Financial Performance Monitoring: A Guide for Board Members of Microfinance Institutions

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Financial Performance Monitoring: A Guide for Board Members of Microfinance Institutions

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INTRODUCTION

The microfinance industry has significantly grown and matured in the past decade. Microfinance has received global attention from donors, the development community, politicians, and the media as a part of the solution to reducing poverty. Aside from the proliferation of microfinance institutions (MFIs) of all types in all regions of the world, there has been a movement to "formalize" MFI operations. Nonprofit organizations and nongovernmental organizations (NGOs) have separated financial operations from other development services in an attempt to make financial operations sustainable. A number of NGOs have opted to become regulated financial institutions under new laws that enable MFIs to operate as specialized banks or nonbank financial institutions, thus joining the ranks of credit unions as regulated or semiregulated financial service providers. Pioneer microfinance banks have begun to expand services and achieve client levels previously unknown.

Microfinance networks and donor organizations have responded to these changes. The focus of technical assistance has gone from training on standardized credit principles to standardized financial reporting and other MFI management tools. As the industry continues to formalize, governing bodies such as boards of directors will play an important role. This requires those who govern MFIs to be capable of understanding the advances in the industry.

Among the many responsibilities of a board of directors is monitoring performance. In the case of financial institutions, board members must be capable of monitoring financial performance.

"A good board member asks questions—including financial questions." [1]

To be more precise, a good board member must ask *relevant and timely* financial questions that assist the board in making decisions. For many board members of MFIs, especially those who have limited experience in microfinance or are new to the board, it is not always easy to know what questions to ask or when to ask them. Board members do know whom to ask; management answers the board's questions. However, if questions are asked too late, or do not address crucial issues, important information might never be shared—not necessarily out of lack of transparency, but out of lack of preparedness of board members.

In order to ask relevant and timely financial questions, board members of MFIs need to be familiar with performance monitoring techniques. This requires that the board have a basic understanding of the key quantitative and qualitative information needed to govern an MFI.

The Financial Services Working Group (FSWG) of SEEP has developed several documents related to performance monitoring and financial analysis, including a paper on financial ratio

[1] "Understanding Nonprofit Financial Statements," John Paul Dalsimer, National Center for Nonprofit Boards Governance Series, 1996, p. 2.

analysis for MFIs and a paper on SEEP members' performance monitoring tools.[2] The good news is that most network organizations take performance monitoring very seriously and have developed numerous tools to gather important financial data from affiliated MFIs. In addition, both affiliates and network organizations have begun to include similar information and financial ratios in their tools. The bad news is that there is still no standard format for reporting, and aside from some of the key information and ratios, there continues to be disagreement among MFIs, networks, and donors as to what information or which data are important, which ratios are the most relevant, and how those ratios should be calculated.[3]

PURPOSE OF THE MANUAL

The purpose of this manual is to build on the work of FSWG by providing a tool for MFI board members to aid them in understanding the role of financial performance monitoring as part of governance. The manual also introduces the reader to the key elements of monitoring financial performance. After all, it is the board's responsibility to secure a successful future for its organization, taking advantage of opportunities and warding off threats. In order to accomplish this, board members must know how to analyze financial performance data and understand what that data reveal about the MFI's future.

THE AUDIENCE

This manual is intended to be used by members of the governing body of an MFI, such as a board of directors, an assembly, an executive committee, or a group by any other name that is tasked with governance or oversight. Throughout this document, the governing body is referred to as a board and its participants as board members.

Not all boards are the same, and not all responsibilities of board members are equal. Some boards have a treasurer and/or a finance committee that is more focused on financial matters than is the rest of the board. However, this manual is meant to be useful to the entire board of directors and assumes each member's willingness to take on the responsibility of monitoring the financial performance of the MFI—even if that implies some training.

WHAT THIS MANUAL IS NOT

Although overall board responsibilities are addressed in Chapter One, this manual is not a comprehensive guide to MFI governance. MFIs have different missions and visions and varying legal structures and stakeholders. This manual does not address the board's role in

[2] "Financial Ratio Analysis of Microfinance Institutions," SEEP Financial Services Working Group, The SEEP Network, 1995, and "SEEP's Financial Services Working Group Performance Monitoring Project," Warren Brown, Tony Sheldon, and Charles Waterfield, The SEEP Network, 2000.

[3] There is a movement toward standardizing the terminology and definitions of key financial ratios, led by MicroRate and including PlaNet Finance, The MicroBanking Bulletin, CGAP, the Inter-American Development Bank, and the U.S. Agency for International Development.

monitoring social goals or client impact, or its duty in representing stakeholders of the institution. It does not discuss board formation, training, or management. These aspects of governance are important, and boards are encouraged to seek other resources to develop systems for analyzing these areas (see Annex 5 for a resource list).

The premise of this manual, however, is that all MFIs are concerned with financial performance and that financial performance is one of the institution's primary goals.

This manual is not a financial analysis handbook. While the concepts of financial analysis are discussed, including financial ratios, it will not train the reader how to be an analyst. Rather, it offers suggestions on what a board member should look for when presented with financial statements and ratios, and introduces different methods of financial analysis.[4] That being said, board members may be asked to think like an analyst in order to better understand what questions they should be asking of management.

This manual does not provide "right" or "wrong" answers; rather, it explains how a board can distinguish between information that makes sense and reveals positive trends that further the goals of the MFI and answers that do not make sense or that may signal trouble ahead.

How the Manual Is Used

SEEP envisions that this manual will be accompanied by a training session for the board, tailored to meet the MFI board's particular needs. The training would be a hands-on session, utilizing the MFI's own financial data, and would include some or all of the exercises and activities detailed in the annexes of this guide.

If that is not the case, the reader may wish to complete the exercises as he or she reviews the manual (the relevant exercises are indicated at the end of each chapter). Ideally, the reader would complete the exercises with other board members, to facilitate the exchange of ideas. To complete the exercises in the annexes, the reader will need to have:

- Financial statements from their MFIs (at a minimum, income statement, balance sheet, and portfolio report) for the two most recent reporting periods;
- Business plan (strategic and/or operating plan);
- Annual budget and a report on actual expenditures to date;
- Activity report for two most recent periods, including number of actual clients, employees, branches, and other relevant information; and
- A calculator.

[4] Board members interested in learning financial ratio analysis should review *Financial Ratio Analysis of Microfinance Institutions,* a paper available from The SEEP Network.

After reviewing the manual, the reader may wish to present a list of required information to MFI management to determine which statements are available in which format. The more recent the statements are, the more relevant the exercises will be. The reader should not despair if not all of the statements are available; much analysis can be done with very basic information. In fact, any difficulties faced in finding the information will help identify the financial reporting issues confronting the MFI.

DESIGN AND CONTENT OF THE MANUAL

The manual is divided into four chapters. The first briefly discusses an overall performance monitoring system, highlighting the traditional involvement and responsibilities of an MFI board in maintaining that system. Chapter Two focuses on financial performance monitoring, the core of this manual, and provides detailed information on financial statements, financial analysis, and ratio analysis. Chapter Three discusses financial reporting by management. The fourth chapter briefly discusses the challenges that a board may face in maintaining an adequate performance monitoring system and provides some suggestions on how to address the same. In the annexes are several exercises in financial and ratio analysis to help build the understanding and skills of board members in order to enable them to perform their financial performance monitoring duties. Annex 1 includes a performance monitoring worksheet that will help a board design a performance monitoring system of its own. Annex 2 includes a series of exercises that the board can use to analyze the financial performance of its MFI. Annex 3 contains an example of break-even analysis, and Annex 4 provides a financial reporting checklist. Finally, Annex 5 contains a resource list for more information on financial performance monitoring.

CHAPTER ONE
DEFINING A PERFORMANCE MONITORING SYSTEM

Financial performance monitoring is only part of an overall performance monitoring system. This chapter goes beyond monitoring financial performance and provides tips on designing an effective strategy to monitor the overall performance of an MFI. Many people become confused when talking about a "system." For the purposes of this manual, a system refers to any regular method or procedure for gathering, reviewing, and utilizing information. Such a system might be limited to board reports and board meetings, or might include a more complex arrangement of direct board participation in long-term MFI functions, such as planning, budgeting, auditing, and management review. Regardless, it is important to enumerate and prioritize the objectives of the board in monitoring performance.

Box 1: Some Definitions

Strategic Plan: Process in which institution expresses its mission and goals and then sets out to analyze the market and institutional factors that affect its ability to best serve its clients and meet its objectives.

Operational Plan: Information from strategic plan is used to specify in more detail what the products and services are and how they will meet demand, as well as how the operations will be financed.

Budget: Operational plan is transformed into financial terms with projections of income and expenses and related assumptions.

As mentioned above, not all boards are the same, and they may have different objectives and duties. There are many overlapping areas of board responsibility, but they can be categorized into four main areas of financial responsibility:

- Business planning and budgeting;
- Risk management and oversight;
- Fiduciary responsibilities; and
- Management assessment and accountability.

BUSINESS PLANNING AND BUDGETING

Business planning incorporates two related processes: strategic planning and operational planning.[5] A business plan generally consists of three related documents: a strategic plan, an operational plan, and an annual budget. The business plan is vital for any institution in order to define its market clearly, identify goals and objectives, and provide both quantitative and qualitative measures of success in achieving the goals and objectives. In addition, the business plan should identify resources available to the institution, both human and financial, and how they will be deployed (or raised) to best serve the institution.

Strategic Planning

[5] "Business Planning and Financial Modeling for Microfinance Institutions," Tony Sheldon and Charles Waterfield, CGAP, 1998 (www.microfin.com).

Frequently, boards are involved in the development and/or approval of a strategic plan. Strategic plans are generally developed every three to five years. The strategic plan discusses major issues, such as the institution's vision and mission. The starting point is taking a hard look at the MFI today using a "SWOT" analysis (looking in depth at the MFI's strengths and weaknesses, which are internal, and opportunities and threats, which are external). The plan addresses these internal and external factors and considers the MFI's articulated vision and mission, in order to define the institution's future goals. These goals may be quantitative (such as reaching a set number of clients) or qualitative (such as developing a professional and highly motivated staff). The strategic plan may be accompanied by an overall budget for the same time period, but includes few details. The budget should identify existing and potential financial resources and provide a general guideline as to what level of funding will be necessary to reach the stated goals. It should also include some financial projections, indicating the MFI's level of financial activities in coming years and the predicted growth of the institution.

Strategic plans should be "living" documents. At a minimum, the board should review the strategic plan annually to assess progress toward the stated goals, and update it as required. Many institutions have a "rolling" strategic plan that is updated annually and extended one more year. The board acts as guardian of the MFI's mission and vision and, once the strategic plan is developed, custodian of the MFI's goals.

Operational Planning and Budgeting

The board plays a less-active role in the development of the operational plan, which is usually generated every year by management, than in the formation of the strategic plan.[6] The operational planning process tends to be more "bottom up," such that the MFI's departments or managers define their annual objectives and list the activities required to reach those objectives. The activities state specifically who will do what and when they will do it. The board's role is to approve the plan and to ensure that it is consistent with the strategic plan of the MFI.

Throughout the year, it is the board's responsibility to monitor the progress of the MFI in achieving its annual objectives. Quantitative objectives are, by definition, measurable, and therefore easy to monitor (such as the size of the loan portfolio). In measuring qualitative objectives, the board may need to look at the progress made in the MFI's various activities (such as developing a new loan product).

The annual budget follows from the operational plan, not vice versa. The linkages between the operational plan and the budget should be clear; the plan provides the rationale, describing how the objectives will be achieved and what the assumptions are, and the budget identifies the revenue or expense associated with each activity. The board may use the budget to monitor performance during the year, often quarterly. Boards should make sure to review not only the MFI's expenditures, but also its revenue. This will indicate progress toward

6 Some institutions prefer a two- or three-year operating plan so that they have a fairly detailed plan beyond a single year.

sustainability, and determine not only how well the MFI is controlling its costs, but also how well it is maximizing its revenue. Operating plans frequently contain detailed financial projections. At a minimum, the MFI should seek to project its loan disbursements, loan portfolio, active clients, and deposits (if applicable).

The annual budget and financial projections of the operating plan are vital to financial performance monitoring, as they are the targets against which actual performance should be judged. Board members should have access to the operating plan and annual budget, be familiar with them, and be aware of the MFI's success in achieving the set targets. As obvious as it may sound, it is worth noting that the operational plan and budget should be presented to the board and approved by the board *before* the new fiscal year begins. This discipline will ensure that targets are agreed to beforehand so that no disputes arise later. The board may wish to help management create a simple reporting format that lists the various objectives and/or activities in one column, and a description of the progress made in another column. Similarly, management should provide the board with a budget variance report, comparing actual numbers to budgeted numbers. The approved operational plan and budget, both in format and substance, provide the basis for any variance analysis.

Some questions to consider when reviewing the operating plan are:

- What is the format for the operational plan and the budget? Is it standardized and clear?
- Does the plan reflect the mission and goals of the MFI as articulated in the strategic plan?
- Is the plan realistic? Does is consider both external factors (the market, the economy) as well as internal factors (funding, staff capacity)?
- Does it include a detailed description of activities? Are they linked to specific goals?
- Does it include quantitative targets, such as portfolio projections, clients, and revenue?
- Are the linkages between the operational plan and the budget obvious? Are budget notes provided to explain how the budget reflects the planned activities?
- What is the timetable for the budgeting process, and does it ensure that the budget will be presented to the board and approved before the new fiscal year begins?
- How is success measured for qualitative objectives? Are there planned activities that contribute to the objectives? Is there a timeline or review process for these objectives?
- What are the funding sources, and how likely are they to be available?

RISK MANAGEMENT AND OVERSIGHT

Risk management has received a lot of attention in recent years.[7] In part, this is due to the maturation of the industry and the movement of MFIs toward becoming regulated financial institutions. Regulatory agencies in most countries require that financial institutions have policies and systems in place to assess various types of risks and develop effective methods to manage them. Some MFI networks and other organizations have begun to set up "self-regulatory" or voluntary monitoring systems to ensure adequate risk management. This is particularly relevant in the wake of the near bankruptcy of Finansol, the transformed MFI in Colombia. In addition, recent economic and political upheaval in many countries has led to quick and unexpected currency and banking crises.

The connection between performance monitoring and risk management is most obvious in the area of financial risks, although the board should consider the entire scope of operational risks and strategic risks facing the MFI. This requires the board to consider the MFI's SWOT analysis focusing on weaknesses and threats. Questions regarding risk management include:

- Credit risk—What is the quality of the portfolio? Is the board receiving timely and accurate information on the level of delinquency? What are the relevant patterns/trends? How are the loans collateralized? How adequate are the loan-loss reserves? What is the write-off policy? How are new products developed, and what risks are involved? How is loan growth managed?

- Liquidity/solvency risk—How will current cash obligations be met in a timely and cost-efficient manner? Is the MFI able to meet the demand for loans on a timely basis, or is it frequently delaying disbursement? How are late repayments affecting the MFI's cash flow?

- Investment risk—What is the policy regarding investing excess cash? Are these investments secure? How are banking relationships monitored? Are the banks used by the MFI considered stable?

- Political and macroeconomic risk—How might political changes or economic policies affect the MFI's ability to conduct business? How might they affect clients' businesses? How is the financial sector as a whole affected, and the microfinance sector in particular? What is the regulatory environment and whose interests are represented there? What processes are in place to monitor and analyze the potential impact on the MFI?

- Currency risk—How stable is the local currency? What is the likelihood of currency devaluation? How will that affect clients' ability to repay? How will it erode the equity (or net asset base) of the MFI? How does the MFI reduce its risk associated with any loans or borrowings in a foreign currency or linked to a foreign currency? What will happen if there is a sudden change in the value of the local currency?

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7 See "A Risk Management Framework for Microfinance Institutions," published by GTZ in July 2000, and "Improving Internal Control," by Anita Campion and published by The Microfinance Network with GTZ, also in 2000.

- Asset/liability management risks—Is the interest rate charged to clients sufficient to cover financial and operational costs? How are maturities of assets and liabilities related?

Board members may actually be better informed than the MFI's management as to many of these risks, particularly board members who are active in the local financial sector. **As part of its regular meetings, the board may want to consider providing a brief on the political and macroeconomic risks facing the MFI. This should lead to discussions with management on how to address these perceived risks.** In any case, a mechanism should be put into place to track and analyze these risks so that they may be considered when making decisions.

In addition, a board must consider operational risks caused by internal factors. This oversight role is meant to ensure that internal weaknesses do not cause larger problems, such as high delinquency or fraud. Achieving this oversight role means establishing appropriate policies and mechanisms, including traditional methods of oversight, such as internal and external audits. It is customary for internal and external auditors to report to the MFI board, rather than management. The discussion of an audit program goes beyond the scope of this manual, but many resources exist to help a board design and manage a regular regime of internal and external audits.[8] General questions for a board to consider are:

- Have there been instances of fraud, and what new policies have been implemented as a result?
- Does the internal auditor report directly to the board of directors? How often and with how much detail? Are the planned activities of the internal auditor unknown to staff?
- Does the internal auditor issue regular audit findings to management? Does management act on such findings? Who ensures that corrective measures are taken?
- What are the major internal risks to the institution? Does the internal audit program focus on the areas of greatest risk?
- Does the board approve the external auditor annually? If applicable, have the reasons to change audit firms been fully explained? Does the board review the annual external audit, including the management letter, and ask relevant questions?
- Does the board review financial policies periodically, and are they being followed?
- Are internal controls clearly defined and adhered to?

[8] See "External Audits of Microfinance Institutions: A Handbook," CGAP Technical Tool Series No. 3.

FIDUCIARY RESPONSIBILITIES

A fiduciary is a person or group holding assets in trust on behalf of another person or group. In the case of MFIs, the "another" may be shareholders, donors, a network headquarters, or the clients or members themselves.[9] Regardless, **the board has a fiduciary responsibility to interested parties to ensure the financial health of the MFI. The board should know who those parties are and what they require of the MFI.** In addition to donors, investors, lenders, depositors, and regulators, the MFI should remember that its clients are also an interested party, even if they are not shareholders or members. If the financial health of the institution is not sustained, clients who have come to depend on the MFI for services will no longer have access to them, which could prove disastrous for entrepreneurs.

Box 2: A Report on Reports?

It is usually the responsibility of a board to monitor the quality and timeliness of an MFI's reports to interested parties, such as regulators, donors, or investors. While it is not recommended that boards review each report before it is sent, it is recommended that they monitor reporting activities and review a sample of management's reports on a regular basis. Boards may wish to consider the following:

1. **Design a report on reporting.** Similar to a progress report, this regular report from management would list each report, its recipient, the responsible individual or department, the due date, the completion date, and the number of days late (if any).
2. **Reports in the board report.** The board may want to require that all outside reports be included as an annex in regular board reports.
3. The board may wish occasionally to request **a sample of outside reports** to compare with their own information and verify accuracy and quality. Alternatively, it may request that this be done by the internal or external auditor. At a minimum, the board may simply require free access to these reports.

Although many of the questions relating to fiduciary responsibilities overlap with the ratios discussed in Chapter Two, here are some additional questions:

- How is the overall financial performance of the MFI? What is the profitability/sustainability of the MFI? Is it according to plan? Are expenses excessive?
- What is the asset quality of the MFI? Are the assets (loan portfolio) of the institution generating sufficient returns?
- Are the assets (including loans and cash) being used solely to further the mission of the MFI? Is there any questionable use of assets?
- What reports/filings are required? Who is responsible for compliance, and how is this monitored?
- If the institution has depositors, how does the institution protect against any loss of deposits? What measures are in place to ensure that depositors' money is safe (for example, a reserve requirement for savings)? How does the MFI maintain the confidence of deposits to avoid a run on them?
- Who monitors compliance with loan covenants, contracts, and regulatory requirements? Have there been any recent irregularities?

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[9] Frequently, NGOs have no beneficial ownership such that no individual or group can benefit from the profits or liquidation of the NGO. In some cases, local law requires that the proceeds from liquidation be given to the government or a charity. This does not mean, however, that the NGO board need not consider beneficiaries. On the contrary, the board needs to be clear on whose behalf it is acting and act in the interest of that group or organization.

- Are investors/shareholders compensated adequately? Are policies in place regarding the reinvestment and distribution of profits?

MANAGEMENT ASSESSMENT AND ACCOUNTABILITY

The board's major responsibility is to assess the chief executive officer (CEO). Because the board necessarily depends on management (particularly the CEO) for information, it may be difficult to evaluate objectively a CEO's performance. It is natural for boards to have a cooperative relationship with management. Indeed, the board needs to provide motivation and appropriate support to management so that it *can* achieve its goals. However, the board must also remember that the institution needs to become stronger than its CEO or key managers.

As with monitoring financial performance, it is important for the board to design a management review system such that management is held to clear objectives. This may be facilitated by developing a format for annual performance plans for the CEO (and senior management) with regular and standardized review of management's progress in fulfilling its plans. Such reviews should include candor between the CEO and board, and analytical rigor. For the latter, "Board members must have the analytical skills to pose the right questions and to be incisive in their discussion of institutional performance."[10]

Financial performance monitoring can be part of the management review insofar as management is evaluated on the institution's performance—particularly its performance related to its stated targets. Management should have incentives, financial or otherwise, to achieve stated targets such that management is rewarded (or censured) for the performance of the MFI.

Some questions to help link institutional financial performance with management accountability include:

- How does actual performance compare with historical performance, budgeted performance, and/or industry standards? What are the reasons for any major variances?
- What remedial interventions (such as technical assistance or training courses) are indicated by the challenges the MFI faces?
- Does the CEO receive an annual performance review? Is his or her raise based on performance? Who establishes benchmarks toward annual goals? Are the annual goals reviewed on a quarterly, or semi-annual, basis?

[10] "Principles and Practices of Microfinance Governance," ACCION International, August 1998, p. 9.

Considerations in Designing a Financial Performance Monitoring System

An MFI's reporting requirements depend on local authorities, network organizations, and donor organizations. The findings from SEEP's Performance Monitoring Systems Project highlighted the frustrations of MFI management with the multitude of reports that MFIs must complete to satisfy all interested parties. When designing a performance monitoring system, there are several issues a board should consider.

Existing Reporting or Monitoring Systems

As mentioned earlier, the board should be aware of the reporting requirements of the MFI. **A good starting point in designing a financial performance monitoring system is for the board to do an inventory of existing reporting requirements.** The board should request a copy of each of these different reports and review their content in order to understand what information management already generates. In addition, management should provide a list of reports with due dates so that the board is aware of deadlines. It is possible that management already disseminates much of the information the board requires. Boards may wish to use some of the existing reporting formats to satisfy their own need for information. In addition, they may wish to match the frequency or timing of additional reporting with that of existing reporting. Unfortunately, other interested parties will rarely have the same information needs as a board. As a result, it is unlikely that a board can rely solely on reports to third parties.

MFI Size, Age, and Legal Status

Variables such as MFI size, age, and legal status determine the financial performance monitoring strategy. The findings from SEEP's Performance Monitoring Systems Project show that the local management team of large, experienced MFIs, particularly those that are regulated, is less likely to benefit from the performance monitoring process than is the management team of young, unregulated MFIs. Small MFIs "tend to view the performance monitoring process more positively, as a process of information exchange." [11] A survey of 25 MFIs done by The Microfinance Network in 1998[12] confirms this notion that boards of for-profit MFIs prioritize more "macro" tasks, such as strategic planning and budgeting, while NGO boards focus on assessing management and monitoring the financial status of the institution. A sample of managing directors and board members prioritized the board's responsibilities as follows:

[11] "Performance Monitoring Systems Project," Warren Brown, Tony Sheldon, Charles Waterfield, SEEP, September 2000, p. 13.

[12] "Current Governance Practices of Microfinance Institutions," Anita Campion, The Microfinance Network, October 1998.

Table 1: Board Responsibility Ranking

	Nonprofit MFIs	For-Profit MFIs
Assess management	1	4
Monitor financial status of MFI	2	3
Approve budget	3	2
Conduct a strategic planning exercise	4	1
Review audit reports	5	5

(1 = most important; 5 = least important)

Boards of large MFIs usually have more-established governance systems that focus on the strategic direction and overall performance of the MFI. In short, CEOs of large MFIs are granted significant trust that is commensurate with the CEO's responsibilities. The hiring (or firing) of the CEO and participation in strategic planning become the primary means through which the board influences the MFI. In terms of financial performance, management usually provides complete financial statements to the board, accompanied by financial analysis of its performance.

To fulfill its fiduciary responsibility, it is important that the board be able to evaluate the financial analysis and understand what is behind the numbers. The board may also stimulate dialogue related to risk management and foster a deeper understanding of the opportunities and threats facing the MFI.

Boards of small or new MFIs may fall between two common extremes. In the first extreme, the board is new, inexperienced, and uninvolved, and management is predominant. In the second extreme, the board plays an overactive role in the MFI's management, assisting management in daily operations. Boards of small MFIs place more emphasis on evaluating the CEO and monitoring the financial status of the MFI than do boards of large MFIs. Small-MFI boards tend to rely less on reports and more on personal interaction to understand what is happening at the MFI. Many small MFIs do not produce traditional financial statements, but rather limit their reports to those required by outside sources. It is important for small-MFI boards to recognize that this informal system of governance will no longer function as the MFI grows. **MFIs, even small**

Box 3: Performance Monitoring at CRECER

CRECER in Bolivia is a financial NGO that has an *asamblea,* or board, of 14 members and a *directorio*, or executive committee, of five.

- The *asamblea* meets twice a year to contribute to and approve strategic plans, approve audited financials, consider new members, and review the performance of the institution. All members of the *asamblea* are encouraged to visit the NGO's regional offices and clients.
- The *directorio* meets monthly to review the monthly financial statements and performance reports, review and approve loans to CRECER, select the audit firm, appoint the internal auditor and review the auditor's reports, set the annual performance plan of the general manager and review her performance, approve institutional policies and procedures as documented in manuals, and approve business plans and annual plans.
- The chief executive has cordial and open relations with the members of the *directorio* and the *asamblea,* and can call upon them as needed. The management of CRECER produces monthly income statements, balance sheets, portfolio and activity reports, and projected cash flow for the subsequent six months.

MFIs, should produce basic financial statements and a financial performance monitoring system. Doing so instills a discipline and formality in board–management relations that is necessary in any successful, professional organization.

CHAPTER TWO
FINANCIAL PERFORMANCE MONITORING

MFIs can produce a lot of financial information—sometimes the challenge is not lack of information, but too much. This chapter provides guidance on what information is required for effective financial performance monitoring. It also provides instruction on how such information should be reviewed so that it is meaningful to the reader.

"Because no one can absorb all the details in a financial report, communicating less (but more meaningful information) is sometimes better than simply providing detailed information with no explanation."[13] Narrative descriptions and summaries from management, as well as charts and graphs, can facilitate the review process. Also, standardized reports encourage familiarity and allow quick access to details. Finally, although absolute numbers are necessary to report, they are more meaningfully interpreted when accompanied by ratios, or indicators.

FINANCIAL STATEMENTS

Absolute numbers do tell an important part of the story. Many numbers appear on the financial statements and in accompanying notes. The most common financial statements are:

- Income statement (or profit-and-loss statement)—a summary of financial activities during a period of time;
- Balance sheet—a summary of the MFI's financial condition on a particular date;
- Statement of changes in financial position (or cash flow)—a summary of the sources (inflows) and uses (outflows) of cash; and
- Portfolio report—a summary of portfolio data, including an aging report of past-due loans, reserve calculations, and write-offs.

It is not uncommon for small MFIs to produce financial reports designed by regulators, donors, or networks rather than the above, traditional financial statements. Small MFIs may also produce a combined statement or report for both financial and nonfinancial programs. Much of the same information may be available in these reports. **However, one of the first steps a board should take is to direct management to produce standard financial statements that segregate financial and nonfinancial services. The board must also decide the frequency with which management will provide financial statements.** Although management should be producing monthly financial statements for its own purposes, it is common for management to provide quarterly statements to its board. The

[13] Ibid, p. 20.

reporting period should coincide with the MFI's fiscal year, such that income statements will cover a recently completed fiscal quarter or semester. Ideally, an MFI will provide information on the current period, the prior period, and the cumulative results for the fiscal year to date (for example, the first quarter, the second quarter, and the first semester). Even better would be if the MFI were to provide a statement from the same period from the previous fiscal year so that the board could compare the past year to the current year for the same period.

Warning: Not all MFIs or financial institutions use the same terminology in their financial statements. Net profit to one MFI might be another's net surplus. A loan-loss expense to one might be a provision expense to another. Board members should be aware of what management puts in each line item of its financial statements.

Table 2: Sample Income Statement
(in '000 of local currency)

	FY 2	FY 1
Financial Income		
Interest and fees on loans	21,000	17,000
Interest on investments	500	1,500
Total financial income	21,500	18,500
Less Financial Expenses		
Interest on deposits	500	0
Interest on loans payable	3,200	3,500
Total financial expense	(3,700)	(3,500)
Net financial income	17,800	15,000
Less Provision for Loan Losses	(2,500)	(3,000)
Less Operating Expenses		
Salaries and benefits	6,000	5,000
Administrative expenses	8,300	8,100
Total operating expense	(14,300)	(13,100)
Net Income from Operations	**1,000**	**(1,100)**
Income from grants	7,100	950
Other nonoperating income/(expense)	0	0
Net Profit/(Loss)	**8,100**	**(150)**

Income Statement

As noted above, the income statement is for a period of time, such as a month or a quarter. The income statement may also be referred to as a profit-and-loss statement, as it shows what the overall net profit or net loss was for that period.[14] The basic information required in the income statement or similar report includes:

a) Financial income—all income derived from financial operations (interest and fees on loans made, interest on investments);

[14] MFIs use different terminology for the bottom line of the income statement. Total income less total expenses may be referred to as net profit, net income, net result, or net surplus, among others.

b) Financial expense—all interest paid on liabilities (loans, deposits);

c) Loan-loss provision—the expense related to creating a loan-loss reserve;[15]

d) Operating expenses—all expenses related to providing services (wages, rent, and so on), not including interest expenses; and

e) Grants for operations—all grants received to pay for operating expenses.

In some cases, financial statements may also include:

f) Grants for loan fund—all grants received for loan capital;[16] and

g) Adjustments for inflation and subsidies—an estimate of in-kind contributions (donations of equipment, personnel, and so on) and an adjustment of equity resulting from inflation (see below).

In most MFIs, a), b), d), e), and f) will be readily available. The board may have to make a special request of management for c), loan-loss provision, and g), adjustments.[17] Even if management does provide c) and g), the board should require the MFI to report on how management calculated both of these numbers. (The role of adjustments is discussed further below.) The statements should segregate financial and nonfinancial services, such that all nonfinancial services are included as nonoperating items.

Balance Sheet

The balance sheet captures a single moment in time at the end of an accounting period, such as a month or a quarter. The balance sheet is a vital tool in understanding the current financial position of the MFI because it summarizes what is owed to the MFI and what the MFI owes to others.

Balance sheet accounts include:

- Cash and cash equivalents—cash on hand, sight or demand deposits, checking accounts, and non–interest-paying accounts;

[15] A loan-loss provision is a "noncash" expense item. That means that it does not represent a cash expense or a loss of cash; rather, it is an estimate of what the potential amount of loan losses may be in the coming months. This provision expense on the income statement creates a reserve on the balance sheet against which any actual loan losses will be deducted. In some MFIs, this may represent the actual amount of written-off loans. It is important for the board to understand the difference and for management to provide a clear explanation of how it calculates the potential (or actual) loan losses.

[16] Not all MFIs show grants for the loan fund as an income item. Many treat them as a contribution of equity, similar to the increase in equity when a corporation issues new stock.

[17] "Financial Ratio Analysis of Microfinance Institutions," The SEEP Network and Calmeadow, 1995.

- Investments—interest-bearing deposits and other money market investments;
- Gross portfolio—all loans to clients, including loans past due but not written off;
- Loan-loss reserves—reserves set aside to cover estimated future losses on past-due loans (stated as a negative number);
- Net fixed assets—all physical property owned by the MFI less depreciation (building, vehicles, office equipment);[18]
- Other assets—all other assets not listed above;
- Deposits—all savings accounts held by the MFI for clients (demand deposits, term deposits, and so on);
- Loans payable—all loans to the MFI from third parties (bank loans, including overdraft lines, central bank loans, and concessionary loans from other organizations);
- Short-term liabilities—accounts payable, including accrued interest payable, wages payable, and others;
- Paid-in or donated equity or capital—equity contributions or subscriptions from shareholders, members, donors, or others;
- Retained earnings from prior period—accumulated net income or loss (list as negative) from previous years; and
- Retained earnings from current period—net income or loss from the current year; this should be the same as the bottom line of the income statement.

[18] Depreciation recognizes the use of the fixed asset by amortizing the cost of the fixed asset over its useful life. Net fixed assets are the total of the purchase prices of fixed assets less the accumulated depreciation of the same fixed assets.

Table 3: Sample Balance Sheet
(in '000 of local currency)

	FY 2	FY 1
Assets		
Cash and banks	5,000	2,500
Loans outstanding	84,000	70,000
(Loan-loss reserve)	(7,000)	(5,000)
Net loans outstanding	77,000	65,000
Investments	8,000	7,000
Other current assets	500	1,000
Net fixed assets	3,300	3,700
Total assets	106,300	90,200
Liabilities and Equity		
Deposits	5,000	0
Short-term debt	13,000	12,000
Long-term debt	47,000	45,000
Total liabilities	65,000	57,000
Shareholder equity	40,100	33,000
Retained earnings	200	0
Current year net profit/(loss)	1,000	200
Total equity	41,300	33,200
Total liabilities and equity	106,300	90,200

As the name implies, a balance sheet must balance such that assets = liabilities + equity.[19] Board members should request balance sheets for a minimum of two consecutive periods in order to compare the current financial condition with that of the previous period.

Because a balance sheet is a snapshot of a moment in time (for example, the last day of the month), it is often important to look at averages over time. This helps eliminate any distortions in the balance sheet that may occur. In addition to a standard balance sheet at the end of a period, many financial institutions complete an "average balance sheet" at the end of a reporting period. Boards may request that MFIs provide an average balance sheet based on the average of the beginning and the end of the reporting period or, if possible, based on the daily average balance of accounts.

Statement of Changes in Financial Position (Cash Flow)

Of the three main financial statements, the statement of changes in financial position (or cash flow statement) is the one MFIs are least likely to have. A cash flow statement provides the link between the income statement and the balance sheets from the beginning and end of the reporting period. It includes all of the sources and uses of cash. Usually, it begins with the net income from operations or net profit (the bottom line of the income statement), and then it

[19] For nonprofits, equity is frequently called "net assets" and is defined as assets – liabilities; in other words, it is the same as "equity," which is the terminology used in this manual.

adds back "noncash" expenses such as loan-loss provisions and depreciation.[20] Finally, it adds all other sources of cash (loan repayments, deposits or borrowings, and increases in other liabilities) and subtracts all other uses of cash (such as loan disbursements, withdrawals and loan repayments, and increases in assets).

At a minimum, the board may wish to know the following standard items on the cash flow statement:

- Loan payments received from clients;
- Loan disbursements to clients;
- Deposits made by clients;
- Withdrawals made by clients;
- Borrowings made by the MFI (from banks, and so on);
- Borrowings repaid by the MFI (to banks, and so on);
- Fixed assets purchased by the MFI; and
- Depreciation of fixed assets.

Table 4: Sample Statement of Changes in Financial Position (in '000 of local currency)

	FY 2	FY 1
Net Income from Operations	**1,000**	**(750)**
Noncash Operating Items		
+ Depreciation	1,000	500
+ Loan loss provision	2,500	3,000
Total noncash items	3,500	3,500
Plus Other Sources		
Loan repayments	110,520	75,000
Net increase in deposits	5,000	-
Net increase in borrowings	3,000	31,300
Net increase in other liabilities	-	-
Total other sources	118,520	106,300
Minus Other Uses		
Loan disbursements	(124,520)	(101,500)
Increase in investments	(600)	(5,000)
Purchases of fixed assets	(600)	(3,000)
Net increase in other assets	500	(1,000)
Total other uses	(125,220)	(110,500)
Changes in Equity Position		
+ Stock issued		
- Dividends paid	(2,400)	
Net change in equity	(2,400)	-
Plus grant income	7,100	950
Less net nonoperating expenses	-	-
Net cash flow	2,500	(500)
Beginning cash balance	2,500	3,000
Ending balance	5,000	2,500

[20] Noncash expenses are expenses that are accrued during a period, but that are not actually paid or do not require a cash payment.

The primary reason that companies, including financial institutions, close their doors is because they run out of cash and are unable to make the minimum payments to creditors. With the additional information in a cash flow statement, the board can better understand the other cash outflows (on loan disbursements, repayment of deposits and borrowings, and purchasing fixed assets). Understanding how the MFI generates enough cash to conduct operations is equally important. For growing MFIs, financial income is not enough to fuel growth. Stock issues, grants, deposits, and other borrowings are frequently required to meet the demand for microloans. The board needs to understand how the MFI is financing its growth and what additional sources of funds it may need in the future.

Portfolio Report

The portfolio report is also known as a portfolio aging report or schedule. The basic idea behind a portfolio report is to provide the reader with some detailed information on the condition or quality of the loan portfolio. Because an MFI is made of financial assets, its financial condition depends on the quality of its primary asset; namely, its loan portfolio. The portfolio report states the overall value of outstanding loans to clients. It then groups the outstanding loans into aging categories, based on loans that are current (no overdue payments), past due or delinquent (have overdue payments), and rescheduled or refinanced. Past-due loans are further divided into categories based on how many days past due they are at the time of the report.

It is important to distinguish the value of *past-due payments* from the value of *past-due loans associated with past-due payments*. The former value is generally called late or delinquent payments, whereas the latter is referred to as the portfolio at risk. Management should know how to calculate portfolio at risk. (If it does not, management can refer to *Financial Ratio Analysis of Microfinance Institutions,* listed in the resource section in Annex 5.)

A portfolio report should typically contain the following information (past-due terms may vary; note the slightly different terms in Table 5):

- Value of current loans;
- Value of loans 1 to 30 days past due;
- Value of loans 31 to 90 days past due;
- Value of loans 91 to 180 days past due;
- Value of loans more than 180 days past due (that have not been written off);
- Value of loans written off; and
- Value of reserves and percentage of certain past-due loans that it covers (or percentage of reserves required by the MFI or regulatory agency).

Usually, the report will provide the value of loans in each category. It will also state the number or percentage of loans in each category to the value of total loans outstanding (see Table 5). This allows the reader to see quickly what percentage of loans falls into each aging category, to gain a sense of the quality of the loan portfolio.

Table 5: Sample Portfolio Report
(in '000 of local currency)

			FY 2	FY 1
Total value of loans disbursed			160,000	130,000
Total number of loans disbursed			1,600	1,300
Number of loans outstanding			1,800	1,500
Value of loans outstanding			84,000	70,000
Average outstanding loan balance			75,000	61,000
Value of payments in arrears			7,000	9,000
Value of outstanding loan balance in arrears			18,000	20,000
Value of loans written off			500	700
Average initial loan size			100	100
Average loan term			12	12
Average number of loan officers			6	6
Aging Report	**No. of Loans in Arrears**	**Outstanding Balance**	**Loss Reserve Requirement**	**Loan-Loss Reserve**
31 to 60 days past due	200	8,750	10%	875
60 days past due	75	5,000	50%	2,500
90 days past due	60	2,500	75%	1,875
> 180 days past due	25	1,750	100%	1,750
Total	360	18,000		7,000

In addition, board members may wish the same portfolio report to include such data as:

- Value of disbursements;
- Number of disbursements;
- Number of loans outstanding;
- Average value of a disbursement;
- Average loan outstanding;
- Number of active borrowers; and
- Number of new clients.

Not all MFIs use the same aging categories as listed above; the categories listed above are recommended by SEEP and CGAP, and are frequently required by most donors. Indeed, regulations may dictate the aging categories that MFIs must use. Regulations may also provide guidance on loan write-offs, instructing institutions to write off loans after a specific period of nonpayment. It is important that the board be aware of local regulations and make sure that the policies of the MFI are at least as conservative as the law requires. In many cases, the board may adopt a more conservative policy if it believes that local regulations are insufficient.

FINANCIAL ANALYSIS

Financial analysis is the art of interpreting financial statements and other data. It is also "a disciplined method of looking at the future, since that's where the payoff of today's decisions will occur. It is this future orientation that most differentiates financial analysis from accounting."[21] Board members can learn quite a bit about the MFI just from reviewing its financial statements for a given period. What is important, however, is to know how past performance may affect the future.

In recent years, reporting standards have improved significantly for all financial institutions. Board members now receive more reliable information than in the past. Still, some financial analysis is necessary to understand the story behind the numbers. An income statement will reveal whether an MFI has a net profit or a net loss for a period, but not why. The balance sheet may show that the MFI has 50 percent of its assets in the loan portfolio, but it will not reveal why it is 50 percent or if 50 percent is an acceptable financial position for the MFI.

Board members should review each of the statements available to them. At a minimum, they should consider the following upon first review:

- What period do the statements cover?
- Did the MFI have a net profit or a net loss for the period? What are the major revenue and expense items? Does the income statement tell the story of how the MFI earned its revenue and spent it?
- Does the balance sheet include assets, liabilities, and equity? Does it balance?
- What are the assets of the MFI? Does the distribution of assets reflect the activities of the MFI?
- What are the liabilities of the MFI? Who are the MFI's major creditors?
- Where does the equity of the MFI come from? How much equity is there?
- What are the major sources and uses of cash? Does the MFI seem to be using its cash wisely?

Initially, the board may find that the financial statements raise more questions than they answer, particularly if they are not accompanied by an analysis from management. The board should not shy away from asking why the MFI is performing as it is. As the board becomes accustomed to analyzing financials, it will be able to recognize the story behind the numbers

[21] *The Cates Bank Risk Analysis Course: A Systematic Approach to Bank and Bank Holding Company Analysis; Book 1*. p. 6.

on its own (see Exercise 2 in Annex 2 for an exercise in analyzing a single period's financial statements).

Trend Analysis

Trend analysis is the examination of a company's financial performance and ratios for several accounting periods to determine changes in its financial position. It is best to compare two or more periods of the same length of time (a year with a year, or a quarter with a quarter, for example). The reader should look for trends, such as increases or decreases in the important line items. Some important questions to ask for each statement are as follows:

Income Statement

- Is financial income increasing over the previous period? If so, is it due to higher loan volume or higher interest rates? If not, is it due to seasonal fluctuations?
- What is the trend in interest paid? Is it similar to the trend in financial income? Is the financial margin (financial income – interest paid) growing or shrinking?
- Are the other sources of income growing? Is the MFI's dependency on nonfinancial income growing?
- Are expenses growing at the same rate as revenue? If they are growing faster than revenue, why? How sustainable is this trend?
- Is the MFI covering its operating costs through its own revenue? If not, is it covering more of its expenses than in the previous period?
- Is the MFI's bottom line growing or shrinking?

Balance Sheet

- Are most of the MFI's assets in the loan portfolio? Are more in the loan portfolio now than in prior periods? Why?
- Does the MFI experience any seasonal fluctuations in lending? If so, how are they identifiable in this balance sheet?
- Are there any unusual increases in other assets, such as fixed assets or accounts receivable? Why?
- What is the growth in costing funds (deposits, loans payable to others)? Does this growth reflect the strategy of the MFI?

- Is there any unusual increase in other liabilities? Why?
- Is equity growing in absolute terms? Is it growing as a percentage of assets?

Cash Flow Statement

- Is the MFI continuing to invest most of its cash resources in loan disbursements?
- Are loan repayments following the same trend as loan disbursements?
- Are there any major changes in either the sources or the uses of cash over the previous period?

Portfolio Report

- Is asset quality improving or declining? Why?
- Has there been any major change in restructured loans? What is the cause?
- Compare the aging accounts from the current period with those of the previous period. Does it appear that delinquent loans are moving from one aging category to the next (that is, from 30 days past due in the prior report to 90 days past due in the current report)?
- Compare current write-offs to past-due loans in the prior period. Is the MFI eventually writing off many of its delinquent loans as opposed to collecting them? Are write-off policies being implemented properly and in a timely fashion?

In the following section, trend analysis will be revisited in the discussion of financial ratios.

RATIO ANALYSIS

Meaningful analyses result from dividing one number by another, or calculating ratios (indicators), rather than from merely reviewing absolute numbers. Any two numbers can be made into a ratio, but some are obviously more meaningful than others. Many indicators for MFIs have become so common as to be considered industry benchmarks. The reader should beware, however; sometimes, basic math plays tricks on us (for instance, if one is starting from zero, growth cannot be calculated, because dividing by zero is impossible). Readers are advised to use common sense to judge whether a ratio seems reasonable or not.

The following section highlights several key ratios.

Understanding the common performance indicators and then choosing which indicators should be tracked for a particular MFI are the subject of this section. (The subsequent section discusses how to interpret the indicators.) The indicators have been grouped into five categories:

- Profitability and sustainability,
- Efficiency and productivity,
- Portfolio quality,
- Growth and outreach, and
- Financial structure.

Profitability and Sustainability Indicators

Profitability and sustainability ratios are the most comprehensive of the ratios here, and reflect the ability of the MFI to continue operating in the future. It makes no difference whether the MFI is nonprofit or for-profit; all reputable MFIs are striving for sustainability, and investors and donors look for those institutions with sustainability potential.

There are five basic profitability/sustainability ratios:

- (Adjusted) return on assets—measures the net operating income as a percentage of average total assets. It reveals how well the MFI uses its assets to generate a profit. For every dollar of assets, how many cents (or dollars) does the MFI generate?

- (Adjusted) return on (ROE)—measures the net operating income as a percentage of average total equity (or net assets). In a for-profit company, this is the most important ratio; equity is the most prized form of financing because it can be used for any purpose. Equity contributors or shareholders monitor the company's ROE to determine what the company's returns will be on its equity investment. In a nonprofit organization, the ratio becomes less meaningful, as most equity is contributed and no returns (or dividends) are paid to the contributors. Still, the ratio reveals how well the nonprofit has used its contributions.

- Operational sustainability—also known as operational self-sufficiency. This is simply operating revenue as a percentage of operating and financial expenses. If the ratio is greater than 100 percent, it means that the MFI is covering all of its costs through its own operations and is not relying on contributions to survive.

- Financial sustainability—also known as financial self-sufficiency. This is similar to operational sustainability; however, the ratio also includes inflation and subsidy adjustments.

- Profit margin—this measures net operating income as a percentage of total revenue. This ratio shows how much of the revenue earned goes to the bottom line. In other words, for every dollar received as revenue, how many cents (or dollars) remain at the end of the day after all expenses are paid?

Note that some ratios use an average, because the numerator is a "flow" figure that occurs over a period of time, and is divided by the average of the "static" figure at the beginning of the period and the end of the period. An average is calculated by adding the beginning and ending figures of the period and dividing by two.

Break-even calculations are frequently used in production or distribution industries, as they are easily understood. The calculation tells how many units need to be sold in order to cover costs. Break-even can obviously also apply to microfinance institutions. It is reached when enough loans with specific terms generate income that exactly equals expenses; in other words, net profit is zero, and the entity is 100-percent sustainable. Break-even calculations can also be used when a new product is being contemplated, or a new market is being served, to assess how long it will take until costs are covered (that is, what the risks are of losing money on the new venture [see Annex 3 for some examples of break-even calculations]).

Box 4: To Adjust or Not to Adjust? That Is the Question

The three most common financial statement adjustments are:

- Inflation, which causes a decrease in equity and a revaluation of fixed assets;
- Subsidies, which include below-market rates on liabilities, in-kind donations, and grants; and
- Aggressive loan-loss provisions and write-off policies, which increase loan-loss provisions and subsequently reduce reserves and portfolio by the amount of write-offs.

The MicroBanking Bulletin advocates adjustments so that comparisons are equitable between organizations. This is obviously a sophisticated nuance, and MFIs are not necessarily expected to do this on their own. Once your financial data are submitted to *The MicroBanking Bulletin*, your financial statements will be adjusted, and the adjustments will be explained in a confidential report to the MFI. Microrate and PlaNet Finance are private rating agencies that evaluate MFIs. Both agencies specify whether the numbers are adjusted or not, and include some adjusted figures and some unadjusted figures.

MFIs need not make adjustments themselves, but it is worth understanding what adjustments can be made. (The best explanation appears in *The MicroBanking Bulletin*, Issue No. 6, April 2001, pp. 73-75.) Be sure you are consistent in comparing figures that either have been adjusted or not adjusted.

Efficiency and Productivity Indicators

Efficiency and productivity are buzzwords in most industries, and the world of microfinance is no exception. This group of indicators obviously directly affects the bottom line, and is important to look at closely, because the most important factor that influences these ratios can be controlled very directly by management—that is, how much money is spent on what. In a competitive environment, efficiency and productivity are the most important means to gain a competitive edge. Decisions about credit methodology, credit terms (loan size, maturities, and so on), and markets in which to operate also affect efficiency and productivity.

Staffing, administrative expenses, and client base are important variables. There are many efficiency indictors from which to choose, but we will focus on five of the most common ratios. Client retention is included in this category because repeat borrowers can be served more efficiently with little effort (or cost) to the MFI.

The five efficiency and productivity indicators considered here are as follows:

- Operating expense ratio—consists of operating expenses as a percentage of average portfolio, revealing how much the MFI spends to maintain its outstanding loan portfolio. This ratio goes hand in hand with the portfolio yield (financial income / average portfolio). This allows the reader to compare easily the expenses of the MFI with its revenue. For instance, if the portfolio yield is 50 percent, then the MFI is striving to have an operating expense ratio lower than 50 percent.

- Cost per borrower—this figure shows how much it costs the MFI to serve clients. It simply requires dividing operating expenses by the average number of clients for the period.

- Cost per unit of money lent—shows how many cents it takes the MFI to make a $1 loan, and is calculated by dividing operating expenses by the value of loans disbursed in the period. As the MFI grows, its cost per unit of money lent should fall.

- Staff productivity ratios—are vital ratios for all financial institutions because staff is usually the largest operating expense. The two ratios calculate the size of the caseload (the number of active clients) each loan officer carries, as well as how much loan portfolio is managed by a single loan officer. The higher the ratios, the more efficient the MFI.

- Client retention—is a hot topic in microfinance. It is generally thought that new clients are the most expensive clients because they must be recruited and trained, and because first-time applicants require greater analysis. Similarly, new clients usually have smaller-than-average loans and therefore generate less financial income. For this reason, MFIs have focused on retaining good clients, the measure of which appears below.[22]

[22] See "Measuring Client Retention," by Rich Rosenberg, in *The MicroBanking Bulletin*, April 2001, pp. 25-26, for a detailed discussion of retention rates and several options.

Portfolio Quality Indicators

The loan portfolio is the engine that drives a financial institution. Similar to an automaker, quality, price, and availability are important in running a successful MFI. Because an MFI does not receive its revenue at the time of "sale" (loan disbursement), but receives the revenue over time, the MFI must continue to worry about quality long after the "sale" of the loan is complete. High quality means low delinquency. Because MFIs have very different policies regarding how they report and manage delinquency, it is important to be sure to use the same definitions when comparing ratios between institutions.

It is now standard practice to calculate portfolio-at-risk (PAR), *not* portfolio in arrears or amount of past-due payments. This means that if a single payment is late, the entire loan balance is at risk, because the chances of recovering the balance of the loan are less if even one payment is late.

It is *crucial* that board members know the details of the quality of the portfolio. Therefore, a portfolio report should always be included with company reports. Management, too, needs this data to run the institution. Although most formal reporting of delinquency does not occur until 30 or 90 days, even the category of one to 30 days is indicative of a problem somewhere—perhaps administratively if not with collections. Also, if the loan maturities are short and payments are frequent (weekly or bi-weekly), then a loan past due 30 days could mean two to four payments are late, which is obviously very serious. Board members should analyze PAR over several reporting periods. If the board notices that PAR tends to migrate from 30 days past due to 180 days past due, it is likely that the MFI is deficient in pursuing delinquent clients.

Box 5: Loan-Loss Provisions and Loan Write-offs

Accounting rules require that financial institutions estimate what future loan losses will be based on the current performance of the loan portfolio. In other words, management must assume that clients who have not made a payment on a loan for some time may very well default on the entire loan. Depending on how many days past due the client's payment or payments are, management assumes there is a 1-percent to 100-percent chance the loan will not be repaid. Management is required to set aside funds for that potential loss; this is known as a loan-loss reserve.

Management creates a loan-loss reserve by creating an expense on the income statement known as a loan-loss provision or provision expense. Unlike a cash expense, such as wages, no money actually leaves the institution as a result of the provision expense. Instead, the amount of the expense is contributed to the loan-loss reserve. Each period, an estimate of loan losses is made, and management must adjust the loan-loss reserve accordingly.

In many cases, the loan is finally paid by the client and the reserve is not touched. In some cases, the loan is considered unrecoverable when it reaches a certain number of days past due, and the loan-loss reserve is reduced by the amount of the loss. Management then takes the loan off its books (or "writes it off") to show it is no longer active, and the loan no longer shows on the balance sheet.

In addition to reviewing the portfolio report carefully, board members may wish to consider two other ratios:

- Loan-loss reserve adequacy—the amount of actual loan-loss reserves divided by the required or suggested loan-loss reserves.

- Write-offs as a percentage of the average gross loan portfolio—which indicates what loans were restated from "at risk" to uncollectable during the period.

Neither of these ratios is transparent, but both indicate how well credit risks are being managed, and how the MFI's profitability is being affected by losses.

Box 6: How to Calculate Write-offs

a) Initial reserve for loan loss (from ending balance sheet of previous period),
b) Plus loan-loss provision (from income statement),
c) Less reserve for loan loss (from this period's balance sheet) = d).

(a+b-c) = d) loans written off during period.

In addition to calculating and reporting PAR, MFIs should have a policy on creating a loan-loss reserve such that the size of this reserve is directly related to the portfolio at risk. CGAP, SEEP, and several network organizations have developed standards for reserves (a sample reserve requirement appears in Table 6). The requirement is based on the estimated risk of not receiving the full amount of the loan. For example, loans that are past due fewer than 30 days may have a 10-percent risk of default, whereas loans past due 100 days or more may have a 75-percent risk of default. Each period, the MFI sets aside (or, in some cases, withdraws) funds from the loan-loss reserve in the form of a loan-loss provision expense. It is important for management to ensure that the level of the reserve reflects the current PAR. The board should monitor the adequacy of the loan-loss reserve.

Table 6: Sample PAR Reserve Requirements

Aging Categories	Reserve Required
1–30 days	10%
31–60 days	25%
61–90 days	50%
90–180 days	87%
181 days or more	100%

Box 5 discusses the difference between portfolio at risk and write-offs, and Box 6 provides guidance on how to calculate write-offs using information from the income statement and balance sheet. Policies on write-offs vary between MFI. While SEEP and CGAP encourage MFIs to write off loans after 180 days, it is important that the board know the MFI's policy for write-offs. Moreover, the board may wish to have a complete explanation and, in many cases, approval authority before loans are written off.

It is important to state that writing off a loan does NOT mean the MFI should cease attempts to collect the full amount of the loans. Write-offs are an accounting procedure, not an operational decision. Loans may be recovered through collection procedures long after they are taken off the books. The board should monitor how successfully management recovers written-off loans. Such recoveries will help minimize the effect of previously written-off loans.

Write-offs pose the greatest risk to an MFI because they are loans that an MFI has determined are uncollectable. Not only will the MFI forgo financial income on a written-off loan, it may also lose the loan principal that is outstanding. Large write-offs can reflect poor management procedures for client selection and loan approvals, or for the collection of delinquent loans.

Growth and Outreach Indicators

Growth and outreach are important targets to monitor not only as "social" objectives, but also as a financial indicator: new clients are the basis for revenue and asset growth. It is fair to say that most MFIs do want to grow. Growth can be calculated for anything by using the following formula: percentage growth = (final amount – initial amount) / initial amount.

Outreach is sometimes defined as the sheer number of clients reached, and sometimes it becomes more specific to include what segment of clients is served. Common outreach categories include gender, age, poverty indices, geographic location, or type of microentrepreneurial activity. Because outreach is so closely linked to the MFI's social goals, which are beyond the scope of this manual, only one example will be shown here, that being the measure of the depth of the portfolio, which indicates which socioeconomic sector is being served.

The key areas of growth that the board should monitor are:

- Loan portfolio growth—which is the engine of revenue growth. An MFI may experience seasonal fluctuation of its loan portfolio such that it may shrink from one quarter to the next. However, an MFI should exhibit long-term growth of its loan portfolio. In addition, the board may wish to consider the growth rate in U.S. dollar (or other "hard currency") terms, such that the MFI's portfolio growth exceeds the devaluation of the local currency vis-à-vis the dollar.

- Growth in borrowers—is a good indicator of future revenues. As the number of experienced clients increases, the loan portfolio and revenues will increase.

- Growth in equity—is the foundation for future asset growth. It also reveals how efficiently the MFI transfers revenues to equity, thereby enabling the institution to grow. Net growth equals the new clients minus the net clients who have left the program. Client withdrawal is critical in assessing client satisfaction and greatly influences efficiency and productivity.

- Depth of portfolio—evaluates how well the MFI is penetrating the market of very-low-income clients by comparing the average outstanding loan size with gross domestic product per capita. While this says little about financial performance, it may be relevant to the MFI's mission or other stated goals.

Financial Structure Indicators

The basis of financial intermediation is the ability to manage assets (the use of funds) and liabilities (the source of funds). Asset/liability management is required on several levels.

- Interest rate management—the MFI must make sure that the use of funds generates more revenue than the cost of funds.
- Asset management—funds should be used to create assets that produce the most revenue (are most "productive").
- Liquidity management—the MFI must also make sure that it has sufficient funds available (or "liquid") to meet any short-term obligations.
- Leverage—the MFI seeks to borrow funds to increase assets, and thereby increase revenue. Increased revenue usually leads to increase net profit, which is vital for commercial institutions with shareholders. At the same time, the MFI must not borrow so much that it is unable to repay its liabilities in times of trouble.

This final group of indicators includes liquidity, capital adequacy (solvency), and asset productivity. There are many ways to measure these balance sheet relationships. Those MFIs that are regulated or that have accessed capital markets must pay close attention to the standard liquidity and solvency ratios.

- Liquidity ratio—measures how much cash the MFI has available to cover its current obligations. As mentioned earlier, lack of cash is the primary reason for the failure of financial institutions. By viewing cash as a percentage of short-term liabilities, the board can see how much cash the MFI has to meet its current obligations.
- Leverage ratio—shows the relationship between liabilities and equity. Liabilities must be repaid, whereas equity may be used for any purpose. It is important that the MFI leverage its equity, but it should not take on so many liabilities that it might be unable to pay them back in the future.
- Capital adequacy—is a major concern of banks. How much equity (capital) does the MFI have to support its assets? In other words, what cushion does the MFI have should its outstanding loans not be repaid before it must default on its obligations (liabilities)?
- Asset productivity—highlight how efficiently the MFI is structured. Generally, loans are the most lucrative account on the balance sheet, because they generate a high rate of financial income. The MFI wishes to maintain a high percentage of its assets in the loan portfolio, in order to be productive and profitable.

The board should be overseeing the asset/liability management of the MFI by reviewing these key ratios. For larger MFIs that have significant borrowing activity, the board may wish to require reports on two additional factors:

- Maturity gap—this report divides all assets and liabilities in categories of maturities or "due dates" in order to compare the average maturity of assets with the average maturity of liabilities. A significant mismatch in either direction can be dangerous.

- Foreign-currency gap—this report compares total foreign-currency assets with total foreign-currency liabilities denominated in foreign currency.[23] This is significant for institutions that operate in countries where two or more currencies are circulating. If there is a significant gap, the board should consider the effects of potential foreign-currency movements on the MFI.

INTERPRETING PERFORMANCE INDICATORS

"Ratios and numbers are always oversimplifications. They are tools for making sense of complicated realities. The better they express those underlying realities, the more useful they are. In an infant industry we must be conscious of the danger of trying to squeeze more out of indicators than they can yield."[24]

Unfortunately, there are no right and wrong ratios, but, rather, ratios must be considered in context. Internal factors, such as the size and maturity of the institution, and external factors, such as the economy, competition, or access to capital, will all affect the MFI's ratios.

Three contexts in which to interpret performance indicators are:

- Trend analysis,
- MFI's projections, and
- Industry standards/benchmarks and comparisons with peer groups.

A variance analysis involves comparing actual numbers with historical numbers, projections, or industry standards *and* then explaining why any difference exists. It is important to explain all significant variances—both positive and negative.

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[23] This includes loans or borrowings that may denominated in local currency but are linked to a foreign currency or other external indicator.

[24] "Putting the Finance into Microfinance," *Microrate,* October 2000, p. 8.

Box 7: What Do CAMELs and PEARLS Have in Common?

Both are acronyms for instruments used to monitor performance of financial institutions. CAMEL was first introduced in 1978 by regulators to measure the soundness of U.S. commercial lending institutions. Fourteen years later, ACCION International undertook a project to modify the CAMEL tool so it would be relevant to MFIs. The results were published in ACCION's Discussion Paper #7, "Performance and Standards in Microfinance: ACCION's Experience with the CAMEL Instrument."

CAMEL stands for these five areas: **C**apital adequacy,
Asset quality,
Management,
Eamings, and
Liquidity.

ACCION's CAMEL comes complete with a manual that describes the rating scheme, weights for each indicator, and adjustments to the financial statements. It has been a valuable addition to the microfinance industry's quest for performance monitoring standards.

PEARLS is an indicator report for the World Council of Credit Unions (WOCCU). It has been used effectively to monitor performance and provide comparative data for the members of WOCCU.

PEARLS stands for the following categories: **P**rotection (loan-loss reserves and write-offs),
Effective financial structure,
Asset quality,
Rates of return and costs,
Liquidity, and
Signs of growth.

Other schemes exist as well. Pro Mujer uses a CCREP, which translates from Spanish to represent portfolio quality, growth, profitability, financial structure, and productivity. What is your MFI's performance monitoring instrument called?

Trend Analysis with Ratios

As mentioned above, it is important to calculate ratios over a period of time in order to compare the performance of your MFI during one period with another period. Without information to see whether the trend is improving or deteriorating, it is impossible to recommend action, make informed decisions, or predict likely scenarios. When comparing periods, avoid doing "elevator" analyses, in which your conclusions sound like the following: "Portfolio quality went up; growth in number of clients went down; and staff productivity went down." Always ask, "WHY?"

Which of these two situations, for example, would you prefer for your MFI: (a) "good" numbers with a deteriorating trend or (b) "bad" numbers with an improving trend? Because cash flow to be used to continue to run the MFI will eventually have to come from the future, it is more likely that the latter situation, with an improving trend, is the preferred one. Without historical data, there is no context in which to interpret the data. Obviously, the more years one can review, the better the analysis will be.

A word of caution is in order when comparing years during different stages of MFI development: there is a tendency to assume that bigger is better or that an increase is a positive trend. That is not always the case. Growth, for example, in early years is generally faster than in later years, so declining growth ratios may actually be a sign of maturity. Conversely, efficiency tends to increase with maturity, so a decline in efficiency may be a sign of trouble. Board members need to use common sense (see Exercise 4 in Annex 2 on calculating ratios and complete the ratios for previous periods).

MFI Projections

Institutions invest time and resources in planning. It is important, then, that the planning process does not end with the printing of a document. Creating financial projections as part of the plan is an important tool in performance monitoring. Comparing actual performance with projected performance is perhaps the best way to measure management's success or failure. It is also an effective means to evaluate the success of the MFI in achieving its goals and fulfilling its mission.

There are many tools available for projections, ranging from a simple Microsoft Excel spreadsheet to the Microfin Model,[25] which automatically projects ratios. Assuming at a minimum that the MFI creates an annual budget in which income and expenses are projected, the MFI needs only to project its portfolio and client growth in order to project ratios. Similar to budget variance reports, management should provide ratio variance reports and submit a summary report to the board, with reasons for significant variances clearly explained.

Comparative Analysis: Industry Standards and Benchmarks

Transparency advocates believe that when information is openly shared, benefits accrue to all. Perhaps one of the most useful outcomes of the proliferation of MFIs has been the sharing of financial information and the creation of a body of comparative data. Those MFIs that are in networks, be they institutional networks like CRS, FINCA, or ACCION, or geographic networks, such as COPEME in Peru and ASOMIF in Nicaragua, have data from other affiliates or institutions. Attempts are made to standardize the formats so that comparisons are possible. As institutions within the networks have more in common with each other, be it merely geographic location or a common mission or methodology, the more meaningful the comparisons become.

Again, there is no single standard that is appropriate for all; a credit union may have a very different leverage ratio than a donor-funded NGO. Fortunately, the proliferation of MFIs means that there are now enough data to create benchmarking groups among MFIs that share similar characteristics.

[25] "Business Planning and Financial Modeling for Microfinance Institutions," Tony Sheldon and Charles Waterfield, CGAP, November 1998. Visit the Web site at www.microfin.com.

The most up-to-date, comprehensive, and widely circulated compilation of comparative data in this field is *The MicroBanking Bulletin*,[26] which is published semi-annually and funded by CGAP. More than 100 MFIs submit financial data to the *Bulletin*. The data are then analyzed, adjusted, and reported anonymously in an aggregate format. Each institution also receives a confidential performance report, which allows the MFI to compare its performance with that of other participating institutions. This tool is invaluable to MFI managers and board members, and should be required reading.

The MicroBanking Bulletin creates peer groups based on geographic region, scale of operations, and target market. Additional groups are analyzed based on age of institution, lending methodology, level of financial intermediation, charter type, and profit status. The average of some 30 ratios is presented. The categories are similar to those presented in this manual, and are as follows:

- Institutional characteristics and outreach indicators;
- Overall financial performance and operating income;
- Operating expenses and portfolio management indicators;
- Efficiency and productivity; and
- Macroeconomic indicators.

The MicroBanking Bulletin (MBB) does not independently verify the information it receives. It does, however, grade the quality of the information according to whether the MBB questionnaire is accompanied by audited financial statements, annual reports, independent evaluations, and recent in-depth financial analyses conducted by independent entities.

If a board is interested in contracting an outside firm to conduct an analysis, it might consider one of the private companies offering such services to MFIs, such as Microrate or PlaNet Finance. Microrate is a rating agency for MFIs.[27] Microrate's materials are proprietary, but some of its data are available to the public. A recent example is "The Latin American Microfinance Industry—How Does It Measure Up?"[28] Seventeen MFIs participated in this project.[29] The benchmark indicators in the report reflect ratios similar to those in this manual and in *The MicroBanking Bulletin*.

Compare institutions with caution. "It is a highly subjective exercise to compare and judge microfinance institutions based on financial and operational indicators, because in certain

[26] *The MicroBanking Bulletin* is a publication of the MicroBanking Standards Project and is available online at www.microbanking-mbb.org. For more information on the creation of peer groups, refer to *The MicroBanking Bulletin,* Volume 6, p. 40, or www.microbanking-mbb.org/methodology.html.

[27] Microrate is a private firm that specializes in evaluating microfinance institutions. Unlike *The MicroBanking Bulletin,* Microrate conducts on-site visits and verifies information. Similar to other rating agencies, Microrate provides it services for a fee and its reports are for public dissemination. Microrate's objectives are "to quantify MFI investment and credit risk for potential investors or creditors; to create a mechanism to link MFIs with domestic and international capital markets; and to stimulate financial deepening in emerging markets."

[28] "The Latin American Microfinance Industry—How Does It Measure Up?" by Tor Jansson and Miguel Taborga, published by the Inter-American Development Bank, 2000.

[29] "Putting the Finance into Microfinance," Microrate, October 2000, www.microrate.com.

cases, their performance and characteristics may be the result of deliberate choices regarding social and financial objectives. The 'benchmarks' chosen in these cases reflect educated judgments…and should be interpreted as a range of acceptable values."[30] (See Exercise 5 in Annex 2, which has a column for benchmarks for 10 indicators to compare with your MFI's numbers.)

[30] Ibid., pp. 8, 12.

CHAPTER THREE
REPORTS FROM MANAGEMENT

The next steps for the board to follow to implement performance monitoring are:

- Decide who reports what, when, to whom, and with what frequency;
- Determine the motivation and consequences for management; and
- Ensure that board members have the opportunity to conduct occasional on-site monitoring.

WHO

For most MFIs, the managing director or CEO provides the link between staff and board. Often, the CEO is a member of the board. Depending on the size, organizational and governance structure, and complexity of the MFI, there may be occasions when the chief financial officer, finance manager, or financial advisor will interact directly with the board or finance committee. Variations exist, but what is important is that the responsibilities and lines of communication are clearly defined.

The staff has several responsibilities related to performance monitoring, including the following:

- To prepare accurate data;
- To analyze the data;
- To submit reports to the board in a timely and organized manner;
- To make appropriate decisions; and
- To be responsive to the board's questions or directives.

WHEN

"There is no single standard...regarding which financial statements the board should receive. The greatest diversity is found in the internally prepared financial statements."[31] A useful benchmark is that the board and/or head office should not require any information that is not useful to the program staff of the organization. This process of reporting should benefit the management staff just as much as, or more than, it benefits the board.

In the 25 MFIs surveyed by The Microfinance Network, the frequency of reports to the board varied depending on whether the institution was for-profit or nonprofit, as follows:[32]

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[31] "Financial Responsibilities of the Nonprofit Board," Andrew S. Lang, National Center for Nonprofit Boards, 1998, p. 21.

[32] "Current Governance Practices of Microfinance Institutions," Anita Campion, The Microfinance Network, 1998, pp. 20, 34.

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Table 7: Frequency of Board Reports in a Year

Report	Nonprofit MFIs	For-Profit MFIs
Balance sheet	5	5
Income statement	5	5
Portfolio report	6	10
Cash flow report	4	2
Strategic plan	1	1
Internal audit report	2	3
External audit report	1	1
Market share information	1	3
Performance by loan product	3	2
Social impact statistics	1	1
Marketing plan	0.5	1

The most dramatic difference between nonprofit and for-profit reporting to the board is that portfolio reports are due nearly twice as frequently for for-profit MFIs. Boards of for-profit MFIs also receive more frequent market share information than do boards of nonprofit MFIs.[33] As far as which indicators are most important, the differences again reflect institutional priorities according to type of institution.[34] Not surprisingly, nonprofit MFIs listed reaching poor entrepreneurs as a "most important" goal to which all other goals are less important, whereas for-profit MFIs listed profitability and asset quality indicators as most important.

The level of detail of the reports should be left up to the judgment of management, and adjusted by the board depending on specific circumstances. Earlier, the notion of "better" information was discussed; that is, information that is summarized, standardized, and often accompanied by charts and graphs. Also, a common courtesy is to have the information available for the board at least one week before the meeting. This gives board members the opportunity to review the numbers and prepare their questions. Often, the finance committee, if one exists, will meet prior to the board meeting to review details with staff and ask preliminary questions.

How much time does staff need to prepare information? Again, if the information requested by the board is also used for everyday management purposes, timeliness is necessary as it relates to the staff's needs, as well. A good goal for monthly statements is 15 to 20 days after the month ends. As the periods become longer, the preparation time is often greater, so year-end statements, for example, may not be ready until 30 to 45 days after the fiscal year closes. Lack of timeliness may signal problems, so management and the board must openly communicate expectations and concerns.

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[33] Additional reports the board should review include any filings, such as IRS Form 990 for MFIs registered in the United States as nonprofit entities, and Office of Management and Budget Form A-133, for those organizations expending $300,000 or more in U.S. federal funds. These documents are public; therefore, the information presented influences the MFI's image and should be reviewed carefully by the board or finance committee.

[34] Ibid.

How

Table 8: Sample "Hot Sheet" from Catholic Relief Services

Indicator	Explanation	Current Period	Previous Period	Change	Comment
Portfolio					
Portfolio-at-risk					
Earned income					
Profit margin					
Cash position					
Social Indicators					
Other Key Information					

Source: "The Board Rules," Kim Wilson, Catholic Relief Services, 2001.

Management needs to be motivated to produce and send the requested information on a timely basis. If management believes this exercise of performance monitoring by the board will be beneficial to them (and to the institution), the chances of getting the information increase. Benefits can range from supportive dialogue and problem-solving sessions to positive feedback and effects on remuneration. If the manager's performance rating includes as an objective the timely submission of required information to the board, then the board can clearly assess compliance, and remuneration is influenced accordingly. The degree to which this kind of motivation is necessary depends entirely on the relationship between the board and senior staff. If the relationship is open and cooperative, the information will most likely flow freely. Board members must realize, however, that "when in the trenches," sending reports to the board sometimes moves down the priority list. Therefore, the expectations of what needs to be sent when must be very clearly defined and reasonable, and followed up accordingly. (See Annex 4 for a sample checklist of what to require when and who should prepare the report.)

One final note on the sources of information used to monitor performance: Although by far the majority of the performance monitoring for boards of directors takes place off-site, it is highly recommended to make occasional visits to the field. The purpose can be to conduct on-site monitoring, either formally or informally. In order to make the indicators "come alive," it is necessary for board members to meet the clients, even see their businesses, and certainly to get to know the staff. Local boards of directors have more opportunities to be in close contact with the field than do boards of network headquarters. Nonetheless, the latter should attempt to visit the field at least once during each board member's term of office.

CHAPTER FOUR
PERFORMANCE MONITORING CHALLENGES FOR BOARDS OF DIRECTORS

MFIs and their boards that have been struggling to monitor performance effectively have learned valuable lessons. There is a high degree of similarity among the monitoring systems used by various networks and MFIs. "Variations in the design and format of the tools, as well as in the frequency of their application, were more than outweighed by these shared goals and approaches."[35]

As an example, the value of the CAMEL tool to ACCION and its affiliates is summarized as follows[36]:

Value to ACCION	Value to ACCION's Affiliates
1) Quality-control mechanism to maintain high standards of performance.	1) Information to be used to access local and international capital markets.
2) Proof that MFIs can be evaluated with the same standards as those used for commercial banks.	2) Link to technical assistance needs, providing more focused and relevant interventions.
3) Tool to strengthen the relationship between ACCION and the local boards of directors of its affiliates.	3) Planning and management tool to more effectively determine institutional priorities and make critical decisions.

As competition increases for clients, staff, and funding, monitoring performance at the management and board levels becomes even more critical. It follows logically that as benchmarks become more widely accepted and comparative data are disseminated, the top performers will be rewarded with a better reputation in the marketplace, and the best clients, the best staff, and the best funding sources will be available to them.

The experience of MFI boards of directors mirrors the progress made by management in performance monitoring. As staff members understand the importance of relevant and timely information, boards will be able to review the reports more regularly and thereby increase the effectiveness of their input. "There was also consistency across networks that the primary challenges are getting accurate and timely information from affiliates, and then being able to provide appropriate follow-up services and interventions."[37]

Key initiatives to improve the network–affiliate performance monitoring relationship[38] can also be applied to the relationship between boards of directors and their MFIs. The challenges are as follows:

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[35] "Performance Monitoring Systems Project," Warren Brown, Tony Sheldon, Charles Waterfield, SEEP, 2000, p. 5.

[36] "Performance and Standards in Microfinance: ACCION's Experience with the CAMEL Instrument," Sonia B. Saltzman, Rachel Rock, Darcy Salinger, ACCION International, 1998, pp. 63–66.

[37] "Performance Monitoring Systems Project," p. 5.

[38] Ibid, pp. 5–6.

- Together, find ways to minimize the time required to complete reports, while ensuring that the quality of the information is maintained.
- Provide qualitative and quantitative feedback.
- Link the process and results to technical assistance recommendations.
- Adapt the process to the MFI's needs and to the level of maturity of the affiliate.
- Have management take the initiative in communicating challenges related to performance monitoring and identify improvements.

Remember, the data presented in the monitoring process are not the end in itself, but a means for the board to make more informed decisions. The data reviewed during this process should be used for other purposes as well, including a review of the institution's interest-rate policy, or decisions regarding institutional structure. Strategic policies and decisions must reflect the reality in which the MFI operates, and by comparing the institution's indicators with those of its peers and with industry standards, the board can ask informed questions and make wiser recommendations.

To summarize, following are some final suggestions for confronting the challenges that boards of directors face in monitoring the performance of MFIs:

- Focus on the *reasons* behind the numbers, not on the numbers themselves,
- Establish clear benefits to management in requiring timely submission of relevant information,
- Visit the MFI occasionally, get to know the staff and the clients, and do informal "spot checks" as an internal auditor would do,
- Learn as much as you can about the microfinance industry by reading publications and attending conferences whenever possible,
- Support board retreats and training workshops that focus on performance monitoring and setting policies regarding reporting requirements, and
- Be transparent and take responsibility for using best practices for your institution to further the establishment of MFI standards and benchmarks.

ANNEX 1
WORKSHEET—DESIGNING AN EFFECTIVE PERFORMANCE MONITORING STRATEGY

Question	Answer	Action Required?	By Whom?	By When?
Strategic planning and budgeting				
1. What is the format for the operational plan and budget? Is it clear and standardized?				
2. What is the timetable for the planning and budgeting process? Does it ensure board approval before the fiscal year begins?				
3. How can you show that assets and income are related to the mission?				
4. What are the funding sources and how likely are they to be available?				
5. How can you show that the budgeted expenses are appropriate?				
Risk management and oversight				
6. What is the quality of the portfolio? What are the relevant patterns/trends?				
7. How are the loans collateralized? How is the portfolio diversified?				
8. How adequate are the loan-loss reserves?				
9. What is the write-off policy?				
10. How are new products developed and what risks are involved?				

11. How is growth managed?				
12. How will current cash obligations be met?				
13. How are investment opportunities being maximized? What is the policy regarding acceptable investments?				
14. Is there sufficient equity to support the debt burden?				
15. How are banking relationships monitored?				
16. How do external risks affect the financial sector? What are present and future regulatory environments?				
17. How are assets and liabilities (rates, maturities, currencies, devaluation, and inflation) managed?				
18. Have there been incidents of fraud and, if so, what new policies have been implemented as a result?				
19. Does the internal auditor report directly to the board? How often and with how much detail?				
20. Is the external auditor approved annually, and are the audit and management letter reviewed?				
21. Are financial policies reviewed by the board, and are they followed?				
Fiduciary responsibilities				
22. How are expenses related to income?				

23. What is the profitability/sustain-ability of the MFI? Are investors compensated adequately?				
24. What reports/filings are required, who is responsible for compliance, and how is this monitored?				
25. If the institution has depositors, how does the MFI safeguard against a run on deposits?				
26. Who monitors compliance with loan covenants, contracts, and regulatory requirements?				
Management accountability				
27. How does actual performance compare with historical or budgeted performance or industry standards? Explain the variances.				
28. What remedial interventions are indicated by challenges faced?				
29. Does the CEO receive an annual performance review? Is management compensation based on performance?				

ANNEX 2
EXERCISES

EXERCISE 1: DEFINING OBJECTIVES FOR A PERFORMANCE MONITORING SYSTEM

Below is a list of reasons a board might want to monitor financial performance. Follow the steps listed below to complete this exercise.

1. First, review the reasons.
2. Add any additional reasons.
3. Then, rank the reasons in order of priority, with one being the most important, assuming they are all relevant to some degree.

____ Ensure donors/investors/lenders that funds are being used properly and efficiently.

____ Ensure depositors/regulators that funds are secure.

____ Ensure management accountability.

____ Measure institutional achievements, including profitability and sustainability.

____ Predict problems, identify "red flags," and suggest solutions.

____ Review and approve the annual budget.

____ Assess risks and identify strategies to mitigate them.

____ Establish financial policies and ensure that they are being followed.

____ Ensure compliance with reporting/filing requirements.

____ Learn more about the microfinance industry and gain the ability to compare the MFI's performance with that of its peer group.

____ Evaluate the MFI's ability to survive financial or market shocks.

____ Assess the MFI's ability to become sustainable.

____ Oversee work of the internal auditor.

____ Select external auditor, approve audit report, and oversee management compliance with audit recommendations.

EXERCISE 2: FINANCIAL ANALYSIS

Take the financial statements provided by management. Identify the four different types of statements or determine which statements most closely resemble the statements described in Chapter Two by looking for the information included in the management reports.

- Review the income statement or its equivalent. Answer the following questions:
  - How many months of operations are covered in the statement?
  - Does the statement segregate the MFI's lending program from other, nonlending programs (for example, training or business development services [BDS])?
  - How much interest and fee revenue from lending activities did the MFI earn in the period?
  - What other sources of revenue are there (such as grants, nonlending programs)?
  - Based on your answers to the previous two questions, what is the main source of revenue for the MFI? Is that consistent with the MFI's plan? If noninterest revenue (such as from grants) is large, how reliable is this other revenue?
  - Does the MFI pay interest to depositors, lenders, or institutional investors?
  - How large is the interest expense compared with the interest revenue?
  - What are the largest expenses of the MFI? Is it possible to determine which expenses go to support the lending operation rather than other, nonlending operations (training, BDS)? If so, what are the total expenses related to the lending program?
  - Subtract all interest expense and expenses related to lending operations from interest and fee revenue. Is the MFI making or losing money on its lending operations?

- Review the balance sheet or its equivalent. Answer the following questions:
  - What is the total loan portfolio of the MFI? What are the total assets?
  - Divide the total loan portfolio by total assets. What percentage of total assets is invested in the loan portfolio?
  - What are the other largest assets? What is their purpose? If they are fixed assets, how do they help facilitate the lending operation?
  - Does the MFI have any costing liabilities (such as deposits or loans from others)?
  - Divide costing liabilities by the total loan portfolio. What percentage of the loan portfolio is funded by costing liabilities?
  - What are the other liabilities? What is their purpose?
  - How much equity (or net assets) does the MFI have? Can you tell what percentage of equity was donated or contributed compared with the percentage that is retained earnings of the MFI?
  - Divide total costing liabilities by total equity. How well does the MFI leverage its equity with borrowed funds?
  - Do retained earnings in the period equal the bottom line of the income statement?

- Review the statement of changes in financial position, or cash flow. Answer the following questions:
  - What are the major uses of cash? the increase of the loan portfolio? fixed-asset purchases?

- What are the major sources of cash? loan repayments? net income from operations? grants? deposits or loans?
- Subtract loan repayments from loan disbursements. Which is larger? If disbursements are larger, how did the MFI fund the new loan disbursements? If repayments are larger, why is the MFI making fewer new loans?
- Did the MFI make any major purchases during this period?
- Did the MFI take any large loans or receive any large grants during this period?

▪ Review the portfolio report. Answer the following questions:
  - Does the value of loans equal the gross loans outstanding in the balance sheet?
  - What percentage of loans is current (with no late payments)?
  - What percentage of loans is restructured? Is there a policy for restructuring loans? Why were these loans restructured?
  - What is the total value of loans past due more than 30 days? past 90 days? Does management have an estimate of how many of these loans will eventually be paid back?
  - Look at the balance sheet for the loan-loss reserve. How does it compare with the value of loans 90 days past due? 180 days past due? Is the reserve sufficient to cover the loss of the loans?
  - Look at the balance sheet for total equity. How does it compare with the value of loans 30 days past due?
  - What is the value of write-offs? How does it compare with the loan-loss reserve? with total equity?

EXERCISE 3: ORGANIZING DATA FOR CALCULATING RATIOS

Please fill in the following form with the information you have for at least two periods. The likely source of the information is shown in bold, to help you find the correct data. Be sure that the figures with asterisks cover the same period of time (such as quarter, semester, or year) for all dates, so that comparisons are valid.

Currency ________________

MFI________________________________ Period of time ____________

	Date	Date	Date
Income statement			
A) Financial income*			
B) Interest paid*			
C) Loan-loss provision*			
D) Operating expenses*			
E) Grants for operations*			
F) Grants for loan fund*			
G) Adjustments for inflation and subsidies*			
Balance sheet			
H) Cash and cash equivalents			
I) Investments			
J) Gross portfolio			
K) Loan-loss reserves			
L) Total assets			
M) Short-term liabilities			
N) Deposits			
O) Total liabilities			
P) Total equity (net worth)			
Portfolio report			
Q) Value of disbursements*			
R) Number of disbursements*			
S) Number of loans outstanding			
T) Number of active borrowers			
U) Number of new clients*			
V) Value of loans 1 to 30 days past due			
W) Value of loans 31 to 90 days past due			
X) Value of loans 91 to 180 days past due			
Y) Value of loans over 180 days past due			
Z) Value of loans written off* (see Box 6 in Chapter Two)			
Other data			
AA) Number of staff			
BB) Number of loan officers			
CC) Noncredit program expenses			
DD) Per capita GNP			

EXERCISE 4: CALCULATING RATIOS

Because the most effective way to learn about indicators is to create them, now you will need a calculator and your most recent financial statements and portfolio reports. You will get an opportunity to practice your mathematical skills and, at the same time, learn more about your MFI. Using the financial statements for the two most recent periods, on the next page please fill in the data from Exercise 3, so the numbers will be organized to facilitate calculation of ratios. If the staff of the MFI has already calculated ratios, you can obviously skip this calculation section and go directly to the section on interpreting ratios. In so doing, however, you run the risk of not fully appreciating the components of the ratios and what, exactly, they each mean.

If your MFI does not produce the financial statements listed in Chapter Two, that is okay. Some of the financial data are probably available in other reports or from the MFI's general ledger. Basic ratios can be calculated from the data, even if the information isn't organized into financial statements. For basic definitions of financial statement terminology, refer to Annex 5.

Using the data you have organized in Exercise 3, calculate these ratios using the formulas below. Remember, you can include the adjustments for inflation and subsidies or not, depending on the level of financial sophistication of the MFI and whether you are comparing your ratios with those of other MFIs.

Be sure that the figures with **asterisks** cover the same period of time (such as quarter, semester, or year) for all dates, so that comparisons are valid.

Indicator	Formula	Lines from Exercise 3	Date	Date	Date
Profitability/Sustainability					
1) (Adjusted) return on assets [(A)ROA]	(Financial income – interest paid – loan-loss provision – operating expenses – adjustments) / average total assets	(A – B – C – D – G) / avg. L			
2) (Adjusted)return on equity [(A)ROE]	Same numerator as above, which is (adjusted) net operating income / average total equity	(A – B – C – D –G) / avg. P			
3) Operational sustainability (or self-sufficiency)	Financial income / (interest paid + loan-loss provision + operating expenses)	A / (B + C + D)			
4) Financial sustainability (or self-sufficiency)	Financial income / (interest paid + loan-loss provision + operating expenses + adjustments)	A / (B + C + D + G)			
5) Profit margin	Same numerator as in (A)ROA / financial income	(A – B – C – D –G) / A			
Productivity/Efficiency					
6) Operating expenses / average gross portfolio	Operating expenses / average gross portfolio	D / avg. J			
7) Cost per borrower	Operating expenses / average no. of borrowers	D / avg. T			
8) Cost per unit of money lent	Operating expenses / value of disbursements	D / Q			

Indicator	Formula	Lines from Exercise 3	Date	Date	Date
9) Staff productivity (no. of borrowers)	No. of active borrowers / number of loan officers	T / BB			
10) Staff productivity (portfolio)	Gross portfolio / number of loan officers	J / BB			
11) Client retention*	Active borrowers at end of period / (active borrowers at beginning of period + new clients during period)	T at end of period / (initial T + U)			
Portfolio quality					
12) Portfolio at risk 1 to 30 days	Portfolio at risk 1 to 30 days / gross portfolio	V / J			
13) Portfolio at risk 31 to 90 days	Portfolio at risk 31 to 90 days / gross portfolio	W / J			
14) Portfolio at risk 91 to 180 days	Portfolio at risk 91 to 180 days / gross portfolio	X / J			
15) Portfolio at risk over 180 days*	Portfolio at risk over 180 days / gross portfolio	Y / J			
16) Loan-loss reserves adequacy	Loan-loss reserves / loans past due more than 30 days	K / (W + X + Y)			
17) Write-offs / avg. gross portfolio	Loans written off / average gross portfolio	Z / avg. J			
Growth/outreach					
18) Portfolio growth	(Gross portfolio at end of period – gross portfolio at beginning of period) / gross portfolio at beginning of period	(J at end of period – initial J) / J at beginning			

Indicator	Formula	Lines from Exercise 3	Date	Date	Date
19) Growth in borrowers	(No. of borrowers at end of period – borrowers at beginning of period) / borrowers at end of period	(T at end of period – initial T) / T at beginning			
20) Growth in equity	(Equity at end of period – equity at beginning of period) / equity at beginning of period	(P at end of period – initial P) / P at beginning			
21) Depth of portfolio[39]	Average loan balance / GNP per capita	(J / T) / DD			
Financial structure					
22) Liquidity	Cash and cash equivalents / short-term liabilities	H / M			
23) Leverage	Total liabilities / total equity	O / P			
24) Capital adequacy	Total equity / gross portfolio	P / J			
25) Asset productivity	Gross portfolio / total assets	J / L			

[39] To reflect the average size of loan disbursed in the numerator, instead of the average loan outstanding, divide the value of the disbursements for the period by the number of disbursements for the period.

EXERCISE 5: "TOP 10"

Choose your own "top 10" indicators. The ones below are just an example to measure actual indicators versus projected indicators and industry standards.

MFI ______________________________ Date ____________________

Indicator	Actual*	Projected*	Benchmarks (MBB) **		Reasons for Variance
1) Operational sustainability			130%		
2) Financial sustainability			112%		
3) Profit margin			8.1%		
4) Operating expenses / avg. gross portfolio			25%		
5) Cost per borrower			$122		
6) Portfolio at risk over 90 days			2.3%		
7) Write-offs / average loan portfolio			N/A		
8) Portfolio growth			N/A		
9) Depth of portfolio			80%		
10) Capital adequacy: equity / gross portfolio			N/A		

*Be sure that if your actual and projected figures are for any period other than one year, they are annualized. For example, if the ratio is for a quarter, you must multiply it by four.
** *The MicroBanking Bulletin* (MBB) benchmarks represent the average for 65 financially sustainable MFIs, taken from the September 2000 issue.

ANNEX 3
BREAK-EVEN CALCULATIONS

Break-even occurs when income generated exactly equals expenses; that is, there is no net income or net profits. In other words, the entity is 100-percent operationally sustainable.

> The formula for break-even number of loans is: fixed costs / contribution margin per loan.

Fixed costs are those expenses that do not vary according to the volume produced. Even though some fixed costs are increased by "steps" (for example, the number of loan officers increases as the portfolio grows), they do not do so with each new loan. So, salaries are considered fixed costs. Another example of a fixed cost for an MFI is rent and utilities.

Variable costs are those expenses that do vary according to the volume produced. Examples of variable costs would be the cost of funds, loan-loss reserves, and costs to register collateral.

The contribution margin is income per loan minus variable costs per loan.

EXAMPLE 1:

An MFI has not grown sufficiently to cover its costs. The board wants to know how much more it needs to grow in order to be sustainable.

The MFI offers one product—individual loans yielding an effective rate of 30 percent p.a. The average outstanding loan is US$300, and there are presently 5,135 borrowers. The cost of funds is 5 percent p.a., and loan-loss provisions are an additional 2 percent. Annual operating costs are $395,000, with excess staff capacity to service an additional 1,000 clients.

What is the break-even? That is, how many borrowers does the MFI need to have to cover its costs? Is this feasible with the present cost structure?

ANSWER:

Fixed costs = $395,000 operating expenses
Contribution margin per loan = (300 X .30) – (300 X .05) – (300 X .02) = 90 – 15 – 6 = 69
Break-even = 395,000 / 69 = 5,725 loans.

EXAMPLE 2:

An MFI plans to expand to a new region. The market studies indicate the potential demand is 10,000 clients, but there are two competing MFIs in the region. What percentage of market penetration does the MFI need to obtain to cover its costs during the first two years of operations? Is this realistic?

The average loan outstanding is projected to be $462. The effective interest rate is 29 percent, and all credit funds are donated. Loan-loss provisions equal 2.5 percent of the portfolio. Start-up costs alone during the first year totaled $59,000. Normal operating costs are projected to be an additional $172,500 per year, with overhead allocation to be $21,000 more per year.

ANSWER:

Assuming the MFI does *not* amortize the start-up costs,
fixed costs for two years = $59,000 + [($172,500 + $21,000) X 2] = $446,000
Contribution margin per loan = $462 X (.29 – .025) = $122.43
Break-even = 446,000 / 122.43 = 3,643 loans in two years.

Market penetration = 1,457 loans the first year and 2,186 the second year (assuming that the split is 40/60 for the two years, and growth in clients is 50 percent in the second year), which represents market penetration of 15 percent and 22 percent, respectively. This sounds realistic given only two competitors.

Now, calculate a "real situation" from your MFI:

ANNEX 4
REPORTING CHECKLIST

Here is a sample of what the board might require to monitor the MFI's performance. These items should be agreed on by management and form part of the financial policies of the institution. They should also be in the board manual, so that members know what to expect when.

Frequency depends on the age of the MFI, the involvement of the board, and the track record of management. Frequencies can change as the situation changes.

Note that management is responsible for all reports. The board should not have to create any reports. The information requested is the minimum needed for management to run the MFI in a responsible and sustainable manner.

Date(s) Completed	Due Date	Report	Frequency	Responsible Party
	By the 20th of the next quarter	Income statement	At least quarterly, but as often as monthly, if appropriate	Management
	By the 20th of the next quarter	Balance sheet	At least quarterly, but as often as monthly, if appropriate	Management
	By the 20th of the next quarter	Portfolio report	At least quarterly, but as often as monthly, if appropriate	Management
	By the 20th of the next quarter	Indicators, with comparisons with prior periods and/or industry standards	Quarterly	Management
	By the 20th of the next quarter	Variance report, with actuals compared with budgeted	Quarterly	Management
	By 3 months prior to fiscal year-end	Operational plan	Annually	Management with board approval
	By 2 months prior to fiscal year-end	Annual budget	Annually	Management with board approval
	Before operational plan for that year	Strategic plan	Every 3 to 5 years	Management with board input and approval

ANNEX 5
RESOURCE LIST

Financial Analysis and Indicators

"The ACCION CAMEL," Sonia Saltzman and Darcy Salinger, ACCION International, 1998.

"Business Planning and Financial Modeling for Microfinance Institutions," Tony Sheldon and Charles Waterfield, CGAP, November 1998. (www.microfin.com)

"Financial Ratio Analysis of Microfinance Institutions," The SEEP Network and Calmeadow, 1995.

Microfinance Handbook, Joanna Ledgerwood, The World Bank, 1999, pp. 185–262.

"Understanding Nonprofit Financial Statements," John Paul Dalsimer, National Center for Nonprofit Boards, 1996. (www.ncnb.org)

Performance Monitoring

"Performance and Standards in Microfinance: ACCION's Experience with the CAMEL Instrument," Sonia B. Saltzman, Rachel Rock, and Darcy Salinger, ACCION International, 1998.

"SEEP's Financial Services Working Group Performance Monitoring Project," Warren Brown, Tony Sheldon, and Charles Waterfield, SEEP, 2000.

The MicroBanking Bulletin Toolkit. (www.microbanking-mbb.org)

Governance

"Current Governance Practices of Microfinance Institutions," Anita Campion, The Microfinance Network, October 1998.

"Financial Responsibilities of the Nonprofit Board," Andrew S. Lang, National Center for Nonprofit Boards, 1998. (www.ncnb.org)

"Principles and Practices of Microfinance Governance," Rachel Rock, Maria Otero, and Sonia Saltzman, Microenterprise Best Practices Project of the U.S. Agency for International Development, implemented by Development Alternatives, Inc., 1998.

"The Audit Committee," Sandra Johnson, National Center for Nonprofit Boards, 1993.

"The Finance Committee," Norah Holmgren, National Center for Nonprofit Boards, 1995.

Industry Comparisons

"The Latin American Microfinance Industry—How Does It Measure Up?" Tor Jansson and Miguel Taborga, Inter-American Development Bank, 2000.

The MicroBanking Bulletin, CGAP. (www.microbanking-mbb.org)

"Model Credit Unions and PEARLS," World Council of Credit Unions. (www.woccu.org)

Risk Management

"A Risk Management Framework for Microfinance Institutions," The Microfinance Network and Shorebank Advisory Services, Inc., GTZ, 2000.

"Improving Internal Control," Anita Campion, The Microfinance Network, with GTZ, 2000.