

Accounting - Self Study Guide for Staff of Micro Finance Institutions

LESSON 3

The Income Statement

OBJECTIVES The purpose of this lesson is to introduce the Income Statement and to define revenue and expenses. The relationship between revenue and expenses and their affect on the Income Statement will be explained.

You will become familiar with definitions of items commonly seen on the Income Statement and how the Income Statement is created. You will develop an understanding of how the Income Statement reflects transactions for a specified period of time rather than at a specific "point-in-time". Topics include:

- The Income Statement
- Revenue
- Expenses
- Comparative Income Statement



The Income Statement

The Income Statement summarizes all income earned and expenses incurred during a specified **accounting period**, and shows the **net income** (or net loss) earned over that period. Unlike the Balance Sheet which reflects a static position at a "point-in-time", the Income Statement reflects all transactions which have occurred during the "accounting period". The term "accounting period" simply refers to the period of time covered by the Income Statement. The accounting period is set to best suit the needs of managers of the organization and may vary between organizations. Generally, the accounting period refers to one fiscal year or one month.

To determine net income, an organization must measure:

- i. the revenue received (or accrued) for goods and services provided to its clients, and
- ii. the cost of goods and services which it incurred in a specified time period.

The technical accounting terms for these elements of net income are **revenues** and **expenses**. Net Income is the difference between revenue and expenses.

$$\text{Net Income} = \text{Revenues} - \text{Expenses}$$

Refer to the Sample Income Statement on the next page.

SAMPLE INCOME STATEMENT

ABC Credit Programme STATEMENT OF INCOME AND EXPENDITURE For the period ended December 31, 1995		
FINANCIAL INCOME:		
Interest on Current & Past Due Loans	15,400	
Interest on Restructured Loans	100	
Interest on Investments	500	
Loan Fees/Service Charges	5,300	
Late fees on Loans	<u>200</u>	
Total Financial Income		21,500
FINANCIAL COSTS:		
Interest on Debt	3,700	
Interest paid on Deposits	<u>0</u>	
Total Financial Costs		3,700
GROSS FINANCIAL MARGIN		17,800
Provision for Loan Losses		2,500
NET FINANCIAL MARGIN		15,300
Operating Expenses		
Salaries and benefits	6,000	
Administrative expenses	2,600	
Occupancy expense	2,500	
Travel	2,500	
Depreciation	400	
Other	<u>300</u>	
Total Operating Expenses		14,300
NET INCOME FROM OPERATIONS		1,000
Grant Revenue for Operations		0
Excess Of Income Over Expenses		1,000

Source: SEEP Financial Services Working Group

Revenue

In accounting terms, revenue refers to money received (or to be received) by the organization for goods sold and services rendered during a given accounting period. When an organization renders services or sells merchandise to its clients, it usually receives revenue in the form of cash or an account receivable. Revenue for a micro-finance organization includes: interest earned on loans to clients; fees earned on loans to clients; interest earned on funds on deposit with a bank, etc.

Expenses

Expenses represent the costs incurred for goods and services used in the process of earning revenue. They are often referred to as the 'cost of doing business' since they represent the costs that are necessary for the organization to generate revenue and thus remain in operation. Direct expenses for a micro-finance organization include financial costs, operating expenses and loan loss provisions (a fourth cost - the Imputed Cost of Capital - is discussed in the FINANCE study guide).

Accounting Definitions (Income Statement)

⇒ *Financial Income:*

- **Interest on Current and Past-Due Loans** - the amount collected from clients for borrowing money from the organization for a specified period of time. The interest rate is generally stated as a percentage of the loan amount on an annual or period basis.

[Note: the principal amount of the loan repaid is not included in income. Only the Balance Sheet accounts are affected by the principal portion of the loan repayment, i.e. the Loans Outstanding decrease and Cash increases. The only time the Income Statement is affected by the principal portion of a loan is when a loan which has been written off is repaid. This is discussed further in the FINANCE study guide.]

- **Interest on Restructured Loans** - the amount of interest collected from borrowers on loans which have been restructured.
- **Interest on Investments** - the amount of interest earned by the organization on its investments such as term deposits and treasury bills.
- **Loan Fees/Service Charges** - the amount collected from borrowers or members, stated either as a percentage of the loan amount or as a flat fee, for loans disbursed.
- **Late Fees on Loans** - the amount collected, as a penalty, from borrowers who have had loans with payments in arrears.

⇒ *Financial Costs*

- **Interest on Debt** - interest paid by the organization to banks and other financial institutions for money loaned to the organization. [Note: the repayment of the principal portion of a bank loan is not included as a financial cost. It is a reduction of a liability on the Balance Sheet.]
- **Interest Paid on Deposits** - interest paid to clients who deposit savings in the organization (either voluntary or forced).

⇒ *Provision for Loan Losses* - based on the historical default rate and the current outstanding Loan Loss Reserve, the Provision for Loan Losses is the amount expensed in a period to increase the Loan Loss Reserve to an adequate level to cover expected defaults of the loan portfolio. Although the Provision for Loan Losses is a non-cash expense, it is treated as a direct expense for a micro-finance organization even though loans will not yet have been written off as loan losses. Some organizations include the Provision for Loan Losses with the operating costs. It is helpful to separate the Provision for Loan Losses as a separate cost as an indicator of portfolio quality. (See Loan Loss Reserve on the Balance Sheet.)

⇒ *Net Financial Margin* - the margin between the revenue an organization generates by lending and the financial costs associated with funding the loan portfolio.

⇒ *Operating Expenses* - expenses which are specific to delivery of credit and savings activities for a specified time period. For a single-purpose organization, all costs should be included. For multi-purpose institutions, all direct costs of financial operations and an appropriate portion of the institution's overhead should be included. The main categories of operating expenses are:

- **Salaries and benefits** - payments to staff for services rendered.
- **Administrative expenses** - costs incurred for administering the organization such as stationery, insurance, legal fees, etc.
- **Occupancy expenses** - expenses made for (i) lease of land and/or buildings for the credit activities, and (ii) expenses for utilities, such as electricity, water, and telephone.
- **Travel** - expenses for transportation, room and board, etc., of staff members traveling for the organization.
- **Depreciation** - an annual, non-cash expense that is determined by estimating the useful life of each asset. Depreciation represents a decrease in the value to property and equipment to account for that portion of their useful life that is used up during each accounting period. Using the most common method called straight-line depreciation, an asset with an estimated useful life of five years would have one-fifth of its purchase price reflected as an expense in each of five years. Land theoretically does not lose value over time and therefore is not depreciated.

- **Other Expenses** - other expenses related to operations, such as training costs, foreign exchange losses, etc.
- ⇒ *Net Income From Operations* - income which is a direct result of the micro-finance organization's activities net of the expenses directly related to those same activities.
- ⇒ *Grant Revenue for Operations* - funds donated to the organization to cover operating expenses.

Comparative Income Statement

By recording net income earned by an organization, the Income Statement measures the economic performance or level of self-sufficiency. It shows the results of business activities of the organization during the specified accounting period and the degree to which revenue generated from these activities covered the organization's costs.

Refer to the Sample Income Statement - Comparative on the next page. *A comparative statement allows management to see how revenue and expenses have increased or decreased over time.* This can then be compared to the stated goals of the organization.

SAMPLE INCOME STATEMENT (COMPARATIVE)

ABC Credit Programme STATEMENT OF INCOME AND EXPENDITURE For the period ended December 31, 1995			
	1995	1994	% Change
FINANCIAL INCOME:			
Interest on Current & Past Due Loans	15,400	12,000	+ 28%
Interest on Restructured Loans	100	50	+100%
Interest on Investments	500	1,500	- 67%
Loan Fees/Service Charges	5,300	5,000	+ 6%
Late fees on Loans	200	300	- 33%
Total Financial Income	21,500	18,850	+ 14%
FINANCIAL COSTS:			
Interest on Debt	3,700	3,500	+ 6%
Interest paid on Deposits	0	0	0%
Total Financial Costs	3,700	3,500	+ 6%
GROSS FINANCIAL MARGIN	17,800	15,350	+ 16%
Provision for Loan Losses	2,500	3,000	- 17%
NET FINANCIAL MARGIN	15,300	12,350	+ 24%
Operating Expenses			
Salaries and benefits	6,000	5,000	+ 20%
Administrative expenses	2,600	2,500	+ 4%
Occupancy expense	2,500	2,500	0%
Travel	2,500	2,500	0%
Depreciation	400	300	+ 33%
Other	300	300	0%
Total Operating Expenses	14,300	13,100	+ 9%
NET INCOME FROM OPERATIONS	1,000	(750)	+ 233%
Income from Grants for Credit Services	0	950	- 100%
Excess Of Income Over Expenses	1,000	200	+ 400%

Source: SEEP Financial Services Working Group

5. The following information is available for MicroFund Inc. for the period ended December 31, 1993. On the basis of this information, prepare an Income Statement.

PARTICULARS	\$	PARTICULARS	\$
Salaries & Benefits:		Provision for Loan Losses	1,000
- managers	1,000	Equipment Leasing	700
- credit officers	750	Interest on Current Loans	4,000
- admin. assistants	250	Utilities	35
Credit officer's travel expenses	45	Office Cleaning	25
Office stationary	250	Management Travel Expense	100
Rent	425	Interest on Past Due Loans	500
Depreciation	110	Interest on Client Deposits	20
Interest on Debt	600	Educational Materials	200
Interest on Investments	200	Computer Software	500
Service Charges	1,500		

MicroFund Inc. INCOME STATEMENT For the period ended December 31, 1993		