New Developments in MFI Reporting Standards

Speaker's Corner Discussion Synthesis

This report summarizes the key points raised in "New Developments in MFI Reporting Standards," a Speaker's Corner held July 21-24, 2009. A complete transcript is available at www.microlinks.org/sc/standards and background materials on the Microfinance Reporting Standards Initiative can be found at: http://seepnetwork.org/Pages/Initiatives/FinancialReportingStandardInitiative.aspx.

Context:

Over the past year and a half, the SEEP Financial Services Working Group has facilitated sector-wide research, dialogue and work in the area of developing and promoting microfinance reporting standards. Reporting Standards refer to "A single set of high quality, understandable global accounting guidelines that require transparent and comparable information in general purpose financial and operational statements for microfinance institutions." See the Reporting Standards Initiative Concept Note for more background information.

> ***Welcome Message***
>
> *The Microfinance Reporting Standards Initiative is gaining momentum…with lots of new activity, including a standards adoption process adapted from the International Accounting Standards Board (IASB).*
>
> ***Drew Tulchin (Host)***

Spearheaded by the Microfinance Reporting Standards Initiative whose members moderated the forum, the online discussion sought to answer such questions as:

- How should the microfinance industry move toward consensus decision-making for financial standards and reporting?
- How can the industry keep stakeholders engaged in the process and compliant with reporting?

Speaker's Corners are online discussions hosted by subject matter experts, designed to help practitioners share and learn from each other. They are hosted on microLINKS (*www.microlinks.org*) and Poverty Frontiers (*www.povertyfrontiers.org*)

The SEEP Network
1875 Connecticut Ave NW, Suite 414
Washington, DC 20009
202.534.1400
www.seepnetwork.org

- What are the main differences between national accounting standards, International Accounting Standards (IAS), and International Financial Reporting Standards (IFRS)?
- What is missing in the current documents: SEEP's Framework for Measuring MFI Performance and CGAP's Microfinance Consensus Guidelines
- What ratios for savings and capital adequacy would improve reporting for MFIs?

This report summarizes what was clearly a preliminary discussion of the topic. Given that MFIs worldwide do not uniformly follow standards and are only beginning to use new tools like IFRS for financial reporting, the discussion raised more questions than answers. The initiative will continue to facilitate conversation and education so that sector stakeholders may access information on the key issues in reporting under IFRS. More data is also needed—both on the differences between national accounting standards and IFRS, as well as the experience of MFIs that have used both.

Nevertheless, three clear themes emerged from the discussion:

1. Implementation of IFRS is a capacity-building challenge – for MFIs, local audit firms, investors and stakeholders generally

2. Insufficient data exists on the differences between national accounting standards and IFRS, and available information is not widely circulated or accessed.

3. As the microfinance industry matures, new financial reporting ratios will be needed.

The Speaker's Corner involved over 16 microfinance and microenterprise specialists, the majority of whom work for MFIs, international donors, MFI networks, and consulting companies. The following pages summarize the main threads of the discussion, organized by the themes identified above.

1. IFRS as a capacity building challenge.

Implementing IFRS for MFI financial reporting appears to challenge the capacity of the entire spectrum of stakeholders in microfinance, from central banks to MFI boards of directors to accounting and auditing professionals to international PVOs and networks to MFI staff.

Muhammad Junaid of the United Nations Capital Development Fund (UNCDF) suggested IFRS should be addressed at three levels: policy, regulation, and training and capacity building. First, governments and central banks must be encouraged to adapt IFRS into national accounting standards. Such an effort requires a government champion that can coordinate a national effort with other major stakeholders. At the level of regulation, there are two

capacity issues. *"Central banks lack the capacity (and in most cases, the willingness, to regulate the microfinance industry,"* observed Junaid. Even if IFRS was required for reporting to regulatory authorities, as several participants in the discussion suggested, Junaid pointed out that "*the majority of MFIs in many countries lack the capacity to prepare and submit professionally prepared accounting statements complying with national or international standards. No amount of regulation can make up for the lack of capacity within MFIs."* Junaid concluded that, *"Training and capacity building of the industry and at the organizational level are the most important* *[element needed] to introduce effective reporting standards."*

Junaid explained that mobilizing support from a wide range of stakeholders is the key to success. *"Effective stakeholder participation in the policymaking process is critical,"* he explained, "*Financial sector associations, accounting, and auditing professional bodies and donors can play a significant role in the adaptation, translation, and dissemination of relevant reporting standards."*

In addition to capacity building of regulatory authorities and the accounting profession, IFRS also requires Board members with new skills. As Eileen Miamidian of CHF International observed, *"Disclosures are significantly more detailed for external audits [under IFRS], which increases the costs of the audits, and [makes] additional demands on board members to understand them."* James Dailey of Micro Energy Credits pointed out that in some cases, IFRS implementation itself depends on a motivated member of the board: *"From working with a number of MFIs, the accounting policies being proposed and implemented are often a matter of training and experience of the accountant or member of the Board that pushes this [idea], which can be a key limitation."*

Depending on the country, MFIs may initially adopt IFRS or transition to IFRS from the national accounting standards that previously governed their financial reporting. As Ruth Dueck Mbeba of MEDA observed, *"The vast majority of MFIs [that] I have contact with have worked in environments where national accounting standards were non-existent or not well-articulated and, as part of national financial or regulatory reform, they have adopted IFRS directly. I see challenges for MFIs in countries where national accounting standards are well known and practiced in the profession (e.g., India), where transition will [have to be] carefully planned.*

2. Insufficient data exists on the differences between national accounting standards and IFRS, and available information is not widely circulated or accessed.

A number of participants pointed out that the differences between national standards and IFRS were not yet well understood. The same applies to differences between IFRS and Generally Accepted Accounting Principles (GAAP), the application of which also vary by country.

Most discussants agreed that more information needs to be gathered and circulated on the experience of MFIs that have made the transition from national standards to IFRS in their financial reporting, including the pros and cons of the respective standards.

Scott Gaul of the Microfinance Information Exchange (MIX) pointed out that the explanations of external auditors could be highly useful for understanding the differences between the two sets of standards, citing the external audits of Cambodian MFIs on the MIX Market (see Box 1).

Box 1 includes more detailed information on ***What we Know Now about IFRS vs. National Accounting Standards***. IFRS is also under constant evolution, and it is important to keep abreast of changes and their impact on microfinance reporting. Box 2 describes "How IFRS impacts an MFI" and Box 3 highlights additional resources on IFRS and MFI financial reporting.

Box 1. National Accounting Standards vs. IFRS: What We Know Now

Information about the differences between IFRS and GAAP accounting is not widely circulated amongst microfinance stakeholders. Generally Accepted Accounting Standards are promoted and generally referred to as national accounting standards by different countries. India has distinct, nationally recognized and applicable GAAP, as does the U.S., among many other countries. Some countries that have traditionally had their own national accounting standards, or their own Generally Accepted Accounting Standards, have decided to transition to IFRS. Other countries are adopting IFRS directly without coming from a strong tradition or history of national accounting standards

The Speaker's Corner discussion identified some of the new demands that IFRS makes on MFI record-keeping and accounting practices, including:

- tracking of additional information, such as loan interest accruals, exchange rates and maturity gaps of assets and liabilities
- recognition of loan commissions and fees over the life of a loan instead of at the time of receipt
- far more detailed disclosure in external audits
- methods of measuring the impairments of assets, particularly loans receivables

Some key questions that went unanswered are whether IFRS values microfinance loans at historical or fair market value, and whether interest income on these loans should be reported on a cash or accrual basis, or amortized over the life of the loan. An MFI network representative noted that most MFI network members reported interested on a cash basis, but that more mature MFIs used the accrual basis. Note the IFRS alert below on recent developments that may negate many of these concerns for MFIs.

In countries that have not yet elaborated national accounting standards, IFRS may be adopted by straightaway by the banking and/or microfinance regulatory authority. In other countries, MFIs may use different standards when preparing financial reporting for different stakeholders: national standards for regulatory authorities and IFRS for international donors and investors. In addition, country-specific GAAP reporting may create yet another layer of difference in reporting conventions.

A number of participants in the Speaker's Corner agreed that making IFRS a regulatory requirement would be a catalyst for MFIs to adopt the standards. But Muhammad Junaid of UNCDF pointed out that such a change would require governments that are committed to instituting national accounting reforms. Blaine Stephens of The MIX then asked the question, if MFI reporting standards converge with IFRS, what role would a microfinance reporting standards have? It is unclear whether mainstream regulatory reporting includes most of the information that MFI managers want to know, or whether there are key pieces of microfinance management information that mainstream banking requirements overlook.

Scott Gaul of the Microfinance Information Exchange (MIX) noted that during the period 2003 – 2007 in Cambodia, out of 14 MFIs that underwent external audits, one switched from national accounting standards to IFRS, one did the reverse, and many used national standards throughout. Of interest, said Gaul, are the detailed explanations provided by auditors on the differences between the two sets of standards. An example of such an explanation comes from an external audit of C-H-C Microfinance Limited:

"The financial statements of the Company represented in United States Dollar ("USD") are prepared under the historical cost convention in accordance with the guidelines issued by the NBC and in accordance with accounting principles generally accepted in the Kingdom of Cambodia and practices within the micro-finance industry. Those principles require that financial instruments be carried at cost less provisions for impairment. This practice differs from the International Financial Reporting Standards which require that loans and receivables be carried at amortised cost using the effective interest method of any difference between the initial amount and the maturity amount, and minus any reduction for impairment or uncollectability.

The presentation of financial statements in conformity with accounting principles generally accepted in the Kingdom of Cambodia requires the Management to make the best estimates and reasonable assumptions that affect the reported amount of assets and liabilities and disclosures of contingent assets and liabilities as of the date of the financial statements and their reported amounts of revenues and expenses during the reporting period. These estimates and assumptions are based on the information available as of the date of the financial statements. Actual results, therefore, could differ from those estimates. The accompanying financial statements are prepared for jurisdiction of Cambodia and are not intended to present the financial position and results of operations and cash flows in accordance with generally accepted accounting principles and practice in other countries and those who are not informed about Cambodia's procedures and practices."

(Source: http://www.mixmarket.org/sites/default/files/medialibrary/20501.2273/CHC_Audit_Report_2007Final.doc)

3. As the microfinance industry matures, new financial reporting ratios may be needed.

Several participants agreed that new MFI reporting ratios would be needed as the industry continues to mature, including deposit concentration and capital adequacy ratios in regulated institutions. In addition, Nancy Sommer of responsAbility, a social investment firm, noted that an open currency position ratio (% of equity plus subordinated-debt) and refinancing and/or restructuring ratios were becoming more useful.

Elissa McCarter of CHF International mentioned that the SEEP Network's Financial Services Working Group (FSWG) was currently revising the Framework for Reporting, Analysis, Monitoring and Evaluation (FRAME), SEEP's publication on MFI financial reporting. The present draft currently envisions adding 8 new ratios to the 18 core ratios of the 2005 publication. Working group members have also agreed to include tables on asset liability management, as per the recent CGAP *Focus Note* (no. 55, June 2009), "Asset Liability Management for Deposit-taking Microfinance Institutions."

IFRS Alert on IAS 39 Financial Instruments: Recognition and Measurement

International Accounting and Financial Reporting Standards are continually undergoing changes! An October 2008 Press Release announced the ability to elect historical cost as the valuation and reporting basis for loans and receivables. A July 2009 Press Release announces further suggestions to change the accounting for loans receivable and interest received on them. If the exposure draft is passed, these changes are expected to be much more favorable for MFI reporting of loans receivable. It is expected that loans will be recognized and measured at historical cost and revenue recognized on a nominal, not amortized basis.

Accrued interest revenue on loans outstanding may still be an issue for MFIs to address.

Box 2. How IFRS Impacts an MFI

As the discussion progressed, it became apparent that IFRS requirements will impact MFIs in several ways:

- external audits will become more costly, as more detailed disclosures would be needed;
- greater staff skills will be required;
- greater external audit skills will be required;
- the management information system (MIS) may have to be altered to track new data, such as the capacity to accrue interest on outstanding loans, track exchange rates and maturity gaps, and possibly to recognize commissions and fees over the life of the associated loans;
- support from knowledgeable Board members will be needed for successful implementation;
- certain flexibility, such as the ability to renegotiate payment schedules, might be lost because of the confusion over how to categorize renegotiated loans under IFRS

With respect to the last point, James Dailey of MicroEnergy Credits sounded a cautionary note about implementation of IFRS in microfinance. "My sense," he said, "is that there are a lot of 'standard rules' that would force a change in the very innovativeness that makes many MFIs successful. It may not be a good argument to resist good practice from the formal financial sector, but it is something to consider."

Next Steps

This report highlights how much more dialogue and education is needed to advance financial reporting standards and make use of new technologies. The SEEP Financial Services Working Group, as leader of the Microfinance Reporting Standards Initiative, is facilitating an ongoing Discussion Board to gather input on:

- IFRS and IAS for Microfinance reporting
- Additional Ratios for Monitoring and Measuring Institutional Performance
- Developing a Reporting Standards Body

Please contact drew@socialenterprise.net to receive regular updates, provide input, and participate in learning and advancement of reporting standards for microfinance.

August 20, 2009. This publication was produced by the SEEP Network. It was prepared by Peggy McInerny and reviewed by Drew Tulchin, Social Enterprise Associates (Facilitator of the Microfinance Reporting Standards Initiative), Ruth Dueck Mbeba, MEDA (Facilitator of the Financial Services Working Group), and Jessica Elisberg, the SEEP Network.

About this Speaker's Corner

Speaker's Corner was sponsored by MicroLINKS, an initiative of USAID, and is held regularly on a variety of topics for microenterprise learning, information and knowledge sharing at www.microlinks.org.

Box 3. Resources on IFRS and MFI Financial Reporting

The full transcript of this online discussion is available Online at **Speaker's Corner**: www.microlinks.org/sc/standards

Microfinance Reporting Standards Initiative Resources
You can access the Initiative library for free by registering at http://members.seepnetwork.org

IFRS for Microfinance Reporting
The Financial Services Working Group – as host of the Microfinance Reporting Standards Initiative – has developed two resources on the topic:

- Reporting Standards Terms and Resources addresses the topic of standards generally
- Overview of IFRS for Microfinance Reporting Discussion July 2009 identifies IFRS and IAS and their possible implications in microfinance reporting

Other Useful Websites

- IFRS and IAS Deloitte: Comparison of IFRS with US GAAP July 2008. Remember that IFRS 2009 releases – which have significant changes to IAS 32 Financial Instruments – will affect this comparative version. Check websites often to look for the most recent updates.
- The International Accounting Standards Board's (IASB) website provides full overview of IFRS and IAS, interpretations and updates at www.iasb.org. This includes the July 2009 publication of IFRS for SME's. Individuals may register for free to receive information on a regular basis. The full version of standards is available for sale at this website.
- Deloitte: www.iasplus.com contains a wealth of information on IFRS and IAS
- Deloitte Touche Tohmatsu, PricewaterhouseCoopers, KPMG and Ernst & Young websites all provide information on IFRS and IAS. Visit their websites in your country

Additional Ratios and Analysis Resources

- CGAP Focus Note (no. 55, June 2009), Asset Liability Management for Deposit-taking Microfinance Institutions.
- World Council of Credit Unions (WOCCU) PEARLS Monograph. Each letter of the word PEARLS measures key areas of Credit Union operations: Protection, Effective financial structure, Asset quality, Rates of return and cost, Liquidity and Signs of growth.
- Bank for International Settlements is an international organization which fosters cooperation among central banks and other agencies in pursuit of monetary and financial stability. The Basel Committee for Banking Supervision has issued a number of frameworks to strengthen support and resources to central banks. Basel II uses a "three pillars" concept – (1) minimum capital requirements (addressing risk), (2) supervisory review and (3) market discipline – to promote greater stability in the financial system. The Basel I accord dealt with only parts of each of these pillars. For additional resources visit www.bis.org.

Microfinance Information Exchange (MIX)
What do IFRS compliant financial statements of MFIs look like? Click on the links below to download audited reports of the MFIs listed:

Kompanion (Kyrgyzstan) - 2008 Audits   Mikrofin (Bosnia) - 2007 Audits   FMFB (Afghanistan) - 2008 Audits

For examples of MFIs in transition to IFRS please click on the following links:

FMFB (Pakistan) - 2007 Audits   OISL (Ghana) - 2007 Audits   C-H-C Limited (Cambodia) – 2007 Audits