Financial Performance Practices in Micro Finance Institution

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Abstract

Financial management practices are crucial determinants of financial performance of microfinance institutions (MFIs). The financial performance of microfinance institutions has received a general global displeasure despite the fact that international and national development programs have been giving high priority on sustainable microfinance for many years. This study was conducted in order to determine the effect of financial management practices on performance of microfinance institutions the prime functional area of financial management and accounting practices are investment, financing, asset management and accounting policies.

KEYWORDS-financial management, micro finance institution, trends, key financial factors, measuring efficiency

INTRODUCTION

Financial management practices are associated with better financial performance of microfinance institutions Efforts by the MFIs management to improve financial performance must be matched with adoption of financial management practices that provide MFIs with sustained competitive advantage over their rivals (Rahaman, 2010). Credit risk is the potential that a financial institutional borrower or counterparty will fail to meet its obligations in accordance with agreed terms .Financial performance originates from the structure and financial position of the firm. Financial statement is the yard stick to monitor and evaluate performance. Business executives use financial statements to draft a comprehensive financial plan that will maximize shareholders wealth and minimize possible risks that may preexist. Financial statements are used in evaluation of financial performance and financial position of a firm. They are prepared for external stakeholders such as lenders, shareholders and government agencies (Rahaman, 2010).

FINANCIAL MANAGEMENT

Financial Management means planning, organizing, directing and controlling the financial activities such as procurement and utilization of funds of the enterprise. It means applying general management principles to financial resources of the enterprise.

MICRO FINANCIAL INSTITUTIONS

Poverty is the main cause of concern in improving the economic status of developing countries. A microfinance institution is an organization that offers financial services to low income populations. Almost all give loans to their members, and many offer insurance, deposit and other services.

A great scale of organizations is regarded as microfinance institutes. They are those that offer credits and other financial services to the representatives of poor strata of population (except for extremely poor strata).

Microfinance is increasingly being considered as one of the most effective tools of reducing poverty. Microfinance has a significant role in bridging the gap between the formal financial institutions and the rural poor. The Micro Finance Institutions (MFIs) accesses financial resources from the Banks and other mainstream Financial Institutions and provide financial and support services to the poor.

MFIs are the pivotal overseas organizations in each country that make individual microcredit loans directly to villagers, micro entrepreneurs, impoverished women and poor families. An overseas MFI is like a small bank with the same challenges and capital needs confronting any expanding small venture but with the added responsibility of serving economically-marginalized populations. Many MFIs are creditworthy and well-run with proven records of success, many are operationally self-sufficient.

Various types of institutions offer microfinance: credit unions, commercial banks, NGOs (Non-governmental Organizations), cooperatives, and sectors of government banks. The emergence of “for-profit” MFIs is growing. In India , these ‘for-profit’ MFIs are referred to as Non-Banking Financial Companies (NBFC). NGOs mainly work in remote rural areas thereby providing financial services to the persons with no access to banking services.

BEST PRACTICES AND EMERGING TRENDS IN FINANCIAL MANAGEMENT AND ACCOUNTING

Good practice in financial management and accounting provides financial benefits, long-term direction and stability to the operations of microfinance institutions. Clear accounting policies contribute to disclosure and transparency in terms of reporting financial performance and providing an accurate reflection of the financial position of the MFI. The key aspects of good practice in financial management and accounting are set out in **Table 1**

Table 1
Good Practice in Financial Management and Accounting

Operational area	Practices
Investment	Careful **investment planning** based on a realistic assessment of safety, liquidity needs and returns in that order **Limits on exposure** to a particular instrument or institution **Limits on non-portfolio assets** to less than 15-20% of total assets
Financing	Comprehensive planning with **scientific forecasting** A long term **planned approach** to fund-raising; proper **contingency measures** like cash credit facilities A financing strategy that entails use of **multiple and stable sources of funds** leading to funding risk mitigation Analysing working capital needs and **maximising efforts to attain a stable liability structure** – even while generating sufficient funds with an optimal cost and conditions
Asset management	Clear strategy to **protect and manage assets** through measures such as internal audit, portfolio tracking, portfolio diversification and client level insurance Use of **current accounts for collection** **Limits for branch office** bank accounts
Accounting	**Cash basis for recognition of interest income** on loans except in cases where loans are repayable in quarterly, half-yearly or yearly instalment basis – cash based recognition of income is a commonly used practice and represents a conservative way of reporting income Treating **grant inflows as non-operational income** and reporting these inflows after determining operational profitability Providing a **detailed disclosure statement** with regard to the accounting policies adopted and also providing details of each account head through schedules to the financial statements Standardising and clearly defining the scope of an external audit through the use of **a formal contracting system**

Source: M-CRIL, 2003. "Improving Microfinance Practice"

Financial management and accounting are inter-related and key functional areas for all institutions engaged in financial intermediation. With a greater scale of operations, increased reliance on commercial funds that provides a platform for attaining high levels of outreach, financial management is now attracting the requisite degree of

attention. The trend to commercialization is also leading to greater recognition of the need for sound accounting practices.

With the scaling up of operations the following trends can be observed in financial management practices

- *Separately dedicated professional staff and department for financial management*;
- *Cash management* is fast becoming an important aspect of financial management in microfinance. Clear cash transfer procedures, specific cash holding limits and emphasis on the optimal utilisation of excess cash are becoming the norm in most progressive MFIs.
- *Cheque based disbursement and repayment:* Some MFIs have now moved towards a cheque-based system of loan disbursement and repayment. Apart from enhancing cash control, this reduces the delays in encashing cheques and allows for the speedy transfer of cash.
- *Accounting*: Documented accounting practices with increasing emphasis on disclosure.

INEFFICIENCY OF MFO

Microfinance Organizations provide small loans and other financial services to low-income, poor, and very poor self-employed people. MFOs may appear inefficient compared to traditional lending institutions for the following reasons:

- MFOs are on average smaller than traditional banks
- In general, MFOs make shorter-term loans than traditional banks
- MFOs make smaller loans than traditional banks
- Many MFOs are relatively new organizations
- Many MFOs are growing rapidly

Although efficiency is an important concept that can be applied to MFOs, it is by no means the only goal of a Microfinance Organization. Indeed, MFOs can be thought to have a dual goal: **financial viability** and **outreach to the poor**.

Those who contend that there is a trade-off between sustainability and outreach argue that the push for MFOs to cover costs, become sustainable and wean themselves from donor financing moves MFOs away from providing services to the poor. The poorest clients, some argue, cannot afford to pay for the full cost of these services in the long run…. For proponents of sustainability, large-scale outreach is possible only through building permanent, viable institutions that respond to the demand for financial services by their customers.

KEY FINANCIAL FACTORS

- **Determinants of Income**

The following are significant determinants of the level of income generated by an MFO's lending activities:

1) Portfolio size
2) Interest Rate
3) Commission Rate
4) Grants and Loans (subsidized or unsubsidized)

***1.* Portfolio size**

The loan portfolio generates the largest share of an MFO's operating income. The loan portfolio is an MFO's most important revenue earning asset. The factors that affect income generated by the loan portfolio are:

- *Number of loans disbursed and number of active clients*: disbursing more loans increases the size of the portfolio
- *Effective loan term* (the *actual* length of time that the average client takes to pay back a loan): loans with longer terms are more costly to the lending institution. The longer the effective loan term, the more capital an MFO requires in order to finance the loan. Of course, designing loan products requires other considerations besides maximization of income. Setting loan terms to meet client needs is essential for successful operations and requires understanding cash patterns of borrowers in the local environment. Setting inappropriate loan terms will often lead to a higher default rate.
- *Client retention*: an MFO's ability to retain clients maintains or increases the size of an institution's portfolio. Furthermore, because new clients' first loans are often limited by a lower initial loan size, retained clients generally have a higher average loan size. Larger loans are, on average, less costly to administer. If an MFO relies on new client outreach alone the average loan size will likely be lower than if the MFO tries to retain clients.
- *Delinquency rate*: Every loan portfolio contains a certain degree of risk because loan repayment is uncertain. A high share of unrecoverable loans can significantly diminish the portfolio's income generating ability.

***2.*Interest Rate**

A higher interest rate means more income for the MFO, but there are many other tradeoffs involved. For example, if an MFO charges a higher interest rate, the demand for loans might decrease. In addition, the default rate on loans might increase. For a full discussion of these and other issues, see the Pricing and Interest Rate Module.

***3.*Commission Rate**

A higher commission rate increases the effective interest rate that the borrower pays and hence, increases the MFO's program income. For more information on fees (or commissions) and interest rates, see the Pricing and Interest Rate Module.

***4.*Grants and Loans (subsidized or unsubsidized)**

These may be from multilateral lending institutions, government funds, or private charities.

CONCLUSION

To improve the quality of life of the poor by providing access to financial and support services; To be a viable financial institution developing sustainable communities; To mobilize resources in order to provide financial and support services to the poor, particularly women, for viable productive income generation enterprises enabling them to reduce their poverty;

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