

Microfinance Bulletin

Mozambique Microfinance Facility

Accounting and Financial Management for Microfinance Institutions

Accounting: Is the process of recording, classifying, and summarizing economic events, that

- Leads to the preparation of financial statements, and
- Provides essential informa-

tion for managers to make sound business decisions.

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 such as assets, liabilities, revenue, expenses and

cash flow are used regularly in the micro-finance industry, managers and those making business decisions in MFIs need to understand basic accounting terminology. It is also helpful for MFI managers to understand the accounting conventions or guidelines that form the basis of the profes-

Accounting Conventions or Guidelines

- **Business Entity Concept:** Every business is a separate entity, distinct from its owner and from other entities. Therefore, personal transactions or assets of other businesses are not included in the records and reports of the business.
- **Going Concern Concept:** The records and financial reports of a business are developed with the assumption that the business will continue to operate indefinitely, and therefore the resources of the business will not be liquidated in the near future.
- **Historical Cost Principle:** Generally, all assets recorded on the books of a business are recorded at their actual, historical cost. This might be less than what it might cost to replace the asset today (e.g. Vehicles) OR a lot less than what the asset could be sold for (e.g. land or buildings). Recording financial assets may require other measurements (e.g. current costs).
- **Double Entry Accounting:** Any given transaction will affect a minimum of two accounts. Every debit entry must have an accompanying credit entry.
- **Realization Principle:** This 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.
- **Matching Principle:** Businesses incur expenses to earn revenues. Expenses should be reported on the Income Statement during the same period as the revenues they generate.
- **Consistency Principle:** Businesses 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 business and the results of its operations. Any changes should be disclosed.
- **Conservatism Principle:** This principle is intended to result in a fair presentation of information from period to period. When presented with a choice, accountants generally record transactions so that assets, revenue and gains are not over-stated and liabilities, expenses and losses are not understated.



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sion.

Accounting in Mozambique

The accounting profession in Mozambique has begun to change in recent years, particularly with the growth of privatization. As companies and businesses are owned and managed by private investors, there is a greater interest in standard accounting approaches and useful, transparent financial statements.

Accounting practice and reporting standards also vary from country to country. It is expected that upcoming financial sector development will include a review and recommendations for Mozambican accounting standards. Currently, Mozambican standards are not completely convergent with International Accounting Standards. The Bank of Mozambique does not have specific reporting requirements for microfinance banks, other than regular banking formats.

International Accounting Standards (IAS) and Financial Reporting Standards (IFRS)

In recent years, there is a growing trend in the world towards common accounting standards defined and illustrated in International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS). Much of this is driven by economic globalization and the need for transparency and clarity in financial information. The microfinance industry is moving in this direction as well. CGAP's publication, *Microfinance Consensus Guidelines: Disclosure*



Guidelines for Financial Reporting by Microfinance Institutions and SEEP's recently published *Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring* reflect references and recommendations based on International Accounting Standards and Financial Reporting Standards.

Specific terminology changes are noted for microfinance institutions:

- The Loan Loss Reserve is now called the Impairment Loss Allowance
- The Loan Loss Provision Expense is now called the Provision for Loan Impairments
- Bad Debts Recovered are termed the Value of Loans Recovered and the account is netted from the Provision for Loan Impairment expense. This category on the Income Statement is called Impairment Losses on Loans.

Accounting for Microfinance Institutions

The role of accounting in microfinance institutions is critical. Microfinance institutions rely on accurate, relevant and timely reports for mean-

ingful analysis and monitoring of operations. Accounting for loan transactions, often called the Client Portfolio System, or the Loan MIS is one of the unique features in microfinance institution accounting. An automated system is the most efficient and reliable in terms of providing current loan portfolio reports.

In addition, MFIs need to consider policies and accounting procedures for other issues that are unique to microfinance. Further elaboration on these and the other issues are included in the recommended resources:

- Accounting for Grants and Donations (IAS 20)
- Accounting for Donations of Fixed Assets (IAS 20 and CGAP's Disclosure Guidelines)
- Accounting for In-Kind Donations and Subsidies (CGAP's Disclosure Guidelines)
- Accounting for Impairment Loss Allowance (IAS 30, IAS 36 and SEEP's Framework)
- Accounting for Deferred Grant Revenue (IFRS 117)
- Accounting for Good Will and Amortization (IAS 38)
- Accrual of Loan Interest Receivable

- Accounting for Inflation Expense in hyper-inflationary economies (IAS 29)
- Translation of Foreign Currency transactions and accounts (IAS 21)

Two areas that are typically challenging for many MFI accountants are illustrated opposite.

Accounting Skills

An accounting system is only as good as the accounting staff who use and manage it. It is important that MFIs employ **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, analyze performance, and make the necessary decisions to improve and strengthen the institution.

Even if an MFI hires a qualified accountant, it is still important to provide good on-the-job training, mentoring and supervision for effective performance.

Financial Management

One of the objectives of the accounting process is to produce financial statements and reports that are meaningful for analysis, monitoring and decision-making. In a microfinance institution, financial ratio analysis is one of

Illustration: Accounting for the Impairment Loss Allowance

The following step-by-step guide outlines the various accounting entries used to adjust the Impairment Loss Allowance account, provide for loan impairments, record loan write-offs, and record any loans recovered after write-off.

1. Prepare the Portfolio Aging Schedule.
2. Calculate the Impairment Loss Allowance percentage for each category of delinquency according to the MFI's policy (NOTE: MFIs using a flat percentage of the portfolio as a reserve would simply make that calculation after reconciling portfolio accounts).

3. To increase the Impairment Loss Allowance, make the following entry:

DEBIT Provision for Loan Impairments (Expense)
 CREDIT Impairment Loss Allowance (Balance Sheet)

4. To decrease the Impairment Loss Allowance, make the following entry:

DEBIT Impairment Loss Allowance (Balance Sheet)
 CREDIT Provision for Loan Impairments (Expense)

(NOTE: In actual practice, most MFIs rarely decrease the Impairment Loss Allowance, since they prefer ensuring adequate provision for future possible losses).

5. When a loan loss is recognized based on the write-off policy:

DEBIT Impairment Loss Allowance (Balance Sheet)
 CREDIT Loan Portfolio (Balance Sheet)

6. After writing off loans, prepare Portfolio Aging Schedule, calculate Allowance again, and adjust Allowance account accordingly.

7. To record the collection of a loan that was previously written off:

DEBIT Bank Account (Balance Sheet)
 CREDIT Value of Loans Recovered (Income Statement)

(NOTE: This approach varies from common banking practice where the recovery of a loan previously written off signals the reinstatement of the loan contract from a legal perspective. In that case, 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).

Illustration: Accounting for Operating and Fixed Asset Donations

- Donations should be clearly shown on financial statements, separate from income generated by the MFI's financial operations.
- The method of accounting for donations should be explained and disclosed. International Accounting Standards recommend an "income" approach. This ensures that donations and grants flow through the Income Statement; a "capital" approach simply posts entries straight to the Balance Sheet, and is not recommended.
- The timing of donation recognition should also be disclosed.

International Accounting Standards recommend that donations and grants – for operations, fixed assets, and capital -- be treated on an accrual basis. This implies that they are recorded as deferred grant revenue when received (a liability on the balance sheet) and recognized as revenue when used for their intended purposes.

- CGAP's publication, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions presents three alternatives when accounting for fixed asset donations. The IAS recommended approach is illustrated below:

1. On receiving the grant for the asset:

DEBIT Cash in Bank
 CREDIT Deferred Grant Revenue

2. On purchasing the asset:

DEBIT Asset
 CREDIT Cash in Bank

3. On depreciating the asset:

DEBIT Depreciation Expense
 CREDIT Accumulated Depreciation

DEBIT Deferred Grant Revenue
 CREDIT Donation for Operations (Income Statement)

the key ways to do that.

This implies that MFI managers need a fairly high degree of financial management skills and understanding. A wide variety of ratios have been used in the past by practitioners, investors, donors and raters. In the past two years, concerted efforts have been made to arrive at consensus

on a common set of definitions and ratios that can be used as a standard across the microfinance industry. The ratios and their calculations are laid out clearly in SEEP's new publication, *Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring*. The main categories of ratios for non-deposit

taking institutions are:

- Profitability and Sustainability Ratios
- Asset/Liability Management Ratios
- Portfolio Quality Ratios
- Efficiency and Productivity Indicators

Adjusted ratios are useful for benchmarking purposes and understanding the true per-

formance of an institution. The SEEP Framework also clearly presents the commonly accepted adjustments, and the way they are calculated. The adjustments include:

- Adjustments for Subsidies
- Inflation Adjustment
- Portfolio at Risk Adjustments.

The SEEP Network and Alternative Credit Technologies (ACT), LLC, with the support of USAID's Accelerated Microenterprise Advancement Project Support, have recently published "Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring."¹

The Framework is based on the work performed by a roundtable of international donors, rating agencies, and The SEEP Network, which produced an earlier work – "Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance." Development Alternatives, Inc. (DAI) provided significant support to SEEP and ACT in completing this Framework.

The growth of the microfinance industry has created a need for common standards, definitions, report formats and ratio calculations. The concept of standards has gained wide acceptance and numerous champions. Network organizations, CGAP and its donor members, the MicroBanking Bulletin, rating firms, and microfinance training centers, to name a few, have worked hard to promote indicators based on

common definitions and calculations.

The purpose of the Framework is to provide microfinance practitioners with a means to develop financial statements and reports so that those statements and reports can be used for meaningful analysis and monitoring and are in accordance with International Financial Reporting Standards (IFRS). The Framework is written by and for practitioners, but it can have value beyond that audience. Other users of microfinance information such as raters, auditors, donors, investors and network organizations may find the standardized reporting formats and ratios helpful.

This edition of the Framework is designed for the reporting and monitoring of non-deposit taking microfinance institutions. Future editions may include common standards for deposit taking

institutions, and possibly indicators for social performance. Efforts are also being taken to ensure the Framework can be supported by software used by the Microfinance Information eXchange (MIX) to communicate business and financial data electronically.

The SEEP Network, with the support of Catholic Relief Services (CRS), has supported the design of a spreadsheet to use as a monitoring and training tool for the Framework.

English copies of the Framework can be ordered online at the SEEP Bookstore at www.seepnetwork.org or by contacting The SEEP Network at 1825 Connecticut Avenue, NW, Washington, D.C. 20009 USA

MMF plans to make a Portuguese translation of the Framework available in November 2005.

Recommended Resources for Accounting in Microfinance Institutions:

1. *Essentials of Accounting, Eighth Edition* By Robert N. Anthony and Leslie K. Breitner. Prentice Hall. October 2002.
2. *Accounting: Study Guide*. Joanna Ledgerwood and Kerri Moloney. Calmeadow Foundation. 1996.
3. *International Accounting Standards: A Practical Guide*. By Marius Koen, Hennie van Greuning. World Bank Publications. 2000.
4. *International Financial and Reporting Standards: A Practical Guide*. By Hennie Van Greuning. 2004.
5. *Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions*. CGAP: R. Rosenberg, P. Mwangi, R. Peck Christen, M. Nasr. 2003. www.cgap.org
6. *Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance*. CGAP. 2003. www.cgap.org
7. *Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring*. The SEEP Network and Alternative Credit Technologies (ACT), LLC. 2005.

Endnotes

¹ Adapted from SEEP's publication, "Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring."