

2012 ANNUAL REPORT AND FINANCIAL STATEMENTS



YOUR BRIDGE TO SUCCESS

Our Vision

Giving Kenyans hope and a future

- Giving** - Proactively seeking to enrich others through service.
- Kenyans** - Belief in our people's potential, home-grown indigenous solutions for Kenyans by Kenyans.
- Hope** - Motivation for optimism.
- A Future** - Facilitate the fulfilment of Kenyans' aspirations and dreams.

Our Mission

To listen and empower Kenyans by providing relevant financial solutions

- To Listen** - Actively engaging others with a view to know them better hence meet their needs
- To Empower** - Going beyond financial services by equipping with knowledge, skills and reaching out through Voice of Community.
- Relevant Financial Solutions** - Financial products and services that respond to customer needs.

Our Values

1. The Lordship of Jesus Christ
2. Listening
3. Learning
4. Excellence
5. Integrity

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CORPORATE INFORMATION

Board of Directors

Ken Wathome	Non- Executive	Chairman
Keith Wright*	Non- Executive	Member
George Adams Maina	Non- Executive	Member
Beverley Nuthu	Non- Executive	Member
Mwikali Muthiani	Non- Executive	Member
Joseph Gichuki (resigned on 13 December 2012)	Non- Executive	

* American

Audit Committee	Executive Committee	Risk Management Committee
Joseph Gichuki (resigned 13 December 2012)	Ken Wathome	George A Maina
Beverley Nuthu	George A Maina	Keith Wright
Paul Kahoro	Mwikali Muthiani	Mwikali Muthiani
	John Mwaru	John Mwaru
	Anne Makori	Amos Mwangi
	Bernard Githinji	Bernard Githinji
		Raphael Lekoolool
Assets & Liabilities Committee		
John Mwaru		
Ireneus Gichana		
Amos Mwangi		
Charity Wainaina		
Raphael Lekoolool		
Bernard Githinji		
James Asiba		

Company Secretary

John L G Maonga
Maonga Ndonge Associates
Nairobi

Registered office

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

Auditors

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

Principal Lawyers

Mboya Wangong'u & Waiyaki Advocates
Lex Chambers, Lavington
P.O Box 74041
00200- Nairobi

Principal Bankers

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

Board of Directors



Ken Wathome

Chairman

Mr. Wathome holds a Bachelor of Arts degree in Land Economics from the University of Nairobi. He is a land economist, a registered valuer and estate agent. He is the Chief Executive Officer of NW Realite Limited, a Registered Valuers, Real Estate and Property Services Company. Mr. Wathome was appointed to the board in 2000.



John Mwara

Managing Director

Mr. Mwara joined Faulu Kenya in January 2006. He was previously the General Manager, Finance and Administration before his appointment as Managing Director in February 2010. He is an expert in Strategic planning, financial and business management with over 15 years' experience in various organizations. He holds a Master of Business Administration (Finance and Entrepreneurship), CPA (K) and CPS (K)



Keith Wright

Non-Executive Director

Mr. Wright is the Country Director of Food for the Hungry in Kenya and the Director of the African Region in charge of over 1,200 staff across eight countries in Africa. He holds a Master of Science in Economic Development as well as a Bachelors Degree in Political Science. He has over eighteen years experience in profit and not-for profit leadership and innovation in Africa. Mr. Wright joined the Board in 2008.



George Adams Maina

Non-Executive Director

Mr. Maina is an engineering graduate of the University of Loughborough in the UK. He has worked for the Royal Dutch Shell Group for over ten years, holding senior positions in the Caribbean, Central America, West Africa, East Africa and Africa as a whole. He has held board positions in a diverse group of companies and organizations covering oil, chemicals, sugar, refineries, finance and conservation sectors in Kenya and abroad. Currently he is working as a business consultant. Mr. Maina joined the Board in 2003.



Joseph Gichuki

Non-Executive Director

Mr. Gichuki is currently an Audit Partner, PKF Kenya. He is also a Fellow of the Institute of Certified Public Accountants of Kenya (ICPAK). He currently serves as the Chairman, Lavington United Church and as Convenor, IFRS (International Financial Reporting Standards) working group and Professional Standards Committee member in ICPAK.



Mwikali Muthiani

Non-Executive Director

Ms. Muthiani is a HR practitioner and is currently the HR Director for the Nation Media Group. She also sits in the Board of AMREF International. Ms. Muthiani joined the Board on 5th May 2009.



Beverley Nuthu

Non-Executive Director

Mrs. Nuthu holds a Bachelor of Commerce degree from University of Nairobi. She is a development consultant in Institutional Strengthening and Resource Mobilization. She previously worked for Coopers and Lybrand (now PricewaterhouseCoopers), World Concern International and Kenya Community Development Fund (KCDF). Mrs. Nuthu is a Certified Public Accountant. She joined the Board in 2006.

Senior Management



John Mwara
Managing Director

Mr. Mwara joined Faulu Kenya in January 2006. He was previously the General Manager, Finance and Administration before his appointment as Managing Director in February 2010. He is an expert in Strategic planning, financial and business management with over 15 years' experience in various organizations.

He holds a Master of Business Administration (Finance and Entrepreneurship), CPA (K) and CPS (K)



Anne Makori
Head of Human Resources

Mrs. Makori joined Faulu Kenya in December 2006 as the Head of Human Resources & Administration. Currently serves as Head of Legal & Human Resources. Mrs. Makori began her career in 1990 as an Advocate. She has worked with various organizations including The Standard Group.

She holds a Bachelor of Laws degree, Diploma in Law, Postgraduate Higher Diploma in Human Resource Management, CPS (K) and a Masters Degree in Leadership (Business and Entrepreneurship).



Raphael Lekolool
Head of Risk

Mr. Lekolool joined Faulu Kenya in May 2009 and is currently the Head of risk. He previously worked in Post Bank and Kenya Commercial Bank. He has over 17 years' experience.

He holds a MBA degree, Bachelors of Science degree in Financial Services, Bachelor of Arts Degree, a member of ICPAK and ACCA, a fellow (FCCA), Associate (ACIB -UK) and a Certified Internal Audit Quality Reviewer.



Churchill Winstone Ochieng
Head of Retail Banking

Mr. Churchill Winstones Ochieng joined Faulu Kenya as Head of Retail Banking in April 2012, having previously worked with CFC Stanbic Bank and Barclays Bank for 2 years and 10 years respectively.



Paul Kahoro
Head of Internal Audit

Mr. Kahoro started his career as an auditor in PKF Kenya before joining Faulu in July 2006. He has have served in various capacities including Senior Audit Manager before being appointed as the Head of Internal Audit in June 2012. †

He is a Certified Public Accountant (CPA (K) and Certified Information Systems Auditor (CISA). He is currently pursuing an MBA degree at the University of Nairobi.



Bernard Githinji
Head of Finance

Mr. Githinji joined Faulu in January 2011 as Finance and Treasury Manager and was appointed Head of Finance in November the same year. He was previously the Head of Finance at CFC Stanbic Holdings, where he held several other positions in Finance and Internal Audit during his tenure spanning over 8 years.

He is a Certified Public Accountant (CPA, K) and holds a Master degree in leadership (Business & Entrepreneurship), Bachelor of Commerce degree and several Certifications.



Charity Wainaina
Head of Marketing

Mrs. Wainaina joined Faulu Kenya in the year 2004 as the Marketing Manager. Previously she worked for Export Trading Limited and McCann Erickson. She has over 10 years experience in Marketing and Communication.

She holds a Master of Business Administration, Bachelor of Commerce degree (Marketing Option), and Microfinance qualifications.



James Asiba
Head of Commercial Services

Mr. Asiba has been in the ICT industry since 1996. He joined Faulu Kenya DTM Limited in 2007 as ICT Manager. Currently serves as the Head of Commercial Services. Previously he worked for Mumias Sugar and Telkom Kenya in various capacities.

He holds a Bachelor's degree in Computer Science and Statistics.



Amos Mwangi
Head of Business Development

Mr. Mwangi joined Faulu Kenya in January 2011 as a Credit Administration Manager and was promoted to the Head of Credit Administration in August the same year. He was pointed as the Head of Business Development in May 2012. Previously he worked at Equity Bank in various capacities.

He holds a Master degree in Banking and Finance, Bachelor of Commerce degree (Accounting option) and CPA (K).



Ireneus Gichana
Head of Banking Operations

Mr. Gichana joined Faulu Kenya DTM in July 2010 as Head of Operations. He is a seasoned banker having over 18 years working experience with Standard Chartered Bank Kenya Ltd where he held various positions including Head of Branch Operations and Service Delivery responsible for the branches network, and Risk Enhancement Project Manager – East Africa.

Mr. Gichana holds a Master of Banking and Finance (Microfinance option), Master of Business Administration and a Bachelor of Arts (Technology Management Studies option).

Chairman's Statement



I am thankful to God as I present the Annual Report and Financial Statements for the year ended 31st December, 2012. Faulu Kenya made a significant stride towards sustainable profitability in a challenging operating environment while reinforcing its position as a market leader in deposit taking amongst deposit taking microfinance institutions.

Operating environment

The operating environment was characterised by high inflation and high interest rates occasioned by aftershocks of the sudden depreciation of the Kenya Shilling against the United States Dollar, the Euro and other hard currencies in the tail end of 2011. This resulted from high imported commodities and food prices occasioned by short supply shocks. The intervention by the Central Bank of Kenya through the Monetary Policy Committee to tame the rising inflation and weakening of the local currency increased the Central Bank Rate to 18%. The yield on 91 days treasury bills rose to 20% in the beginning of the year. This high interest rate regime persisted for the 1st half of 2012 but stabilized at 8% in the 2nd half of 2012 thereby increasing the cost of funds throughout the year.

Notwithstanding these challenges, the Kenyan economy grew by 4.7% in the 3rd quarter of 2012 from 4% in the same period last year.

The political environment remained stable during the year with political realignments in preparation for the 2013 general election. A stronger governance and institutional framework continued to support stability post promulgation of the new constitution.

Financial results

During the year under review, Faulu marked a significant turnaround reporting a pre-tax profit of Shs 98 million up from Shs 16 million in 2011. This performance was driven by growth in operating income from Shs 1 billion to Shs 1.2 billion and improvements on operational efficiencies in 2012.

The quality of the loan book improved significantly with Portfolio at Risk (PAR) declining from 10.4% to 5.26% and loan loss provisions declined from Shs 41 million in 2011 to Shs 38 million in 2012.

Total assets grew by Shs 2.5 billion or 49% to Shs 7.6 billion driven by the growth in the outstanding loans balances and deposit liabilities.

Strengthening the capital base

The divestiture program started in 2011 has progressed successfully with its closure expected to bring in additional capital within the year 2013.

This program is in line with the MFI Act enforced by the Central Bank of Kenya regulations limiting single shareholder ownership of no more than 25% of shares in the institution. The board has been actively vetting and engaging potential investors to ensure compliance with the Central Bank of Kenya.

Business prospects

Central Bank has issued the "Guidelines on the Appointment and Operations of Third Party Agents by Deposit Taking Microfinance Institutions". The guideline allows DTMs to contract third parties to undertake specified DTM business on their behalf. This is expected to extend the availability

of cost effective financial services in Kenya as envisaged in Vision 2030. The guideline took effect on 2nd January 2012. Faulu will take advantage of this development and penetrate deeper into the markets without having to lay out a costly branch infrastructure.

In 2013, Faulu brand shall continue to be felt intensely with increased campaigns and use of our points of representation country wide and ride on technology based solutions, so as to serve its customers better.

I take this opportunity to thank the Management and Staff for their hard work and dedication in ensuring these strides in 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



Ken Wathome

Chairman

Managing Director's Report



It is with great honour that I present to you the Annual Report and Financial Statements of Faulu Kenya DTM Ltd for the year ended 31st December 2012. We are grateful to God for having favoured us in the year as we made great strides towards sustainable profitability.

Economic Environment

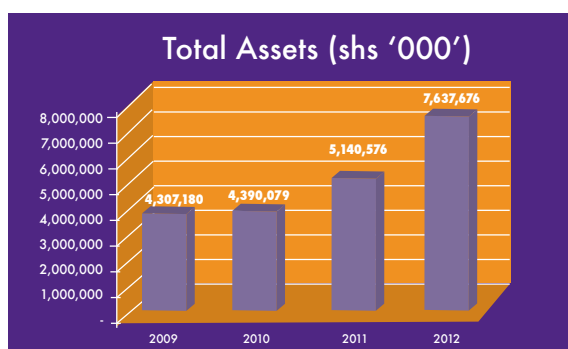
The Kenyan economy stabilized after a rocky start in 2012. The Central Bank's tight monetary Policy in the first half of the year effectively brought inflation under control and stabilized the exchange rate. The overall inflation declined to 3.2% from a high of 21% in December 2011 mainly due to reduced prices of basic foodstuffs and energy prices. 91 Day T-bill Rate declined to 8.138% from a rate of 19.905% in December 2011.

The Monetary Policy Committee continued to maintain a tight monetary policy retaining the Central Bank Rate at 18% during the first half of the year. The rate started to ease in the second half of the year and closed at 9.5% in December 2012.

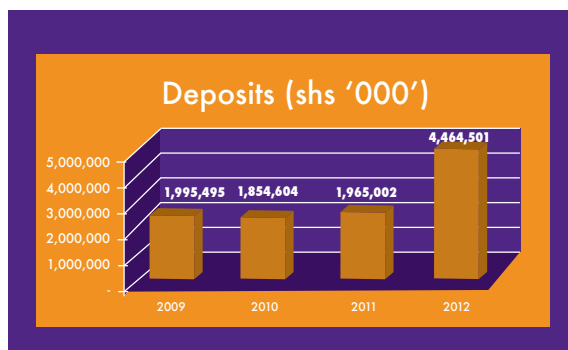
Financial Performance

In the year under review, Faulu continued to maintain positive growth trends. The profit before tax for the year ended 31st December 2012 rose by Shs 82 million to Shs 98 million compared to a profit of Shs 16 million in the corresponding period in 2011.

Total Assets increased by Shs 2.5 billion to Shs 7.6 billion compared to Shs 5.1 billion in 2011 supported by growth in loans, balances with banks and short term investments. Loans and advances to customers increased by Shs 1.7 billion to Shs 5.052 billion at 31 December 2012 compared to Shs.3.31 billion in 2011. The growth was supported by market driven products introduced in the year as well as enhanced customer care across all branches.



Customers' confidence in Faulu as a deposit taker continued to increase in the year as evidenced by the phenomenon growth experience in deposits received. Customer deposits increased by Shs 2.5 billion to Shs 4.5 billion.



Future Outlook

Faulu intend to grow its business through innovative ways in tandem with its mission of providing relevant financial solutions to Kenyans. We expect to maintain positive growth trends, brand visibility and a competitive edge. Faulu will continue to implement a strategy focusing on delivery of value to the customers, cost management initiatives and improved staff productivity. We will also focus on achieving and/or surpassing the set budget despite the unpredictable political environment and the ever-changing market demands, to maintain positive growth trends experienced in 2012 and keep a competitive edge.

Faulu will continue to adhere to the philosophical drivers that make the company unique.

Infrastructure and Customer Service

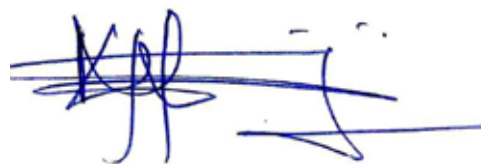
Faulu will continue to expand its branch network to take the services closer to its clientele. This will be achieved through leveraging technology to penetrate its target markets by taking advantage of the agency banking model to reach the customer base. Temenos24, Faulu's core banking application will also be upgraded to support product and services offering. This will enable Faulu to provide world class efficient service to customers and be a platform that will enable Faulu to offer customer centric and market driven range of products.

In its bid to improve customer service, Faulu shall continue to train and develop the employees equipping them with the necessary skills to effectively serve the customers. Such trainings will be geared towards customer care and leadership development programmes aimed at empowering employees.

Conclusion

"Beyond expectation" is our goal this year as we position Faulu as a bank that is friendly and seeking for a double bottom line.

Finally, I take this opportunity to thank the board of directors, the management and staff for their efforts to ensure sustainable profitability. I also thank our esteemed customers for their patronage through-out the year.



John Mwara
Managing Director

REPORT OF THE DIRECTORS

The directors present their report together with the audited financial statements for the year ended 31 December 2012.

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

	2012 Shs '000
Profit before taxation	97,652
Taxation	(39,358)
Profit for the year transferred to retained earnings	58,294

Dividend

The current Board of Directors do not recommend the payment of a dividend in respect of the year (2011: Shs nil).

Company Secretary

Mr John L G Maonga of Maonga Ndonge Associates was appointed as company secretary in place of Anne Makori with effect from 3 April 2012.

Directors

The current board of directors is as shown on page 2. Joseph Gichuki resigned as a director with effect from 13 December 2012.

Auditors

The auditors, Deloitte & Touche, having expressed their willingness, continue in office in accordance with section 159(2) of the Companies Act and subject to approval by the Central Bank of Kenya under section 29(1) of the Kenyan Microfinance Act (2006).

BY ORDER OF THE BOARD SECRETARY



Nairobi
2013

CORPORATE GOVERNANCE STATEMENT

Faulu Kenya Deposit Taking Microfinance Limited received its Deposit Taking License from the Central Bank of Kenya on 21st May 2009, becoming the first institution in Kenya to be licensed to receive deposits from the public under the Micro Finance Act (2006). The board of directors 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 Kenya Deposit Taking Microfinance Limited is also responsible for ensuring that the company complies with the laws of Kenya, the highest standards of corporate governance and universally accepted business ethics. The board has developed, adopted and benchmarked a framework of internationally recognized principles of good corporate governance, which it endeavours to adhere to in the pursuit and maintenance of the highest possible standards.

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 is comprised of a balance 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 companies strategies;
- Elaborating duty of care and confidentiality, including establishing responsibility and obligations of individual Board members;
- Review and approve 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 4 main board committees:

1. The Executive Committee

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

2. The Audit Committee
3. The Risk Management Committee
4. The Credit 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 Strategy 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 committee attendance during the year was as follows:

Audit Committee		Risk Management / Credit Committee		Executive Committee	
Beverly Nuthu	100%	George A Maina	100%	Ken Wathome	100%
Joseph Gichuki	100%	Mwikali Muthiani	100%	George A Maina	100%
Paul Kahoro*	100%	John Mwara	100%	Mwikali Muthiani	100%
		Raphael Lekoolool*	100%	John Mwara	100%
		Bernard Githinji*	100%	Anne Makori*	100%
		Amos Mwangi*	100%	Bernard Githinji*	100%

*Senior management

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, bylaws and other internal regulations;
- (d) Acting as boards central coordination point for investigation of complaints relating to financial statements, compliance, and internal controls and
- (e) Oversee independence of external auditors.

The Executive Committee

The Executive Committee has been established by the Board to assist in executing the following responsibilities:

- (a) Assisting the board in discharging its responsibility relative to strategy and human resources and general operations oversight;
- (b) Providing entrepreneurial leadership to the company within a framework of prudent and effective controls which enable risk to be assessed and managed;
- (c) Strategy formulation and ensuring that there are adequate policies systems and structures to successfully implement company's strategies;
- (d) Monitoring the institutions performance against strategic plans and objectives on an ongoing basis as well as through regular meetings;

- (e) Distinguishing responsibilities and privileges reserved to the Board and those delegated to executive management, usually in the person of the MD; and
- (f) Providing high-level advice and assistance to the management, as requested by the MD for the execution of the company's strategy.

The Risk Committee

The committee comprises of three 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 has been established to assist the Board with the following responsibilities;

- (a) Review and oversee the overall lending policy of the company;
- (b) Deliberate and consider loan applications beyond the discretionary limits of the Credit Risk Management committee;
- (c) Review lending by the Credit Risk Management committee.

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

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

- (a) Allow a credit facility or guarantee to be outstanding;
- (b) Incur any liability;
- (c) Enter into any contract or transaction; or
- (d) Conduct its business or part thereof in a fraudulent or reckless manner detrimental to the institution interest or the interest of depositors or the general public, as directed in the Microfinance Act 2006 (s.32).

CORPORATE GOVERNANCE STATEMENT (CONTINUED)

Scheme of Arrangement

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

Restriction on Trading and Investment

The Board of Directors certifies that Faulu Kenya Deposit Taking Microfinance Limited would not -

- (a) Acquire or hold, directly or indirectly, any part of the share capital of; or
- (b) Have a beneficial interest in any financial, commercial, agricultural, industrial or other undertaking, where the value of the institution’s interest exceeds 25% in the aggregate of the institution’s core capital, except in an undertaking in fulfilment of a debt due to the institution.

Single Borrower Limit

The institution did not extend loans exceeding 5% of its core capital to any single end-user borrower. The board of directors ensures that loans or credit facilities equivalent to the maximum limit are extended only to those borrowers who have the capacity or have an established track record of satisfactory repayment. Faulu Kenya Deposit Taking Microfinance Limited has well-defined credit policies and procedures covering the maximum lending limits and approval levels, rate to be charged, repayment period,

loan tracking and collateral. The institution did not grant a microfinance loan to any single end user or its associate that exceed 2% of its core capital and that the aggregate amount of microfinance loans will be more than 70% of the institution’s total loan portfolio. Where there is a credit facility of more than 2% of the core capital, hereby referred to as a large exposure, such credit facility shall in aggregate not exceed 30% of the institution’s total loan portfolio. Where a credit facility is non-performing, the outstanding balance will be net of provisions for purposes of determining the single borrower exposure limit. Faulu Kenya Deposit Taking Microfinance Limited submits to the Central Bank a return on single borrower limits on a quarterly basis.

KYC Requirements

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



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Director
2013



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Director
2013

STATEMENT OF DIRECTORS' RESPONSIBILITIES

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

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

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

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



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Director
2013



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Director
2013

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

Report on the Financial Statements

We have audited the accompanying financial statements of Faulu Kenya Deposit Taking Microfinance Limited, set out on pages 12 to 53 which comprise the statement of financial position as at 31 December 2012, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' Responsibility for the Financial Statements

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

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on our judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we considered the internal controls relevant to the entity's preparation of the financial statements that give a true and fair view in order to design audit procedures that were

appropriate in the circumstances, but not for the purpose of expressing an opinion on the entity's internal controls. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, the financial statements give a true and fair view of the state of financial affairs of the company as at 31 December 2012 and of its profit and cash flows for the year then ended in accordance with International Financial Reporting Standards and the requirements of the Kenyan Companies Act.

Report on Other Legal Requirements

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

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

Certified Public Accountants (Kenya)
2013, Nairobi

STATEMENT OF COMPREHENSIVE INCOME FOR THE YEAR ENDED 31 DECEMBER 2012

	Note	2012 Shs '000	2011 Shs '000
Interest income	5	1,233,565	1,025,918
Interest expense	6	(389,741)	(244,606)
Net interest income		843,824	781,312
Fees and commissions	7	399,605	214,301
Foreign exchange gains		3,052	1,320
Other operating income	8	15,968	18,325
Operating income		1,262,449	1,015,258
Administration and operating expenses	9(i)	(1,148,869)	(979,391)
Transformation expenses	9(ii)	(3,661)	(4,548)
Impairment losses on loans and receivables	17	(38,096)	(41,093)
		(1,190,626)	(1,025,032)
Operating profit / (loss)		71,823	(9,774)
Grant income	11	16,459	15,488
Share of associate company's profit	20	9,370	10,423
Profit before tax		97,652	16,137
Taxation charge	12	(39,358)	(14,053)
Profit for the year		58,294	2,084
Other comprehensive income:			
Surplus on revaluation of buildings		-	35,000
Deferred tax on revaluation surplus	23	-	(10,500)
Other comprehensive income for the year		-	24,500
Total comprehensive income for the year		58,294	26,584
Earnings per share (basic and diluted)	13	4.86	0.17

STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 2012

	Note	2012 Shs '000	2011 Shs '000
ASSETS			
Cash and bank balances		196,329	113,237
Short term deposits with banks	14	956,525	384,289
Government securities	15	292,248	278,865
Loans to customers	16	4,949,198	3,237,624
Due from related organizations	18	81	81
Other assets	19	322,139	202,804
Tax recoverable	12 (c)	57,421	43,803
Other investment	20	46	46
Investment in associate companies	20	33,356	26,797
Intangible assets	21	87,842	96,789
Property and equipment	22	742,491	749,703
Deferred tax asset	23	-	6,538
TOTAL ASSETS		7,637,676	5,140,576
LIABILITIES AND EQUITY			
LIABILITIES			
Cash collaterals	24	1,515,587	1,366,145
Customer deposits	25	2,948,914	598,857
Borrowings	26	2,161,910	2,426,294
Deferred tax liability	23	30,009	-
Due to related companies	18	1,513	945
Other liabilities	28	365,143	192,029
		7,023,076	4,584,270
CAPITAL RESOURCES			
Share capital	29	120,000	120,000
Share premium		274,125	274,125
Retained earnings		3,938	23,710
Revaluation reserve		88,323	89,262
Statutory reserve		128,214	49,209
		614,600	556,306
TOTAL LIABILITY AND EQUITY		7,637,676	5,140,576

The financial statements on pages 21 to 63 were approved and authorised for issue by the board of directors on 15th February 2013 and were signed on its behalf by:



Director



Managing Director



Director



Company Secretary

STATEMENT OF CHANGES IN EQUITY FOR THE YEAR ENDED 31 DECEMBER 2012

	Share capital Shs'000	Share premium Shs'000	Retained earnings Shs'000	Revaluation reserve Shs'000	Statutory reserve Shs'000	Total Shs'000
At 1 January 2011	120,000	274,125	43,587	65,440	26,570	529,722
Profit for the year	-	-	2,084	-	-	2,084
Other comprehensive income for the year	-	-	-	24,500	-	24,500
Total comprehensive income	-	-	2,084	24,500	-	26,584
Transfer of excess depreciation	-	-	969	(969)	-	-
Deferred tax on excess depreciation	-	-	(291)	291	-	-
Transfer to statutory reserve	-	-	(22,639)	-	22,639	-
At 31 December 2011	120,000	274,125	23,710	89,262	49,209	556,306
At 1 January 2012	120,000	274,125	23,710	89,262	49,209	556,306
Profit and total comprehensive income for the year	-	-	58,294	-	-	58,294
Transfer of excess depreciation	-	-	1,341	(1,341)	-	-
Deferred tax on excess depreciation	-	-	(402)	402	-	-
Transfer to statutory reserve	-	-	(79,005)	-	79,005	-
At 31 December 2011	120,000	274,125	3,938	88,323	128,214	614,600

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 IAS39 on financial instruments. The statutory reserve is not distributable.

Revaluation reserve arises on revaluation of land and building and is not distributable.

STATEMENT OF CASH FLOWS

FOR THE YEAR ENDED 31 DECEMBER 2012

	Note	2012 Shs '000	2011 Shs '000
CASH FLOWS FROM OPERATING ACTIVITIES			
Cash generated from/(used in) operations	30(a)	1,025,538	(414,733)
Taxation paid	12(c)	(13,618)	(8,297)
Net cash generated from / (used in) operating activities		1,011,920	(423,030)
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of intangible assets	21	(3,305)	(9,566)
Purchase of property and equipment	22	(75,522)	(38,944)
Net cash used in investing activities		(78,827)	(48,510)
CASH FLOWS FROM FINANCING ACTIVITIES			
Loan received	30(c)	761,256	666,950
Loan repaid	30(c)	(1,086,731)	(504,636)
Net cash (used in) / generated from financing activities		(325,475)	162,314
INCREASE / (DECREASE) IN CASH AND CASH EQUIVALENTS		607,618	(309,226)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR		439,032	748,258
CASH AND CASH EQUIVALENTS AT END OF YEAR	30(b)	1,046,650	439,032

Our Customers



Faulu business loans have enabled me to expand my business

My printing business has grown, thanks to Faulu business loan.



With Faulu SME Loan I have truly benefited

As a civil servant, Faulu gave me a personal loan.



NOTES TO THE FINANCIAL STATEMENTS FOR THE YEAR ENDED 31 DECEMBER 2012

1 ACCOUNTING POLICIES

Statement of compliance

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

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

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

(i) Relevant new and revised IFRSs effective in the current period

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

Amendments to IFRS 7 Disclosures - Transfers of Financial Assets	<p>The amendments to IFRS 7 increase the disclosure requirements for transactions involving transfers of financial assets. These amendments are intended to provide greater transparency around risk exposures of transactions where a financial asset is transferred but the transferor retains some level of continuing exposure in the asset.</p> <p>The application of the amendment had no effect on the company's financial statements as the company did not transfer any such financial assets during the year.</p>
Amendments to IAS 12 Deferred Tax: Recovery of Underlying Assets	<p>The amendments to IAS 12 provide an exception to the general principle set out in IAS 12 Income Taxes that the measurement of deferred tax should reflect the manner in which an entity expects to recover the carrying amount of an asset. Specifically, the amendments establish a rebuttable presumption that the carrying amount of an investment property measured using the fair value model in IAS 40 Investment Property will be recovered entirely through sale. The amendments were issued in response to concerns that application of IAS 12's general approach can be difficult or subjective for investment property measured at fair value because it may be that the entity intends to hold the asset for an indefinite or indeterminate period of time, during which it anticipates both rental income and capital appreciation.</p> <p>The application of the amendments had no effect on the company's financial statements as the company had no investment property in its statement of financial position.</p>
Amendments to IFRS 1 Severe Hyperinflation	<p>The amendments regarding severe hyperinflation provide guidance for entities emerging from severe hyperinflation either to resume presenting IFRS financial statements or to present IFRS financial statements for the first time</p> <p>The amendments had not effect on the company's financial statements as the company did not trade in such hyperinflation environment.</p>

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

ACCOUNTING POLICIES (Continued)

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

ii) *New and amended standards and interpretations in issue but not yet effective in the year ended 31 December 2012*

	Effective for annual periods beginning on or after
IFRS 7, Amendments-Disclosure: offsetting financial assets and financial liabilities	1 January 2013
IFRS 9 Financial Instruments (as revised in 2010)	1 January 2015
IFRS 10 Consolidated Financial Statements	1 January 2013
IFRS 11, Joint Arrangements	1 January 2013
IFRS 12, Disclosure of Interests in Other Entities	1 January 2013
IFRS 13, Fair Value Measurement	1 January 2013
IAS 19, Employee Benefits (2011) - Revised requirements for pensions and other post-retirement benefits, termination benefits and other changes.	1 January 2013
IAS 27, Separate Financial Statements (as revised in 2011)	1 January 2013
IAS 28, Investments in Associates and Joint Ventures	1 January 2013
IAS 32, Financial Instruments: Presentation - Amendments to application guidance on the offsetting of financial assets and financial liabilities	1 January 2014
IFRIC 20, Stripping costs in the production phase of a surface mine	1 January 2013

iii) *Impact of relevant new and amended standards and interpretations on the financial statements for the year ended 31 December 2012 and future annual periods*

- **IFRS 9, Financial Instruments**

IFRS 9 *Financial Instruments* issued in November 2010 and amended in October 2010 and December 2011 introduces new requirements for the classification and measurement of financial assets.

IFRS 9 requires all recognised financial assets that are within the scope of IAS 39 *Financial Instruments: Recognition and Measurement* to be subsequently measured at amortised cost or fair value. Specifically, debt investments that are held within a business model whose objective is to collect the contractual cash flows, and that have contractual cash flows that are solely payments of principal and interest on the principal outstanding are generally measured at amortised cost at the end of subsequent accounting periods. All other debt investments and equity investments are measured

at their fair values at the end of subsequent accounting periods.

The most significant effect of IFRS 9 regarding the classification and measurement of financial liabilities relates to the accounting for changes in fair value of a financial liability (designated as at fair value through profit or loss) attributable to changes in the credit risk of that liability. Specifically, under IFRS 9, for financial liabilities that are designated as at fair value through profit or loss, the amount of change in the fair value of the financial liability that is attributable to changes in the credit risk of that liability is recognised in other comprehensive income, unless the recognition of the effects of changes in the liability's credit risk in other comprehensive income would create or enlarge an accounting mismatch in profit or loss. Changes in fair value attributable to a financial liability's credit risk are not subsequently reclassified to profit or loss. Previously, under IAS 39, the entire amount of the change in the fair value of the financial liability designated as at fair value through profit or loss was recognised in profit or loss.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1. ACCOUNTING POLICIES (Continued)

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

iii) Impact of relevant new and amended standards and interpretations on the financial statements for the year ended 31 December 2012 and future annual periods (Continued)

- **IFRS 9, Financial Instruments (Continued)**

IFRS 9 is effective for annual periods beginning on or after 1 January 2015, with earlier application permitted.

The directors anticipate that IFRS 9 will be adopted in the company's financial statements for the annual period beginning 1 January 2015 and that the application of IFRS 9 may have a significant impact on amounts reported in respect of the company's financial assets and financial liabilities (e.g the company will classify financial assets as subsequently measured at either amortised cost or fair value). However, it is not practicable to provide a reasonable estimate of that effect until a detailed review is done.

- **IFRS 11: Joint Arrangements**

IFRS 11 replaces IAS 31 'Interests in Joint Ventures'. It requires a party to a joint arrangement to determine the type of joint arrangement in which it is involved by assessing its rights and obligations and then account for those rights and obligations in accordance with that type of joint arrangement.

Joint arrangements are either joint operations or joint ventures:

- A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement (joint operators) have rights to the assets, and obligations for the liabilities, relating to the arrangement. Joint

operators recognise their assets, liabilities, revenue and expenses in relation to its interest in a joint operation (including their share of any such items arising jointly)

- A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement (joint venturers) have rights to the net assets of the arrangement. A joint venturer applies the equity method of accounting for its investment in a joint venture in accordance with IAS 28 'Investments in Associates and Joint Ventures (2012)'. Unlike IAS 31, the use of 'proportionate consolidation' to account for joint ventures is not permitted.

The standard is effective for annual periods beginning on or after 1 January 2013. The company will apply this amendment prospectively. The directors anticipate no material impact to the company's financial statements currently. The company would however, have to apply this standard to any such arrangements entered in the course of its expansion strategy.

- **IFRS 12 Disclosure of Interests in Other Entities**

IFRS 12 requires the extensive disclosure of information that enables users of financial statements to evaluate the nature of, and risks associated with, interests in other entities and the effects of those interests on its financial position, financial performance and cash flows.

In high-level terms, the required disclosures are grouped into the following broad categories:

- Significant judgements and assumptions - such as how control, joint control, significant influence has been determined
- Interests in subsidiaries - including details of the structure of the group, risks associated with structured entities, changes in control, and so on

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1. ACCOUNTING POLICIES (Continued)

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

iii) Impact of relevant new and amended standards and interpretations on the financial statements for the year ended 31 December 2012 and future annual periods (Continued)

- IFRS 12 Disclosure of Interests in Other Entities (Continued)
- Interests in joint arrangements and associates - the nature, extent and financial effects of interests in joint arrangements and associates (including names, details and summarised financial information)
- Interests in unconsolidated structured entities - information to allow an understanding of the nature and extent of interests in unconsolidated structured entities and to evaluate the nature of, and changes in, the risks associated with its interests in unconsolidated structured entities

IFRS 12 lists specific examples and additional disclosures which further expand upon each of these disclosure objectives, and includes other guidance on the extensive disclosures required.

The adoption of IFRS 12 in the company's financial statements for the annual period beginning 1 January 2013 and that the application of the new standard would result in more extensive disclosures in the financial statements.

- **IFRS 13 Fair Value Measurements**

IFRS 13 replaces the guidance on fair value measurement in existing IFRS accounting literature with a single standard. The IFRS is the result of joint efforts by the IASB and FASB to develop a converged fair value framework. The IFRS defines fair value, provides guidance on how to determine fair value and requires disclosures about fair value measurements. However, IFRS 13 does not change the requirements

regarding which items should be measured or disclosed at fair value.

IFRS 13 applies when another IFRS requires or permits fair value measurements or disclosures about fair value measurements (and measurements, such as fair value less costs to sell, based on fair value or disclosures about those measurements).

With some exceptions, the standard requires entities to classify these measurements into a 'fair value hierarchy' based on the nature of the inputs:

- Level 1 - quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date;
- Level 2 - inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly;
- Level 3 - unobservable inputs for the asset or liability.

The scope of IFRS 13 is broad; it applies to both financial instrument items and non-financial instrument items for which other IFRSs require or permit fair value measurements and disclosures about fair value measurements, except in specified circumstances. In general, the disclosure requirements in IFRS 13 are more extensive than those required in the current standards. For example, quantitative and qualitative disclosures based on the three-level fair value hierarchy currently required for financial instruments only under IFRS 7 Financial Instruments: Disclosures will be extended by IFRS 13 to cover all assets and liabilities within its scope.

The directors anticipate that the application of the new Standard may affect the amounts reported in the financial statements and result in more extensive disclosures in the financial statements, however, the company is yet to assess IFRS 13's full impact and intends to adopt the standard no later than the accounting period beginning on or after 1 January 2013.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1. ACCOUNTING POLICIES (Continued)

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

(iii) Impact of relevant new and amended standards and interpretations on the financial statements for the year ended 30 December 2012 and future annual periods (Continued)

- **Disclosures – Offsetting Financial Assets and Financial Liabilities (Amendments to IFRS 7)**

Amends the disclosure requirements in IFRS 7 **Financial Instruments**: Disclosure to require information about all recognised financial instruments that are set off in accordance with paragraph 42 of IAS 32 Financial Instruments: Presentation.

The amendments also require disclosure of information about recognised financial instruments subject to enforceable master netting arrangements and similar agreements even if they are not set off under IAS 32. The IASB believes that these disclosures will allow financial statement users to evaluate the effect or potential effect of netting arrangements, including rights of set-off associated with an entity's recognised financial assets and recognised financial liabilities, on the entity's financial position.

The amendments to IFRS 7 are effective for annual periods beginning on or after 1 January 2013 and interim periods within those annual periods. The director's anticipate that the application of these amendments to IFRS 7 may result in more disclosures being made with regard to offsetting financial assets and financial liabilities in the future.

- **Presentation of Items of Other Comprehensive Income (Amendments to IAS 1)**

These amend IAS 1, Presentation of Financial Statements, to revise the way other comprehensive income is presented.

The amendments:

- Preserve the amendments made to IAS 1 in 2007 to require profit or loss and Other comprehensive Income (OCI) to be presented together, i.e. either as a single 'statement of profit or loss and comprehensive income', or a separate 'statement of profit or loss' and a 'statement of comprehensive income' – rather than requiring a single continuous statement.
- Require entities to group items presented in OCI based on whether they are potentially reclassifiable to profit or loss subsequently. i.e. those that might be reclassified and those that will not be reclassified.
- Require tax associated with items presented before tax to be shown separately for each of the two groups of OCI items (without changing the option to present items of OCI either before tax or net of tax).

The above amendments are generally effective for annual periods beginning on or after 1 July 2012. The company will apply the amendments prospectively. Other than presentation, the directors anticipate no material impact to the company's financial statements.

- **Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32)**

Amends IAS 32 Financial Instruments: Presentation to clarify certain aspects because of diversity in application of the requirements on offsetting, focused on four main areas:

- the meaning of 'currently has a legally enforceable right of set-off'
- the application of simultaneous realisation and settlement
- the offsetting of collateral amounts
- the unit of account for applying the offsetting requirements.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1. ACCOUNTING POLICIES (Continued)

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

(iii) Impact of relevant new and amended standards and interpretations on the financial statements for the year ended 30 December 2012 and future annual periods (Continued)

• Offsetting Financial Assets and Financial Liabilities (Amendments to IAS 32) (Continued)

The amendments to IAS 32 are not effective until annual periods beginning on or after 1 January 2014, with retrospective application required. The directors anticipate that the application of this amendment may result in more disclosures being made with regard to offsetting of financial assets and financial liabilities in the future. The company will apply the amendments prospectively.

• IAS 19 (as revised in 2012)- Employee Benefits

The amendments to IAS 19 change the accounting for defined benefit plans and termination benefits. The most significant change relates to the accounting for changes in defined benefit obligations and plan assets. The amendments require the recognition of changes in defined benefit obligations and in fair value of plan assets when they occur, and hence eliminate the 'corridor approach' permitted under the previous version of IAS 19 and accelerate the recognition of past service costs. The amendments require all actuarial gains and losses to be recognised immediately through other comprehensive income in order for the net pension asset or liability recognised in the consolidated statement of financial position to reflect the full value of the plan deficit or surplus.

The amendments to IAS 19 are effective for annual periods beginning on or after 1 January 2013 and require retrospective application with certain exceptions. The directors anticipate that the amendments to IAS 19 will be adopted in the Group's financial statements for the annual period beginning 1 January 2013 and that the application of the amendments to IAS 19 will not have an impact on the financial statements.

• IAS 28 Investments in Associates and Joint Ventures (2012)

This Standard supersedes IAS 28 Investments in Associates and prescribes the accounting for investments in associates and sets out the requirements for the application of the equity method when accounting for investments in associates and joint ventures.

The Standard defines 'significant influence' and provides guidance on how the equity method of accounting is to be applied (including exemptions from applying the equity method in some cases). It also prescribes how investments in associates and joint ventures should be tested for impairment.

The standard is effective for annual periods beginning on or after 1 January 2013. The company will apply this amendment prospectively. The directors, however, anticipate no material impact to the company's financial statements.

(iii) Early adoption of standards

The company did not early-adopt new or amended standards in 2012.

(a) Basis of preparation

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

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1 ACCOUNTING POLICIES (Continued)

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

(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.

(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

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

neither the taxable profit nor the accounting profit.

1 ACCOUNTING POLICIES (Continued)

(d) Taxation (Continued)

(ii) *Deferred tax (Continued)*

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, commission and grant income

In the normal course of business, the company earns fees

and commission income from a diverse range of services to its customers. Fees and commission income and expenses that are integral to the effective interest rate on a financial asset or liability are included in the measurement of the effective interest rate.

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

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

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

(f) Property and equipment

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

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1. ACCOUNTING POLICIES (Continued)

(g) Depreciation

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

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

Depreciation on revalued assets 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.

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 at an annual rate of 12.5%.

(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.

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.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1. ACCOUNTING POLICIES (Continued)

(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) Loans and provision for loan impairments

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

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

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

When a loan is deemed uncollectible, it is written off against the related provision for impairment losses. Subsequent recoveries are credited to the provision for impairment losses in the profit and loss account. If the amount of the impairment subsequently decreases due to

an event occurring after the write-down, the release of the provision is credited to the provision for impairment losses in the profit or loss.

(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. Currently, the company's contribution is limited to Shs 200 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.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1. ACCOUNTING POLICIES (Continued)

(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.

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.

Impairment and uncollectability of financial assets

At the end of each reporting period, all financial assets are subject to review for impairment.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1. ACCOUNTING POLICIES (Continued)

(o) Financial instruments (Continued)

i) Classification and measurement (Continued)

Financial assets (Continued)

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.

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 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.

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) 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.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

1 ACCOUNTING POLICIES (Continued)

(q) Cash collateral

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

(r) Cash and cash equivalents

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

(s) Statutory reserve

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.

(u) Comparatives

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

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.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

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

i) Key sources of estimation uncertainty

Property and equipment

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

3 FINANCIAL RISK MANAGEMENT

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

- credit risk
- liquidity risk
- market risks

a) Credit risk

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

management reporting purposes, the company considers and consolidates all elements of credit risk exposure.

The Risk Management 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 borrowers, 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.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

3 FINANCIAL RISK MANAGEMENT (continued)

Credit risk (continued)

(i) Management of credit risk

Concentrations of assets and off balance sheet items:

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

(a) Loans to customers

	2012 Shs '000	%	2011 Shs '000	%
Agriculture	49,492	1%	50,774	1%
Business services	3,365,455	68%	2,746,910	85%
Consumer	1,534,251	31%	439,940	14%
	4,949,198	100%	3,237,624	100%

Cash collaterals

	2012 Shs '000	%	2011 Shs '000	%
0 - 30 days	49,328	3%	50,152	4%
31 - 90 days	40,282	3%	42,772	3%
91 - 180 days	106,834	7%	141,701	10%
Over 180 days	1,319,143	87%	1,131,520	83%
	1,515,587	100%	1,366,145	100%

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

3 FINANCIAL RISK MANAGEMENT (continued)

Credit risk (continued)

(ii) Maximum exposure to credit risk before collateral held

	2012 Shs '000	%	2011 Shs '000	%
Credit exposures:				
On balance sheet items:				
Short term deposits with banks	956,525	15%	384,289	10%
Loans to customers	5,052,440	81%	3,308,513	83%
Government securities	292,248	4%	278,865	7%
	6,301,213	100%	3,971,667	100%

iii) Classification of loans and receivables

	2012 Shs '000	2011 Shs '000
Neither past due nor impaired	4,790,234	3,137,252
Past due but not impaired	70,994	67,568
Impaired	191,212	103,693
Gross	5,052,440	3,308,513
Less: allowances for impairment (note 17)	(103,242)	(70,889)
Net	4,949,198	3,237,624

Loans and receivables that are neither past due nor impaired

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

Past due but not impaired loans

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

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

3. FINANCIAL RISK MANAGEMENT (CONTINUED)

a) Credit risk (Continued)

Impaired loans

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

Allowances for impairment

The company establishes an allowance for impairment losses that represents its estimate of incurred losses in its loan portfolio. The main components of this allowance

are a specific loss component that relates to individually significant exposures, and a collective loan loss allowance in respect of losses that have been incurred but have not been identified on loans subject to individual assessment for impairment.

Write-off policy

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

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

Loans to customers

	Gross Shs '000	Net Shs '000
31 December 2012		
Neither past due nor impaired	4,790,234	4,783,840
Past due but not impaired	70,994	61,231
Impaired	191,212	104,127
	5,052,440	4,949,198

Loans to customers

	Gross Shs '000	Net Shs '000
31 December 2011		
Neither past due nor impaired	3,137,252	3,085,064
Past due but not impaired	67,568	66,445
Impaired	103,693	86,115
	3,308,513	3,237,624

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

3. FINANCIAL RISK MANAGEMENT (CONTINUED)

a) Credit risk (Continued)

Collateral held

The company's collateral mainly consists of cash collateral held against loans and receivables to customers (note 24). The fair value of collateral is Sh1,515,587,000 (2011: Sh1,366,145,000).

b) Liquidity risk

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

(i) Management of liquidity risk

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

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

(ii) Source of funding

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

(iii) Exposure to liquidity risk

The key measure used by the company for managing liquidity risk is the ratio of net liquid assets to deposits from customers. For this purpose net liquid assets are considered as including cash and cash equivalents and investment in securities for which there is an active and liquid market less any deposits from banks, debt securities issued, other borrowings and commitments maturing within the next month. The company regulators require that the company maintains a liquidity ratio of 20% effective May 2009. The company complied with the liquidity requirements during the year. The average liquidity ratio for the year was 33.0% (2011 - 32.0%).

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.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)
3. FINANCIAL RISK MANAGEMENT (CONTINUED)
b) Liquidity risk (continued)

	Maturing in less than 1 month	1 month less than 3 month	3 month less than 6 month	6 month less than 1 year	1 year less than 3 year	3 year less than 5 year	Over 5 years	Total
	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000
FINANCIAL LIABILITIES								
Cash collateral held	49,327	40,282	106,834	541,051	414,175	351,659	12,258	1,515,587
Borrowings	403,572	151,928	119,922	228,136	701,088	558,577	26,472	2,189,694
Customer deposits	1,106,533	57,664	152,932	774,510	592,887	503,396	17,547	3,205,469
Total liabilities (contractual maturity dates)	1,559,433	249,874	379,688	1,543,697	1,708,150	1,413,632	56,277	6,9110,750
FINANCIAL ASSETS								
Cash and bank balances	27,565	-	-	-	-	-	-	27,565
Short term deposits with banks	-	716,525	240,000	-	-	-	-	956,525
Government securities	-	20,000	-	-	272,248	-	-	292,248
Loans to customers (net)	163,229	135,051	372,128	1,978,840	1,785,301	1,883,301	72,050	6,389,899
Total assets (expected maturity dates)	190,794	871,576	612,128	1,978,840	2,057,549	1,883,301	72,050	7,666,237
NET LIQUIDITY GAP	(1,368,639)	621,702	232,440	435,143	349,399	469,669	15,773	755,487
As at 31 December 2011								
Total liabilities (contractual maturity dates)	854,875	138,383	239,025	1,054,286	1,481,437	625,185	6,399	4,399,590
Total assets (expected maturity dates)	232,672	101,861	512,469	1,448,349	1,455,059	248,365	15,240	4,014,015
NET LIQUIDITY GAP	(622,203)	(36,522)	273,444	394,063	(26,378)	(376,820)	8,841	(385,575)

NOTES TO THE FINANCIALS 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 Management Committee which is responsible for the development of detailed risk management policies. The policies are subject to review and approval by the board.

Exposure to interest rate risk

The company is exposed to various risks associated with the effects of fluctuation in the prevailing levels of market interest rates on financial position and cash flows. The risk committee closely monitors the interest rates trends to minimize the potential adverse impact of interest rate

changes. The table overleaf summarizes the exposure of interest rate risk at the balance sheet date. The company maintains an appropriate mix of fixed and floating rates deposit base. Interest rates on advances to customers and other risk assets are either pegged to the company's lending rate 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.

NOTES TO THE FINANCIALS 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).

	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	Non-interest bearing Shs '000	Total Shs '000
A. FINANCIAL ASSETS									
Cash and bank balances	-	-	-	-	-	-	-	196,329	196,329
Short term deposits with banks	-	705,472	251,053	-	-	-	-	-	956,525
Government securities	-	20,000	-	-	272,248	-	-	-	292,248
Loans to customers (net)	161,081	131,543	348,870	1,766,821	1,352,501	1,148,354	40,028	-	4,949,198
Total financial assets	161,081	857,015	599,923	1,766,821	1,624,749	1,148,354	40,028	196,329	6,421,865
B. FINANCIAL LIABILITIES									
Cash collateral held	-	-	-	-	-	-	-	1,515,587	1,515,587
Borrowings	398,451	150,000	118,400	225,241	692,192	551,490	-	26,136	2,161,910
Customer deposits	1,017,970	53,049	140,692	712,521	545,434	463,106	16,142	-	2,948,914
Total financial liabilities	1,416,421	203,049	259,092	937,762	1,237,626	1,014,596	16,142	1,541,723	6,626,411
C. On statement of financial position- interest sensitivity gap									
D. As at 31 December 2011	(1,255,340)	653,966	340,831	829,059	387,123	133,758	23,886	(1,345,394)	(204,546)
Total financial assets	145,716	101,861	512,469	1,448,349	1,455,059	248,365	15,240	86,956	4,014,015
Total financial liabilities	804,323	95,611	106,733	439,425	997,102	581,557	-	1,366,145	4,390,896
E. On statement of financial position- interest sensitivity gap	(658,607)	6,250	405,736	1,008,924	457,957	(333,192)	15,240	(1,279,189)	(377,281)

NOTES TO THE FINANCIALS 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:

	2012 Shs'000		2011 Shs'000	
	Effect on profit	Effect on equity	Effect on profit	Effect on equity
3% increase in interest rates	31,442	22,101	24,593	17,215
3% decrease in interest rates	(31,442)	(22,010)	(24,593)	(17,215)

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:

	Shs '000	USD	Euro	Total
A. ASSETS				
Cash and bank balances	191,521	4,717	91	196,329
Short term deposits with banks	956,525	-	-	956,525
Government securities	292,248	-	-	292,248
Loans to customers (net)	4,949,198	-	-	4,949,198
Total financial assets	6,389,492	4,717	91	6,394,300
B. LIABILITIES				
Cash collateral held	1,515,587	-	-	1,515,587
Borrowings	2,135,774	26,136	-	2,161,910
Customer deposits	2,948,914	-	-	2,948,914
Total financial Liabilities	6,600,275	26,136	-	6,626,411
C. NET BALANCE SHEET POSITION	(210,783)	(21,419)	91	(232,111)
As at 31 December 2011				
A Total financial assets	4,013,871	36	108	4,014,015
B Total financial liabilities	4,345,523	45,773	108	4,391,404
NET BALANCE SHEET POSITION	(331,652)	(45,737)	-	(377,389)

NOTES TO THE FINANCIALS 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.

	2012 Shs'000		2011 Shs'000	
	Effect on profit	Effect on equity	Effect on profit	Effect on equity
Currency - Euro				
+ 10% Shs movement	(2,142)	(1,499)	4,587	2,516
-10% Shs movement	2,142	1,499	(4,587)	(2,516)
Currency - US dollars				
+ 10%Shs movement	9	6	3,595	3,211
- 10% Shs movement	9	6	(3,595)	(3,211)

4 CAPITAL RISK MANAGEMENT

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

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

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

Various limits are applied to elements of the capital base. Qualifying tier 2 capital cannot exceed tier 1 capital;

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

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

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

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

4. CAPITAL RISK MANAGEMENT (Continued)

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

- A minimum level of regulatory capital of Shs 60 million.
- A ratio of core capital to the risk-weighted assets plus risk-weighted off-statement of financial position

assets at or above the required minimum of 8%.

- Core capital of not less than 8% of total deposit liabilities.
- Supplementary capital of not less than 12% of risk-weighted assets plus risk-weighted off-statement of financial position items.

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

The capital position at 31 December was as follows;

	2012 Shs '000	2011 Shs '000
Tier 1 capital		
Share capital	120,000	120,000
Share premium	274,125	274,125
Retained earnings	3,938	23,710
	398,063	417,835
Tier 2 capital		
Subordinated debt	279,750	345,412
Collective allowances for impairment	57,105	38,586
Revaluation reserve	22,316	22,556
	359,171	406,554
Regulatory capital	754,234	824,389
Total risk-weighted assets	4,568,426	3,086,867
Borrowings	2,161,910	2,426,294
Gearing	543%	581%
Capital ratios		
Total regulatory capital expressed as a percentage of total risk-weighted assets (CBK minimum -12%)	17%	27%
Total tier 1 capital expressed as a percentage of total risk-weighted assets (CBK minimum -12%)	9%	14%

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

4 CAPITAL RISK MANAGEMENT (Continued)

Capital allocation

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

and activities is undertaken independently of those responsible for the operation, by Risk and Compliance and Credit, and is subject to review by the Board Credit Committee or ALCO as appropriate.

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

5. INTEREST INCOME

Loans and receivables	
Held to maturity investments-treasury bonds	
Short term bank deposits	
Other loans	

	2012 Shs '000	2011 Shs '000
	1,126,461	965,564
	22,592	23,342
	77,904	34,956
	6,608	2,056
	1,233,565	1,025,918

6 INTEREST EXPENSE

Savings accounts	
Bank overdrafts/borrowed funds	
Treasury bond amortized	

	2012 Shs '000	2011 Shs '000
	125,150	27,424
	256,887	208,850
	7,704	8,332
	389,741	244,606

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

7 FEES AND COMMISSIONS

	2012 Shs '000	2011 Shs '000
Registration fees	12,320	15,130
Loan set up fees	186,840	94,637
Commission (net)	164,046	75,553
Chattels mortgage fees	36,399	28,981
	399,605	214,301

8 OTHER OPERATING INCOME

	2012 Shs '000	2011 Shs '000
Bad debts recovered	58	11,971
Other income	15,910	6,354
	15,968	18,325

9 i) ADMINISTRATION AND OPERATING EXPENSES

	2012 Shs '000	2011 Shs '000
Staff costs (note 10)	517,899	503,075
Office operations and supplies	382,733	247,926
Training and evaluation	18,879	6,155
Office rent and repairs	88,857	81,427
Travelling expenses	12,043	13,115
Depreciation of property and equipment	82,732	93,225
Audit fees	3,638	3,501
Amortisation of intangible assets	12,252	12,846
Directors' fees	8,664	3,580
Assets written off	-	2,697
Other expenses	9,494	11,844
Provision for doubtful receivable - FSD Grant	11,678	-
	1,148,869	979,391

ii) TRANSFORMATION EXPENSES

	2012 Shs '000	2011 Shs '000
Consultancy	3,661	4,548

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)
10. STAFF COSTS

	2012 Shs '000	2011 Shs '000
Staff salaries and wages	410,275	416,979
Medical expenses	53,013	49,625
Company contributions to defined contribution pension scheme	23,729	25,770
Temporary labour	24,641	13,679
Provision for accumulated leave	4,402	(5,145)
Staff awards	134	247
Staff uniforms	49	120
Statutory pension contributions (NSSF)	1,656	1,800
	517,899	503,075

11. GRANT INCOME

	2012 Shs '000	2011 Shs '000
USAID – Micro Private Enterprise Development (note 27)	-	1,625
Financial Sector Deepening (FSD)	16,549	13,863
	16,549	15,488

12. TAXATION
(a) TAXATION CHARGE/(CREDIT)

	2012 Shs '000	2011 Shs '000
Current tax expense		
Based on the adjusted profit for the year at 30%	-	-
Share of associate company taxation (note 20)	2,811	3,127
	2,811	3,127
Deferred taxation (note 23)		
Current year charge	36,410	10,926
Prior year under provision	137	-
	36,547	10,926
	39,358	14,053

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

12. TAXATION

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

	2012 Shs '000	2011 Shs '000
Accounting profit before taxation	97,652	16,137
Tax at the applicable rate of 30%	29,296	4,841
Tax effect of income not taxable	(7,749)	(4,861)
Tax effect of expenses not deductible for tax purposes	14,863	10,946
Prior year under provision- deferred tax	137	-
	36,547	10,926
Share of associate company taxation	2,811	3,127
	39,358	14,053

(c) TAX RECOVERABLE

Balance at 1 January	(43,803)	(35,506)
Paid in the year	(13,618)	(8,297)
Balance at 31 December	(57,421)	(43,803)

13. EARNINGS PER SHARE

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

	2012 Shs '000	2011 Shs '000
Profit for the year attributable to ordinary shareholders (Shs '000)	58,294	2,084
Weighted average number of ordinary shares in issue ('000')	12,000	12,000
Earnings per share – basic & diluted (Shs)	4.86	0.17

There were no potentially dilutive shares outstanding at 31 December 2012 (2011: nil).

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

14. SHORT TERM DEPOSITS

	2012 Shs '000	2011 Shs '000
(a) With banks:		
Housing Finance Limited	53,287	-
Bank of Africa Limited	634,536	184,289
Consolidated Bank of Kenya Limited	102,209	-
Eco Bank Limited	151,722	200,000
	941,754	384,289
b) With corporate companies:		
Car & General (K) Limited	14,771	-
	956,525	384,289

Effective interest rate average 10.25% in 2012 and 6.56% in 2011. All the deposits mature in 2013.

15. GOVERNMENT SECURITIES

	2012 Shs '000	2011 Shs '000
Treasury bonds - held to maturity		
Maturing within 1 year	20,000	-
Maturing between 1 and 3 years	272,248	109,959
Maturing between 3 and 10 years	-	168,906
	292,248	278,865

The effective interest rate on treasury bonds during the year ended 31 December 2012 was 8.1% (2011 - 6.8%).

Government securities (treasury bonds) with a value of Shs292,248,000 (2011-Shs 278,865,000) are under a lien against Standard Chartered Bank Kenya Limited loan (note 26).

16. LOANS TO CUSTOMERS

	2012 Shs '000	2011 Shs '000
Gross loans to customers (secured)	5,052,440	3,308,513
Accumulated impairment losses (note 17)	(103,242)	(70,889)
	4,949,198	3,237,624

The effective interest rate on customer advances at 31 December 2012 was 31% (2011 - 30.6%). Advances to customers are secured by cash collaterals (note 24) and chattels mortgages. Non-performing loans and advances amounted to Shs 86,115,000 (2011: Shs 205,755,000).

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

17. IMPAIRMENT LOSSES ON LOANS AND RECEIVABLES

	2012 Shs '000	2011 Shs '000
At 1 January	70,889	128,107
Additional provision during the year	38,096	41,093
Amounts written off	(5,743)	(98,311)
At 31 December	103,242	70,889

18. RELATED PARTY BALANCES

	2012 Shs '000	2011 Shs '000
Due from related organisations		
Faulu Uganda Limited	81	81
Due to related organisations		
Faulu Advisory Services Limited	1,513	945

19. OTHER ASSETS

	2012 Shs '000	2011 Shs '000
Staff receivables	27,547	17,036
Grants receivable	11,389	11,678
Prepaid expenses	26,668	53,559
Deposits and sundry receivables	268,213	120,531
Less: provision for doubtful receivable - FSD grant	(11,678)	-
	322,139	202,804

20. INVESTMENTS

Other investments

	2012 Shs '000	2011 Shs '000
Faulu Tanzania Limited:		
Investment at cost - 10% shareholding	46	46
Investment in associate company		
Faulu Advisory Services Limited:		
At 1 January	26,797	19,501
Share of profit for the year	9,370	10,423
Share of taxation (note 12(a))	(2,811)	(3,127)
	33,356	26,797

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

The reporting date of Faulu Advisory Services Limited is 31 December. The company is incorporated in Kenya. Its principal activity is guaranteeing loans advanced by Faulu Kenya Deposit Taking Microfinance Limited and training beneficiaries of microfinance loans on business related courses.

A summary of unaudited financial information as of 31 December 2012 is presented below:

	Assets	Liabilities	Revenues	Profit	% of interest
	Shs'000	Shs'000	Shs'000	Shs'000	held
31 December 2012	182,458	110,931	90,370	37,480	25%
31 December 2011	57,396	129,500	146,886	41,691	25%

21. INTANGIBLE ASSETS – COMPUTER SOFTWARE

	2012 Shs '000	2011 Shs '000
COST		
At 1 January	219,099	210,589
Additions	3,305	9,566
Disposals	-	(1,056)
At 31 December	222,404	219,099
AMORTISATION		
At 1 January	122,310	110,493
Charge for the year	12,252	12,846
Disposals	-	(1,029)
At 31 December	134,562	122,310
NET BOOK VALUE		
At 31 December	87,842	96,789

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

22. PROPERTY AND EQUIPMENT

	Freehold land and buildings	Motor vehicles	Computers and equipment	Electronic office equipment	Durable non-electrical equipment	Work in progress	TOTAL
	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000	Shs '000
COST/VALUATION							
At 1 January 2011	150,000	6,051	95,813	48,596	647,372	-	947,832
Additions	-	-	1,914	1,050	27,657	8,323	38,944
Revaluation surplus	35,000	-	-	-	-	-	35,000
Eliminated on disposal	-	-	(17,361)	(5,796)	(3,750)	-	(26,908)
At 31 December 2011	185,000	6,051	80,366	43,850	671,279	8,323	994,869
At 1 January 2012	185,000	6,051	80,366	43,850	671,279	8,323	994,869
Additions	-	480	3,669	1,115	8,614	61,645	75,522
Transfer of WIP	-	7,009	-	2,577	-	(9,586)	-
At 31 December 2012	185,000	13,540	84,035	47,541	679,893	60,381	1,070,389
DEPRECIATION							
At 1 January 2011	-	4,403	55,262	16,722	99,790	-	176,177
Charge for the year	1,375	412	12,033	7,945	71,460	-	93,225
Eliminated on disposal	-	-	(16,480)	(5,248)	(2,509)	-	(24,237)
At 31 December 2011	1,375	4,815	50,815	19,419	168,741	-	245,165
At 1 January 2012	1,375	4,815	50,815	19,419	168,741	-	245,165
Charge for the year	1,341	2,131	9,316	6,497	63,447	-	82,732
At 31 December 2012	2,716	6,946	60,132	25,916	232,188	-	327,898
NET BOOK VALUE							
At 31 December 2012	182,284	6,594	23,903	21,624	447,705	60,381	742,491
At 31 December 2011	183,625	1,236	29,551	24,430	502,538	8,323	749,703

Land and buildings were last revalued at Shs 185,000,000 as at 31 May 2011 by Lloyd Masika Limited, registered valuers, on an open market value basis by reference to market evidence of recent transactions for similar properties.

At 31 December 2012, the net book value of the freehold land and building at original cost was Shs 54,593,165 (2011: Shs 54,593,165).

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

23. DEFERRED TAX LIABILITY/(ASSET)

	2012 Shs '000	2011 Shs '000
The net deferred tax asset is attributable to the following items:		
Excess depreciation over capital allowances	(4,015)	(3,581)
Deferred tax on revaluation surplus	39,000	38,668
Tax losses	(1,785)	(39,830)
Provision for staff leave pay	(3,093)	(1,773)
Unrealised exchange loss	(98)	(22)
	30,009	(6,538)

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

At 1 January	(6,538)	(27,964)
Profit or loss credit (note 12(a))	36,410	10,926
Deferred taxation on revaluation surplus dealt with through equity	-	10,500
Prior year under provision	137	-
At 31 December	30,009	(6,538)

At 31 December 2012, the company had tax losses amounting to Shs 5,948,577 (2011- Shs 132,768,144) available for set off against future taxable income. Under the new Kenyan legislation, with effect from 1 January 2011, tax losses can only be carried forward to a maximum of four years.

24. 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.

	2012 Shs '000	2011 Shs '000
0- 30 days	49,328	50,152
31 -90 days	40,282	42,772
91-180 days	106,834	141,701
Over 180 days	1,319,143	1,131,520
	1,515,587	1,366,145

The effective interest rate on the cash collaterals held at 31 December 2012 was nil (2011: nil).

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

25. CUSTOMER DEPOSITS

	2012 Shs '000	2011 Shs '000
Savings account	953,010	438,677
Fixed account	1,995,904	160,180
	2,948,914	598,857

The effective interest rate on customer deposits as at 31 December 2012 is 6.5% (2011: 4.0%).

26. BORROWINGS

	2012 Shs '000	2011 Shs '000
Loan from Deutsche Bank (Eur 5,000,000)	466,250	466,250
Loan from Habitat (\$ 200,000)	-	3,842
Loan from Standard Chartered Bank Limited	225,000	375,000
Loan from KIVA Microfund	26,136	45,773
Loans from Symbiotics Fund	250,432	241,810
Loan from Bank of Africa Limited	150,000	556,260
Loan from Eco Bank Limited	300,000	400,000
Loan from European Investment Bank	345,640	-
Bank overdrafts	398,452	337,359
	2,161,910	2,426,294

The borrowings are repayable as follows:

On demand or within one year	26,136	386,973
Within 1 year	892,091	241,811
After 1 year within 3 years	692,193	931,260
After 3 years and within 5 years	551,490	866,250
	2,161,910	2,426,294

The Bank of Africa debt comprises of a loan disbursed at Shs 400M in September, 2011 for a maximum period of 72 months with interest rate of 11%. It is backed by a Guarantee issued by USAID, an overdraft from the same institution of Shs 100M is lien by Shs 50M held in deposits. Further there are two US dollar loans (fully hedged) obtained from Symbiotics SA for 10.5% interest rate each for a period of 2 years from October 2011 for USD 2M loan and November 2011 for USD 1M loan.

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

The loan from European Investment Bank of EURO 4M was advanced at 11.576% repayable semi-annually till 15 October 2016 with first repayment date of 15 April 2012.

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

26. BORROWINGS (CONTINUED)

The bank overdraft is held with Standard Chartered Bank Kenya Limited for working capital requirements and is secured by government securities (note 15). The effective interest rate for the year ended 31 December 2012 was 12.8% (2011-19.1%).

The loan from Habitat is unsecured and the interest rate

on the loan is 5.0% per annum. The loan was fully repaid in the year.

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

The loan from KIVA Micro fundis interest free, unsecured and has no fixed repayment terms.

27. DEFERRED INCOME

1 January
Less: transferred to profit or loss (note 11)
At 31 December

	2012 Shs '000	2011 Shs '000
1 January	-	1,625
Less: transferred to profit or loss (note 11)	-	(1,625)
At 31 December	-	-

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

28. OTHER LIABILITIES

Accrued expenses
Staff leave provision
Sundry liabilities

	2012 Shs '000	2011 Shs '000
Accrued expenses	37,930	22,575
Staff leave provision	10,311	5,909
Sundry liabilities	316,902	163,545
	365,143	192,029

29. SHARE CAPITAL

Authorised:
24,000,000 ordinary shares of Shs 10 each
Authorised, issued and fully paid:
12,000,000 ordinary shares of Shs 10 each

	2012 Shs '000	2011 Shs '000
Authorised: 24,000,000 ordinary shares of Shs 10 each	240,000	240,000
Authorised, issued and fully paid: 12,000,000 ordinary shares of Shs 10 each	120,000	120,000

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

30. NOTES TO THE STATEMENT OF CASH FLOWS

	2012 Shs '000	2011 Shs '000
(a) RECONCILIATION OF LOSS BEFORE TAXATION TO CASH GENERATED FROM OPERATIONS		
Profit before taxation	97,652	16,137
Adjustment for:		
Depreciation	82,732	93,225
Amortisation of computer software	12,252	12,846
Loss on disposal of tangible assets	-	2,670
Loss on disposal of intangible assets	-	27
Share of associate company's profit	(9,370)	(10,423)
	183,266	114,482
Working capital changes:		
Increase in loans to customers	(1,711,574)	(688,472)
Movement in related party balances	568	(2,702)
Increase in other assets	(119,335)	(65,011)
Increase/(decrease) in cash collaterals held	149,442	(19,553)
Decrease in deferred income	-	(1,625)
Increase in customer deposits	2,350,057	129,951
Increase in other liabilities	173,114	118,197
Cash generated from / (used in) operations	1,025,538	(414,733)
(b) ANALYSIS OF THE BALANCES OF CASH AND CASH EQUIVALENTS		
Cash and bank balances	196,329	113,237
Short term deposits with banks (note 14)	956,525	384,289
Treasury bonds (note 15)	292,248	278,865
Bank overdraft (note 26)	(398,452)	(337,359)
	1,046,650	439,032

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.

	2012 Shs '000	2011 Shs '000
Movement in borrowings		
At 1 January	2,088,933	1,926,619
Received in the year	761,256	666,950
Paid in the year	(1,086,731)	(504,636)
At 31 December	1,763,458	2,088,933

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

31. RELATED PARTY TRANSACTIONS

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

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

Amounts not settled as at the end of each reporting period in respect of transactions with related parties are disclosed in note 18.

Key management compensation

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

Salaries and other benefits

Directors' remuneration

Fees for services as directors

	2012 Shs '000	2011 Shs '000
Salaries and other benefits	74,644	67,490
Fees for services as directors	8,664	3,580

32. CONTINGENT LIABILITIES

The company is a defendant in various legal suits with an estimated liability of Shs 2,120,000(2011 - Shs 184,000). In the opinion of the directors, after obtaining appropriate legal advice, the outcome of such actions will not give rise to any significant loss.

33. CAPITAL COMMITMENTS

The company had no capital commitments authorised or contracted for at end of the year (2011: Shs nil).

34. FUTURE RENTAL COMMITMENTS UNDEROPERATING LEASES

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

Within one year

Between one and five years

Over 5 years

	2012 Shs '000	2011 Shs '000
Within one year	6,726	70,212
Between one and five years	184,686	293,337
Over 5 years	13,680	74,172
	405,092	437,721

The lease rental expense incurred during the year in respect of company offices rental amounted to Shs74, 978,178 (2011 - Shs Shs72, 907,126).

NOTES TO THE FINANCIALS STATEMENTS (CONTINUED)

35. DIVESTITURE

CBK regulations as set out in the microfinance Act 2006 limits single shareholder ownership to no more than 25% of shares in the institution. In efforts of capitalisation and addressing this requirement, the board has been actively vetting and engaging potential investors to invest in Faulu through a divestiture program aimed at divesting 75% of the current holding from Faulu Kenya Trust and Food For the Hungry International. The divestiture program started in 2010 has progressed successfully with its closure expected to bring in additional capital of about Shs 1.5 billion by end of quarter one of 2013. Faulu is within the set timelines as stipulated by the Central Bank guidelines.

36. 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.

37. INCORPORATION

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

38. CURRENCY

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

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