MANUAL ON Financial Systems of SHG Federations

NATIONAL RURAL LIVELIHOOD MISSION

TABLE OF CONTENTS

INTRODUCTION

The Self-Help Groups and their federations[1]at the primary level referred to as village organisation and at secondary level as cluster level federations need to be financially self-reliant and sustainable. This requires strong focus on building systems and processes to ensure that these community based organisations operate with greater accountability and minimal risks.

A system helps defineinter-relationship between different parts which form a federation – including staff, assets, resources, time and information. It helps solve present problems and problems that could occur in future. System defines in detail the roles, policy as well as the process that would guide the work of the federation.

Financial management systems record and categorizes how money comes to the federation and how it goes out. It helps to plan how money would be used – its inflows and outflows, income and expense as well as the assets and liabilities - and most importantly audited, to ensure transparency in fund utilization. A good system helps build trust of the members, and other stakeholders like banks and government to provide resources, as it gives confidence that it would be managed well. Good financial

[1]The federations at the village/ primary level are referred to in most states as Primary level federation (PLF) or Village Organisation VO. These primary level federations could be further aggregated at the cluster level comprising a group of villages into federation referred to in this manual as secondary level federation (SLF) but also termed Cluster Level Federation (CLF) or Block Level Federation (BLF) in most states. The manual will use the term PLF and SLF.

management system is therefore necessary to build sustainable federations as it helps efficient management of money that helps money grow.

If adequate attention is not given to designing systems and ensuring that they are followed, there is high risk of federations controlled by few individuals who may not be responsive to the needs of the members.

The federations are governed by its office bearers that form the board / executive committee. This manual is aimed to help the board / executive committee design systems of PLF or Village Organisation and CLF. It is suggested that it be used as a guide – to focus on areas where systems are necessary with certain standards for effective management of federation. It is however suggested that the board members take the final decision based on their local context, member needs as well as state level policies as guided by the project facilitation team.

The manual uses the term **federation** to define financial management practices that are common for both PLF and SLF unless specific policies require separate mention of the different tiers.

The board members need to have in-depth discussion to decide the way the federation's money would be managed so as to formulate financial systems and policies. The systems need to be based on the core values and principles of the SHG programme. It is important to continually reiterate the key values that should be reflected in the systems design. The board members therefore always need to question – is it democratic, are we ensuring transparency, is the interest of the SHG member safeguarded, how is efficiency and sustainability of the institution ensured.

Let us design for our federations, a system that would ensure that in the years to come, is not dependent on promoters and founders of the federation. When the leadership is rotated, new leaders are also equipped to drive the institution effectively.

Once defined, system ought to be followed. However, once implemented, the task is not over. Being alert to the deficiencies of the systems – to know where things are not working as expected and accordingly revise or change the system - is necessary for federation to remain dynamic and robust.

FINANCIAL SYSTEMS OF FEDERATION

A federation once established has different sources as well as utilization of fund. It is very important to develop annual action plan and budget to understand where the money is coming from and where it is going to be used, so as to ensure profitability. Let us look at the membership structure once to understand the source of funds.

MEMBERSHIP

The PLF shall have minimum 5 and maximum 20 SHGs, extending to 25 in exceptional cases. The SLF typically will have approximately 25-30 PLFs or 3,000 -3500 individual women members organized into SHGs.

Two models are adopted as per the directives of the state mission management unit:

1. PLF takes the function of financial intermediation which includes disbursement of loans, savings and if required also insurance and other financial services
2. In many states, the policy is to promote financial services at the level of SLF only to mitigate the risks associated with cash handling at multiple levels

As per the cooperative law in which the SLF are registered, the individual SHG member has to become a shareholder in the SLF. However, for all practical purposes, it is the SHG that gets membership in the PLF and the PLF only is eligible for membership to the SLF.

ANNUAL WORKS AND FINANCIAL PLAN

FINANCIAL YEAR

The Financial Year of the federation is from 1st April to 31st March. The planning of the federation should be done preferably in the month of January and February every year so as to share the plan in March and start implementation from 1st April.

The plan needs to focus on the following areas:

- Geographical outreach and spread
- Non-financial services to the members
- Capacity building
- Financial services including – savings, loan disbursement and repayment insurance and pension
- Technical services
- Profitability and sustainability
- Linkages with other institutions
- Convergence with other government departments

The executive committee and staff should be involved in the planning process. The plan should be approved in the Annual General Body Meeting.

The Annual Plan should be further divided into quarterly and monthly plans. The monthly plan along with the previous monthly progress should be prepared by the staff and presented in the last meeting of federation every month. The federation President should approve the plan in this meeting after consultation with the executive committee.

While planning there is a need to focus on the following:

- Appropriate changes according to the decisions made in the meeting.
- Parameters like number of staff, their skills and efficiency, nature of work, time available.
- The prescribed format used for review should be used for planning activities and desired objectives,

PARTICULARS	PLAN	PROGRESS	REASON FOR DEVIATION	NEXT PLAN
Outreach • Village • SHG • Members • PLF				
Training to: • Members • Board of Directors and staff				
Non Financial Services- • Health • Livelihood • Legal counseling • Education • Other				
Financial Services • Savings • Loans • Insurance • Pension				
Technical Services • Audit of SHGs and PLF • Gradation				
• Convergence with government depts.				
• Linkages with other institutions				
• Profitability and Sustainability				

SPECIAL PROJECT PLANNING

If the federation is implementing a project like Swachha Bharat Abhiyan planning should also be done as per the approved project proposal. Project planning should be the responsibility of the executive committee of the federation. This planning should also be done annually, quarterly and monthly like the other plans following the same procedure. This plan has to be approved and ratified in the annual general body meeting of the federation.

BUDGET

The plan outlines the work that needs to be done by the federation. The budget outlines the areas where the money would be utilized to achieve the plan. While preparing budget, it is important to also understand from where money will come and plan accordingly. Having high targets or goals without corresponding funds will not result in realistic plan.

The budget as part of annual work and finance plan should be made at the same time as the program planning is done and both should complement each other.

ANNUAL BUDGET

Annual Budget should be prepared according to the annual works and finance plan and should be approved in the Annual General Body Meeting (AGM).

The staff should prepare the budget with the help of the Executive Committee at least eight days in advance. Changes if any as suggested by the executive committee should be incorporated and budget finalized.

The annual budget is divided into five parts:

1. **Funds at the disposal of the federation** – this would include fee, grants as well as any loans that may be required.
2. **Utilisation of the funds** as per the annual plan – example includes giving loans or purchase of assets. This would exclude expenses.
3. **Expenditure** likely to be incurred
4. **Income** earned by providing services and effective utilization of funds.

The Executive Committee may consider preparing a quarterly budget for the first quarter of next year as the AGM may normally happen in the first quarter of the next financial year.

QUARTERLY BUDGET

With reference to the annual budget it should be divided into quarters as per the annual work plan. The budget can be further broken down into monthly budgets to have better monthly cash flow planning at the federation level. It is important to track if the expenditure is as per the budget and there are resources mobilized to incur the budgeted expense.

SPECIAL PROJECT BUDGET

The staff should prepare the budget according to each activity as mentioned in the special project plan. The approved project proposal should be used for reference for this purpose. This should be submitted to the executive committee at least eight days in advance of the EC meeting. The executive committee should approve this budget with reference to the annual budget and special project Plan. Wherever possible, the special project budget should be included into the annual budget clearly specifying the special budget.

The treasurer should monitor whether the program expenses are done according to the budgeted amounts. Where the variation is more than 5-10% (depending on the absolute amount) the reason for such variance should be specified.

The suggested format for six months is given below for reference.

Particulars	Unit	Unit Cost	Qtr 1			Qtr 2		
			Budgeted	Actual	Reason for variance	Budgeted	Actual	Reason for variance
Source of Fund								
Use of Fund								
Expenditure								
Income								

It is important that the fund that is a liability is not used for expenditure. If savings or borrowing from external agencies is used for paying salaries, then there would be insufficient money to return the savings.

Only grants or other funds that are part of the income of the federation are used for meeting the expenses of the federation. Board members of the federation need to be very alert regarding the source from where expenditure is being made.

Annual works and finance plan helps ensure that there is no scarcity of fund to meet the routine expenses of the federation.

FLOW OF FUNDS IN FEDERATIONS

In order to facilitate flow of funds it is important that village level SHG meetings be conducted prior to PLF meeting date. For example if PLF meeting is on 7th all the SHG meetings should be conducted between 1st and 6th of each month.

The SLF meeting should be conducted after the PLF meetings have been completed. It is advised that the SLF meeting be conducted twice a month so that the review of half of the PLFs can be taken in the first meeting followed by review of the remaining PLFs in the second SLF meeting.

The second meeting of the SLF should be conducted in the third or fourth week of each month for financial review of the month and plan for next month. At least 2/3rd of the Executive Council of the SLF should be present.

Let us now understand how the money flows from SHG to PLF and then to SLF in the meetings.

Understanding Flow of Funds (FOF)

It is important for federation board members to follow the flow of money within the federation - under which heads the money comes in and goes out. Specifically, it helps to understand the total amount of money being transferred into and out of a federation, since it affects its liquidity – i.e., cash availability.

The flow of funds is divided into inflows and outflows.

Inflows denote the money that is received and outflow is the money that is paid out of the federation. It is important to note that inflow does not mean income as there are savings and loan repayments that flow in which are not income. Similarly, money that is paid out also includes loan repayment to banks, deposit in bank, which are not necessarily expenditures. Inflows and outflow help track availability of funds at any given point so that better fund management can be done.

There are two types of cash flows - both inflows and outflows. It is important to know the distinction between these two:

Capital Nature (Assets and Liabilities) - money that flows into the federation and remains for long term items and yield benefits over a period of time beyond the financial year. This includes borrowings from banks as inflow, or loans given to members as outflow.

Revenue Nature (Income and Expenditure) – under this category, inflows are income and outflows are expenditure of the federation, that helps in day to day running of the federation.

It is important to know the distinction between the inflows that are liabilities and inflows that are income of the federation. Similarly, assets and expenditure must be distinguished in outflows.

Distinction can be made on the following parameters:

Basis	Capital	Revenue
Purpose	Source and use of fund that helps federation extend its operations and consequently generate earnings.	Maintain federation's ability to meet operating cost
Components	Inflows include bank loans, mission fund and member's contribution. Major outflow is loan to members	Earnings of the federations and expenditure for routine operations.
Period	Extends to more than one year	For one year period
Reflected in	Balance sheet	Income and Expenditure

Let us now understand the inflows and outflows of capital and revenue nature in detail.

INFLOW

CAPITAL NATURE

Member's share in federation, as well as savings, loan outstanding and repayment of loan installments is of capital nature. The capital nature inflows are used to generate revenue and therefore it is advised that they be not used for direct expenditure on day to day operations, since these funds are liable to be returned back any time.

Inflows of capital nature include:

1. Share Capital and savings (where applicable) from Members/ federation
2. Savings from SHGs/ federation
3. Loan outstanding on members / federation
4. Outstanding of external loan /borrowings
5. Capital Grants from the Mission: Community Investment Fund (CIF), Vulnerability Reduction Fund (VRF), Livelihood Fund
6. Specific Conditional Grants from Project/ Line departments
7. For target / Vulnerable Groups / Communities[2]
8. Any other capital Nature: Surplus and Reserve Funds, any fund for livelihood activities.

EXPLANATION OF INFLOWS OF CAPITAL NATURE

1. **Share Capital & Savings -** The federation mobilizes the funds from its members with the objective to increase ownership (members) and owner's funds in the form of share capital and savings from members. These funds are called as owners'

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[2] Target / Vulnerable Groups / Communities include:

a) Destitute b) Primitive Tribal Groups (PTGs), Nomadic Tribes, ST/SC/Minorities c) Woman-headed-households, Widows/Single women d) Households in traditional occupations (artisans) e) Migrant families f) People living with HIV/AIDS & Other Chronically illness g) Survivors of human trafficking & sex workers h) Ex-manual scavengers & Ex-bonded labourers i) Persons with Disability (PwD) Persons / Groups j) Elderly aged Persons / Groups k) Trans genders Persons / Groups

investment/equity. Every year the federation has to pay annual interest on owners' equity.
The SHG in the PLF and the PLF in the SLF is advised to put in a certain amount as share capital to be paid in one or more installments as decided by the EC. It is suggested that the SHG contribute Rs. 2,000 per SHG and Rs. 5,000 per PLF to SLF.

It is suggested that the monthly saving amount can range from Rs. 100 to Rs. 500 per SHG in the PLF. Savings amount of Rs. 500 to 1,000 per month per village organization is suggested for PLF in the SLF.

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2. **Loans outstanding -**Generally, members borrow loans from the SHGs internal corpus and pay back the loan in installments. Loans outstanding is the amount that remains with the borrower (could be SHG or PLF) after deducting the principal repaid from the total amount borrowed.

3. **Outstanding of external loans/ borrowing** – The federation borrows from external agencies like banks. After deducting the principal amount repaid from the total loan taken, we get outstanding of external borrowing.

4. **Capital Grants from the mission:** There is inflow of funds from the mission to the SHGs through SLF as well as PLFs in the form of Community Investment Fund. There is also vulnerability reduction fund and livelihood fund that is granted from the mission for specific purpose.

5. **Specific Conditional Grants from Project/ Line departments:** Some SLFs or PLFs are also provided with grant for specific government programmes which are to be used as revolving fund in the federations.

INCOME (REVENUE) NATURE

Income means revenue earnings of the federation, which is not to be returned but is to be used to meet the expenses. The Income and Expenditure statement summarizes the net results of a federation (Surplus /Deficit) in a particular period of time – usually a year or less than that. The federation's income statement usually follows the following items:

1. Admission Fee (Entrance Fee)
2. Annual Membership Fee (Membership Renewal Fee)
3. Interest on Loans
4. Interest from Bank A/c: a) savings account b) fixed or recurring deposits
5. Penalties / Fines
6. Income/Surplus from collective business activities
7. Start-up Funds
8. Commission/Service charges for the services of PrL
9. Grants (Income Nature)
10. Training and Capacity Building funds, project fund (?)
11. Resource fee/ Spl. Fee / Others

1. **Admission Fee (Entrance Fee) -** When a new individual member i.e., SHG joins the federation they pay one time Admission Fee. It is suggested that the amount can range from Rs. 10 to 50 per member* to the PLF.

The PLF pays an admission fee to the SLF to become member. It is advised that the amount be Rs. 500 to 1000/- per PLF to the SLF.

This amount is not be refunded at the time of member withdrawal/ Removal.

2. **Annual Membership and Renewal Fee -** The amount is received by the federation for services rendered to its members. To maintain active membership in federation, at the start of the each financial year, the member will pay to the federation Annual Membership Fee or Membership Renewal fee through their SHGs. This amount is treated as Revenue (Income) and is used for recurring expenses of the PLF. Itwill not be refunded at the time of member withdrawal/ removal.
   The amount can range from Rs. 10 to 50 per member* to the PLF and Rs. 200 to 500/- per PLF to the SLF.

3. **Interest on Loans -** The interest amount is the main source of income to the federation. This amount is received by the federation on various loan products provided to its members. This is treated as income of the federation.

4. **Interest spread -** In order to decide the interest amount to be charged to the member, it is important to know the financial and operational cost of the federation. Interest spread is calculated by subtracting the interest charged to the member from the cost of borrowing/ cost of funds. The margin or spread is important for financial sustainability of the federation.

   The guideline for interest spread is as follows: member repays to the SHG at 12% rate of interest. The SHG retains 3% interest and passes on 9% of the interest collected to the PLF. The PLF retains 3% and passes on 6% to the SLF. The suggested interest spread is minimum of 3 % and maximum of 6% rate of interest.

   ***Advice:** Only after optimum utilization of own funds, can the federation borrow funds from external sources. It is suggested that idle funds must be below 5% of the total funds available to ensure proper rotation of internal funds before borrowing from external sources.

5. **Interest from Savings Bank A/c-** This amount is earned from the federation savings bank account.
   ***Advice:** Care should be taken that the idle fund in the bank account is close to minimum. When it is exceeding the minimum balance requirement, the Federation should first return the external loan outstanding, if any.

6. **Interest from fixed deposit A/c -** Idle fund that is not expected to be utilized for some time can be put in as fixed deposit to earn additional interest as compared to savings account.
   ***Advice:** Standing instructions can be given to banks to transfer the amount exceeding Rs.10000/-in the savings bank account as fixed deposit of 10000 each to be liquidated as required.

7. **Penalties / Fines:** This amount is received from the members who violate the rule of the federation on timely savings and loan repayments. This source of income, helps analyze the federation's administrative / Governance performance. Fines / penalties should be collected regularly, with no exception. Higher amount

collected as fines indicate lack of member's concern and attitude towards federation rules and discipline while a negligible amount indicates that the rule ins not being followed.

The suggested penalties include:

- Penalty for non-attendance/ late attendance meetings
- Penalty for non-payment/ late payment of share capital
- Penalty for non -payment of membership fee/ renewal fee
- Penalty for non-payment/ late payment of saving
- Penalty for non-repayment/ late payment of loan
- Penalty for non-payment/ late payment of service charge

The office bearers can decide if the member can be exempted from paying the penalty in case of emergencies / genuine reason.

8. **Income/Surplus from collective business activities:** The promoting agency encourages the members of the federation to take up of any livelihood interventions including collective community enterprises / commodity cooperatives / collective business activities. The income of federation depends upon quality of goods, quantity of goods and the margin or spread – i.e., the difference between purchase price and selling price.

9. **Start-up Funds:** Federations initially do not have the funds for setting up of office, provide for its utilities including furniture. Therefore, the mission/project may provide a one-time grant for procuring the basic infrastructure needed for establishment of the federation office.

10. **Commission/Service charges for the services of PLF:** Charges paid by the members for specific services like training, audit, insurance renewal, and so on are treated as income.

11. **Grants:** Grants received for capacity building of its members, leaders, staff and volunteers or any grant from mission/line department /donor for a specific purpose or activity and which is not to be repaid is treated as income.

12. **Resource Fee/special Fee to federation:** Federations give fee for resource services to non-members or other organizations and earn income like audit fee, insurance renewal fee, commissions on marketing operations and so on. Resource fee received from visitors is also included.

OUTFLOW

The cash out flows are of two kinds:

1) **Capital (Investment) Nature:** It denotes the use of fund that would help growth of business. For example, the inflows in the form of savings or external loan ought to be invested in giving out loans to members. The objective is to earn interest that would generate enough revenue to help the federation meet its operational expenses.

2) **Expenditure Nature:** The operating and financial expenses incurred for maintenance of federation to effectively deliver services to members.

Asset Management

When a table or other infrastructure is acquired it is counted as an asset, and is treated as investment. Every asset has a life and as years progress the value of asset's life reduces with time and/or usage. The value of life reduced is reflected as depreciation and is treated as expenditure. Consider the case of a table worth Rs.100 and having a life of ten years. So, every year the life reduced by 10% i.e., 10 rupees which is shown as expenditure. It is called depreciation in accounting terms.

The table below gives the details of the expenditure heads and the guidelines to the federations on deciding policy on expenditure.

Expenditure Head	Definition	Recommendation to PLF	Recommendation to SLF
Admission fee paid to SLF	When federation takes membership in higher tier organisation (e.g.: SHG in PLF or PLF in SLF) it has to pay a one-time Admission Fee, that is non-refundable.	One-time fee of ---	One - time fee of ---
Annual Membership renewal fee to SLF	Amount paid by PLF to SLF for services received from SLF and also to maintain active membership in PLF. It is non-refundable.	Annually Rs....	Annually Rs. ----
Interest spread on CIF Loan	The interest paid on the borrowed CIF funds received from mission vide SLF	3% to 6%	6% to 9%
Accountant Honorarium per month	It is a fixed regular expenditure around the year. PLF is paying the cost of the services received from PLF accountant	Normally the range is between 250 to 2000	Normally the range is between Rs. 2000 to Rs. 5000
Stationary & Xerox per annum	When PLF requires stationery and/or photocopy, the same may booked as expense as and when it occurs	To be decided by EC	To be decided by EC
Penalties / Fines	This expenditure amount is paid by SHG to PLF and PLF to CLF, when it breaks the attendance norms of the SLF or amount defaulted	Rs. --- on Rs. 1000 installment not paid	Rs. --- on Rs. 1000 installment not paid
VO Office rent per month	It is a fixed and regular monthly expenditure around the year. PLF is paying the hire charges of VO office to the office building owner	Not to exceed ---- amount	Not to exceed ---- amount

Travelling Charges per month	It is recurring expenditure for staff and EC for attending SLF meetings, visiting banks, visiting project office etc.,	As per policy of EC	As per policy of EC
Meetings Expenditure per month	For monthly meetings, it is a fixed regular expenditure around the year. At the time of special meetings like Annual General Body Meeting the PLF may book this expenditure as and when it occurs. These amounts may be paid to the service providers those who given services for the above purpose	As per the norms decided by EC from time to time	As per the norms decided by EC from time to time
Bank Commission/ charges	This amount is deducted by bank from savings bank account for corresponding expenditure like SMS charges, annual bank charges, Cheque book issue or cheque/DD clearing charges etc.	As per bank policy	As per bank policy
VO Audit fee	Audit fee paid to the auditors who has done the audit (i.e.: Internal Audit & External Audit).	As per the norms decided by EC	As per the norms decided by EC
Cadre payments (if any)	If the PLF is receiving any services from the Para Professionals like Pashu Sakhi, Tablet Sakhi, ICRP etc., any amount is paid to them will be recorded as expenditure. If any financial support received from project/ any external sources that will be recorded in the income side.	As per the norms decided by EC based on overall framework of the mission	As per the norms decided by EC based on overall framework of the mission
Visitors expenditure (if any)	Amount spent towards conducting of trainings and other capacity building activities to members, leaders, staff and other volunteers/cadre	As per the norms decided by EC	As per the norms decided by EC
	If any amount is spent at the time of visit of any outsider, it will be recorded in this particular head. If any supportive amount/ reimbursement received for this purpose that will be recorded in the income side		

Resource fee paid to SHGs (if any)	Sometimes PLF will charge some amount of resource fee from visitors to organise the SHG meeting in the village	As per the agreement / understanding between EC and external agency	As per the agreement / understanding between EC and external agency
Bank Mithra Honorarium paid to SLF	SHGs will contribute a little amount towards Bank Mithra Honorarium to PLF. The accumulated amounts in PLF are in turn paid to SLF, which are then paid to the Bank Mithra	As per norms	As per norms
Interest on external borrowings (if any)	The interest amount is paid on the external borrowed funds.	As stipulated by the external agency	As stipulated by the external agency
Audit of Accounts to be shared in AGM	Fee paid to the external auditor – a chartered accountant - for annual audit. Quarterly internal audit is also recommended for federations with high volume transactions and / or age of the institution	As per the agreement between auditor and federation. Audit report is mandatory	As per the agreement between auditor and federation Audit report is mandatory
Any Other expenditure	Distributed interest subvention amount/ Bonus	As agreed in EC	As agreed in EC

Transactions in Meetings

It is important that the receipt and payment as well as the income and expenditure statement is read out in the monthly EC meeting and approved. The second meeting at the end of the month should focus on review of financial transactions of SHGs in the PLFs and of PLF in the SLF.

1. Progress of the PLF
    a. Present the statements of cash inflows and outflows of each PLF
    b. Present the income and expenditure statement of each PLF highlighting net profit or loss
    c. Demand collection Balance report of the month, status of repayment collection, including issues of default, if any
    d. Bank balances of each PLF
2. Progress of SLF
    a. Statement of cash inflows and outflows
    b. Income and expenditure statement
    c. Loan disbursement report
    d. Demand collection balance report of the month
    e. Status of PLFs overdue more than 90 days
    f. Bank balance of SLF
3. Loan demand or repayment to bank or external agency

4. Sanction of loan applications of PLF
5. Action/ decision on PLFs where amount is not deposited

It is also important to check receipts of the deposited amounts and verify the amount deposited with the bank before presenting the report to the EC.

The financial decisions should also be written in the Proceedings Book and circulated to the PLFs so that all the representatives in PLF are aware about the decisions.

Liquidity Risk

The risk that the federation may not have enough liquid assets to meet the demand for cash outflows, including saving withdrawals, loan disbursements, and payment of operating expenses. A lack of liquidity can put a quick and final end to federation efforts to mobilize deposits – and, in the worst case, can cause it to collapse or close.

In case the cash flow is negative, and the loan demand is high, the federation must plan for external fund mobilization.

If additional cash is available the federation can plan to incentivize the team for loan disbursement above the initial target or prepay external loan to avoid paying interest on borrowed funds. The federation can also repay the loans to external agencies.

Management Of Income And Expenditure

In the booklet on products and services, we looked at savings, loan and insurance products offered by the federation in detail. We have also looked at the flow of funds – how the money comes in and goes out. It is important to know that not all the money that flows into the federation is income and not all the money that goes out is expense.

What is income?

All the money that is earned by the federation for providing services or by investing money is income. Income is money earned by the federation with no compulsion to return - either to member or to bank – except by way of dividend or gifts. It includes interest earned by federation on loans given to members, penalties, bank interest and so on.

What is the difference between income and inflow?

Income is different from inflows like savings which is to be returned to members at some future date. Loan repayment and loan from banks are also examples of money flowing into the federation. It is money received but not income, since it is to be returned.

What is expenditure?

It is payment made for any goods or services received by the federation. All the money that is spent and will never come back to the federation is considered as expenditure. It includes payment of rent, salaries, travel, telephone charges and other such expenses that are incurred by the federation.

What is the difference between expenditure and outflow?

Repayment of loans taken from the bank is an outflow of the federation. However, it is not an expense but a payment of a money received at an earlier date. Receiving loan is not an income – since it is just transfer of money.

It is like Sita has borrowed 100 rupees from Laxmi. The 100 rupees has to be returned to Laxmi, but if Sita returns 110 rupees then 10 rupees is the income Laxmi gets from the transaction as interest. If Laxmiuses the 10 rupees to buy a pen that is expenditure.

The table below gives some examples of income and expenditure- the detailed chart of accounts for the federation is given in Annex I.

Income	Expenditure
Interest from loans	Salary
Bank interest	Rent
Membership fee	Travel
Audit fee	Meeting expenses

The previous section explained inflows – which were categorized into capital nature and income nature. Outflows were categorized into investment nature and expenditure nature.

The income nature of inflows and expenditure nature of outflows as explained in the cash flow chapter is the income and expenditure. This section aims to help classify the income and expenditure as the details are given in the previous section.

Sources of Income – Process and Policy

Income earned can be classified according to its sources:

Internal sources - money *received from the members* for services provided by the federation – it includes interest on loans, audit and training fee, membership fee, penalty and so on.

External sources- grants received from the mission to meet operational expenses, interest earned on bank deposit and fee received from external agencies for services delivered.

Internal Source

Interest Income

The federations are mostly dependent on interest income from the lending activities. Currently, the federation is being capitalized with CIF fund:

- CIF-Seed Capital;
- CIF-Vulnerability Reduction Fund –for reducing vulnerability like food insecurity;
- Livelihoods /Layering Fund

Specific states may have additional funds for capitalization of the federation.

For example, federation A has received total CIF capitalization of around Rs. 100 lakhs. CLF A can earn around Rs. 6 lakhs in a year as interest in a year (with an interest spread of 6% per annum or 0.5% per month) provided it is being rotated amongst the SHGs regularly and there is no idle fund.

Commission fee from Members on bank linkage

The federations can earn a bank linkage facilitation fee from each of the SHG on anannual basis. For example, federations can charge the SHGs 1% of the average monthly bank loan outstanding once in a year.

Other Internal income

Membership fee, admission fee and penalties, are some of the other internal sources of income. Federations can also meet operational costs by charging service fee for providing technical services –like audit, training and so on.

External Source

SHG Bank Linkage Facilitation Fee/ BC commissions

The federations are supported by the mission in the initial years to meet the cost of operations. It could provide following types of funds:

1. Start-up fund
2. Operational fund
3. Establishment fund
4. Cadre fund
5. Training fund

Some federations may also have additional funds.

Banks are another external source of income for financial sustainability of the federation. Income from banks is of two types;

1. Interest on deposits
2. Commissions from bank for facilitating credit linkages -charge can also be paid by banks as commission under the business development correspondent model as well as bulk lending by banks to federation for on lending to members.

Non-Financial Services

The federations also provide non-financial services like facilitation of livelihood promotion, access to rights and entitlements, food and nutrition, health, water and sanitation, counseling center etc. on a cost to cost basis. Though there is limited income from these revenue streams it is important for federations to diversify their sources of income so as to not depend only on interest income for meeting all expenditures.

EXPENDITURE POLICY OF FEDERATION

Expenditure is classified into two types:

Operational/ administrative expenses – this includes all expenses incurred on meeting day to day operations of the federation – like salary, travel, meeting expenses, rent, photocopy and so on.
Financial expenses – this includes all expenses that are incurred to facilitate financial transactions in the federation – like paying interest on bank loan, membership fee to higher order institution, interest paid on savings deposited in the federation, bank charges and audit fee.
The detailed expenditure heads are explained in the cash flow chapter, under outflows.

GUIDELINES TO INCREASE INCOME AND REDUCE EXPENDITURE

It is first important to break down core direct expenses into the **biggest (and most important) and the smallest (and least important) expense and then d**evelop a **minimum budget** (what you need to cover to survive) and a **maximumbudget**required to deliver on all federation objectives.

The federation should then list down current sources of income excluding funds from the mission. This would help to identify the gap between income and expenditure to know if the federation would survive in the absence of funds received from the mission.

In order to increase income and reduce expenditure, the federation can adopt one or more of the following strategies:

INCOMEINCREASE

1. **Increase outreach** – increase in the number of SHGs and members will increase membership fee, saving, and number of borrowers and hence increase income of the federation
2. **Bulk lending** – federations can take loans from banks and lend to SHGs on a higher rate of interest and the differential interest is the income for the federation
3. **Less idle fund** – higher rotation of funds ensures higher income and higher idle fund reduces the income
4. **Business activities by federation** – the federations are advised to start business activities that would earn profits for the federation – like commodity procurement, custom hiring centers, computer centers and so on. Rent earned from the training centers of federations and an important source of income
5. **Technical services to other agencies** – experienced federations and their leaders can offer consultancy – training, studies, services to other agencies and federations; collection of service fee/ incentives by implementing government schemes.
6. **Increase interest rate** – federations can increase the rate of interest and keep higher margin to meet the budget requirements

7. **Negotiate for better commission from banks**– higher facilitation charges that banks give to federations can be requested
8. **Diversify services** – federations can provide a range of services for which fee can be charged – insurance commission, training fee, convergence fee

Cost Reduction

1. **Reducing the cost of borrowing from financial institutions -** Borrowing from lower cost sources helps reduce financial expenses
2. **Reducing administrative expenses –** federations need to check and reduce cost of meetings, travel, stationery, phone and internet, power and other such routine expenses by standardising costs and taking approval before expenditure.
3. **Negotiating discounts**- key service providers like external auditors, insurance companies can be requested for lower charges
4. **Use of technology to reduce cost** – for maintaining MIS and accounts, use of Information Technology helps smooth and faster flow of information. Technology will make the whole system operationally efficient and cheaper.
5. **Increasing outreach of services-** Aggregation of services like insurance, marketing, help reduces transaction costs and gives access to quality services
6. **Hiring local people –**appointment of SHG members/ family members of SHGs as local community cadres at all levels reduces the costs. Since the perceived advantages of the services of the federation are higher, it increases ownership and reduces attrition.

Portfolio Management in Federations

Definition of Portfolio

The total loan amount held with the members at any given date is known as "portfolio as on that date". It is the closing balance or outstanding of the loans and is the most important asset of the federation. Portfolio plays a vital role in the organizational sustainability of any institution. For the federation involved in financial services, the income from loans / portfolio is the major portion of the income.

Standard –More than 90% of the total assets should be in the loan portfolio and remaining may be in cash, bank and other assets balances like fixed deposits, stock inventory etc.

Importance of loan portfolio and its effect on Federations

- Largest asset of federation
- Main source that generates income (interest and fees)
- Main service of the Financial federation that is demanded by SHGs
- Reason for Federation existence

Definition of Default

Default occurs when a loan installment is due and the borrower cannot or will not repay the loan. The Federation may continue its collection efforts. Usually a loan is declared in default when the defaulter has stopped payment of a loan for more than 3 or more consecutive installments.
Default is expensive for any Federation. It affects the program by:

- Slowing rotation of funds
- Loss of principal
- Delay in interest income - earnings
- Increase collection costs (visits, analysis, legal costs)
- Decrease profitability – as loan loss provisioning reduces surplus
- Cause program to lose credibility
- Leads to ever- increasing repayment problems
- Threaten long-term viability
- Demoralize the sub-committees
- Loan write- off require infusion of capital

How to calculate Default?

There are three ways to assess nature and extent of default in the federation. There must be a good MIS which provides an aging schedule of all loans including past due loans.

1) Portfolio in Arrears (PIA)
2) Portfolio at Risk (PAR)

3) Recovery Rate (RR)

Portfolio in Arrears (PIA)

It shows the amount of installment not paid and the number of days for which it has not been paid. It only includes principal amount and does not include interest.

How to Calculate

$$PIA = \frac{Loan\ in\ Arrears\ or\ in\ default}{Total\ Loan\ Portfolio\ Outstanding}$$

Portfolio in Arrears (PIA) is calculated by dividing the all past due (installment amounts) of all loans with defaultby outstanding portfolio as of a certain date. Generally, the default is calculated based on the number of days – 30 days, 60, 90 180 days- which must be clearly stated.

Any loan installment not paid for 90 consecutive days or three or more installments is at risk of defaulting to federation.The older the default, the less likely it is that the loan will be repaid.

Portfolio at Risk (PAR)

It is the most widely accepted measure of portfolio quality. It is always higher than PIA since it includes the total outstanding amount of the loans of which the installment is due. It shows the portion of the portfolio that is “contaminated” by arrears and therefore at risk of not being repaid.

How to Calculate

$$PAR = \frac{Portfolio\ at\ Risk\ Amount(more\ than\ 90\ days)}{Gross\ Loan\ Portfolio\ Outstanding}$$

Portfolio at Risk (PAR) is calculated by dividing the outstanding balance of all loans with arrears by total outstanding portfolio as on a certain date. Since the ratio is often used to measure loans affected by arrears of more than 30, 60, 90, 120, 180 days, the number of days must be clearly stated.

Repayment Rate

It shows amount paid compared to amount due or expected during a specific period. The federations need to track on time repayment rate as it gives information on timely collection at any given point.

How to Calculate

$$RR = \frac{Total\ Loan\ Amount\ Repaid\ (current\ and\ past\ due\ principal\ only) - Prepayment}{Total\ Loan\ Demand\ (Principal)}$$

- PAR is the best indicator for assessing the risk of potential losses
- Arrears rate overestimates portfolio quality
- The Loan repayment rate does not properly measure loan portfolio quality.
- Repayment rate is good for cash- flow planning.

WHAT TO DO IN CASE OF DEFAULT?

The credit history of members guides loan decisions in future. Defaulters will lose their creditability for availing future loans – even if benefitted through loan waivers under Government policy in case of non- repayment of loans.

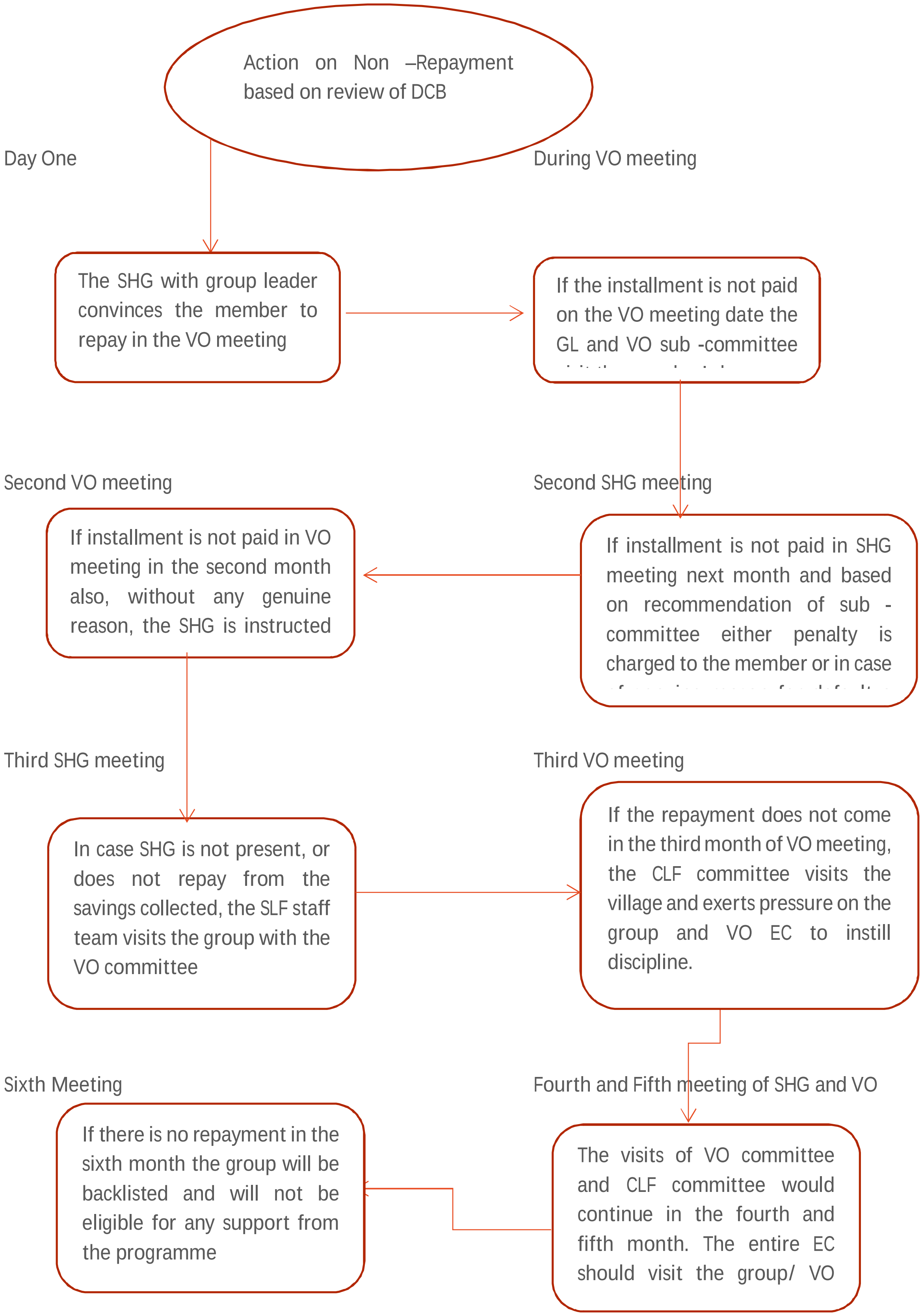
The followings are standard practices to manage and control default cases.

Precautionary methods	Curative methods
Selection of borrowers based on eligibility criteria	Need to differentiate between willful defaulter and non- repayment due to exigencies.
Loan size and term to suit member needs and according to repayment capacity of borrower	Establish a target level of acceptable default based on thorough understanding of the cost and effect of default on the program.
The method of repayment collection should be convenient and transparent	Develop policy that lists the steps to be taken when a loan becomes past due. (*Refer to section on default management at field level*)
Incentives for timely repayment – that can include larger loan size, interest rebates, and access to training. Disincentives include penalty, no further access to loans, collection of collateral, and legal action as last recourse to create discipline	Get the members to give in writing on stamp paper when the loan would be repaid and who all are responsible for the same.
Strong, cost effective Management Information Systems for loan tracking for reliable, accurate and timely data generation	Regular visits and follow up by the same team is necessary to establish rapport and ensure repayments
Relevant and timely dissemination of data to field teams	Visits by loan utilization committee for loan monitoring
Life and accident insurance of borrower and of cattle and other assets purchased through loan	

DEFAULT MANAGEMENT AT FIELD LEVEL

Default Management is a shared responsibility of executive committee of VO and CLF, SHG Leader and members and Field Staff. As part of the member education, the executive committee needs to be sensitive to the issues of defaulting members and use persuasive methods for repayment.

In recovery, the role of EC is important and not just of the office bearers. The chart below gives a step by step process that is recommended at the field level.


Action on Non –Repayment based on review of DCB
Day One
The SHG with group leader convinces the member to repay in the VO meeting
During VO meeting
If the installment is not paid on the VO meeting date the GL and VO sub -committee
Second VO meeting
If installment is not paid in VO meeting in the second month also, without any genuine reason, the SHG is instructed
Second SHG meeting
If installment is not paid in SHG meeting next month and based on recommendation of sub - committee either penalty is charged to the member or in case
Third SHG meeting
In case SHG is not present, or does not repay from the savings collected, the SLF staff team visits the group with the VO committee
Third VO meeting
If the repayment does not come in the third month of VO meeting, the CLF committee visits the village and exerts pressure on the group and VO EC to instill discipline.
Sixth Meeting
If there is no repayment in the sixth month the group will be backlisted and will not be eligible for any support from the programme
Fourth and Fifth meeting of SHG and VO
The visits of VO committee and CLF committee would continue in the fourth and fifth month. The entire EC should visit the group/ VO

Benefit of on time Repayment

It is important to share benefit of on time repayment to the members. While the advantage of non repayment is the principal amount is used in business expansion, it is important to understand the long term implications of on time and late payment of loans:

	On - Time Payments	Late or No Payments
BENEFIT / COSTS	Probability of immediate larger follow up loans	High payment of interest as principal amount not repaid
	Development of positive credit history	Maintain capital (or portion) from loan in business or use for other purposes.
	Positive reputation among peers	Fewer or no trips to financial institution to make payments (lower transaction costs)
	Access to training, savings or other program services	Lower transaction costs of attending meetings and other activities of lending institution
	Access to advice from federation staff and sub committees	Penalty for late payments
	Award or prizes for timely repayment	Delay future loans or loss of access to future loans
	Lower interest rates on second / third loans - interest rebate	Possible legal action and costs including loss of collateral
	Pay interest and capital of current loan	Loss of access to other program services
	Pay time and transportation costs to make payments	Hassle of frequent visits and pressure by members, federation EC and sub committees.
	High opportunity costs	Negative reputation among peers

Provisioning Policy For Loan Loss

This measure gives an indication of the expense incurred by the federation to anticipate future loan losses. In anticipation of future loss due to non-recoverable loan, federations make annual provision to manage the risk of loan loss.

The federation Executive Committee can make a provision of 2 p.c. of loan amount outstanding during the financial year as loan loss provision from its annual income. Executive committee may takes decision to increase or decrease the amount as per the loan loss under special circumstances.

The loan loss provision will be made at the end of financial year. For annual loan loss provision expense is set aside as per the set policy the federation.

> "A WELL- DEFINED POLICY THAT ESTABLISHES A LOAN LOSS RESERVE AND PERIODICALLY DECLARES LOANS NON- RECOVERABLE SAVES A PROGRAM FROM DECLARING A LARGE AMOUNT UNRECOVERABLE ALL AT ONCE AND THEREBY DRASTICALLY REDUCING ASSETS."

Without making realistic assessment of loans that will not be repaid -called loan losses, federations tend to inflate profits. When losses occur in a particular financial year federation viability would be deeply affected. Hence the possible loss of income because of non-repayment of loan needs to be considered.

The loan loss provision is therefore the fund allocated from the income to set off possible non-repayment of loans. So, if out of total loan outstanding of 1000 rupees in federation there is a possibility of 20 rupees not coming back, then that amount need to be reflected as loan loss provision and shown as expenditure in income and expenditure statement.

The quality of assets – that is the loan that is outstanding with the members – determines the real worth of the federation.

A loan loss provision is the amount shown on the Income and Expenses Statement as expenditure.

Loan losses or write-offs occur only as an accounting entry. They do not mean that loan recovery should not pursue. In fact, it should be identified. They decrease the reserve and the outstanding portfolio.

How to Calculate

$$Loan\ Loss\ Ratio = \frac{Loan\ Loss\ Provision\ Expenses}{Average\ Loan\ Outstanding}$$

The Provision Expenses Ratio is calculated by dividing the loan loss provisioning expenses to average loan outstanding for the period

Standard: It should not exceed 2% of total loan outstanding

Rescheduling and Refinancing

When a borrower runs into repayment problems, federation may renegotiate the loan, either rescheduling it (that is, stretching out its original payment terms) or refinancing it (that is, replacing it— even though the member hasn't really repaid it—with a new loan to the same member).

It is important to recognize that heavy use of rescheduling or refinancing can cloud the Federation ability to judge its loan loss rate.

This is one of many reasons why renegotiation of default loans should be kept to a minimum—some Federations simply prohibit the practice. And renegotiated loans should always be flagged and reported separately from the rest of the portfolio. If used to reduce default, rescheduling and refinancing can spell disaster for the portfolio

Under certain exceptional conditions federations may permit loan rescheduling or refinancing. The conditions are as follows:

1. If borrower is a defaulter and after persuading, is ready to pay loan amount but negotiates for revised repayment schedule.
2. A borrower meets with unforeseen incident and incurs heavy loss like fire, death of family member, road accident and medical emergency etc.
3. In case of natural calamities when loan repayment is not possible then members of the federation will be convinced to repay the loans on revised terms and loan repayment in that case would be rescheduled to ensure repayments will resume as their business activities resumes.

Impact of Rescheduling or refinancing of Loans

Standards for creating Loan Loss Reserves	
Status of Loans	**Reserve Rate %**
Current	0%
1-30 days past due	0%
31 – 60 days past due	10%
31- 90 days past due	25%
91 – 180 days past due	50%
181 – 365 days past due	75%
Above 365 days past due	100%

Rescheduling and refinancing is solution or problem ?

- Rescheduling and refinancing are not recommended.
- Once members discover they have the option of rescheduling, they tend to stop paying.
- Rescheduling and refinancing are measures to try to hide the problem, not solve it.
- Hiding the problem does not make it go away – these are still late loan payments with all the associated costs.
- It means you may end up with an even greater problem of delinquency.

Effect of Loan Loss Provisions, Reserves, and Write-Offs on Financial Statements

The main points between the LLR, LLP and Write offs

Loan Loss Reserve (LLR)	Loan Loss Provision (LLP)	Write- Offs
An account that represents the amount of outstanding principal that is not expected to be recovered by the federation.	Amount expensed on the income and expenses statement.	Occurs only as an accounting entry.
Negative asset on the balance sheet that reduces the outstanding portfolio. (An alternative presentation is to show it as a liability.)	Increases the loan loss reserve	Do not mean that loan recovery should not continue to be pursued.
		Decrease the reserve and the outstanding portfolio.