

**FAULU KENYA DEPOSIT TAKING
MICROFINANCE LIMITED**

FINANCIAL STATEMENTS

31 DECEMBER 2009

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2009

CONTENTS	PAGES
Corporate information	2
Chairman's statement	3
Report of the directors	4
Corporate governance	5-6
Statement of directors' responsibilities	7
Independent auditors' report	8 - 9
Statement of comprehensive income	10
Statement of financial position	11
Statement of changes in equity	12
Statement of cash flows	13
Notes to the financial statements	14- 46

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED
CORPORATE INFORMATION

Board of directors

Ken Wathome	Non- Executive	Chairman
Gregory Vestri (Resigned)	Non- Executive	Member
Keith Wright*	Non- Executive	Member
Ken Ikiara	Non- Executive	Member
George Adams Maina	Non- Executive	Member
Eric Kimani	Non- Executive	Member
Terry Davidson**	Non- Executive	Member
Beverley Nuthu	Non- Executive	Member
Mwikali Muthiani (Appointed on 5 May 2009)	Non- Executive	Member

* American

** British

Managing Director

John Mwara (Appointed on 12 January 2010)

Lydia Koros (Resigned on 12 January 2010)

Audit Committee	Executive Committee	Risk Management Committee
Ken Ikiara Eric Kimani Beverley Nuthu	Ken Wathome George A Maina Mwikali Muthiani John Mwara Pauline Githugu	George A Maina Terry Davidson John Mwara
Assets and Liabilities Committee	Credit Committee	
John Mwara Paul Kihui Helen Kithinji Raphael Lekoolool Anne Kimari	George A Maina Terry Davidson John Mwara	

Company Secretary

Pauline Githugu
Certified Public Secretary (Kenya)
P O Box 60240
Nairobi - 00200

Registered office

Ngong Lane
Off Ngong Road
P O Box 60240
Nairobi - 00200

Auditors

Deloitte & Touche
Certified Public Accountants (Kenya)
"Kirungii", Ring Road Westlands
P O Box 40092
Nairobi - 00100

Principal Lawyers

Kamotho Maiyo & Mbatia Advocates
Posta Sacco Plaza
P O Box 70676
Nairobi - 00400

Principal Bankers

Standard Chartered Bank Kenya Limited
Yaya Centre Branch
P O Box 40310
Nairobi - 00100

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

CHAIRMAN'S STATEMENT

The year 2009 was a year of mixed fortunes for Faulu Kenya DTM Limited (Faulu). This was the year in which Faulu made history by becoming the first Microfinance Institution in the country to receive a licence from Central Bank of Kenya to take deposits from the public, under the provisions of the Microfinance Act, 2006. This was both a boon for the many clients who have put their faith in the company over the years and a gesture of confidence in Faulu by the regulator. We remain the only licenced microfinance institution to date.

Early in the year the company also commissioned a new Core Banking system, the T-24 Emerge System. This was a high cost investment that we believe becomes a key part of the infrastructure that will support the new business transition to a banking environment and thereby facilitate future expansion of the business.

2009 was also a year that also witnessed the worst drought in decades in Kenya. This made the economic lives of our clients considerably worse whilst the business operating environment became difficult thereby significantly affecting our agricultural portfolio. None the less, the measures put in place through the group guarantee methodology were able to help mitigate the effects of the drought. Some relief was experienced towards the end of the year as the long awaited rains set in.

On a global platform, the major world economies had slumped into a recession that started late 2008 and saw an unprecedented collapse of financial institutions in America and Europe. The Kenyan environment was not spared as access to credit became more difficult. We are however grateful to the International Finance Corporation who partnered with us in our mission to provide relevant financial services to Kenyans by guaranteeing a debt issued by Standard Chartered Bank in July, 2009. This debt facilitated the building and equipping of banking branches in the third and fourth quarters of 2009 as well as the acquisition of point of sale devices which will be operated through our Agency partnerships, chiefly the Postal Corporation of Kenya. We are rolling out 26 banking branches by June 2010 and 400 POS service points. We are also grateful to the Financial Services Deepening (FSD) and the Emerging Markets Group who gave us grants to continue with the institutional transformation and the training of our clients in Financial Education, respectively.

Locally the inflation rate remained high ranging from 28% at the beginning of 2009 to 19% at its lowest level, as the effects of drought affected the economy.

2009 Results

In the midst of the gloom the company's growth continued in the same upward trend that has been witnessed over the last few years closing with over 250,000 clients in December as compared with 159,860 clients at the close of 2008. The Total Assets grew from KShs 3.7 Billion to KShs 4.3 Billion in the same period. Deposits also grew from KShs 1.47Billion to KShs 2 Billion.

However this being a transformational year we made a decision to invest and commit resources towards putting in place an operational platform to grow the deposit taking business into the future. We also acknowledged that this was a year in which expenditure would be incurred without immediate realisation of income. In 2009 we netted a loss of Kshs 49 million including Kshs 36 million in transformation expenses. Going forward the institution is now better placed to offer a broader range of financial services and gain economies of scale in efficiency resulting to sustainable profitability.

Our Future

Our motivation to transform into a deposit taking micro-finance institution was in line with our mission "to listen and empower Kenyans by providing relevant financial solutions". The foundation has been set, and through the offering of the various deposit taking channels that range from our banking branches, agency networks and technology based channels, we are optimistic that we will realise our vision of Giving Kenyans a Hope and a Future by extending our reach to the 14 million unbanked Kenyans.

I wish to take this opportunity to thank the management and staff for their hard work against a very difficult working environment. I also wish to thank my fellow board members whose wisdom and contribution helped steer the organization during the year.

Thank you and God bless you.

Ken Wathome
Chairman

2010

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

REPORT OF THE DIRECTORS

The directors present their report together with the audited financial statements for the year ended 31 December 2009.

PRINCIPAL ACTIVITIES

The principal activity of the company is the transformation of lives through the provision of loans to micro and small entrepreneurs and deposit taking from the public.

OPERATING RESULTS

	Shs '000
Loss before taxation	(72,498)
Taxation credit	23,344
	<hr/>
Loss for the year	<u>(49,154)</u>

TRANSFORMATION

The company transformed to a deposit taking microfinance institution under the Microfinance Act. Included in the results for the year are transformation related expenses amounting to 36.7 million (2008 - Shs 60.6 million) and capital cost of Shs 207.0 million spent on the Management Information Systems (MIS) and banking branches rollout.

DIVIDEND

The directors do not recommend the payment of a dividend in respect of the year (2008: Shs nil).

DIRECTORS

The current board of directors is as shown on page 2.

AUDITORS

The auditors, Deloitte & Touche, having expressed their willingness, continue in office in accordance with section 159(2) of the Companies Act and subject to section 41(1) of the Kenyan Microfinance Act (2006).

BY ORDER OF THE BOARD

SECRETARY

Nairobi

2010

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

CORPORATE GOVERNANCE STATEMENT

Faulu Kenya Deposit Taking Microfinance Limited received its Deposit Taking License from the Central Bank of Kenya on 21st May, 2009, becoming the first institution in Kenya to be licensed to receive deposits from the public under the Micro Finance Act (2006). The board of directors of the institution is responsible for ensuring that the institution complies with the laws of Kenya and the prudential guidelines of the Central Bank of Kenya. The Board is comprised of two shareholder representative and six independent directors.

The board of directors of Faulu Kenya Deposit Taking Microfinance Limited is responsible for ensuring that the company complies with the laws of Kenya, the highest standards of corporate governance and universally accepted business ethics. The board has developed, adopted and benchmarked a framework of internationally recognized principles of good corporate governance, which it endeavours to adhere to in the pursuit and maintenance of the highest possible standards. There are 4 main board committees (members of whom are shown on page 2) as follows;

1. The Executive Committee
2. The Audit Committee
3. The Risk Management Committee
4. The Credit Committee

The attendance during the year was as follows:

Audit Committee		Risk Management / Credit Committee			Executive Committee	
Ken Ikiara	87.5%	George A Maina	100%		Ken Wathome	89%
Eric Kimani	62.5%	Terry Davidson	75%		George A Maina	100%
Beverly Nuthu	87.5%				Beverly Nuthu	89%
					Mwikali Muthiani	76%

The Roles and Responsibilities of Audit Committee (as set out in the Microfinance Act 2006 s.27)

The audit committee shall assist the board in raising the standards of corporate governance and internal controls in the following areas:-

- (a) ensuring that financial and operational information is prepared in a timely and accurate manner;
- (b) improving the quality of financial record keeping and reporting;
- (c) strengthening the effectiveness of internal and external audit functions;
- (d) strengthening the internal control environment and risk management;
- (e) enhancing public confidence in the credibility and stability of the institution; and
- (f) monitoring incidences of non-compliance with the Act and regulations issued there under as well as any other relevant legislations and regulations, and advising the board on the best solutions.
- (g) monitoring the ethical conduct of the institution and developing the code of conduct and ethical standards and requirements, including effectiveness of procedures for handling and reporting complaints; and

Monitoring and Evaluation

The board assesses its own performance and that of the management in the discharge of their duties and responsibilities and develops and submits to the Central Bank an annual self assessment board evaluation, not later than three months after the end of each financial year.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

CORPORATE GOVERNANCE STATEMENT (Continued)

Appointment of Chief Executive Officer

The board has complied with the following provisions as directed by the Microfinance Act 2006 (s.31) as concerns the transitioning of the Chief Executive Officer;

- (a) Every institution shall have a Chief Executive Officer who shall be appointed by the board and whose terms and conditions of service shall be determined by the board in the instrument of appointment.
- (b) No Chief Executive Officer shall be appointed without the prior approval of the Central Bank.
- (c) No person shall be appointed as Chief Executive Officer of an institution unless such person has at least five years experience in banking business, economics, law, or finance at senior management level with experience in microfinance practices or such other conditions as may be determined by the board.
- (d) The board of every institution shall report to the Central Bank the resignation or removal of the Chief Executive Officer of its institution within seven days of such resignation or removal.

Reckless and Fraudulent Activities

The board of directors ensures that the Institution and the management do not;

- (a) allow a credit facility or guarantee to be outstanding ;
- (b) incur any liability ;
- (c) enter into any contract or transaction; or
- (d) conduct its business or part thereof

in a fraudulent or reckless manner detrimental to the institution interest or the interest of depositors or the general public, as directed in the Microfinance Act 2006 (s.32).

Scheme of Arrangement

The board of directors confirm that the institution shall not enter into any scheme of arrangement with its creditors.

Restriction on Trading and Investment

The board of directors certifies that Faulu Kenya Deposit Taking Microfinance Limited would not -

- (a) acquire or hold, directly or indirectly, any part of the share capital of; or
- (b) have a beneficial interest in

any financial, commercial, agricultural, industrial or other undertaking, where the value of the institution's interest exceeds 25% in the aggregate of the institution's core capital, except in an undertaking in fulfilment of a debt due to the institution.

Single Borrower Limit

The institution did not extend loans exceeding 5% of its core capital to any single end-user borrower. The board of directors ensures that loans or credit facilities equivalent to the maximum limit are extended only to those borrowers who have the capacity or have an established track record of satisfactory repayment. Faulu Kenya Deposit Taking Microfinance Limited has well-defined credit policies and procedures covering the maximum lending limits and approval levels, rate to be charged, repayment period, loan tracking and collateral. The institution did not grant a microfinance loan to any single end user or his associate that exceed 2% of its core capital and that the aggregate amount of microfinance loans will be more than 70% of the institution's total loan portfolio. Where there is a credit facility of more than 2% of the core capital, hereby referred to as a large exposure, such credit facility shall in aggregate not exceed 30% of the institution's total loan portfolio. Where a credit facility is non-performing, the outstanding balance will be net of provisions for purposes of determining the single borrower exposure limit. Faulu Kenya Deposit Taking Microfinance Limited submits to the Central Bank a return on single borrower limits on a quarterly basis.

KYC Requirements

The board of directors ensures that management obtains and maintains proper identification of customers wishing to open accounts or make transactions or enter into an engagement with the institution whether directly or indirectly through proxy; and maintains adequate and accurate records for a minimum of seven years regarding its customers, sources of funds and transactions, as required by the Microfinance Act 2006.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The Kenyan Companies Act and the Microfinance Act (2006) require the directors to prepare financial statements for each financial year which give a true and fair view of the state of affairs of the company as at the end of the financial year and of the operating results of the company for that year. The two Acts of parliament require the directors to ensure that the company keeps proper accounting records which disclose with reasonable accuracy at any time the financial position of the company. The directors are also responsible for safeguarding the assets of the company.

The directors are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and the requirements of the Kenyan Companies Act. This responsibility includes: designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, selecting and applying appropriate accounting policies, and making accounting estimates that are reasonable in the circumstances.

The directors accept responsibility for the annual financial statements, which have been prepared using appropriate accounting policies supported by reasonable and prudent judgements and estimates, in conformity with International Financial Reporting Standards and in the manner required by the Kenyan Companies Act. The directors are of the opinion that the financial statements give a true and fair view of the state of the financial affairs of the company and of its operating results. The directors further accept responsibility for the maintenance of accounting records which may be relied upon in the preparation of financial statements, as well as adequate systems of internal financial control.

Nothing has come to the attention of the directors to indicate that the company will not remain a going concern for at least the next twelve months from the date of this statement.

.....
Director

.....
Director

2010

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

Report on the Financial Statements

We have audited the accompanying financial statements of Faulu Kenya Deposit Taking Microfinance Limited, set out on pages 10 to 46 which comprise the statement of financial position as at 31 December 2009, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' Responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and the requirements of the Kenyan Companies Act. This responsibility includes: designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we considered the internal controls relevant to the company's preparation and fair presentation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the company's internal controls. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the accompanying financial statements give a true and fair view of the state of financial affairs of the company as at 31 December 2009 and of its loss and cash flows for the year then ended in accordance with International Financial Reporting Standards and the requirements of the Kenyan Companies Act.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF
FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED (Continued)

Report on Other Legal Requirements

As required by the Kenyan Companies Act we report to you, based on our audit, that:

- i) we have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit;
- ii) in our opinion proper books of account have been kept by the company, so far as appears from our examination of those books; and
- iii) the company's statement of financial position and statement of comprehensive income are in agreement with the books of account.

Certified Public Accountants (Kenya)

2010

Nairobi

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 2009

	Note	2009 Shs'000	2008 Shs'000
INTEREST INCOME	5	822,406	557,919
INTEREST EXPENSE	6	(156,780)	(112,560)
NET INTEREST INCOME		665,626	445,359
Fees and commissions	7	122,278	129,359
Foreign exchange (losses)/gains		(1,117)	3,498
Other operating income	8	21,354	7,939
OPERATING INCOME		808,141	586,155
Administration and operating expenses	9(i)	(865,679)	(515,049)
Transformation expenses	9(ii)	(36,667)	(60,656)
Impairment losses on loans and advances	17	(4,433)	(23,256)
OPERATING LOSS		(98,638)	(12,806)
Grant income	11	21,936	47,809
Share of profit /(loss) in associate company	20	4,204	(3,559)
(LOSS)/PROFIT BEFORE TAXATION		(72,498)	31,444
Taxation credit/(charge)	12	23,344	(19,820)
(LOSS)/PROFIT FOR THE YEAR		(49,154)	11,624
OTHER COMPREHENSIVE INCOME:			
Surplus on revaluation of buildings		93,893	-
Deferred tax on revaluation surplus	26	(28,168)	-
OTHER COMPREHENSIVE INCOME FOR THE YEAR NET OF TAX		65,725	-
TOTAL COMPREHENSIVE INCOME FOR THE YEAR		16,571	11,624
(LOSS)/EARNINGS PER SHARE – basic and diluted	13	(4.68)	1.94

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 2009

	Note	2009 Shs '000	2008 Shs'000
ASSETS			
Cash and bank balances		19,255	113,770
Short term deposits with banks	14	123,138	76,671
Government securities	15	297,410	292,334
Advances to customers	16	2,923,596	2,859,978
Due from related organisations	18	260	260
Other receivables	19	122,223	54,064
Tax recoverable	12(c)	30,258	26,447
Other investment	20	46	46
Investment in associate companies	20	5,829	2,886
Intangible assets	21	126,641	125,449
Property and equipment	22	658,524	171,287
		<hr/>	<hr/>
TOTAL ASSETS		4,307,180	3,723,192
		<hr/> <hr/>	<hr/> <hr/>
LIABILITIES AND EQUITY			
LIABILITIES			
Cash collaterals held	23	1,913,643	1,475,392
Customer deposits		81,852	-
Borrowings	24	1,599,017	1,637,678
Deferred income	25	2,167	2,888
Deferred tax liability	26	11,992	9,749
Due to related organisations	18	969	1,005
Other liabilities	27	45,219	70,730
		<hr/>	<hr/>
		3,654,859	3,197,442
		<hr/>	<hr/>
CAPITAL RESOURCES			
Share capital	28	120,000	60,000
Share premium		274,125	224,125
Retained earnings		122,524	241,625
Revaluation reserve		65,725	-
Statutory reserve		69,947	-
		<hr/>	<hr/>
		652,321	525,750
		<hr/>	<hr/>
TOTAL LIABILITIES AND EQUITY		4,307,180	3,723,192
		<hr/> <hr/>	<hr/> <hr/>

The financial statements on pages 10 to 46 were approved by the board of directors on
and were signed on its behalf by:

2010

)
) Directors
)
) Company Secretary

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 2009

	Share capital Shs'000	Share premium Shs'000	Retained earnings Shs'000	Revaluation reserve Shs'000	Statutory reserve Shs'000	Total Shs'000
At 1 January 2008	60,000	224,125	230,001	-	-	514,126
Total comprehensive income	-	-	11,624	-	-	11,624
At 31 December 2008	<u>60,000</u>	<u>224,125</u>	<u>241,625</u>	<u>-</u>	<u>-</u>	<u>525,750</u>
At 1 January 2008	60,000	224,125	241,625	-	-	525,750
Issue of shares	60,000	50,000	-	-	-	110,000
Transfer to statutory reserve	-	-	(69,947)	-	69,947	-
Total comprehensive income	-	-	(49,154)	65,725	-	16,571
At 31 December 2009	<u>120,000</u>	<u>274,125</u>	<u>122,524</u>	<u>65,725</u>	<u>69,947</u>	<u>652,321</u>

The statutory reserve relates to the excess provisions for impairment of loans and advances as computed per the Kenyan Microfinance Act (2006) over the loans and advances impairment provision as computed in accordance with IAS 39 on financial instruments. The statutory reserve is not distributable.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 31 DECEMBER 2009

	Note	2009 Shs'000	2008 Shs'000
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash generated from/(used in) operations	29(a)	378,383	(761,766)
Taxation paid	12(c)	(5,131)	(37,082)
		<hr/>	<hr/>
Net cash generated from/(used in) operating activities		373,252	(798,848)
		<hr/>	<hr/>
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of intangible assets	21	(55,467)	(83,990)
Purchase of property and equipment	22	(432,096)	(74,573)
		<hr/>	<hr/>
Net cash used in investing activities		(487,563)	(158,563)
		<hr/>	<hr/>
CASH FLOWS FROM FINANCING ACTIVITIES			
Corporate bond repaid		(150,000)	(100,000)
Issue of shares	28	110,000	-
Loan received	29(c)	460,114	366,759
Loan repaid	29(c)	(10,667)	-
		<hr/>	<hr/>
Net cash generated from financing activities		409,447	266,759
		<hr/>	<hr/>
INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS		295,136	(690,652)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR			
		78,106	768,758
		<hr/>	<hr/>
CASH AND CASH EQUIVALENTS AT END OF YEAR	29(b)	373,242	78,106
		<hr/> <hr/>	<hr/> <hr/>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2009

1 ACCOUNTING POLICIES

Statement of compliance with International Financial Reporting Standards (IFRS)

The financial statements have been prepared in accordance with International Financial Reporting Standards.

For the Kenyan companies Act reporting purposes, in these financial statements the balance sheet is represented by/is equivalent to the statement of financial position and the profit and loss account is presented in the statement of comprehensive income.

Adoption of new and revised International Financial Reporting Standards (IFRS)

(i) Standards and Interpretations affecting amounts reported in the current period (and/or prior periods)

The following new and revised standards and interpretations have been adopted in the current period and have affected the amounts and disclosures reported in these financial statements. Details of other standards and interpretations adopted in these financial statements that have had no effect on the amounts reported are set out in (ii) below;

IAS 1 (Revised), presentation of financial statements

A revised version of IAS 1 was issued in September 2007. It prohibits the presentation of items of income and expenses (that is, 'non-owner changes in equity') in the statement of changes in equity, requiring 'non-owner changes in equity' to be presented separately from owner changes in equity in a statement of comprehensive income.

According to the amendment of IAS 1 in January 2008, each component of equity, including each item of other comprehensive income, should be reconciled between carrying amount at the beginning and at end of the period. Since the change only impacts presentation aspects, there is no impact on retained earnings.

The company also elected to use the titles per revised IAS 1 of 'statement of financial position' and 'statement of cash flows' to describe the 'balance sheet' and 'cash flow statement' respectively.

The company has not presented three statements of financial position in these financial statements because it has not applied an accounting policy retrospectively, made a retrospective restatement of items in its financial statements, or reclassified items in its financial statements that affected the statement of financial position at the beginning of the earliest comparative period.

Adoption of these interpretations and standards has not led to any changes in the company's accounting policies.

IFRS 8, 'Operating segments'

The new standard requires a 'management approach', under which segment information is presented on the same basis as that used for internal reporting purposes. The segments will be reported in a manner that is consistent with the internal reporting provided to the chief operating decision-maker. The new standard will enable investors to assess the company, business performance from the same perspective used by management in making decisions about operating matters.

The company has only one operating segment which is the entity and as such has not revised its operating and reportable segment and the application of IFRS 8 does not have an impact in the figures reported on the financial statements although it has impacted in the manner in which the company presents information on its operating segments.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

Adoption of new and revised International Financial Reporting Standards (IFRSs) (Continued)

Impact of the new and revised standards and interpretations in issue (Continued)

(ii) *Standards and interpretations effective in 2009, with no effect on these financial statements:*

The following new and revised standards and interpretations are effective in the current financial year and have been adopted in these financial statements. Their adoption has not had any impact on the amounts reported in these financial statements but may affect the accounting for future transactions or arrangements.

- IFRS 1: First-Time Adoption of International Financial Reporting Standards - Amendment relating to cost of an investment on first-time adoption (effective for accounting periods beginning on or after 1 January 2009);
- IFRS 2 Share-based payment – Amendments relating to vesting conditions and cancellations (effective for annual periods beginning on or after 1 January 2009);
- IFRS 7 ‘Financial instruments – Disclosures’ (amendment) – effective 1 January 2009. The amendment requires enhanced disclosures about fair value measurement and liquidity risk. In particular, the amendment requires disclosure of fair value measurements by level of a fair value measurement hierarchy. The adoption of the amendment results in additional disclosures but does not have any impact on the financial position or the comprehensive income of the company.
- IFRS 9: Financial instruments Part 1: Classification and Measurement (effective for accounting periods beginning on or after 1 January 2013);
- IAS 27: Consolidated and Separate Financial Statements – Consequential amendments arising from amendments to IFRS 3 (effective for accounting periods beginning on or after 1 July 2009);
- IAS 39: Financial Instruments: Recognition and Measurement – Amendments for eligible hedged items (effective for accounting periods beginning on or after 1 July 2009);
- IFRIC 17: Distribution of non-cash assets to owners (effective for accounting periods beginning on or after 1 July 2009);
- IFRIC 18 Transfers of assets from customers (effective for accounting periods beginning on or after 1 July 2009);
- IFRIC 19: Extinguishing financial liabilities with equity instruments (effective for accounting periods beginning on or after 1 July 2010).

(iii) *New and revised standards and interpretations in issue not yet effective*

At the date of authorisation of these financial statements, the following revised standards and interpretations were in issue but not yet effective.

- IFRS 3: Business combinations – Comprehensive revision on applying the acquisition method (effective for accounting periods beginning on or after 1 July 2009);
- IFRS 9, Financial instruments part 1: Classification and measurement (effective for accounting periods beginning 1 January 2013)
- IAS 28, Investments in Associates: Consequential amendments arising from amendments to IFRS 3 (effective for accounting periods beginning on or after 1 July 2009)
- IAS 39, Financial Instruments: Recognition and Measurement: Amendments relating treatment of loan prepayment penalties as closely related derivatives (effective for accounting periods beginning on or after 1 January 2010)
- IAS 39, Financial Instruments: Recognition and Measurement: Amendments for eligible hedged items (effective for accounting periods beginning on or after 1 July 2009); amendments for embedded derivatives when reclassifying financial instruments (effective for accounting periods ending on or after 30 June 2009)
- IFRS 8, Operating Segments: Amendments on disclosure of information about segment assets (effective for accounting periods beginning on or after 1 January 2010)
- IAS 1, Presentation of Financial Statements: amendment for the classification of convertible instruments (effective for accounting periods beginning on or after 1 January 2010)
- IAS 7, Statement of Cash Flows, Amendment relating to current and non-current classification of convertible instruments (effective for accounting periods beginning on or after 1 January 2010).

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

Adoption of new and revised International Financial Reporting Standards (IFRSs) (Continued)

Impact of the new and revised standards and interpretations in issue (Continued)

(iii) New and revised standards and interpretations in issue not yet effective

- IAS 17, Leases: Amendment for classification of leases of land and buildings (effective for accounting periods beginning on or after 1 January 2010)
- IAS 36: Impairment of Assets: Amendment relating the unit of accounting for goodwill impairment test (effective for accounting periods beginning on or after 1 January 2010)
- IAS 38, intangible Assets: Amendment for measuring the fair value of an intangible asset acquired in a business combination (effective for accounting periods beginning on or after 1 January 2010)

The directors anticipate that the adoption of the above standards and interpretations will have no material impact on the financial statements of the company in the period of initial application.

Improvements to IFRS

'Improvements to IFRS' were issued in May 2008 and April 2009. They contain numerous amendments to IFRS that the IASB considers non-urgent but necessary. 'Improvements to IFRS' comprise amendments that result in accounting changes for presentation, recognition or measurement purposes, as well as terminology or editorial amendments related to a variety of individual IFRS standards. Most of the amendments are effective for annual periods beginning on or after 1 January 2009 and 1 January 2010 respectively, with earlier application permitted.

The directors anticipate that the adoption of amendments to various IFRS resulting from the International Accounting Standards Board (IASB)'s annual improvements projects, when effective, will have no material impact on the financial statements of the company.

(iv) Early adoption of standards

The company did not early-adopt any new or amended standards in 2009.

(a) Basis of preparation

The financial statements are prepared under the historical cost convention, as modified to include revaluation of certain assets at fair value.

(b) Interest income and expense

Interest income and expense for all interest bearing financial instruments are recognised within the statement of comprehensive income on accrual basis using the effective interest method. The effective interest rate is the rate that exactly discounts the estimated future cash payments and receipts through the expected life of the financial instruments (or, where appropriate, a shorter period) to the carrying amount of the financial instruments. The effective interest rate is established on initial recognition of the financial asset and liability and is not revised subsequently.

The calculation of the effective interest rate includes all fees and points paid or received transaction costs, and discounts or premiums that are an integral part of the effective interest rate. Transaction costs are incremental costs that are directly attributable to the acquisition, issue or disposal of a financial asset or liability.

Fair value changes on other derivatives held for risk management purposes, and other financial assets and liabilities carried at fair value through profit or loss, are presented in net income on other financial instruments carried at fair value in the statement of comprehensive income.

Once a financial asset or a company of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest that was used to discount the future cash flows for purposes of measuring the allowance for impairment.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(c) Investment in associate company

An associate is an entity over which the company has significant influence and that is neither a subsidiary nor an interest in a joint venture. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies. The results and assets and liabilities of associates are incorporated in these financial statements using the equity method of accounting. Under the equity method, investments in associates are carried in the statement of financial position at cost as adjusted for post-acquisition changes in the company's share of the net assets of the associate, less any impairment in the value of individual investments. Losses of an associate in excess of the company's interest in that associate are recognised only to the extent that the company has incurred legal or constructive obligations or made payments on behalf of the associate.

(d) Taxation

Current taxation is provided on the basis of operating results for the year as shown on the financial statements adjusted in accordance with the tax legislation.

Deferred taxation is provided, using the liability method, for all temporary differences arising between the tax bases of assets and liabilities and their carrying values for financial reporting purposes. Currently enacted tax rates are used to determine deferred taxation.

A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which the unused tax credits can be utilised.

(e) Fees, commission and grant income

In the normal course of business, the company earns fees and commission income from a diverse range of services to its customers. Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

Other fees and commission income, including account servicing fees, are recognised as the related services are performed.

Other fees and commission expense relates mainly to transaction and service fees, which are expensed as the services are received.

Grant income is recognised over the period necessary to match with the costs for which they are intended to compensate on a systematic basis. The unmatched grant is treated as deferred income.

(f) Property and equipment

Property and equipment are stated at acquisition cost less accumulated depreciation and any accumulated impairment losses. Acquisition cost includes the direct purchase price and incidental costs such as freight and insurance. Land and buildings are stated in the statement of financial position at their revalued amounts, being the fair value at the date of revaluation less any subsequent accumulated depreciation. Revaluations are performed with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair values at the end of each reporting period. Any revaluation increase arising on the revaluation of such land and buildings is recognised in other comprehensive income, except to the extent that it reverses a revaluation decrease for the same asset previously recognised in profit or loss, in which case the increase is credited to profit or loss to the extent of the decrease previously expensed. A decrease in the carrying amount arising on the revaluation of such land and buildings is recognised in profit or loss to the extent that it exceeds the balance, if any, held in the properties revaluation reserve relating to a previous revaluation of that asset.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(g) Depreciation

Depreciation on property and equipment is calculated on the reducing balance at the following annual rates:

Motor vehicles	25.0%
Computers and related equipment	30.0%
Electronic office equipment	25.0%
Durable non-electrical equipment	12.5%
Buildings on freehold land	2.5%
Freehold land	nil

(h) Intangible assets - computer software development costs

Costs incurred on computer software are initially accounted for at cost as intangible assets and subsequently at cost less any accumulated amortisation and accumulated impairment losses. Amortisation is calculated on a straight line basis over the estimated useful lives at an annual rate of 30%.

(i) Impairment

At each statement of financial position date, the company reviews the carrying amounts of its assets to determine whether there is any indication that these assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any).

(j) Leases

The company's leases are classified as finance leases whenever the terms of the lease substantially transfer all risks and rewards of ownership to the company as a lessee. All other leases are classified as operating leases.

Rentals payable under operating leases are amortised on the straight line basis over the term of the relevant lease.

(k) Loans and provision for loan impairments

Loans and advances are recognised when cash is advanced to borrowers. They are categorised as originated loans and carried at amortised cost.

Provisions for loan impairment are established if there is objective evidence that the company will not be able to collect all amounts due according to the original contractual terms of loans. The objective evidence of impairment of the receivables is when there is a significant financial difficulty of the counter party or when there is a default or delinquency in the interest or principal payments. The allowance recognised is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the effective interest rate computed at initial recognition.

Identified provisions are recognised for loans and advances that are individually significant. Unidentified provision is measured and recognised on a portfolio basis where there is objective evidence that probable losses are present in components of the loan portfolio at the statement of financial position date. This is estimated based upon historical patterns of losses in each component, the credit ratings allocated to the borrowers and reflecting the current economic climate in which the borrowers operate.

When a loan is deemed uncollectible, it is written off against the related provision for impairment losses. Subsequent recoveries are credited to the provision for impairment losses in the profit and loss account. If the amount of the impairment subsequently decreases due to an event occurring after the write-down, the release of the provision is credited to the provision for impairment losses in the statement of comprehensive income.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(l) Retirement benefit obligations

Company's defined contribution pension scheme

The company operates a defined contribution pension scheme for its permanent employees. The assets of the scheme are held and administered independently of the company's assets. The scheme is funded by contributions from both the company and employees. The company's contribution to the scheme is limited to 10 per cent of the employees' basic salary while employees contribute 5 per cent of their basic salary. The company's contribution is charged to the statement of comprehensive income in the year to which it relates.

Statutory defined contribution pension scheme

The company also contributes to the statutory National Social Security Fund. This is a defined contribution scheme to which the company's obligation is limited to a specified contribution per employee per month. Currently, the company's contribution is limited to Shs 200 per employee per month and is charged to the statement of comprehensive income in the year to which it relates.

(m) Foreign currencies

Transactions in foreign currencies are translated at the rates ruling at the dates of the transactions. Monetary assets and liabilities denominated in foreign currencies are translated into Kenya Shillings at the rates of exchange ruling at the statement of financial position date. Gains and losses on exchange are dealt with in the statement of comprehensive income in the year in which they arise.

(n) Employee entitlements

Employee entitlements to annual leave are recognised when they accrue to employees. An accrual is made for the liability for annual leave outstanding at the statement of financial position date.

(o) Financial instruments

A financial asset or liability is recognised when the company becomes party to the contractual provisions of the instrument.

The company classifies its financial assets into the following categories: Financial assets at fair value through profit or loss; loans, advances and receivables; held-to-maturity investments; and available-for-sale assets. Management determines the appropriate classification of its investments at initial recognition.

Financial assets at fair value through profit or loss

This category has two sub-categories: Financial assets held for trading and those designated at fair value through profit or loss at inception. A financial asset is classified in this category if acquired principally for the purpose of selling in the short term or if so designated by management. Derivatives are also categorised as held for trading. Financial assets at fair value through profit and loss are stated at fair value, with any gains or losses arising on remeasurement recognised in profit or loss. The net gain or loss recognised in profit or loss incorporates any dividend or interest earned on the financial asset and is included in the 'other gains and losses' line item in the statement of comprehensive income

Loans, advances and receivables

Loans, advances and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the company provides money, goods or services directly to a debtor with no intention of trading the receivable. Loans and receivables are measured at amortised cost using the effective interest method, less any impairment. Interest income is recognised by applying the effective interest rate, except for short-term receivables when the recognition of interest would be immaterial.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(o) Financial instruments (Continued)

Held to maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that management has the positive intention and ability to hold to maturity. Where a sale occurs other than an insignificant amount of held-to-maturity assets, the entire category would be tainted and classified as available for sale. Held-to-maturity investments are measured at amortised cost using the effective interest method less any impairment, with revenue recognised on an effective yield basis.

Available-for-sale financial assets

Financial assets that are not (a) financial assets at fair value through profit or loss, (b) loans, advances and receivables, or (c) financial assets held to maturity.

Financial assets are initially recognised at fair value plus transaction costs for all financial assets not carried at fair value through profit or loss. Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the company has transferred substantially all risks and rewards of ownership.

Available-for-sale financial assets and financial assets at fair value through profit or loss are subsequently carried at fair value. Loans, advances and receivables and held-to-maturity investments are carried at amortised cost using the effective interest method. Gains and losses arising from changes in fair value are recognised in other comprehensive income and accumulated in the investments revaluation reserve, with the exception of impairment losses, interest calculated using the effective interest method, and foreign exchange gains and losses on monetary assets, which are recognised in profit or loss. Where the investment is disposed of or is determined to be impaired, the cumulative gain or loss previously accumulated in the investments revaluation reserve is reclassified to profit or loss. Dividends on available-for-sale equity instruments are recognised in the statement of comprehensive income when the company's right to receive payment is established.

Fair values of quoted investments in active markets are based on quoted bid prices. Equity securities for which fair values cannot be measured reliably are measured at cost less impairment.

Impairment and uncollectability of financial assets

At each statement of financial position date, all financial assets are subject to review for impairment.

If it is probable that the company will not be able to collect all amounts due (principal and interest) according to the contractual terms of loans, receivables, or held-to-maturity investments carried at amortised cost, an impairment or bad debt loss has occurred. The amount of the loss is the difference between the asset's carrying amount and the present value of expected future cash flows discounted at the financial instrument's original effective interest rate (recoverable amount). The carrying amount of the asset is reduced to its estimated recoverable amount through use of the provision for bad and doubtful debts account. The amount of the loss incurred is included in statement of comprehensive income for the period.

Borrowings

Borrowings are recorded at the proceeds received. Finance charges, including premiums payable on settlement or redemption, are accounted for on the accruals basis and are added to the carrying amount of the instrument to the extent that they are not settled in the period in which they arise.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(o) Financial instruments (continued)

Available-for-sale financial assets (Continued)

Financial Liabilities

After initial recognition, the company measures all financial liabilities including customer deposits other than liabilities held for trading at amortised cost. Liabilities held for trading (financial liabilities acquired principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin) are subsequently measured at their fair values.

(p) Deferred expenditure

Expenditure incurred in relation to a borrowing facility from which the company will derive benefits over a period beyond the year in which the facility is secured, if material, is capitalised and amortised over the life of the facility.

(q) Cash collateral

Cash collaterals represent payments made by loanees as security for loans taken. In accordance with the loan agreements, the amounts are refundable upon the successful repayment of loans by loanees and at the time a loanee leaves the loan scheme. The amounts are utilised to cover loans in the event of default.

(r) Cash and cash equivalents

For the purposes of the statement of cash flows, cash equivalents include short term liquid investments which are readily convertible into known amounts of cash and which were within three months of maturity when acquired, less advances from banks repayable within three months from the dates of the advances.

(s) Statutory reserve

IAS 39 requires the company to recognise an impairment loss when there is objective evidence that loans and advances are impaired. However, the Microfinance (Deposit Taking Microfinance Institutions) Regulation 2008 require the company to set aside amounts for impairment losses on loans and advances in addition to those losses that have been recognised under IAS 39. Any such amounts set aside represent appropriations of retained earnings and not expenses in determining profit or loss. These amounts are dealt with in the statutory reserve.

(t) Comparatives

Where necessary, comparative figures have been adjusted to conform with changes in presentation in the current year.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

2 CRITICAL ACCOUNTING ESTIMATES AND JUDGEMENTS IN APPLYING THE ENTITY'S ACCOUNTING POLICIES

In the process of applying the entity's accounting policies, management has made estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances. These are dealt with below:

Impairment losses on loans and advances

The entity reviews its loan portfolios to assess impairment regularly. In determining whether an impairment loss should be recorded in the statement of comprehensive income, the company makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans, before a decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a company, or national or local economic conditions that correlate with defaults on assets in the entity. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Held -to-maturity investments

The entity follows the guidance of IAS 39 on classifying non-derivative financial assets with fixed or determinable payments and fixed maturity as held-to-maturity. This classification requires significant judgement. In making this judgement, the company evaluates its intention and ability to hold such investments to maturity. If the company fails to keep these investments to maturity other than for the specific circumstances – for example, selling an insignificant amount close to maturity – it will be required to reclassify the entire class as available-for-sale. The investments would therefore be measured at fair value not amortised cost.

Property and equipment

Critical estimates are made by the directors in determining depreciation rates for property and equipment.

3 FINANCIAL RISK MANAGEMENT

The Company has exposure to the following risks from its use of financial instruments:

- credit risk
- liquidity risk
- market risks

a) Credit risk

Credit risk is the risk of financial loss to the company if a customer or counterparty to a financial instrument fails to meet its contractual obligations, and arises principally from the company's loans and advances to customers and other banks and investment securities. For risk management reporting purposes, the company considers and consolidates all elements of credit risk exposure.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT

a) Credit risk (Continued)

(i) Management of credit risk (Continued)

The Risk Management Committee manages and oversees the overall lending policy of the company. Measures to minimize credit risk include the following among others;

- Establishing the authorization structure for the approval and renewal of credit facilities.
- Establishment of IT controls to avoid unauthorized lending and to generate exception reports on new advance accounts.
- Placing limits on the amounts of risk accepted in relation to one borrower, or group of borrower, and to industry segments.
- Regular analysis of the ability of borrowers and potential borrowers to meet interest and capital repayment obligations.
- Obtaining collateral and corporate/personal guarantees.
- Reviewing compliance with agreed exposure limits. Regular reports are provided to the Risk Committee on the credit quality of portfolios and appropriate corrective action is taken.

Concentrations of assets, liabilities and off balance sheet items:

Details of significant concentrations of the company's financial assets, financial liabilities and off balance sheet items by industry groups are as detailed below:

(a) Advances to customers

	2009		2008	
	Shs'000	%	Shs'000	%
Agriculture	709,985	22	857,993	30
Business services	1,987,707	71	2,001,985	70
Consumer	225,904	7	-	-
	<u>2,923,596</u>	<u>100</u>	<u>2,859,978</u>	<u>100</u>

(b) Cash collaterals held

	2009	%	2008	%
0- 30 days	160,158	8	111,217	8
31-90 days	258,241	14	200,906	14
90-180 days	294,574	15	229,173	15
Over 180 days	1,200,670	63	934,096	63
	<u>1,913,643</u>	<u>100</u>	<u>1,475,392</u>	<u>100</u>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

a) Credit risk (continued)

Concentrations of assets, liabilities and off balance sheet items (Continued)

(ii) Maximum exposure to credit risk before collateral held

	2009	%	2008	%
	Shs'000		Shs'000	
Credit exposures:				
On balance sheet items:				
Short term deposits with banks	123,138	3	76,671	2
Advances to customers	2,923,596	89	2,859,978	89
Government securities	297,410	8	292,333	9
	<u>3,344,144</u>	<u>100</u>	<u>3,228,982</u>	<u>100</u>

	2009	2008
	Shs'000	Shs'000
iii) Classification of loans and advances		
Neither past due nor impaired	1,738,145	2,070,265
Past due but not impaired	998,508	627,157
Impaired	270,306	241,486
	<u>3,006,959</u>	<u>2,938,908</u>
Gross	3,006,959	2,938,908
Less: allowance for impairment (note 16)	(83,363)	(78,930)
	<u>2,923,596</u>	<u>2,859,978</u>

Loans and advances that are neither past due nor impaired

The company classifies loans and advances under this category for those exposures that are upto date and in line with contractual agreements. Such loans would have demonstrated financial conditions, risk factors and capacity to repay that are acceptable. These exposures will normally be maintained largely within approved product programs and with no signs of impairment or distress. These exposures are categorised as normal accounts in line with guidelines issued by banking regulators and a provision of 1 % is made and appropriated from revenue reserves to statutory reserves.

Past due but not impaired loans

Loans and securities where contractual interest or principal payments are past due but the company believes that impairment is not appropriate on the basis of the level of security/collateral available and/or the stage of collection of amounts owed to the company. A collective allowance for impairment of 5% is made to cover losses which have been incurred but have not yet been identified. These exposures are categorised as watch per the microfinance regulations.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

a) Credit risk (continued)

Impaired loans

Impaired loans are loans for which the company determines that it is probable that it will be unable to collect all principal and interest due according to the contractual terms of the loan/securities agreement(s). These accounts under guidelines issued by company's regulators are termed as non-performing loans. The company establishes a specific allowance for impairment losses that represents its estimate of incurred losses in its loan portfolio. These exposures are categorised as classes 3 – 5 per the microfinance regulations.

Allowances for impairment

The company establishes an allowance for impairment losses that represents its estimate of incurred losses in its loan portfolio. The main components of this allowance are a specific loss component that relates to individually significant exposures, and a collective loan loss allowance in respect of losses that have been incurred but have not been identified on loans subject to individual assessment for impairment.

Write-off policy

The company writes off a loan/security balance (and any related allowances for impairment losses) when it determines that the loans/securities are uncollectible. This determination is reached after considering information such as the occurrence of significant changes in the borrower/issuer's financial position such that the borrower/issuer can no longer pay the obligation, or that proceeds from collateral will not be sufficient to pay back the entire exposure.

Set out below is an analysis of the gross and net (of allowances for impairment) amounts of individually impaired assets based on age:

	Advances to customers	
	Gross	Net
	Shs'000	Shs'000
31 December 2009		
Neither past due nor impaired	2,560,764	2,504,059
Past due but not impaired	175,889	161,361
Impaired	270,306	258,176
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	3,006,959	2,923,596
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FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

a) Credit risk (continued)

	Advances to customers Gross Shs'000	Net Shs'000
31 December 2008		
Neither past due nor impaired	2,830,237	2,795,422
Past due but not impaired	69,791	41,459
Impaired	38,880	23,097
	2,938,908	2,859,978

Collateral held

The company holds cash collateral against loans and advances to customers (note 23). Chattels and mortgages over property and other assets are also held.

b) Liquidity risk

The company is exposed to the risk that it will encounter difficulty in raising funds to meet commitments associated with customer requirements. Liquidity risk is addressed through the following measures:

(i) Management of liquidity risk

The company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the company's reputation. The Risk committee, is tasked with the responsibility of ensuring that all foreseeable funding commitments and deposits withdrawals can be met when due and that no difficulties meeting financial liabilities as they fall due is encountered.

A portfolio of short-term liquid assets largely made up of short-term liquid investment securities and bank facilities ensure that sufficient liquidity is maintained within the company as a whole.

(ii) Source of funding

The company has an aggressive strategy aimed at increasing the customer base and maintains a diversified and stable base of customers. The company also borrows from the banks for short term liquidity requirements.

(iii) Exposure to liquidity risk

The key measure used by the company for managing liquidity risk is the ratio of net liquid assets to deposits from customers. For this purpose net liquid assets are considered as including cash and cash equivalents and investment in securities for which there is an active and liquid market less any deposits from banks, debt securities issued, other borrowings and commitments maturing within the next month. The company regulators require that the company maintains a liquidity ratio of 20% effective May 2009. The average liquidity ratio for the year was 25.2 % (2008 – 14.5%).

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

b) Liquidity risk (continued)

The table below represents the cash flows payable by the company under non- derivative financial liabilities by remaining contractual maturities at the balance sheet date. The amounts disclosed in the table are the contractual undiscounted cash flows. The company manages the inherent liquidity risk based on expected undiscounted cash inflows.

	Maturing in less than 1 month Shs'000	1 month less than 3 months Shs'000	3 months less than 6 months Shs'000	6 months less than 1 year Shs'000	1 months less than 3 years Shs'000	3 years less than 5 years Shs'000	Over 5 years Shs'000	Total Shs'000
FINANCIAL LIABILITIES								
Cash collaterals held	160,159	258,242	294,574	806,263	394,405	-	-	1,913,643
Borrowings	66,561	270,000	25,314	34,241	461,450	964,650	-	1,822,216
Customer deposits	81,920					-	-	81,920
Total liabilities (contractual maturity dates)	308,640	528,242	319,888	840,504	855,855	964,650	-	3,817,779
FINANCIAL ASSETS								
Cash and bank balances	19,255	-	-	-	-	-	-	19,255
Short term deposits with banks	126,154	-	-	-	-	-	-	126,154
Government securities		202,000	100,410	-	-	-	-	302,410
Advances to customers (net)	347,736	552,293	610,601	1,496,271	740,033	-	-	3,746,934
Total assets (expected maturity dates)	493,145	754,293	711,011	1,496,271	740,033	-	-	4,194,753
NET LIQUIDITY GAP	184,505	226,051	391,123	655,767	(115,822)	(964,650)	-	1,376,974
As at 31 December 2008								
Total liabilities (contractual maturity dates)	32,318	146,433	746,591	608,924	628,777	905,174	1,813	3,070,030
Total assets (expected maturity dates)	73,673	504,869	556,186	1,116,559	843,502	187,907	-	3,282,695
NET LIQUIDITY GAP	41,355	358,436	(190,405)	507,635	214,725	(717,267)	(1,813)	212,665

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

b) Market risks

Market risk is the risk that changes in market prices, such as interest rate, equity prices, foreign exchange rates and credit spreads will affect the company's income or the value of its holdings of financial instruments. The objective of market risk management is to manage and control market risk exposures within acceptable parameters, while optimising the return on risk.

Management of market risks

Overall authority for market risk is vested in the Risk committee which is responsible for the development of detailed risk management policies. The policies are subject to review and approval by the board.

Exposure to interest rate risk

The company is exposed to various risks associated with the effects of fluctuation in the prevailing levels of market interest rates on financial position and cash flows. The risk committee closely monitors the interest rates trends to minimize the potential adverse impact of interest rate changes. The table overleaf summarizes the exposure of interest rate risk at the balance sheet date. The company maintains an appropriate mix of fixed and floating rates deposit base. Interest rates on advances to customers and other risk assets are either pegged to the company's lending rate. The company's rates are adjusted from time to time to reflect the cost of deposits.

Interest rates on cash collateral held are determined by the company with the company retaining the discretion to adjust the rates in line with changes in market trends. The interest rates, therefore, may fluctuate depending on the movement in the market interest rates. The company also invests in fixed interest rate instruments issued by the Government of Kenya through the Central Bank of Kenya.

The matching and controlled mismatching of the maturities and interest rate of assets and liabilities is fundamental to the management of the company. It is unusual for a company's assets and liabilities to be completely matched due to the nature of business terms and types.

Included in the table overleaf are financial assets and liabilities at carrying amounts categorized by the earlier of contractual repricing or maturity dates.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

b) Market risks (continued)

Interest rate risk (continued)

The table below summarises the exposure to interest rate risks. Included in the table are the company's assets and liabilities at carrying amounts, categorised by the earlier of contractual repricing or maturity dates. The company does not bear an interest rate risk on off balance sheet items. (All figures are in Kenya Shillings).

	Less than 1 month Shs'000	1 month less than 3 months Shs'000	3 months less than 6 months Shs'000	6 months less than 1 year Shs'000	1 year less than 3 years Shs'000	3 years less than 5 years Shs'000	Over 5 years Shs'000	Non-interest bearing Shs'000	Total Shs'000
A. FINANCIAL ASSETS									
Cash and bank balances	-	-	-	-	-	-	-	19,255	19,255
Short term deposits with banks	123,138	-	-	-	-	-	-	-	123,138
Government securities	-	202,000	100,150	-	-	-	-	-	302,150
Advances to customers (net)	683,962	438,038	501,537	1,639,680	-	-	-	-	3,263,217
Total financial assets	807,100	640,038	601,687	1,639,680	-	-	-	19,255	3,707,760
B. FINANCIAL LIABILITIES									
Cash collaterals held	-	-	-	-	-	-	-	1,913,643	1,913,643
Borrowings	66,561	250,000	10,114	3,841	291,116	625,811	-	-	1,247,443
Customer Deposits	81,852	-	-	-	-	-	-	-	81,852
Total financial liabilities	148,413	250,000	10,114	3,841	291,116	625,811	-	1,913,643	3,242,938
C. On balance sheet interest sensitivity gap	658,687	390,038	591,573	1,635,839	(291,116)	(625,811)	-	(1,894,388)	464,822
D. As at 31 December 2008									
Total Financial Assets	49,492	485,320	519,190	909,339	693,096	-	-	53,712	2,710,149
Total Financial Liabilities	31,495	145,341	420,295	578,672	1,015,200	421,349	466,250	96,325	3,174,927
E. On balance sheet interest sensitivity gap	17,997	339,979	98,895	330,667	- (322,104)	- (421,349)	- (466,250)	(42,613)	(464,778)

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

c) Market risks (continued)

Interest rate risk stress test

The impact that an immediate hypothetical increase or decrease in interest rates of 3% applied at the beginning of the year would have on the profit for the year assuming a growing balance sheet and current interest rate risk profile would be as follows:

	2009 Shs'000	2008 Shs'000
3% increase in interest rates	6,993	4,741
3% decrease in interest rates	(6,993)	(4,741)

The model does not take into account any corrective action in response to interest rate movements, particularly in adverse situations.

Currency risk

The company operates wholly within Kenya and its assets and liabilities are reported in the local currency. The company's currency position is as follows:

(All figures are in Kenya Shillings thousands).

	Shs	USD	Total
A ASSETS			
Cash and bank balances	10,864	8,391	19,255
Short term deposits with banks	123,138	-	123,138
Government securities	297,410	-	297,410
Advances to customers (net)	2,923,596	-	2,923,596
Total financial assets	3,355,008	8,391	3,363,399
B. LIABILITIES & SHAREHOLDERS' FUNDS			
Cash collaterals held	1,913,643	-	1,913,643
Customer deposits	81,852	-	81,852
Borrowings	1,599,016	-	1,599,016
Total financial liabilities	3,594,511	-	3,594,511
C NET BALANCE SHEET POSITION	(239,503)	8,391	(231,112)
As at 31 December 2008			
A Total financial assets	3,384,066	13,072	3,397,138
B Total financial liabilities	3,184,806	-	3,184,806
C NET BALANCE SHEET POSITION	199,260	13,072	212,332

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

Market risks (Continued)

The table below summarizes the estimated impact of a 10% decline/appreciation of the Kenya Shilling against the two major currencies traded by the company i.e. the US Dollar and the Euro.

	2009 Shs'000	2008 Shs'000
10% depreciation of the Kenya Shilling	<u>(1,011)</u>	<u>(8,000)</u>
10% appreciation of the Kenya Shilling	<u>1,011</u>	<u>8,000</u>

4 CAPITAL RISK MANAGEMENT

The Central Bank of Kenya sets and monitors capital requirements for Deposit Taking Microfinance Institutions as a whole.

The Deposit Taking Microfinance regulatory capital is analysed into two tiers:

- Tier 1 capital, which includes ordinary share capital, share premium, perpetual bonds (which are classified as innovative Tier 1 securities), retained earnings after deductions for intangible assets, and other regulatory adjustments relating to items that are included in equity but are treated differently for capital adequacy purposes.
- Tier 2 capital, which includes qualifying subordinated liabilities, collective impairment allowances and the element of the fair value reserve relating to unrealised gains on equity instruments classified as available-for-sale.

Various limits are applied to elements of the capital base. Qualifying tier 2 capital cannot exceed tier 1 capital; and qualifying term subordinated loan capital may not exceed 50 percent of tier 1 capital. There also are restrictions on the amount of collective impairment allowances that may be included as part of tier 2 capital. Other deductions from capital include the carrying amounts of investments in subsidiaries that are not included in the regulatory consolidation, investments in the capital of Deposit Taking Microfinance and certain other regulatory items.

Risk-weighted assets are determined according to specified requirements that seek to reflect the varying levels of risk attached to assets and off-statement of financial position exposures.

The institution's aim is to build a strong capital base so as to maintain investor, creditor and market confidence and to sustain future development of the business. The impact of the level of capital on shareholders' return is also recognised and the Deposit Taking Microfinance recognises the need to maintain a balance between the higher returns that might be possible with greater gearing and the advantages and security afforded by a sound capital position.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

4 CAPITAL RISK MANAGEMENT (Continued)

In implementing current capital requirements, the Central Bank of Kenya requires each Deposit Taking Microfinance to maintain;

- A minimum level of regulatory capital of Shs 60 million.
- A ratio of core capital to the risk-weighted assets plus risk-weighted off-statement of financial position assets at or above the required minimum of 8%.
- Core capital of not less than 8% of total deposit liabilities.
- Supplementary capital of not less than 12% of risk-weighted assets plus risk-weighted off-statement of financial position items.

The Deposit Taking Microfinance has complied with all externally imposed capital requirements throughout the period.

Faulu Kenya Deposit Taking Microfinance Limited became a Deposit Taking Microfinance on 21 May, 2009. The capital position at 31 December was as follows;

	2009 Shs'000	2008 Shs'000
Tier 1 capital		
Share capital	120,000	60,000
Share premium	274,125	224,125
Retained earnings	122,524	241,625
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	516,649	525,750
	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>
Tier 2 capital		
Subordinated debt	1,166,250	866,250
Collective allowances for impairment	69,947	-
Revaluation reserves	16,431	-
	<hr style="border-top: 1px solid black;"/>	<hr style="border-top: 1px solid black;"/>
	1,252,628	866,250
	<hr style="border-top: 1px solid black;"/>	<hr style="border-top: 1px solid black;"/>
Total regulatory capital	1,033,298	1,051,500
	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>
Total Risk-weighted assets	2,159,741	1,803,113
	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>
Borrowings	1,599,017	1,647,678
	<hr style="border-top: 1px solid black;"/>	<hr style="border-top: 1px solid black;"/>
Gearing	265.2%	313.4%
	<hr style="border-top: 1px solid black;"/>	<hr style="border-top: 1px solid black;"/>
	2009	2008
Capital ratios		
Total regulatory capital expressed as a percentage of total risk-weighted assets	47.8%	58.3%
	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>
Total tier1 capital expressed as a percentage of risk-weighted assets	23.9%	29.2%
	<hr style="border-top: 3px double black;"/>	<hr style="border-top: 3px double black;"/>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

4 CAPITAL RISK MANAGEMENT (Continued)

Capital allocation

The allocation of capital between specific operations and activities is, to a large extent, driven by optimisation of the return achieved on the capital allocated. The amount of capital allocated to each operation or activity is based primarily upon the regulatory capital, but in some cases the regulatory requirements do not reflect fully the varying degree of risk associated with different activities. In such cases the capital requirements may be flexed to reflect differing risk profiles, subject to the overall level of capital to support a particular operation or activity not falling below the minimum required for regulatory purposes. The process of allocating capital to specific operations and activities is undertaken independently of those responsible for the operation, by Risk and Compliance and Credit, and is subject to review by the Board Credit Committee or ALCO as appropriate.

Although maximisation of the return on risk-adjusted capital is the principal basis used in determining how capital is allocated within the Deposit Taking Microfinance to particular operations or activities, it is not the sole basis used for decision making. Account also is taken of synergies with other operations and activities, the availability of management and other resources, and the fit of the activity with the Deposit Taking Microfinance's longer term strategic objectives. The Deposit Taking Microfinance's policies in respect of capital management and allocation are reviewed regularly by the Board of Directors.

5 INTEREST INCOME

	2009 Shs'000	2008 Shs'000
Loans and advances	785,039	504,850
Held to maturity investments-government securities	23,025	18,980
Short term bank deposits	12,082	32,818
Other loans	2,260	1,271
	<u>822,406</u>	<u>557,919</u>

6 INTEREST EXPENSE

Cash collaterals held	653	5,939
Savings accounts	477	-
Bank overdrafts/borrowed funds	127,432	65,718
Held to maturity-corporate bond	28,218	40,903
	<u>156,780</u>	<u>112,560</u>

7 FEES AND COMMISSIONS

Registration fees	49,892	43,017
Loan set up fees	66,516	65,161
Sale of booklets	-	2
Client seminar fees	-	1
Insurance administration fees	-	18,203
Commissions	619	350
Ledger fees	1,322	19
Chattels mortgage fees	3,929	2,606
	<u>122,278</u>	<u>129,359</u>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

	2009 Shs'000	2008 Shs'000
8 OTHER OPERATING INCOME		
Bad debts recovered	10,000	258
Other income	11,354	7,681
	<u>21,354</u>	<u>7,939</u>
9 (i) ADMINISTRATION AND OPERATING EXPENSES		
Staff costs (note 10)	459,907	327,238
Office operations and supplies	169,288	86,977
Training and evaluation	48,121	9,249
Office rent and repairs	56,402	35,090
Travelling expenses	28,219	22,088
Depreciation of property and equipment	38,752	24,273
Write back of amortisation of software not in use	-	(12,406)
Audit fees	2,670	2,055
Amortisation of intangible assets	54,275	3,808
Directors' fees	5,080	4,002
Other expenses	2,965	12,675
	<u>865,679</u>	<u>515,049</u>
(ii) TRANSFORMATION EXPENSES		
The company is transforming to a deposit taking microfinance under the Microfinance Act. These are transformation related expenses for MIS and banking branches rollout comprising of:		
	2009 Shs'000	2008 Shs'000
Marketing expenses	23,953	33,796
Branding and positioning	5,026	16,212
Consultancy	7,688	6,541
Business valuation	-	3,352
Legal fees	-	755
	<u>36,667</u>	<u>60,656</u>
10 STAFF COSTS		
Staff costs comprise the following items:		
Staff salaries and wages	344,550	239,597
Medical expenses	32,033	19,119
Company contributions to defined contribution pension scheme	18,175	14,211
Temporary labour	52,887	43,155
Provision for accumulated leave	7,339	9,131
Staff uniforms	2,880	597
Statutory pension contributions (NSSF)	2,043	1,428
	<u>459,907</u>	<u>327,238</u>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

	2009 Shs'000	2008 Shs'000
11 GRANT INCOME		
USAID – Micro Private Enterprise Development (note 25)	721	963
Financial Sector Deepening (FSD)	21,215	46,846
	<u>21,936</u>	<u>47,809</u>
12 TAXATION		
(a) TAXATION EXPENSE		
Current tax expense		
Based on the adjusted profit for the year at 30%	-	6,638
Prior year under provision	1,320	-
Share of associate company taxation (note 20)	1,261	-
	<u>2,581</u>	<u>6,638</u>
Deferred taxation (note 26)		
Current year (credit)/charge	(23,642)	10,624
Prior year (over) /under provision	(2,283)	2,558
	<u>(25,925)</u>	<u>13,182</u>
	<u>(23,344)</u>	<u>19,820</u>
(b) RECONCILIATION OF EXPECTED TAX BASED ON ACCOUNTING (LOSS)/PROFIT TO TAX (CREDIT)/EXPENSE		
Accounting (loss)/profit before taxation	<u>(72,498)</u>	<u>31,444</u>
Tax at the applicable rate of 30%	(21,749)	9,433
Tax effect of income not taxable	(7,547)	(14,343)
Tax effect of expenses not deductible for tax purposes	8,176	22,172
Prior year (over)/ under provision-current	1,320	-
-deferred	(2,283)	2,558
	<u>(22,083)</u>	<u>19,820</u>
Share of associate company taxation	(1,261)	-
	<u>(23,344)</u>	<u>19,820</u>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

12 TAXATION (Continued)

	2009 Shs'000	2008 Shs'000
(c) TAXATION RECOVERABLE		
Balance at 1 January	(26,447)	3,997
Prior year under provision	1,320	-
Charge for the year (note 12(a))	-	6,638
Paid in the year	(5,131)	(37,082)
	<u> </u>	<u> </u>
Balance at 31 December	<u> </u> <u> </u>	<u> </u> <u> </u>

13 (LOSS)/EARNINGS PER SHARE

The (loss)/earnings per share is calculated by dividing the net (loss)/profit attributable to shareholders by the number of ordinary shares in issue during the year.

	2009	2008
(Loss)/profit for the year attributable to ordinary shareholders (Shs'000)	<u> </u> <u> </u>	<u> </u> <u> </u>
	Number	Number
Weighted average number of ordinary shares in issue	<u> </u> <u> </u>	<u> </u> <u> </u>
(Loss)/earnings per share – basic & diluted	<u> </u> <u> </u>	<u> </u> <u> </u>

There were no potentially dilutive shares outstanding at 31 December 2009 (2008: nil).

14 SHORT TERM DEPOSITS WITH BANKS

	2009 Shs '000	2008 Shs'000
Housing Finance Corporation Kenya (HFCK)	72,113	76,671
Kenya Commercial Bank Limited	51,025	-
	<u> </u>	<u> </u>
	<u> </u> <u> </u>	<u> </u> <u> </u>

The effective interest rate on short term deposits with banks averaged 9.5% (2008 – 6.0%). The deposits mature in January 2010.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

	2009 Shs'000	2008 Shs'000
15 GOVERNMENT SECURITIES		
HELD TO MATURITY INVESTMENTS		
Treasury bills:		
(a) Maturing within 90 days of the statement of financial position date	302,150	296,950
Less: unearned discount	(4,740)	(4,616)
	<u>297,410</u>	<u>292,334</u>
(b) Movement in investments in Government Securities can be summarised as follows:		
At 1 January	296,950	275,000
Additions	604,300	582,250
Disposals at 31 December	(599,100)	(560,300)
	<u>302,150</u>	<u>296,950</u>

The effective interest rate on treasury bonds during the year ended 31 December 2009 was 7.8% (2008 – 7.8%) while the effective interest rate on the treasury bills was 7.3% (2008 – 7.3%).

Government securities with a value of shs 296,950,000 (2008-shs 296,250,000) are under a lien against Standard Chartered Bank Kenya Limited loan (note 24).

	2009 Shs'000	2008 Shs'000
16 ADVANCES TO CUSTOMERS		
Gross advances to customers (secured)	3,006,959	2,938,908
Accumulated impairment losses (note 17)	(83,363)	(78,930)
	<u>2,923,596</u>	<u>2,859,978</u>

All advances to customers mature within one year of disbursement and are all to micro and small enterprises except for the advances to staff. Included in loans and advances is an amount of shs 51,401,308 (2008- shs nil) representing amounts of loans that had been approved but not disbursed, shs 84,852,909 (2008 – shs nil) representing interest prepaid and shs 128,340,126.(2008- shs nil) representing principal prepayment adjusted to the gross loan balance. This scenario arose due to the difference in capturing and recording of the loans advances from the new MIS system and the previous Micro banker system. The new system is contract based and does not allow netting of prepayments unlike the previous system which recomputed the outstanding balances when there was a prepayment. The effective interest rate on customer advances at 31 December 2009 was 21.8% (2008 – 23.5%). Advances to customers are secured by cash collaterals (note 23) and chattels mortgages.

	2009 Shs'000	2008 Shs'000
17 IMPAIRMENT LOSSES ON LOANS AND ADVANCES		
At 1 January	78,930	64,557
Additional provision during the year	4,433	23,256
Less write offs:	-	(8,883)
	<u>83,363</u>	<u>78,930</u>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

	2009 Shs'000	2008 Shs'000
18 RELATED PARTY BALANCES		
Due from related organisations		
Faulu Kenya Trust	180	180
Faulu Uganda Limited	80	80
	<u>260</u>	<u>260</u>
Due to related organisations		
Faulu Advisory Services Limited	931	931
Faulu Tanzania Limited	38	74
	<u>969</u>	<u>1,005</u>
19 OTHER RECEIVABLES		
Staff receivables	10,274	6,882
Grants receivable	11,679	9,537
Prepaid expenses	18,143	7,202
Deposits and sundry receivables	82,127	30,443
	<u>122,223</u>	<u>54,064</u>
20 INVESTMENT IN ASSOCIATE COMPANIES		
Faulu Tanzania Limited:		
Investment at cost - 10% shareholding	46	46
Faulu Advisory Services Limited:		
At 1 January	2,886	-
Acquired during the year	-	6,445
Share of profit / (loss) for the year	4,204	(3,559)
Share of taxation (note 12)	(1,261)	-
	<u>5,829</u>	<u>2,886</u>

The reporting date of Faulu Advisory Services Limited is 31 December. There is no share of taxation in 2008 because the company was not in a taxable position due to accumulated tax losses from prior years.

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

20 INVESTMENT IN ASSOCIATE COMPANIES (Continued)

Faulu Tanzania Limited is classified as an investment and recognised at cost.

	2009 Shs'000	2008 Shs'000
The investments comprise:		
At cost:		
Faulu Tanzania Limited:		
24,500 ordinary shares of TShs 1,000 each	46	46
Faulu Advisory Services Limited		
3,000 ordinary shares of KShs 100 each	7,500	7,500
	<u>7,546</u>	<u>7,546</u>

	Country of Incorporation	Assets Shs'000	Liabilities Shs'000	Revenues Shs'000	Profit Shs'000	% of interest held
Faulu Advisory Services Limited	Kenya	<u>129,734</u>	<u>139,241</u>	<u>67,609</u>	<u>9,810</u>	<u>30%</u>

	2009 Shs'000	2008 Shs'000
21 INTANGIBLE ASSETS		
COST		
At 1 January	141,622	57,632
Additions	55,467	83,990
At 31 December	<u>197,089</u>	<u>141,622</u>
AMORTISATION		
At 1 January	16,173	12,365
Charge for the year	54,275	3,808
At 31 December	<u>70,448</u>	<u>16,173</u>
NET BOOK VALUE		
At 31 December	<u>126,641</u>	<u>125,449</u>

Intangible assets comprise the cost of acquired computer software.

The intangible assets includes amount related to the installation of the new Core Banking System Emerge T24 acquired in 2008. Software development and installation was completed at the end of the 2009 financial year. Amortisation of the new software commenced in the 2009 financial year.

Based on impairment review performed by directors as at 31 December 2009, no indication of impairment was identified (2008: nil).

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

22 PROPERTY AND EQUIPMENT

	Freehold land and buildings Shs'000	Motor vehicles Shs'000	Computers and equipment Shs'000	Electronic Office Equipment Shs'000	Durable non-electrical equipment Shs'000	Work in progress Shs'000	Total Shs'000
COST/VALUATION							
At 1 January 2008	60,574	5,712	25,702	7,259	59,404	-	158,651
Additions	-	-	18,285	3,496	52,792	-	74,573
At 31 December 2008	60,574	5,712	43,987	10,755	112,196	-	233,224
At 1 January 2009	60,574	5,712	43,987	10,755	112,196	-	233,224
Additions	-	-	33,029	7,510	67,576	323,981	432,096
Revaluation surplus	89,426	-	-	-	-	-	89,426
At 31 December 2009	150,000	5,712	77,016	18,265	179,772	323,981	754,746
DEPRECIATION							
At 1 January 2008	3,284	2,558	17,259	4,873	9,691	-	37,664
Charge for the year	1,182	788	8,019	1,470	12,813	-	24,273
At 31 December 2008	4,466	3,346	25,278	6,343	22,504	-	61,937
At 1 January 2009	4,466	3,346	25,278	6,343	22,504	-	61,937
Charge for the year	-	591	15,522	2,980	19,658	-	38,751
Reversal on revaluation	(4,466)	-	-	-	-	-	(4,466)
At 31 December 2009	-	3,937	40,800	9,323	42,162	-	96,222
NET BOOK VALUE							
At 31 December 2009	<u>150,000</u>	<u>1,775</u>	<u>36,216</u>	<u>8,942</u>	<u>137,610</u>	<u>323,981</u>	<u>658,524</u>
At 31 December 2008	<u>56,108</u>	<u>2,365</u>	<u>18,711</u>	<u>4,411</u>	<u>89,692</u>	<u>-</u>	<u>171,287</u>

Land and buildings were last revalued at Shs 150,000,000 as at 18 December 2009 by Lloyd Masika Limited, registered valuers, on an open market value basis by reference to market evidence of recent transactions for similar properties.

At 31 December 2009, the net book value of the freehold land and building at original cost was Shs 54,593,165 (2008 - 56,107,516).

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

23 CASH COLLATERALS HELD

Cash collaterals represent payments made by loanees as security for loans taken. In accordance with the loan agreements, the amounts are refundable upon the successful repayment of loans by loanees and at the time a loanee leaves the loan scheme. The amounts are utilised to cover loans in the event of default.

	2009 Shs'000	2008 Shs'000
0- 30 days	160,158	111,217
31-90 days	258,241	200,906
91-180 days	294,574	229,173
Over 180 days	1,200,670	934,096
	<u>1,913,643</u>	<u>1,475,392</u>

The effective interest rate on the cash collaterals held at 31 December 2009 was nil (2008: 0.5%).

24 BORROWINGS

	2009 Shs'000	2008 Shs'000
Corporate bond	250,000	400,000
Bank overdraft (secured)	66,561	404,669
Loan from Deutsche Bank (Eur 5,000,000)	466,250	466,250
Loan from Habitat (\$ 200,000)	3,842	14,509
Loan from Citi Bank (\$ 5,000,000)	352,250	352,250
Loan from Standard Chartered Bank Limited	450,000	-
Loan from KIVA Microfund	10,114	-
	<u>1,282,456</u>	<u>833,009</u>
	<u>1,599,017</u>	<u>1,637,678</u>

The borrowings are repayable as follows:

On demand or within one year	316,561	554,669
After 2 years and within 5 years	1,282,456	1,083,009
	<u>1,599,017</u>	<u>1,637,678</u>

The corporate bond, which matures in 2010, is not secured against any of the company's assets. However, it is guaranteed (75%) by Agence Francaise De Developpement (AFD) up to a maximum principal amount of 6,000,000 Euro or its equivalent in Kshs. The interest rate on the bond is pegged to the interest on the 91 day treasury bills plus 0.5% and is payable quarterly. In addition, the company pays 0.38% of the outstanding principal amounts as guarantee fees on a quarterly basis. The effective interest rate on the corporate bond at 31 December 2009 was 8.7% (2008 - 8.7%).

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

24 BORROWINGS (Continued)

The loan from Deutsche Bank is unsecured and the interest rate on the loan is 6.5% per annum. The loan repayment will commence in 2014.

The bank overdraft is held with Standard Chartered Bank Kenya Limited for working capital requirements and is secured by government securities (note 15). The effective interest rate for the year ended 31 December 2009 was 12.0% (2008-19.0%).

The loan from Habitat is unsecured and the interest rate on the loan is 5.0% per annum. The loan repayment will commence on 2013.

The loan from Citi Bank is unsecured and the interest rate on the loan is 2.8% per annum above the 91 day treasury bill rate.

The loan from Standard Chartered Bank Limited is guaranteed by International Finance Corporation up to a maximum of shs 360,000,000. The interest rate on the loan is 1.25% above the 91 day treasury bill rate.

The loan from KIVA Microfund is interest free, unsecured and has no fixed repayment terms.

25 DEFERRED INCOME

At 1 January	2,888	3,851
Less: transferred to statement of comprehensive income (note 11)	(721)	(963)
	<u>2,167</u>	<u>2,888</u>
At 31 December	<u><u>2,167</u></u>	<u><u>2,888</u></u>

Deferred income represents the net book value of assets purchased through a grant received from USAID – Micro Private Enterprise Development.

26 DEFERRED TAX LIABILITY

The net deferred tax asset is attributable to the following items:

Accelerated capital allowances	8,532	14,738
Deferred tax on revaluation surplus	28,168	-
Tax losses	(22,506)	-
Provision for staff leave pay	(2,202)	(4,989)
	<u>11,992</u>	<u>9,749</u>
	<u><u>11,992</u></u>	<u><u>9,749</u></u>

The movements in the deferred tax account during the year were as follows:

At 1 January	9,749	(3,433)
Profit or loss (credit)/charge (note 12(a))	(23,642)	10,624
Deferred taxation recognised in other comprehensive income	28,168	-
Prior year (over)/ under provision	(2,283)	2,558
	<u>11,992</u>	<u>9,749</u>
At 31 December	<u><u>11,992</u></u>	<u><u>9,749</u></u>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

	2009 Shs'000	2008 Shs'000
27 OTHER LIABILITIES		
Accrued expenses	29,451	29,690
Staff leave provision	7,339	16,630
Sundry liabilities	8,429	24,410
	<u>45,219</u>	<u>70,730</u>
	2009 '000	2008 '000
28 SHARE CAPITAL		
Authorised:		
12,000,000 ordinary shares of Shs 10 each	<u>120,000</u>	<u>120,000</u>
Issued and fully paid:		
12,000,000 (2008 – 6,000,000) ordinary shares of Shs 10 each	<u>120,000</u>	<u>60,000</u>

The movement in the number of shares issued and fully paid during the year was as follows:

	Number of shares Sh'000	Share capital Shs'000	Share premium Shs'000	Total Shs'000
At 1 January 2009	6,000	60,000	224,125	284,125
Issue of shares during the year	6,000	60,000	50,000	110,000
	<u>12,000</u>	<u>120,000</u>	<u>274,125</u>	<u>394,125</u>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

29 NOTES TO THE STATEMENT OF CASH FLOWS

	2009 Shs'000	2008 Shs'000
(a) RECONCILIATION OF (LOSS)/PROFIT BEFORE TAXATION TO CASH GENERATED FROM/(USED IN) OPERATIONS		
(Loss)/profit before taxation	(72,498)	31,444
Adjustment for:		
Depreciation	38,751	24,273
Write back of amortisation on software not in use	-	(12,406)
Amortisation of computer software	54,275	3,808
Loss on disposal of shares	-	66
Share of (profit)/loss of associate	(4,204)	3,559
	<hr/>	<hr/>
Operating profit before working capital changes	16,324	50,744
Increase in advances to customers	(63,618)	(1,178,688)
(Decrease)/increase in related party balances	(36)	10,164
Increase in other receivables	(68,159)	(17,429)
Increase in cash collaterals held	438,251	400,000
Decrease in deferred income	(721)	(963)
Increase in customer deposits	81,852	-
Decrease in other liabilities	(25,510)	(25,594)
	<hr/>	<hr/>
Cash generated from/(used in) operations	<u>378,383</u>	<u>(761,766)</u>
(b) ANALYSIS OF THE BALANCES OF CASH AND CASH EQUIVALENTS		
Cash and bank balances	19,255	113,770
Short term deposits with banks (note 14)	123,138	76,671
Treasury bills (note 15)	297,410	292,334
Bank overdraft (note 24)	(66,561)	(404,669)
	<hr/>	<hr/>
	<u>373,242</u>	<u>78,106</u>

For the purpose of the statement of cash flows, cash and cash equivalents comprise cash in hand, deposits held at call with banks, and short-term investments in money market instruments, net of bank overdrafts.

	2009 Shs'000	2008 Shs'000
(c) Movement in borrowings		
At 1 January	833,009	466,250
Received in the year	460,114	366,759
Paid in the year	(10,667)	-
	<hr/>	<hr/>
At 31 December	<u>1,282,456</u>	<u>833,009</u>

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

30 RELATED PARTY TRANSACTIONS

Faulu Kenya Trust is the principal shareholder of Faulu Kenya Deposit Taking Microfinance Limited. Faulu Tanzania Limited is an investment in which Faulu Kenya Deposit Taking Microfinance Limited owns 10 % shareholding. Faulu Kenya Trust owns 70% of Faulu Kenya Deposit Taking Microfinance Limited and is the ultimate holding company of Faulu Advisory Services Limited. Food for the Hungry Association (FH) owns 30% of Faulu Kenya Deposit Taking Microfinance Limited.

Faulu Kenya Deposit Taking Microfinance Limited, Faulu Advisory Services Limited and Faulu Kenya Trust are also related by virtue of common directorship.

Amounts not settled as at the statement of financial position date in respect of transactions with related parties are disclosed in note 18.

Key management compensation

The remuneration of directors and other members of key management during the year were as follows:

	2009 Shs'000	2008 Shs'000
Salaries and other benefits	61,924	43,710
Directors' remuneration		
Fees for services as directors	5,080	4,002

31 CONTINGENT LIABILITIES

The company is a defendant in various legal suits with an estimated liability of Shs 184,000 (2008 - Sh 6,985,430). In the opinion of the directors, after obtaining appropriate legal advice, the outcome of such actions will not give rise to any significant loss.

	2009 Shs'000	2008 Shs'000
32 CAPITAL COMMITMENTS		
Authorised and contracted for	27,232	-

FAULU KENYA DEPOSIT TAKING MICROFINANCE LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

33 FUTURE RENTAL COMMITMENTS UNDER OPERATING LEASES

The future lease payments in respect of obligations under operating leases are as follows:

	2009 Shs'000	2008 Shs'000
Within one year	62,273	16,925
Between two and five years	363,545	48,591
Over 5 years	130,974	-
	<hr/>	<hr/>
	556,792	65,516
	<hr/> <hr/>	<hr/> <hr/>

The lease rental expense incurred during the year in respect of company offices rental amounted to Sh 45,499,558 (2008 - Sh 15,073,811).

34 OPERATING SEGMENTS INFORMATION

The entity's business is not organised on the basis of differences in related products and services or differences in geographical areas of operation.

35 INCORPORATION

Faulu Kenya Deposit Taking Microfinance Limited is incorporated in Kenya under the Companies Act.

36 CURRENCY

These financial statements are presented in Kenya Shillings thousands (Shs'000).