deposits and withdrawals
- Amount of interest on savings due

The system should contain this information for both current loans and past due loans. In practice most MFIs do not maintain this information in usable form on loans that have been paid off or written off. This is a substantial deficiency. Archiving completed loans in historical records may be a good solution, but these records must be accessible and useful in making new loan disbursements.

The MIS should not only track individual client transactions. The portfolio should be tracked and segmented according to:

- The Credit Officer responsible for them
- By product, if several products are offered
- By Branch and by centre or cluster within the Branch
- By loan size if variable loan sizes are offered
- Aging reports by Credit Officer, area and Branch
- Rescheduled or renegotiated loans
- Historical loan history
- Other relevant characteristics needed for good portfolio and product management

This toolkit does not go into great depth in the structure and details of designing and structuring a strong client loan tracking system for MFIs. Greater detail is provided in some of the tools and resources cited in the toolkit bibliography. “*Management Information Systems for Microfinance Institutions: A Handbook*” (Waterfield, C.) published by the Consultative Group to Assist the Poorest in February 1998 is an exhaustive resource for structuring MIS systems in MFIs.

MFI Accounting Policies

In brief, MFIs also need to review and set up basic accounting policies as they relate to the national or international standards of accounting. The following list is not an exhaustive list, but is an example of the areas in which MFIs need to develop policies.

- Methods of depreciation, depletion and amortization
- Method of accounting – cash or accrual
- Treatment of expenditure during construction or software development (intangible assets)
- Conversion or translation of foreign currency items (transactions, grants, loans)
- Treatment of goodwill
- Valuation of investments

- Treatment of retirement benefits
- Valuation of fixed assets
- Treatment of contingent liabilities

Accounting policies are discussed in further depth in Section 5 on Internal Controls. While policies and procedures are part of the internal control environment, accounting policies in themselves also have a broader connection to the national or international accounting policies applicable to the entity.

This section has laid out the foundation and key structural components to consider when setting up an MFI's financial reporting system. The following two sections enter the "nuts and bolts" of accounting activities. They outline the detailed accounting documents and processes within an accounting system. Sections 3 and 4 are targeted for MFI accountants and bookkeepers, although managers need to understand the processes and the key control issues to effectively supervise staff.

3. Accounting Documents

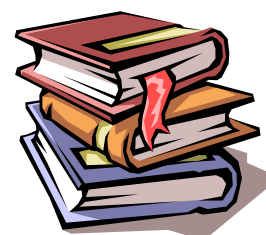
Microfinance is a financial service activity. As such, the principle “tools of the trade” are people, paper and money. There are no significant inventories or raw materials held in stock and no assembly line of physical goods production. However, financial transactions – loan disbursements, loan repayments, savings deposits, savings repayments, and expense payments -- form the heart of accounting transactions in an MFI. Therefore this toolkit includes sections that emphasise the accounting documents and the accounting cycle related to microfinance activities.

Accounting documents may vary, depending on whether a manual system or an automated system is used to keep the general ledger. *Handout 3.1 Sample Accounting Documents for MFIs* include sample illustrations of a variety of the following documents and forms. The following paragraphs describe basic accounting documents – from source documents to Transaction Vouchers to documents and reports produced by the accounting system.

Source Documents

The substance of source documents depends on the content of the financial transaction. Some basic and common elements of source documents are:

1. Title of document and Company name and address
2. Date and serial number
3. Name of person completing the document
4. Signature or stamp of the person completing the document
5. Name of person or organisation receiving the document
6. Content of the transaction
7. Number of items and price, if applicable, and monetary amount.
8. The financial stamp of the organisation preparing the document



Source documents include all the documents related to the loan and savings procedures with MFI clients. This would include, but not be limited to:

- Customer Registration Documents
- The Loan Application and assessment
- The Loan Approval (Sanction) form or document
- The Contract or the Promissory Note
- Loan Disbursements Sheets or Registers
- Loan Collection Sheets or Registers
- MFI Receipts for cash transactions!
- Client passbooks
- Client ledger cards for loans and savings

These source documents form the basis of the MFI’s loans and savings transactions. They are usually handled through manual processes and practices, although client ledger records for loans and savings are usually automated. These source documents must be linked to the accounting transaction voucher and the journals and registers that are entered into the MFI’s general ledger. *Handout 3.2 Sample Client Forms for MFIs* provide a range of forms often used in handling client financial transactions in an MFI.

Accounting Transaction Voucher

Each time a transaction takes place, there must be accompanying documentation. Preparing a voucher ensures that the transaction is recorded consistent with the appropriate accounting procedure.

Every organisation has specific ways of preparing vouchers. The most important point to remember is that vouchers result in a paper trail for each transaction. This allows the organisation to have adequate internal control over its record keeping and ensure that its assets are safeguarded. The Accounting Transaction Voucher is usually not posted directly to the general ledger. It is recorded only in journals and subsidiary ledgers. In automated accounting systems, the vouchers are entered directly into the system.

Vouchers are supported by invoices and cheque stubs or cash requests and generally include the following:

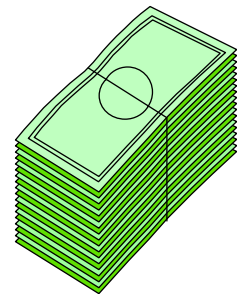
- Number and nature of voucher (serially pre-printed)
- Name of department
- Date prepared
- Account name and number
- Amount of money
- Source and description of the transaction
- Authorised signature(s) of Preparer and Reviewer
- Attachment of original invoices and cash requests (the source documents)
- Proof of delivery or completion of services rendered

The designated supervisor must authorise or approve all vouchers.

An automated general ledger will automatically store most of the books of account, as in the journals (cash journal, bank journal, and general journal), the subsidiary ledgers, and the general ledger. Most software packages will also capture the fixed assets ledger. However, for manual systems, the following records and documents form the “books of account”.

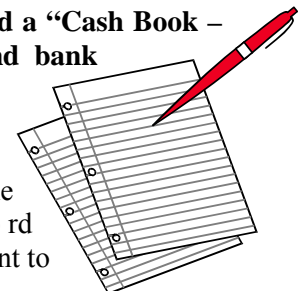
Cash and Bank Journals (Cash Book or a Journal cum ledger)

The cash journal is used to record all the activity in the cash kept on hand in a Branch or Head Office. The appearance of the journal and the process of recording entries are similar to that of the bank journal (as illustrated in *Handout 3.1 Sample Accounting Documents for MFIs*). Extra columns can also be added for frequently recurring items, like small office expenses, as illustrated.



At the end of every day, the actual cash kept on hand **must be counted** to ensure it is equal to the “Cash Balance” in the journal. Someone other than the person responsible for maintaining the cash box shall conduct this check. A Cash Count sheet is important for your MFI auditors to review and verify, particularly for year end cash counts.

In some countries the Cash Book (for Cash and Bank accounts) is considered a “Cash Book – cum ledger” in that individual entries are made, but the actual cash and bank balances are updated with each individual entry.



The Bank Journal (or Bank Book) is used to record all activities — deposits and disbursements — in the bank account **as they occur**. If there is more than one bank account, then each account must have its own Journal or Bank Book to record transactions. This is done to simplify the process of reconciling the bank statement to the accounting records and to ensure control over the accounts.

The entries are recorded in the journals according to the vouchers as of the date of the bank transaction. The bank balance column is updated after each day’s entries. Typically, a bank journal is a bound book with ledger pages with up to 30 columns across. There are columns designated to specific accounts that have recurring transactions or entries in the month – like cheques to clients for loans, salary payments, office expenses and travel expenses. Each column is sub-totalled at month end, and the total is posted to the general ledger at the end of the reporting period.

General Journal

A “General Journal” is used to record transactions that do not involve the receipt or disbursement of cash. Such transactions could include the following:

1. Recording accounts payable and accrued expenses
2. Record advances for client loans or client deposit repayments
3. Correct an error from a previous entry,
4. Record depreciation expense,
5. Make adjustments to prepaid expense or deferred revenue accounts,
6. Make adjustments to the Impairment Loss Allowance account
7. Record in-kind grants or donations, or
8. Any other non-cash transaction.

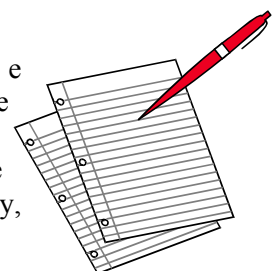
The general journal does not keep a cumulative balance like the cash and bank journals. Each entry in the general journal “stands alone” and is supported with an approved voucher and various schedules and supporting documentation. A typical page in a journal book will look like this:

Figure 3.1: General Journal Sample

Entry Number	Account Name or Description	Voucher #	General Ledger		
			Acct #	Debit	Credit
1					
2					
3					

General Ledger

The general ledger is the source of information used to prepare the trial balance and the financial statements. It is set up using the Chart of Accounts with one page for each account, or organised by account number, beginning with the asset accounts and ending with expense accounts. The general ledger represents the accumulation in one place of all information about changes in an asset, liability, equity, revenue, or expense item.



If there are certain accounts with a large number of transactions, the accountant may choose to also maintain Subsidiary Ledgers. Subsidiary Ledgers record the account by breaking it into detailed categories. However, the general ledger will carry the “control account” that summarises the totals and transactions of the subsidiaries.

General Ledger Controls

The information in the general ledger is used to record, accumulate, and store accounting information. Therefore, it is important to maintain a strict set of controls over the set-up, recording and finalising of the ledgers

1. Before a new ledger is used, record the financial year, number of pages in the ledger (assuming a bound book), the accountant’s signature, and date clearly on the title page.
2. If a loose-page ledger is used, the pages must be compiled and bound into a ledger book
3. Entries written into the general ledger (referred to as “posting” entries) come from the three journals described above, not from transaction vouchers or subsidiary ledgers.
4. Number each page in sequence with the account name and number listed at the top.
5. Post entries with blue or black ink, not pencil. Use red ink for reversals or corrections and add signature and date of correction.
6. At the end of each period, the general ledger shall be “Closed”, that is, the balance of every account shall be computed.
7. For income and expense accounts, use one line for the “Current Month Total” and a separate line for the cumulative total for the year to date.
8. Prepare a Trial Balance. (See Section 4.)
9. At the end of the financial year, the balances in the Income and Expense accounts shall be “Closed” to the account, “Current Year Profit”. (See Section 4.)
10. The balances in the Asset, Liability, and Equity Accounts shall be carried forward to open the “Beginning Balance” of the new financial year. (See Section 4.)

Subsidiary Ledgers

Subsidiary Ledgers are used for any account that records numerous detailed transactions. Subsidiary Ledgers are used to reduce the size and complexity of the general ledger. They also serve an important role in controlling the integrity of data and providing the current status of a loan or savings balance.

In an MFI, there will always be a Subsidiary Ledger to record individual client accounts for loans and savings activity. By maintaining Subsidiary Ledgers on a regular (daily) basis, MFI staff and clients themselves will be able to track the loan and savings transactions and balances at any point in time. When Subsidiary Ledgers are used, client loans and savings activities are usually summarised in the Cash and Bank Journals. Only the totals are posted to the General Ledger, rather than each individual transaction. When Subsidiary Ledgers are used, there must always be an end-of-month reconciliation of the individual balances in the Subsidiary Ledgers with the control account for Loans Receivable in the General Ledger.

Subsidiary ledgers are also used for travel advances, staff advances, accounts payable and accounts receivable.

Fixed Assets Ledger

A fixed ledger records all fixed assets capitalised in the MFI’s general ledger. It includes columns for the date of Purchase, Asset Description, Serial Number (if applicable), donor source, the value of assets (end of previous fiscal year), current period additions, current period disposals, assets (end of current year/ period), depreciation rate, accumulated depreciation (end of previous fiscal year), current year/period depreciation, accumulated depreciation (end of current year/period), net book value (current year/period), and net book value of the previous fiscal year.

All columns should be totalled down, by asset category, and in total. The totals should agree to the total categories of assets and accumulated depreciation in the general ledger.

The Audit Trail

Documents are an integral part of all accounting systems. Automating accounting system is a more efficient way to handle the accounting process. But MFI accountants must remember that auditors are only able to audit the hard copy print-outs of the various accounting reports. Auditors can not verify processes and transactions in electronic form, since they are subject to change or deletion very easily. Hard copies verify the integrity of transactions, data entry, month end or year end cut offs, and the accuracy of entries.

If your MFI uses an automated accounting system, ensure that journals, batch transactions and the general ledger is printed out monthly and stored with that month’s accounting records. The audit trail means that all source documents, vouchers and registers are physically traceable and linked through the hard copy records and documents in an accounting system.

Monthly print-out of accounting journals and records:

- All journals recording the entry of each transaction; many times this print out is called a “batch journal”
- All general journal adjustments
- All bank reconciliations and supporting schedules
- All general ledger accounts for the month/period
- All other reconciliations and documents that are made electronically and form part of the month end accounting process



Document Controls

Documents are an integral part of all accounting systems. They should be stored in sequential order to ensure that documents do not go missing, or unable to be later traced. They should also be stored in environments that are generally free of excessive dust and humidity. **Source documents like pre-numbered receipts, purchase orders or invoices should be recorded in a Document Register, so that MFI staff “sign out” the documents, and “sign in” when the books or documents have been completely used, and only the book copy remains.** Handout 3.3 Sample Document Register shows how this control might be implemented. It does require good implementation to make the control effective.

Good management and control of the MFI’s documents is important because many documents are readily convertible to cash (e.g. a receipt) or goods (e.g. a purchase order). Control of documents will help to control the MFI’s physical resources including cash.

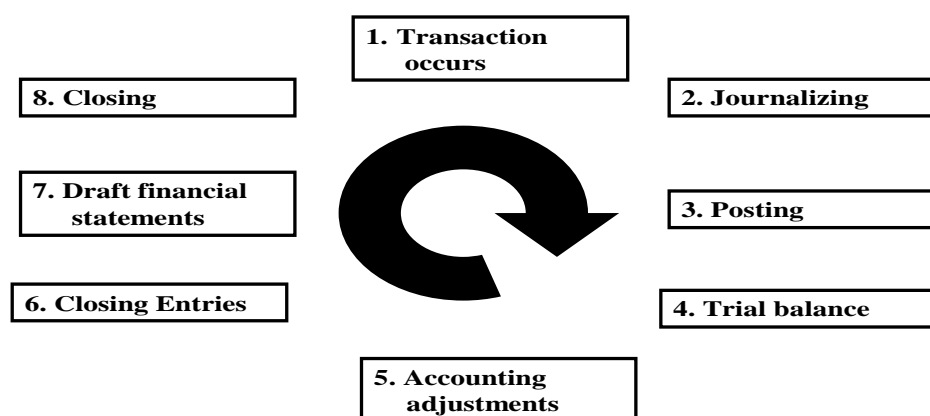
It is challenging to talk about accounting documents without the context of how they are used. They are an integral part of the accounting cycle and accounting processes. The following section illustrates the various steps and processes in the accounting cycle, referencing accounting documents as needed.

4. The Accounting Cycle

The accounting cycle is the monthly or periodic process used to record and post financial transactions for the preparation of financial statements. It includes the process of review and reconciliation. The accounting cycle described here is applicable to both automated and manual accounting systems. In an automated system, many of the calculations, posting and account accumulations occur within the software. However, the process is the same as if a manual system were used.

The following describes any financial transaction that takes place within the MFI – whether a client pays registration fees, is disbursed a loan, pays a loan, or whether the MFI pays salaries, rent and operational expenses. The transactions include those that take place with the MFI itself, and not those transactions that the MFI’s clients may have with one another (e.g. internal savings or internal lending of Self Help Groups). *Handout 4.1 Sample Accounting Cycle* illustrates the flow of financial transactions and data through the accounting cycle with actual data and transactions.

Figure 4.1: Accounting Cycle



Transactions

The accounting cycle begins with the source document that verifies, supports, and documents the transaction, and its accounting transaction voucher. Financial transactions do not occur in a void without any documents. Documents could include receipts, invoices, agreements, contracts, memos, bank deposit slips and notes to support the transaction, when it occurred, what is affected, a rationale for its occurrence and approval that recognises the transaction’s legitimacy. The accounting transaction voucher is the MFI’s document that triggers the recording process in the MFI’s accounting system. Before being entered, the voucher is drawn up, account codes are assigned, calculations are checked and managerial approval is granted.

Classifying Transactions

The next step in the cycle is to classify the transaction. The chart of accounts will provide the proper code to record the transaction in the accounting system. The classification of transactions is also based on the double entry system of accounting. Any transaction will affect a minimum of two accounts – and reflect an increase or a decrease to accounts. The transaction may affect a debit account and a credit account. It may also increase one debit account and decrease another debit account. Alternately, it could increase a credit account and decrease a different credit account as well. The main point in

classifying transactions is that the Chart of Accounts is followed, and followed consistently and correctly in the treatment of transactions.

Journaling

All financial transactions are entered into the accounting system by means of the journals, whether the cash journal, the bank journal or the general journal. The journals act as a daily diary of transactions, listing them in chronological order from the accounting transaction vouchers. The journals record how each transaction affects an asset, liability, equity, revenue or expense account. Each entry has a debit and a credit.

At the end of the reporting period, take the following steps:

- Add each column of items together to arrive at a total.
- Verify that the total debits equal the total credits, also called cross-balancing, for each of the columns of the journals.
- Verify that the balance of cash on hand in the cash journal agrees to the physical count of cash on hand.
- Reconcile the bank balance in the bank journal with the bank statement from the bank (refer to specific steps in the following section on reconciliations).

Posting to the General Ledger

- a. Posting is the process of transferring journal entry information from the Journals to the General Ledger. At the end of the reporting period, perform the following procedures:
 1. Ensure the debits and credits totals for all journals, the cash journal, the bank journal and the general journal are equal
 2. Post the totals for the period to the General Ledger
 3. Double-check each posting for accuracy
 4. Update the accumulated totals in the General Ledger
- b. In addition, detailed client transactions (not summarized) must be posted to each client account in the subsidiary ledgers (or client accounts, MIS). This includes disbursements, repayments, adjustments (if posting errors), and savings contributions. It is critical that the posting to the client accounts be completely accurate, and timely, since at the end of the reporting period, the sum total of all loans outstanding must balance to the loans outstanding in the general ledger.



Trial Balance

At the end of an accounting period, after all journal entries have been made and posted to the General Ledger, a trial balance is prepared to help in the preparation of the financial statements.

The trial balance is prepared by:

1. Taking the account balances from the General Ledger
2. Listing the accounts having debit balances in one column and those having credit balances in the other column.
3. Totalling the debit balances.
4. Totalling the credit balances
5. Comparing the sum of the debit balances and the sum of the credit balances. (The sums should be equal in order for the ledger accounts to be in balance)

A trial balance is a first test of accurate posting in the ledgers. However, it does not mean that the ledger accounts are free from error. Some errors can not be detected in a balanced trial balance. These include posting to the wrong accounts, and posting the wrong amounts in both the debit and the credit column.

Figure 4.2: Sample Trial Balance

ABC Microfinance Institute

Trial Balance as of _____ (date)

Account #	Account Name	Debit	Credit
1005	Cash on Hand	500	
1010	Cash in Banks	5,000	
1110	Loan Portfolio	45,000	
1120	Rescheduled Loans	0	
2120	Client savings		40,000
3130	Member Shares		5,000
3150	Retained Surplus		3,000
4110	Interest on Loans		5,000
5100	Volunteer Honorariums	1,000	
5370	Miscellaneous expenses	500	
5380	Meeting expenses	1,000	
	TOTAL	53,000	53,000

Reconciliations

Before finalising the trial balance, it is important to make reconciliations of various processes and accounts to ensure good internal control and integrity of the financial data. *Handout 4.2 Sample Reconciliation Schedule* provides a schedule of the various kinds of reconciliations that need to be conducted. They include items like petty cash, bank reconciliations, disbursements (reconciling the general ledger to the client loan tracking system), loan repayments (reconciling the general ledger to the client loan tracking system) travel advances, accounts payable, and outstanding loan balances (the general ledger to the client loan tracking system). *Handout 4.3 Reconciliation Tips* provides simple tips and approaches one could take in conducting reconciliation. It will give you an idea of “where to start” when trying to analyse a discrepancy, and suggestions of how to find the error. In general, the most critical reconciliations and confirmations are:

- a. Petty Cash Verification. Handling and verifying petty cash was described in Section 4 in detail, including the importance of physically counting petty cash.
- b. Bank Reconciliation (Make a bank reconciliation of the bank statement to the MFI general ledger, and record any adjustments as necessary, e.g. bank charges, outstanding cheques, etc.) *Handout 4.4 Sample Bank Reconciliation* provides specific instructions and a sample template to use in the preparation of bank reconciliations.
- c. Loans and Savings Subsidiary Account Reconciliations

To reconcile the subsidiary ledgers, take the following steps:

1. Prepare a list of all clients from the Subsidiary Ledger, by name, client number, principal balance outstanding, and savings balance outstanding
2. Double-check the accuracy of the list with the Subsidiary Ledger balances
3. Double-check the accuracy of the addition of the list
4. Compare the totals of the client list with the General Ledger balances
5. Investigate any discrepancies by double-checking the posting to the Subsidiary Ledger from the Cash and Bank Journals
6. Investigate any discrepancies by double-checking the addition and subtraction of transactions in the client Subsidiary Ledger
7. Investigate any discrepancies by double-checking the accuracy of transactions recorded in the Bank Journals and comparing with actual bank statements.

Accounting Adjustments

Accounting adjustments are made to record corrections, non-cash entries (e.g. depreciation) and accruals of estimated items. They are usually recorded in the general journal, as they often do not involve cash or bank, and if they do, they are to record corrections or unusual entries or transactions. The most common types of adjustments in microfinance institutions are described below very briefly. There may be others as well, and it is the work of accountants and bookkeepers to use their professional discretion and local resources to know how to make these entries.

Correction of Errors:

Errors can and do occur throughout the accounting cycle, and at times they are not detected until some time in the future. The best approach in making a correction is to first reverse the incorrect entry, and then re-post the correct entry. When correcting an error of a previous accounting period that has already been closed, both the reversal and the correction are posted in the current period. Previous period statements are not adjusted retroactively.

Non Cash Adjustments:

The majority of non-cash adjustments or general journal entries include the following items: record depreciation, recognise or amortise pre-paid rent, record accrued expenses like interest payable, expenses payable, provision for loan impairments, allowances, write-offs, etc. These are based on the broader accounting policies adopted by the MFI. The policies and their accounting treatment are covered extensively in Section 6.

Draft Financial Statements and Closing

Once the reconciliations and accounting adjustments have been posted, accountants are able to prepare draft and final financial statements from the trial balance. Financial statements can be – and should be – prepared monthly for internal management purposes. In this case, income and expense accounts are not actually closed to the retained earnings each month. Rather income and expenses are officially “closed” to the retained earnings account at the end of the financial year. This process is described more fully in Section 7.

Why is Loan and Savings Information so Important?

“Management information systems? Our computer people handle that!”

“I get all these numbers every month, but I have no idea what I’m supposed to do with them.”

“If only I’d known that four months ago.”

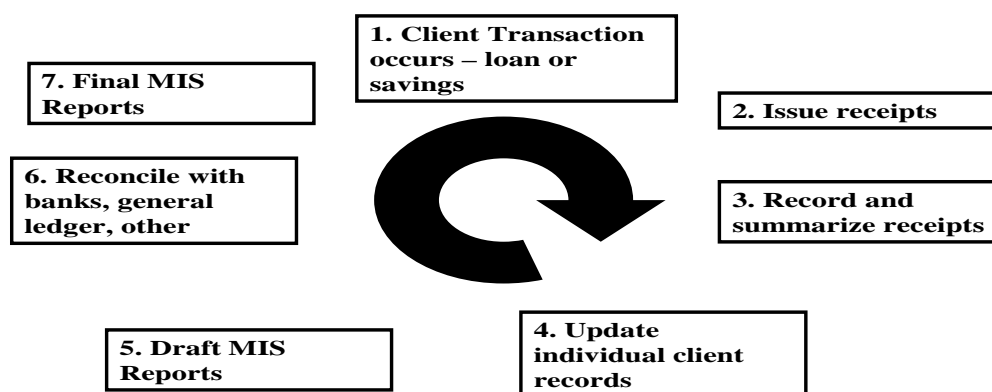
Many MFIs may be guilty of having too much paperwork and too many forms. However, MFIs rely on loan and savings information for their very survival. Having good information is essential for an institution to perform efficiently and effectively – the better its information, the better it can manage its resources. Having the right kind of information is just as critical, because too much paper or information can be confusing and inefficient – adding very little value in the end to work processes.

A management system is the series of processes and actions involved in capturing raw data, processing the data into usable information, and disseminating the information to users in the format needed. An MIS is not a computer programme and it involves more than calculating numbers. Information management is about people communicating with one another about events that affect the work of their institution

This section of the toolkit outlines the very basic procedures for accounting for client loans and savings transactions. Most MFIs may have more specific forms and detailed procedures, depending on their methodology and work processes. The samples in this toolkit provide the basic minimum needed for entry into the accounting systems and basic internal controls.

Transforming data into user-friendly information is the challenge – particularly for client transactions! The illustration below describes the general cycle of accounting for client transactions. **At the heart of the process, are the individual client record that contains both the schedule for loan instalments and the historical record of repayments made.**

Figure 4.3: Accounting Cycle for Client Transactions in the MIS



Transaction Occurs – Client Receipt or Payment

Any and every financial transaction involves a form – whether a receipt for a loan repayment, a client passbook for updating savings deposits, or a loan disbursement receipt or record. These documents trigger entries into the client management information system (the MIS) and the financial accounting system (the journals and bank accounts).

Issue Receipts or Verify Receipts of Payments

Many MFIs that use a group lending methodology do not issue individual receipts to group members who are repaying. However, repayments are recorded in a Repayment or Collection Register that documents all collections submitted by the group members at the meeting. This may be acceptable, provided that collections received outside of group meetings are duly receipted, and provided that

group members also sign off on the Repayment Register to acknowledge that their payment has been made. Their individual passbooks must also be immediately updated for the payment.

Record and Summarise Receipts for General Ledger

Cash or Repayment Registers must be summarised daily or weekly, agreed to bank deposit slips, and be reviewed and approved for entry into the MFI's general ledger. It is very important that deposits are made of collections intact, and that the deposit is supported by bank documentation. This will form the basis for the transaction voucher needed to enter the transactions into the general ledger.

Note that in most cases, the summarised totals are entered into the accounting system, and not individual group member transactions. In some cases, individual entries are also posted in detail to the general ledger.

A daily reconciliation is ideal for better control and a strong audit trail. If the deposit is comprised of the receipts of several days, the deposit should clearly document the Repayment Register reference and amounts, to ensure the audit trail is complete.

Update Client Records with Individual Transactions

This is the process of "posting" individual client transactions to individual records. In a manual system, this might be a loan ledger card, illustrated in *Handout 3.2 Sample Client Forms*. This record acts as the subsidiary record for one individual client or one group, depending on the methodology. All disbursements are entered, all repayments are entered and balances updated. All savings deposits and withdrawals are also entered on the client record. Such detailed processes are intended to ensure transparency, build client trust, and strengthen the internal controls of the MFI.

Draft MIS Reports

At this point in the cycle of accounting for client transactions, draft portfolio reports should be generated and reviewed for accuracy, for completeness, and for any other issues. This is the chance to verify the accuracy and reliability of the report, and to verify entries with the source document and journal summaries that were used for data entry. Unusual balances or amounts should be investigated. The best verification process is for Credit Officers to get their portfolio reports as soon as possible in the reporting cycle and review for reasonableness!

Reconcile MIS and General Ledger

A critical step at this point is to ensure that the outstanding balances on the MIS reports agree with the general ledger control accounts – for both outstanding loans receivable and for savings balances. This reconciliation should take place whether automated systems are integrated or not. Most modular systems or programs still have steps in their processes that need to be taken in order to ensure synchronisation of entries in both systems.

If the MFI has "stand alone" systems – one system for accounting and one system for the client portfolio -- this reconciliation is very, very critical, and can also be very, very challenging, since it requires "entering data" into the two systems independently. This increases the exposure to error and also abuse due to fraud or poor controls in managing data entry.

Issue Summarised MIS Reports

Handout 4.5 Sample Portfolio Reports provides a number of portfolio reports that are generated either manually or through an automated system. They include Loan Disbursements, Loan Repayments, and an Outstanding Loan Balance report, that includes portfolio quality information. The loan portfolio reports include aging analysis needed to produce a Loan Aging Schedule. The challenge of handling

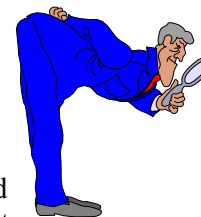
client transaction accounting on a manual basis cannot be under-estimated. It is cumbersome, prone to error and extremely tedious. Most of the times, groups that still use manual systems are reluctant to prepare and produce reports – putting at risk good portfolio management.

Remember – just like the hard copy audit trail is important for accounting documents in the monthly accounting process, daily and weekly or monthly printouts of an automated client loan tracking system is also part of the audit trail. *Handout 4.6 Sample MIS Report Schedule* outlines some of the regular reports then need to be printed regularly – for audit purposes and for management information and control.

It is virtually impossible to outline and discuss the accounting cycle without referencing internal control issues and procedures. Typically, MFIs conduct operations with large volumes of cash in highly decentralised locations. The nature of MFI operations itself are considered high risk. The following section on internal controls outlines the broader aspects of the topic and provides practical suggestions for **key controls for MFI managers and accountants**.

5. Internal Control Procedures

“Internal Controls” refers to all the policies and procedures adopted by the management of an entity to help ensure the orderly and efficient conduct of its business. The internal control system extends beyond matters relating directly to the accounting system and comprises the control environment and control procedures. The “control environment” refers to the attitudes and atmosphere in the MFI towards maintaining strong internal controls. MFI Board and senior management should lead and promote the “control” atmosphere – by example, by approving risk management policies, and by supporting management and the internal audit function in implementing strong control systems.



Internal controls help to promote the **basic objectives of management** and try to provide reasonable (but not absolute) assurance of the following:

- **Profitability or sustainability:** MFIs must be financially and institutionally sustainable to effectively provide financial services and products to the poor communities they serve. All the operating processes, work flows, and delivery channels are designed to provide those financial services, and to do so efficiently, according to policy, and without the loss of reputation or resources of the institution.
- **Adherence to management policies:** MFI management is responsible for the overall administration of the MFI; the Board and regulatory authorities approve policies that management implements. Management’s administrative controls are internal controls designed to promote operational efficiency and encourage adherence to established management policies.
- **Safeguarding of assets:** The physical assets of an MFI can be accidentally destroyed, misused or stolen unless they are protected by adequate controls. Non-physical assets such as loans receivable, important documents (e.g. Client loan contracts or receipt copies), and financial records are also vulnerable. Computer data, records and reports can also be destroyed or lost if care is not taken to protect them through reliable and safe backup procedures, clear assignment of duties, and controlled operating environments.
- **Prevention and detection of fraud and error:** Your MFI’s internal control system is important in the prevention and detection of error, fraud or other irregularities. The cost of preventing a particular error, should be balanced against the likelihood of the error occurring and the amount of the error that could occur.
- **Accuracy and completeness of accounting records:** Part of the internal control system is a strong accounting system. The accounting system must produce accurate and complete accounting records.
- **Timely preparation of reliable financial information:** Financial reports and information must be reliable and timely if it is to be useful for management decision making. This is more of a function of the accounting and finance staff who use an accounting system, than the accounting system itself.
- **Discharge of statutory responsibilities:** All MFIs are accountable to external stakeholders – whether it is their Board of Directors, their shareholders, Central Bank regulators, or donors. These stakeholders have both statutory and non-statutory expectations of your MFI, and an internal control system can provide support and means to fulfil those.
- **Protection of staff members against disinformation:**

The internal control system extends beyond matters relating directly to the accounting system and comprises the control environment and control systems.

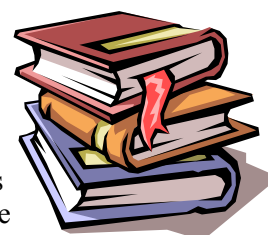
Control Environment

The control environment is the **overall attitude, awareness, and actions of the MFI’s Board of directors and managers** regarding the internal control system and its importance. If top management believes control is important, others in your MFI will sense that and respond by conscientiously adhering to the policies and procedures established. However, if top management appears to only give “lip service” to internal control, or apply double standards and policies for the mselves, it is almost certain that control objectives will not be as effective. A strong control environment - for example, one with tight budgetary controls and an effective internal audit function - can significantly complement specific control procedures. Factors reflected in the control environment include:

- The function of the Board of directors and its committees, particularly the Audit Committee,
- Management’s philosophy and operating style, its commitment to integrity and ethical values; its commitment to competence,
- The organisational structure and methods of assigning authority and responsibility,
- Management’s control system and methods, including the internal audit function, and
- Human Resource policies and procedures, and segregation of duties, and
- Management reaction to external influences.

Policies and Procedures

A microfinance institution needs clear and comprehensive Board approved accounting policies for its accounting and financial management system. Documented policies and procedures provide guidance and structure to staff, a basis for consistent treatment of financial data, and the foundation for internal control and accountability. Accounting policies should be developed within the context of local accounting standards, and apply best practices in microfinance to the extent possible.



Examples include depreciation policies, write-off policies, loan loss write-offs, loan loss provisions, deferred revenue or expenses, Allowance for Loan Losses policies, accrued interest policies, and at times, reporting formats. Refer to the various accounting policies that MFIs should make sure to clarify in Section 1 of this toolkit.

Handout 5.1 Sample Accounting Policies provides an example of what types of policies and items need to be covered in accounting policies. Section 6 of this toolkit provides detailed illustrations and procedures of how to use and apply different accounting policies, and in which situations.

Qualified, Trained and Motivated Staff

An accounting system is only as good as the accounting staff that use and manage it. It is important that your MFI employs qualified and trained staff to carry out accounting responsibilities. Bookkeepers or data entry staff should record financial transactions and activities, and must know how to do that correctly. Accountants should verify, reconcile and produce financial statements supported by accompanying schedules, and must know how to do that well. MFI Finance Managers and Executive Directors need to understand financial information, verify reports, analyse performance, and make the necessary decisions to improve and strengthen the institution.

External and Internal Audits

External audits are generally required of most MFIs, if not by the donor, then by local regulating bodies. External audits can be useful in verifying the reasonableness of financial statements, and add credibility to the transparency of your MFI. However, it is not the role of external auditors to maintain

an orderly set of financial records, or to be responsible for maintaining strong systems and preventing fraud. This is your responsibility – as MFI. “*External Audits of Microfinance Institutions: A Handbook*” Volumes 1 and 2 published by the Consultative Group to Assist the Poorest. In 1998 provide useful resources for external auditors of MFIs. The Volumes are available at www.cgap.org.

Internal audits can improve a MFIs financial and operating systems; their purpose is to determine whether stated policies and procedures are followed, report any findings to the contrary, identify risks to the institution, and make recommendations to management to minimize those risks. An effective internal audit function in an MFI greatly strengthens internal control systems, and also gives the external auditor confidence to rely on the financial statements.

General Control Procedures

Specific control procedures are the policies and procedures that guide staff to process transactions, manage assets, and conduct their work. Control policies and procedures also enhance and strengthen the reliability of data and information in the accounting system.

The accounting transaction voucher (discussed in Section 4 on Accounting Documents), supported by source documents, is the beginning point whereby information enters the accounting system. The integrity of the entire system, including the financial reports, depends upon the internal control procedures designed to ensure the integrity of the individual transactions.



1. **Transactions shall be valid.** The system must not permit the inclusion of fictitious or non-existent transactions in journals or other records.
 - All pre-printed forms shall be pre-numbered and kept under the control of the Head Accountant
 - All transactions entered in the journals must be recorded in numerical order
 - All transactions must be fully substantiated by supporting source documents
 - Any changes made to entries must be made by first reversing the incorrect entry and then entering the new one. Entries that have already been posted should not be changed.
2. **Transactions shall be properly authorised.** Upon approval of the annual budget, the Manager alone authorises expenditures. These shall remain within budget by classified categories unless approvals are received for any changes. Supporting documentation and vouchers for transactions that have been paid, shall be stamped “Paid” and dated.

The personal expenses of the Manager shall be within the approved budget and she/he shall provide to the Accountant the appropriate source documents for expenses.

3. **Transaction records shall be complete.** The system must prevent the omission of transaction from the records. All pre-numbered forms must be accounted for in numerical order, including forms that have been mutilated or otherwise voided due to error.
4. **Transactions shall be properly valued.**
 - Expense reports, invoices, receipts and other transactions shall be checked for accuracy and initialled by someone other than the person preparing the voucher.
5. **Transactions shall be properly classified.**
 - The transactions must be entered into the journals with the proper account categories according to the chart of accounts.
6. **Transactions shall be recorded at the proper time.**

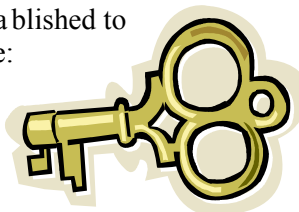
- Recording transactions before or after they occur will increase the likelihood of error
- All transactions occurring in any given month must be recorded in the books during that month.
- Proper month-end cut-off procedures shall be maintained to ensure consistent reporting from month-to-month

7. All transactions must be supported by adequate and appropriate documents that justify and support the payment.

Specific Control Procedures

Control procedures are the policies and procedures that management has established to achieve the entity’s specific objectives. Control procedures include things like:


- Accounting and financial policies and procedures to ensure correct and consistent treatment of transactions and operational activities
- Independent checks and review of performance
- Adequate separation of duties (Have different persons “Approve”, “Record” and “Do”)
- Proper authorisation and approval of transactions and activities
- Design and use of adequate documents and records (Pre-numbered documents, Document Registers, multiple copies, Chart of Accounts, manuals and written procedures, etc.)
- Physical control over assets and records (In financial institutions, many records – like receipts, purchase orders, or payment vouchers – are records that have “near-cash” quality. They need to be well controlled)
- Security and controls over the application, change, continuity and backup of computer systems, databases and software



Segregation of Duties

The above controls are often best maintained by a system of **independent checks** and **segregation of duties** within the accounting function. This ensures that each person performs only certain functions within the system and another checks that person’s work. This is necessary to ensure that no one person has control over the entire processing of any given transaction. There are typically three functions in any given transaction: **Record, Approve, and Do**. These three functions shall be carried out by three different persons where ever possible.

An advance for loan disbursements, for example, has three functions: 1) approve the transfer, 2) contact the bank to request the transfer, and 3) record the transaction in the books. In the head office, there are three persons, so the duties can be appropriately segregated.

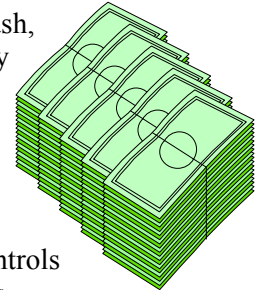


Handout 5.2 Sample Monthly Accounting Checklist lists the various steps of the accounting process in preparing monthly financial statements. A checklist of this nature can be useful for training purposes, but also to assist a supervisor in reviewing and checking the monthly accounting process. *Handout 5.3 Sample Manager’s Accounting Report Checklist* is another tool that can be used to help managers in their independent review and verification of an accountant’s work. This type of checklist review strengthens the work of the accounting staff in producing reliable financial statements, provides a

systematic basis for the manager to review reports, and reminds them of the specific items to look for. It might be appropriate during a manager's training period, or for manager's who are very unfamiliar with financial reports. *Handout 5.4 Sample Management Checklists* illustrate some of the tools and checklists used for different levels of branch and centre supervision and monitoring.

Accounting for Cash

Special focus and attention is given to the MFI's handling and accounting of cash, since it is the most vulnerable medium of exchange in the institution, yet with very high volumes and numbers of transactions. The proper management of cash is very important for a micro-finance institution for the following reasons:



- There are a large number of transactions of cash receipts and cash disbursements.
- The chance of fraud being committed regarding cash is high and strict controls are therefore required. Properly maintained cash books help to achieve this.
- Timely payments to creditors increase the reputation of the organisation.
- Timely payments from clients improve the financial position.

1. Loan repayments

The primary source of operating cash received by a micro-finance institution is the repayment of loans from clients. In some cases, payments are made directly into a bank account. In other cases, payments are made to the teller or cashier. Sometimes payments are made directly to loan officers.

All collection procedures should include the following:

- Issue pre-printed repayment schedules to each client with the loan proceeds. Include bank account numbers, if paid to a bank.
- Issue pre-numbered receipts to borrowers for bank deposit slips or cash funds received.
- List all collections, including field collections, and compare with journal.
- Each individual receipt is recorded in two places: the individual client ledger cards and the cash receipts journal.
- Reconcile the total receipts for each day with the daily bank deposit slip (the institution's deposit, not the client's).

A designated supervisor must review and verify that all cash receipts were deposited in tact to the MFI's bank account, and that all cash receipts are accounted for at the close of business daily.

Payments should not be made to loan officers. If there is no other option, additional control procedures need to be established. See the example below.

In a village banking programme in Bangladesh, all the loan officers gather every morning and write on a blackboard the total to be collected during that day's client visits. At the end of the day, the loan officers gather again to write the total actually received. The group notes any discrepancy, and a follow-up visit is scheduled for the next day by the office coordinator. Immediate follow-up dramatically reduces the opportunity for theft.

2. Other receipts

There are other types of cash receipts over which the general manager must have direct control.

Donor Funds. The general manager must be responsible for the deposit of donor funds to ensure timely and proper crediting to the institution's account. No donor funds should be received and deposited without his/her knowledge.

Sale of Assets. The general manager must personally approve the sale of any asset, complete with signature on the bill of sale and signature on the voucher showing the receipt of cash.

All cash receipts from whatever source must be recorded in a cash book and reconciled to the daily bank deposit slip.

In some institutions, all incoming mail is first reviewed by the general manager and then forwarded to the appropriate employee for further handling.

3. Cash Disbursements

Bank account - cheques

General Control Techniques:

- Use only pre-numbered cheques for disbursements
- Have proper documentation support for cheques
- Cancel supporting documents when paid (Stamp them "Paid" and write the date)
- Cheque signing by management with no access to records
- Keep voided cheques, but ensure signatures are obliterated
- Post or deliver cheques or disbursements directly to client or payee
- If hand delivered, obtain a receipt
- Record all cheques in numerical order in the cash disbursements journal and allocate each cheque to the proper operating expense account number
- Do not pre-sign any cheques and store all un-used cheques under lock and key
- Use an imprest petty cash fund system with one custodian

Operating cash

Many local operating environments handle all or most financial transactions in cash. There are many reasons: banks have no branches in some rural areas, banks may not cater to microfinance clientele, petty traders or business vendors do not have bank accounts or prefer doing business with cash. This increases the controls and procedures necessary for handling MFI operating cash.

General Control Techniques:

- Use a vault or safe that is well-secured and under lock and key for storing operating cash.
- Assign two staff for dual control of the vault.
- Use a Vault Register that records the denomination of currency on hand, the date and signature of physical count, and the signature of a supervisor reviewing the balances on hand with the Cash Book.
- Use a Cash Book to record all cash transactions – deposits and withdrawals – updating the cash balance on hand. This includes all transactions related to loans and to operating expenses.
- Ensure that all cash disbursements are duly authorised and supporting documentation is attached to the payment voucher.
- Cancel supporting documents when paid (Stamp them "Paid" and write the date)
- Ensure that the party or clients receiving the cash, signs to confirm receipt of funds.

Petty cash

Where an MFI can use cheques to handle most financial transactions, small supplies and items are often paid through “petty cash” rather than by cheque. Procedures for handling the petty cash fund need to be clearly outlined and consistently followed.

General Control Techniques:

- Petty cash should be maintained on an imprest basis. At any given time, the cash and receipts in the cash box shall total the imprest level. The level should be maintained at a specific amount.
- Only the designated staff person will handle petty cash. Actual cash will be spot-checked and verified by the supervisor at least once per week. The staff person in charge of the fund will reimburse for any discrepancies.
- All requests for petty cash must be signed by an authorised supervisor on a pre-numbered voucher.
- A cheque to replenish the fund should be issued when the fund is low, and at the end of every month.
- The cash and vouchers should be kept in locked box or safe.

The designated supervisor must do a physical count of the petty cash at the end of each period, and make a surprise spot-check at least twice during the month!

Handout 5.5 Sample Cash Count and Verification is a document that many external auditors look for in verifying end of year balances. Signatures in the petty cash or cash book itself to indicate a date and verification of a cash count are also important.

Handout 5.6 Sample Vault Register is a record that MFIs often use in tracking the amount of cash in their vault at any given time. MFIs often use a large ledger book with several columns for the different bills and coins that are in the vault. The Register records the bills by denomination, the date, and the person who made the cash count on that date. It is good practice to make daily cash count of cash in the safe, particularly if the MFI itself deals with cash for client transactions.

Strong internal controls are a critical part of the accounting process in any organisation. They are especially important for MFIs who typically handle very large volumes of cash transactions in situations where the segregation of duties is not always possible. Internal controls are necessary management functions in an MFI’s accounting systems and processes. The *MicroSave* toolkit on “*Internal Audit and Controls for MFIs*” (Dueck Mbeba 2007) provides additional resources in this topic.

The next section addresses specific procedures and topics for accounting in MFIs. It is important for both MFI managers and accountants to understand the key concepts. Most of the concepts and approaches used relate to International Accounting Standards, but MFIs should check with local accounting bodies to see if there are special procedures recommended in their contexts.

6. Accounting Procedures for Microfinance

This section of the toolkit addresses specific accounting procedures for microfinance. Wherever possible, MFIs are recommended to establish sound accounting policies consistent with international standards and best practices for the sector. This includes the application of the accrual method for accounting. However, in establishing accounting policies and procedures for recording and classifying financial transactions in an MFI, the institution also needs to look at several other issues.

- First and foremost, the MFI should consult with the local accounting standards body to determine the policies and standards in the national context. This is primary. In many countries local accounting standards are in a state of rapid change and development, so they should be consulted regularly to determine any updates important for MFIs.
- Secondly, the MFI should consult with local statutory and regulatory bodies, such as the Central Bank or the relevant Companies legislation, to determine if there are unique accounting standards that would determine practice and procedure in the MFI. Reporting expectations may well be there, but in some cases there are also specific accounting standards
- Thirdly, an MFI should confer with its local taxation legislation and departments to determine any relevant issues in reporting for tax purposes. For example, many tax laws prescribe depreciation rates, prohibit provisional expenses, or mandate required expenditures for companies. MFIs need to be aware of the taxation issues that affect them, and if their own policies vary from applicable taxes levied, will need to adjust their accounts for filing tax returns. Financial statements for tax purposes generally do not have a large bearing for the MFI stakeholders, unless there are large differences from the audited financial statements, or there are unusual amounts of liable taxes.
- Finally, in the absence of national accounting standards or relevant statutory or tax guidance, MFIs should consult with International Accounting Standards to determine the proper accounting treatment of transactions. This may be particularly important for areas where there is no local standard, or for unusual items that require specialised treatment or disclosure. A solid understanding of International Accounting Standards is useful in any case, since the general global trend is convergence and adoption of International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS).

The following sections illustrate the accounting treatment of the most common topics and procedures needed for recording and classifying transactions in an MFI. Appropriate references are included in the bibliography and should be referred to periodically as standards evolve and change over time.

Cash vs. Accrual Accounting

Accrual accounting is the method of accounting that recognises and books revenue or expense transactions when they take place, whether or not cash changes hands. According to International Accounting Standards, financial statements should be based on accrual accounting. However, International Accounting Standards also encourage the “exercise of prudence” when it comes to recording revenue or expenditures for items that show signs of risk or the possibility of not being realised.

Example of Accounts Payable:

When expenses are incurred in the current period, but payable or paid in another period, they are recorded as accounts payable in the current period. It is important to record expense accruals at the financial year end:

Debit: Expense
Credit: Accounts Payable

Estimated expenses can also be recorded as accrued expenses. An example is the case of audit fees. Rather than record a large expense at year end in one period, the expense can be estimated in advance and pro-rated or allocated monthly.

Debit: Expense
 Credit: Accrued Expenses Payable

Example of Amortisation of Prepaid Expenses:

Payments that cover expenses for more than one future accounting period should be recorded as a prepaid expense, an asset account on the balance sheet. Annual insurance premiums, prepaid rent advances, or housing advances are such examples. The periodic expense (e.g. monthly or quarterly) is then amortised until the prepaid expense account is reduced to zero.

Debit: Prepaid Expense
 Credit: Bank account

Debit: Expense
 Credit: Prepaid Expense

Accounting for Client Transactions

Accountants should be able to handle the basic accounting related to client transactions. Most are straightforward, but it is worthwhile to note specific variations.

Example of Loan Disbursements:

Debit: Loan Portfolio Receivable
 Credit: Bank

Example of Loan Receipts:

Debit: Bank or Cash
 Credit: Interest
 Credit: Loan Portfolio Receivable

Example of Partial Payments:

The key issue with partial payments is to allocate the payment to penalties and interest first. Any remaining funds in the payment are credited to Loan Portfolio Receivable.

Example of Prepayments:

Generally, prepayments are posted to an account called prepayments.

Debit: Cash or Bank
 Credit: Prepayment (a Liability)

When the loan becomes due, it is handled in the following way. The amount of interest will be as scheduled if flat interest is charged. If clients are charged interest on a declining balance basis, interest must be calculated as of the day that the client prepaid.

Debit: Prepayments
 Credit: Interest
 Credit: Loan Portfolio Receivable

Example of Savings Deposits:

Debit: Cash or Bank
 Credit: Client Deposits

Example of Savings Payments to Clients:

Debit: Client Deposits
 Credit: Cash or Bank

Accounting for Accrued Loan Interest Revenue

International Accounting Standards recommend that MFIs use the accrual based system of accounting for all transactions, including the recognition of loan interest revenue. Accrual-based accounting is a system in which revenues and expenses are recognised and booked in the period in which they arise, regardless of when the cash is received or paid out. Although many MFIs use accrual-based accounting methods, they often revert to the cash basis for loan collections. This may be appropriate in a start-up stage, though it is very important to remember that any exception from accrual based accounting must be disclosed in the notes to the financial statements.

If the accrual principle is not applied to an MFI's loan repayments, the financial statements will be affected in two situations. The first situation is where the period reporting date falls between the client's scheduled repayment dates. Consider, for example, an MFI which has loans outstanding with monthly instalments due mid-month. However, the financial statements are prepared as of the end of the month. In accordance with accrual based accounting, the MFI has earned 15 days of interest by month-end, even though payment will not be received for another 15 days. This accrued interest needs to be recorded to properly state the MFI's financial position as of the end of the month.

The second situation is in accounting for loan interest revenue on delinquent loans. In accordance with accrual based accounting, loan interest should be recognised when it becomes due, regardless of when payment is received. For example, a monthly loan payment that was not paid on June 15, and remains outstanding on June 30, has earned 46 days of accrued interest (31 days from May 15 to June 15 and 15 days from June 16 through June 30). Consistent application of the accrual approach actually requires two adjustments for the period reporting date. The first adjustment is to recognise the interest due on the delinquent loan. The second adjustment is to record an estimate for the amounts deemed to be uncollectible. This second adjustment applies the prudence principle, and accounts for the possibility that this delinquent loan, and its accrued interest revenue, may not be collected.

Accounting for accrued loan interest revenue is time-consuming and the additional revenue booked in the financial accounts may in fact be immaterial for many small MFIs. Accruing loan interest revenue, providing for any uncollectible amounts due to delinquency, and de-recognising interest when writing a loan off are complicated procedures that are further discussed in Advanced Accounting resources.

Small MFIs may choose to record loan interest on a cash basis, and disclose this deviation from accrual accounting in the notes to the financial statements. However, be sure to know what the legal requirements may be for your type of MFI!

When your MFI is required to strictly adhere to accrual accounting for loan interest revenue, the following explanation provides the rationale and background on the issues involved.

- When financial reporting dates fall between repayment dates, calculating and recording accrued loan interest revenue for amounts earned during the accounting period should be conducted. Previous period accruals must also be reversed. The overall impact to total revenue might be insignificant, but monitoring Accrued Interest Receivable on the balance sheet could provide helpful information to management, particularly if the account increases rapidly.

- In order to arrive at this calculation, the institution's loan tracking system (i.e. automated or manual) should be able to provide this information. In an automated system, a demand collection report generated for the reporting period date, rather than the actual instalment date, should clearly show the amount of interest and principal due.
- International Accounting Standards recognise that some situations – specifically delinquency -- may reduce the likelihood of collecting both interest and principal of some loans, and advise “the exercise of prudence.” Therefore, accrued interest revenue should be adjusted to reflect a more accurate value of the interest receivable, which follows the same logic as when providing for loan losses. The Balance sheet should reflect the prudent principal and interest receivable should not overstate these assets. The effect of the adjustment to provide for uncollectible interest revenue would reduce both the interest receivable account and interest revenue on the income statement.
- MFIs should not indefinitely continue accruing interest on delinquent loans. Determining an appropriate time period to accrue interest revenue will be based on the type of loan and its repayment period, for example agricultural or seasonal loans with balloon payments. After selecting an appropriate and prudent period, MFIs should recognise interest on non-performing loans on a cash basis – when the repayment is actually received. These policies must be disclosed in the notes to the financial statements.
- When accrued loan interest revenue is considered uncollectible, it should be “de-recognised” and recommended for write-off. Any de-recognition of loan interest should be disclosed. When the de-recognition takes place on interest recorded in the current year, it must be passed through the Income and Expense Statement, but disclosed separately for full transparency. When de-recognition of interest relates to interest recognised in previous periods, the entry must be passed through the Prior Period Adjustment account.

Accounting for Impairment Loss Allowance and Provision for Loan Impairments

In accordance with the principle of conservatism and prudence, financial statements should not overstate the assets and revenue of an entity, nor understate the liabilities or expenses. In the financial sector (e.g. banks and MFIs), this implies that loans receivables should reflect a reasonable estimate of amounts that may not be collected in the future. An accounting entry, based on the MFI's policy, creates the Impairment Loss Allowance. This is a contra-account to the Loan Portfolio on the Balance Sheet. In the past, MFIs have also called this the Allowance for Loan Losses or the Loan Loss Reserve.

The basis for developing the policy and the accounting entries are derived from a variety of sources – the portfolio quality in an Aging Report, an analysis of historical trends and historical write-offs. Young MFIs do not have the experience or history to shape the policy. In that case, MFIs are advised to apply published industry standards in setting policies. It is better to err on the side of prudence and conservatism.

How Old Are the Overdue Payments?

Loan aging allows the management to know how much of a delinquent loan is overdue and also for how long it has been overdue. The longer a loan payment is overdue, the higher the risk of never receiving the overdue payment, and also future payments. When loans become delinquent, they are referred to as the portfolio at risk. The total amount of delinquent loan balances is at risk, and not simply the late payments. Aging of past due amounts also allows MFI managers to determine if delinquency management strategies are effective. Are loans still slipping into later categories, or are they being contained in the 0 - 30 day category?

Formal financial institutions normally “age” the loans and provide allowances for loan impairments according to the number of days that have passed since the first payment was missed. The actual

number of days in an aging schedule may be regulated by legal or banking standards of the country. Most MFIs group portfolio at risk in increments of 30 days, e.g. 1 – 30 days, 31 – 60 days, 61 – 90 days, etc. Each category of portfolio at risk is multiplied by a rate that represents the perceived possibility of the loans in that category not being repaid. The categories are added together to arrive at the total Impairment Loss Allowance on the portfolio. A sample aging report follows.

International best practices in microfinance (“Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring.” SEEP Network) suggest the following categories and amounts for calculating risk and the Allowance:

Portfolio Aging Schedule		(A) Number of Loans in Arrears	(B) Outstanding Loan Balance	(C) Impairment Loss Allowance (%)	
1.	0 days	3,700	350,000	0%	0
2.	1 - 30 days past due	105	3,750	10%	375
3.	31 – 90 days past due	100	5,000	30%	1,500
4.	91 – 180 days past due	75	5,000	60%	3,000
5.	Over 180 days past due	60	2,500	100%	2,500
6.	Rescheduled	20	1,750	100%	1,750
7.	Total	4,060	368,000		9,125

Many MFIs require clients to make weekly or fortnightly repayments. Therefore a client who is 30 days late may already be 2 – 4 instalments behind in repayments. The actual risk in this case may be much more than the 10% suggested for MFIs in the above table. It is important for MFIs to track their history to determine realistic levels of risk on their delinquent loans.

Another common issue for many MFIs is to take a general allowance of 2% of the portfolio, simply because that is the suggested amount made by many Central Banks. However, it is more prudent and useful to the reader of financial statements for the MFI to record an Impairment Loss Allowance based on the actual quality of the portfolio – based on aging of delinquent loans.

In setting the policy for providing for loan impairments through an Allowance, the objective is to be fair, but conservative. The method and determination of the Allowance, provisions, write off procedures and recovery of losses must be fully disclosed in the financial statements of the organisation.

The following chart illustrates the definitions and inter-relationship between key terms in accounting for non-cash adjustments to providing for possible future losses of the loan portfolio.

Impairment Loss Allowance	Provision for Loan Impairments	Loan Write-Offs
<ul style="list-style-type: none"> • An account that represents an estimate of the amount of outstanding principal that the MFI does not expect to recover in the future • Negative asset on the balance sheet that reduces the outstanding portfolio. 	<ul style="list-style-type: none"> • Amount expensed on the income and expenses statement. • The provision is used to increase or decrease the Impairment Loss Allowance 	<ul style="list-style-type: none"> • Occur as an accounting entry • Do not mean that loan recovery should not continue to be pursued. • A write off decreases the Impairment Loss Allowance and the outstanding portfolio

Notice that the “Allowance” is a balance sheet account that effectively reduces the value of the Loan Portfolio. The “Provision for Impairment Losses” is a current period expense in the income statement. The Provision expense increases or decreases the Allowance based on the perceived risk after aging the portfolio. Each period, an entry is made to adjust the Allowance account and bring it to the appropriate level for the period. If the Allowance decreases from the previous period, which is highly unlikely, the “provision” will be a credit expense on the income statement. In most cases, MFIs do not make a credit entry to the expense if the Allowance decreases. The effect is simply to report an Allowance that is more conservative than the defined policy.

The Impairment Loss Allowance is an accounting entry that presents the Loan Portfolio more conservatively. Generally, MFIs do not set aside special funds or cash reserves for this Allowance.

Figure 6.1: Illustration of Accounting for the Impairment Loss Allowance and Provisions

<p>Before making any accounting adjustments, make sure the following steps take place.</p>									
1.	Prepare the Portfolio Aging Schedule according to the MFI’s policy.								
2.	Calculate the Impairment Loss Allowance based on the MFI’s policy for each category.								
3.	Compare the Allowance for the current period with the previous period’s balance. To increase the Impairment Loss Allowance, make the following accounting entry:								
	<table style="width: 100%; border: none;"> <tr> <td style="width: 15%; text-align: right;">DR</td> <td style="width: 45%;">Provision for Loan Impairments (Expense)</td> <td style="width: 15%;"></td> <td style="width: 25%;"></td> </tr> <tr> <td></td> <td style="text-align: right;">CR</td> <td style="text-align: left;">Impairment Loss Allowance (Balance Sheet)</td> <td></td> </tr> </table>	DR	Provision for Loan Impairments (Expense)				CR	Impairment Loss Allowance (Balance Sheet)	
DR	Provision for Loan Impairments (Expense)								
	CR	Impairment Loss Allowance (Balance Sheet)							
4.	To decrease the Impairment Loss Allowance, make the following accounting entry:								
	<table style="width: 100%; border: none;"> <tr> <td style="width: 15%;"></td> <td style="width: 45%;">DR</td> <td style="width: 15%; text-align: left;">Impairment Loss Allowance (Balance Sheet)</td> <td style="width: 25%;"></td> </tr> <tr> <td style="text-align: right;">CR</td> <td style="text-align: left;">Provision</td> <td style="text-align: right;">for Loan Impairments (Expense)</td> <td></td> </tr> </table>		DR	Impairment Loss Allowance (Balance Sheet)		CR	Provision	for Loan Impairments (Expense)	
	DR	Impairment Loss Allowance (Balance Sheet)							
CR	Provision	for Loan Impairments (Expense)							
<p><i>Note: There is rarely a decrease in the Impairment Loss Allowance. Many MFIs make NO adjustment to the account if the Allowance decreases, ensuring that there is more than adequate provision established.</i></p>									

Accounting for Loan Write-Offs and Write-Off Recoveries

A write-off represents an accounting adjustment to remove a loan that is no longer considered collectible from the accounts. Clients are not generally informed of write-offs, as some MFIs continue collection efforts, depending on the circumstances of the write-off. Certainly, information about write-offs should be maintained by the MFI, since the client should not be allowed to apply for a new loan in the future.

The following illustration reflects International Accounting Standards for write-offs. Write-offs must be disclosed in a schedule to the financial statements that shows the changes and movements in the Allowance for Loan Losses account for the period.

Figure 6.2: Illustration of Accounting for Loan Write-offs and Write-off Recoveries

International Accounting Standards

1. When a loan loss is recognised based on the write-off policy:

DR	Impairment Loss Allowance	(Balance sheet)
CR	Loan Portfolio	(Balance sheet)

2. After writing off a loan or collecting a written off loan, re-do the Portfolio Aging Schedule, calculate the Allowance again, and adjust the Impairment Loss Allowance to reflect the change in the Aging Schedule made by the Write-off.

3. To record a collection on a loan that has been written-off:

DR	Cash (Balance Sheet)
CR	Value of Loans Recovered (Income Statement – within the Provision for Loan Impairment section)

Note: This approach varies slightly from common banking practice where the recovery of a loan previously written off signals the reinstatement of the loan contract from a legal perspective. The collection of any portion of a previously written off loan triggers a re-entry of the entire loan into the books again, offset by the Allowance in its entirety.

Accounting for Deferred Expense on Group Formation

In general, best practice and International Accounting Standards suggest to simply write-off group formation expenses as they are incurred. However, some countries do allow MFIs to defer expenses on group formation. This means that instead of writing off these developmental expenses, they are charged to a Deferred Expense on the balance sheet and amortised in future periods. This illustrates the principles of accrual accounting and matching.

For example, some MFIs charge direct costs such as salaries and benefits, training and travel costs related to the formation and training of Self Help Groups as a deferred expense. Those expenses are recognised in periods when those Groups become mature and are fully functioning within the MFI's operational network and generate interest revenue. These prepaid expenses are then gradually expensed in order to match against the loan interest revenue that the Groups generate for the MFI. Should the MFI conclude that the Group will not become functional and perform well (although the standards do not clearly outline specific criteria), the MFI may write off the total of these expenses at any time.

Without a written MFI policy or clear documentation, this policy may be abused resulting in inaccurate or inconsistent financial statements. In actual practice, given the current trends of rapid growth and competition in the microfinance sector, an auditor's bias is toward conservatism, and to simply write-off group formation costs.

If an MFI elects to defer group formation costs, the same accounting treatment applied to Prepaid Expenses would be applied. Full disclosure and rationale for the policy is required in the notes to the financial statements.

Figure 6.3: Illustration of Deferred Expense on Group Formation

MFI For The Poor spent 240,000 in the past year on the formation of groups with the expectation that they would lend to the groups for many years to come. The various costs were incurred through salaries and transportation expenses in visiting the groups for training and monitoring.

DR	Deferred Expense – Group Formation	240,000	
	CR Bank		240,000

Monthly journal adjustments in the following year, assuming a 2 year amortisation period would be as follows:

DR	Group Formation Expenses	10,000	
	CR Deferred Expense – Group Formation		10,000

Accounting for Software Development and Amortisation

Many MFIs choose to purchase a commercial “off-the shelf” software for their accounting and loan tracking purposes, even if it must be customised to some extent. However, the development of customised software for the MFI is also considered an investment to be used in future periods in operations and is eligible to be capitalised and amortised in future periods. Costs must be clearly documented, and the estimated useful life should be reasonable, considering the pace of technological and software changes. These capitalised costs are classified as an Intangible Asset on the balance sheet and might be amortised between 3 – 5 years. In reality, most software is not projected to have a very long shelf life.

Figure 6.4: Illustration of Accounting for Software Development and Amortisation

Accounting software development and customisation

Community MFI invested in the development of their own software for their rapidly growing MFI. They dedicated staff to this project and in 2 years, incurred 3,600,000 in costs toward software development that they estimated to serve them for the following 3 years.

The following accounting entries are made for various operating activities:

Investment of the software

DR	Software Development Capitalised (Balance Sheet Asset)	3,600,000	
	CR Bank (Balance Sheet Asset)		3,600,000

Monthly amortisation in the first year’s use

DR	Amortisation of Software (Expense)	100,000	
	CR Accumulated Software Amortisation (Bal Sheet)		100,000

Accounting for the Purchase and Depreciation of Fixed Assets

Fixed Assets are not recorded as expenses, but are capitalised to the balance sheet because they have a life and usefulness to the MFI beyond one year in the future. MFIs should have a capitalisation policy that guides the amount or value of the asset that is eligible for capitalisation. Items under this value are generally expensed in the period in which they are purchased. The amount to capitalise may also be prescribed by local accounting standards and must be disclosed as a policy in the notes to the financial statements.

A fixed asset ledger should be maintained, reflecting purchase date, serial and identification number, depreciation rate, accumulated depreciation and the net book value of the asset.

Common fixed assets in MFIs include: computers, office equipment, office furniture, motorcycles, vehicles, and bicycles. Some MFIs own their own building and property used as office premises.

On making a fixed asset purchase:

Debit: Fixed Asset
Credit: Bank Account

As the asset is used, accounting entries are made to record the wear and tear on the asset by entering a depreciation expense. The corresponding entry is made to accumulated depreciation, and deducted from the cost of the asset to disclose net book value of the asset on the balance sheet.

Debit: Depreciation Expense
Credit: Accumulated Depreciation

Accounting for the Sale or Disposal of Fixed Assets

When a fixed asset is sold, the MFI will usually receive cash in exchange for the asset that reflects the market value of the item. However, the market value may be more or less than the net book value that sits on the book.

On selling a fixed asset:

Debit: Cash or Bank Account
Debit: Accumulated Depreciation for that Fixed Asset
Credit: Fixed Asset
Debit/Credit: Gain or Loss on Sale of Fixed Asset

Similar treatment is given to the disposal of fixed assets, whether they are no longer working, broken or stolen. In this case, there is no exchange of cash, and the entire net book value must be written off as a loss, unless there is recovery from an insurance policy. Any proceeds for the sale or disposal of fixed assets are shown as non-operating income on the financial statements.

The details of re-valuing fixed assets for fair market value are not included in this toolkit, but it is recommended that this standard be applied to MFIs. For the most part, MFIs only carry computers, vehicles and other depreciable assets with little residual value. However, larger MFIs purchase property and buildings that should be assessed for re-valuation from time to time.

Accounting for Grants and Donations

International Accounting Standards clearly recommend the application of accrual accounting in recording and recognising grants. As grant-related expenditures are incurred, the related grant income is recognised by transferring the same amount from deferred grant income to grant income. This is a clear application of the **matching** principle. In MFIs, grants and donations are always recorded separately from operational activities. They are shown “below” the operating line on the Income Statement, together with non-operating income and expenses and taxes. When transferred to the Balance Sheet, they are not included in the Retained Earnings from operations, but in Contributed Capital (or Donated Equity).

MFIs or organisations often receive grants or donations in lump sum advance instalments. The application of the accrual accounting method means that the amounts are recorded as deferred revenue

when received. They are only transferred to revenue as the related project expenses are incurred (generally one entry at the end of the reporting period).

On receipt of the grant or donation:

Debit: Bank
 Credit: Deferred Grant Revenue

On making expenditures related to the grant:

Debit: Expense
 Credit: Bank Account

Debit: Deferred Grant Revenue
 Credit: Grant Revenue

Figure 6.5: Illustration of Accounting for Grants and Donations

Operating subsidies

MFI For The Poor has received a one year grant for 500,000 as operating subsidies. They expect to use most of the funds in the current year, but not necessarily all of them. MFI For The Poor applies the accrual accounting approach, and prepares financial statements monthly.

The following accounting entries are made for various operating activities:

Receipt of the grant of 500,000

DR Bank Account (Asset) 500,000
 CR Deferred Revenue (Other Long Term Liability) 500,000

Funds are used for various operational activities (as per the grant agreement) for 80,000 in the month

DR Expenses (Income and Expense Statement) 80,000
 CR Bank Account (Asset) 80,000

At the end of the month, all the grant related expenses are totalled, and an accounting journal entry is prepared to recognise the related revenue. Note that at this point, the entry is NOT about the original amount of cash received, but recognising income only on the amount that was actually spent.

DR Deferred Revenue (Liability) 80,000
 CR Grant Revenue (Income and Expense Statement) 80,000

T Account Example:

Deferred Grant Revenue	Debit	Credit	Balance
A. Opening Balance			0 CR
B. Receipt of Grant Funds		500,000	500,000 CR
C. Recognition of Grant Income	80,000		
D. Ending Balance			420,000 CR

Accounting for Fixed Asset Donations

Many MFIs receive grants or donations for fixed assets – either through cash contributions or donations in-kind. The accounting treatment for cash contributions follows below. Accounting procedures for in-kind donations are described in a later section, but would follow the same patterns

of revenue recognition that is described in this section. The only distinction would be to identify the Grant Income as In-Kind.

The key issue in accounting for cash donations for fixed assets is when to recognise the amount on your Income Statement. Is the grant recognised as income when it is received, when the fixed assets are actually purchased, or over the life of the asset? While it is important to review your policy with your external accountants, the description below is a generally accepted practice in the industry.

International Accounting Standards recommend that donations and grants be treated on an accrual basis. Using an income approach to grants for fixed assets implies that the funds are first recognised on the Balance Sheet when received, either as Deferred Grant Revenue in the liability section or in the Reserve for Fixed Assets in the equity section. The fixed assets are then recorded at their cost, as in the normal fashion, when purchased. The grant funds, however, are recognised as revenue only when these assets are depreciated in accordance with the matching principle. Revenue recognition will take place, pro rata, over the useful life of the assets acquired, by reducing Deferred Grant Revenue (or Reserve for Fixed Assets). The net effect to the Income and Expense statement will be zero, since the same amount of grant revenue and depreciation related to the asset will be recorded in each period. Please refer to the following figure to illustrate this approach.

Figure 6.6: Illustration for Donations and Grants for Fixed Assets

MFI For The Poor received 125,000 for purchasing motorcycles for their rural work with microfinance Self Help Groups.			
The following accounting entries are made for various operating activities:			
On receiving the grant of 125,000			
DR	Bank Account (Balance Sheet Asset)	125,000	
	CR	Deferred Grant Revenue or Reserve for Fixed Assets	125,000
On purchasing the motorcycles for operational use			
DR	Fixed Assets (Balance Sheet Account)	125,000	
CR	Bank Account	125,000	
On recording depreciation of 1,000 for the month:			
DR	Depreciation (Expense)	1,000	
	CR	Accumulated Depreciation	1,000
Recognition of grant revenue:			
DR	Deferred Grant Revenue or Reserve for Fixed Assets	1,000	
	CR	Grant Revenue (Income Statements)	1,000

Accounting for Donations of Loan Capital

In the past, MFIs have frequently posted Donations of Loan Capital (also called Contributed Capital for Portfolio Expansion) directly to the Balance Sheet at the time the amount is received. However, International Accounting Standards recommend that these donations be included in the Income Statement as Donations of Loan Capital before being transferred to the Balance Sheet at period end. There are two accounting approaches are illustrated following.

Figure 6.7: Illustration of Donations for Loan Capital

MFI For The Poor has received a grant for 1,000,000 designated strictly for portfolio expansion in the MFI. They expect to release the funds quarterly for the next two years to grow the portfolio. Financial statements are prepared quarterly. The quarterly recognition of revenue will be 125,000 as it is an estimate of the amount invested in the portfolio during that period.

Receipt of the loan capital grant of 1,000,000

DR	Bank Account (Balance Sheet Asset)	1,000,000	
CR	Deferred Revenue (Other Long Term Liability)		1,000,000

Funds are invested in portfolio growth each quarter for two years and the quarterly revenue recognition will be:

DR	Deferred Revenue	125,000	
CR	Donations for Loan Capital (Income Statement)		125,000

At year end, the Donations for Loan Capital will be posted to the Donated Equity in the Balance Sheet.

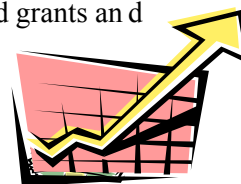
Accounting for In-Kind Subsidies and Grants

Many MFIs receive material amounts of subsidies in -kind, such as office rent, the use of vehicles, technical assistance, or the salaries of key personnel. Receipts of in-kind donations and subsidies for MFI operations follow the same accounting treatment for other grants as outlined in International Accounting Standards.

However, since the in-kind contributions do not flow through the operations of the MFI in the form of cash, they must be recognised through journal adjustments that are supported by appropriate and objective documentation (e.g. agreements, formal letters or memos, Memorandum of Understanding). In some cases, it may be necessary to record the in-kind costs at their best estimates if the actual cost is not known. The challenge that this poses is that estimates may be highly subjective, and without any relevant comparisons, may not realistically reflect the value of the goods and services.

The expenses are included in general operating expenses, and the related revenue is included in donations for operations.

In MFIs analytical financial statements, grants and donations, including in-kind grants and donations, are always recorded separately from the financial revenue of operations. They are shown “below” the operating line on the Income Statement, together with non-operating income and expenses and taxes. When transferred to the Balance Sheet, they are not included in the Retained Earnings from operations, but in Donated Equity. Some MFIs show in-kind subsidies separate from grants and donations received in cash.



Loans made to MFIs at less than market rates of interest are called subsidised loans, soft loans, or concessional loans. They are recorded separately from commercial loans on the balance sheet in order to identify the effects of “subsidy” in analysis. Full disclosure of loan terms, conditions and security for all types of borrowing is a standard reporting expectation. Normally, the additional cost of these subsidised funds is not included with in-kind donations and subsidies. However, they are included in analytical adjustments.

Figure 6.8: Illustration of Donations of In-kind Subsidies and Grants

MFI For The Poor will receive the following in-kind subsidies from the parent international NGO in the fiscal year ending December 31, 2006, as documented in a Memorandum of Understanding signed in December 2005. The MFI would like to record the effects of these subsidies monthly in the accounting records to reflect the actual costs of operations.

Annual office rent space: 12,000 (monthly charge of 1,000)
 One full-time manager (salary and benefits): 60,000 (monthly charge of 5,000)

Monthly journal adjustments would be as follows:

DR	Office Rent in-kind (Expense)	1,000
DR	Management Salaries in-kind (Expense)	5,000
	CR In-Kind Donations Income	6,000

These amounts and the details of the Memorandum of Understanding would be fully disclosed in a Note to the financial statements.

MFIs are encouraged to record all donated fixed assets at their fair market value on the books of the MFI for true and fair presentation of their financial position and related operational costs (i.e. depreciation). Regardless of the method used, the policy and treatment of in-kind donations of fixed assets should be fully disclosed in the notes to the financial statements.

Accounting for Financial Costs

An MFI's financial costs include the following components in the category of Financial Costs: interest costs on funds borrowed; commitment cost for funds or facilities availed (i.e. Lines of credit); processing fees charged by the lender; bank charges incurred to get the fund transferred to the bank accounts of the MFI; guarantee fees or commission paid to procure the loan fund and incidental expenses arising from the terms of the loan agreement. Processing fees for making various financial arrangements are considered on time expenses and recognised in the financial year in which the fund is obtained.

Net exchange gains or losses on foreign currency transactions are also included in the category of Financial Costs. These costs might be incurred through transactions conducted in foreign currencies, or through re valuing foreign assets or liabilities on the balance sheet, e.g. a bank account held in foreign currency.

Financial costs could be summarised on one expense line in the Income and Expense statement. However, a schedule in the financial statements should show a detailed break down of financial costs incurred.

Translation of Foreign Currency

Sometimes an MFI is expected to report in a currency other than the one used to record the general ledger (called the functional or local currency). An example would be a general ledger in the local currency, and reports in Euros. In general, the principle is to use an average exchange rate for the revenue and expenses of the period, and the ending exchange rate for balance sheet items. Fixed assets are usually recorded at historical cost. Gains or losses on the Translation of Foreign Currency are reported on the Income and Expense Statement as non-operating revenue or expenses. **Remember, translation of foreign currency for reporting purposes is different than accounting for foreign currency transactions as discussed above. Gains or losses on transactions are not posted to the accounts, since the general ledger accounts are still carried in the local currency.**

Accounting for Bank Partnerships

There are commercial banks which provide capital and legally own a microfinance loan portfolio managed by an MFI. This “partnership model” is guided by an agreement that outlines the responsibilities of the parties, and the operational details. Usually, the bank will advance funds to the MFI for a stated rate, who then lends to micro-borrowers at a higher rate and collects repayments from them for an agreed upon fee from the bank. This type of portfolio is legally owned by the bank; the MFI acts as an agent, and handles transactions with micro-borrowers on behalf of the bank.

From an accounting perspective, transactions can be passed through the accounts as a Loan Payable to the Bank. However, loan collections from clients include the MFI’s fee that is retained by the MFI, as in the illustration below.

Example: A repayment of 3,000 is received where 2,900 is principal and interest payment, passing through the MFI to be repaid to the bank. The MFI retains 100 as their fees for managing the loan. Only the fee is booked in the MFI as Other Income.

Transactions in these partnership models are very similar to agent models in terms of accounting. They do need to be handled differently from the MFI’s usual disbursements and collections processes:

- Loan collections will be credited to Loan Payable to the Bank for the principal and the bank’s portion of the interest. This detail must be disclosed in the MFI’s transfer of funds to the bank.
- The MFI’s portion must be credited to Fees from Bank partnerships (Other Income).
- Accounts with the bank should be regularly reconciled and available for clear and accurate confirmation for interim or year-end audit purposes.
- The Notes to the financial statements must clearly disclose any partnership with leading banks, the legal status and nature of the arrangement, the details of interest and fees, and the term of the agreement.

Accounting for Applications in Technology Services

Today, the world in which MFIs operate is fast adopting technology that can increase penetration and expansion of services, and reduce delivery costs significantly. Regardless of the reasons for adopting technology and for the service results, the integration of advanced technology will have its own implications for the MFI accountant.

A commercial bank established a partnership with an MFI to manage a variety of portfolio and banking services for its clientele and micro-enterprise sector. The bank agreed to open bank accounts for clients.

The bank offered Automatic Teller machines (ATM) services to these clients using Smart Cards with which clients could make deposits on loans and deposit and withdraw savings. The ATM services were managed by an Information and Communications Technology provider (ICT). The bank held the accounts, and the MFI worked with and processed clients in order to provide the financial services.

The ICT company servicing the ATM held all the information transacted at the machines, in daily batch reports. The reports showed the withdrawals and deposits to accounts. However, the batch reports were not issued to the bank regularly for cash updates to accounts. The reports were not issued to the MFI either, and without timely, accurate information, the MFI was not able to update its MIS on client accounts, and more importantly make immediate follow up on delinquent accounts.

Use of Personal Data Assistants (PDA’s), smart cards, debit cards, cellular phones, or Point of Sale (POS) technology have all been tested and are gaining broader acceptance in the microfinance sector.

They can increase growth and scale in the sector (particularly in remote rural areas), increase efficiencies, and provide additional access and services for clients. In many cases, technologies are still under development. However, the process of electronic data transfer, and managing information exchange must be managed. Daily updates, weekly or monthly reconciliations, and independent verification are critical control measures that cannot be abandoned in accounting and financial controls by the MFI.

All technological tools have major accounting and internal control issues for management and reporting in an MFI.

- Regular reconciliations of information and transactions between the parties are essential to good control. The ICT provider should provide daily reports to the MFI of any transactions taken place. This will inform the MFI of any delinquency in a timely manner.
- The ICT provider should also provide daily transaction reports to the bank so that cash and other balances can be updated promptly.
- Transactions must be entered and any reporting cut-off dates, for example, month end and year end, must be strictly observed.
- The Notes to the financial statements must clearly disclose the use of any technology, agreements with any ICT providers, or partnership banks and confirmation of period end balances.

Accounting for Agency Relationships

MFIs often look to diversify services for their clients, but may be limited because of regulatory issues or technological infrastructure. Typical examples are micro-insurance and money transfer services. A strategic alliance with Western Union, for example, can provide a valuable, high-demand service to the MFI's clientele, without the MFI setting up the necessary infrastructure to facilitate transfers. Rather, the MFI will receive an agent fee for providing the service on behalf of Western Union.

In most countries, MFIs are not allowed to carry out commercial insurance business and services. However, they are able to act as a corporate agent between the insurance company and clients. The MFI will collect premiums and remit premiums to the insurance provider. They will also collect, reconcile and submit claims to the insurance provider, and on approval and payment from the insurance company, will settle claims to clients. The insurance company will pay a fee to the MFI, but will retain the responsibility for indemnification of policy holders.

In this case, the transactions are processed through the MFI's accounting records as a "flow through." Funds flow in and out of the MFI, but do not pass through the income and expense statement. Agent fees are booked as revenue in the MFI's accounting system and reflected as such on the financial statements.

Specific accounting tips include:

- It may be helpful to set up several control accounts through which to pass transactions, for example, premiums collected, premiums remitted, settlements received, and settlements issued. This would facilitate basic reconciliation of accounts to payments and documents submitted to the insurance provider.
- Accounts would be aggregated and netted out in financial statement presentation, as needed. The nature of the agreement and details of fees earned should be disclosed in the Notes to the financial statements.
- These accounts could be set up through the Income Statement, if clearly disclosed. It might be more prudent to have the transactions pass through the Balance Sheet, and only book fee income to the Income and Expense Statement.

7. Financial Statements and Reports

The financial statements are the final tangible output of the accounting system. The balance sheet and the income statement are produced from the general ledger. The cash flow statement analyses the sources and the uses of cash in the period. It is the financial statements, together with portfolio and operational reports that provide what is needed for financial analysis in MFIs. Financial statements and portfolio reports allow for the calculation and analysis of financial performance ratios. Financial statements, particularly when compared to budget, or compared to previous periods, become a barometer of measuring change and growth, and performance according to plans.

Usually, draft statements are prepared first, allowing accountants to conduct the necessary reconciliations and make the corrections needed to ensure that information is accurate. However, financial statements should also be produced in a timely fashion, very shortly after the month end. It may be necessary to sacrifice 100% accuracy in order to produce reasonably reliable statements for analytical purposes.



MFI Financial Statements Characteristics:

Financial reporting standards for MFIs in India have been designed to promote the following standards of excellence:

- **Clarity and understanding:** the information provided in financial statements should be readily understandable by users. This does not mean that information about intricate matters that is important for decision-making should be excluded merely on the ground that it might be too difficult for certain users to understand.
- **Relevance** (i.e. materiality): Information provided by the financial statements must be relevant to the users of those statements. This implies that MFI financial statements should be structured and produced to be useful and relevant to all stakeholders such as funding agencies, government agencies, etc.
- **Reliability:** To be useful, information and reports must also be reliable. Information has the quality of reliability when it is free from material errors, misstatements and bias and can be depended upon by internal as well as outside users.
- **Comparability:** The financial statement of the microfinance institutions should be drawn based upon principles and policies that are followed consistently and uniformly throughout the institution. This is necessary to make the information generated by the financials comparable over the years, within the same institution, as well across institutions. A common “Chart of Accounts” is meant to meet this purpose. Reports that show actual performance against budget also provide a means to evaluate performance.

Who uses financial information?

The key stakeholders of the organisation all need access to financial information. Key stakeholders include: board of directors, executive director, managers, and loan staff (supervisors and credit officers).

What Financial Information and Reports?

Generally, an MFI's financial status can be determined by three types of financial reports that have their basis in two separate, yet interdependent systems:

- Financial statements (from the accounting general ledger) – the Balance Sheet, the Income and Expense statement
- Cash flow statements (from the accounting system) – Cash Flow Statements; Cash Flow Projections can be prepared from the statements as well in order to plan for smooth operations
- Portfolio reports (from the client portfolio system, essentially the sub-ledger of the accounting system) and operational reports

The Financial Statements

The starting point for sound financial management is the timely and accurate production of financial reports. This is absolutely critical to the health of a microfinance programme. If financial records are not produced accurately and punctually, the ratio analysis becomes misleading and unreliable. A microfinance organisation should produce financial statements from its accounting system on a monthly basis if at all possible. Though the particular format varies somewhat from country to country, financial statements include:

- the **Income Statement**, also called Profit and Loss Statement, or Statement of Revenues and Expenses, and
- the **Balance Sheet** (including a Statement of Changes in Equity)

Handout 7.1 Sample Financial Statements include sample balance sheet and income statements commonly used in MFIs.

The Income and Expense Statement

The primary indicators of an organisation's capacity to generate income are found in its Income Statement. The Income Statement provides an overview of financial performance and activity over a given period of time, such as a month, quarter or year. While the balance sheet is like a photograph at a point in time, or a "stock" statement, the income statement covers a period of time. It is a "flow" statement. The income statement summarises the total revenue earned in the period and the total expenses incurred in the period. An excess of revenue over expenditure is called a profit or surplus; when expenses are greater than income, the MFI will report a loss or deficit.

Income Statement presentation generally includes two or even more columns of data. It will show the current period's activity, and also a column that shows the past period's activity. Some MFIs show budget columns, percentage of budget, current quarter activity, year to date activity and so on. Information on the Income Statement is normally divided between revenue accounts and expense accounts. It also generally segregates operating from non-operating accounts. Operating accounts relate to the core business of an MFI – its financial service activity. Non-operating accounts include any revenue and expenses from other activities, donations and grants, the disposal of fixed assets, and from Extraordinary Items.

Income

Income is what a microfinance organisation *receives* for what it does -- provide financial services, including lending money. MFIs also generate income from non-operating activities – such as training, the sale of merchandise or books, and from external sources. Most MFIs generate the following internal income from their financial service activity:

- interest income
- fees for services
- penalties for late loan payments
- registration and application fees



External income is the amount received as **grants from donors** in support of the MFI. It is generally considered as non-operating activity and reported on separately in the Income and Expense Statement.

Expenses

Expenses are costs the MFI must incur to carry out its activities. Expenses are broken down into different categories such as salaries, rent and transportation. Expenses are usually considered *direct* or *indirect*. Direct expenses are those which relate to a particular activity, product or service. For example, salaries for credit officers are the direct expense of the credit department. Indirect expenses, also called overhead, are those expenses which can not be tied exclusively to a single activity. For example, the salary of the executive director is considered overhead when he/she is part of an MFI that has many products and services, and may also provide non-financial services to its clients. Typical expenses for the MFI include:

- Financial costs (interest on loans or debt investments, interest paid on deposits or any other client savings)
- Provision for loan impairments (the estimate of future loan losses incurred)
- Operating expenses (all other operational expenses incurred in conducting the activities of the MFI)

The Balance Sheet

The balance sheet is a statement of financial position of the MFI at a particular point in time. It is like a stock statement, giving account for the MFI’s structure. It reflects the state of affairs on a given date, usually at the end of a particular period, a month or a year. Most MFIs produce a balance sheet on a monthly basis at a minimum, giving the ending balance of all assets, liabilities and equity accounts – the three balance sheet components. Equity is also referred to as net worth or capital at times.

A balance sheet always balances, meaning that the debits must equal the credits. The basic accounting equation applies to the balance sheet:

Assets = Liabilities + Equity (Revenue – Expenses)

As in any mathematical or algebraic equation, this above equation can also be expressed as follows:

Liabilities – Assets = Equity

OR

Equity = Assets – Liabilities

The presentation of the balance sheet may vary from country to country, and from institution to institution. International Accounting Standards do not recommend any particular format; as long as the accounts are in balance and the above equations are in agreement, any type of format is acceptable.

Assets

Assets are what a MFIs organisation *has* or is *owed*. For an MFI these typically include:

- cash
- investments – short and long term
- client loan portfolio (an Impairment Loss Allowance, known as a “contra” account, reduces the balance of the loan portfolio by an amount set aside to cover future losses), and
- fixed assets -- equipment, property, vehicles (the Accumulated Depreciation account is also a “contra” account since it reduces the value of the assets based on their wear and tear, and provides a “net value” of assets that is more in line with their fair market value, as used items)

Assets also include other items like prepaid expenses, miscellaneous accounts receivable, intangible assets (e.g. software development and goodwill). From a financial perspective, assets represent an investment for the generation of future receipts of cash and revenue for the MFI. For example, a microfinance organisation lends out funds with the expectation that the funds will be repaid with interest. In order to purchase or build the asset base, an organisation either borrows money (a liability), invests its own money (accumulated surpluses), or attracts investors who contribute capital or equity.

Assets are generally classified on the balance by type and then by maturity of their liquidation to cash. Traditionally, the reporting emphasis has been on asset maturity – and to report and list assets by their cash or near-cash value. This created the emphasis on long-term and short-term assets. Assets that were readily liquidated were reported first on the Balance Sheet. The current trend in International Financial Reporting Standards is to report the assets according to their *use* or *intended use*. However, for ratio calculation purposes, specifically, the liquid ratio, MFI financial statements do encourage reports that segregate assets between those that mature in less than 12 months from those that mature in more than 12 months.

Liabilities

Liabilities are what an MFI *owes* to others. Liabilities are debts the microfinance institution has incurred and must pay off in the future. The balance sheet records the amount payable – principal and interest as of the date of the balance sheet. For MFIs these typically include:

- client savings and deposits
- trade accounts payable
- bank overdraft accounts and lines of credit
- borrowed funds

Liabilities are an important source of funds for MFI operations. Debt can be an efficient and effective way to generate revenue. For example, an MFI will often borrow money (either from clients in the form of savings or from a bank, donor or other financial institution) and lend this money to their clients at a higher rate of interest than they pay for the borrowed money. Without this source of borrowed funds, the MFI will have fewer assets (specifically, less cash to lend to its client base) and therefore lower potential for generating future income.

Liabilities, like assets, are also classified on the balance sheet by type and then by their maturity and obligation to repay. Traditionally, the reporting distinction has been on liability maturity – short-term being liabilities that mature within 1 year and long-term being liabilities that mature beyond 1 year. This format is retained to accommodate liquidity ratio analysis for MFIs. The sample balance sheet in *Handout 7.1 Sample Financial Statements* is typical of the current microfinance reporting formats.

Equity (Net Worth or Capital)

An MFI's equity or net worth represents what the organisation *owns*. Capital is made up of two components: contributed or paid-in capital such as grant funds, share capital, or privately invested contributed capital. It is also made up of the accumulated



earnings/deficits from operations. Unlike liabilities, the equity or net worth does not have to be paid back. Payment of dividends to shareholders will reduce the value of the capital that is accumulated in the MFI.

An institution, whose assets have been financed largely by debt, will have high liabilities compared to its capital; one might wonder about its ability to pay off its debts or to meet its cash flow or liquidity requirements. On the other hand, an MFI that has high net worth compared to its liabilities may not be leveraging its resources adequately to access external funding sources, assuming they are available.

The advantage of funding assets through equity rather than liabilities is that the money does not need to be repaid. Therefore the cash earned from assets can be used to cover operating expenses, or it can be reinvested. A strong equity base is critical to building an institution that will survive and grow.

Finding the appropriate structural balance between liabilities and equity is an ongoing process; there is no simple or magic solution, as there are many variables that enter into this analysis.

- The availability of funds and the types of funds are critical factors. Are funds available at concessional rates or market rates? Concessional rates will help to maximize cash flows in the short term.
- The methodology deployed by the MFI will play into the decision as well. Is the MFI involved in retail or wholesale lending (i.e. lending to fairly independent Self Help Groups)?
- MFI competition will affect the decisions on the balance sheet capital structure. What interest rates are MFI borrowers willing and able to pay for credit products? What are other MFIs offering? A highly competitive MFI market will drive down borrowing costs to clients, forcing the MFI to use the lowest possible cost of funds available in order to allow for adequate margins to cover their operating costs.

Handout 7.1 Sample Financial Statements provides one example of MFI financials, using one international approach for presentation. The samples are adapted from the SEEP produced “Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring.” MFIs and auditors often use other presentation styles that are perfectly acceptable and may be more common in the local context. *Handout 7.2 Sample Audited MFI Statements* provides such a format.

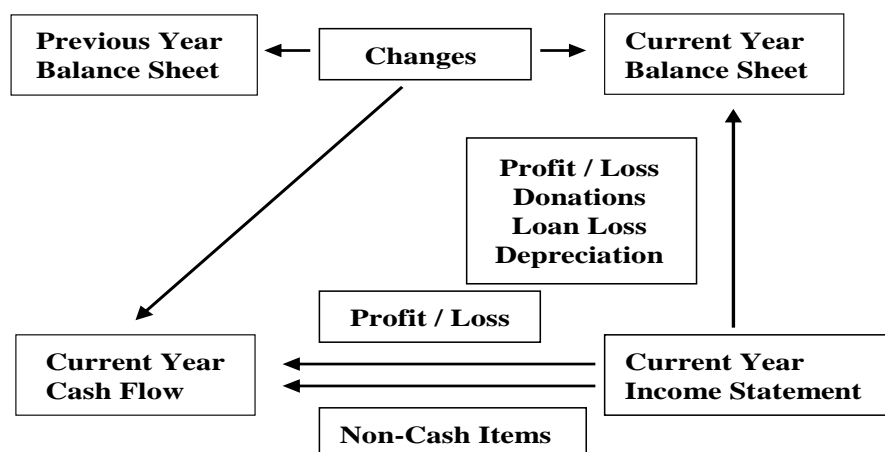
The primary issue with financial statements is that they provide meaningful and easy to understand information, and that the y balance – that in some way, the accounting equation is clearly in balance. MFIs should also remember that auditors will need to produce a Statement of Changes in Equity as part of the complete financial statement package.

Cash Flow Statements

Cash Flow statements are useful tools in the analysis of liquidity (comparing actual liquidity to the policy set by the MFI), in reviewing external liquidity requirements (e.g. for the Central Bank or for other regulatory bodies), for analyzing the sources and uses of cash, and for efficient management of operations.

The traditional Cash Flow Statement is included in the organisation’s audited financial statements. It shows the sources of changes in cash balances throughout the year, the sources and uses of funds, through operations, through increases and decreases in investments, receivables, and liabilities, and the resulting cash balances at the end of the fiscal year. In actual practice, the Cash Flow Statement is used the least by most MFI practitioners, particularly those in young MFIs that are focussed on the bottom line performance of the operations.

Figure 7.1 Understanding Relationships between Financial Statements



The above diagram may be helpful to fully understand the relationships between the financial statements, and especially the role of the Cash Flow Statement with other statements. Changes in cash balances of the MFI are brought about through a variety of activities. These activities are captured from both the Income Statement and the Balance Sheet.

The Income Statement is comprised of cash activities and non-cash activities if the MFI applies accrual accounting. The non-cash activities need to be extracted in order to understand the increases and decreases in cash arising from Income Statement activities. This would include items like depreciation, accrued expenses and the provision for loan impairments for example. The Balance Sheet is also comprised of changes due to cash and non-cash activities brought about through the application of accrued accounting.

The Cash Flow Statement summarises the transactions or events that cause cash to increase (which become the sources of cash) and the transactions or events that cause cash to decrease (which become the uses of cash). The following three paragraphs are adapted from the SEEP Framework.²

The sources of cash can include events that cause the following changes:

- A decrease in assets other than cash, such as receiving loan repayments from clients;
- An increase in liabilities, such as accepting a deposit or borrowing from a bank;
- An increase in Paid-In Capital, such as selling shares to investors or members; and
- An increase in retained earnings through generating net income.

The uses of cash can include events that cause the following changes:

- Increases in assets other than cash, such as making loans to clients;
- Decreases in liabilities, such as repaying a deposit or paying the principal on borrowed funds;
- Decreases in Paid-In Capital, such as re-purchasing shares or reimbursing member shares; and

² “Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring”, SEEP Network, 2005, pg. 23.

- Decreases in retained earnings through generating a net loss (after taxes and donations) or payment of dividends to shareholders.

A Cash Flow Statement classifies these inflows and outflows of cash into the following three major categories:

- *Operating Activities*, the cash receipts and payments related to the MFI's ongoing provision of financial services, including lending and deposit services;
- *Investing Activities*, the cash receipts or outlays for acquiring or selling Fixed Assets or financial investments; and
- *Financing Activities*, the borrowing and repayment of borrowings, the sale and redemption of Paid-In Capital, and the payment of dividends. This does not include the financial activities related to regular operating activities.

There are two approaches to prepare a Cash Flow Statement. One is the called the "direct method" and it is probably the more intuitive of the two approaches. The Direct Cash Flow Statement in a sense reconstructs the Income Statement and tracks all operational events that have caused an inflow or outflow of cash. It also captures all investing and financing events that have created an inflow or outflow of cash.

The Indirect Cash Flow Statement takes a deductive approach to preparation and format. It begins with the Net Income reported on the Income and Expense Statement and then adds back all non-cash expenses from the Income Statement. It also then adds or subtracts all cash increases or decreases from operational events, including loan disbursements and loan repayments, increases and decreases in trade payables and other liabilities, and increases and decreases in client deposits and in other assets or Trade Investments. Then it shows all increases and decreases in cash due to investing activities and also financial activities. Again, financial activities are those related to borrowings and debt investments with the MFI, and not regular operating activities that related to providing financial services.

Handout 7.1 Sample Financial Statements illustrates a both Direct and Indirect Cash Flow Statements. The sample is also taken from the SEEP document "Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring", 2005.

As MFIs grow and diversify – and include the mobilisation of deposits as a financial service and a means to generate capital, and access debt financing, the Cash Flow Statement takes on increasing importance. It is an important tool for monitoring and managing the changes in cash position of the MFI, and may signal issues to address in the debt and equity balance and capital structure of the MFI.

The Portfolio and Operational Reports

The information on the portfolio report is technically not part of the general ledger accounting system, but part of the subsidiary ledger that manages client loans and savings transactions. The summarised Portfolio Report provides the status of loan disbursements and collections during the current month and the current year. Good portfolio tracking systems also report the total amount of loans outstanding, the amount of loans late, the amount at risk, and the aging of the loans. Most systems also track the number of loans and/or clients in these categories.

Many MFIs look to the portfolio tracking systems to provide much more information on impact, and to segment portfolio by Loan Officer, by product, by Branch, and so on. The financial information on portfolio reports is considered the most important for financial management and ratio analysis purposes. Certain operational and non-financial data is also used in ratio analysis.

Together with the financial statements, the information on the Portfolio Report is used to calculate key financial ratios that help to measure the progress and health of the financial institution. For this

reason, the focus of the Portfolio Report in this toolkit is on actual output of financial service operations, and not client impact. Some portfolio tracking systems are very extensive, and include options for generating the Impairment Loss Allowance, and Human Resource data reports. Other systems are less sophisticated and simply provide the raw data with which to collate and prepare Portfolio Reports.

Handout 7.3 Sample Portfolio and Non-Financial Data Reports illustrates the key data needed for MFI ratio analysis.

Disclosure of Financial Information:

Full financial disclosure is a mandatory part of financial reporting standards according to International Financial Reporting Standards and best practices in microfinance. Full disclosure promotes transparency and accountability in financial reporting, and may strengthen investors' understanding and confidence in the MFI and its management.

Notes to the financial statements are normally part of the MFI's report to the Board of Directors, and must be part of the audited financial statements. Typically, this includes an overview of key accounting policies, operational details, and supporting schedules that have been part of the accounting process that produced the financial statements. Common disclosure expectations and practice in preparing and presenting financial statements are listed below. Further items are elaborated in the CG AP resource "Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions" (Rosenberg, 2003).

Notes to the Statements:

The Accounting Policies applied in the preparation of the accounts are detailed in the Notes. For example, they include, but are not limited to, the following:

- **Notes on the MFI's Business Activities:** The Notes will briefly outline the core activities of the MFI, its business approach, objectives, and methodologies used in its operations.
- **Ownership, Board composition, and governance:** The Notes provides details about the legal structure and registration of the MFI, the Board of Directors, where they come from, and their terms on the Board. The Notes also list the structure of the Management Committee, which is the executive management team of the MFI.
- **Historical cost basis of accounting:** One of the fundamental policies is the basis of accounting – and for the most part, this continues to be historical cost basis. International Accounting Standards promote fair value accounting, but application to MFIs is rather limited. MFIs who engage in more sophisticated investments, real estate transactions or mergers and acquisitions should refer to International Accounting Standards for specific details in fair value accounting.
- **Accrual basis of accounting:** This policy is another one of the fundamentals of accounting practice, and must be disclosed. Very few MFIs practice a cash basis of accounting, since most national accounting standards recommend that they apply accrual accounting. The policy on loan interest accruals should be described, particularly if there is an exception to accrual accounting for loan repayments. Any policies on when to stop accruing for delinquent loans, or a reversal of interest on delinquent loans previously accrued should be clearly described.
- **Fixed asset capitalisation policy:** Assets over a stated value will be capitalised on the balance sheet and depreciated in future periods. Those under the stated value will be expensed in the current year, and the Notes must disclose the policy.
- **Depreciation rates:** The Notes also list the depreciation rates applied to various classes of assets. They may refer to the rates acceptable by local tax laws, but not necessarily.
- **The Impairment Loss Allowance policy:** The MFI's policy for the Impairment Loss Allowance must also be disclosed, whether it is a general reserve of say 2%, a specific

reserve based on the MFI's history of write-offs, or on international best practices for microfinance.

- **The Write-off policy:** The Write-off policy is disclosed in a note.
- **Loans and Borrowings:** The details of all loans should be disclosed, including terms, conditions, currency, maturity, repayment schedules, restrictions, security on all borrowings from banks, investors, and overdraft agreements must be disclosed in detail. The supporting schedules (see below) will outline the specific values of both secured and non-secured loans, but the basic agreements will be outlined in this Note.
- **Contingent liabilities:** Contingent liabilities are possible liabilities that may arise in future periods, but have not yet been declared or confirmed to the MFI. Examples could include potential law suits, any third party financial guarantees, or tax re-assessments in process.
- **Guarantees:** Any guarantees that the MFI itself or directors have provided to third parties must be disclosed in the Notes to the financial statements.
- **Shareholdings and capital accounts:** The Notes should disclose the details and specific types of shareholding and capital accounts – including contributed capital, donated capital, paid up capital and the types of shares allowed and already issued.
- **Details of Prior Period Adjustments, if any:** If the MFI has posted any Prior Period Adjustments in the year, these details must be disclosed in the Notes, if not in the details of the Equity Statement.
- **Post-balance sheet events:** Any major events that take place following the date of the balance sheet and before the date of the Auditor's Report should be highlighted in the Notes. This might include a lawsuit, the effects of a natural disaster, a major fraud expected to have a material effect on the MFI's financial position, a change in legal registration, a major new grant or investor, or a change in ownership or controlling interest.
- **Related party transactions:** The Notes should outline any related party transactions undertaken by the MFI, for example, advances or loans to Board of Directors, agreements or transactions with related NGOs, parent companies or organisations, and the like.
- **Relevant details of any legal obligations:** Any legal obligations, both confirmed and pending must also be disclosed in the Notes.

Supporting Schedules to the Financial Statements

The supporting schedules provide additional detail and breakdown of aggregated figures reported on the balance sheet. Typically, this includes:

- **Fixed Asset schedules:** The Fixed Asset schedules will show the summarised asset classes taken from the ledger, additions and disposal of assets, historical accumulated depreciation, adjustments to accumulated depreciation from disposals, current year depreciation and rates, current year accumulated depreciation, and the net book value of assets. The balance sheet usually shows the total of all net fixed assets.
- **Provision for Loan Impairments:** These schedules will vary depending on the method used in making provisions and write-offs. First, the movements in the Loans Receivable account are usually detailed, opening balance, disbursements, less collections, and the ending balance. If write-offs are made against the Impairment Loss Allowance, a schedule showing the changes in the Allowance (Balance Sheet) and Provision accounts (Income and Expense Statements) is expected.
- **Aging Schedule:** The portfolio aging schedule is a standard schedule to be produced. It should disclose the late loans in categories suggested by international best practices for microfinance. This is generally 0 – 30 days, 31 – 60 days, 61 – 90 days, 91 – 180 days, over 180 days (and in some cases over 365 days late).
- **Cash and Bank:** The details of the MFI's bank accounts are also disclosed in a schedule, including the currency of the account, the detailed balances, and where held. Various cash accounts are also detailed, including any Cash in Transit.
- **Accounts Receivable and Accounts Payable schedules:** Details of various accounts receivable and payable are also listed in various schedules, specifying the vendor and the

amount. Any loans and advances to staff, management or the Board of Directors must be disclosed in these schedules.

- **Accumulated grants and donations in equity:** Although not always required by national accounting standards, it is good practice for MFIs to highlight the source of various donors in their accumulated grants and donations. The most important disclosure is to ensure that retained earnings or deficits show the amount of earnings or losses related to operations, and the amount from donations.
- **Liabilities:** Any type of investments, bank loans – whether secured or unsecured should be disclosed in detail. This would include the loan term, interest rate, interest payable, security and other relevant details.
- **Income and Expense schedules:** Since the financial statements usually aggregate accounts, both income and expense accounts are usually detailed in a variety of schedules.

Consolidating Financial Statements of Branches

To consolidate the financial statements of several branches with an MFI's Head Office, may require additional work, and a few adjustments. Ideally, the accounting software should enable consolidation. If consolidating manually, use a large spreadsheet, laying columns of each Branch side by side – both debits and credits. Create a debit and credit column called “Eliminating Entries.” These entries will NOT be posted to any general ledgers; however, because the various branches and Head Office accounts may reflect “inter-company” or “inter-departmental” entries (e.g. Branch Advances, Payable to Head Office), they need to be “eliminated” when presenting a consolidated picture of the organisation. Otherwise, some accounts may be overstated. Common “inter-company” accounts include:

- Head Office Subsidies (income in the Branch, and an expense in the Head Office)
- Inter-company payables and Receivables (Advances to Branch, and Payable to Head Office)

Handout 7.4 Sample Consolidated Financial Statements is a very simplistic illustration of how eliminating entries would be applied when consolidating the financial statements of an MFI with those of its one Branch. **Note: Eliminating entries when consolidating financial statements are not passed through the books of account. They are for analytical and consolidation purposes only!**

Closing Entries

At the end of the accounting year, accountants must close revenue and expense accounts by transferring their balances to the current year profit/loss account. Closing entries:

- Are prepared after the final financial statements are completed.
- Leave revenue account with zero balance by debiting the account and crediting current year profit/loss account.
- Leave expense accounts with zero balance by crediting the account and debiting the current year profit/loss account.

The current year profit/loss account in the Income Statement is posted to and equal to the current year profit/loss in the Balance Sheet (i.e. current year retained earnings). An MFI may hold several equity accounts, some related to operations and others to donations and grants. If this is the case, the donations and grants for the year are first posted directly to the donated equity account. Then the remaining operational profit and losses are closed to the general retained earnings account. MFIs may also hold special reserve accounts, or restricted equity accounts. Posting profits or losses to these accounts, or transferring between accounts generally takes place according to the MFI's policy, or to specific Board or member resolutions.

If you are using an automated accounting general ledger software, the key thing is to know your software well. Know how the closing process works; know how the equity accounts function. Non-

operating items and grant revenues should be posted to specific equity accounts first before closing the year through an automatic software command. If your software does not accommodate special postings to equity accounts, create a simple spreadsheet that clearly shows the sources of donated equity or special reserves.

Other External Reports

MFIs are generally required to report to some external regulatory bodies. This could include:

- the Income Tax department
- the Companies Registrar
- the Charities Register (if an NGO)
- the Central Bank of the country

Most, if not all will require the MFI's audited financial statements, including notes to the financial statements. However, income tax returns generally include some adjustments to a company's accounts for specific income tax regulations. A charity return may require specific and detailed information on cash disbursements.

A Central Bank will require additional reporting from banks and regulated MFIs on deposits, cash reserves and capital adequacy. These reports vary in frequency and the type of information required.

Emerging Trends

The microfinance sector is growing very rapidly in some countries, and much more gradually in others. As it does, the issues become more complex for governance, management and accounting. The following lists a number of the trends emerging in the sector today.

- **Transformation** of MFIs generally refers to a legal restructuring from an NGO status to a registered company or bank that falls under some supervisory review of a regulatory body, like the Central Bank.
- **International investors** for the MFI sector have rapidly outpaced donor investors in the past 5 years, and their potential is significant and hardly tapped. Both the business and the social opportunity have attracted investors – primarily foreign – to this market. The absorptive capacity of MFIs to take on this debt has not kept pace, and as a result, any investments that are made, in debt or equity, require fairly in depth analysis and due process.
- **Securitisation**, also called factoring, includes the “selling” of portfolios to larger banks, with the MFI retaining an agent's role for the bank in providing financial services to the sector.
- Taking MFIs to **capital markets**, and raising capital through public offerings on stock markets is another emerging trend, involving considerable analysis, valuation and accounting implications.
- **Mergers and acquisitions** are likely to increase in the microfinance sector, as it becomes more competitive, and smaller, weaker institutions are unable to compete for client services and loyalties when larger, financially stronger institutions offer more innovative products and client-focussed services. The pace of mergers and acquisitions will vary for different countries and contexts, depending on the maturity of the financial sector, the microfinance sector, and the business growth opportunities.
- **Technological innovations** are rapidly becoming part of the financial services sector. The use of cell phones and wireless data exchange has enormous potential, particularly in countries

with a highly developed information technology infrastructure and with high cellular phone adoption in the general population. The involvement of the ICT industry as both the carrier/mode of financial transactions and the information provider, changes the scope and nature of traditional MFI work, including their accounting processes.

Each country context varies with respect to the state and development of the financial sector and banking regulations. Additional resources for these topics are generally best sourced from country or regional contexts. This is because the legal, tax, banking and accounting issues are very country specific and may vary greatly from country to country. Typically, MFIs must be prepared to consider any or all of the following issues when moving ahead with emerging changes in the microfinance sector.

Issue:	Considerations:
Type of legal registration	Legal and financial expert advice and counsel is generally needed to consider the most appropriate type of legal structure for MFIs. In India, this could be a Non-Bank Finance Company, a Section 25 company, a Trust or Society. The type of legal entity may restrict or prohibit an MFI's operational plan, so decision-makers must understand the consequences and outcomes of various possibilities.
Valuation, Rollover and Capital structuring	<p>Transformations, mergers and acquisitions, securitisation and raising funds through capital market offerings all involve financial and legal consultation to answer key questions. Is the MFI being "sold" or valued in its entirety, or will only some assets or liabilities be considered in the transaction? Regardless of the approach, objective, independent opinion must make a fair market valuation of assets and liabilities and a justifiable estimation of goodwill and potential future earnings.</p> <p>This valuation is a critical process for an accounting "rollover" to a new legal entity, for planning the capital structure of the new company, and for preparation in securitisation or entrance into capital markets. There may be income tax implications in any or all of the transactions, depending on the tax legislation and the specific legal entity under deliberation.</p>
Due Diligence and Ratings	<p>Investors – international or local – typically subject the MFI to some rating or due diligence exercise before investing in the MFI. There is a cost for these activities, both financial and in staff time as the evaluator looks at key components of the institution – financial performance, management, governance, systems, and an assessment of risks.</p> <p>A due diligence exercise is generally undertaken prior to or as part of the valuation process for an amalgamation, merger, or an investment – either debt or equity.</p>
Costs and Investments	<p>A range of costs can be expected for most of the emerging trends, particularly transformation:</p> <ul style="list-style-type: none"> • Legal costs • Accounting costs • Audit fees • Incorporation fees

	<ul style="list-style-type: none"> • Bank license fees • Rating fees • Additional due diligence costs (if not included)
Other Issues	<p>One of the main issues in transformation and investments is that of governance structure. Central Banks generally restrict a single shareholder to less than a prescribed percentage. Others have restrictions for foreign interests or shareholders.</p> <p>Central bankers, investors and equity stakeholders will all evaluate the composition and expertise of the Board to determine their capacity to govern the institution.</p> <p>Some loans are guaranteed through personal guarantors; upon transformation, the questions need to be asked: is the liability a part of the sale? Does the guarantee follow the liability to a new legal entity?</p> <p>Finally there are legal documents to be drawn up: Memorandum of Understanding, transfer agreements, and the details of share certificates.</p>

Where to Go From Here

This toolkit has established the basic components and foundation of an MFI accounting structure and system and the documents, policies and procedures need to manage the accounting process. Numerous tools and examples have been provided for your MFI to take and further develop its systems.

1. The first reminder is to:

Know what you don't know!

Be familiar with the various issues in accounting and reporting for MFIs, even if you are not an accountant and lack the technical knowledge and experience in accounting itself. Know the basic accounting and reporting standards that are changing at an increasing pace in our globalised world. It is very important that MFIs refer to ongoing developments in both the accounting and banking sectors in their country contexts. In the absence of strong guidance, it is highly recommended to refer to the International Accounting Standards outlined in this toolkit, and to international best practices for microfinance.

2. The second thing to remember in structuring, setting up or adapting your current accounting system is:

Begin with the end in mind!

Clearly understand the information needs of your MFI's stakeholders and report readers. This includes your Branch staff and management, MFI Head Office management, your Board, investors, and regulatory and industry stakeholders. Understand what automated processes must be well-managed in order to get good data. Know how that data is used to create meaningful information for your users.

3. Finally,

Hire the qualified, experienced accounting staff to implement and manage a good accounting system. Get professional advice and guidance when needed!

A strong general ledger system, policies and procedures, a Chart of Accounts, control procedures, and qualified and trained staff are essential to basic accounting systems that provide the foundation for sound financial reporting and management!

This toolkit has provided the basic tools, guidelines and samples common to many MFIs. Remember that they need to be edited and adapted to your specific situation! Advanced topics have not been discussed in depth, but are referred to generally. References or handouts provide links to additional information for advanced topics.

Resource Bibliography

Anthony, Robert N. “Essentials of Accounting – Fifth Edition.” Harvard Business School. Addison-Wesley Publishing Company. 1993.

Cracknell, David, Henry Sempangi, Graham A.N. Wright. “Costing and Pricing of Financial Services – A Toolkit.” *MicroSave Africa*, March 2004.

“External Audits of Microfinance Institutions: A Handbook.” Volumes 1 and 2. Consultative Group to Assist the Poorest. Technical Tool Series No. 3. December 1998.

van Greuning, Hennie. “International Financial Reporting Standards – A Practical Guide.” The World Bank. 2004

Helms, Brigit. “Cost Allocation for Multi-Service Microfinance Institutions, Occasional Paper No.2 Consultative Group to Assist the Poorest. April 1998.

International Accounting Standards and International Financial Reporting Standards.
www.iasplus.com

Ledgerwood, Joanna, Kerri Moloney . “Financial Management Training for Micro-finance Organisations: Accounting.” Calmeadow. 1996.

“Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring.” Developed by the SEEP Network Financial Services Working Group and Alternative Credit Technologies, LLC. 2005.

Nagarajan V. & Co. “Accounting Standards for Micro-Finance Institutions in India.” (Draft for discussion). SIDBI Foundation for Micro-Credit, 2005.

Nagarajan V. & Co . “Accounting Guidelines for Micro-Finance Institutions in India.” (Draft for discussion). SIDBI Foundation for Micro-Credit, 2005.

Rosenberg, Richard, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr. “Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions.” Consultative Group to Assist the Poorest, July 2003.

Waterfield, Charles, Nick Ramsing. “Management Information Systems for Microfinance Institutions: A Handbook.” Consultative Group to Assist the Poorest. Technical Tool Series No. 1 February 1998.