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FAULU MICROFINANCE BANK LIMITED

**ANNUAL REPORT AND
FINANCIAL STATEMENTS**

31 DECEMBER 2017

FAULU MICROFINANCE BANK LIMITED

REPORTS AND FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2017

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FAULU MICROFINANCE BANK LIMITED

CORPORATE INFORMATION

Board of Directors

Dr. Peter W. Muthoka	Non- Executive Chairman	
Apollo N. Njoroge	Managing Director	
Peter J Mogan*	Non- Executive Director	
George Maina	Non- Executive Director	
Beverly Nuthu	Non- Executive Director	Resigned on 31 st May, 2017
Joshua Muiru	Non- Executive Director	
Peter Gachuba	Non-Executive Director	
Catherine Musakali	Non-Executive Director	
Mwikali Muthiani	Non-Executive Director	Resigned on 31 st May, 2017
Peter K. Mwangi	Non- Executive Director	
Theunis Kruger **	Non- Executive Director	Appointed 1 st January, 2017
Werner Alberts	Non- Executive Director	Resigned on 1 st November, 2017

Audit Committee

Joshua Muiru
Catherine Musakali

IT Committee

George Maina
Peter Gachuba
Joshua Muiru
Apollo Njoroge

Risk and Compliance Committee

George Maina
Joshua Muiru
Peter Gachuba
Peter K. Mwangi
Catherine Musakali

Remuneration and Nominating Committee

Dr. Peter W. Muthoka
George Maina
Peter K. Mwangi

Credit Committee

Peter Gachuba
Catherine Musakali
Theunis Kruger

Registered office

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

Company Secretary

Nkirote K. Mworira***
UAP Old Mutual Towers
Upperhill Road,
P.O. Box 43013 - 00100
Nairobi, Kenya

Principal Bankers

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

Auditors

Deloitte & Touche
Certified Public Accountants
(Kenya)
Deloitte Place, Waiyaki Way,
Muthangari
P O Box 40092
00100 - Nairobi

Principal Lawyers

Daly & Inamdar Advocates
6th Floor, ABC Towers, ABC
Place, Waiyaki Way
P.O. Box 40034, Nairobi
00100 Kenya

*Canadian

**South African

*** Appointed on 24th April, 2017 following resignation of Pauline Ngonyo on 23rd April, 2017

FAULU MICROFINANCE BANK LIMITED

CHAIRMAN'S STATEMENT

It is my pleasure to present to you the Faulu Microfinance Bank Limited (the "Bank") Annual Report and Financial Statements for the year ended 31st December 2017. The financial statements include the consolidated financial statements of the Bank and its subsidiary (together, the "Group"). This is yet again another great year for the Bank as we continue to grow and develop. Our most notable achievement this year was the successful upgrade of T24 system from R10 to R16 with an intention to give our customers the best experience possible and this will play a significant role in enabling us to dedicate more time to providing better services given the reduction in laborious and manual processes.

Operating Environment

In a year marked by significant political instability and uncertainty, deteriorating economic conditions and consequent credit rating downgrades, financial pressure on Kenyan consumers continued to intensify. Factors in the macroeconomic environment, together with the muted outlook for domestic growth, have weighed heavily on consumer confidence while rising living costs eroded disposable income.

For the year ended 31st December 2017, Kenya's economy expanded by 4.4% slower than 5.6% growth recorded as at close of 2016. This was mainly attributed to slower growth in the agriculture sector at 3.1% as compared to a growth of 3.8% recorded in Q3'2016, due to the effects of the 2016/17 drought, and a slowdown in the growth of the financial intermediation sector, which expanded by 2.4%, down from 7.1% recorded in Q3'2016.

The overall year on year inflation stood at 4.5% in December 2017 which is within the Central Bank of Kenya preferred range of 2.5% and 7.5%. The slowdown in the cost of living measure comes amid government subsidies on maize flour, Kenya's staple, in the wake of a biting drought that pushed up prices, prompting State intervention.

The Kenyan shilling remained stable through the year closing at Ksh.103.3 against the US dollar, largely helped by record inflows from Kenyans abroad and interventions by the Central Bank of Kenya (CBK) amid fears on impact of elections on the economy.

Financial Results

During the year under review, the Group posted pre-tax profits of Ksh. 178 million up from Ksh. 107 million in 2016.

The non-performing loans ratio increased from 7.98% in December 2016 to 16.49% in December 2017. This was mainly attributed to harsh macro-economic conditions owing to prolonged electioneering period as well as the drought making it unfavourable for business operation.

Total Group assets reduced by 7.6% down from Ksh. 27.4 billion in December 2016 to Ksh. 25.3 billion in 2017 driven by the decline in loans to customers from Ksh. 17.95 billion in 2016 to Ksh. 16.96 billion in 2017.

Developments in the Banking Sector

For the year ended 31st December 2017, the banking sector saw a number of developments as detailed below.

Risk Based Supervision:

All banks and mortgage finance institutions are required to formulate their own Internal Capital Adequacy Assessment Process, and provide comprehensive reports on their revised business models, that ensures that overall internal capital levels that are adequate and consistent with their strategies, business plans, risk profiles and operating environments.

Movable Property Security Rights law 2017:

The law facilitates use of movable assets as collateral for credit facilities. This law will enhance the ability to access credit using movable assets and also provide an opportunity for banks to create a niche, especially in the SME and private household loans segment

FAULU MICROFINANCE BANK LIMITED

CHAIRMAN'S STATEMENT (Continued)

Developments in the Banking Sector (Continued)

Chase Bank Kenya Limited ("Chase Bank") and Imperial Bank Limited (Imperial Bank") sale of majority stake:

The Central Bank of Kenya (CBK) shortlisted potential investors in Chase Bank, and received a Non-binding offer for Chase Bank from SBM Holdings. CBK has also shortlisted investors who expressed interest in taking an equity stake in Imperial Bank and they are expected to submit their formal proposals

Looking forward

As the Group continues to expand its infrastructure, alternative channels, cost containment and increased innovation adopted will support the Bank's growth and diversification.

Increased adoption of technology will reduce operational cost and improve efficiency. Some of the measures include integration with the mobile application platforms and internet banking to facilitate increased collection of deposits and disbursement of loans with lower operating cost

Diversification into different revenue streams will also increase non-funded income given the introduction of interest rate cap which has negatively impacted funded income to the banks.

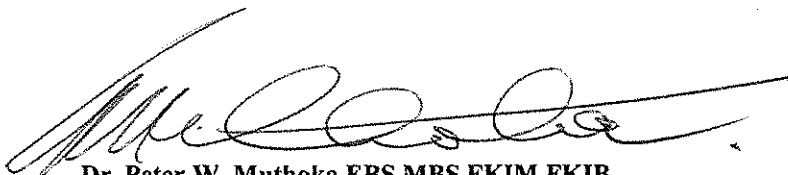
Our focus will remain acquiring entry level customers as well as offering transformative products to Retail and Micro Small medium enterprises.

Acknowledgement

I take this opportunity to thank the Management and Staff for their hard work and dedication providing important vehicle towards profitability. I also thank my fellow Board members whose wisdom and contribution helped steer the organisation during the year.

Finally, I wish to recognize and extend my sincere gratitude to our esteemed customers who have kept faith in us throughout the year.

Thank you and God Bless You



Dr. Peter W. Muthoka EBS MBS FKIM FKIB
Chairman

FAULU MICROFINANCE BANK LIMITED

REPORT OF THE DIRECTORS

The directors present their report together with the audited financial statements (the “company” or Bank” or “Faulu”) and its subsidiary (together, the “Group”) for the year ended 31 December 2017, which disclose its state of affairs in accordance with the Kenyan Companies Act and Microfinance Act.

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 FOR THE YEAR

	Group		Bank	
	2017	2016	2017	2016
	Shs '000	Shs'000	Shs '000	Shs'000
Profit before tax	177,996	107,407	163,486	97,564
Taxation charge	(73,780)	(58,264)	(69,427)	(54,905)
	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Profit for the year transferred to retained earnings	<u>104,216</u>	<u>49,143</u>	<u>94,059</u>	<u>42,659</u>

BUSINESS REVIEW

Operating Environment

The World Bank reviewed the Kenyan economic growth to 4.4% from 5.6% representing the slowest growth for Kenya in five years. They attributed this decline to sluggish credit growth, the prolonged drought in the first half of the year and the prolonged election season experienced during the year

The average inflation for year 2017 was 7.98% up from inflation rate of 6.3% that was experienced the previous year.

The political environment in 2017 was turbulent, the highlight being the nullification of the August presidential election. There were minor but violent protests, during the electioneering period. This slowed the economy, especially the private sector as players adopted a cautious, wait and see attitude.

The country's economic growth is expected to rebound to 5.5% and 5.9% in 2018 and 2019 respectively.

The performance of the Group has been detailed in the Chairman's Statement.

Market Description and Branch Networks

The Bank has 41 banking branches and 25 marketing offices. These hubs and branches currently serve close to 400,000 customers. The bulk of the Bank's customers are engaged in commercial activity of a retail nature, with a reasonable number engaged in service businesses, agriculture and manufacturing. The Bank closed two banking branches and 14 marketing hubs through consolidation to drive efficiency and serve customers better.

FAULU MICROFINANCE BANK LIMITED

REPORT OF THE DIRECTORS (CONTINUED)

Products and Services

Over the years, Faulu has developed several products in response to the needs of its clients. Because these needs are dynamic and keep changing according to social economic trends, Faulu commits to remain relevant to its clientele. Faulu's product and services which are customer driven range from savings accounts, term accounts, loans as well as insurance products.

Risk Management

The Bank has put in place a robust risk management and corporate governance framework that scopes and explains the components of business risks, financial risks, operational risks as well as detailing the mitigation and response plans for each category of risk. The year ended 31st December 2017 was characterized by a myriad of risks ranging from uncertainties in the political environment, tough operating environment which led to tight liquidity stances as well as drought which hampered productivity in the agricultural sector. The Bank will continue to monitor all risks affecting its business to ensure appropriate actions are taken to reduce potential impact.

Refer to note 3 of the financial statements for a description of the Bank's financial risks and how they are mitigated.

Conclusion

The Bank has continued to position itself through customer empowerment by offering meaningful financial education, proactively addressing customer needs, community empowerment, offering under one roof integrated financial services. This also includes establishing sufficient presence in brick and mortar, agency banking, point of sale services, ATMs and digital channels in the form of mobile banking.

DIVIDEND

The directors do not recommend the payment of a dividend in respect of the year (2016: 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 the Kenyan Companies Act and subject to approval by the Central Bank of Kenya under section 29(1) of the Kenyan Microfinance Act (2006).

DIRECTORS' STATEMENT AS TO THE INFORMATION GIVEN TO THE AUDITORS

Each of the persons who is a director at the date of approval of this report confirms that:

- So far as the director is aware, there is no relevant audit information of which the company's auditors are unaware; and
- the director has taken all the steps that he ought to have taken as a Director in order to make himself aware of any relevant audit information and to establish that the company's auditors are aware of that information.

BY ORDER OF THE BOARD



SECRETARY

Nairobi

23rd March 2018

FAULU MICROFINANCE BANK LIMITED

CORPORATE GOVERNANCE STATEMENT

Faulu Microfinance Bank Limited received its Deposit Taking License from the Central Bank of Kenya on 21 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 issued by the Central Bank of Kenya.

The Board of Directors of Faulu Microfinance Bank Limited is also responsible for ensuring that the company complies with 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.

The Board of Faulu upholds the values of uncompromised integrity, while conforming to the highest standards of ethics, honesty, trust, fairness, quality and pursuit for excellence.

Board size, composition and appointments

The Board comprises a balanced mix of proficient individuals. This takes into account a balance of executive, non-executive and independent Directors, various skills and competencies, differing experiences and team roles, balance gender and age factors. This ensures ability to add value while ensuring that there is an appropriate balance of power on the Board such that no individuals/interests has unfettered power or can dominate the Board decision making process.

There is a formal and transparent process for all appointments to the Board. On an annual basis, the Board reviews and assesses the composition and performance of the Board to ensure that:

- (a) The mix of membership is appropriate and compatible with the requirements of both the Board and the company;
- (b) Non-executive Directors commit adequate time and contribute effectively to the Board.

The Board is directly involved in the sourcing and appointment of new Directors and appointments are based on merit and against objective criteria.

Board responsibilities

The Board is responsible for setting the direction of the company, corporate values and standards, and ensures that its obligations to shareholders are understood and met. In particular, their responsibilities include the following:

- Providing entrepreneurial leadership to the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- Strategy formulation (including company vision, mission and values) and ensuring that there are adequate policies systems and structures to successfully implement the company's strategies;
- Elaborating duty of care and confidentiality, including establishing responsibility and obligations of individual Board members;
- Reviewing and approving the strategic plans and annual budgets, financial statements; and
- Monitoring the company's performance against strategic plans and objectives on an ongoing basis, as well as through mandatory quarterly meetings.

Chairman and Managing Director

The roles and responsibilities of the Chairman of the Board and the Managing Director remain distinct and separate. The Chairman provides overall leadership to the Board without limiting the principles of collective responsibility for Board decisions. The Managing Director is responsible to the Board and takes responsibility for the effective and efficient running of the institution on a day-to-day basis.

Board Committees

The committees of the Board consist of a balanced mix of non-executive and executive Directors. The Board has constituted the following 5 main Board committees:

FAULU MICROFINANCE BANK LIMITED

CORPORATE GOVERNANCE STATEMENT (Continued)

Board Committees (Continued)

1. The Audit Committee
2. The Risk and Compliance Committee
3. The Credit Committee
4. The Remuneration and Nominating Committee
5. The IT Committee

Other ad hoc committees are set up as and when the need arises. The committees regularly reports to the Board on their activities and decisions.

Board and Board Committee Meetings

The Board and its committees meet regularly in accordance with business requirements. Adequate notice was given for each meeting and directors received in good time detailed papers on the issues to be discussed. The Board and Board committees attendance during the year was as follows:

Board of Directors attendance	
Dr. Peter W. Muthoka	100%
Joshua Muiru	100%
George Maina	100%
Beverley Nuthu	100%
Mwikali Muthiani	100%
Catherine Musakali	75%
Peter J. Mogan	75%
Peter K. Mwangi	100%
Peter Gachuba	100%
Theunis Kruger	100%
Werner Alberts	75%
Apollo Njoroge	100%

Board Sub-committees

Risk and Compliance Committee	
George A Maina	100%
Peter Mwangi	100%
Joshua Muiru	100%
Catherine Musakali	100%
Peter Gachuba	100%
Werner Alberts	100%

Audit Committee	
Joshua Muiru	100%
Beverley Nuthu	100%
Catherine Musakali	100%
Werner Alberts	100%

Remuneration and Nominating Committee	
Dr. Peter W. Muthoka	100%
George Maina	100%
Peter K Mwangi	30%

FAULU MICROFINANCE BANK LIMITED

CORPORATE GOVERNANCE STATEMENT (Continued)

Credit Committee	
Peter Gachuba	100%
Mwikali Muthiani	100%
Werner Alberts	100%
Theunis Kruger	100%
Catherine Musakali	100%

IT Committee	
George Maina	100%
Joshua Muiru	100%
Peter Gachuba	75%
Apollo Njoroge	100%

The Audit Committee

The Audit Committee has been established by the Board to assist in raising the standards of corporate governance and internal controls in the following areas:-

- (a) Assisting the board in oversight of preparation and presentation of Financial Statements;
- (b) Recommending and reviewing adherences to accounting policies and internal controls;
- (c) Assisting the Board in ensuring the company's compliance with applicable laws and regulations as well as the company's charter, by laws and other internal regulations;
- (d) Acting as Board's central coordination point for investigation of complaints relating to financial statements, compliance, and internal controls; and
- (e) Oversee independence of external auditors.

The Risk and Compliance Committee

The committee currently comprises of six Board members and has been established by the board to assist in the following responsibilities:

- (a) Establishing the company's risk policies, including risk tolerances, consistent with the Risk Management Program and ensuring that senior management takes steps necessary to identify, measure, monitor and control risk;
- (b) Reviewing the adequacy of the company's capital and allocations to various business units considering the types and sizes of risks at those business units; and
- (c) Establishing an enterprise-wide risk management framework for all functions in the company and at all levels.

The Credit Committee

The Committee is a Board Committee established by and among the Board of Directors to assist in discharging their corporate governance duties by:

- a) Reviewing and recommending for approval of the Board policies with respect to credit risk of the Bank's operations;
- b) Reviewing and monitoring the application and effectiveness of such policies;
- c) Review lending practices and quality of loan portfolio;
- d) Ensure that there are effective procedures and adequate resources to identify and mitigate credit risk;
- e) Monitor and evaluate all issues that may materially impact on the present and future quality of the loan portfolio and credit risk management;
- f) Delegate and review lending limits to the sanctioning arms of the institution; and
- g) Ensure adequate provisions for loans and advances, bad and doubtful debts and write off policy.

FAULU MICROFINANCE BANK LIMITED

CORPORATE GOVERNANCE STATEMENT (Continued)

The Remuneration and Nominating Committee

The committee has been established to assist the board with the following responsibilities;

- (a) Guiding and directing the implementation of remuneration strategy, policies, group-wide remuneration principles, related proposals and structure, whilst taking into consideration local conditions; and
- (b) Monitoring and controlling the remuneration and benefit structures and their costs.

The IT Committee

The Information Technology (IT) Board Committee was established by the board of the Bank as part of its mandate to drive transformation, governance and business growth for the bank. The committee's mandate includes the following:

1. Develop and sustain the IT plan for the Bank and ensure approval by the Board. This includes:
 - a. Responsibility of managing strategic IT related projects like the core banking upgrade/replacement; and
 - b. Coordinating components of the IT plans from all units across the Bank;
2. Develop and recommend the Bank's IT policy;
3. Review and recommend IT project development plans in the context of IT strategic and transformation agenda;
4. Create ad hoc committees to address strategic ICT issues, when required; and
5. Review, coordinate and arbitrate major ICT activities across the Bank
6. Provide an update to the Board, Regulators and the relevant Old Mutual board on the progress made in the identified IT strategic projects and the transformation agenda.

Management Committees

i) The Assets and Liabilities Management Committee (ALCO)

This committee meets every month or more frequently when necessary. ALCO, a risk management committee, is tasked with the responsibility of ensuring that all foreseeable funding commitments and deposit withdrawals can be met as and when they fall due, and the company does not encounter difficulties in meeting its obligations or financial liabilities as they fall due. This includes management of operational risks, interest rate, market and exchange rate risks and ensuring compliance with statutory requirements governing liquidity.

ii) The Management Credit Risk Committee

This committee meets regularly to approve new credit applications and renewals within the delegated limits set by the Board. The committee also regularly makes recommendations to the Board Credit Committee on the revision of limits. All approvals are independent of the originating business unit.

Monitoring and Evaluation

The Board assesses its own performance and that of management in the discharge of their duties and responsibilities and develops and submits to the Central Bank of Kenya an annual self-assessment of the Board performance.

FAULU MICROFINANCE BANK LIMITED

CORPORATE GOVERNANCE STATEMENT (Continued)

Reckless and Fraudulent Activities

The Board of Directors ensures that the institution and management do not;

- (a) Allow a credit facility or guarantee to remain 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's 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 ensures that the institution does not enter into any scheme of arrangement with its creditors.

Restriction on Trading and Investment

The Board of Directors certifies that Faulu Microfinance Bank Limited:

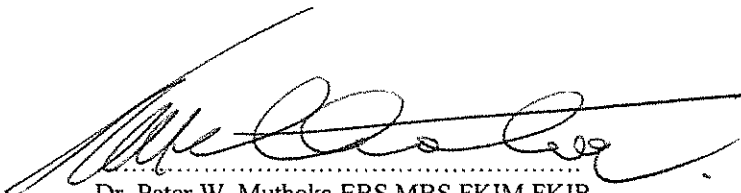
- (a) Has not acquired or held, directly or indirectly, any part of the share capital of; or
- (b) Have a beneficial interest in any financial, commercial, agricultural, industrial or other undertaking, where the value of the institution's interest exceeds 25% in the aggregate of the institution's core capital, except in an undertaking in fulfilment of a debt due to the institution.

Single Borrower Limit

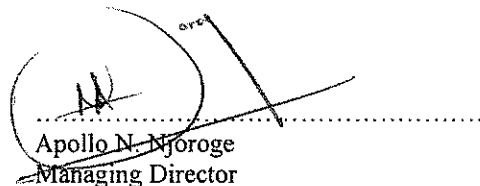
The institution did not extend loans exceeding 5% of its core capital to any single end-user borrower. The Board of Directors ensures that loans or credit facilities equivalent to the maximum limit are extended only to those borrowers who have the capacity or have an established track record of satisfactory repayment. Faulu Microfinance Bank 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 granted loans to 3 single end users that exceeded 2% of its core capital. These loans were extended to entities in the following sectors: Two real estate entities (Shs 115.7 million and Shs 90 million); and an insurance brokerage entity (Shs 96.8 million). The aggregate amount of loans was not more than 70% of the Bank's total loan portfolio.

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.



Dr. Peter W. Muthoka EBS MBS FKIM FKIB
Chairman



Apollo N. Njoroge
Managing Director

FAULU MICROFINANCE BANK LIMITED

STATEMENT OF DIRECTORS' RESPONSIBILITIES

The Kenyan Companies Act, 2015 requires the directors to prepare financial statements for each financial year that give a true and fair view of the financial position of the company as at the end of the financial year and of its profit or loss for that year. It also requires the directors to ensure that the company maintains proper accounting records that are sufficient to show and explain the transactions of the company and disclose, with reasonable accuracy, the financial position of the company. The directors are also responsible for safeguarding the assets of the company, and for taking reasonable steps for the prevention and detection of fraud and error.

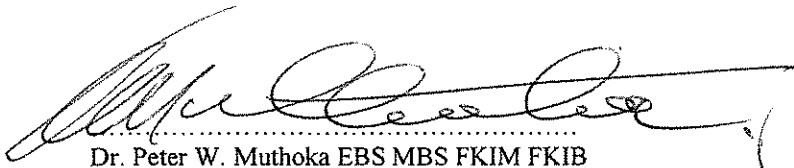
The directors accept responsibility for the preparation and presentation of these financial statements in accordance with the International Financial Reporting Standards and in the manner required by the Kenyan Companies Act, 2016. They also accept responsibility for:

- (i) designing, implementing and maintaining such internal control as they determine necessary to enable the presentation of financial statements that are free from material misstatement, whether due to fraud or error;
- (ii) selecting suitable accounting policies and applying them consistently; and
- (iii) making accounting estimates and judgements that are reasonable in the circumstances.

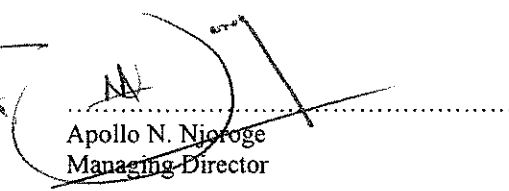
Having made an assessment of the company's ability to continue as a going concern, the directors are not aware of any material uncertainties related to events or conditions that may cast doubt upon the company's ability to continue as a going concern.

The directors acknowledge that the independent audit of the financial statements does not relieve them of their responsibilities.

Approved by the board of directors on 23rd March 2018 and signed on its behalf by:



Dr. Peter W. Muthoka EBS MBS FKIM FKIB
Chairman



Apollo N. Njoroge
Managing Director

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF FAULU MICROFINANCE BANK LIMITED

Report on the Audit of the Financial Statements

Opinion

We have audited the accompanying consolidated and separate financial statements of Faulu Microfinance Bank Limited (the "Bank") and its subsidiary (together, the "Group"), set out on pages 16 - 60, which comprise the consolidated and separate statement of financial position as at 31 December 2017, and the consolidated and separate statement of profit or loss and other comprehensive income, consolidated and separate statement of changes in equity and consolidated and separate statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the consolidated and separate financial statements give a true and fair view of the consolidated and separate financial position as at 31 December 2017 and of its consolidated and separate financial performance and consolidated and separate cash flows for the year then ended in accordance with International Financial Reporting Standards ("IFRS") and the requirements of the Kenyan Companies Act.

Basis for Opinion

We conducted our audit in accordance with International Standards on Auditing ("ISA"). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Group in accordance with the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code), which is consistent with the ethical requirements that are relevant to our audit of the financial statements in Kenya. We have fulfilled our other ethical responsibilities in accordance with these requirements.

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

Other Information

The directors are responsible for the other information, which comprises corporate information, chairman's statement, report of the directors, corporate governance statement and the statement of director's responsibilities. The other information does not include the financial statements and our auditor's report thereon.

Our opinion on the consolidated and separate financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated and separate financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated and separate financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed on the other information that we obtained prior to the date of this auditor's report, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF FAULU MICROFINANCE BANK LIMITED (CONTINUED)

Responsibilities of the Directors and Those Charged with Governance

The directors are responsible for the preparation of the consolidated and separate financial statements that give a true and fair view in accordance with IFRS and the requirements of the Kenyan companies Act, and for such internal controls as directors determine are necessary to enable the preparation of consolidated and separate financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated and separate financial statements, the directors are responsible for assessing the Group and Bank's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Group and the Bank or to cease operations, or have no realistic alternative but to do so. Those charged with governance are responsible for overseeing the Group and Bank's financial reporting process.

Auditor's Responsibilities for the Audit of the consolidated and separate financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated and separate financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated and separate financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group and Bank's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the directors.
- Conclude on the appropriateness of the directors' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group and Bank's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated and separate financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group and Bank to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated and separate financial statements, including the disclosures, and whether the consolidated and separate financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the consolidated and separate financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

INDEPENDENT AUDITORS' REPORT TO THE MEMBERS OF
FAULU MICROFINANCE BANK LIMITED (CONTINUED)

Report on other matters prescribed by the Kenyan Companies Act, 2015

In our opinion the information given in the report of the directors on pages 5 and 6 is consistent with the consolidated and separate financial statements.

The engagement partner responsible for the audit resulting in this independent auditors' report is CPA Anne Muraya - P/No 1697.

Deloitte & Touche

Certified Public Accountants (Kenya)

Nairobi, Kenya

23 March 2018

FAULU MICROFINANCE BANK LIMITED

STATEMENT OF PROFIT OR LOSS AND OTHER COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 2017

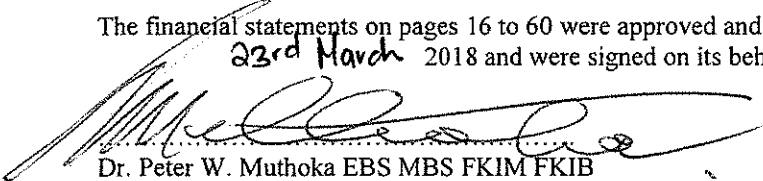
	Note	Group		Bank	
		2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Interest income	5	4,046,500	4,220,811	4,046,500	4,220,811
Interest expense	6	(1,960,152)	(2,143,882)	(1,960,152)	(2,143,882)
Net interest income		2,086,348	2,076,929	2,086,348	2,076,929
Fees and commissions	7	416,847	393,680	391,977	382,030
Foreign exchange (loss)/income		(5,339)	15,189	(5,339)	15,189
Other operating income	8	24,793	3,232	22,747	404
Operating income		2,522,649	2,489,030	2,495,733	2,474,552
Administration and operating expenses	9	(1,957,460)	(2,196,914)	(1,945,054)	(2,192,279)
Impairment losses on loans and receivables	16	(232,402)	(188,362)	(232,402)	(188,362)
Impairment losses on deposit and intangible assets	18 & 21	(158,710)	-	(158,710)	-
		(2,348,572)	(2,385,276)	(2,336,166)	(2,380,641)
Operating profit		174,077	103,754	159,567	93,911
Share of associate company's profit	19	3,919	3,653	3,919	3,653
Profit before tax		177,996	107,407	163,486	97,564
Taxation charge	11	(73,780)	(58,264)	(69,427)	(54,905)
Profit for the year		104,216	49,143	94,059	42,659
Other comprehensive income					
<i>Items that will not be reclassified subsequently to profit or loss</i>					
Gain on revaluation of property	20	58,871	-	58,871	-
Deferred tax thereon	26	(10,123)	-	(10,123)	-
		48,748	-	48,748	-
Total comprehensive income for the year		152,964	49,143	142,807	42,659
Earnings per share (basic and diluted)	12	2.17	1.02	1.96	0.89

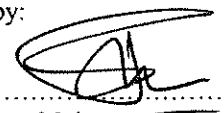
FAULU MICROFINANCE BANK LIMITED

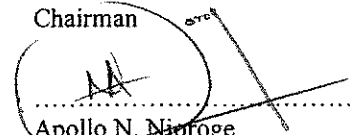
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 2018


	Note	Group		Bank	
		2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
ASSETS					
Local currency cash		297,185	310,838	297,185	297,540
Balances due from banks and financial institutions		122,300	334,337	122,300	334,337
Short term deposits with banks	13	985,000	2,271,571	985,000	2,271,571
Cash balances with Central Bank of Kenya	17	782,985	1,016,104	782,985	1,016,104
Government securities	14	2,500,000	1,750,000	2,500,000	1,750,000
Tax recoverable	11(c)	237,739	192,135	237,739	197,777
Loans to customers	15	16,957,894	17,954,979	16,957,894	17,954,979
Other assets	18	906,475	1,356,669	900,171	1,329,202
Due from related companies	29(b)	54,194	-	54,194	-
Investment in associate companies	19(a)	48,181	45,439	48,181	45,439
Investment in Faulu Insurance Agency	19(b)	-	-	1,000	1,000
Property and equipment	20	1,418,502	1,842,087	1,418,083	1,842,087
Intangible assets	21	1,020,425	328,873	1,020,425	328,873
TOTAL ASSETS		25,330,880	27,403,032	25,325,157	27,368,909
LIABILITIES AND EQUITY					
LIABILITIES					
Cash collaterals	22	711,957	980,802	711,957	980,802
Customer deposits	23	15,698,740	16,365,424	15,738,146	16,390,424
Borrowings	24	3,571,774	4,386,811	3,571,774	4,386,811
Other liabilities	25	649,133	1,195,246	638,945	1,177,737
Tax payable	11(c)	616	-	-	-
Due to related companies	29(a)	55,600	46,862	44,597	18,413
Deferred tax liability	26	134,856	72,647	134,856	72,647
		20,822,676	23,047,792	20,840,275	23,026,834
EQUITY					
Share capital	27	480,000	480,000	480,000	480,000
Share premium		2,899,759	2,899,759	2,899,759	2,899,759
Retained earnings		316,661	260,152	294,133	247,781
Revaluation surplus		260,709	212,756	259,915	211,962
Statutory reserve		551,075	502,573	551,075	502,573
		4,508,204	4,355,240	4,484,882	4,342,075
TOTAL LIABILITIES AND EQUITY		25,330,880	27,403,032	25,325,157	27,368,909

The financial statements on pages 16 to 60 were approved and authorised for issue by the board of directors on 23rd March 2018 and were signed on its behalf by:


Dr. Peter W. Muthoka EBS MBS FKIM FKIB
Chairman


Joshua Muiru
Director


Apollo N. Njoroge
Managing Director


Nkirote K. Mworira
Company Secretary

FAULU MICROFINANCE BANK LIMITED

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 2017

GROUP

	Share capital Shs'000	Share Premium Shs'000	Retained earnings Shs'000	Revaluation surplus Shs'000	Statutory reserve Shs'000	Total Shs'000
At 1 January 2016	480,000	2,899,759	243,563	212,756	470,019	4,306,097
Profit for the year	-	-	49,143	-	-	49,143
Total comprehensive income for the year	-	-	49,143	-	-	49,143
Transfer to statutory reserve	-	-	(32,554)	-	32,554	-
At 31 December 2016	480,000	2,899,759	260,152	212,756	502,573	4,355,240
At 1 January 2017	480,000	2,899,759	260,152	212,756	502,573	4,355,240
Profit for the year	-	-	104,216	-	-	104,216
Other comprehensive income	-	-	-	48,748	-	48,748
Total comprehensive income for the year	-	-	104,216	48,748	-	152,964
Transfer to statutory reserve	-	-	(48,502)	-	48,502	-
Transfer of excess depreciation net of deferred tax	-	-	795	(795)	-	-
At 31 December 2017	480,000	2,899,759	316,661	260,709	551,075	4,508,204

FAULU MICROFINANCE BANK LIMITED

STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 31 DECEMBER 2017

BANK

	Share capital Shs'000	Share premium Shs'000	Retained earnings Shs'000	Revaluation surplus Shs'000	Statutory reserve Shs'000	Total Shs'000
At 1 January 2016	480,000	2,899,759	236,882	212,756	470,019	4,299,416
Profit for the year	-	-	42,659	-	-	42,659
Total comprehensive income for the year	-	-	42,659	-	-	42,659
Transfer to statutory reserve	-	-	(32,554)	-	32,554	-
Transfer of excess depreciation net of deferred tax	-	-	794	(794)	-	-
At 31 December 2016	480,000	2,899,759	247,781	211,962	502,573	4,342,075
At 1 January 2017	480,000	2,899,759	247,781	211,962	502,573	4,342,075
Profit for the year	-	-	94,059	-	-	94,059
Other comprehensive income	-	-	-	48,748	-	48,748
Total comprehensive income for the year	-	-	94,059	48,748	-	142,807
Transfer to statutory reserve	-	-	(48,502)	-	48,502	-
Transfer of excess depreciation net of deferred tax	-	-	795	(795)	-	-
At 31 December 2017	480,000	2,899,759	294,133	259,915	551,075	4,484,882

The statutory reserve relate to the excess provisions for impairment of loans and advances as computed per the Kenyan Microfinance Act (2006) over the loans and advances impairment provisions as computed in accordance with International Accounting Standards 39 Financial Instruments: Recognition and Measurement. The statutory reserve is not distributable.

FAULU MICROFINANCE BANK LIMITED

STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 31 DECEMBER 2017

		Group		Bank	
	Note	2017 Shs'000	2016 Shs'000	2017 Shs'000	2016 Shs'000
CASH FLOWS FROM OPERATING ACTIVITIES					
Cash used in operations	28(a)	(173,661)	(2,401,380)	(144,742)	(2,430,187)
Taxation paid	11(c)	(65,506)	(62,984)	(56,127)	(62,984)
		<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net cash used in operating activities		(239,167)	(2,464,364)	(200,869)	(2,493,171)
		<u> </u>	<u> </u>	<u> </u>	<u> </u>
CASH FLOWS FROM INVESTING ACTIVITIES					
Purchase of property and equipment	20	(469,839)	(558,157)	(469,839)	(558,157)
Purchase of intangible asset	21	(13,219)	(36,347)	(13,219)	(36,347)
		<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net cash used in investing activities		(483,058)	(594,504)	(483,058)	(594,504)
		<u> </u>	<u> </u>	<u> </u>	<u> </u>
CASH FLOWS FROM FINANCING ACTIVITIES					
Borrowings received	28(c)	1,200,000	3,171,069	1,200,000	3,171,069
Borrowings repaid	28(c)	(1,981,099)	(1,386,922)	(1,981,099)	(1,386,922)
		<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net cash (used in) / generated from financing activities		(781,099)	1,784,147	(781,099)	1,784,147
		<u> </u>	<u> </u>	<u> </u>	<u> </u>
DECREASE IN CASH AND CASH EQUIVALENTS		(1,503,324)	(1,274,721)	(1,465,026)	(1,303,528)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR		2,907,809	4,182,529	2,869,511	4,173,039
		<u> </u>	<u> </u>	<u> </u>	<u> </u>
CASH AND CASH EQUIVALENTS AT END OF YEAR	28(b)	1,404,485	2,907,809	1,404,485	2,869,511
		<u> </u>	<u> </u>	<u> </u>	<u> </u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2017

1 ACCOUNTING POLICIES

Statement of compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) and the Kenyan Companies Act.

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 profit or loss and other comprehensive income.

Application of new and revised International Financial Reporting Standards (IFRSs)

(i) *Relevant new standards and amendments to published standards effective for the year ended 31 December 2017*

The following new and revised IFRSs were effective in the current year but had no material impact on the amounts reported in these financial statements.

Amendments to IAS 12: *Income Taxes* Amends IAS 12 Income Taxes to clarify the following aspects:

Unrealised losses on debt instruments measured at fair value and measured at cost for tax purposes give rise to a deductible temporary difference regardless of whether the debt instrument's holder expects to recover the carrying amount of the debt instrument by sale or by use.

The carrying amount of an asset does not limit the estimation of probable future taxable profits.

Estimates for future taxable profits exclude tax deductions resulting from the reversal of deductible temporary differences.

An entity assesses a deferred tax asset in combination with other deferred tax assets. Where tax law restricts the utilisation of tax losses, an entity would assess a deferred tax asset in combination with other deferred tax assets of the same type.

Effective for annual periods beginning on or after 1 January 2017

Amendments to IAS 7: *Statement of Cash Flows*

Amends IAS 7 Statement of Cash Flows to clarify that entities shall provide disclosures that enable users of financial statements to evaluate changes in liabilities arising from financing activities

Effective for annual periods beginning on or after 1 January 2017

Annual Improvements to IFRS Standards 2015–2017 Cycle

Makes amendments to the following standard:

IFRS 12: *Disclosure of Interests in Other Entities* - Clarifies the scope of the standard by specifying that the disclosure requirements in the standard, except for those in paragraphs B10–B16, apply to an entity's interests listed in paragraph 5 that are classified as held for sale, as held for distribution or as discontinued operations in accordance with IFRS 5: *Non-current Assets Held for Sale and Discontinued Operations*

Effective for annual periods beginning on or after 1 January 2017

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

Application of new and revised International Financial Reporting Standards (IFRSs)

(ii) *Relevant new and amended standards and interpretations in issue but not yet effective in the year ended 31 December 2017.*

<i>New and Amendments to standards</i>	Effective for annual periods beginning on or after
IFRS 9	1 January 2018
IFRS 15	1 January 2018
IFRS 16	1 January 2019
IFRS 17	1 January 2021

IFRS 9 Financial Instruments

IFRS 9, issued in November 2009, introduced new requirements for the classification and measurement of financial assets. IFRS 9 was amended in October 2010 to include requirements for the classification and measurement of financial liabilities and for derecognition.

Key requirements of IFRS 9:

Classification and measurement

Financial assets are classified by reference to the business model within which they are held and their contractual cash flow characteristics. The 2015 version of IFRS 9 introduces a 'fair value through other comprehensive income' category for certain debt instruments. Financial liabilities are classified in a similar manner to under IAS 39, however there are differences in the requirements applying to the measurement of an entity's own credit risk.

Impairment

The 2015 version of IFRS 9 introduces an 'expected credit loss' model for the measurement of the impairment of financial assets, so it is no longer necessary for a credit event to have occurred before a credit loss is recognised.

Hedge accounting

Introduces a new hedge accounting model that is designed to be more closely aligned with how entities undertake risk management activities when hedging financial and non-financial risk exposures.

Derecognition

The requirements for the derecognition of financial assets and liabilities are carried forward from IAS 39.

Based on an analysis of the Group's financial assets and financial liabilities as at 31 December 2016 on the basis of the facts and circumstances that exist at that date, the directors of the Bank have performed a preliminary assessment of the impact of IFRS 9 to the Group's consolidated financial statements. Based on this assessment, the Group's impairment losses on loans and receivables recognised on the statement of financial position, are anticipated to increase by an estimated range of between 230% to 300% from the position reported at 31 December 2017.

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(ii) *Relevant new and amended standards and interpretations in issue but not yet effective in the year ended 31 December 2017 (Continued)*

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

IFRS 15 Revenue from Contracts with Customers

In May 2016, IFRS 15 was issued which establishes a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. IFRS 15 will supersede the current revenue recognition guidance including IAS 18 Revenue, IAS 11 Construction Contracts and the related Interpretations when it becomes effective.

The core principle of IFRS 15 is that an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Specifically, the Standard introduces a 5-step approach to revenue recognition:

- Step 1: Identify the contract(s) with a customer
- Step 2: Identify the performance obligations in the contract
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to the performance obligations in the contract
- Step 5: Recognise revenue when (or as) the entity satisfies a performance obligation

Under IFRS 15, an entity recognises revenue when (or as) a performance obligation is satisfied, i.e. when 'control' of the goods or services underlying the particular performance obligation is transferred to the customer. The directors of the company do not anticipate that the application of IFRS 15 in the future may have a significant impact on amounts reported

IFRS 16 Leases

IFRS 16 specifies how an IFRS reporter will recognise, measure, present and disclose leases. The standard provides a single lessee accounting model, requiring lessees to recognise assets and liabilities for all leases unless the lease term is 12 months or less or the underlying asset has a low value. Lessors continue to classify leases as operating or finance, with IFRS 16's approach to lessor accounting substantially unchanged from its predecessor, IAS 17.

The directors of the company anticipate that the application of IFRS 16 in the future may have a significant impact on amounts reported in respect of the company's financial assets and financial liabilities. However, it is not practicable to provide a reasonable estimate of the effect of IFRS 16 until a detailed review has been completed by the company.

IFRS 17 Insurance Contracts

IFRS 17 requires insurance liabilities to be measured at a current fulfillment value and provides a more uniform measurement and presentation approach for all insurance contracts. These requirements are designed to achieve the goal of a consistent, principle-based accounting for insurance contracts. IFRS 17 supersedes IFRS 4 *Insurance Contracts* as of 1 January 2021.

The directors of the company do not anticipate that the application of IFRS 17 in the future may have a significant impact on amounts reported

(iii) *Early adoption of standards*

The company did not early-adopt any new or amended standards in 2017.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(a) Basis of preparation

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

Basis of consolidation

The consolidated financial statements incorporate the financial statements of the bank and its subsidiary Faulu Insurance Agency Limited for the year ended 31 December 2017. Subsidiaries are those companies in which the bank has power to exercise control over the operations of the entities. The accounting policies of subsidiaries have been changed when necessary to align them with the policies adopted by the group. Intra-group balances and any unrealised income and expenses arising from intra-group transactions are eliminated in preparing the consolidated financial statements.

(b) Interest income and expense

Interest income and expense for all interest bearing financial instruments are recognised within the profit or loss 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 profit or loss.

Once a financial asset or a portfolio 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.

(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

Income tax expense represents the sum of the tax currently payable and deferred tax.

(i) Current tax

The tax currently payable is based on taxable profit for the year. Taxable profit differs from profit as reported in the statement of comprehensive income because of items of income or expense that are taxable or deductible in other years and items that are never taxable or deductible. The company's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the end of the reporting period.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(d) Taxation (Continued)

(ii) *Deferred tax*

Deferred tax is recognised on temporary differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit. Deferred tax liabilities are generally recognised for all taxable temporary differences. Deferred tax assets are generally recognised for all deductible temporary differences to the extent that it is probable that taxable profits will be available against which those deductible temporary differences can be utilised. Such deferred tax assets and liabilities are not recognised if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised for taxable temporary differences associated with investments in associates, except where the company is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in the foreseeable future. Deferred tax assets arising from deductible temporary differences associated with such investments and interests are only recognised to the extent that it is probable that there will be sufficient taxable profits against which to utilise the benefits of the temporary differences and they are expected to reverse in the foreseeable future.

The carrying amount of deferred tax assets is reviewed at the end of each reporting period and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax liabilities and assets are measured at the tax rates that are expected to apply in the period in which the liability is settled or the asset realised, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. The measurement of deferred tax liabilities and assets reflects the tax consequences that would follow from the manner in which the company expects, at the end of the reporting period, to recover or settle the carrying amount of its assets and liabilities.

(iii) *Current and deferred tax for the year*

Current and deferred tax are recognised in profit or loss, except when they relate to items that are recognised in other comprehensive income or directly in equity, in which case, the current and deferred tax are also recognised in other comprehensive income or directly in equity respectively.

(e) Fees and commission

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.

(f) Property and equipment

Property and equipment are stated at cost or as professionally revalued less accumulated depreciation and any impairment charge. Professional valuations are carried out in accordance with the company's policy of revaluing freehold land and buildings. Revaluations are performed with sufficient regularity such that the carrying amounts do not differ materially from those that would be determined using fair values at the end of each reporting period and at least once in every three years.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(f) Property and equipment (Continued)

Any revaluation increase arising on revaluation of such property, plant and equipment 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 revaluation of such property, plant and equipment is recognised in profit or loss to the extent that it exceeds the balance, if any, held in the revaluation surplus reserve relating to a previous revaluation of that asset.

(g) Depreciation

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

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

Depreciation is recognised in profit or loss. On subsequent sale or retirement of a revalued property and equipment, the attributable revaluation surplus remaining in the revaluation reserve is transferred directly to equity. Each year, the difference between depreciation based on the revalued carrying amount of an asset (the depreciation charged to the profit or loss) and the depreciation based on the assets' original cost is transferred from the revaluation surplus to revenue reserves, net of related deferred taxation.

An item of property and equipment is derecognised upon disposal or when no future economic benefits are expected to arise from the continued use of the asset. Any gain or loss arising on the disposal or retirement of an item of property and equipment is determined as the difference between the sales proceeds and the carrying amount of the asset and is recognised in profit or loss.

(h) Work in progress

Work in progress relates to construction of the banking halls for the branches. Cost includes materials, direct labour and any other direct expenses incurred in respect of the project. The amounts are transferred to property and equipment once is completed and commissioned. Depreciation of these assets, on the same basis as other property assets, commences when the assets are ready for their intended use.

(i) 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.

(j) Impairment of tangible and intangible assets other than goodwill

At the end of each reporting period, the company reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those 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). Where it is not possible to estimate the recoverable amount of an individual asset, the company estimates the recoverable amount of the cash-generating unit to which the asset belongs. Where a reasonable and consistent basis of allocation can be identified, corporate assets are also allocated to individual cash-generating units, or otherwise they are allocated to the smallest group of cash-generating units for which a reasonable and consistent allocation basis can be identified.

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(j) Impairment of tangible and intangible assets other than goodwill (Continued)

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the estimates of future cash flows have not been adjusted.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (or cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised immediately in profit or loss.

Where an impairment loss subsequently reverses, the carrying amount of the asset (or a cash-generating unit) is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset (or cash-generating unit) in prior years. A reversal of an impairment loss is recognised immediately in profit or loss, unless the relevant asset is carried at a revalued amount, in which case the reversal of the impairment loss is treated as a revaluation increase.

(k) 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.

(l) Impairment and uncollectability of financial assets

At the end of each reporting period, 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 and 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 financial 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 the profit or loss for the period.

The company reviews its loan portfolios to assess impairment regularly. In determining whether an impairment loss should be recorded in the profit or loss, 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, or national or local economic conditions that correlate with defaults on assets in the company.

If a loss on a financial asset carried at fair value (recoverable amount is below original acquisition cost) has been recognised directly in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative net loss that had been recognised directly in other comprehensive income is removed from equity and recognised in profit or loss for the period even though the financial asset has not been derecognised. Where a loan is deemed uncollectible, it is written off against the related provision for impairment losses. Subsequent recoveries are credited to the profit or loss for the year.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(m) Retirement benefit obligations

i) *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 profit or loss in the year to which it relates.

ii) *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 and is charged to the profit or loss in the year to which it relates.

iii) *Other 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 end of each reporting period.

(n) 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 end of each reporting period. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated. Gains and losses on exchange of monetary items are dealt with in the profit or loss in the period in which they arise.

(o) Financial instruments

i) Recognition

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

ii) Classification and measurement

Financial assets

The company classifies its financial assets into the following categories: Financial assets at fair value through profit or loss; loans and receivables; held- to- maturity investments; and available-for-sale investments.

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 or loss are stated at fair value, with any gains or losses arising on measurement 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 operating income' line item in the profit or loss.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(o) Financial instruments (Continued)

ii) Classification and measurement (Continued)

Financial assets (Continued)

Loans and receivables

Loans 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 borrower 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.

Held to maturity investments

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 and receivables, or (c) financial assets held to maturity, and are measured at fair values. 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 profit or loss 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.

Derecognition of financial assets

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.

Financial liabilities

After initial recognition, the company measures all financial liabilities including customer deposits, cash collaterals 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.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

1 ACCOUNTING POLICIES (Continued)

(o) Financial instruments (Continued)

ii) Classification and measurement (Continued)

Financial liabilities (Continued)

Derecognition of financial liabilities

Financial liabilities are derecognised when and only when the company obligations are discharged, cancelled or they expire. The difference between the carrying amount of the financial liability derecognised and the consideration paid and payable is recognised in profit or loss.

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.

(p) Derivative financial instruments

Derivatives, which comprise solely forward foreign exchange contracts, are initially recognised at fair value on the date the derivative is entered into and are subsequently measured at fair value. The fair value is determined using forward exchange market rates at the end of the reporting period or appropriate pricing models. The derivatives do not qualify for hedge accounting. Changes in the fair value of derivatives are recognised immediately in the profit and loss.

(q) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the statement of financial position where there is a legal enforceable right to set off the recognised amounts and there is an intention to settle on net basis, or realise the asset and settle the liability simultaneously.

(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

Where impairment losses required by the microfinance (Deposit Taking Institutions) Regulation 2008 issued by the Central Bank of Kenya exceed those computed under International Financial Reporting Standards (IFRS), the excess is recognised as a statutory reserve and accounted for as an appropriation from revenue reserves. The reserve is not available for distribution.

(t) Revaluation reserve

This arises on revaluation of land and buildings and is not distributable. When revalued land or buildings are sold, the portion of the properties revaluation reserve that relates to that asset is transferred directly to retained earnings. Items of other comprehensive income included in the properties revaluation reserve will not be reclassified subsequently to profit or loss.

(u) Comparatives

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

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:

i) **Critical accounting judgements in applying the company's policies**

Impairment losses on loans and receivables

The entity reviews its loan portfolios to assess impairment regularly. In determining whether an impairment loss should be recorded in the profit or loss, 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 and not amortised cost.

ii) **Key sources of estimation uncertainty**

Property and equipment

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

Fair value measurement and valuation

Some of the company's assets and liabilities are measured at fair value for financial reporting process. In estimating the fair value of an asset or liabilities, the company uses market – observable data to the extent it is available. Where level 1 inputs are not available, the company engages third party qualified valuers to perform the valuation.

3 FINANCIAL RISK MANAGEMENT

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

- credit risk
- liquidity risk
- market risks

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3 FINANCIAL RISK MANAGEMENT (Continued)

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.

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

- a) Establishing the authorization structure for the approval and renewal of credit facilities.
- b) Establishment of IT controls to avoid unauthorized lending and to generate exception reports on new advance accounts.
- c) Placing limits on the amounts of risk accepted in relation to one borrower, or group of borrower, and to industry segments.
- d) Regular analysis of the ability of borrowers and potential borrowers to meet interest and capital repayment obligations.
- e) Obtaining collateral and corporate/personal guarantees.
- f) 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.

(i) Management of credit risk

Concentrations of assets and off balance sheet items:

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

Loans to customers	2017 Shs '000	%	2016 Shs '000	%
Agriculture	3,209	0.02%	90,306	0.5%
Trade	6,540,916	38.6%	7,324,771	40.8%
Consumer	10,413,769	61.4%	10,539,901	58.7%
	<u>16,957,894</u>	<u>100%</u>	<u>17,954,979</u>	<u>100%</u>

Cash Collaterals

Agriculture	52,081	7%	164,472	17%
Trade	487,714	69%	119,036	12%
Consumer	172,162	24%	697,294	71%
	<u>711,957</u>	<u>100%</u>	<u>980,802</u>	<u>100%</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (CONTINUED)

3 FINANCIAL RISK MANAGEMENT (Continued)

a) Credit risk (Continued)

(ii) Maximum exposure to credit risk before collateral held

	2017		2016	
	Shs '000	%	Shs '000	%
Credit exposure on balance sheet items:				
Short term deposits with banks	985,000	4%	2,271,571	9%
Loans to customers (gross)	17,278,035	80%	18,384,042	76%
Government securities	2,500,000	11%	1,750,000	7%
Bank balances	122,300	1%	334,337	3%
Cash reserve requirement	782,985	4%	1,016,104	4%
	<u>21,668,320</u>	<u>100%</u>	<u>23,756,054</u>	<u>100%</u>

(iii) Classification of loans and receivables

	2017 Shs '000	2016 Shs '000
Neither past due nor impaired	11,740,158	12,958,354
Past due but not impaired	2,688,677	3,959,369
Impaired	2,849,200	1,466,319
	<u>17,278,035</u>	<u>18,384,042</u>
Gross	17,278,035	18,384,042
Less: allowances for impairment (note 16)	(320,141)	(429,064)
	<u>16,957,894</u>	<u>17,954,979</u>

Loans and receivables that are neither past due nor impaired

The company classifies loans and receivables under this category for those exposures that are up to 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 regulatory 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 regulatory 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 MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

a) Credit risk (Continued)

(iii) Classification of loans and receivables (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.

Loans to customers

	Gross Shs '000	Net Shs '000
31 December 2017		
Neither past due nor impaired	11,740,158	11,740,158
Past due but not impaired	2,688,677	2,688,677
Impaired	2,849,200	2,529,059
	<u>17,278,035</u>	<u>16,957,894</u>
31 December 2016		
Neither past due nor impaired	12,958,354	12,958,354
Past due but not impaired	3,959,369	3,959,369
Impaired	1,466,319	1,037,256
	<u>18,384,042</u>	<u>17,954,979</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (CONTINUED)

a) Credit risk (Continued)

Cash Collateral held

The company's cash collateral consists of collateral held against loans and receivables to group customers (note 22). The fair value of cash collateral is Shs 711,956,573 (2016: Shs 980,802,070).

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 Compliance and Credit 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. The liquidity ratio as at 31 December 2017 was 26.4% (2016:27.0%).

(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 company complied with the liquidity requirements during the year. The average liquidity ratio for the year was 29.7% (2016 – 30.6%).

The table below represents the cash flows payable by the company under non- derivative financial liabilities by remaining contractual maturities at the end of the reporting 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.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT (Continued)

b) Liquidity risk (continued)

As at December 2017	Maturing in less than 1 month Shs '000	1 month less than 3 month Shs '000	3 month less than 6 month Shs '000	6 month less than 1 year Shs '000	1 year less than 3 year Shs '000	3 year less than 5 year Shs '000	Over 5 years Shs '000	Total Shs '000
FINANCIAL LIABILITIES								
Cash collateral held	247,587	29,541	40,097	54,838	199,816	93,724	46,354	711,957
Borrowings	2,625,466	19,631	-	169,631	378,523	378,523	-	3,571,774
Customer deposits	5,858,414	5,477,055	2,440,563	1,943,269	16,098	2,747	-	15,738,146
Total liabilities (contractual maturity dates)	8,731,467	5,526,227	2,480,660	2,167,738	594,437	474,994	46,354	20,021,877
FINANCIAL ASSETS								
Cash and bank balances	419,485	-	-	-	-	-	-	419,485
Short term deposits	885,000	100,000	-	-	-	-	-	985,000
Cash reserve requirement	291,460	272,488	121,420	96,679	801	137	-	782,985
Government securities	100,000	-	-	-	550,000	1,850,000	-	2,500,000
Loans to customers (net)	1,535,310	2,370,439	440,543	847,345	5,191,614	3,633,627	2,939,016	16,957,894
Total assets (expected maturity dates)	3,231,255	2,742,927	561,963	944,024	5,742,415	5,483,764	2,939,016	21,645,364
NET LIQUIDITY GAP	(5,500,212)	(2,783,300)	(1,918,697)	(1,223,714)	5,147,978	5,008,770	2,892,662	1,623,487
As at 31 December 2016								
Total liabilities (contractual maturity dates)	4,868,344	7,311,908	2,436,865	2,841,917	2,089,805	1,969,651	239,547	21,758,037
Total assets (expected maturity dates)	2,097,700	1,382,394	287,125	748,688	3,651,865	8,913,074	6,543,686	23,624,532
NET LIQUIDITY GAP	(2,770,644)	(5,929,514)	(2,149,740)	(2,093,229)	1,562,060	6,943,423	6,304,139	1,866,495

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

3 FINANCIAL RISK MANAGEMENT(Continued)

c) Market Risk

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 Compliance and Credit 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 end of reporting period. 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 or 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 MICROFINANCE BANK LIMITED

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

3 FINANCIAL RISK MANAGEMENT(Continued)

c) Market risks (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 statement of financial position items. (All figures are in Kenya Shillings).

	Less than 1 month Shs '000	1 month less than 3 month Shs '000	3 month less than 6 month Shs '000	6 month less than 1 year Shs '000	1 year less than 3 year Shs '000	3 year less than 5 year Shs '000	Over 5 years Shs '000	Non- interest bearing Shs '000	Total Shs '000
A. FINANCIAL ASSETS									
Cash and bank balances	-	-	-	-	-	-	-	419,485	419,485
Short term deposits	885,000	100,000	-	-	-	-	-	-	985,000
Cash reserve requirement	-	-	-	-	-	-	-	782,985	782,985
Government securities	100,000	-	-	-	550,000	1,850,000	-	-	2,500,000
Loans to customers (net)	2,239,239	1,666,509	440,543	847,345	5,191,614	3,633,627	2,939,016	-	16,957,894
Total financial assets	3,224,240	1,766,509	440,543	847,345	5,741,614	5,483,627	2,939,016	1,202,470	21,645,364
B. FINANCIAL LIABILITIES									
Borrowings	2,625,466	19,631	-	169,631	378,523	378,523	-	-	3,571,774
Customer deposits	1,674,522	5,618,784	3,875,904	3,886,615	421,637	127,545	133,138	-	15,738,146
Cash collateral held	-	-	-	-	-	-	-	711,957	711,957
Total financial liabilities	4,299,989	5,638,415	3,875,904	4,056,246	800,160	506,068	133,138	711,957	20,021,877
C. On statement of financial position-interest sensitivity gap	(1,075,749)	(3,871,906)	(3,435,361)	(3,208,901)	4,941,454	4,977,559	2,805,878	490,513	1,623,487
D. As at 31 December 2016									
Total financial assets	1,799,979	1,382,394	287,125	748,868	3,651,865	8,913,074	5,527,582	1,313,645	23,624,532
Total financial liabilities	1,094,288	6,954,024	3,547,915	4,826,080	2,562,789	1,685,368	106,771	980,802	21,758,037
E. On statement of financial position-interest sensitivity gap	705,691	(5,571,630)	(3,260,790)	(4,077,212)	1,089,076	7,227,706	5,420,811	332,843	1,866,495

FAULU MICROFINANCE BANK 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:

	2017 Shs'000		2016 Shs'000	
	Effect on profit	Effect on equity	Effect on profit	Effect on equity
3% increase in interest rates	62,716	43,901	72,760	114,624
3% decrease in interest rates	(62,716)	(43,901)	(72,760)	(114,624)

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 and all amounts are stated in Shs.

	Shs '000	USD	Euro	Total
A. ASSETS				
Cash and bank balances	408,084	209	92,306	419,485
Short term deposits with banks	985,000	-	-	985,000
Cash reserve requirement	782,985	-	-	782,985
Government securities	2,500,000	-	-	2,500,000
Loans to customers (net)	16,957,894	-	-	16,957,894
Total financial assets	21,633,933	209	92,306	21,645,364
B. LIABILITIES				
Cash collateral held	711,957	-	-	711,957
Borrowings	3,571,774	-	-	3,571,774
Customer deposits	15,738,146	-	-	15,738,146
Total financial liabilities	20,021,877	-	-	20,121,877
NET BALANCE SHEET POSITION	1,429,972	209	92,306	1,523,487
As at 31 December 2016				
A Total financial assets	22,586,913	5,110,977	100,972	27,798,862
B Total financial liabilities	21,758,037	-	-	21,758,037
NET BALANCE SHEET POSITION	828,876	5,110,977	100,972	6,040,826

FAULU MICROFINANCE BANK LIMITED

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

3 FINANCIAL RISK MANAGEMENT (Continued)

c) 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.

	2017 Shs'000 Effect on profit	2016 Shs'000 Effect on profit
Currency - Euro		
+ 10% Shs movement	(9,231)	(10,097)
- 10% Shs movement	9,231	10,097
	<u> </u>	<u> </u>
Currency - US dollars		
+ 10% Shs movement	(21)	(511)
- 10% Shs movement	21	511
	<u> </u>	<u> </u>

4 CAPITAL RISK MANAGEMENT

The Central Bank of Kenya sets and monitors capital requirements for microfinance banks.

The Microfinance bank 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 % 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 Microfinance bank 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 Microfinance bank 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 MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

4 CAPITAL RISK MANAGEMENT (Continued)

In implementing current capital requirements, the Central Bank of Kenya requires each microfinance bank 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 10%.
- 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.

Faulu Microfinance Bank Limited has complied with all externally imposed capital requirements throughout the period.

The capital position at 31 December was as follows;

	BANK	
	2017	2016
	Shs '000	Shs '000
Tier 1 capital		
Share capital	480,000	480,000
Share premium	2,899,759	2,899,759
Retained earnings	294,133	247,781
	<u>3,673,892</u>	<u>3,627,540</u>
Tier 2 capital		
Collective allowances for impairment	251,065	246,776
Revaluation reserve	65,177	53,189
	<u>316,243</u>	<u>299,965</u>
Regulatory capital	<u>3,990,135</u>	<u>3,884,053</u>
Total risk-weighted assets	<u>20,085,217</u>	<u>19,742,082</u>
Borrowings	<u>3,571,774</u>	<u>4,386,811</u>
Capital ratios		
Total regulatory capital expressed as a percentage of total risk-weighted assets (CBK minimum -12%)	19.9%	19.7%
Total tier 1 capital expressed as a percentage of total risk-weighted assets (CBK minimum -10%)	<u>18.3%</u>	<u>18.4%</u>

FAULU MICROFINANCE BANK 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 Microfinance bank 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 Microfinance Bank's longer term strategic objectives. The Microfinance bank's policies in respect of capital management and allocation are reviewed regularly by the Board of Directors.

5. INTEREST INCOME

	GROUP AND BANK	
	2017	2016
	Shs '000	Shs '000
Loans and receivables	3,565,692	3,753,040
Short term bank deposits	258,392	294,667
Held to maturity investments-treasury bonds	222,416	173,103
	4,046,500	4,220,811
	4,046,500	4,220,811

6. INTEREST EXPENSE

	GROUP AND BANK	
	2017	2016
	Shs '000	Shs '000
Savings accounts	1,461,173	1,761,926
Bank overdrafts/borrowed funds	498,979	381,956
	1,960,152	2,143,882
	1,960,152	2,143,882

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

7 FEES AND COMMISSIONS

	GROUP		BANK	
	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Registration fees	475	1,050	475	1,050
Loan set up fees	263,159	274,219	263,159	274,219
Commission (net)	142,587	101,046	117,717	89,396
Chattels mortgage fees	10,626	17,365	10,626	17,365
	<u>416,847</u>	<u>393,680</u>	<u>391,977</u>	<u>382,030</u>

8 OTHER OPERATING INCOME

	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Bad debts recovered	14,013	402	14,013	402
Other income	10,780	2,830	8,734	2
	<u>24,793</u>	<u>3,232</u>	<u>22,747</u>	<u>404</u>

9 ADMINISTRATION AND OPERATING EXPENSES

	GROUP		BANK	
	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Staff costs (note 10)	1,042,652	1,037,992	1,031,648	1,037,992
Office operations and supplies	390,488	651,303	390,399	651,303
Training and evaluation	3,501	24,292	3,501	24,292
Office rent and repairs	172,382	153,959	172,382	153,959
Travelling expenses	39,007	48,702	39,007	48,702
Depreciation of property and equipment	158,363	170,027	158,363	170,027
Audit fees	4,971	4,653	4,587	4,287
Amortisation of intangible assets	63,272	37,157	63,272	37,157
Directors' fees	15,137	18,427	15,137	18,427
Other expenses	67,657	50,402	66,758	46,133
	<u>1,957,460</u>	<u>2,196,914</u>	<u>1,945,054</u>	<u>2,192,279</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

10 STAFF COSTS

	2017 Shs '000	GROUP 2016 Shs '000	2017 Shs '000	BANK 2016 Shs '000
Staff salaries and wages	820,368	866,811	809,365	866,811
Medical expenses	88,965	82,458	88,965	82,458
Company contributions to defined contribution pension scheme	73,033	75,942	73,033	75,942
Temporary labour	2,647	3,088	2,647	3,088
Staff awards	1,169	1,852	1,169	1,852
Staff uniforms	159	232	159	232
Statutory pension contribution (NSSF)	1,248	1,915	1,248	1,915
Recruitment	2,505	4,195	2,505	4,195
Health & safety	100	2,292	100	2,292
Staff welfare & entertainment	6,657	1,458	6,657	1,458
Staff bonus	35,000	(11,981)	35,000	(11,981)
Medical awareness	871	876	871	876
Provision for accumulated leave	8,757	8,418	8,757	8,418
Staff related surveys	1,173	436	1,172	436
	<u>1,042,652</u>	<u>1,037,992</u>	<u>1,031,648</u>	<u>1,037,992</u>

11 TAXATION

(a) TAXATION CHARGE

Current tax expense

Based on the adjusted profit for the year at 30%	21,230	27,789	16,877	24,430
Share of associate company taxation (note 19)	1,176	1,096	1,176	1,096
Prior year (over) / under provision for current tax	(712)	14,852	(712)	14,852
	<u>21,694</u>	<u>43,737</u>	<u>17,341</u>	<u>40,378</u>

Deferred taxation (note 26)

Current year charge / (credit)	52,086	26,528	52,086	26,528
Prior year (over)/under provision of deferred tax	-	(12,000)	-	(12,000)
	<u>52,086</u>	<u>14,528</u>	<u>52,086</u>	<u>14,528</u>
	<u>73,780</u>	<u>58,264</u>	<u>69,427</u>	<u>54,905</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

11 TAXATION (Continued)

(b) RECONCILIATION OF EXPECTED TAX BASED ON ACCOUNTING PROFIT TO TAX CHARGE

	GROUP		BANK	
	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Accounting profit before taxation	177,996	107,407	163,486	97,564
Tax at the applicable rate of 30%	53,399	32,222	49,046	29,269
Tax effect of expenses not deductible for tax purposes	19,917	22,094	19,917	21,688
Prior year under provision-deferred tax	-	(12,000)	-	(12,000)
Prior year (over) / under provision-current tax	(712)	14,852	(712)	14,852
	72,604	57,168	68,251	53,809
Share of associate company taxation (note 19)	1,176	1,096	1,176	1,096
	73,780	58,264	69,427	54,905

(c) TAX (RECOVERABLE)/PAYABLE

Balance at 1 January	(192,135)	(168,917)	(197,777)	(171,200)
Charge for the year	21,230	27,789	16,877	24,430
Paid in the year	(65,506)	(62,984)	(56,127)	(62,984)
Prior year (over) / under provision	(712)	11,977	(712)	11,977
Balance at 31 December*	(237,123)	(192,135)	(237,739)	(197,777)

The tax recoverable Group balance for 2017 of Shs. 237,123,000 comprises of the tax recoverable of the Bank (Shs. 237,739,000) and tax payable amount of the subsidiary company (Shs. 616,000) shown on the statement of financial position. These amounts have not been offset because the Bank does not have the legal right to do so.

12 EARNINGS PER SHARE

Earnings per share are calculated by dividing the net profit attributable to shareholders by the number of ordinary shares in issue during the year.

	GROUP		BANK	
	2017	2016	2017	2016
Profit for the year attributable to ordinary shareholders (Shs '000)	104,216	49,143	94,059	42,659
Weighted average number of ordinary shares in issue ('000')	48,000	48,000	48,000	48,000
Earnings per share – basic & diluted (Shs)	2.17	1.02	1.96	0.89

There were no potentially dilutive shares outstanding at 31 December 2017 (2016: nil).

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

13 SHORT TERM DEPOSITS WITH BANKS

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
Held to maturity		
Commercial Bank of Africa	100,000	-
The Co-operative Bank of Kenya Limited	300,000	501,191
KCB Bank Limited	-	1,770,380
Equity Bank Limited	200,000	-
NIC Bank Limited	300,000	-
Credit Bank Limited	85,000	-
	<u>985,000</u>	<u>2,271,571</u>

Effective interest rate average 13% in 2017 and 13% in 2016. All the deposits mature within 90 days from the balance sheet date.

14 GOVERNMENT SECURITIES

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
Treasury bonds - held to maturity		
Maturing within 1 year		-
Maturing between 1 and 3 years	550,000	-
Maturing over 3 Years	1,850,000	1,750,000
	<u>2,400,000</u>	<u>1,750,000</u>
Treasury bills – held to maturity	100,000	-
	<u>2,500,000</u>	<u>1,750,000</u>

The effective interest rate on treasury bonds during the year ended 31 December 2017 was 12% (2016 – 14.7%) and that of treasury bills was 10.3% (2016 – N/a).

Treasury bonds worth Shs 303 million are pledged as security for the Standard Chartered Bank Limited borrowing shown on note 24. (2016: Treasury bonds worth Shs 300 million were pledged as security on the KCB loan facility).

15 LOANS TO CUSTOMERS

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
Gross loans to customers	17,278,035	18,384,042
Accumulated impairment losses (note 16)	(320,141)	(429,064)
	<u>16,957,894</u>	<u>17,954,979</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

15 LOANS TO CUSTOMERS (Continued)

The effective interest rate on customer advances at 31 December 2017 was 20% (2016 – 21%). Advances to customers are secured by cash collaterals (note 22) and chattels mortgages. Other forms of collateral include land and buildings and motor vehicles. As at 31 December 2017, the total fair value of these other forms of collateral on non-performing loans was Shs. 6,188,696,432 (2016: Shs. 2,293,381,256) The net non-performing loans and advances amounted to Shs. 2,849,200,180. (2016: Shs.1,466,319,305).

16 IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
At 1 January	429,064	249,034
Additional provision during the year	232,402	188,362
Amounts written off	(341,325)	(8,332)
	<hr/>	<hr/>
At 31 December	<u>320,141</u>	<u>429,064</u>

17 CASH BALANCES WITH CENTRAL BANK OF KENYA

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
Cash reserve requirement	<u>782,985</u>	<u>1,016,104</u>

As at 31 December 2017, the cash ratio requirement was 5.25% (2016: 5.25%) of eligible deposits. These funds are not available for the day to day operations of the Bank and are non-interest bearing.

18 OTHER ASSETS

	GROUP		BANK	
	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Staff receivables	1,706	-	1,706	-
Prepaid expenses	89,929	106,853	89,929	106,853
Deposits and sundry receivables	808,536	1,248,442	808,536	1,430,660
Commission receivable	6,304	6,642	-	-
	<hr/>	<hr/>	<hr/>	<hr/>
	<u>906,475</u>	<u>1,356,669</u>	<u>900,171</u>	<u>1,329,202</u>

Included in deposits & sundry receivables is Shs.330 million (2016; Shs 443 million) held in Chase Bank Limited, following the bank's receivership. An impairment provision of Shs. 113 million was recognized on this deposit in the current year. Additionally, suspended interest of Shs 272 million has been netted off against deposits and sundry receivables (2016; Shs 203 million).

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

19 INVESTMENTS IN SUBSIDIARY AND ASSOCIATE COMPANY

(a) Investments in associate company

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
Faulu Advisory Services Limited:		
At 1 January	45,439	42,881
Share of profit for the year	3,919	3,653
Share of taxation (note 11(a))	(1,176)	(1,095)
	<u>48,181</u>	<u>45,439</u>

The reporting date of Faulu Advisory Services Limited is 31 December. The company is incorporated in Kenya which is also its principal place of business. The company holds 25% ownership interest in the associate company. Its principal activity is guaranteeing loans advanced by Faulu Microfinance Bank Limited and training beneficiaries of microfinance loans on business related courses.

The associate company is a private company and there are no quoted market prices available for its shares.

There were no contingent liabilities relating to the company's interest in the associate.

Summarised financial information below represents amounts shown in the associate's unaudited financial statements (adjusted by the company for equity accounting purposes) as of 31 December 2017:

	2017 Shs '000	2016 Shs '000
Non-current assets	2,752	85,711
Current assets	251,818	167,220
Total assets	<u>254,570</u>	<u>252,931</u>
Current liabilities	<u>(57,290)</u>	<u>(61,277)</u>
Revenue	<u>61,860</u>	<u>66,920</u>
Profit from continuing operations before tax	<u>15,675</u>	<u>14,613</u>
Other comprehensive income	<u>-</u>	<u>-</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

19 INVESTMENTS IN SUBSIDIARY AND ASSOCIATE COMPANY (Continued)

(a) Investments in associate company (continued):

Reconciliation of summarised financial information to the carrying amount of the interest in associate company and the net results recognised:

	2017 Shs '000	2016 Shs '000
Total assets	254,570	252,931
Total liabilities	(24,131)	(116,734)
	<hr/>	<hr/>
Net assets	230,439	136,197
	<hr/>	<hr/>
Company's share of net assets of associate @ 25%	57,610	34,049
	<hr/>	<hr/>
Profit of associate before taxation	15,675	14,613
	<hr/>	<hr/>
Company's share @ 25%	3,919	3,653
Company share of associate's taxation	1,176	1,096
	<hr/>	<hr/>
Net result of associate recognised	2,743	2,557
	<hr/>	<hr/>

(b) Investments in Faulu Insurance Agency Limited

The group financial statements include the results of a subsidiary of Faulu Microfinance Bank Limited, Faulu Insurance Agency Limited. The principal activity of the company is the provision of insurance agency services,

The subsidiary company's financial year end is 31 December and are incorporated as limited liability companies. They are incorporated in Kenya under the Companies Act and domiciled in Kenya.

This subsidiary is 100% owned and fully controlled by the Bank. This investment is recognised at a cost of Shs. 1,000,000 (2016: Shs. 1,000,000) in the Bank's financial statements

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

19 INVESTMENT IN SUBSIDIARY AND ASSOCIATE COMPANIES (Continued)

(b) Investments in Faulu Insurance Agency (Continued)

The results and net assets of the consolidated subsidiary company are as outlined below:

Faulu Insurance Agency Limited

	2017 Sh'000	2016 Sh'000
Summarised statement of financial position		
Total assets	46,128	68,207
Total liabilities	21,806	14,165
	<hr/>	<hr/>
Net assets	24,322	54,042
	<hr/> <hr/>	<hr/> <hr/>
Summarised statement of profit and loss and other comprehensive income		
Revenue	29,155	26,587
	<hr/>	<hr/>
Profit before income tax	14,510	11,197
Income tax expense	(4,353)	(3,359)
	<hr/>	<hr/>
Total comprehensive income for the year	10,157	7,838
	<hr/> <hr/>	<hr/> <hr/>
Summarised statement of cash flows		
Net cash generated from operating activities	5,880	28,807
Net cash generated in investing activities	419	25,000
	<hr/>	<hr/>
Net increase in cash and cash equivalents	5,461	3,807
	<hr/>	<hr/>
Cash and cash equivalents at beginning of year	38,298	9,490
	<hr/>	<hr/>
Cash and cash equivalents at end of year	39,406	38,298
	<hr/> <hr/>	<hr/> <hr/>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

20 PROPERTY AND EQUIPMENT –BANK

	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 (WIP) Shs '000	Total Shs '000
COST/VALUATION							
At 1 January 2016	355,297	25,647	158,145	126,606	1,368,974	100,271	2,134,940
Additions	-	-	7,413	17,848	63,550	469,346	558,157
Transfer to/(from) WIP	-	-	1,663	7,685	77,859	(156,848)	(63,041)
Assets Written Off	-	(339)	(457)	-	(1,077)	-	(1,873)
At 31 December 2016	355,297	25,308	166,763	152,140	1,509,306	412,770	2,621,583
At 1 January 2017	355,297	25,308	166,763	152,140	1,509,306	412,770	2,621,584
Additions	-	-	2,436	4,663	27,105	435,635	469,839
Transfer to/(from) WIP	-	-	-	-	25,283	(813,150)	(787,867)
Assets written off	-	-	(45)	(6,615)	-	-	(6,660)
Revaluation increase	49,703	-	-	-	-	-	49,703
At 31 December 2017	405,000	25,308	169,154	150,189	1,561,694	35,255	2,346,599
DEPRECIATION							
At 1 January 2016	6,547	14,117	100,358	46,868	442,855	-	610,745
Charge for the year	1,320	2,881	18,509	23,370	123,947	-	170,027
Eliminated on write off	-	(281)	(340)	-	(655)	-	(1,276)
At 31 December 2017	7,867	16,717	118,527	70,238	566,147	-	779,496
At 1 January 2017	7,867	16,717	118,527	70,238	566,147	-	779,496
Charge for the year	1,301	2,148	15,104	19,341	120,469	-	158,363
Eliminated on write off	-	-	(125)	(2)	(48)	-	(175)
Elimination on revaluation	(9,168)	-	-	-	-	-	(9,168)
At 31 December 2017	-	18,865	133,506	89,577	686,568	-	928,516
NET BOOK VALUE							
At 31 December 2017	405,000	6,443	35,648	60,612	875,126	35,255	1,418,083
At 31 December 2016	347,430	8,591	48,326	81,902	943,159	412,770	1,842,087

Land and buildings were revalued at Shs 405,000,000 as at 31 December 2017 by Gimco Limited, registered valuers.

At 31 December 2017, the net book value of the freehold land and building based on original cost was Shs 48,564,184 (2016: Shs 48,565,484).

GROUP - The Group property and equipment 2017 balance of Shs. 1,418,502,000 includes the subsidiary's assets with a net book value of Ksh 419,000 (2016: nil).

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

20 PROPERTY AND EQUIPMENT (Continued)

Fair value measurement of the company's freehold land and buildings

The company's land and buildings are stated at their revalued amounts, being the fair values at the date of revaluation, less any subsequent accumulated depreciation and subsequent accumulated impairment losses. The fair value measurements of the company's leasehold land and buildings as at 31 December 2017 were performed by Gimco Limited, registered and independent valuers (i.e. not related to the company). Gimco Limited are members of the Institute of Surveyors of Kenya and they have appropriate qualifications and relevant and recent experience in the fair value measurement of properties in the various locations in Kenya. The fair value of land was determined by reference to market evidence of recent transactions for similar properties. The fair value of the building was based on the cost approach. Under this approach, the fair value is estimated at the cost of erecting a building adjusted to take into account the physical state of the actual structure.

Details of the company's freehold land and buildings and information about fair value hierarchy as at 31 December 2017 are as follows:

	Level 1	Level 2	Level 3	Fair value As at 31 December Shs'000
	Shs'000	Shs'000	Shs'000	
31 December 2017				
Land	-	350,000	-	350,000
Building	-	-	55,000	55,000
	=====	=====	=====	=====
31 December 2016				
Land	-	300,000	-	300,000
Building	-	-	47,430	47,430
	=====	=====	=====	=====

There were no transfers between level 1 and level 2 during the year.

21 INTANGIBLE ASSETS – COMPUTER SOFTWARE

	GROUP AND BANK	
	2017	2016
	Shs '000	Shs '000
COST		
At 1 January	564,535	465,147
Additions	13,219	36,347
Impairment losses	(75,182)	-
Transfer from WIP	787,867	63,041
	-----	-----
At 31 December	<u>1,290,439</u>	<u>564,535</u>
AMORTISATION		
At 1 January	235,662	198,505
Charge for the year	63,272	37,157
Elimination on impairment	(29,188)	-
	-----	-----
At 31 December	<u>269,746</u>	<u>235,662</u>
NET BOOK VALUE		
At 31 December	<u>1,020,425</u>	<u>328,873</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

22 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.

	GROUP AND BANK	
	2017	2016
	Shs '000	Shs '000
0 - 30 days	610,935	22,631
31 - 90 days	48,439	24,514
91 - 180 days	26,617	40,863
Over 180 days	25,966	892,794
	<u>711,957</u>	<u>980,802</u>

The effective interest rate on the cash collaterals held at 31 December 2017 was nil (2016: nil).

23 CUSTOMER DEPOSITS

	GROUP		BANK	
	2017	2016	2017	2016
	Shs '000	Shs '000	Shs '000	Shs '000
Savings account	2,125,957	3,868,358	2,125,957	3,868,358
Fixed account	13,572,783	12,497,066	13,612,189	12,522,066
	<u>15,698,740</u>	<u>16,365,424</u>	<u>15,738,146</u>	<u>16,390,424</u>

The effective interest rate on customer deposits as at 31 December 2017 is 10.7% (2016: 11%).

24 BORROWINGS

	GROUP AND BANK	
	2017	2016
	Shs '000	Shs '000
Loans:		
Standard Chartered Bank	694,444	-
Symbiotics fund	1,221,222	1,221,222
Old Mutual Emerging Markets	-	506,054
European Investment Bank	709,800	946,400
Oiko	750,000	525,000
IFAD	196,308	200,200
Bank overdrafts	-	33,938
	<u>3,571,774</u>	<u>4,386,811</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO FINANCIAL STATEMENTS (CONTINUED)

24 BORROWINGS (Continued)

	GROUP AND BANK	
	2017	2016
	Shs '000	Shs '000
The borrowings are repayable as follows:		
Within 1 year	1,059,623	1,187,606
After 1 year within 3 years	2,315,844	2,032,340
After 3 years and within 5 years	196,307	1,133,497
Over 5 years	-	33,367
	3,571,774	4,386,811
	3,571,774	4,386,811

During the year, additional debts were acquired from the following: -

Shs 750 million from Standard Chartered Bank Limited with interest rate pegged to the Kenya Bankers reference Rates (KBRR) plus a margin of 2.5%. Kshs 500million payable in 3 years (last instalment due on August 2020) and Kshs 250million payable in bullet after one year (due on August 2018) repayment is through direct monthly debits from the account. They are secured by government securities (note 14) with a value of Shs. 300 million.

Shs 450 Million from Oiko with interest rate pegged on TB 91 Days +2% Minimum of 10% -14% capping for the 1st 12 Months) payable annually up to November 2019.

The Bank overdrafts were held at Standard Chartered Bank Kenya Limited ("SCB") and KCB Bank Limited ("KCB") for working capital requirements. The KCB overdraft facility expired during the year whilst the SCB overdraft was undrawn with a limit of Shs. 250 million. The interest rates are pegged to the Kenya Bankers reference Rates (KBRR) plus a margin of 2.1% and 5.13% respectively.

IFAD (International Fund for Agricultural Development) loan of Shs 200.2 million (Current balance Shs 196.3 million) was granted by the Government of Kenya through Profit Fund in February 2012. It is aimed at promoting financial deepening in rural financial sector by availing access to credit for agricultural related projects. The loan period is 10 years with four year grace period all-inclusive at an interest rate of 5% on reducing balance.

The effective interest rate on the other borrowings for 2017 and 2016 are as follows: Symbiotics (12.63%); European Investment Bank (9.2%); Oiko (10%); IFAD (5%).

Covenant Breaches

Faulu Microfinance Bank Limited has existing covenants with its lenders which require the Bank to maintain its non-performing loan ("NPL") ratio below the limits of; 8% for Oiko Credit, 10% for European Investment Bank (EIB), 10% for Symbiotics and 9% for Standard Chartered Bank. The increase in non-performing loans in the Bank therefore caused a breach the above covenants. As at December 2017, the NPL ratio was 16.5% and the total funding from the four lenders was Shs 3.4 billion. At worst case scenario, the lenders can recall their funds due to the covenant breach and lead to a significant reduction in the bank's liquidity. Symbiotics requires the Bank to have an uncovered capital ratio of less than or equal to 25%. The Bank is currently in breach of this requirement.

In view of the above breaches, the Bank's management has taken deliberate steps to proactively engage with the respective lenders to inform them of the breaches and discuss the way forward. Several meetings have been held with them as a result of which all the lenders have formally granted waivers on the covenant breaches up to 31st December 2018. In addition, management has further planned to mitigate the risks arising from the covenant breaches by arranging for additional funding totalling Shs 2 billion from three banks. The conclusion of these facilities are at various advanced stages with the target of being finalized in the second quarter of 2018.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

25 OTHER LIABILITIES

	GROUP		BANK	
	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Accrued expenses	216,706	306,547	216,705	306,547
Staff leave provision	25,844	23,715	25,844	23,715
Bonus provision	35,000	13,512	35,000	13,512
Sundry liabilities	371,584	851,472	361,396	833,963
	<u>649,133</u>	<u>1,195,246</u>	<u>638,945</u>	<u>1,177,737</u>

26 DEFERRED TAX LIABILITY

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
The net deferred tax asset is attributable to the following items:		
Excess depreciation of capital allowances	64,151	24,638
Deferred tax on revaluation surplus	97,323	87,200
Bonus provision	(14,553)	(4,107)
Provision for staff leave pay	(7,753)	(7,115)
Other provisions	(4,312)	(27,970)
	<u>134,856</u>	<u>72,647</u>

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

At 1 January	72,647	58,119
Charge to profit or loss (note 11(a))	52,086	26,528
Prior year over provision of deferred tax (note 11(a))	-	(12,000)
Charge to equity on revaluation of property	10,123	-
At 31 December	<u>134,856</u>	<u>72,647</u>

27 SHARE CAPITAL

	GROUP		BANK	
	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Authorised: 60,000,000 ordinary shares of Shs 10 each	<u>600,000</u>	<u>600,000</u>	<u>600,000</u>	<u>600,000</u>
Authorised, issued and fully paid: 48,000,000 (2016: 48,000,000) ordinary shares of Shs 10 each	<u>480,000</u>	<u>480,000</u>	<u>480,000</u>	<u>480,000</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

28 NOTES TO THE STATEMENT OF CASH FLOWS

(a) RECONCILIATION OF PROFIT BEFORE TAXATION TO CASH UTILISED IN OPERATIONS FROM OPERATIONS

	GROUP		BANK	
	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Profit before taxation	177,996	107,407	163,486	97,564
Adjustment for:				
Depreciation	158,363	170,027	158,363	170,027
Amortisation of computer software	63,272	37,157	63,272	37,157
Write off of assets	6,485	597	6,485	597
Share of associate company's profit	(3,919)	(3,653)	(3,919)	(3,653)
Impairment of intangible asset	45,994	-	45,994	-
	<u>448,191</u>	<u>312,889</u>	<u>433,681</u>	<u>301,692</u>
Working capital changes:				
Decrease in loans to customers	997,085	(1,371,297)	997,085	(1,371,297)
Movement in related party balances	(70,608)	18,234	(27,743)	18,234
Decrease in other assets	450,194	(362,148)	429,031	(457,302)
Decrease in cash collaterals held	(268,845)	(243,785)	(268,845)	(243,785)
Decrease in customer deposits	(666,684)	924,865	(652,278)	924,865
Decrease in other liabilities	(546,113)	(392,602)	(538,792)	(315,058)
Increase in government securities	(750,000)	(1,028,672)	(750,000)	(1,028,672)
Decrease in cash reserve ratio	233,119	(258,864)	233,119	(258,864)
	<u>(173,661)</u>	<u>(2,401,380)</u>	<u>(144,742)</u>	<u>(2,430,187)</u>

(b) ANALYSIS OF THE BALANCES OF CASH AND CASH EQUIVALENTS

Cash and bank balances	419,485	645,176	419,485	631,878
Short term deposits with banks (note 13)	985,000	2,296,571	985,000	2,271,571
Bank overdraft (note 24)	-	(33,938)	-	(33,938)
	<u>1,404,485</u>	<u>2,907,809</u>	<u>1,404,485</u>	<u>2,869,511</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.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

28 NOTES TO THE STATEMENT OF CASH FLOWS (Continued)

(c) Movement in borrowings

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
At 1 January	4,386,811	2,670,527
Received in the year	1,200,000	3,171,069
Paid in the year*	(2,015,037)	(1,488,723)
	<hr/>	<hr/>
At 31 December	3,571,774	4,352,873
Bank overdraft	-	33,938
	<hr/>	<hr/>
At 31 December	<u>3,571,774</u>	<u>4,386,811</u>

* The borrowings repaid amounts shown on the statement of cashflows exclude the movements in the bank overdraft. This is because the bank overdrafts are included in the cash and cash equivalent balances (note 28 (b)).

29 RELATED PARTY TRANSACTIONS

Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial or operational decisions.

Old Mutual Holdings Limited is the principal shareholder of Faulu Microfinance Bank Limited.

Old Mutual Holdings Limited, Faulu Kenya Trust and Food for the Hungry Association (FH) are shareholders in Faulu Microfinance Bank Limited.

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

All transactions with related parties are at arm's length in the normal course of business, and on terms and conditions similar to those applicable to other customers. Amounts not settled as at the end of each reporting period in respect of transactions with related parties are disclosed under note 29.

Deposits are made in the Bank by directors and companies associated to directors. Advances to customers at 31 December 2017 include advances and loans to staff and directors as indicated below:

(a) Due to related parties:

	GROUP		BANK	
	2017 Shs '000	2016 Shs '000	2017 Shs '000	2016 Shs '000
Old Mutual Holdings Limited	<u>55,600</u>	<u>46,862</u>	<u>44,597</u>	<u>18,413</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

29 RELATED PARTY TRANSACTIONS (Continued)

(b) Due from related parties

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
UAP Holdings Limited	54,194	-
c) Advances to customers:		
- Directors	14,452	44,232
- Employees	333,416	436,649
	<u>347,868</u>	<u>480,881</u>
d) Customer deposits:		
- Directors	83,360	151,739
- Employees	180,112	250
- Companies associated with directors	767,741	2,420,287
	<u>263,472</u>	<u>2,572,276</u>
e) Related party transactions		
- Group recharges from Old Mutual Holdings Limited	44,597	18,413
	<u>44,597</u>	<u>18,413</u>

Key management compensation

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

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
Salaries and other benefits	128,426	124,615
Directors' remuneration		
Fees for services as directors	15,137	18,426
	GROUP AND BANK	
	2017 number	2016 number
Average Number of Employees		
Senior management	13	11
Number of staff	635	749
Total employees	<u>648</u>	<u>760</u>

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

30 CONTINGENT LIABILITIES

The company is a defendant in various legal suits with an estimated liability of Shs 122 million (2016 - Shs 500 million). In the opinion of the directors, after obtaining appropriate legal advice, the outcome of such actions will not give rise to any significant loss.

31 CAPITAL COMMITMENTS

The company had capital commitments worth Shs 800 million relating to IT Capex and software infrastructure upgrade (2016: Shs 467 million for IT hardware infrastructure upgrade).

32 FUTURE RENTAL COMMITMENTS UNDER OPERATING LEASES

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

	GROUP AND BANK	
	2017 Shs '000	2016 Shs '000
Within one year	35,862	14,471
Between one and five years	368,490	370,819
Over 5 years	188,444	462,745
	592,796	848,035
	592,796	848,035

The lease rental expense incurred during the year in respect of company offices rental amounted to Shs. 163,135,859 compared to Shs. 147,617,208 in 2016

33 SHAREHOLDING STRUCTURE

The shareholding structure is analysed as follows:

	No of Shares	% of Holding
Old Mutual Holdings Limited	32,160,000	67%
Micsha Capital Limited	3,840,000	8%
Food for the Hungry Association	4,800,000	10%
The Faulu Kenya Trust	7,200,000	15%
	48,000,000	100%
	48,000,000	100%

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.

FAULU MICROFINANCE BANK LIMITED

NOTES TO THE FINANCIAL STATEMENTS (Continued)

35 ULTIMATE AND IMMEDIATE HOLDING COMPANY

The immediate holding and parent company is Old Mutual Holdings Limited, a company incorporated and domiciled in Kenya under the Companies Act. The ultimate holding company is Old Mutual Plc. which is incorporated in United Kingdom.

36 INCORPORATION

Faulu Microfinance Bank Limited is domiciled and incorporated in Kenya under the Companies Act.

37 EVENTS SUBSEQUENT TO YEAR END

There are no significant events after reporting period which have been reported in these financial statements

38 CURRENCY

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