

Accounting for Microfinance Organizations

Natalia Epifanova and Katya Fishukova

1. What This Module Covers

International best practice in microfinance suggests that good financial analysis is the basis for successful and sustainable microfinance operations. The quality of financial analysis depends on the quality of the information that has been recorded for analysis and this information is derived largely from the accounting system. Therein lies the purpose of this module – to enable microfinance organizations (MFOs) to apply sound accounting principles to ensure high quality financial analysis.

The module will cover the following issues:

- Major Elements
- Basic accounting principles
- Double-Entry Accounting
- Financial Statement
- Balance Sheet
- Income Statement
- Cash Flow Statement
- Accounting cycle

Obtaining basic knowledge of underlying accounting principles can assist a manager with identifying and analyzing problems. The course will emphasize distinctive features of MFO program accounting. The ultimate purpose of the course is to provide the students with clear understanding of how to develop an effective accounting system.

Good accounting practices are an important cornerstone in building a successful microfinance project. Accounting records are the starting point for measuring performance, revising your budget, and reporting progress. An effective accounting system allows for clear-sighted management rather than guesswork. Moreover, good financial reporting will inspire confidence from donors or other sources of loan capital. Accounting is simply the process of recording financial transactions, grouping them by category, and summarizing the results for a certain time period. The bookkeeper will be responsible for recording all financial transactions in a transaction journal on a day-to-day basis. This process is described below using examples of typical transactions.

2. Basic accounting principles for MFOs

It is obvious that it is not possible for all microfinance organizations to use the same accounting standards because they are frequently dedicated by local practices and internal needs. But we can define general accounting principles for microfinance organizations:

- The “Double entry” principle means that assets are equal to the sum of liabilities and equity. Any given transaction will affect a minimum of two accounts within assets, liabilities, or equity. 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. Revenue or expense items record non-stock (or flow) transactions. Non-stock transactions begin within a reporting period and expire at the end of the period. Ultimately, the 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.
- The “Conservatism and prudence” principle means recording financial transactions such that *assets, revenues, and gains are not overstated and liabilities, expenses and losses are not understated*. It is intended to result in the fair presentation of financial results.
- The “Materiality” principle requires that each material item should be presented separately in the financial statements. Material items are those that may influence the economic decision of a user.

- The “Realization” principle requires that revenue be recognized in the accounting period it is earned, rather than when it is collected in cash. It defines the point at which revenue is recognized.
- The “Matching” principle means that organizations incur expenses to earn revenues. Expenses should be reported on the Income Statement during the same period as the revenues they generate.

3. Financial statements

If the transactions are properly described and the amounts are accurate, an outside Accountant can use them to prepare professional reports. The Accountant will classify inflows and outflows and summarize the activity in a financial statement. At a minimum for microfinance organizations, financial statement should include both a balance sheet and an income (profit and loss) statement¹. But according to the more stringent requirements of International Accounting Standards, MFO financial statement also should include a cash-flow statement (sources and uses of funds) and include ledgers that report on the status of the loan portfolio. Financial statement should be presented in local currency and also show financial information for both the current year and at least the previous year.

3.1. Balance Sheet

A **balance sheet** is a summary of the financial position at a specific point in time. It presents the economic resources of an organization and the claims against those resources. A balance sheet also shows the net worth of MFO at the present moment. To have a clear example let us imagine some fictitious firm “Microloan” that has financial data for three years of its activity in the microfinance market (see table 1).

¹ See some very interesting examples in: “Disclosure Guidelines for Financial Reporting by Microfinance Institutions”. Consultative Group to Assist the Poorest. Washington, D.C, January 2001 (provisional version, pending results of field testing). [<http://www.cgap.org/assets/images/FSGuidelines-final.pdf>].

Table 1.
The example of balance sheet and income statement
of the hypothetical firm “Microloan”

Unadjusted Financial Statements	Year 1	Year 2	Year 3
Balance Sheet as of 31 December			
Assets			
Cash	10,000	40,000	100,000
Investments	15,000	60,000	90,000
Portfolio	180,000	500,000	800,000
(reserve)	0	(20,000)	(20,000)
Property	120,000	120,000	120,000
<i>Total Assets</i>	<i>325,000</i>	<i>700,000</i>	<i>1090,000</i>
Liabilities			
Loans	0	260,000	480,000
Deposits	0	100,000	210,000
Equity			
Capitalized Earnings	315,000	325,000	340,000
Accumulated Earnings	10,000	15,000	60,000
<i>Total Liabilities and Equity</i>	<i>325,000</i>	<i>700,000</i>	<i>1090,000</i>
Income Statement For 1 January To 31 December			
Income			
Credit Income	20,000	120,000	250,000
Investments	5,000	10,000	25,000
Donations	90,000	70,000	40,000
<i>Total Income</i>	<i>115,000</i>	<i>200,000</i>	<i>315,000</i>
Expenses			
Personnel	80,000	120,000	155,000
Administration	25,000	45,000	60,000
Provisions	0	5,000	0
<i>Total Operational Costs</i>	<i>105,000</i>	<i>170,000</i>	<i>215,000</i>
Financial Costs	0	15,000	40,000
<i>Total Expenses</i>	<i>105,000</i>	<i>185,000</i>	<i>255,000</i>
Net Income	10,000	15,000	60,000

Assets are items in which an organization has invested its funds for the purpose of generating revenue and represent what is *owned* by the organization or *owed* to it by others.

Usually assets consist of the next categories².

² Adopted from: Technical Guide for the Analysis of Microenterprise Financial Institutions. Inter-American Development Bank Microenterprise Unit. November, 1995.

Cash is all liquid assets that generated little or no interest. It may include cash on hand, site deposits, checking accounts or other instruments paying little or no interest.

Investments are liquid assets that do bear interest, such as national savings certificates, treasury bills and other different certificate of deposits.

The gross loan **portfolio** is the principal balance of all of the MFO's outstanding loans including performing and non-performing loans that have not yet been written off. The gross loan portfolio is frequently referred to as the **loan portfolio** or **loans outstanding**, both of which creates confusion as to whether they refer to a gross or a net value. The gross loan portfolio should not be confused with the value of the loans disbursed³. As the last means the value of all loans disbursed during the period, regardless of whether they are performing, non-performing or written off, it is important to note that the value disbursed can be several times more than gross loan portfolio.

The (**reserve**) account shows the portion of the gross loan portfolio that has been expensed (provisioned for) in anticipation of losses due to default. This item should exactly demonstrate the level of risk in the portfolio.

Fixed Assets include the purchase value of all equipment. This item may also include *intangible assets*, which have no physical properties but represent a future economic benefit to the given microfinance organization, such as MFO's goodwill.

The (**depreciation**) account is a cumulative reserve for the replacement of fixed assets.

Property includes all real estate holdings.

Total Assets include all asset accounts minus the (reserve) account and accumulated depreciation.

Liabilities represent what is owed by the organization to others.

Loans represent all borrowed funds the MFO must repay.

Deposits are the savings deposits captured by the MFO. This item may include any current, checking or savings account that are payable on demand.

³ For details see: Definitions of Selected Financial Terms, Ratios and Adjustments for Microfinance. Printed by: Micro, Small and Medium Enterprise Division Sustainable Development Department Inter-American Development Bank. August, 2002.

Equity represents the capital or net worth of the organization and includes capital contributions of members, investors or donors, retained earnings (donations for operating and non-operating expenses), and the current year surplus.

Capitalized Earnings are retained earnings capitalized from previous fiscal periods.

Accumulated Earnings shows the net income for the present fiscal period.

3.2. The Income Statement

This part of the financial statement is a report of financial activity during a particular time period such as a month or a year. It is also known as the profit and loss statement. It summarizes revenues (what you earned) and expenses (what you spent) to arrive at net surplus or deficit (what's left from your earnings after subtracting what you spent). If the period results in a net surplus, this is added to retained surplus and your net worth is increased. Look at the outline below to see how categories are grouped together and summarized in a Financial Statement (see table 1).

An **income statement** reports the organization's financial performance over a specified period of time (see table 1). It summarizes all revenue earned and expenses incurred during a specified accounting period. An institution prepares an income statement so that it can determine its net profit or loss (the difference between revenue and expenses).

We have to note the terms revenue and income are often intersubstitutable as are the terms income and profit⁴.

Income refers to money earned by an organization for goods sold and services rendered during an accounting period, including interest earned on loans to clients, fees earned on loans to clients, interest earned on deposits with a bank, etc.

Credit Income is comprised from all interest, commission and fees, which the MFO derived from lending operations.

Investment Income is all income earned on all invested funds including income from foreign exchange transaction.

Donations are all funds received from local and international donors.

⁴ In details see: Definitions of Selected Financial Terms, Ratios and Adjustments for Microfinance. Printed by: Micro, Small and Medium Enterprise Division Sustainable Development Department Inter-American Development Bank. August, 2002.

Expenses represent costs incurred for goods and services used in the process of earning revenue.

Personnel expenses are salaries and staff expenses. It may also include all other payments made to or for employees of MFO such as bonuses and benefits.

Administrative expenses are non personnel-related costs directly related to the provision of financial services or other services that form the MFOs financial services relationship with its clients.

Depreciation represents the value of fixed assets written-off each year.

Provisions show the costs incurred in the current fiscal period for creating a reserve for “bad” loans.

Extraordinary Write-off (or **a charge-off**) shows the value of “bad” loans in the current period. This item is necessary to distinguish these expenses from provisions against future losses.

Financial costs are all interests, fees and commissions incurred on all liabilities of MFO.

An income statement relates to a balance sheet through the transfer of cash donations and net profit (loss) as well as depreciation, and in the relationship between the loan loss provision and the reserve. An income statement also relates to a cash flow statement through the net profit/ loss as a starting point on the cash flow (indirect method). Unlike a Balance Sheet an income statement starts at zero for each period.

3.3. Cash Flow Statement

A **cash flow statement** shows where an institution’s cash is coming from and how it is being used over a period of time. It classifies the cash flows into operating, investing and financing activities.

Operating activities: services provided (income- earning activities).

Investing activities: expenditures that have been made for resources intended to generate future income and cash flows.

Financing activities: resources obtained from and resources returned to the owners, resources obtained through borrowings (short- term or long- term) as well as donor funds.

The direct method, by which major classes of gross cash receipts and gross cash payments, shown to arrive at net cash flow (recommended by International Accounting Standards).

The indirect method, works back from net profit or loss, adding or deducting non-cash transactions, deferrals or accruals, and items of income or expense associated with investing and financing cash flows to arrive at net cash flow.

3.4. Portfolio Report

A **portfolio report** provides information about the lending and savings operations of an MFO. It provides timely and accurate data about the quality of the portfolio. It usually also includes other key portfolio performance indicators (e. g., outreach).

A portfolio report should represent the scale of late payment on loans of the end of the current reporting period, and any measurement of late payment should be thoroughly explained⁵.

Information at a portfolio report usually includes:

- Number and value of loans outstanding at the end of the period
- Total value and number of loans disbursed during the period
- Average outstanding balance of loans
- Value of outstanding loan balances in arrears, value of payments in arrears
- Value of loans written off during period
- Portfolio aging analysis
- Information on loan terms, loan officers, savings accounts and balances, etc.

Portfolio quality ratios can be calculated from portfolio information. This information together with the aging analysis can give a picture of the health of the portfolio and can also give valuable insight into an MFO's sustainability. This relates to the income statement in that it is the portfolio that generates the income for the MFO. This relates to

⁵ See in details: “Disclosure Guidelines for Financial Reporting by Microfinance Institutions”. Consultative Group to Assist the Poorest. Washington, D.C, January 2001 (provisional version, pending results of field testing).

the balance sheet in that it provides information on the value of the outstanding loan portfolio and value of loans written off during the period.

This relates to the balance sheet and income statement in that the portfolio data is used as an input to calculate the loan loss reserve on the balance sheet, from which the amount of loan loss provision on the income statement is calculated.

For good evaluation of the portfolio's value used to measure the level risk of loan default that is assessed by two indicators:

- 1) The **arrears rate** shows the value of past-due principal payments as a percentage of outstanding principal balance of the portfolio:

$$\text{Arrears rate} = \frac{\text{Balance of past-due principal payments}}{\text{Outstanding Principal Portfolio}}$$

- 2) The **portfolio at risk ratio** measures the total outstanding principal balance of all loans that have any payment in arrears as a percentage of the outstanding principal portfolio.

$$\text{Portfolio at risk ratio} = \frac{\text{Outstanding Principal Portfolio of delinquent loans}}{\text{Outstanding Principal Portfolio}}$$

Both of these indicators have some disadvantages. The first of them underestimates the amount of the portfolio at risk, but the second exaggerates the actual risk of portfolio.

Lets return to our hypothetical firm "Microloan". Table 2 shows the arrears analysis as presented our firm "Microloan". The value payments past-due is equal to 13.75% of their portfolio.

Table 2
Past-due payments (principal) at end of Year 3

	Share of total	Percentage of Portfolio
Portfolio	800,000	100%
1-30 days late	40,000	5%
31-60 days late	30,000	3.75%
61-90 days late	15,000	1.875%
More than 90 days late	25,000	3.125%
Total	110,000	13.75%

But if we consider portfolio according to the balance of doubtful or uncollectible loans, the potential effect of loan default is more significant. Table 3 points to 37.5% of “Microloan”’s portfolio at risk.

Table 3
Outstanding of delinquent Loans (principal) at end of Year 3

	Share of total	Percentage of Portfolio
Portfolio	800,000	100%
1-30 days late	120,00	15%
31-60 days late	80,000	10%
61-90 days late	65,000	8.125%
More than 90 days late	35,000	4.375%
Total	300,000	37.5%

Further we should test how accurately our indicators reflect the value and the level of risk in the collectible portfolio. Loans belong to uncollectible if they are removed from the portfolio asset account and written-off to the *extraordinary write-off (or a charge-off)*. Usually, microfinance organization makes the decision to classify a loan as uncollectible at its own discretion. But it is generally accepted that delinquent loans with payments more than 90 days past-due are classified as uncollectible and should be written-off the books.

The adjusted portfolio analysis indicates that “Microloan” is carrying 50,000 in delinquent loans of more than 90 days and the adjusted portfolio is 750,000 at the end of Year 3. This balance should be written-off. But it is necessary to allocate this write-off to the appropriate accounting period. There are two basic methods of allocating the write-off: in the year in which the loan became more than 90 days delinquent or in the year it was originated. In table 4 we use the first method because it is most accurate due to the dates that are available for us in the case of "Microloan".

Table 4
Allocation of write-off for hypothetical firm “Microloan”

	Year 1	Year 2	Year 3
Extraordinary write-offs (annual)	10,000	15,000	25,000
(cumulative)	10,000	25,000	50,000
Unadjusted Portfolio	180,000	500,000	800,000
<i>Adjusted Portfolio</i>	<i>170,000</i>	<i>475,000</i>	<i>750,000</i>

There is another category of loans to reflect the level of risk. This is the category of a doubtful loan. Unlike uncollectible loans, doubtful loans are kept in the book but a reserve is established in the event that the loan becomes uncollectible. The calculation at the table 5 shows that at the end Year 3 “Microloan” should have 64,500 in reserves to cover the actual level of risk in the adjusted portfolio.

Table 5
Calculation of reserve for loan loss at the end of year 3

	Percentage required for reserve	Balance of Delinquent Loans	Amount required for reserve
1-30 days late	10%	120,00	12,000
31-60 days late	25%	80,000	20,000
61-90 days late	50%	65,000	32,500
Total	—	265,000	64,500

Like the extraordinary write-off, the provision expenses incurred in establishing the reserve account must be allocated over the past three years. The most accurate way to allocate the expenses is to classify the portfolios at the end of years 1 and 2 and adjust the reserve accounts accordingly. If the arrears information is not available, we can assume that the reserve account, as a percentage of the portfolio, should have been constant (and equal to the current level) in all three years. For our firm “Microloan” the 64,500 reserve calculated is equal to 8.6% of the 750,000 adjusted portfolio. Table 6 shows the distribution of this 8.6% across years 1 through 3.

Table 6

Allocation of provision expenses for loan-loss reserve

	Year 1	Year 2	Year 3
Adjusted Portfolio	170,000	475,000	750,000
Reserve for bad debt (8,6%)	(14,620)	(40,850)	(64,500)
Annual Provision expenses	14,620	26,230	23,650

Finally we should compare the results of these calculations to the provisions and write-offs that appear on the unadjusted financial statement and make all adjustments. Table 7 shows the relevant lines from the unadjusted Balance sheet of “Microloan”.

Table 7

Portfolio and reserve accounts from unadjusted financial statement

	Year 1	Year 2	Year 3
Portfolio	180,000	500,000	800,000
(reserve)	–	(20,000)	(20,000)
Provisions	–	5,000	–
Extraordinary write-off	–	–	–

Table 8 summarizes the adjustments necessary to reconcile the financial statement with the results of the analysis.

Table 8

Portfolio and reserve accounts from unadjusted financial statement

	Year 1	Year 2	Year 3
Portfolio	170,000	475,000	750,000
(reserve)	(14,620)	(40,850)	(64,500)
Provisions	14,620	26,230	23,650
Extraordinary write-off	10,000	15,000	25,000

The principles of assessing the real value of the portfolio are the same for adjusting asset accounts and income accounts. Now consider the fixed assets of MFO. First of all we should check that all equipment used in the “Microloan” has been accounted for on the balance sheet. In Table 1 we see that our MFO has no fixed assets. But in Year 2 “Microloan” suppose receives some office automation equipment donated by an international donor and but never reports this transaction on their financial statements. But, if the total worth of the office automation equipment is 20,000, we should enter this value as income in Year 2 and register the equipment received as a fixed asset. Further it is necessary to depreciate those assets. In the case of “Microloan”, the worth 20,000 is depreciated out over five years (depreciation expenses are 4,000 per Year).

In the end we can introduce our calculated changes to the financial statements. And of course the net income and accumulated earnings accounts have other values due to the adjustments and some additions. Thus we have a possibility to construct the Adjusted Financial Statement presented (see table 9).

Table 9
The example of balance sheet and income statement
of the hypothetical firm “Microloan”

Adjusted Financial Statements	Year 1	Year 2	Year 3
Balance Sheet as of 31 December of each year			
Assets			
Cash	10,000	40,000	100,000
Investments	15,000	60,000	90,000
Portfolio	170,000	475,000	750,000
(reserve)	(14,620)	(40,850)	(64,500)
Fixed Assets	0	20,000	20,000
(depreciation)	0	(4,000)	(8,000)
Property	120,000	120,000	120,000
<i>Total Assets</i>	<i>300,380</i>	<i>670,150</i>	<i>1,007,500</i>
Liabilities			
Loans	0	270,000	480,000
Deposits	0	100,000	210,000
Equity			
Capitalized Earnings	315,000	300,380	310,150
Accumulated Earnings	(14,620)	9,770	7,350
<i>Total Liabilities and Equity</i>	<i>300,380</i>	<i>670,150</i>	<i>1,007,500</i>
Income Statement For 1 January To 31 December of each year			
Income			
Credit Income	20,000	120,000	250,000
Investments	5,000	10,000	25,000
Donations	90,000	90,000	40,000
<i>Total Income</i>	<i>115,000</i>	<i>220,000</i>	<i>315,000</i>
Expenses			
Personnel	80,000	120,000	155,000
Administration	25,000	45,000	60,000
Depreciation	0	4,000	4,000
Provisions	14,620	26,230	23,650
Extraordinary Write-offs	10,000	15,000	25,000
<i>Total Operational Costs</i>	<i>129,620</i>	<i>210,230</i>	<i>267,650</i>
Financial Costs	0	15,000	40,000
<i>Total Expenses</i>	<i>129,620</i>	<i>225,230</i>	<i>307,650</i>
Net Income	(14,620)	5,230	7,350

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