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FINANCIAL MANAGEMENT OF COMMUNITY-BASED FINANCIAL INSTITUTIONS

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FINANCIAL MANAGEMENT

OF

COMMUNITY BASED FINANCIAL INSTITUTIONS

A TRAINING MANUAL

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1996

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1. INTRODUCTION

1.1 Defining Financial Management:

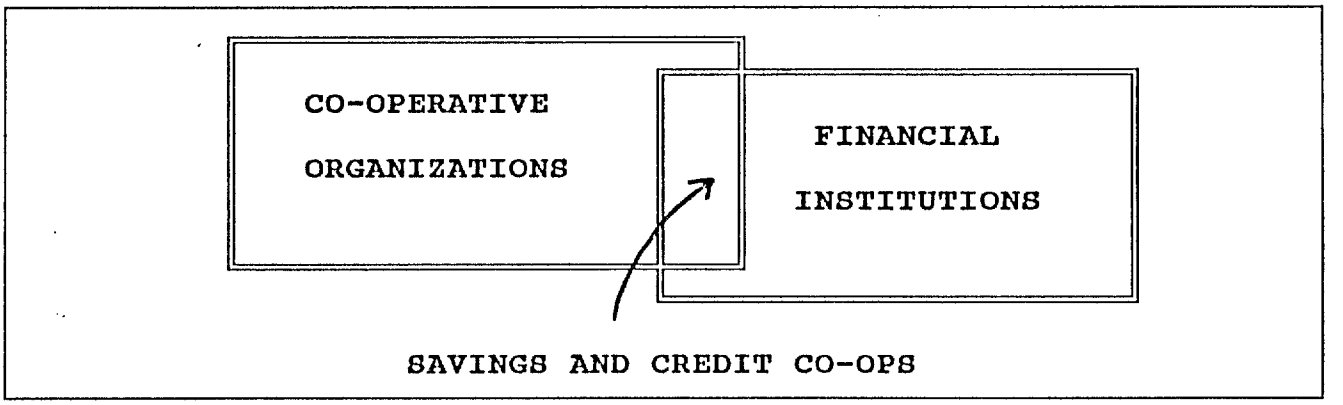
Financial management is the field of management that focuses on the financial component of an organisation's activities. Its primary function is to ensure that funds are raised and disbursed in an appropriate manner and in keeping with the goals and objectives of the organization.

In this manual, financial management is addressed within the specific context of community-based financial institutions (CBFIs). Such organizations can take many different legal and structural forms. For the purposes of simplicity and consistency, one organizational model has been selected for application in this manual: the model of the savings and credit co-operative. While there are a few distinct legal features that apply to the co-operative form of savings and credit organization but do not apply to other forms (for e.g. NGOs, un-registered societies, charitable societies, etc.), most of the terms, principles and techniques used in this manual will apply across the board to all varieties of community-based savings and credit organizations.

1.2 The Context of Savings and Credit Co-operatives:

In savings and credit co-operatives (SCCs), the tools of financial management must be applied within two important frameworks:

i) the society as co-operative, which is owned, controlled and used by its members-shareholders; and
ii) the society as financial institution, which mobilizes savings and disburses credit.



These two features of savings and credit co-operatives means that the financial management issues they face are distinct from those encountered in most other types of co-operatives on one hand, and other types of financial institutions on the other hand.

1.3 Summary of the Manual:

This manual was designed as an introductory text for trainers and staff within the international network of community-based financial institutions. It comprises five chapters, and at the end of each chapter is short quiz and/or case study exercise related to the subject matter.

The materials assume that trainees have a basic understanding of the structure, operations, and accounting system of their savings and credit organization. Upon completing the manual, a participant should be able to:

- describe the financial structure of a savings and credit organization;
- identify and explain the main issues faced in financial management of a community-based savings and credit organization;
- read, analyse, and interpret a financial statement;
- facilitate a financial planning process within a savings and credit organization.

While the text refers mainly to primary-level societies, most of the concepts are equally applicable to the various apex organizations that have emerged within the community based financial sector. For example, an illustration of a district union financial statement is provided in Appendix 3, and could be applied in the Case Study exercises instead of the primary society.

1.4 Acknowledgements:

A preliminary outline for this manual was developed in 1993 by Wilson Kabanda of the Uganda Co-operative Savings and Credit Union, while studying for a Diploma in Social Development at the Coady International Institute of St. Francis Xavier University, in Antigonish, Canada.

The text was then revised by Anthony Scoggins, Lecturer at the Coady Institute, as part of a curriculum development exercise conducted in 1994 with the staff of the Federation of Thrift and Credit Co-operative Societies of Sri Lanka (SANASA). It continues to be revised and adapted annually, and this latest version was prepared for a national level workshop of CBFI representatives held in Bangalore in June, 1996 under the sponsorship of the Indo-US Housing Finance Expansion Project.

The author acknowledges the contribution made by two publications of the World Council of Credit Unions, to the early drafts of this manual, namely Jim Jerving's Financial Management for Credit Union Managers and Directors and Credit Union Management and Organisation by Dean Mahon.

2. FINANCIAL STRUCTURE AND FLOWS IN A SAVINGS AND CREDIT CO-OPERATIVE

2.1. Overview of a Co-operative's Financial Structure:

In order to operate, most enterprises require an investment of funds with which to purchase basic equipment, stocks, supplies, etc. Money invested by the owners is referred to as capital or equity. In a community or member-owned business like a co-operative, the owners' investment is generally referred to as share capital. A second source of funds is borrowing from outsiders (i.e. non-owners) and such funds are referred to as liabilities. In the case of both capital and liabilities, the funds mobilised are available to the enterprise for its use, but these monies belong to other persons and must eventually be repaid.

The funds thus mobilised must be put to use in keeping with the purpose of the enterprise. The primary purpose of financial institutions is to provide credit: thus much of the money in a savings and credit co-operative (SCC) is invested in loans to members. The balance of the funds are usually deposited or invested in other institutions. Some of the monies may also be invested in buildings and equipment for the development of the co-operative. All of these applications of funds are known as assets and effectively belong to the enterprise.

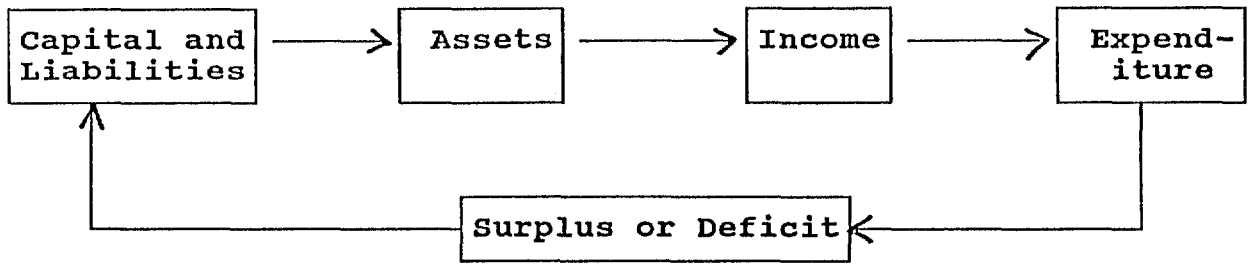
If managed properly, these assets should in turn generate income for the enterprise. The major form of income for an SCC is interest on loans.

From this income, the co-op must pay for the cost of doing business. These cost items are known as expenses and in most financial institutions the major expense items are the costs of money (interest paid to depositors) and salaries.

One of the major tasks of financial management is to ensure that the income generated from business activities is greater than the expenses incurred doing business. If this is the case, then the enterprise has generated a profit (or surplus). This can then be put aside in a reserve fund, allocated to some special projects, and/or divided amongst the member-owners.

If the expenses incurred doing business exceeded the income generated, then the enterprise has incurred a loss. In effect, the enterprise has consumed some of the capital that belongs to the owners.

Figure 2: The Financial Structure of an Enterprise



2.2 Sources of Funds in a Savings and Credit Co-operative:

2.2.1 Funds From Members:

The members who form and own an SCC are also its immediate financiers. In the beginning, the society may have only one type of saving instrument, but as the co-op grows, members needs evolve, and management becomes more sophisticated, a number of different savings instruments can be introduced.

a) **Shares:** A member invests in his/her co-operative by purchasing shares. The amount of shares required is set in the by-laws and it is the purchase of these shares that grants full membership rights and obligations to members. Co-operative shares are of a fixed value and cannot normally be traded.

Usually, shares cannot be withdrawn unless a member is leaving the society. In some countries, there are restrictions on the re-imbursement of co-op shares. This is done to protect the total value of the society's capital, and requires either another member to purchase the shares of the withdrawing member, or the use of a 'Share Transfer Fund'.

As co-op shares are considered the owners' risk capital, they do not generally receive a guaranteed return. However, if the society generates a surplus, the members may decide to pay a dividend on their shares.

Because shares are a long-term investment by members, the money they represent can be applied to purchasing long-term (or fixed) assets such as land, building, equipment, etc.

b) **Savings:** In most SCCs, members are also encouraged to contribute additional savings beyond the required share capital. These savings are usually the major source of funds from which loans are granted.

Some societies set uniform savings policies for all members, specifying minimum amounts and required regularity. Others allow more flexibility.

Policies regarding interest on savings and rights of withdrawal also vary greatly, but usually members savings earn interest at a pre-set rate and are relatively open to withdrawal.

c) **Fixed Deposits:** Like banks, SCCs have introduced fixed deposits for which members can receive a guaranteed rate of interest if the funds are deposited for a set term, (eg. 12 or 24 months). The advantage to the society is that the funds are lodged with the co-op for a known period of time; the disadvantage is that the interest paid on these deposits is higher than that paid for ordinary savings.

d) **Current Accounts:** In some countries, co-operatives are introducing current accounts for their members. In situations where the co-operative system is able to negotiate a cheque clearing arrangement with a commercial bank, co-op members can write cheques on such accounts. In cases where this is not yet possible, members are simply allowed to withdraw money without the notice required for other accounts. Usually the rate of interest paid by the co-operative on current accounts is very low. But members see this disadvantage as being balanced by the added convenience of easy access.

SUMMARY OF SAVINGS INSTRUMENTS

	Defining Characteristics	Financial Cost (Interest rate)
Shares	- basis of ownership rights - serve as risk capital - amount usually fixed - limited rights of withdrawal - dividends paid at year-end from surplus	Limited cost (at discretion of members)
Savings	- discretionary or compulsory - fixed rate of return - may have limits to withdrawals	Moderate cost
Fixed Deposits	- for set periods of time - limited rights to withdraw - usually larger amounts only	High cost
Current Accounts	- quick access - fluctuating balances	Low cost

It should be noted that the method of classifying these savings instruments varies between SCCs. Some classify all monies saved by members as "member's capital". Others define only members' shares as capital, and treat other savings from members as liabilities.

2.2.2 Funds From Lending Institutions:

To supplement members savings and increase the pool of funds available for on-lending, co-operatives may borrow from lending institutions. Wherever possible, co-operatives usually borrow through their federation's inter-lending or central finance facility. When necessary, they also borrow from commercial or governmental banks.

From a management perspective, while such loans increase the capacity of the co-operative to on-lend to members they increase the vulnerability of the society to loss, either through failure of members to re-pay or due to the relatively higher cost of borrowed money compared to funds generated funds from members.

2.2.3 Funds from Operations:

As noted above, well-managed societies should generate income in excess of their expenses. This produces a surplus which members may decide to re-invest within the society. This re-investment can take the form of a collective reserve which belongs to the co-operative itself. Or the surplus may be credited to members individual share accounts but retained within the society.

2.2.4 Funds from Donors:

From time to time, certain co-operatives may receive donations from local or international agencies. If these funds are to be spent on the purchase of goods or services, the money is usually treated as income. However, if the donated monies are to be preserved in the form of a revolving fund or long-term fixed asset, the value of the donation is usually termed "donated capital" and treated like a long-term investment in the co-operative.

2.3 <u>Applications of Funds.</u>

The accumulated funds mobilised from these various sources and in these different forms are then put to use by the savings and credit co-operative. These items are considered assets of the society.

2.3.1 Loans:

The primary purpose of the society is to provide credit to members, therefore most SCCs on-lend the majority of their funds. This is

usually in the form of term loans, although some societies also offer mortgage loans, lines of credit and other more specialised credit instruments. In some cases, special loan programs are operated with funds obtained from outside the society (eg. low-income housing loans).

The successful management of the loan portfolio is generally considered the most challenging aspect of the financial management of SCCs.

2.3.2 Investments:

Most financial co-ops also allocate part of their funds to income generating investments. This is an effort to spread the risk of lending only to members, while generating more income than would be realized by leaving the money in a simple savings account. Such investments also provide accessible funds if the cash reserves of the society begin to run low.

Usually these investments take the form of fully secured deposits with other financial institutions, including the national federation. Less often, co-operatives will invest in businesses or income generating projects which they directly own and manage. Even less frequently, co-operatives invest in privately owned businesses or other speculative activities.

2.3.3 Cash:

All financial institutions must retain some cash (on hand or readily available) in order to meet the day to day requirements of doing business. A relatively small amount of cash is actually held in the till or safe of a society. The balance is held in a current or savings account with the co-operative's own financial institution. These funds generate almost no income for the society and their handling is often risky and expensive.

2.3.4 Fixed Assets:

In order to conduct business as a financial institution, SCCs must purchase equipment, furniture and even buildings in keeping with their resources and member needs. These long term acquisitions constitute a small but important part of a co-operative's assets.

2.4 <u>Incomes:</u>

As noted above, the proper management of the society's assets will generate income for the co-operative. The major forms of income in an SCC are:

- Interest on Loans
- Return on Investments, and
- Service Fees.

Other, smaller sources of income can include entrance fees, income from sale of stationery, donations, and rental income.

2.5 Expenses:

In the course of operating the society, a variety of expenses are incurred. In SCCs, these are often clustered into six groups:

a) cost of funds: including interest paid on savings and deposits, plus interest paid on loans;

b) personnel costs: salaries, benefits, training, etc.;

c) facility costs: rent, maintenance of building and equipment, depreciation, etc.;

d) operational costs: stationery, office supplies, etc.;

e) security costs: security, insurance, audit, etc.

d) governance costs: member education, meetings, communication, etc.

2.6 Surplus and Loss:

As noted above, if by year end the society has generated income in excess of its expenses, it has thereby generated a surplus. If the expenses exceed the income, then a loss has been incurred.

For those societies formally registered under an act of government, there may be restrictions upon how a surplus is to be allocated. For example, there are set provisions on allocation of surplus in most Co-operative Acts, and in acts related to charitable societies there are usually restrictions against the division of surplus.

2.6.1 Statutory Allocations:

In the case of co-operative societies, most Co-operative Acts stipulate an amount that has to be set aside as a reserve for bad debts. This allocation is usually calculated as a simple percentage of the total surplus: it is often 20-25% of surplus.

(In some countries the Co-operative Act requires societies to do a calculation of their loan delinquency and actual exposure to loss. The allocation to reserves is then based on this figure.)

In most cases, the monies placed in the reserve for bad debts (often called the Statutory Reserve) must be deposited intact in a special account opened specifically for this purpose with the

Federation or a commercial bank. These monies can then only be accessed with the express permission of the Government's supervisory authority.

In some countries there are additional statutory allocations beyond the reserve for bad debts. These may include a national education fund, a local education fund, a share transfer fund, and an audit fund.

2.6.2 Discretionary Allocations:

Following those allocations required by law, members of the society may decide at their annual general meeting to set aside further funds. These could be for re-investment in certain projects or donations to certain causes. For example, it is not uncommon to have a Building Fund in which annual allocations are placed each year until an amount adequate to start construction has accumulated.

2.6.3 Division of Surplus:

At the annual general meeting members also determine what portion of the surplus will be divided amongst themselves and how that money shall be allocated. The general practice is to pay dividends to members upon their shares, because this rewards the risk-taking members who have received no return yet on their investment. Such dividends serve as an incentive to members to build up their shares. And since dividends are generally credited to members individual share accounts, the money stays within the co-operative.

An alternative approach is drawn from the traditional co-operative principle of "patronage rebates", which states that members should be compensated in proportion to their contribution to the surplus of the society. In SCCs, this is interpreted to mean that a surplus is effectively the product of overcharging borrowing members on interest. As such, a portion of the surplus of a society is sometimes rebated to members as a percentage of the interest they paid in the past year. Use of interest rebate, however, is declining as most societies are squeezed for funds and find it strategically wiser to motivate savers rather than reward borrowers.

2.6.4 Retention of Surplus:

Finally, the members may decide at the annual general meeting that a portion of the surplus should simply be retained by the society itself. In a sense, this constitutes the society's own savings and is usually entitled Retained Surplus or Retained Earnings. These funds can be divided or allocated in future years, as the need arises. In the meantime, they provide a pool of free funds available for on-lending to members. It should be noted that in some countries, surpluses that are retained by co-operative

societies in this manner are considered "profit" by the government and taxed in accordance with corporate income tax laws.

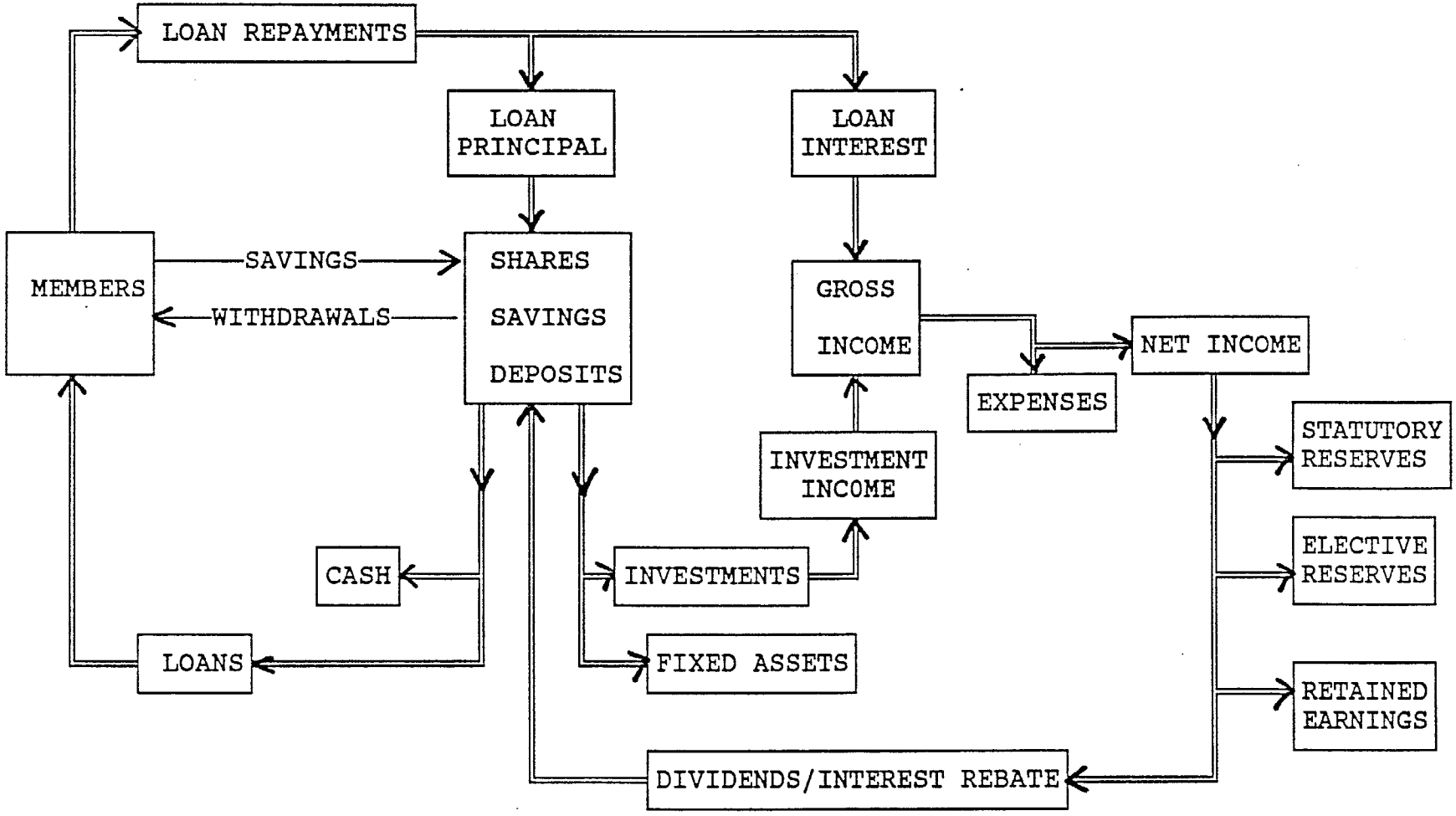
In the èventuality of a co-operative society incurring a loss, usually none of the above provisions apply. (An exception to this occurs in countries where the allocation for bad debt reserves must be made regardless of the society's bottom line. In such cases, the allocation is treated as an expense and serves to increase the loss.) If a loss is incurred after a society has built up an adequate Retained Surplus, a dividend might still be paid to members from this fund.

Otherwise, the loss is carried forward on the Balance Sheet as a Retained Deficit. Some co-operators argue that if members divide up a surplus by crediting it to their individual accounts, then they should also share the loss by having an amount debited to (i.e. deducted from) their individual accounts. Although it seems a reasonable proposal, in practice it is rarely done in SCCs.

2.7 SUMMARY:

The narrative above is summarized on the following page by an illustration of the different elements of the finances of a savings and credit co-operative. The arrows in the diagram represent the direction of the flow of funds.

FLOWS OF FUNDS IN A SAVINGS AND CREDIT CO-OPERATIVE



2.8 QUIZ ONE.

1. What are the major sources of funds in a savings and credit co-operative?

2. What are the main differences between members shares and members savings in an SCC?

3. What are the main applications or uses of money in an SCC?

4. What are the major sources of income in an SCC?

5. What are the main categories of expenses in an SCC?

6. Explain the difference between a surplus and a loss in an SCC.

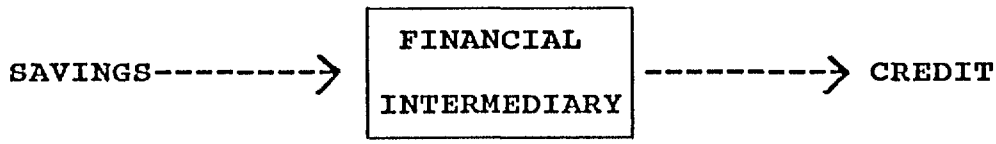
7. If an SCC has a surplus at year end, what must be done and what can be done with that money?

3. KEY ISSUES IN THE FINANCIAL MANAGEMENT OF SAVINGS AND CREDIT CO-OPERATIVES

3.1 Introduction:

Savings and credit co-operatives are financial intermediaries. That is to say, they mobilise savings and then convert these savings into loans and investments.

The Nature Of Financial Intermediaries



As a community-based, member-owned financial institution, SCCs have somewhat different objectives and priorities from commercial or government-owned banks. But to be successful, all of these institutions have to respect certain basic principles of financial management. These principles relate to four general areas of management:

1. Asset-Liability Management
2. Cash Management
3. Income Management
4. Risk Management

These four areas are defined and introduced in this chapter.

3.2 Asset-Liability Management

The money mobilised by financial institutions in the form of shares, savings and deposits does not belong to that institution, but to the depositors. In that sense these funds are **liabilities** to the bank or co-operative.

On the other hand, the financial institution then takes that money and makes use of it. Most usually, it makes loans or investments, purchases property or equipment, and keeps some in its own bank account. These items are all considered **assets** by the society.

Asset-liability management is the combined planning and managing of these assets and liabilities. The purpose of asset-liability management is to ensure that the financial institution provides a mix of services and produces a level of income in keeping with its plans and objectives.

There are two major components of asset-liability management:

i) matching the maturity of the liabilities and assets; and
ii) managing the interest rate spread between the assets and liabilities.

As the interest rate question will be explored in the section below on Income Management, here will be addressed the issue of matching maturities.

Matching is the structuring of the maturities and amounts of assets to co-incide with those of liabilities. In other words, short-term (or current) liabilities such as savings must be matched with short term assets such as short-term loans or deposits. Similarly, the funds derived from long-term liabilities such as shares or long-term fixed deposits should be placed in longer term investments or loans.

By matching the maturities of assets to liabilities, the manager is able to ensure that the society has always has sufficient funds to meet its cash obligations. Since it is never possible to match perfectly the term of all assets and liabilities, some savings and credit federations adopt a "mis-match" guideline of 5 - 10%. Societies that exceed that limit may be subject to disciplinary action.

3.3 Cash Management

Cash is defined in financial institutions as all money that has immediate purchasing power, such as physical currency, plus current and savings accounts.

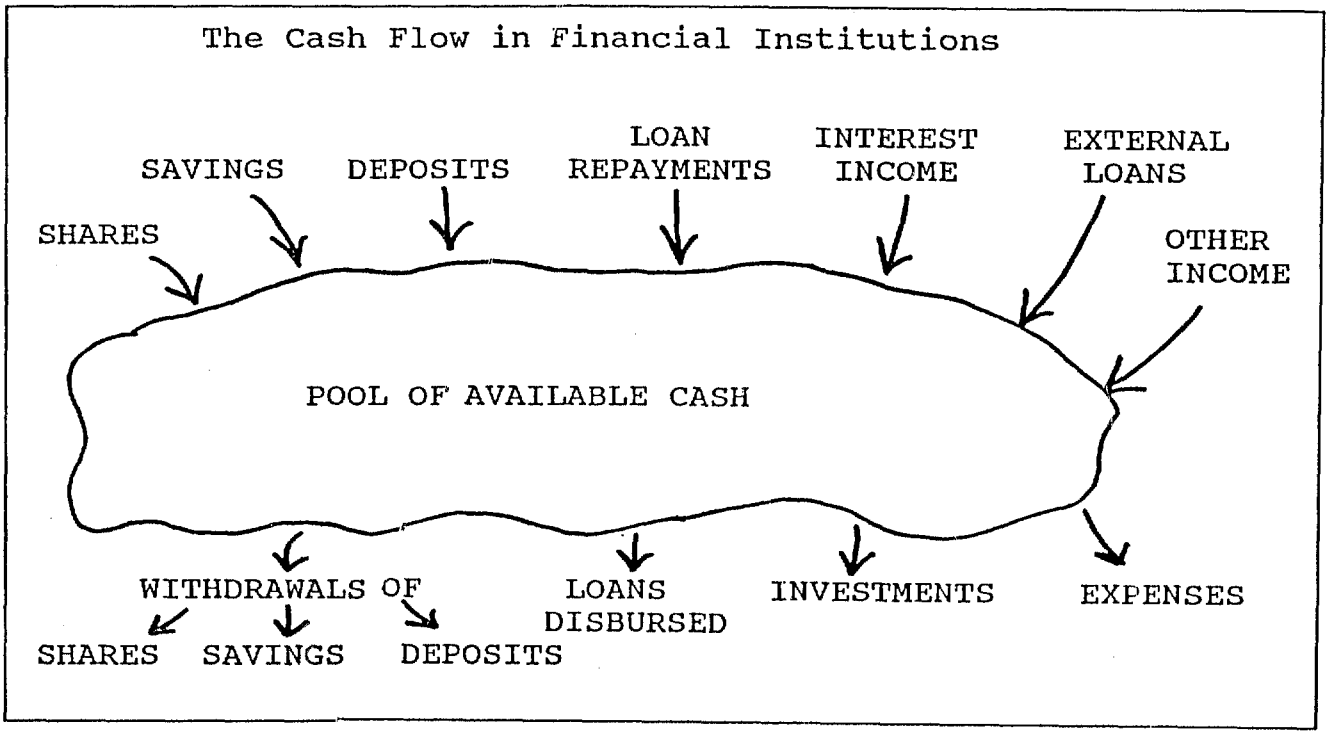
Cash management is therefore the planning and management of cash inflows and cash outflows such that adequate cash reserves are maintained while not unduly constraining the income earning capacity of the society.

Cash flow management is closely linked to the issue of **liquidity.** Liquidity is defined as the ability to meet demand for funds. Liquidity management is therefore the process of ensuring that demand for funds is met. Since liquid or convertible assets (those that can be converted into cash within three months) usually receive a lower rate of return than do longer term assets (like loans or term deposits), the desire to keep a good reserve of cash must be balanced with the need to earn income.

The liquidity or cash flow position of an SCC may vary according to some regular monthly, seasonal or annual cycles. But many savings and credit federations and/or government regulatory agencies have statutory liquidity requirements that societies have to meet on a monthly basis. For example, in many jurisdictions, SCCs are obliged

to maintain in liquid or convertible assets an amount equal to 15% of its total withdrawable deposits and notes payable.

The cash flows of a financial institution can be represented as flows into and out from a central pool:



The primary tool for managing liquidity is the cash flow statement which projects cash inflows, outflows and the resulting balance. (See format in appendix). Various ratios can also be applied to the financial statement to enable monitoring of the liquidity situation. These are explored in the chapter on Analysis of Financial Statements.

3.4 Income Management

In order to prosper and grow, any business enterprise must generate sufficient income to cover its expenses and provide a reasonable return to the owners' capital. The purpose of income management is therefore to plan and manage the earnings of an enterprise such that earnings generated are adequate to cover all expenses, pay a return on capital and enable future growth and development. This is commonly referred to as "managing the bottom-line".

For financial institutions the major income and expense items relate to the mobilization of funds and the subsequent application of these funds as loans or investments. These costs and incomes are listed below:

Cost of Funds	Income from Funds
- interest on savings and deposits	- interest received on loans
- interest paid on loans	- income from investments
- dividends paid on shares	

Financial institutions must therefore manage their resources such that the income generated from their loans and investments is adequate to pay the cost of funds and cover all the administrative or overhead costs of doing business.

The key to this process is maintaining an appropriate difference between the interest rate paid for funds and the interest rate received. This is known as the interest rate spread. The net income that this generates, in form of money is known as the financial margin. For example:

$100,000 loans at	15%	generates	$ 15,000	Income
$100,000 savings at	8%	costs	8,000	Expense
Spread =	7%		$ 7,000	= Financial Margin

The management of an SCC must therefore monitor the various rates of interest of the society to ensure that the spread and margin are adequate to meet the society's financial objectives. This can be particularly difficult in co-operatives where different types of funds carry different costs and generate different incomes. For example:

Types of Funds	Cost	Revenue
Member Savings	13%	18%
Member Deposits	15%	18%
Donated Revolving Fund	0%	8%
Gov't Housing Program	10%	14%
Loan from Federation	18%	22%

A related concept is that of loan yield which refers not to the interest rate charged on a loan, but the interest actually generated from it. Obviously, late or non-repayment of loans will have a negative impact on the co-operative's financial margin. For example, $100,000 in loans at a rate of 15% should generate interest income of $15,000 in a year. However, if the income actually received is only $12,000, this indicates a yield of only 12%. Since 1/5th of the expected income has not been received, this

suggests that 1/5th or 20% of the loans are delinquent. This obviously requires immediate management action.

The concept of loan yield is also helpful in situations where co-operatives have a number of different types of loans out at different rates of interest. Calculating an over-all yield for the loan portfolio is one way of simplifying the calculation problems.

3.5 Risk Management

Risk simply means the uncertainty of loss, and it is a reality of all human activity. Savings and credit co-operatives face a variety of risks in the course of doing business, and risk management is therefore defined as the process of protecting the society's assets and resources from loss.

There are three alternative strategies comprising risk management:

i) absorbing the risk: essentially accepting the risk and being prepared to pay the cost of loss. For example, building up internal reserves to cover bad debts is a form of risk absorption;

ii) transferring the risk: usually done through insurance agreements through which another party agrees to accept (for a set price, i.e the premium) the risk of loss. Life insurance or fire insurance are two examples;

iii) avoiding the risk: in which the society decides not to undertake a certain activity, due to the high risk of loss. For example, discontinuing a certain loan program, refusing to make speculative investments, or deciding not to retain any cash in hand at the end of the day are all illustrations of risk avoidance.

For financial institutions the major risks tend to be financial risks, most particularly the risks involved in lending. Other types of financial risks involve setting of interest rates, liquidity management and investment-related risks. For all of these risks, the management are required to assess the risk of loss and take appropriate actions. Such actions might include setting collateral requirements on loans, specifying liquidity standards, and restricting forms of investment.

A second major risk for financial institutions is the risk of criminal activity, that is to say robbery, embezzlement, forgery, etc. The management is also responsible to see that the necessary security precautions are put in place and maintained. These range from establishing appropriate cash handling procedures to installing alarm systems and training internal audit committees.

3.6 Quiz Two:

1. What are the main activities of a financial intermediary?

2. What are the two main components of asset-liability management?

3. What does liquidity mean?

4. What are the main flows of cash into an SCC?

5. And what are the main flows of cash out of the co-operative?

6. What is the difference between financial margin and interest spread? Illustrate with an example.

4. FINANCIAL STATEMENTS OF SAVING AND CREDIT COOPERATIVES.

4.1. What are Financial Statements?:

Financial statements are summaries of past financial activities drawn from the accounting records of an enterprise. These statements report past performance in the mobilization and application of resources and indicate the society's current situation.

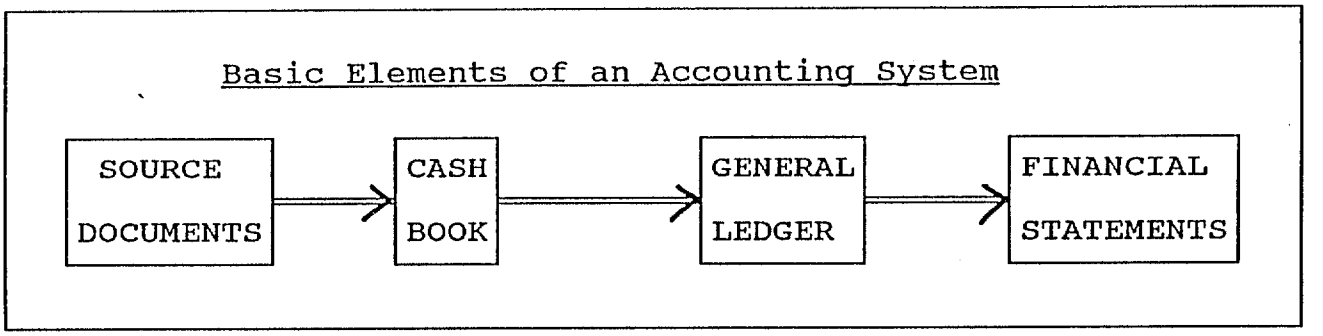
Financial statements are an important source of information for two groups of readers: those internal to the enterprise (directors, management and share holders) and those external to the enterprise (such as Government, lending institutions, and donors).

4.2 Source of Financial Statements:

The information reported in financial statements is generally drawn from the accounting system of the enterprise. In most enterprises, the accounting system comprises four steps of record-keeping:

- Source Documents: original records of transactions, such as receipts and vouchers, cheques, passbooks, invoices, etc.
- the Cash Book: in which all transactions are recorded in chronological order (some societies have a separate book called a Journal for non-cash transactions);
- the General Ledger: in which the information from the Cash Book is organized in accounts (Cash, Bank, Loans, Deposits, Shares, etc.) such that running totals or balances can be extracted for all items;
- the Financial Statements: in which the amounts listed in the General Ledger are presented in summary form for a set period.

There is a common misconception in many co-operatives that the only real financial statements are the externally audited (i.e. verified) financial statements prepared at year end. This is not correct. Each month the Treasurer of every SCC should prepare a set of financial statements for the review of the Board. The full legal format prepared by the auditor need not be used: there are simpler formats which are not difficult to prepare and in fact are much more easily understood by the Board and other members.



There may be some variations between the accounting forms and procedures used by different SCCs. For example, some issue receipts for every member transaction; others consider the member's passbook as an official receipt. Some have two separate cash books (one for receipts and one for disbursements) while others use a single book or a synoptic system. But in general, the accounting systems used in savings and credit co-operatives are very similar around the world. The physical format of the forms also varies depending upon whether a manual, mechanical or computerised accounting system is in place.

There is one significant variation in accounting practices however, and that is the difference between the **cash basis** of accounting and the **accrual** basis. Most smaller or younger co-operatives use a cash-based accounting system, in which transactions are recorded and entered as and when cash moves into or out of the society.

As societies become more sophisticated, however, they generally convert over to an accrual based system, in which income and expenses are accounted for as and when they are earned or incurred. For example, the interest earned on a one-year term deposit in a bank is calculated and recorded every month, instead of waiting for the day at year-end when the interest is actually received. Similarly, although the entire cost of the society's annual building insurance is paid on the first day of the year, it is charged as an expense on a monthly basis over the course of the year.

4.3 Criteria and Characteristics of Financial Statements:

Although different users of the financial statements have different information needs, all statements should be:

- Mathematically accurate
- Reliable, in the sense that the same results would be obtained if the statements were prepared by another person.
- Capable of verification, that is the information can be traced back to its source to check its correctness.

- Timely, that is presented within the proper time frame for its use.
- Cost Effective, that is the value of financial information must outweigh the cost of producing it.

4.4 Types of Financial Statements:

There are four types of financial statements produced by SCCs:

- Cash flow summary,
- Balance Sheet,
- Income and Expenditure Statement, and
- Statement of Balance Disposable

3.4.1 Cash Flow Summary:

This statement is a simple summary of cash inflows and outflows over a given period of time. In many smaller savings and credit co-operatives this is the only statement produced on a monthly basis. This is because the figures that make up this statement can be easily extracted from the cash book. And secondly, the level of management skills in such societies tends to be low and in practice simply consists of managing the society's bank account.

Cash Flow Summary (Model)

Receipts		Disbursements	
Opening Cash Balance	500		
Shares Purchased	500	Shares Withdrawn	100
Members Savings	4,000	Savings Withdrawn	1,000
Members Deposits	3,000	Deposits Withdrawn	500
Loans Repayments	3,500	Loans Granted	5,000
Interest Received	800	Equipment Bought	1,500
Fines Received	200	Expenses Paid	1,000
		Closing Cash Balance	3,400
Total Cash Available	12,500	Total Accounted	12,500

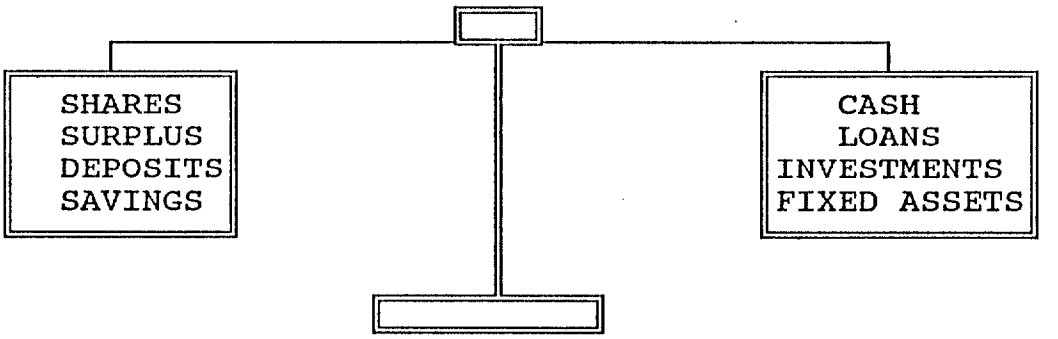
4.4.2 Balance Sheet:

The balance sheet provides a listing of all the assets, liabilities and capital of an enterprise at a given point in time. As such, it is a "snapshot" of the sources of funds (liabilities and capital) and how these funds have been applied (as assets).

The design of the balance sheet is based on the "accounting equation" that states:

Liabilities and Capital = Assets

This can also be illustrated as a balance:



LIABILITIES AND CAPITAL ASSETS

The Liability and Capital side of the balance sheet usually comprises three categories of items:

a) Members Capital (or Equity): This consists of the funds that members have directly invested, such as share capital and savings. Other items include the funds retained by the society from previous surpluses, usually in the form of reserves or retained earnings. Sometimes donated funds are also treated as a form of capital.

b) Long term Liabilities: These comprise funds acquired by the society but not due for settlement in the near future. (The 'near future' is usually defined as one year.) These obligations may comprise term or mortgage loans or deposits.

c) Current Liabilities: These are obligations acquired by the society that are to be paid off within a financial year. Examples include unpaid bills such as audit and supervision fees, overdrafts and taxes.

Items on the Asset side of the Balance Sheet can be grouped into four:

a) Cash: This general heading includes cash on hand, balances in current and savings accounts.

b) Investments: These are usually in the form of term holdings or deposits in other organizations. Within the savings and credit system, there is a general inclination to invest in sister co-operatives such as district and national unions, the Cooperative Bank, or similar organizations. Sometimes investments are listed on the Balance Sheet according to the organization invested in, other times they are listed according to the type of investment (shares, deposits, etc.) or the term of the investment (long vs. short).

c) Loans: Loans to members are usually consolidated under one general heading, although they may be subsequently disaggregated into long-term loans, short-term loans, overdrafts, and overdue loans.

d) Fixed Assets: These are assets not to be sold off in the ordinary course of business but put to use during society operations. They normally last for a number of years and include such items as land, buildings, vehicles, furniture and equipment. Each group of fixed assets is recorded in the balance sheet at its original cost and then (with the exception of land) depreciated. Depreciation is the loss in value of an asset due to various factors, notably wear and tear and the passage of time. It should be noted that depreciation is a book-entry rather than a cash transaction, since the cash was actually disbursed at the time of purchase. However, some societies do make "provisions for depreciation" in which a reserve is established and credited with an allocation of funds that should, by the time the asset is used up, be sufficient to purchase a replacement.

A model Balance Sheet is provided below. The format is simple and clear for all to understand.

Unity Savings and Credit Co-operative
Balance Sheet as at 31/12/93.

Liabilities and Capital		Assets	
Members Shares	50,000	Cash	10,000
Members Savings	170,000	Investments	40,000
Loan from Fed.	70,000	Loans	160,000
Reserves	9,000	Fixed Assets	113,000
Retained Surplus	24,000		
Total Liabilities and Capital	323,000	Total Assets	323,000

4.4.3 Income and Expenditure Statement:

This statement, (sometimes called Profit and Loss or Operating Statement) reports on the profitability of the society over a given period of time. The statement lists:

a) the types of income earned by the society, the amount earned from each, and the total income earned;
b) the types and amounts of expenditure and the total thereof. As noted above, these expenses are often grouped under six general headings:
   - cost of funds
   - personnel costs
   - facility costs
   - operational costs
   - security costs
   - governing costs

c) the surplus or loss incurred over the period.

An example of the format of a simple Income and Expense Statement is provided below:

Unity Savings and Credit Co-operative
Income & Expenditure Account for Year Ended 31/12/93

Income :		
Interest on loans	120,000	
Service charges	10,000	
Stationary sale	5,000	
Investment Income	10,000	
Total Income		145,000
Expenses:		
Salaries and Wages	30,000	
Interest on Savings	70,000	
Depreciation	7,000	
Dues to Federation	8,000	
Electricity	2,000	
Total Expenses		117,000
Net Surplus		28,000

4.4.4 Statement of Balance Disposable:

The Statement of Balance Disposable is the bridge between the Income and Expenditure Statement and the Balance Sheet. Through this account is cleared the surplus or loss from the Income and Expenditure Statement and consolidated with the earlier balance. Then the necessary allocations are made to reserves or other accounts. The remaining balance is then carried forward to the Capital side of the Balance Sheet. An illustration is provided below.

Balance Disposable as at 31/12/93.

Net surplus this year		28,000
Less Allocations:		
25% Statutory Reserve:	7,000	
10% Co-operative Fund:	2,800	
15% Common Good Fund:	4,200	
Total Allocations:		14,000
Balance Available		14,000
Opening Balance		10,000
Closing Balance		24,000

In some SCCs, the balance disposable account is closed on an annual basis and the balance transferred to Retained Earning Account.

4.5 **Notes to Financial Statements:**

The formal financial statements are often supplemented by a set of notes that are technically part of the statements themselves. These notes disclose additional relevant information that cannot be deduced from the financial figures. Such notes may include:

- disclosures on significant accounting policies used;
- the method of depreciation used on the fixed assets;
- information concerning contingent liabilities, loss exposure for loans, etc.

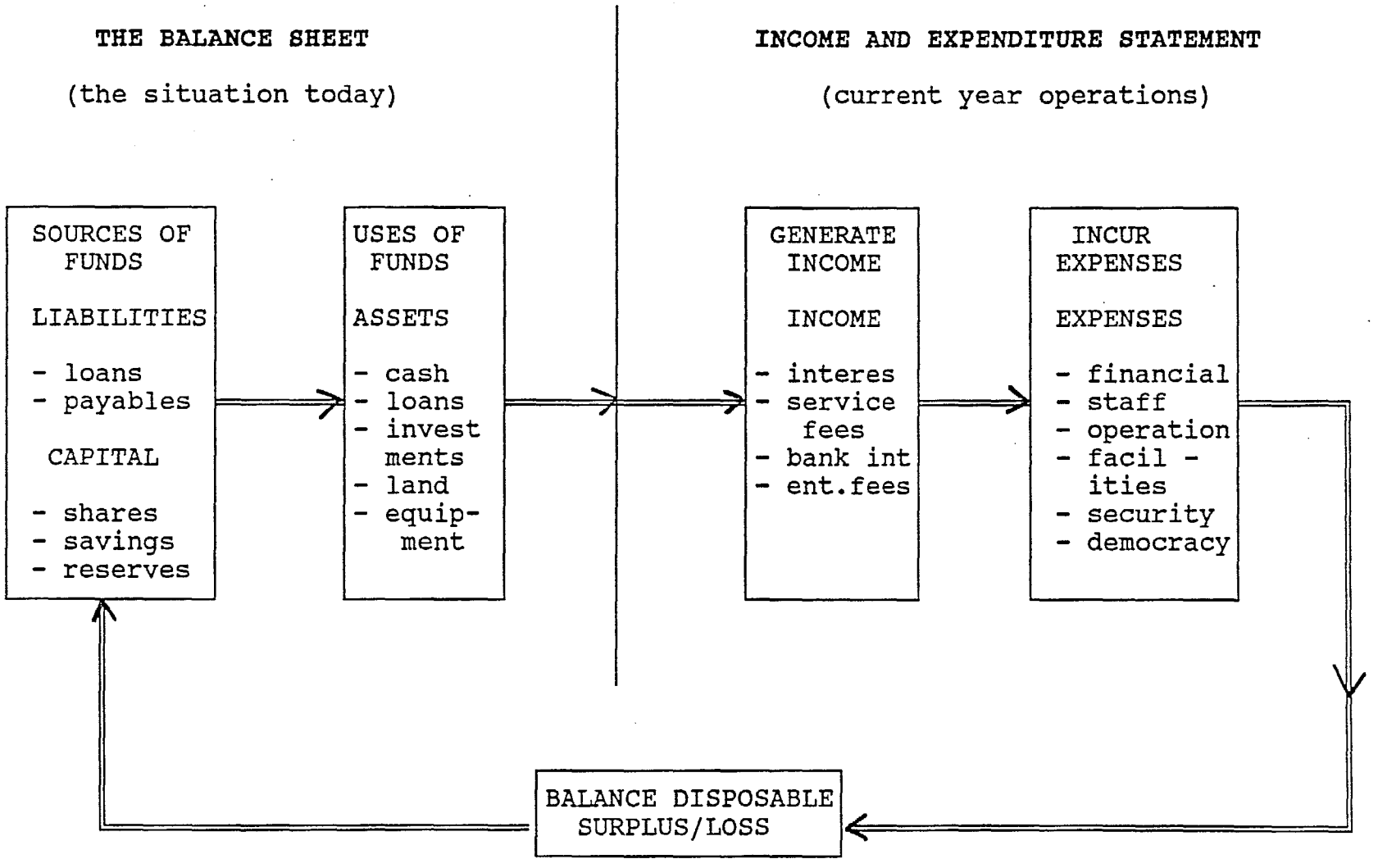
4.6 Limitations of Financial Statements :

Financial managers must keep in mind that they are managing more than money and numbers. Financial statements are the product of accounting records and information that cannot be expressed in monetary terms is usually not included. Such information includes such important factors as:

- the society's human resources (including staff, volunteers and membership);
- the types and quality of the society's loans (number, purposes, repayment trends, exposure to loss, adequacy of security), and
- current market valuation of assets.

For this reason, financial statements are frequently supplemented by a set of non-monetary statistics, including data on the above items. Technically, these are not usually part of the formal financial statement although the information included is often very useful to management. Furthermore, the financial statements should also be supplemented by narrative reports from the elected and full-time management, which often explain some of the non-financial dimensions of the societies operations.

THE RELATIONSHIP BETWEEN THE FINANCIAL STATEMENTS



4.8 Quiz No. Three

1. What are financial statements?

2. Who are the main users of financial statements?

3. Where does the information presented in financial statements come from?

4. Name the four main financial statements found in an SCC?.

5. Below are a list of account titles commonly found in SCC.

   Firstly, in the column marked "Statement", identify which of the accounts belong on the Balance Sheet (B/S), and which are found on the Income and Expenditure Statement (I/E)?

   Secondly, for those accounts that you believe should be on the Balance Sheet, specify in the "Type" column whether they are Assets (A), Liabilities (L) or Capital (C). Similarly, for those that should be on the Income and Expenditure Statement, specify whether they are Income (I) or Expenses (E).

	Statement	Type
- Loans to members	_____	_____
- Wages and Benefits	_____	_____
- Members Savings	_____	_____
- Members Shares	_____	_____
- Interest on Loans	_____	_____
- Furniture and Equipment	_____	_____
- Electricity Expense	_____	_____
- Statutory Reserve	_____	_____
- Cash in Bank	_____	_____
- Surplus	_____	_____
- Dues to District Union	_____	_____

6. In which section of the financial statements would you find the information that explains the society's choice of accounting policies?

4.8 CASE STUDY #1: READING FINANCIAL STATEMENTS

4.8.1 TASK: Below are provided the Balance Sheet and Income/Expense Statement of Solidarity Savings and Credit Society. Read the following description of the society and review the statements. Then answer the questions that follow.

4.8.2 BACKGROUND TO THE SOCIETY:

Solidarity Savings and Credit Society emerged from an emergency relief and rehabilitation project in a large slum community on the margins of a major urban area in India. Following a major typhoon and flooding that devastated the area in 1973, a number of NGOs established a presence in the community to assist in emergency relief. By 1975, much of the relief work had wound down and many of the agencies had moved on.

But a small group of social workers decided to establish a permanent presence in the community. They founded a new organization, the Association for Community Empowerment (ACE) and shifted the focus of their developmental activities from relief and charity to community education and activism. Under ACE's initiative, neighbourhood committees, women's groups, and youth clubs were formed. By 1981, these community associations had formed their own federation known as the Forum for Action (FACT), which subsequently obtained legal registration.

Although the initial focus of FACT was political advocacy and action to secure local services and benefits, through the 1980s it gradually began to engage in a number of economic activities. As many of its member groups had initiated small savings schemes, the proposal was made at the FACT annual meeting in 1984 to form a community bank.

Through its NGO contacts, ACE secured the services of a specialist in community-based savings and credit to lead a broadly-based education and consultation process in 1985. This lead to the formation in 1986 of the Solidarity Savings and Credit Society (SSCS).

The structure and operations of SSCS is relatively simple. Membership is open to any individual who is a member of a community group affiliated to FACT. (There are currently 325 affiliated groups with a total membership of 13,000. Current actual membership is 3,850.) Basic savings and loan application and repayment activities take place at the group level, where voluntary leaders collect the savings and keep basic records. Initial decisions about loan applications are also taken at this level, because group members must stand as security for borrowers from their own groups.

The group leaders meet monthly in "cluster meetings" with FACT's professional community animators, who verify the basic records, review and collate loan applications, and then physically transport the funds to the SSCS office.

The society maintains an office within the ACE building. A full-time manager, accountant and two clerks are directly employed by SSCS. The cost of field services however, is effectively subsidised by the free provision of outreach services to SSCS by FACT staff.

Loan applications from members are reviewed by a committee comprising the manager, two Community Animators appointed by the FACT Board (which also serves as the Board of SSCS), and two group leaders elected by their peers. Once a loan application is approved, the group and borrower are informed. The borrower and group executive must then come to the office to sign the various papers and receive the disbursement. Loan repayment is done at group level.

SSCS requires each member to save a minimum of Rs. 20 per month and to contribute Rs. 5/month to a compulsory group insurance scheme. Over the years, many groups have raised their required savings amount to Rs. 50 and even Rs. 100. Individual members who wish to save amounts greater than the savings contribution required by their respective group, can put money in a Special Deposit Account.

The first Rs.250 contributed by each member is considered as Share Capital and is not normally withdrawable. The balance of savings are considered Members Savings.

Members with the required shares and group guarantee are eligible to borrow up to ten times their savings to a maximum loan of Rs. 10,000. The society charges 16% on regular loans to members and pays 10% interest on deposits and 7% on savings. Members shares receive a dividend, payable after every annual general meeting. In the last two years, dividends of 8% have been paid.

In 1994, ACE and FACT were able to negotiate a special Rs. 1 million loan through the Municipal Housing Authority. These funds are provided to SSCS at a rate of only 6% p.a. for on-lending to members for housing up-gradation. The society charges 9% interest on these loans.

4.8.3

YEAR-END FINANCIAL STATEMENTS OF SOLIDARITY SAVINGS AND CREDIT SOCIETY

THE BALANCE SHEET

LIABILITIES AND CAPITAL	1995	1994	ASSETS	1995	1994
Members Shares	760,000	712,000	Cash in Hand	21,000	19,000
			Cash in Bank	624,000	937,000
General Reserve	169,000	163,000			
Common Good Fund	72,000	67,000	Member Loans	5,938,000	5,201,000
Insurance Fund	320,000	293,000	Housing Loans	946,000	927,000
Retained Surplus	38,000	34,000			
Members Savings	6,528,000	6,145,000	Deposit in Bank	1,729,000	1,625,000
Special Deposits	429,000	376,000			
Loan: Mun.Hsg Auth.	960,000	935,000	Equipment	27,000	22,000
Accounts Payable	9,000	6,000			
TOTAL LIAB. AND CAPITAL	9,285,000	8,731,000	TOTAL ASSETS	9,285,000	8,731,000

4.8.4

THE INCOME AND EXPENDITURE STATEMENT

INCOME	1995	1994
Interest Received On:		
Deposits	151,000	127,000
Loans	688,000	647,000
Savings	15,000	17,000
Other Income:	23,000	19,000
TOTAL	877,000	810,000

EXPENSES	1995	1994
Interest Paid On:		
Mem. Savings	415,000	365,000
Members Dep.	39,000	31,000
Housing Loan	56,000	42,000
Operational Expenses:		
Staff wages	108,000	91,000
Honorarium	27,000	21,000
Travel & Mtgs.	23,000	17,000
Bank Charges	16,000	12,000
Rent	36,000	36,000
Annual Gen Mtg	32,000	29,000
Stationery	17,000	16,000
Education	42,000	28,000
Depreciation	1,000	1,000
Surplus	76,000	154,000
TOTAL	877,000	810,000

4.8.5 Case Study Questions:

1. By what amount did the liabilities and capital of the society increase over the past year?

2. What were the major sources of this increase in money available to the society?

3. Which of the society's assets increased in the past year?

   Which ones decreased?

4. Did the society generate a surplus or a loss in 1995? Was that bigger or smaller than its surplus the previous year?

5. What are the major sources of income for the co-operative?

6. What are the largest expense categories?

7. What were the total expenses in 1995? - in 1994?

8. Rather than list a long list of expense items on the financial statement, it is helpful to organize them into categories. Give an example of a set of expense categories that could be used in this case.

5. The Analysis and Interpretation of Financial Statements

5.1 Introduction :

The information contained in a financial statement is only of benefit when it is analysed and interpreted such that the significance of the numbers and their implications for the society's operations become clear to decision-makers.

Financial analysis therefore is that part of the financial management process that converts large amounts of raw financial data into a form helpful for decision making. This usually requires the identification and calculation of summary indicators of enterprise performance. Just as the health of a person can be partially extrapolated from key indicators such as temperature, blood pressure, weight/height ratio, etc. the health of an enterprise can be deduced in a similar manner.

The three main techniques of financial analysis are:

- trend analysis: the comparison of the same indicator between two points in time;
- common size analysis: the reduction of groups of data to a selected base; and
- ratio analysis: establishing the mathematical relationship between two different indicators.

For all three techniques, a key element of financial analysis is not just calculating the figures, but comparing them to a set standard. This standard may take many forms:

- a target set by the Board of Directors: for example that members shares reach Rs. 250,000 by year end;
- a guideline set by the National Union: for e.g. that liquidity be maintained at 15% of total assets; or
- a legal requirement by government authorities: for e.g. that reserves equal the total value of delinquent loans.

4.2 Trend Analysis:

Trend analysis is a measure of the change in an indicator between two points in time. It is probably the most common form of financial analysis, and is usually stated as a percentage change since last year.

The mathematical calculation is as follows:

$$\frac{\text{Amount this year - Amount last year}}{\text{Amount last year}} = \text{\% change}$$

Example of Trend Analysis : 1994 Total Income: $150,000
1995 Total Income: 200,000

$$\frac{200{,}000 - 150{,}000}{200{,}000} \times 100 = \frac{50{,}000}{200{,}000} = .25 = 25\%$$

The computation may be done for a number of years so as to identify a clear trend. Similarly, trends can be compared between different items (why was the rate of growth of interest income slower than the growth rate of loans disbursed?), or between societies (why was Co-operative A only able to increase savings by 5%, when Co-operative B's savings increased by 20% in the same period?)

5.3 Common Size Analysis:

Common size analysis can be applied to both Balance Sheets and Income and Expenditure Statements. In both cases, a base figure is identified, and all the other figures in the statement are then quoted as percentages of that figure. For the balance sheet, the base amount is the figure for Total Assets. For the Income Statement, the base figure is usually the figure for Total Income.

5.3.1 Common Size Analysis of the Balance Sheet: In the example below, all of the Balance Sheet figures for two year-end statements have been calculated as percentages of Total Assets.

	1994	%	1995	%
Liabilities and Capital				
Federation Loan	70,000.00	22	35,000.00	9
Members shares	50,000.00	15	60,000.00	15
Members savings	170,000.00	53	250,000.00	63
Reserves	9,000.00	3	15,000.00	4
Retained surplus	24,000.00	7	36,000.00	9
Total Liab. & Cap.	323,000.00	100	396,000.00	100
Assets:				
Cash	10,000.00	3	58,000.00	15
Loans	160,000.00	50	200,000.00	50
Fixed assets	113,000.00	35	110,000.00	28
Investment	40,000.00	12	28,000.00	7
Total Assets	323,000.00	100	396,000.00	100

The Common-size analysis of the balance sheet can be helpful in assessing the general liquidity situation of the society, and also the asset-liability mix. Some national federations have established guidelines for the society's asset mix. For example:

A Proposed Asset Mix		
Cash:	5 - 10	%
Investments:	15 - 20	%
Loans:	60 - 75	%
Fixed Assets:	5 - 10	%

5.3.2 Common Size Analysis of the Income and Expenditure Statement:

A common size analysis of the income and expenditure statement uses the Total Income figure as the basis of calculation. All other items in the statement are expressed as a percentage of Total Income, and thereby become much more easily compared and assessed. An example follows:

Income	1994	%	1995	%
Interests on loan	120,000.00	83	130,000.00	79
Service charges	10,000.00	7	10,000.00	6
Stationary sales	5,000.00	3	10,000.00	6
Investment income	10,000.00	7	15,000.00	9
Total Income	145,000.00	100	165,000.00	100
Expenses				
Salaries & wages	30,000.00	21	40,000.00	24
Interest on savings	70,000.00	48	85,000.00	52
Depreciation	7,000.00	5	5,000.00	3
Risk management	8,000.00	6	10,000.00	6
Electricity	2,000.00	1	2,000.00	1
Total expenses	117,000.00	81	142,000.00	86
Surplus	28,000.00	19	23,000.00	14

The common size analysis of the income and expenditure statement provides management with useful information about the respective income generating and cost-incurring elements of the society's operations. Many Federations set guidelines for their affiliates,

based upon the experience of their most successful societies. Such guidelines may indicate that a particular allocation of expenses tends to be the most effective for successful growth. For example:

PROPOSED ALLOCATION OF EXPENSES (as a percentage of total income)	
Cost of funds:	40 - 50%
Staff costs:	15 - 20%
Security costs:	12 - 18%
Facility costs:	10 - 15%
Operational costs:	8 - 12%
Democracy costs:	5 - 10%

If these figures are monitored by the management of both the society and district or national union, then significant variations from the proposed guidelines can be quickly identified, explanations sought, and remedial action taken as necessary.

5.4 Financial ratios:

Another way of analysing financial statements is to directly relate distinct items through the use of ratios. These ratios can reveal the relationships between different elements of the co-operative's financial operations. Not unlike trend and common size analyses, the application of ratios is meaningful only if standards of performance are identified that enable managers to interpret whether performance is satisfactory or requires remedial action.

There are an unlimited number of possible ratios: the key is to identify, calculate and monitor those that are most relevant to the society. These can then be monitored on a regular basis. A proposed selection of key ratios for savings and credit co-operatives is provided below:

5.4.1 Liquidity ratios: As noted previously, liquidity is the ability of the society to meet current demands for loans. Liquidity ratios determine cash and liquid assets are adequate to meet loans demands and other immediate demands such as members withdrawals or employee wages. Key liquidity ratios are:

a) **Loans to savings ratio:** This ratio measures the extent to which members savings are channelled back to members as loans. It is calculated simply by dividing Total Savings (including shares and deposits) into Total Loans Outstanding.

$$\frac{\text{Total Loans Outstanding}}{\text{Total Savings}} = \frac{750,000}{1,000,000} = 75\%$$

A ratio higher than the acceptable standard might indicate liquidity problems, loan delinquency, heavy withdrawal of savings, or excessive loan demand. On the other hand, a ratio lower than the standard might indicate excessive liquidity, misapplication of savings, a high savings rate, very low loan demand, or overly restrictive lending practices.

b) **Current ratio:** Is a measure of the society's ability to pay off current obligations. It is computed by dividing current assets by current liabilities.

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{125{,}000}{100{,}000} = 1.25/1.00$$

This calculation is only possible if the information available identifies the terms of the various assets and liabilities. ("Current" is generally identified as maturing within the year.) A ratio greater than 1:1 (eg. a 3:1 ratio) indicates that the society is able to meet its obligations. A ratio less than 1:1 (eg. 0.7:1) indicates that a liquidity crisis is likely.

5.4.2 Earnings ratios:

These ratios indicate the extent to which a society is earning revenue in keeping with its resources and obligations.

a) **Loan Yield ratio:** Also called 'return on loans ratio', this ratio broadly measures the productivity of outstanding loans. It is computed by dividing the Interest Received on Loans by Average Loan Balance. Average loan balance in turn, is calculated as follows:

$$\frac{\text{Opening Loan Balance} + \text{Closing Loan Balance}}{2} = \text{Ave. Loan Balance}$$

Illustration: Loan balance as of January 1 = $450,000
Loan Balance as of December 31 = $550,000
Interest Income generated = $50,000

$$\text{Average Loan Balance} = \frac{450{,}000 + 550{,}000}{2} = \$500{,}000$$

$$\text{Loan Yield} = \frac{\$\ 50{,}000}{500{,}000} = 10\%$$

Clearly, the significance of the loan yield figure will depend upon the interest rate on loans. The yield should ideally equal the interest rate being charged on loans. In the illustration, if the society is charging 12% on loans, then one sixth of the interest due is not being received. The reasons for this requires further investigation. As such, the loan yield ratio can give a reader a quick way of assessing loan delinquency rates without reviewing individual ledgers or delinquent loan schedules.

Similar ratios can be calculated for other income-earning assets such as investments. These will give a good indication of the rates of return being generated on these different asset types. Also, an overall "Return on Assets" can be calculated by combining all Interest Income and dividing by Average Total Assets.

$$\frac{\text{Total Interest Income}}{\text{Average Total Assets}} = \text{Return on Assets}$$

b) **Spread Analysis:** Spread analysis focuses upon identifying the rates of income and expenditure generated by the society. By stating these factors in terms of % rates relative to the total average assets, the operations of a society can be easily assessed and compared with set standards or other societies. For example:

$$\frac{\text{Interest and Dividend Expense}}{\text{Average Total Assets}} = \text{Cost of Funds}$$

$$\text{Return on Assets} - \text{Cost of Funds} = \text{Gross Spread}$$

$$\frac{\text{Operating (Non-Financial) Costs}}{\text{Average Total Assets}} = \text{Net Operating Costs}$$

$$\text{Gross Spread} - \text{Net Operating Costs} = \text{Operating Spread}$$

4.3.3. Loans Quality :

a) **Delinquency Ratio:** The quality of loans is normally determined by the level of delinquency. The delinquency ratio is computed as follows:

$$\frac{\text{Total delinquent loans}}{\text{Total loans outstanding}} = \text{Delinquency Ratio}$$

This ratio is a significant determinant of the health of a savings and credit society. There are various definitions of a "delinquent loan", covering both the length of time required and the amount considered delinquent. A general rule of thumb in co-operative systems is that a loan is considered delinquent once payment is overdue one month. At that time the total amount of the loan is considered delinquent, - not just the overdue payment.

Given the critical importance of the loan portfolio to a savings and credit co-operative, a delinquency rate above the acceptable standard calls for a thorough investigation of loan policy, processing and disbursement procedures, supervision and collection procedures etc., - followed by remedial action.

b) **Delinquent Loans to Reserves Ratio:** A related ratio measures the capacity of a co-operative to absorb loan write-offs with its own funds, rather than placing the members savings and shares at risk.

$$\frac{\text{Value of Delinquent Loans}}{\text{Reserves and Undivided Earnings}}$$

Rather than use the total figure of delinquent loans in the above calculation, some co-operative systems have developed a method of weighting the loss exposure of the society in terms of the length of time that a loan is delinquent. In this format, the loss exposure is calculated as follows:

		LOSS EXPOSURE
(Value of Loans 1 - 3 Months Delinquent)	x 10 % =	_____
(Value of Loans 3 - 6 Months Delinquent)	x 25 % =	_____
(Value of Loans 6 - 12 Months Delinquent)	x 50 % =	_____
(Value of Loans > 1 Year Delinquent)	x 100 % =	_____
Total Loss Exposure	=	_____

Then, $$\frac{\text{Total Loss Exposure}}{\text{Reserves and Undivided Earnings}}$$

If the Loss Exposure ratio is greater than 1 (that is to say, if the Loss Exposure of a society exceeds its Reserves), then that SCC may be obliged to allocate additional funds to its reserves.

5.4 Capitalization:

The basic measure of a society's capitalization is the debt/equity ratio, in which the amount of funds borrowed from outsiders is compared to the amount of funds contributed by the owners.

$$\text{Debt/Equity Ratio:} \quad \frac{\text{Total External Debts}}{\text{Total Members Equity}}$$

This ratio is a measure of who owns the society. If the ratio is greater than 1 (i.e. 2:1) then obviously the society is mainly financing itself through external sources. This might indicate low savings capacity or low member confidence. If the ratio is less than 1 (i.e. 1:3), then it indicates that the society is relatively self sufficient and generating its funds internally.

In some countries there is a legally imposed or policy standard which dictates a set minimum level of member's capitalization of a co-operative. This may be defined in terms of the debt equity ratio, or as a simple percentage of total Liabilities and Capital.

5.5 Limitations of financial ratios :

Although financial ratios can be helpful sources of information for management decision-making, they do have limitations. First of all, a ratio is no better than the figures from which it is derived. So the base figures must be accurate. Secondly, ratios must be seen in their appropriate context (in relation to other indicators, periods of time, external conditions, etc.). And finally, the standards by which ratios are assessed must themselves be accurate and relevant, and adapted to prevailing conditions.

5.6 Quiz No. Four:

1. What are the three main techniques used in the analysis of financial statements?

2. What different types of standards might be used in conducting financial analysis of the financial statements of a thrift and credit co-operative?

3. What is meant by the expression "asset mix"? Give an illustration.

4. Explain the concept of common-size analysis. Use a diagram to illustrate how it is used.

5. Give an example of a liquidity ratio for a thrift and credit co-operative.

6. What is the formula for calculating loan yield of a co-operative?

7. Explain the concept of spread analysis.

8. What is meant by the term "loss exposure"? How might it be calculated in a thrift and credit co-operative?

9. What are some of the limitations to using financial ratios as the basis for management decision-making?

5.7 Case Study Exercise:

Using the financial statements of Solidarity Savings and Credit Society that were provided in the previous chapter, calculate the following set of financial indicators and ratios.

1. Trend Analysis:

$\frac{\text{Amount this year - amount last year}}{\text{Amount last year}}$ = % change

- MEMBERSHIP: _____ = _____%
- MEMBERS SHARES: _____ = _____%
- MEMBERS DEPOSITS: _____ = _____%
- TOTAL ASSETS: _____ = _____%
- CASH: _____ = _____%
- LOANS TO MEMBERS: _____ = _____%
- INVESTMENTS: _____ = _____%
- FIXED ASSETS: _____ = _____%
- INTEREST INCOME: _____ = _____%
- TOTAL INCOME: _____ = _____%
- INTEREST EXPENSES: _____ = _____%
- TOTAL EXPENSES: _____ = _____%
- SURPLUS: _____ = _____%

2. Common Size Analysis:

2.1 Common Size Analysis of the Balance Sheet:

Assets	1995	%	1994	%
Cash Loans Investments Fixed assets				
Total Assets		100		100

Liab.and Capital	1995	%	1994	%
Loans and Payables Members shares Savings & Deposits Reserves Retained Surplus				
Total Liab. & Cap.		100		100

2.2 Common Size Analysis of the Income and Expenditure Statement

Income	1995	%	1994	%
Interests on loan Investment income Other Income				
Total Income		100		100
Expenses Interest on Deposits Interest on Loans Personnel Expenses Operational Expenses Security Expenses Facility Expenses Democracy Expenses				
Total Expenses				
Surplus				

3. Ratios:

3.1 Liquidity ratios:

a) **Loans to savings ratio:**

$$\frac{\text{Total Loans Outstanding}}{\text{Total Savings}} = \underline{\qquad\qquad} = \underline{\qquad} \%$$

b) **Current ratio:**

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \underline{\qquad\qquad} =$$

3.2 Earnings ratios:

a) **Loan Yield ratio:**

$$\text{Loan Yield} = \frac{\text{Interest on Loans}}{\text{Average Loan Balance}} = \underline{\qquad\qquad} = \underline{\qquad} \%$$

$$\text{Ave. Loan Balance} = \frac{\text{Opening Loan Balance+Closing Loan Balance}}{2}$$

$$= \underline{\qquad\qquad\qquad\qquad} = \underline{\qquad\qquad}$$

b) **Return on Investment:**

$$\frac{\text{Total Investment Income}}{\text{Average Total Investment}} = \underline{\qquad\qquad} = \underline{\qquad} \%$$

c) **Return on Assets:**

$$\frac{\text{Total Interest Income}}{\text{Average Total Assets}} = \underline{\qquad\qquad} = \underline{\qquad} \%$$

d) **Spread Analysis:**

$$\frac{\text{Interest and Dividend Expense}}{\text{Average Total Assets}} = \text{Cost of Funds}$$

_____ = _____ %

Return on Assets - Cost of Funds = Gross Spread

_____ % - _____ % = _____ %

$$\frac{\text{Operating (Non-Financial) Costs}}{\text{Average Total Assets}} = \text{Net Operating Costs}$$

_____ = _____ %

Gross Spread - Net Operating Costs = Operating Spread

_____ % - _____ % = _____ %

3.4 Loans Quality :

a) **Delinquency Ratio:**

$$\frac{\text{Total delinquent loans}}{\text{Total loans outstanding}} = _____ = _____ \%$$

b) **Delinquent Loans to Reserves Ratio:**

$$\frac{\text{Value of Delinquent Loans}}{\text{Reserves and Undivided Earnings}} = _____ = _____ \%$$

3.5 Capitalization:

Debt/Equity Ratio: $\frac{\text{Total External Debts}}{\text{Total Members Equity}}$ = _____ = _____%

4. From the various ratios and statistics you have calculated above, what would you say are the major strengths and weaknesses of the Solidarity Savings and Credit Society? Justify your assessment.

	REASONS/RATIONALE
STRENGTHS	
WEAKNESSES	

. Which of the above areas are ones which you think the society could reasonably tackle in the upcoming year. What is your suggestion for action?

AREA OF CONCERN	PRESCRIBED ACTION

6. FINANCIAL PLANNING FOR CO-OPERATIVE SAVINGS AND CREDIT SOCIETIES

6 .1 Introduction:

A budget is a financial plan showing how resources will be acquired and deployed in a set time period in order to accomplish certain objectives.

Budgeting is thus only one component of the overall planning process within a co-operative. As money is the means to an end for a co-operative and not the end itself, then the financial plan should follow after the broader plan for the organization has been completed.

This broader organizational plan usually comprises three distinct elements:

1. The defining of the organization's mission and vision. The mission is a brief and simple statement of the overall purpose of the organization; from this can be developed a statement of what the organization should look like in the future. This is the vision statement and it too should be brief and simple.

2. The strategic plan of an organization is the plan for the mid to long-term future. Nowadays, in a world of rapid social, economic, political and technological change, the "long-term" is defined as five years or so. Many organizations are therefore elaborating their strategic plans in terms of where the organization will be in the year 2000. These plans are not detailed operational plans, but outline the general strategies, organizational priorities and directions for the next five years. This plan will help the senior management of the organization allocate its scarce resources in a manner which most effectively moves the organization towards its stated vision.

3. Each year, every organization should put in place a detailed operational plan that is elaborated in the context of the broader strategic plan. This plan should have specific and measurable objectives, along with detailed action plans. The annual budget of an organization is developed in terms of this operational plan, as are departmental and individual workplans.

The budget is not only a planning tool to be looked at on the first and last day of each year. A budget can also be an important tool in the on-going management of an enterprise, particularly in terms of monitoring performance and exercising financial controls. In some co-operatives, budget approval is the source of legal

authorization for management to spend funds. In such cases, the budget must be approved by members at a General Meeting.

6.2 The Budgeting Process:

As explained above, a useful and realistic budget for an organization can only be elaborated in the context of the larger operational plan. The annual planning process of savings and credit co-operatives generally comprises the following process:

1. Review and confirm organization's mission and vision.

2. Review strategic plan; note progress made to date on strategic priorities and directions.

3. Review accomplishments and shortcomings of last year's operational plan. Identify priority areas for action.

4. Conduct situational analysis: assess forces in the external environment and factors in the internal environment. Identify priority areas for action.

5. Set organizational and operational objectives. Elaborate simple plans and cost estimates.

6. Elaborate detailed budget in keeping with above objectives and estimates.

7. Assess budget realism: confirm or adapt operational and financial objectives accordingly.

8. Adopt operational plan and budget.

9. Begin implementation and monitoring process.

Although operational and financial plans can technically be elaborated by only a small group of people, general management and co-operative practice advocates making the process as participatory as possible. This ensures that ownership of the plan is shared by all in the organization and enhances commitment to achieving the set objectives.

In savings and credit co-operatives this commitment to a participatory process usually translates into involving members in the setting of mission and vision statements; Directors in the setting of strategic and operational objectives; and management and general staff in the elaboration of the plan specifics. This broadly-based process also ensures that the plan and budget is understood by as many as possible.

In the sections that follow, the steps of the budgeting process are outlined in sequence.

6.2.1 Step 1: Taking Stock:

This comprises two activities; firstly, a review of last year's performance compared to plan targets and budget projections. This is followed by an analysis of the current situation. The situational analysis should include an assessment of:

a) forces in the external environment (eg. economic trends, legislative change, new players in market, etc.); and

b) factors in the internal environment (membership, financial position, staff relations, policy issues, etc.).

From this review, and keeping in mind the organization's long-term strategic plan, a set of priority areas for action are identified.

6.2.2 Step 2: Setting Financial Objectives:

Once the Board and Management have completed their year-end review and situational analysis, they establish a set of priorities for the upcoming year. These priorities must be translated into specific operational and financial objectives. Sometimes the Board does this task itself; sometimes it is delegated to the co-operative's management staff.

To be effective, such objectives should be "smart", that is:

S = Specific (the nature of the desired change)
M = Measurable (the extent of change)
A = Achievable (realistic but challenging)
R = Result oriented (describe outcome of action)
T = Time bound (when change will occur)

It should be noted than an evaluable objective does not state how the desired change will be accomplished. Specifying solutions at this early stage only hinders thinking about possible alternatives.

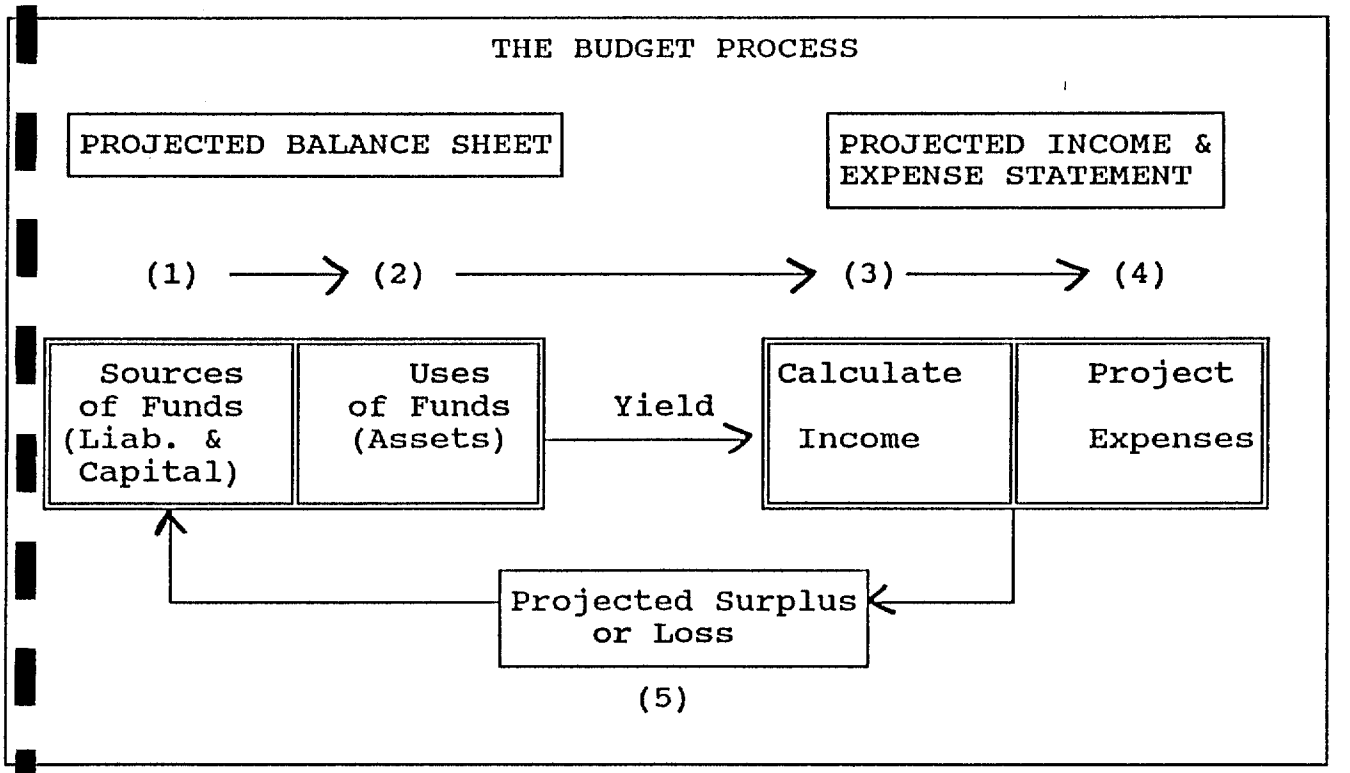
6.2.3 Step 3: Developing Action Plans:-

This is described as the tactical planning stage of financial planning. At this stage the personnel (staff and/or volunteers) responsible for achieving the set objectives identify and assess the alternative courses for action to reach these targets. The Manager must then oversee the consolidation of these various action plans into a realistic plan for the entire organization. Setting unrealistic objectives or assigning unreasonable workloads is not

helpful to organizational development.

5.6 Step 4: **Developing the Budget:-**

At this stage a preliminary budget is developed. In keeping with the flow of funds in a savings and credit co-operative (see Figure X, above), the budget is developed in a step-by-step, logical sequence, beginning with the balance sheet and then moving to the income and expenditure statement.



Worksheets for a budgeting exercise are provided as an appendix to this document.

6.2.5 Step 5: **Approving the Budget:-**

Once all the various budget figures are calculated, a narrative summary is generally provided, highlighting the main issues. For example, elaborating the budget may have shown certain operational objectives (like building an office extension) to have been unrealistic. This report is then provided to the Directors before the end of the year so that they can make the final decisions prior to presenting the budget to members at the Annual General Meeting.

Unfortunately, some co-operative managers and Boards view the annual budget as a public relations exercise, rather than as a realistic plan to guide management. In fact, a budget should meet the following criteria before being approved:

i) Relationship to strategic plan: does the budget contribute to the society's long-range objectives?

ii) Realism: is the budget realistic, considering past trends and experience?

iii) Progressive:- is the overall plan progressive enough to provide targets worth aiming at?

iv) National standards: does the plan work towards the objectives of the national savings and credit movement?

v) Services: does the plan take advantage of all opportunities to improve services to members?

6.2.6 Step 6: **Implementation:-**

Implementing the approved budget is the responsibility of the manager. Here, effective communication is vital. Employees must be made aware of their responsibilities and management's expectations of their achievements.

6.2.7 Step 7: **Monitoring Budget Performance:-**

A well prepared budget provides a useful standard against which performance can be monitored and controlled. Monitoring involves comparing the actual results with the budgeted so as to identify variance (divergence) from the plan. This gives rise to the practice of "management by exception", in which budget monitoring focusses upon those line items where the variances between budget and actual is considered unacceptable (for eg. + or - 10%). The remaining items are reviewed only fleetingly.

If it becomes apparent during the monitoring process that the entire budget is no longer workable due to some unforeseen development, it may be found necessary to conduct a complete revision. In some co-operatives, a complete revision of the budget requires approval of a general membership meeting; in others it can be conducted by the Board and management.

6.3 Quiz No. Five:

1. How would you define a budget?

2. What are the three main elements of an organizational plan?

3. In which of these three does the budget fall?

4. What are the two aspects of an organization that you must study in the preliminary stage of situational analysis (taking stock)?

5. What is meant by the expression "a smart objective"?

6. Describe the sequence of steps taken when the numbers are being inserted into the first draft of the budget. (Which numbers are compiled first, which second, third, etc.?)

7. What are some of the criteria for approving, amending or rejecting a budget?

8. "A budget is an optimistic and probably unattainable projection of a co-operative's finances, prepared by the Board of Directors to make themselves look good before the members". Agree or disagree?

6.4 Case Study:

The Board of Directors of Solidarity Savings and Credit Society have just had their annual planning meeting. They have set the following targets for 1996 and propose the following policy changes.

Assume that you are the manager of the society. Using the budget worksheets provided in the Appendix, prepare a draft budget for 1996.

What follow-up recommendations would you make while presenting the draft budget to the Board?

Board Targets for Year-end 1994:

- to recruit 500 new members through an education campaign that will cost Rs. 15,000.
- to reduce loan overdues by 30%
- to increase loans to members to 80% of total assets
- out of the year-end surplus, to pay at least 10% dividend on shares, and allocate Rs. 50,000 to a Building Fund.

Board Proposed Policy Changes for 1996:

- to increase the minimum savings rate to Rs. 25 per month.
- to increase the monthly honorarium for group leaders from Rs. 25 to Rs. 35

Other Factors:

- due to tightening financial constraints at FACT, beginning in mid-year 1996, the Savings and Credit Society will be obliged to start contributing to the cost of field services. This will be introduced as a service charge of Rs. 250 per month per field worker.

APPENDIX 1

MONTHLY CASH FLOW PROJECTION
_____ THRIFT AND CREDIT CO-OPERATIVE

1. CASH RECEIPTS	J	F	M	A	M	J	J	A	S	O	N	D	TOTAL
SHARES													
SAVINGS													
DEPOSITS													
LOAN PAYMENTS													
INTEREST INCOME													
INVESTMENT INCOME													
OTHER INCOME													
TOTAL RECEIPTS													

2. CASH DISBURSEMENTS	J	F	M	A	M	J	J	A	S	O	N	D	TOTAL
SHARE WITHDRAWAL													
SAVINGS WITHDRAWAL													
DEPOSITS WITHDRAWAL													
LOANS DISBURSED													
INVESTMENTS MADE													
EXPENSES PAID													
PURCHASES OF ASSETS													
TOTAL DISBURSEMENTS													

3. CASH BALANCE	J	F	M	A	M	J	J	A	S	O	N	D	TOTAL
OPENING BALANCE													
PLUS RECEIPTS													
CASH AVAILABLE													
LESS DISBURSEMENTS													
CLOSING BALANCE													

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APPENDIX 2

SAVINGS AND CREDIT CO-OPERATIVE BUDGET WORKSHEETS

NAME OF CO-OPERATIVE: _____

1. TAKING STOCK:

1.1 MAJOR ACHIEVEMENTS OF SCC IN THE PAST YEAR:

1.2 MAJOR SHORTCOMINGS OF SCC IN PAST YEAR:

1.3 MAJOR EXTERNAL FACTORS THAT WILL AFFECT SCC PERFORMANCE IN THE UPCOMING YEAR:

1.4 MAJOR INTERNAL FACTORS THAT WILL AFFECT SCC PERFORMANCE IN THE UPCOMING YEAR:

2. SPECIFIC OBJECTIVES FOR THE YEAR:

1. PROJECTED BALANCE SHEET:

1.1 LIABILITIES AND CAPITAL

	BEGINNING OF YEAR	END OF YEAR	AVERAGE
MEMBERS SHARES			
MEMBERS SAVINGS			
MEMBERS DEPOSITS			
BORROWED FUNDS			
GENERAL RESERVE			
OTHER RESERVES			
RETAINED SURPLUS			
CURRENT SURPLUS			
TOTAL LIAB & CAP			

1.2 ASSETS

	BEGINNING OF YEAR	END OF YEAR	AVERAGE
CASH IN HAND			
SAVINGS ACCOUNT			
LOANS TO MEMBERS			
INVESTMENTS			
FIXED ASSETS			
TOTAL ASSETS			

3. PROJECTED INCOME AND EXPENDITURE STATEMENT:

3.1 PROJECTED INCOME

	PROJECTED YIELD AS %	AVERAGE BALANCE	INCOME
CASH IN HAND			
SAVINGS ACCOUNT			
LOANS TO MEMBERS			
INVESTMENTS			
FIXED ASSETS			
TOTAL INCOME			

3.2 PROJECTED EXPENSES

3.2.1 FINANCIAL COSTS:

	AVERAGE BALANCE	INTEREST RATE	COST
DEPOSITS			
SAVINGS			
SHARES			
BORROWINGS			
TOTAL FINANCIAL COSTS			

3.2.2 OTHER COSTS:

	LAST YEAR	COMMENTS	PROJECTED COST
PERSONNEL			
FACILITIES			
OPERATIONS			
SECURITY			
DEMOCRACY			
TOTAL COSTS			

4. SUMMARY OF INCOME AND EXPENDITURE:

TOTAL PROJECTED INCOME: _____

FINANCIAL COSTS: _____

OTHER EXPENSES: _____

TOTAL EXPENSES: _____

PROJECTED SURPLUS/LOSS: _____

PROJECTED SURPLUS/LOSS ON BALANCE SHEET _____

DIFFERENCE _____

5. CONCLUDING COMMENTS: (Particularly re need for re-working objectives, plans, or budget to improve fit.)