FINANCIAL PERFORMANCE EVALUATION

(A Case Study of Awash International Bank (AIB))

A Research project submitted to the Department of Accounting and Finance, College of Business and Economics, Mekelle University, for the partial Fulfillment of the Degree of Master of Science in Finance and Investment

By

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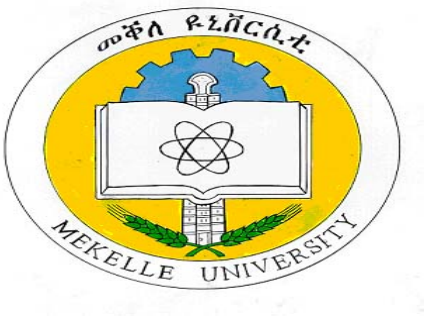
Reg. No. PR/0014/01



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June, 2010

Study On

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DECLARATION

I Abdi Dufera, hereby declare that the project work entitled “Financial Performance Evaluation: A case study of Awash International Bank S.C” submitted by me for the award of the Degree of Master in Finance & Investment of Mekelle University at Mekelle, is original work and it hasn’t been presented for the award of any other Degree, Diploma, Fellowship or other similar titles of any other university or institution.

Place: Mekelle Signature……

Date…… Name: ----------

CERTIFICATE

I certify that the project work entitled "**Financial Performance Evaluation": A case study of Awash International Bank S.C**" is the bonafide work of Mr. Abdi Dufera who carried out the research under my guidance. Certified further, that to the best of my knowledge the work reported here in doesn't form part of any other project report or dissertation on the bases of which a degree or award was conferred on an earlier occasion on this or any other candidate.

Place: Mekelle

Signature: ----------

Date: May, 2010

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May 2010,

ABDI DUFERA

ABSTRACT

This study was conducted under the title "Financial performance evaluation: a case study of Awash International Bank (AIB) S.C.". Its main objective was to compare and examine empirically the performance of the first private commercial bank in Ethiopia, i.e. Awash International Bank (AIB) in comparison with industry average with respect to liquidity; profitability; credit risk & solvency and efficiency for the period of 2003-2009.

This study was employing ratios (15 in total) such as Return on Asset (ROA), Return on Equity (ROE), Profit Expense Ratio (PER), Return On Deposit (ROD), Net Interest Margin (NIM), Loan to Deposit ratio (LDR), Cash To Deposit Ratio (CDR) Loan to Assets Ratio (LAR), Debt to Equity Ratio (DER), Debt to Total Asset Ratio (DTAR); Equity Multiplier(EM), Non-performing Loans to Total Loans, Asset Utilization (AU), Income to Expense ratio (IER) and Operating Efficiency(OE).

This study found that all results of profitability measures go in favor of industry average. The results indicate that Awash International Bank was less profitable than industry average. However, AIB was consistently improving and performing better in making good returns on investment (assets), satisfying their shareholders in offering competitive or even better returns, making good returns customers' deposits and also managing their operating expenses over the Years until 2007.From 2007 onwards, profitability of the bank started to decrease. Besides, an overall analysis of all liquidity, efficiency, and risk and solvency measures reveals that AIB was less liquid, efficient in asset utilization, income generation, and managing its expenses and less risky and more solvent than industry average. However, the results also show the AIB is improving overtime considerably in these liquidity, efficiency and risk & solvency measures during the period under the study

Acronyms

AIB	**Awash International Bank**
AU	Asset Utilization
CDR	Cash Deposit Ratio
DER	Debt to Equity Ratio
DTAR	Debt to Total Assets Ratio
EM	Equity Multiplier
IER	Income to expense Ratio
LAR	Loan to Asset Ratio
LDR	Loan to Deposit Ratio
NIM	Net Interest Margin
OE	Operating Efficiency
PER	Profit Expense Ratio
ROA	Return on Assets
ROD	Return on Deposit
ROE	Return on Equity
NPTL	Non-performing Loans to Total Loans

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CHAPTER I
INTRODUCTION

This chapter covers background of the study, statement of the problem, research questions, justification of the study, objective of the study, research methodology, significance of the study, scope of the study, limitation and organization of the study.

1.1 Background of the study

A bank is a financial intermediary that accepts deposits and channels those deposits into lending activities. Banks are a fundamental component of the financial system, and are also active players in financial markets. The essential role of a bank is to connect those who have capital (such as investors or depositors), with those who seek capital (such as individuals wanting a loan, or businesses wanting to grow) (http://en.wikipedia.org/wiki/Bank).

Role of Banks in a Developing Economy

Banks play a very useful and dynamic role in the economic life of every modern state. A study of the economic history of western country shows that without the evolution of commercial banks in the 18th and 19 the centuries, the industrial revolution would not have taken place in Europe. The economic importance of commercial banks to the developing countries may be viewed thus:

- **Promoting Capital Formation: -** A developing economy needs a high rate of capital formation to accelerate the tempo of economic development, but the rate of capital formation depends upon the rate of saving. Unfortunately, in underdeveloped countries, saving is very low. Banks afford facilities for saving and, thus encourage the habits of thrift and industry in the community. They

mobilize the ideal and dormant capital of the country and make it available for productive purposes.

- **Encouraging Innovation: -** Innovation is another factor responsible for economic development. The entrepreneur in innovation is largely dependent on the manner in which bank credit is allocated and utilized in the process of economic growth. Bank credit enables entrepreneurs to innovate and invest, and thus uplift economic activity and progress.
- **Influence Economic Activity:** - Banks are in a position to influence economic activity in a country by their influence on the rate interest. They can influence the rate of interest in the money market through its supply of funds. Banks may follow a cheap money policy with low interest rates which will tend to stimulate economic activity.
- **Facilitator of Monetary Policy: -** Thus monetary policy of a country should be conductive to economic development. But a well-developed banking system is on essential pre-condition to the effective implementation of monetary policy. Under-developed countries cannot afford to ignore this fact. A fine, an efficient and comprehensive banking system is a crucial factor of the developmental process.
- **Netting and settlement of payments** – banks act as both collection and paying agents for customers, participating in inter-bank clearing and settlement systems to collect, present, be presented with, and pay payment instruments. This enables banks to economize on reserves held for settlement of payments, since inward and outward payments offset each other. It also enables the offsetting of payment flows between geographical areas, reducing the cost of settlement between them.
- **Maturity transformation** – banks borrow more on demand debt and short term debt, but provide more long term loans. In other words, they borrow short and lend long. With a stronger credit quality than most other borrowers, banks can do

this by aggregating issues (e.g. accepting deposits and issuing banknotes) and redemptions (e.g. withdrawals and redemptions of banknotes), maintaining reserves of cash, investing in marketable securities that can be readily converted to cash if needed, and raising replacement funding as needed from various sources (e.g. wholesale cash markets and securities markets).

Conversely, Banks are susceptible to many forms of risk which have triggered occasional systemic crises. These include liquidity risk (where many depositors may request withdrawals beyond available funds), credit risk (the chance that those who owe money to the bank will not repay it), and interest rate risk (the possibility that the bank will become unprofitable, if rising interest rates force it to pay relatively more on its deposits than it receives on its loans)

Banking crises have developed many times throughout history, when one or more risks have materialized for a banking sector as a whole. Prominent examples include the bank run that occurred during the Great Depression, the U.S. Savings and Loan crisis in the 1980s and early 1990s, the Japanese banking crisis during the 1990s, and the sub-prime mortgage crisis in the 2000s. Usually, the governments bail out the bank through rescue plan or individual public intervention (Michele, 2009).

Moreover, Rising and stiff competition, deregulation, globalization, and continuous innovation to provide acceptable financial services to customers have given rise to the interest of all the concerned and interested parties in detailed critical evaluation of banks (Banking 2010). Unlike in the past, banks can no longer earn legally mandated yield spreads between the average interest rates earned on sources and uses of funds. Nor can banks continue to reap monopoly rents from bank charters that naturally endowed them with a considerable degree of market power. Instead, today's more competitive banking environment is causing banking institutions to evaluate carefully the risks and returns involved in serving the needs of the public (Benton and James2005).

Various groups of individuals are particularly interested in evaluating bank performance. First and foremost, *bank shareholders* are directly affected by bank performance. Investors take advantage of bank information to develop expectations concerning future performance that can be used to help price common shares (in addition to capital notes and debentures that may be issued by the bank). Second, *bank management* traditionally is evaluated on the basis of how well the bank performs relative to previous years and compared with similar (or peer group) banks. Hence, employees' salaries and promotions are frequently tied to the performance of the bank. Bankers also need to be informed about the condition of other banks with which they have business dealings. Third, *regulators*, concerned about the safety and soundness of the banking system and the preservation of public confidence, monitor banks using on-site examinations and computer based "early warning systems" to keep track of bank performance. Fourth, *depositors* may also be interested in evaluating the performance of the bank, as the nominal values of their deposits are not guaranteed. Fifth, and last the *business community* and general public should be concerned about their banks' performance to the extent that their access to credit and other financial services is linked to the success or failure of their bank (Benton and James2005).

Furthermore, numerous studies argue that the efficiency of financial intermediation affects economic growth while others indicate that bank insolvencies can result in systemic crises, which have adverse consequences for the economy as a whole, (Levine, 2005). Thus, the performance of banks has been an issue of major interest for various stakeholders such as depositors, regulators, customers, and investors.

Financial statements for banks present a different analytical problem than manufacturing and other service companies. As a result, analysis of the bank's financial statements requires a distinct approach that recognizes the bank's somewhat unique functions and risks.

As banking is one of the most highly liquid industries, investors have some level of assurance in the soundness of the banking system. As a result, investors can focus most of their efforts on how a bank will perform in different economic environments.

Hence, to evaluate banks' performance, we can use different methods. These methods can be classified in three ways: The traditional method of financial indices based on balance sheet and income statement analysis, parametric methods based on the knowledge of production function and non-parametric methods that do not require production function (Wozniewska, 2008).

If the financial market were efficient, market price for banks' stock price would be one of the most appropriate tools for measuring banks' performances. The alternative to the market approach is the accounting-based financial ratio approach, which has commonly been used for measuring the financial performance of firms (Abdu, 2004).

Since the stock price data for Ethiopia's commercial banks are not available, the accounting based financial ratios was used as a measure of financial performance in this study.

Financial performance analysis trough the traditional method of financial indices based on balance sheet, and income statement analysis is an important theme and it is widely used to summarize the information in a company's financial statements in assessing its financial health.

1.2 Statement of the Problem

Financial performance of a company, being one of the major characteristics, defines competitiveness, potentials of the business, economic interests of the company's management and reliability of present or future contractors. Therefore, financial performance analysis and identification of their weaknesses and strengths using financial performance indicators has its contribution to the management, shareholders, the public (customers of the bank), the regulator (the government), the financial sector,

and the economy as a whole. In a competitive financial market, bank performance provides signal to depositors and investors whether to withdraw or invest funds respectively from the bank. Similarly, it flashes direction to bank managers whether to improve its deposit service or loan service or both. Regulators are also interested in the financial health of banks for regulation purposes.

The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions. Owners and managers require financial statements to make important business decisions that affect its continued operations. Financial analysis which measure financial performance is then performed on these statements to provide management with a more detailed understanding of the figures. Furthermore, the rationale of financial analysis is to diagnose the information contained in financial statement so as to judge the future earning, ability to pay interest, debt maturities, profitability and sound dividend policy.

Awash International Bank (AIB) S.C. was established in November 1994 as the 1st private commercial bank in Ethiopia after deregulation. It started operation in February 1995. Bank's business has expanded over the years. The bank's total assets reached over Birr 2.4 billion, the number of the Bank's shareholders reached over 2200, and it's paid up capital increased from Birr 158.4 million to Birr 136 million.

Although few studies have been made as related to financial performance analysis of banks, such as performance comparison between the government and private banks, insurance, and other financial institutions such analysis in the case of Awash International bank still remains unexplored. The researcher has tried to fill this lack of evidence by extending the issue to the specific context of the company.

Therefore, the aim of this study is to evaluate and compare financial performance of Awash International bank (AIB) against the industry average, to provide some comments by observing several financial ratios, analyzing trends of various elements of

financial statement of AIB past seven years performance results, and to improve its banking business. Hence, this became the basis of the study.

1.3 Research Question

The study addressed the following specific research questions:

1. What does look like the financial trend of various elements of the financial statements of the AIB?
2. Does the bank face difficulties in financing its loan and future investment expansions?
3. Is the profitability of Awash International bank strong enough to exist in the competitive financial industry?
4. How is the company utilizing its assets?
5. What is the company's financial position to meet its current obligation?

1.4 Justification of the Study

The rationale behind this study is to evaluate the Awash International Bank financial performance and let the bank management to know the performance of the bank for last seven years and comment them what to do so as to improve the bank performance.

1.5 Objectives of the Study

1.5.1 General Objective

The overall object of the study is to examine and compare the financial performance of Awash International Bank (AIB) against the industry average from the viewpoint of a neutral onlooker.

1.5.2 Specific Objective

The specific objectives of the study are:

- To study and analyze the trends of various elements of the financial statements of the AIB
- To analyze and compare the risk and solvency position of the AIB against the industry average
- To examine and compare the overall profitability of the AIB against the industry average
- To analyze and compare the liquidity position of the AIB against the industry average
- To evaluate and compare how effectively the company is utilizing its assets against the industry average.

1.6 Research Methodology

1.6.1 Research Design

Since the major emphasis in this study was on the description of data and insights into the facts, the research design most appropriate for the study was case study, Quantitative and Descriptive Research Design.

1.6.2 Sampling method

The issue of sampling in this study has little significance, as the main aim of this study was a case study to examine and compare the financial performance of Awash International Bank (AIB) S.C. against the industry average. Hence, the researcher selected the commercial banks which were established and published annual report before 2009 to compute industry average, these include the Commercial Bank of Ethiopia, Awash International Bank, Dashen Bank, Wegagen Bank, Bank of Abyssinia,

United Bank, Nib International Bank, Lion International Bank, Zeman Bank, and Oromia International Bank, as his sample for the study using non-probability design based on subjective judgment (purpose sampling) so as to incorporate those banks in the study.

1.6.3 Source and Instruments of Data collection

The source of data for this study was predominantly from secondary sources. However, the data needed for this study were gathered from both Secondary and primary sources. The audited annual financial reports for the selected banks during the year 2003 to 2009 were used as a source of secondary data in order to compare and evaluate the financial performance of AIB against the industry average. Help of other sources like literature from various books, journals, newspapers, reports of the National Bank of Ethiopia and various websites, were also used as a source of secondary data. Secondary data was collected through personal review of the above listed sources and types of data. Furthermore, in order to support the secondary data, when clarification was required finance department of the bank was communicated through telephone. Judgmental sampling was used to select the interviewees. This judgmental sampling was taken based on who provide the best information for the purpose of this study.

1.6.4 Methods of Data Analysis

The collected data through the above tools was analyzed using the techniques of ratio analysis to find out the true picture of the financial performance of awash international bank over the recent seven years.

Finally, trend analysis (or time series analysis) and comparison against the industry average was made. The analyzed data was presented using tables and diagrams that are appropriate to explain the facts.

1.7 Significance of the Study

The study is expected to have importance to many parties. Since the study revolves around one of the popular issues of current business scenario, the following are the expected significances

1) It provides some insight about the evaluation process of banking industry.
2) To initiate the concerned organizations to reassess existing practices and put a renewed emphasis on those undermined ones.
3) To serve as a reference material for both academicians and practitioners
4) To initiate other interested researchers to carry out more extensive studies in the area

1.8 Scope of the Study

There are numerous approaches to measure the performance of a bank. Calculation of average cost and presenting it through curvature is one of the means to judge the efficiency of commercial bank. Such curvature will demonstrate a relationship between bank size and unit of production. The other most widely used methods are Data Envelopment Analysis and the Stochastic Frontier Approach. Nevertheless, because of data insufficiency neither of these methods were used for the study. Hence, the study was covered only the recent seven years (2003-2009) of audited annual financial statements using, ratio analysis, and common size statements analysis.

In addition, independent valuation of attributes such as politics, economic cycle, inflation that could affect the financial performance of the company were not considered.

1.9 Limitations of the Study

This study is not without its limitations like any other study. One of the limitations is that financial data beyond audited financial statements was unavailable to the researcher. This is so because, according to the policy of the company, those financial statements that have been not published in newspapers or the annual report of the bank cannot be disclosed.

1.10 Structure of the Study

The presentation of this study takes the following form: The first chapter is introductory which consists of background of the study, statement of the research problem, research question, justification of the study, objective of the study, research design and methodology, significance of the study, scope of the study, and research limitation. The second chapter provides the related summary of literature review on the financial performance analysis. Chapter three presents the socioeconomic – demographic characteristics of the study population. Chapter four is devoted to the analysis of data and discussion based on data collected. Finally, chapter five concludes the study and provides relevant recommendations.

CHAPTER II

REVIEW OF THE RELATED LITRATURE

This chapter is composed of two major parts: the theoretical framework and empirical studies. The theoretical framework part presents meaning of financial statements, Presentation of Bank Financial Statements, Meaning of Financial Statement Analysis, Objective of Financial Statement Analysis, and Tools for Financial Analysis used in the financial performance evaluation of banks. The empirical studies part presents various related researches and their results.

2.1. Theoretical Framework

The problem of banking and financial system soundness has become more important in all countries over the recent years. The financial sector, and especially the banking system, is vulnerable to systemic crises which has led to the creation of costly safety nets, as depositor insurance schemes with well-known moral hazard problem. It is argued that there is increasing evidence that banks are “black boxes” due to the week transparency and banks’ unwillingness to disclose information (Neely et al., 1997). To measure banks’ creditworthiness and risk exposures is a complicated issue and it is not easy to interpret banks’ accounting data. Kosmidou, K. (2008), argued that “Indicators of business failures and nonperforming loans are also usually available only at low frequencies, if at all; the latter are also made less informative by banks desire to hide their problems for as long as possible.” This means that it is needed to use as fully and complexly as possible all available financial information from the official financial statements of banks for making financial analysis of banks’ performance.

Currently, bank regulators commonly use the traditional method of financial indices based on the financial statements to evaluate banks’ financial performance (Abdus, 2004)

2.1.1. Meaning of Financial Statements

Financial statements refer to such statements, which contains financial information about an enterprise. It is the final product of accounting work done during the accounting period – quarterly / half-yearly / annually (Bernstein & Wild, 2000). Financial statements are prepared in monetary terms. Some refer to them as 'Annual Accounts', when they are prepared on a yearly basis. However, interim financial statements are prepared for a shorter period, usually a quarter, and hence called 'Quarterly Financial Statements'.

The financial statements are prepared by the board of directors for reporting to shareholders in discharge of their stewardship function and hence corporate law enjoins upon them the responsibility of laying down them before annual general meeting of the shareholders so as to give a 'true and fair view' of the affairs of the company. The profit and loss account shall be annexed to the balance sheet and auditor's report (including the auditor's separate, special, or supplementary report, if any) shall be attached thereto (Bernstein & Wild, 2000).

2.1.2. Presentation of Bank Financial Statements

Financial data on commercial banks are presented in two basic documents: the Report of Condition (i.e. the balance sheet) and the Report of Income (i.e. the income statement) (Benton and James2005).

2.1.2.1. The Balance Sheet

A bank's balance sheet presents the institution's financial condition at a single point in time. Balance sheets are prepared on a particular date- usually the last day of a month, year or quarter .Because balance sheets capture a condition at one point in time, it is useful to compare data for several accounting periods. In this way, trends in the bank's financial condition over time can be assessed.

Assets cash assets include vault cash, deposits at the Federal Reserve (primarily to meet legal reserve requirements), deposits at other banks (for clearing purposes and also to compensate the other banks for providing currency and coin services),and cash items in the process of collection. All of these four categories of assets have one common feature - namely they earn no interest. As such, bank management should attempt to minimize its investment these assets.

Interest – bearing bank balances, such as short term certificates of deposit at other banks and federal funds sold are highly liquid earning assets. They are generally used as part of the bank's liquidity management program.

The next major category of bank assets is investment securities. Since banks are generally prohibited from owning equity securities (except in their securities affiliates), the securities that appear on bank balance sheets are almost entirely debts. Regulations force banks to be lender rather than investors.

Loans, the least liquid of banking assets and the major source of risk, are the largest asset category for most banking institutions as well as the primary source of bank earnings. Loans and lease are classified into the following categories.

- Loans secured by real estate
- Commercial and industrial loans, including loans to depository institutions
- Loans to individuals for household, family, and other personal expeditions
- Loan to finance agricultural production
- All other loans and lease-financing receivables

From gross loans and leases, two deductions are made-unearned income and the reserve for loan and lease losses - to arrive at net loans and leases. Unearned income represents the amount of income that has been deducted from a loan (for example, in the case of a discounted note) but has not yet been recognized as income on the income statement because it is distributed over the life of the note.

The amount in the reserve account reflects an estimate by bank management of probable **charge-offs** for uncollectible loans and leases on the balance sheet date. Although regulatory authorities are involved in the estimation process, bank management ultimately determines the final valuation of the reserve account. Actual losses are deducted from the reserve account, and recoveries are added back to reserves. The adequacy of the valuation reserve is an important element in the analysis of a bank's risk.

"Other real estate" is any other real estate owned by the bank and usually represents property that has been obtained through collateral foreclosures on problem loans.

The final asset category is all other assets. This includes intangible assets - assets without physical substance-such as good will recognized in business combinations.

Liabilities Bank liabilities consist primarily of the various types of deposit accounts that the institution uses to fund its lending and investing activities.

Depository accounts vary in terms of interest payments, maturity, check-writing privileges, and insurability. Demand deposits are transaction accounts that are payable to the depositor on demand and pay no interest. Now accounts represent the total of all transaction accounts less demand deposits. They are accounts that pay interest and permit check writing but do not include money market deposit accounts. Money market deposit accounts (MMDAS) are savings accounts on which the bank pays market interest and check writing is limited to a certain number of checks per month. The other savings deposits category comprises all savings deposits other than money market deposit accounts and includes regular passbook accounts with no set maturity and overdraft protection plan accounts.

Capital subordinated notes and debentures are actually liabilities but are shown in the capital section because this type of debt has the characteristics of capital in terms of maturity and permanence and can be counted as capital in meeting certain regulatory requirements. "All common and preferred equity" capital is the par value of all common

and preferred stock outstanding, surplus or additional paid-in capital (the amount by which the original sale of the stock exceeded par value), undivided profits or retained earnings (all of the institution's earnings since its inception less any dividends paid), and capital reserves (a cushion used to absorb unexpected losses on loans and securities).

2.1.2.2. The Income Statement

The income statement, which shows all major categories of revenue and expenditures, the net profit or lose for the period, and the amount of cash dividends declared, measures a firm's financial performance over a period of time, such as a year, quarter or month. The income statement and the balance sheet are integrally related and both should be evaluated when assessing bank performance.

Interest Income loans are the largest asset category for most bank balance sheets, and interest and fees on loans are the primary sources of bank income. This category of revenue, which includes all year-to-date interest and fees on loans, is presented first on the income statement. Income from lease financing is year-to-date income derived from lease financing receivables.

The analyst must realize that income reported on loans and leases is accrued, meaning that it is recognized over the appropriate time period of the loan rather than when cash is actually received. A bank can recognize this income for at least ninety days before the loan goes on non-accrual status.

The income reported is divided into full taxable and tax-exempt portions. The tax-exempt amount includes year-to-date income on loan obligations of state and political subdivisions, and tax-exempt income from direct lease financing. The fully taxable amount is total interest and fees on loans and income from lease-financing receivables less tax-exempt income. The estimated tax benefit results from having tax-exempt loan and lease-financing income from municipal loans and leases. It is estimated and added

to income in order to improve the comparability of interest income among different banks over several times.

Interest Expense: Interest expense is the largest expense for most banks. Interest expense is allocated into six categories

a. Interest paid on time deposits of $100,000 or more;
b. Interest on other deposits;
c. Interest expense on federal funds purchased and securities sold under agreements to repurchase;
d. Interest on note balances issued to the government treasury and on other borrowed money;
e. Interest on mortgage debt and capital leases on bank premises, fixed assets and other real estate owned; and
f. Interest on subordinated notes and debentures

Net interest income: Net interest income on a tax-equivalent basis is total interest income less total interest expense. The relationship between net interest income - the amount by which interest received exceeds interest paid and total assets is an important analytical tool in assessing a bank's ability to generate profits through the management of interest earning assets and interest bearing liabilities.

Non-interest Income: Non-interest income includes all other sources of income from fiduciary activities, service charges on deposits, gains or losses and commissions and fees on assets held in trading account, foreign exchange trading gains or losses , loan and security guarantees, derivative securities services and other off-balance sheet activities. These categories of income have increased in relative importance for many banks as a result of deregulation's impact on the permissible financial services.

Other Expense: Three other types of expenses are deducted from adjusted operating income to arrive at pretax operating income. overhead expense includes salaries and

employee benefits, expenses of premises and fixed assets (net of rental income) and other non interest operating expenses. The provision for loan and lease losses is the year to date amount allocated to loan and lease loss reserves (on the balance sheet). Remember that unexpected losses are charged against the balance sheet reserves account.

Gains or losses on the sale, exchange, redemption or retirement of securities other than those held in trading accounts are netted against pretax operating income to determine pretax operating income on a tax-equivalent basis. Security gains and losses can be an important element in measuring bank performance. The analyst should be aware that a bank can influence operating profit for a period through these securities transactions.

Income tax Expense: Income tax in includes the total estimated federal, state, local, and foreign (if applicable) income taxes on operating income (including securities gains and losses).

Net Income: - Income taxes are deducted from pretax operating income to arrive at net operating income. If there are any extraordinary items, defined as transactions that are both unusual in nature and not expected to recur, these are deducted/added, net of taxes, to determine net income.

2.1.3. Meaning of Financial Statement Analysis

The process of critical evaluation of the financial information contained in the financial statements in order to understand and make decisions regarding the operations of the firm is called 'Financial Statement Analysis'.

The term "Financial Analysis," also known as analysis and interpretation of financial statements refer to the process of determining financial strength and weaknesses of the firm by establishing strategic relationship between the items of the balance sheet, income statement and other operative data.

According to Metcalf and Titard, "Analyzing financial statements is the process of evaluating the relationship between the component parts of the financial statements to obtain a better understanding of a firm's position and performance."

In the words of Myers, "Financial statement analysis is largely a study of relationship among the various financial factors in a business as disclosed by a single set of statements, and a study of the trend of these factors as shown in a series of statements."

2.1.4. Objective of Financial Statement Analysis

Analysis of financial statements reveals important facts concerning managerial performance and the efficiency of the firm. Broadly speaking, the objectives of the analysis are to apprehend the information contained in financial statements with a view to know the weaknesses and strengths of the firm and to make a forecast about the future prospects of the firm thereby, enabling the analysts to take decisions regarding the operation of, and further investment in, the firm. (Khan, M Y, 2007).

To be more specific, the analysis is undertaken to serve the following objectives:

- To assess the current profitability and operational efficiency of the firm as a whole as well as its different departments so as to judge the financial health of the firm.
- To ascertain the relative importance of different components of the financial position of the firm
- To identify the reasons for change in the profitability / financial position of the firm
- To judge the ability of the firm to repay its debt and assessing the short-term as well as the long-term liquidity position of the firm

Through the analysis of financial statements of various firms, an economist can judge the extent of concentration of economic power and pitfalls in the financial policies pursued. The analysis also provides the basis for many governmental actions relating to licensing, controls, fixing of prices, ceiling on profits, dividend freeze, tax subsidy and other concessions to the corporate sector.

It also helps the management in self-appraisal and the shareholders (owners) and others to judge the performance of the management.

2.1.5. Significance of Financial Analysis

Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the various items of the balance sheet and the profit and loss account. Financial analysis can be undertaken by management of the firm or by parties outside the firm, viz. owners, trade creditors, lenders, investors, lab our unions, analysts and others (Jagels, et al., 2003). The nature of analysis will differ depending on the purpose of the analyst.

A technique frequently used by an analyst need not necessarily serve the purpose of other analysts because of the difference in the interests of the analysts. Financial analysis is useful and significant to different users in the following ways:

a. **Finance Manager:** Financial analysis focuses on the facts and relationships related to managerial performance, corporate efficiency, financial strengths and weaknesses and creditworthiness of the company. A finance manager must be well equipped with the different tools of analysis to make rational decisions for the firm. The tools for analysis help in studying accounting data so as to determine the continuity of the operating policies, investment value of the business, credit ratings and testing the efficiency of operations. The techniques are equally important in the area of financial control, enabling the finance manager to make constant reviews of the actual financial operations of the firm to analyse the causes of major deviations, which may help in corrective action wherever indicated.

b. **Top Management:** The importance of financial analysis is not limited to the finance manager alone. Its scope of importance is quite broad who includes top management in general and the other functional managers. Management of the

firm would be interested in every aspect of the financial analysis. It is their overall responsibility to see that the resources of the firm are used most efficiently, and that the firm's financial condition is sound. Financial analysis helps the management in measuring the success or otherwise of the company's operations, appraising the individual's performance and evaluating the system of internal control.

c. **Short-term Creditors:** A creditor, through an analysis of financial statements, appraises not only the urgent ability of the company to meet its obligations, but also judges the probability of its continued ability to meet all its financial obligations in future. Creditors are particularly interested in the firm's ability to meet their claims over a very short period. Their analysis will therefore, confine to the evaluation of the firm's liquidity position.

d. **Long-Term Creditors**: Suppliers of long-term debt are concerned with the firm's long-term solvency and survival. They analyse the firm's profitability overtime, its ability to generate cash to be able to pay interest and repay the principal and the relationship between various sources of funds (capital structure relationships). Long-term tenders do analyse the historical financial statements. However, they place more emphasis on the firm's projected financial statements to make analysis about its future solvency and profitability.

e. **Investors:** Investors, who have invested their money in the firm's shares, are interested about the firm's earnings. As such, they concentrate on the analysis of the firm's present and future profitability. They are also interested in the firm's capital structure to ascertain its influences on firm's earning and risk. They also evaluate the efficiency of the management and determine whether a change is needed or not. However, in some large companies, the shareholders' interest is limited to decide whether to buy, sell, or hold the shares.

f. **Labour Unions**: Labour unions analyze the financial statements to assess whether it can presently afford a wage increase and whether it can absorb a wage increase through increased productivity or by raising the prices.

g. **Others**: The economists, researchers, etc. analyze the financial statements to study the present business and economic conditions. The government agencies need it for price regulations, taxation, and other similar purposes.

2.1.6. Types of Analysis

Financial statements can be subjected to two types of analysis. They are:

1) **Trend analysis or dynamic analysis,** which is made by analyzing the financial statements over a period of years. This indicates the trend of such variables, as sales, cost of production (or operation) profits, assets, and liabilities. For this purpose, comparative financial statements are prepared horizontally.

2) **Structural analysis or static analysis,** which is made by analyzing a single set of financial statements as are prepared on a particular date. It is called structural analysis, because the relationship between different accounting variables is studied as, for example, the ratio of net profit to sale s or the ratio of liquid assets to current liabilities.

2.1.7. Tools for Financial Analysis

The end products of the accounting process are balance sheet, income statement, and statement of cash flows. These are supplemented by detailed explanation in the Director's Report, annexure, and schedules. The information contained in the financial statements are arranged in such a manner that enables analyst to make inferences about the working and financial health of the enterprise.

The numbers given in the financial statements are not of much use to the decision maker. These numbers are to be analyzed over a period of time or in relation to other numbers so that significant conclusions could be drawn regarding the strengths and weaknesses of a business enterprise. The tools of financial analysis help in this regard.

A number of methods can be used for the purpose of analysis of financial statements. These are also termed as techniques or tools of financial analysis. Out of these, and enterprise can choose those techniques, which are suitable to its requirements. The principal techniques of financial analysis are (Gitman, 2004):

- Comparative statements,
- common-size statements,
- Trend Analysis
- cash flow analysis and
- ratio analysis

2.1.7.1 Comparative Statement

These are the statements showing the profitability and financial position of a firm for different periods in a comparative form to give an idea about the position of two or more periods. It usually applies to the two important financial statements, namely, Balance Sheet and Income Statement prepared in a comparative form. The financial data will be comparative only when same accounting principles are used in preparing these statements. If this is not the case, the deviation in the use of accounting principles should be mentioned as a footnote. Comparative figures indicate the trend and direction of financial position and operating results. This analysis is also known as 'horizontal analyses

Advantages

1. These statements indicate trends in sales, cost of production, profits, etc., helping the analyst to evaluate the performance, efficiency, and financial condition of the undertaking. For example, if the sales are increasing coupled with the same or better profit margins, it indicates healthy growth.
2. Comparative statements can also be used to compare the position of the firm with the average performance of the industry or with other firms. Such a comparison facilitates the identification or weaknesses and remedying the situation.

Disadvantages

1. Inter-firm comparison may be misleading if the firms are not of the same age and size, follow different accounting policies in relation to depreciation, valuation of stock, etc., and do not cater to the same market.
2. Inter-period comparison will also be misleading if the period has witnessed frequent changes in accounting policies.

2.1.7.2 Common-Size Statement

These are the statements, which indicate the relationship of different items of a financial statement with some common item by expressing each item as a percentage of the common item. The percentage thus calculated can be easily compared with the results corresponding percentages of the previous year or of some other firms, as the numbers are brought to common base. Such statements also allow an analyst to compare the operating and financing characteristics of two companies of different sizes in the same industry. Thus, common-size statements are useful, both, in intra-firm comparisons over different years and in making inter-firm comparisons for the same year or for several years. This analysis is also known as ‘Vertical analyses.

2.1.7.3 Trend Analysis

It is a technique of studying the operational results and financial position over a series of years. Using the previous years' data of a business enterprise, trend analysis can be done to observe the percentage changes over time in the selected data. The trend percentage is the percentage relationship, which each item of different years bear to the same item in the base year. Trend analysis is important because, with its long run view, it may point to basic changes in the nature of the business. By looking at a trend in a particular ratio, one may find whether the ratio is falling, rising, or remaining relatively constant. From this observation, a problem is detected or the sign of good management is found.

For calculating trend percentages, the base year may be any one of the periods involved in the analysis but the earliest period is mostly taken as the base year. Each item of base year is assumed to be equal to 100 and on that basis, the percentage of item of each year calculated.

2.1.7.4 Cash Flow Analysis

It refers to the analysis of actual movement of cash into and out of an organization. The flow of cash into the business is called cash inflow or positive cash flow and the flow of cash out of the firm is called as cash outflow or a negative cash flow. The difference between the inflow and outflow of cash is the net cash flow. Cash flow statement is prepared to project the manner in which the cash has been received and has been utilized during an accounting year as it shows the sources of cash receipts and also the purposes for which payments are made. Thus, it summarizes the causes for the changes in cash position of a business enterprise between dates of two balance sheets.

2.1.7.5 Ratio Analysis

Financial ratios are useful indicators of a firm's performance and financial situation. This is so because accounting numbers do not explain any phenomenon on their own. However, when a relationship is established between two numbers figuring in the three financial statements, i.e., balance sheet, income statement, and cash flow statement, one can make an assessment regarding the phenomenon. Ratio analysis involves calculation and interpretation of financial numbers by relating them in a logical manner in order to assess the strengths and weaknesses underlying the performance of an enterprise. We calculate ratios because in this way that we get a comparison that may prove more useful. In order to comment on the quality of a ratio one has to make a comparison with some standard or benchmark (Fabozzi, et al., 2003). These benchmarks could be:

Cross-Sectional Analysis: involves comparison of different firms' financial ratios over the same period in time. It usually concerns two or more companies in similar lines of business. The typical business is interested in how well it has performed in relation to other firms in its industry.

One of the most popular forms of cross-sectional analysis compares a company's ratios to industry averages published by statistical agencies.

Trend Analysis (or Time-Series Analysis): In trend analysis, ratios are compared over periods, typically years. Year-to-year comparisons can highlight trends and point up possible need for action. Trend analysis works best with three to five years of ratios.

The theory behind time-series analysis is that the company must be evaluated in relation to its past performance ,developing trends must be isolated ,and appropriate action must be taken to direct the firm towards immediate long term goals .Time-series analysis is often helpful in checking the reasonableness of a firm's projected financial statements.

Certainly, the most informative approach to ratio analysis combines both cross-sectional and trend analyses. A combined view makes it possible to assess the trend in the behavior of the ratio in relation to the trend for the industry.

The analysis of bank performance concentrates on the following four type's financial ratios:

(a) Profitability ratios;

(b) Liquidity ratios;

(c) Risk and solvency ratios; and

(d) efficiency ratios

2.1.7.5.1 Profitability Ratios

Profitability ratios are generally considered to be the basic bank financial ratio in order to evaluate how well bank is performing in terms of profit. For the most part, if a profitability ratio is relatively higher as compared to the competitor(s), industry averages, guidelines, or previous years' same ratios, then it is taken as indicator of better performance of the bank. In the banking literature, different scholars in measuring bank performance have used many profitability ratios (Iqbal et al., 2005). The main performance indicators computed for banks are:

a. Return On Assets (ROA)

Return on assets indicates the profitability on the assets of the firm after all expenses and taxes (Van Horne 2005). It is a common measure of managerial performance (Ross, Westerfield, Jaffe 2005). It measures how much the firm is earning after tax for each dollar invested in the assets of the firm. That is, it measures net earnings per unit of a given asset, moreover, how bank can convert its assets into earnings (Samad & Hassan 2000). Generally, a higher ratio means better managerial performance and efficient utilization of the assets of the firm and lower ratio is the indicator of inefficient use of

assets. Firms can increase ROA either by increasing profit margins or asset turnover but they can't do it simultaneously because of competition and trade-off between turnover and margin. ROA is calculated as under:

ROA = Net Profit after Tax / Total Asset.

b. Return on Equity (ROE)

Return on equity indicates the profitability to shareholders of the firm after all expenses and taxes (Van Horne 2005). It measures how much the firm is earning after tax for each dollar invested in the firm. In other words, ROE is net earnings per dollar equity capital. (Samad & Hassan 2000). It is also an indicator of measuring managerial efficiency (Ross 1994). By and large, higher ROE means better managerial performance; however, a higher return on equity may be due to debt (financial leverage) or higher return on assets. Financial leverage creates an important difference between ROA and ROE in that financial leverage always magnifies ROE. This will always be the case as long as the ROA (gross) is greater the interest rate on debt (Ross, Westerfiled, Jaffe 2005). Usually, there is higher ROE for high growth companies. ROE is calculated as under:

ROE = Net profit after tax / Shareholders' Equity

c. Profit to Expenses Ratio (PER)

It measures the operating profitability of the bank with regards to its total operating expenses. Operating profit is defined as earnings before taxes and operating expenses means total non-interest expenses. The ratio measures the amount of operating profit earned for each dollar of operating expense. The ratio indicates to what extent bank is efficient in controlling its operating expenses. A higher PER means bank is cost efficient and is making higher profits (Samad & Hassan 2000). PER is calculated as under:

PER = Profit before tax / Operating Expenses

d. Net Interest Margin (NIM)

Net interest income is the difference between interest income and interest expense. It is the gross margin on a bank's lending and investment activities. The higher the ratio the cheaper the funding or the higher the margin the bank is obtaining. A bank's net interest margin is a key performance measure that drives ROA (Peters, Raad & Sinkey, 2004). NIM is calculated as under:

NIM= (Interest Income – Interest Expense) / Total Asset

e. Return on Deposit (ROD)

To most financial analysts, Return on Deposit (ROD) is one of the best measures of bank profitability performance. This ratio reflects the bank management ability to utilize the customers' deposits in order to generate profits. (Tarawneh, 2006) have used this ratio as a profitability measurement. ROD is calculated as under:

ROD = Net Profit after Tax / Total Deposit

2.1.7.5.2 Liquidity Ratios

Liquidity ratios indicate the ability of the firm to meet recurring financial obligations. Liquidity is important for the firm to avoid defaulting on its financial obligations and, thus, to avoid experiencing financial distress (Ross, Westerfield, Jaffe 2005). These ratios measure ability of the firm to meet its short-term obligations, maintain cash position, and collect receivables. In general, sense, the higher liquidity ratios mean bank has larger margin of safety and ability to cover its short-term obligations. Because saving accounts and transaction deposits can be withdrawn at any time, there is high liquidity risk for both the banks and other depository institutions. Banks can get into liquidity problem especially when withdrawals exceed new deposit significantly over a short period of time (Samad & Hassan 2000). There are several measures for liquidity

1. Cash Deposit Ratio (CDR)

Cash in a bank vault is the most liquid asset of a bank. Therefore, a higher CDR indicates that a bank is relatively more liquid than a bank, which has lower CDR. Depositors' trust to bank, is enhanced when a bank maintains a higher cash deposit ratio. CDR is calculated as under:

CDR = Cash / Deposit.

2. Loan Deposit Ratio (LDR)

Loan to deposit is the most important ratio to measure the liquidity condition of the bank. Bank with Low LDR is considered to have excessive liquidity, potentially lower profits, and hence less risk as compared to the bank with high LDR. However, high LDR indicates that a bank has taken more financial stress by making excessive loans and shows risk that to meet depositors' claims bank may have to sell some loans at loss. LDR is calculated as under:

LDR= Loan / Deposit

3. Loan to Asset Ratio (LAR)

Like LDR, loan to assets ratio (LAR) is also another important ratio that measures the liquidity condition of the bank. Whereas LDR is a ratio in which liquidity of the bank is measured in terms of its deposits, LAR measures the percentage of assets that are tied up in loans. That is, it gauges the percentage of total assets the bank has invested in loans (or financings). The higher is the ratio the less the liquidity is of the bank. Similar to LDR, the bank with low LAR is also considered to be more liquid as compared to the bank with higher LAR. However, high LAR is an indication of potentially higher profitability and hence more risk. LAR is calculated as under:

LAR = Loan / Asset

2.1.7.5.3 Credit Risk and Solvency Ratios

This is a class of ratios, which measures the risk and solvency of the bank. These ratios are also referred to as gearing, debt, or financial leverage ratios. The extent to which a firm relies on debt financing rather equity is related with financial leverage. These ratios determine the probability that the firm default on its debt contacts. The more the debt a firm has the higher is the chance that firm will become unable to fulfill its contractual obligations. In other words, higher levels of debt can lead to higher probability of bankruptcy and financial distress. Although, debt is an important form of financing that provided significant tax advantage, it may create conflict of interest between the creditors and the shareholders (Ross, Wedsterfield, and Jaffe 2005). If the amount of assets is greater than amount of its all types of liabilities, the bank is considered to be solvent. "Deposits" constitute major liability for any type of bank whether Islamic or conventional. To gauge risk and solvency of the bank, measures usually used are Debt-Equity Ratio (DER), Debt to Total Assets Ratio (DTAR), and Equity Multiplier (EM).

A bank is solvent when the total value of its asset is greater than its liability. A bank becomes risky if it is insolvent. The following are the commonly used measures for a risk and insolvency.

i. Debt Equity Ratio (DER)

The extent to which firm uses debt. It measures ability of the bank capital to absorb financial shocks. In case, creditors default in paying back their loans or the asset values decrease bank capital provides shield against those loan losses. A bank with lower DER is considered better as compared to the bank with higher DER. DER is calculated as under:

DER = Total Debt / Shareholders' Equity

ii. Debt To Total Asset Ratio (DTAR)

It measures the amount of total debt firm used to finance its total assets. It is an indicator of financial strength of the bank. It provides information about the solvency and the ability of the firm to obtain additional financing for potentially attractive investment opportunities. Higher DTAR means bank has financed most of its assets through debt as compared to the equity financing. Moreover, higher DTAR indicates that bank is involved in more risky business. DTAR is calculated as under:

DTAR = Total Debt / Total Assets

iii. Equity Multiplier (EM)

How many times the total assets are of the shareholders' equity is measure by equity multiplier. In other words, it indicates the amount of assets per dollar of shareholders' equity. Higher value of EM means that bank has used more debt to convert into assets with share capital. Generally, the higher is the EM the greater is the risk for a bank. EM is calculated as under:

EM =Total Asset / Total Shareholders' Equity

iv. Non- Performing Loans to Total Loan Ratio (NPTL)

Nonperforming loans, or NPL, are loans that are no longer producing income for the bank that owns them. Loans become nonperforming when borrowers stop making payments and the loans enter default. The exact classification can vary from institution to institution, but a loan is usually considered to be nonperforming after it has been in default for three consecutive months.

Banks often report their ratio of nonperforming loans to total loans as a measure of the quality of their outstanding loans. A smaller NPL ratio indicates smaller losses for the bank, while a larger (or increasing) NPL ratio can mean larger losses for the bank as it writes off bad loans. NPTL is calculated as under:

NPTL = Non-performing Loans/Total Loans

2.1.7.5.4 EFFICIENCY RATIOS

The presence of inefficiencies is considered an inherent feature of banking. According to Turati (2003:2), "banks are regarded as firms that emerge as a result of some sort of market imperfections; hence they bring about a certain degree of inefficiency with respect to perfect competitive outcome". Banking efficiency is important at both macro and micro levels and in order to allocate resources effectively, banks should be sound and efficient Hussein (2000).

Efficiency in banking can be distinguished between allocative and technical efficiency. Allocative efficiency is the extent to which resources are being allocated to the use with the highest expected value. A firm is technically efficient if it produces a given set of outputs using the smallest possible amount of inputs (Falkena et al, 2004). Outputs could be loans or total balance of deposits, while inputs include labour, capital and other operating costs. A firm is also said to be cost efficient if it is both allocatively and technically efficient (Mester, 1997). Studies on X-inefficiency, which is a measure of the loss of allocative and technical efficiency, has been carried out particularly internationally. The results showed that X-inefficiency is between 20-30 % of total banking costs in the US (Berger & Mester, 1997). According to Falkena et al (2004:38), "the notion of X-inefficiency suggests that comfortable incumbents may not produce in the most efficient method. If a few players dominate the market, they may be sheltered from competitive forces and may use rule-of-thumb rather than best practice methods".

These ratios measure how effectively and efficiently the firm is managing and controlling its assets. These ratios indicate the overall effectiveness of the firm in utilizing its assets to generate sales, quality of receivables and how successful the firm is in its collections, the promptness of payment to suppliers by the firm, effectiveness of the inventory management practices, and efficiency of firm in controlling its expenses. Higher value of these ratios is taken as good indicator, which means firm is doing well.

Ratios used to measure efficiency of the bank are Asset Utilization (AU), Income to Expense Ratio (IER), and Operating efficiency (OE) (Hasan, Z. (2005).

(a) Asset Utilization (AU)

How effectively the bank is utilizing all of its assets is measured by assets utilization ratio. The bank is presumably said to using its assets effectively in generating total revenues if the AU ratio is high. If the ratio of AU is low, the bank is not using its assets to their capacity and should either increase total revenues or dispose of some of the assets (Ross, Westerfield, and Jaffe 2005). Total revenue of the bank is defined as net spread before provision plus all other income. AU is calculated as under:

AU = Total Revenue / Total Asset

(b) Income Expense Ratio (IER)

Income to expense is the ratio that measures amount of income earned per dollar of operating expense. This is the most commonly and widely used ratio in the banking sector to assess the managerial efficiency in generating total income vis-à-vis controlling its operating expenses (Samad & Hassan 2000). High IER is preferred over lower one as this indicates the ability and efficiency of the bank in generating more total income in comparison to its total operating expenses. Total income in the study is defined as net spread earned before provisions plus all other income while the Other Expenses in the income statement are treated as total operating expense for the study. IER is calculated as under

IER = Total income / Total Operating Expenses

(c) Operating Efficiency (OE)

Unlike IER, which measures the amount of income earned per dollar of operating expense, OE is the ratio that measures the amount of operating expense per dollar of operating revenue. It measures managerial efficiency in generating operating revenues and controlling its operating expenses. In other words, how efficient is the bank in its operations (Ross, Wedsterfield, and Jaffe 2005). Lower OE is preferred over higher OE as lower OE indicates that operating expenses are lower than operating revenues. Operating revenue is defined as net spread earned before provisions plus fee, brokerage, commission, and for ex income. Other expenses is defined same as we defined in the previous ratio. OE is calculated as under:

OE=Total Operating Expenses / Total Operating Revenue

2.1.8. Limitations of Using Financial Ratios

Financial ratios have certain limitations in their use and are not meant to be applied as definitive answers. They are usually used to provide additional details in the determination of the results of financial and managerial decisions. They can provide clues to the company's performance or financial situation.

However, on their own, they cannot explain whether performance is good or bad. As for the external financial analysis, ratios also play a role of basic indicators, showing just an overview of studying business entity. Ratios have to be interpreted carefully. Some of the limitations about using ratios in financial analysis are (Girmachew 2010):

- Ratios with large deviations from the norm only indicate symptoms of a problem. It is essential always to carry out additional analysis based on internal data to isolate the causes of the problem. Ratio analysis just directs attention to potential weak spots. It does not provide conclusive evidence and only shows the existence of a problem;

- There is considerable subjectivity involved, as there is no "correct" number for the various ratios. Further, it is hard to reach a definite conclusion when some of the ratios are favorable and some are unfavorable;

- Ratios may not be strictly comparable for different firms due to a variety of factors such as different accounting practices or different fiscal year periods. Furthermore, if a firm is engaged in diverse product lines, it may be difficult to identify the industry category to which the firm belongs. Also, just because a specific ratio is better than the average does not necessarily mean that the company is doing well; it is quite possible rest of the industry is doing very poorly;

- Ratios are based on financial statements that reflect the past and not the future. Unless the ratios are stable, it may be difficult to make reasonable projections about future trends. Furthermore, financial statements such as the balance sheet indicate the picture at "one point" in time, and thus may not be representative of longer periods;

- Financial statements provide an assessment of the costs and not value. For example, fixed assets are usually shown on the balance sheet as the cost of the assets less their accumulated depreciation, which may not reflect the actual current market value of those assets;

- Financial statements do not include all items. For example, it is hard to put a value on human capital (such as management expertise). And recent accounting scandals have brought light to the extent of financing that may occur off the balance sheet;

- Results can be distorted by inflation, which can cause the book values of inventory and depreciable assets to differ greatly from their true (replacement)

values. Additionally, inventory costs and depreciation write-offs can differ from their true values, thereby distorting profits. Without adjustment, inflation tends to cause older firms (older assets) to appear more efficient and profitable than newer firms (newer assets);

- Difficulty to decide the proper basis of comparison. The problem of standards of comparison is usually an important case. It is also impossible to compile an industry wide averages or ratios that serve as a useful standard to measure all firms;

- The standard of comparison do not consider the different technological, social, market, etc. , conditions of a company;

2.1. Review of Empirical Studies

Below are a summary of previous Empirical studies on financial performance analysis in the context of different countries.

Hempel and Simonpson (1998) have made a study on bank's financial performance and managerial efficiency in Taiwan. The study found that the higher the ROA, the higher is the financial performance or profitability of the banks.

Samad and Hassan (2000) evaluate Inter-temporal and Interbank Performance in profitability, liquidity, risk and solvency, and community involvement of an Islamic bank (Bank Islamic Malaysia Berhad (BIMB) over 14years for the period 1984-1997. The study is inter-temporal in that it compares the performance of BIMB between the two-time period 1984-1989 and 1990-1997. To evaluate interbank performance, the study compares BIMB with two conventional banks (one smaller and one larger than BIMB) as well as with eight conventional banks. Using financial ratios to measure these performance and F-test and T-test to determine their significance, the results show that

BIMB make statistically significance improvement in profitability during 1984-1997, however, this improvement when compared with conventional banks is lagging behind due to several reasons. The study reveals that BIMB is relatively less risky and more solvent as compared to conventional banks. These results also conform to risk-return profile that is BIMB is comparatively less profitable and less risky. Performance evaluation of BIMB indicates that it is more liquid as compared to the group of eight conventional banks.

Abdus Samad (2004) in his paper examines the comparative performance of Bahrain's interest-free Islamic banks and the interest-based conventional commercial banks during the post Gulf War period 1991-2001. Using nine financial ratios in measuring the performances with respect to (a) profitability, (b) liquidity risk, and (c) credit risk, and applying Student's t-test to these financial ratios, the paper concludes that there exists a significant difference in credit performance between the two sets of banks. However, the study finds no major difference in profitability and liquidity performances between Islamic banks and conventional banks.

Ahmad and Hassan (2007) analyzed the asset quality, capital ratios, operational ratios such as net profit margin, net interest income, income to asset ratio, non-interest income to asset ratio and liquidity ratios for seven years from 1994 to 2001. Islamic banks on an average were the preeminent performer in terms of lowest non-performing to gross loan ratio, capital funds to total asset ratio, capital funds to net loans ratio, capital funds to short-term loan ratio, capital funds to liabilities ratio, non-interest expense to average asset ratio and most of the liquidity ratios. Therefore, it can be concluded that Islamic banks are outperforming others in capital adequacy and adequate liquidity. Except Return on Equity Ratio, Islamic Banks were at par with the industry in all other cases.

Saleh and Rami (2006) in order to evaluate the Islamic banks' performance in Jordon examine and analyze the experience with Islamic banking for the first and second Islamic bank, Jordan Islamic Bank for Finance and Investment (JIBFI), and Islamic International Arab Bank (IIAB) in Jordon. The study also highlights the domestic as well as global challenges being faced by this sector. Conducting profit maximization, capital structure, and liquidity tests as performance evaluation methodology, the paper finds several interesting results. First, the efficiency and ability of both banks have increased and both banks have expanded their investment and activities. Second, both banks have played an important role in financing projects in Jordan. Third, these banks have focused on the short-term investment. Fourth, Bank for Finance and Investment (JIBFI) is found to have high profitability. Finally, the study concludes that Islamic banks have high growth in the credit facilities and in profitability.

CHAPTER III
ORGANIZATIONAL PROFILE

In this part of the paper, an attempt is made to give a highlight on banking industry at national level in general and AIB in particular. A brief coverage is given on its establishment, vision, mission and objectives, ownership and governance, and its achievements over the decade.

3.1 Industry Overview

3.1.1 The Birth and Development of Banking Services in Ethiopia

It was in 1950 that the first bank, the Bank of Abyssinia was established based on the agreement signed between the Ethiopian Government and the National Bank of Egypt, which was owned by the British. Its capital was 1 million shillings. According to the agreement, the Bank was allowed to engage in commercial banking (selling shares, accepting deposits and effecting payments in cheques) and to issue currency notes. The agreement prevented the establishment of any other bank in Ethiopia, thus giving monopoly right to the Bank of Abyssinia. The Bank, which started operation a year after its establishment agreement was signed, opened branches in Harar, Dire Dawa, Gore and Dembi-Dolo as well as an agency office in Gambela and a transit office in Djibouti. Apart from serving foreigners residing in Ethiopia, and holding government accounts, it could not attract deposits from Ethiopian nationals who were not familiar with banking services.

The Ethiopian Government, under Emperor Haile Sellassie, closed the Bank of Abyssinia, paid compensation to its share holders and established the Bank of Ethiopia which was fully owned by Ethiopians, with a capital of Pound Sterling 750,000. The Bank started operation in 1932. The majority shareholders of the Bank of Ethiopia ware

the emperor and the political elites of the time. The bank was authorized to combine the functions of central banking (issuing currency notes and coins) and commercial banking. The bank of Ethiopia opened branches in Dire Dawa, Gore, Dessie, Debre Tabor, and Harrar.

With the Italian occupation (1936-1941), the operation of the Bank of Ethiopia came to a halt, but a number of Italian financial institutions were working in the country. These were Banco Diroma, Banco Di Napoli and Banca Nazionale del Lavoro. It should also be mentioned that Barclays Bank had opened a branch and operated in Ethiopia during 1942-1943.

In 1943, Banque Del Indochine was opened and functional until 1963. In 1945, the Agricultural Bank was established but was replaced by the Development Bank of Ethiopia in 1951, which changed into the Agricultural and Industrial Development Bank in 1970. In 1963, the Imperial savings and Home ownership public Association (ISHOPA) and the Investment Bank of Ethiopia were founded. The later was renamed Ethiopian Development Corporation S.C. was also founded.

With the departure of the Italians and the restoration of Emperor Haile Selassie's government, the state Bank of Ethiopia was established in 1943 with a capital of 1 million Maria Theresa Dollars by a charter published as General Notice No. 18/1936 (EC). The bank, which like its predecessor, combined the functions of central banking with those of commercial banking, opened 21 branches, including one in Khartoum (the Sudan) and a transit office in Djibouti.

In 1963, the state Bank of Ethiopia split into the National Bank of Ethiopia and the Commercial Bank of Ethiopia S.C. with the purpose of segregating the functions of central banking from those of commercial banking. The new banks started operation in 1964.

The first privately owned company in banking business was the Addis Ababa Bank S.C. established in 1964. 51% of the shares of the bank were owned by Ethiopian

shareholders, 9% by foreigners living in Ethiopia and 40% by the National and Grindlays Bank of London. The Bank carried out typical commercial banking business. Banco Di Roma and Banco Di Napoli also continued to operate.

Thus, up until the end of 1974, there were state owned, foreign owned and Ethiopian owned banks in Ethiopia. The banks were established for different purposes: central banking, commercial banking, development banking, and investment banking. Such diversification of functions, lack of widespread banking habit among the wider population, the uneven, and thinly spread branch network, and the asymmetrical capacity of banks, made the issue of competition among banks almost irrelevant.

3.1.2 Banking Services during the Dergue Period

On January 1, 1975, all private banks were nationalized and, along with state owned banks, placed under the coordination, supervision and control of the National Bank of Ethiopia. The three private banks, Banco Di Roma, Banco Di Napoli and the Addis Ababa Bank S.C. were merged to form "Addis Bank." Eventually in 1980, this bank was itself merged with the Commercial Bank of Ethiopia S.C. to form the "Commercial Bank of Ethiopia," there by creating a monopoly of commercial banking services in Ethiopia.

In 1976, the Ethiopian Investment and savings S.C. was merged with the Ethiopian Government Saving and Mortgage Company to form the Housing and Savings Bank. The Agricultural and Industrial Development Bank continued under the same name until 1994 when it was renamed Development Bank of Ethiopia.

Thus, from 1975 to 1994 there were four state owned banks i.e., the National Bank of Ethiopia (the central bank), the Commercial Bank of Ethiopia, the Housing and Savings Bank, and the Development Bank of Ethiopia.

3.1.3 Banking Services: Post-Dergue Period

After the overthrow of the Dregue regime by the EPRDF, the Transitional Government of Ethiopia was established and the New Economic Policy for the period of transition was issued. This new economic policy replaced centrally planned economic system with a market-oriented system and ushered in the private sector. Several private companies were formed during the early 1990s one of which is Oda S.C., which conceived the idea of establishing a private bank and a private insurance company in anticipation of a law, which will open up the financial sector to private investors.

3.2 The Establishment Process of AIB

3.2.1 The Role of Oda S.C.

Oda share company is the first broad based shareholding business entity established in March 1992, immediately after the market led economic policy was pronounced by the then Transitional Government of Ethiopia (TGE). It was, however, only possible for the company's Board of Directors to assign a management body for the company in the beginning of August 1992.

The immediate task of the newly assigned management of the company was to prepare its first business plan, which was promptly completed and submitted to the Chairman of the Board of Directors, Ato Hambissay Wakwoya, for presentation to, and deliberation by, the Board. The business plan included budgetary allocation for feasibility studies of ten investment projects, among which, plans for the establishment of a private bank and an insurance company were include.

Consistent with its approved first business plan, Oda Share Company selected and hired consulting professionals who undertook and finalized the feasibility studies for the two proposed projects of banking and insurance. The Board of Directors of Oda share company, on its regular meeting of February 1993, approved the feasibility studies of

the projects and instructed the management of the company to launch the implementation and commence organizing potential investors for equity participation in the envisaged financial entities.

The Banking proclamations emerged much later on January 31, 1994. The absence of enabling proclamations on the one hand and lack of practical experience and exposure in banking and insurance on the part of Oda's Directors and managers on the other hand, made the launching efforts appear much less credible. In order to overcome such obvious shortcomings, Oda share company persistently decided to go forward with the projects by drawing together people of very high public relations profile, highly qualified bankers, insurance professionals, businessmen, etc. from different sectors and disciplines to form the organizing committee

3.2.2 Organizing/Founders Committee

It was at this juncture that Lt. Girma Wolde-Giorgis (currently the President of the Federal Democratic Republic of Ethiopia) was requested by the originators of the projects, Ato Debela Gutema and Ato Hambisa Wakwoya, to chair the organizing committee and the subsequently restructured founders' committee. Lt. Girma Wolde-Giorgis accepted the proposed responsibility happily and successfully led the formation activities in that capacity up until December 1993. he relinquished his chairmanship in favor of the career finance professional, Ato Bulcha Demeksa who newly joined the founders' committee and led it until he was finally elected chairman of the Board of Directors of Awash International Bank S.C. on august 20,1994.

The Founders' Committee, under the chairmanship of Ato Bulcha Demeksa, was meeting regularly every week to finalize the establishment process of the institutions. Ato Bulcha continued to serve as Chairman of the Board of Directors of AIB until 2004.

Up to these specific times of phenomenal events, Oda Share Company made immeasurable and decisive contributions to bring the financial institution to life. Apart

from originating the idea of the projects, launching the feasibility studies, constituting the organizing and founding committees, the company exerted relentless efforts in conducting presentations at many places in and outside Addis Ababa and, above all, in providing multi-faceted services as a founding secretariat for the projects. It expended Birr 350,446.68 of its own funds (later refunded) in order to finance the expenses required darning the formation processes of the Awash International Bank S.C. One can imagine the financial loss Oda Share Company could have incurred had the formation processes failed to materialize.

Awash International Bank S.C. pays their heartfelt tribute to Oda S.C. for its initiative and contribution in the establishment process of this financial institution.

3.2.3 Legal Foundations of AIB

The Transitional Government of Ethiopia, promulgated the following proclamations pertaining to the finance sector in early 1994:

- The "Monetary and Banking Proclamation No. 83/1994", which became effective from January 30, 1994, empowering the National Bank of Ethiopia to license and supervise banks, insurers and other financial institutions;
- The "Licensing and Supervision of Banking Business Proclamation No. 84/1994", which came into force as of January 31, 1994, the proclamation set the requirements for the licensing and supervision of banks;
- These proclamations and other relevant laws, such as the commercial code of Ethiopia 1960, constituted the legal foundation on which the establishments of all banks, including state-owned ones, are based. The National Bank of Ethiopia regulates based on these laws and the directive it issues.

3.2.4 Raising the Capital

Raising the minimum capital required by the law for establishing a bank (Birr 10 million) was one of the toughest challenges faced by the formation committees.

Raising the required capital involved conducting several meetings with potential investors and knocking at several doors. Finally, paid-up capital of Birr 23,123,917 was raised by 486 founding shareholders to establish the bank. Over the past years AIB's paid up capital reached Birr 135.7 millions.

3.2.5 Choosing the Name

In retrospect, choosing the names of the bank was not easy. Several names were tabled and considered; names which all appeared to sum up the vision of the founder shareholders for the bank. Finally, the name "Awash" won the competition. The bank was named after the famous Awash River. The Awash River starts its long journey in the plateau of central Ethiopia and gently flows downstream through the rift valley, generating electric power, irrigating large commercial farms, quenching the thirst of millions of people and animals along its banks, thus providing an invaluable economic lifeline for the country. The symbolic name of "Awash" for the companies that the shareholders selected reflects the aspiration o the founders' of the bank that these institution serve as economic lifeline of the nation.

That is the lofty idea of the founding shareholders of the bank: to make Awash International Bank S.C. the most useful bank to Ethiopia.

3.2.6 Launching AIB

The first meeting of the founding shareholders of the Awash International Bank S.C. was held at the Ethiopian Roads Authority Hall on August 20, 1994, where a twelve member Board of Directors was elected to steer AIB towards the achievement of its

goals. AIB obtained its license from the National Bank of Ethiopia on November 10, 1994 and started operation on February 13, 1995 at its Bole Main Branch, Genete Limat Building.

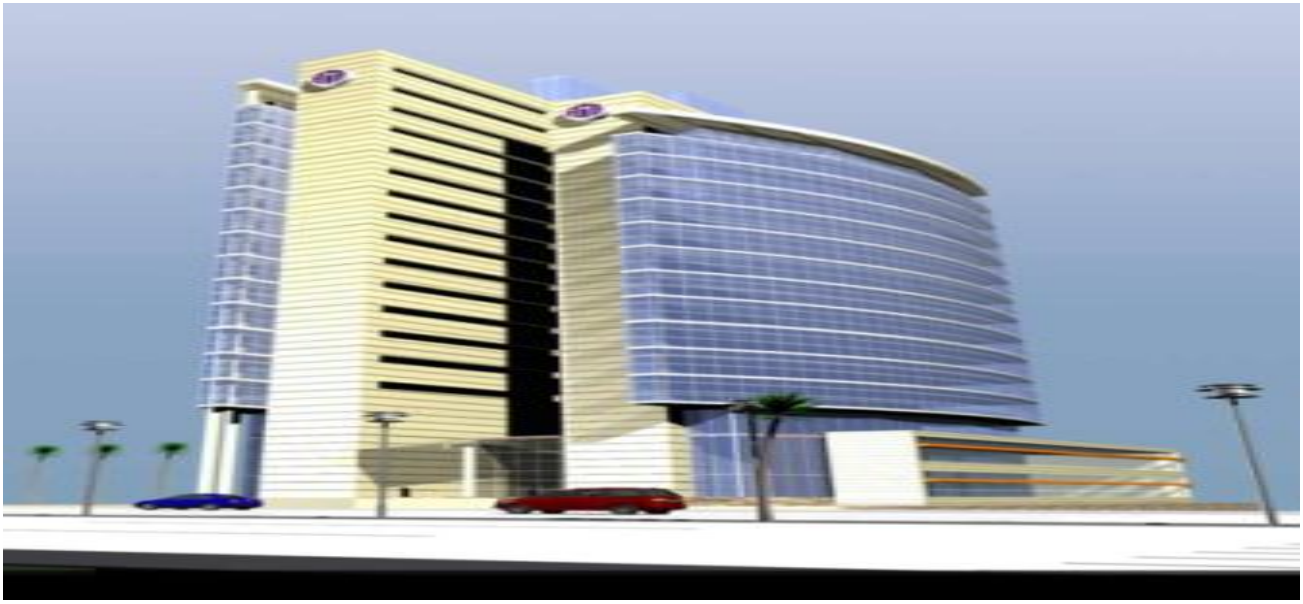


Figure3.1. the Future AIB/AIC Headquarters building, currently under construction

3.2.7 Vision, Mission, value statement, & Objectives of AIB

The vision, mission, and value statement of the bank as discussed and approved by the Board of Directors includes the following:

- **AIB'S Vision**: "To be the most preferred Bank of the people"
- **AIB'S Mission**: "To provide efficient, competitive, diversified and profitable banking services to a continuously growing number of customers in a socially responsible manner supported by Appropriate modern banking technology as well as qualified , trained and motivated team of management and employees imbued with high professional and ethical standards"

Objectives

- ✓ To meet the needs of the emerging private sector for quality and dependable domestic and international banking services
- ✓ To expand and diversify commercial banking services tailored to the growing needs of customers
- ✓ To operate profitably and generate attractive return on equity
- ✓ To contribute towards the economic and social development of Ethiopia and its people

Table1: The core Values of Awash International Bank (AIB) and actions recommended as per the value

No	**AIB's Core Values**	**Actions Recommended as per value**
1	Public trust and confidence are the very foundations of our banking business	AIB always ensures high integrity and honesty of its management and staff and keeps on boosting its image
2	We believe in growing together with our customers	AIB does its best to let its customers succeed in their Businesses
3	Our customers are our guests of honor	AIB does its best to satisfy the needs of its customers
4	Competent leadership with the right vision and competent employees imbued with strong team sprit are the driving forces of our bank's continued growth	AIB adopts continued management and staff development programs both on the job and off the job

5	Our bank realizes its social responsibility towards the society in which it operate	AIB supports environment-friendly projects , social problem alleviating projects, various sport activities, emergency needs of the society and similar other activities
6	Our desire is to build a strong and healthy bank of which the current and future generations will be proud of	AIB keeps on increasing its capital base, building its asset size, maintaining healthy loan portfolio, expanding its branch net work and modernizing its systems of operation

Source: The vision and mission statement of Awash International Bank (AIB)

3.2.8 Major activities of Awash International Bank (AIB)

The major activities of the Awash International Bank are described as follows:

1. Mobilize all types of deposits (savings, demand and time) and pay interest on interest bearing accounts
2. Provide loans and advances to its customers , including long term investment / project financing,
3. Provide domestic and international monetary transfer service,
4. Provide international banking services such as imports and export operations;
5. Handle foreign currency transactions, namely- buying and selling travelers' cheques, buying and selling foreign currency notes;
6. Maintain and operate non-resident birr and foreign currency accounts service;
7. Provide deposit services in foreign currency for Ethiopian Nationals and foreign Nationals of Ethiopian origin,
8. Handle money transfers sent through Money Gram International Money Transfer Service And International Business Group
9. Provide advice on banking, finance, and investment to its customers.

3.2.9 Company Management System

Management means the administration and the governing body that is concerning the whole organization. All the decision and strategies are been proposed and evaluated the management of the organization. Awash International Bank S.C., being an incorporated entity per dictates' of the Ethiopian Commercial Code, the Ethiopian Banking Law and its business mandate. The management is purposefully separated from the ownership as dictated by the country's commercial code and customary practice. Basically, AIB is organized in three tier structure comprising of the Shareholders' General Assembly (Supreme Authority), the Board of Directors and the Executive Management that is fully empowered to run the day-to-day operations of the Bank.

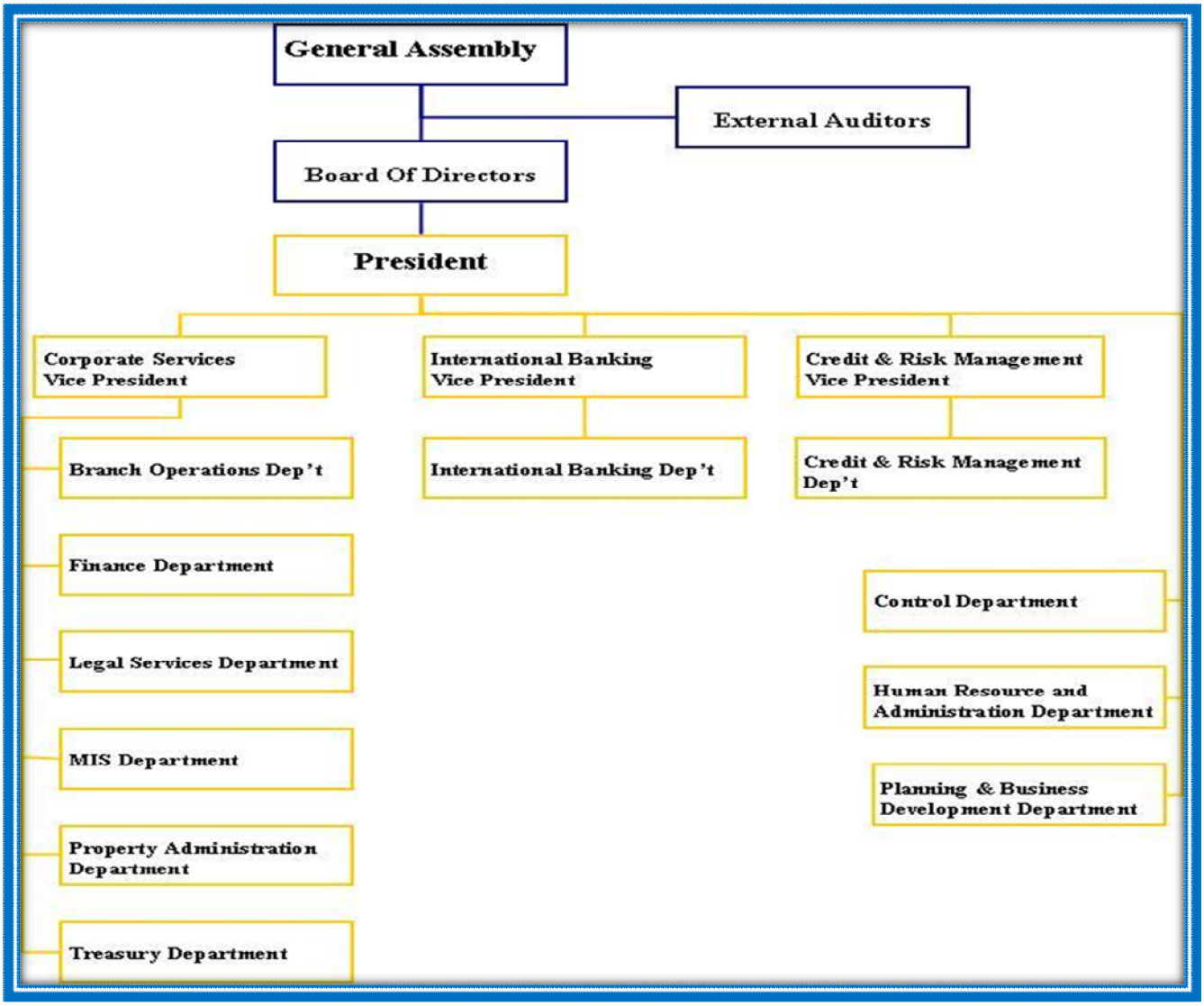
3.2.9.1 The General Assembly (Shareholders' Meeting)

Awash International Bank (AIB) is a share company established in 1994 by 463 shareholders with an initial capital of over Birr 24 million. Currently the number of shareholders has risen significantly to reach over 2700 with a subscribed capital of Birr 550,000 million and paid up capital of Birr 442 million. The Bank's supreme authority, according to the article of association, is the Shareholder's General Assembly, which convenes at least once annually. The General Assembly elects Board of Directors to oversee the operation of the Bank, which is run by the Executive management.

3.2.9.2 External Auditors

The General Assembly, in addition to electing the Board of Directors, assigns an external auditor to independently audit the Bank's operation as stipulated in the country's commercial code. Currently, A. A. Bromhead & Co. is AIB's auditor.

3.2.9.3 The Functional Organizational Structure of AIB



Source: AIB brochure

3.2.9.4 The Board of Directors

The twelve members Board of Directors, according to the article of association, serves for three-year term. Every shareholder, regardless of the amount of shares he/she owns is eligible to vote and be elected to the board since AIB's shares are unclassified. AIB's

current Board of Directors, which comprises of eleven members, is chaired by Ato Bekele Nedi.

3.2.9.5 The Executive Management

AIB's executive branch is responsible for the management of day to day operations. According to the current structure, it comprises of the CEO (The President), three Vice presidents and eleven departments as well as numerous other divisions and sections, each with distinct duties and responsibilities. As depicted in the organizational structure (above) the majority of the departments are organized under the three vice presidents while three of them report to The President. The functional structure of the executive branch is subject to change any time to meet the requirements of the time.

3.2.9.6 Achievements of AIB over the Decade

AIB's decade of service to the nation has been full of success stories in all spheres of the Bank's operation. The Bank maintained a track record of growing profitability throughout the decade with an average earnings per share of Birr 208 over the decade. The number of the Bank's shareholders reached over 2200 and it's paid up capital rose almost to Birr 136 million. The bank's total assets reached Birr 2.4 billion by the end of the decade. The bank created over 1100 new jobs and paid Birr 55.6 million in the form of profit tax alone to the Government Treasury.

During the decade, AIB introduced state-of-the art banking technology in order to link all of its branches on-line and provide efficient banking services to its customers. It has also acquired branch buildings in Jimma and Nekemte and plots of land in Addis Ababa and Shashamane as a move towards owning its own branch buildings in due course. It has also acquired a plot of land in the heart of Addis Ababa together with Awash Insurance Company to build their headquarters.

CHAPTER IV
DISCUSSIONS AND ANALYSIS

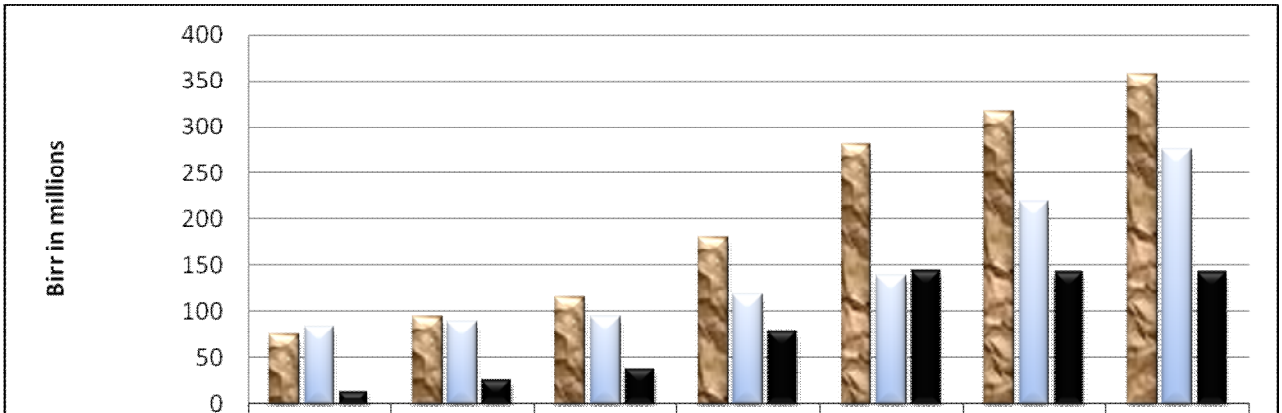
In this part of the paper, detail discussions and analysis of the study findings are presented. The financial performance evaluation obtained by thoroughly analyzing the company's financial statements. Each financial performance indicator (financial ratio) is presented independently in a graph or a table. The analysis is presented in the following sequence; first the Financial Highlights of the company's followed by the ratios analysis.

4.1 Financial Highlights

4.1.1 Total Income, Total Expenses, and Net Profit

During the seven years (2003-2009) of the study, the total growth of total income, total expenses and net profit of AIB were on average 198.78 percent, 87.35 percent, and 521.47 percent respectively (see appendix table 1). In appendix table 2, total income ranges from Birr 75 millions to Birr 357 millions maintaining Birr 202.79 millions on an average with a standard deviation of Birr 115.05 million per year. Total expenses ranges from Birr 26 to Birr 120 millions maintaining Birr 60.86 millions on an average with a standard deviation of Birr 37.84 million per year. Moreover, net profit ranges from Birr 14 to Birr 143.5 millions maintaining Birr 83.62 millions on an average with a standard deviation of Birr 59.01 million per year. Figure 4.1 shows a bar diagram of total income, total expenses, and net profit for seven years.

Figure 4. 1**: Bar Diagram of Total Income, Total Expenses, and Net Profit.**



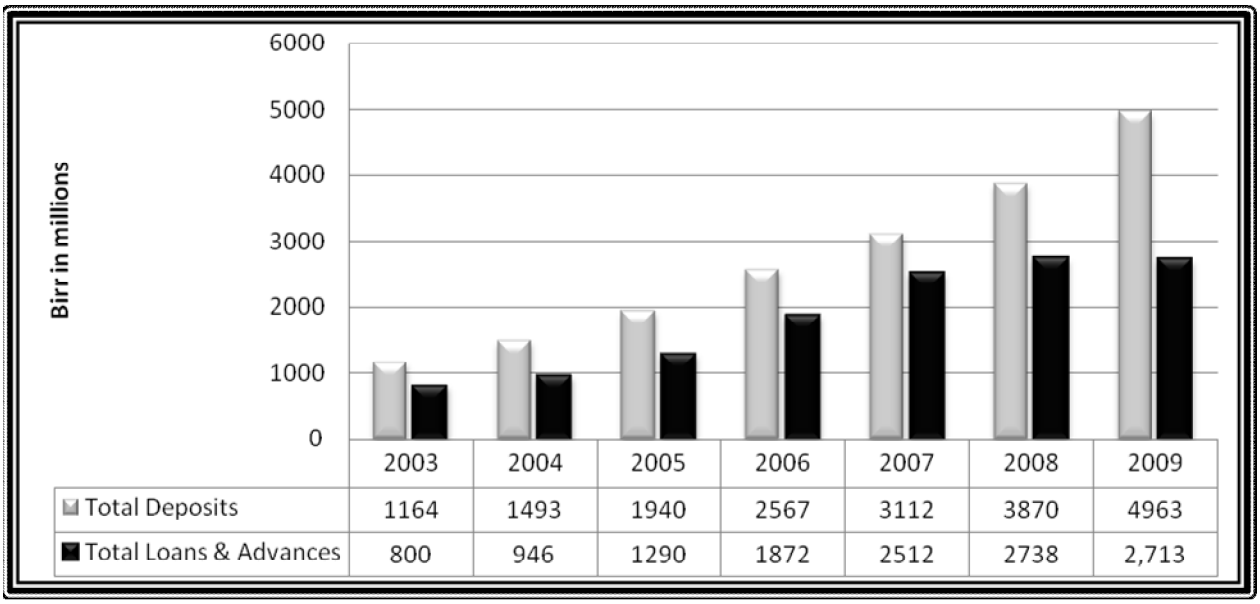
	2003	2004	2005	2006	2007	2008	2009
Total Income	75	94	115	180	281.5	317	357
Total Expenses	83	89	94	117	139	219	275
Net Profit	14	26	38	78	143.5	142.8	143

Source: researcher's own computation from financial statements

4.1.2 Total Deposits and Total Loans & Advances

During the seven years of study, the total growth of total deposits and total loans & advances of AIB were on average 154.50 percent and 151.48 percent respectively (see appendix table 1). In appendix table 2, total deposits ranges from Birr 1164 to Birr 4963 millions maintaining Birr 2729.86 millions on an average with a standard deviation of Birr 1358 million per year. Total loans & advances ranges from Birr 756 to Birr 2611 millions maintaining Birr 1742.43 millions on an average with a standard deviation of Birr 804.11 million per year. Figure 4.2 shows a bar diagram of total deposits and total Loans & advances for seven years.

Figure 4. 2: Bar Diagram of Total Deposit and Total Loans & Advance.



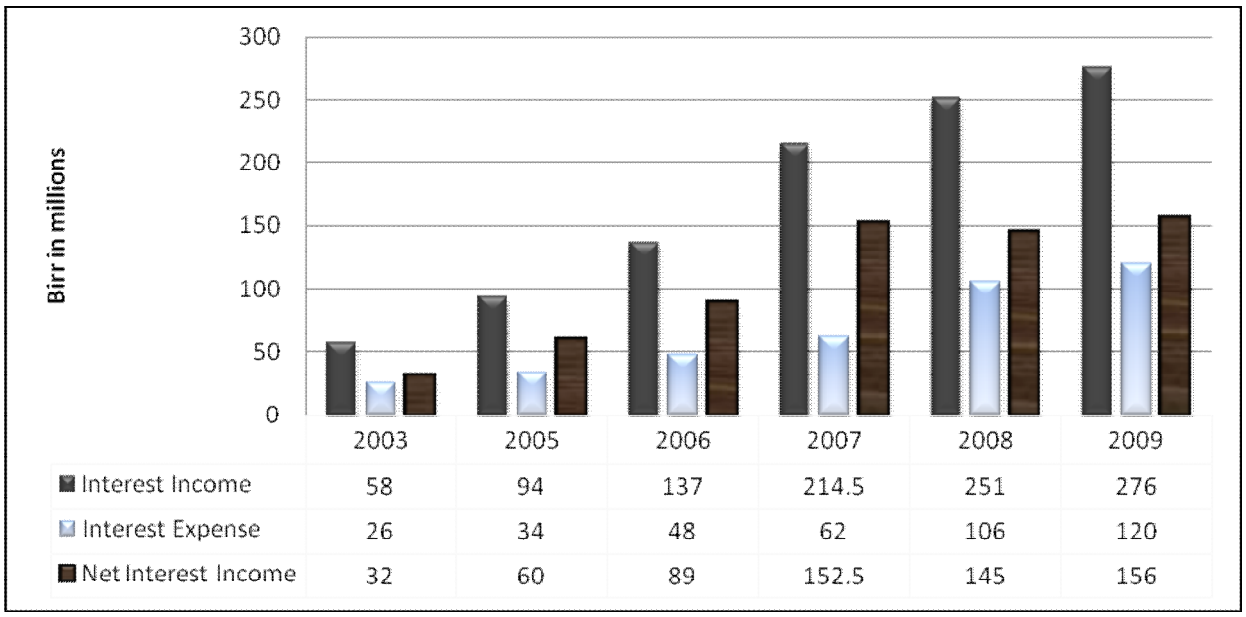
	2003	2004	2005	2006	2007	2008	2009
Total Deposits	1164	1493	1940	2567	3112	3870	4963
Total Loans & Advances	800	946	1290	1872	2512	2738	2,713

Source: researcher's own computation from financial statements

4.1.3 Interest Income, Interest Expense, and Net Interest Income

During the seven years of study, the total growth of interest income, interest expense and net interest income of AIB were on average 198.99 percent, 155.73 percent and 211.96 percent respectively (see appendix table 1). In appendix table 2, interest income ranges from Birr 58 to Birr 276 millions maintaining Birr 156.93 millions on an average with a standard deviation of Birr 89.81 million per year. Interest expense ranges from Birr 26 to Birr 120 millions maintaining Birr 60.86 millions on an average with a standard deviation of Birr 37.84 million per year. Net interest income ranges from Birr 32 to Birr 156 millions maintaining Birr 96.07 millions on an average with a standard deviation of Birr 54.77 million per year. Figure 4.3 shows a bar diagram of interest income, interest expenses and net interest income for seven years.

Figure 4.3: Bar Diagram of Interest Income, Interest Expense, and Net Interest Income.



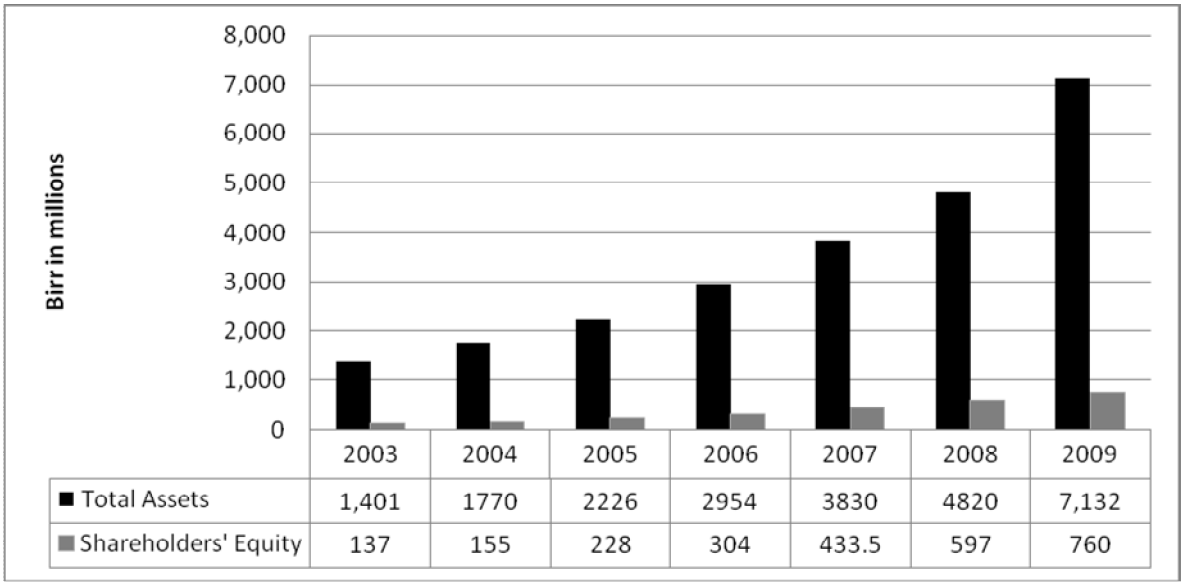
	2003	2005	2006	2007	2008	2009
Interest Income	58	94	137	214.5	251	276
Interest Expense	26	34	48	62	106	120
Net Interest Income	32	60	89	152.5	145	156

Source: researcher's own computation from financial statements

4.1.4 Total Assets and Shareholders' Equity

During the seven years of study the total growth of total assets and shareholders' equity of AIB were on average 170.43 percent, and 33.53 percent respectively (see appendix table 1). In appendix table 2, total assets ranges from Birr 1401 to Birr 7132 millions maintaining Birr 3447.57 millions on an average with a standard deviation of Birr 2014.26 million per year. Shareholders' equity ranges from Birr 137 to Birr 760 millions maintaining Birr 373.5 millions on an average with a standard deviation of Birr 235.45 million per year. Figure 4.4 shows a bar diagram of total assets and shareholders' equity for seven years

Figure 4.3: Bar Diagram of Total Assets and Shareholders' Equity



	2003	2004	2005	2006	2007	2008	2009
Total Assets	1,401	1770	2226	2954	3830	4820	7,132
Shareholders' Equity	137	155	228	304	433.5	597	760

Source: researcher's own computation from financial statements

4.2 Ratio Analysis

As it was already mentioned, a bank's balance sheet and income statement are valuable information sources to evaluate financial strengths and weaknesses of a bank and its business trends. Although the birr amounts found on these statements provide valuable insights into the financial performance and condition of the bank, the researcher typically use data from them to develop financial ratios to evaluate the bank financial performance. In all of the remainder of this chapter, the researcher undertakes key ratios commonly used by bank analysts to evaluate different dimensions of financial performance of Awash International Bank S.C., including liquidity, profitability, efficiency, and credit risk & solvency in comparison with the industry average over seven years. Since there are twelve commercial banks started operation until 2009, so the researcher first calculated, ratios from consolidated financial statements to compute industry average and then compare this ratios with ratio of Awash International Bank in each year.

4.2.1 Liquidity Ratios

The liquidity ratios measure the capability of bank to meet its short-term obligations. Generally, the higher value of this ratio indicates that firm has larger margin safety to cover its short-term obligations. Among the various liquidity measures, the study uses the following three liquidity ratios.

4.2.1.1 Loan to Deposit Ratio

Loan to deposit ratio indicates the percentage of the total deposit locked into non-liquid asset. A higher loan deposit ratio indicates that a bank takes more financial stress by making excessive loan. Therefore, lower loan deposit ratio is always favorable to higher loan deposit ratio. This low value of loan deposit ratio also indicates effectiveness of mediation function of bank.

Table 4.1: Loan to Deposit Ratio (LDR)

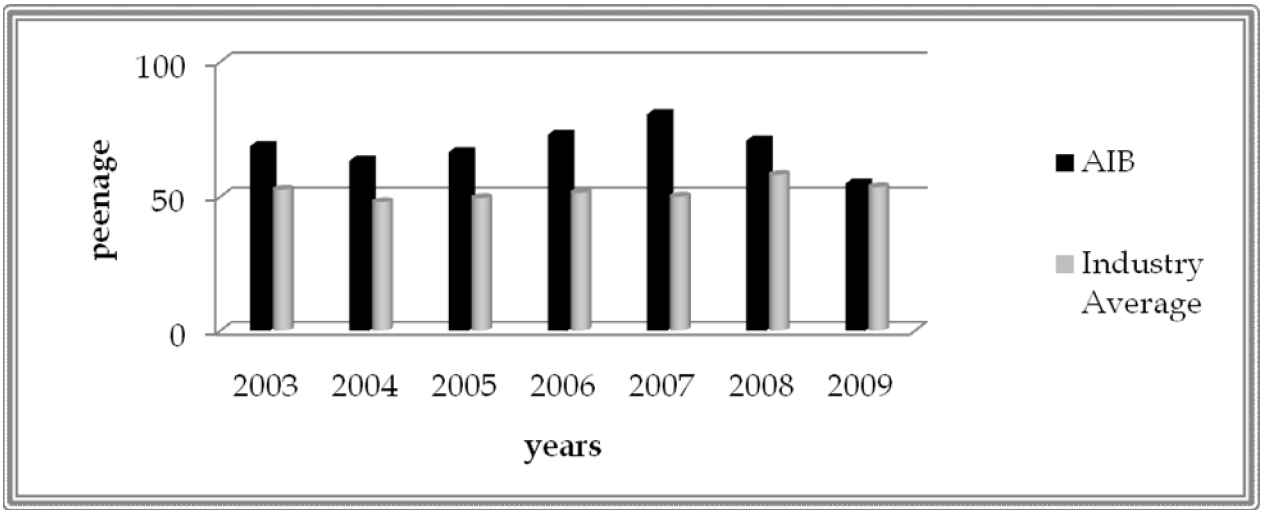
	2003	2004	2005	2006	2007	2008	2009	Mean
AIB	68.73%	63.36%	66.49%	72.93%	80.72%	70.75%	54.66%	68.23%
Industry Average	52.47%	47.91%	49.43%	51.31%	49.92%	57.81%	53.38%	51.75%

Source: researcher's own computation from financial statements

High loan to deposit ratio for AIB compared with industry average during 2003-2009 indicates that AIB has been comparatively less liquid (see table 4.1 and Fig.4.5). LDR of AIB decreased from 68.73%in 2003 to 54.66% in 2009. This overall declining trend in LDR of AIB indicates the tendency of comparatively more increase in deposits than loans and further emphasizes improved liquidity position of AIB. Alternatively, LDR of

AIB decreased from 80.72% in 2007 to 54.66% in 2009 as a consequence of the National Bank of Ethiopia set a maximum outstanding loan limit to all banks in the country to control inflation (see appendix 4). Moreover, this reveals that the bank may not be earning as much as they could be. Compared with industry average, LDR of AIB has been reasonably higher in which LDR of industry average floating between approximately 52.47% and 53.38 %. The Mean LDR of AIB 68.23% is higher than Mean LDR of industry average 51.75%. Hence, considering the last seven years trend in LDR, AIB is less liquid with compared to industry average.

Figure 4.5: Loan to Deposit Ratio (LDR) Trend



Source: researcher's own computation from financial statements

4.2.1.2 Cash Deposit Ratio (CDR)

Another measure of liquidity of the bank is the cash to deposit ratio. The higher the ratio the better is the liquidity position of the bank, therefore, the more is the confidence and trust of the depositors in the bank as compared to the bank with lower CDR.

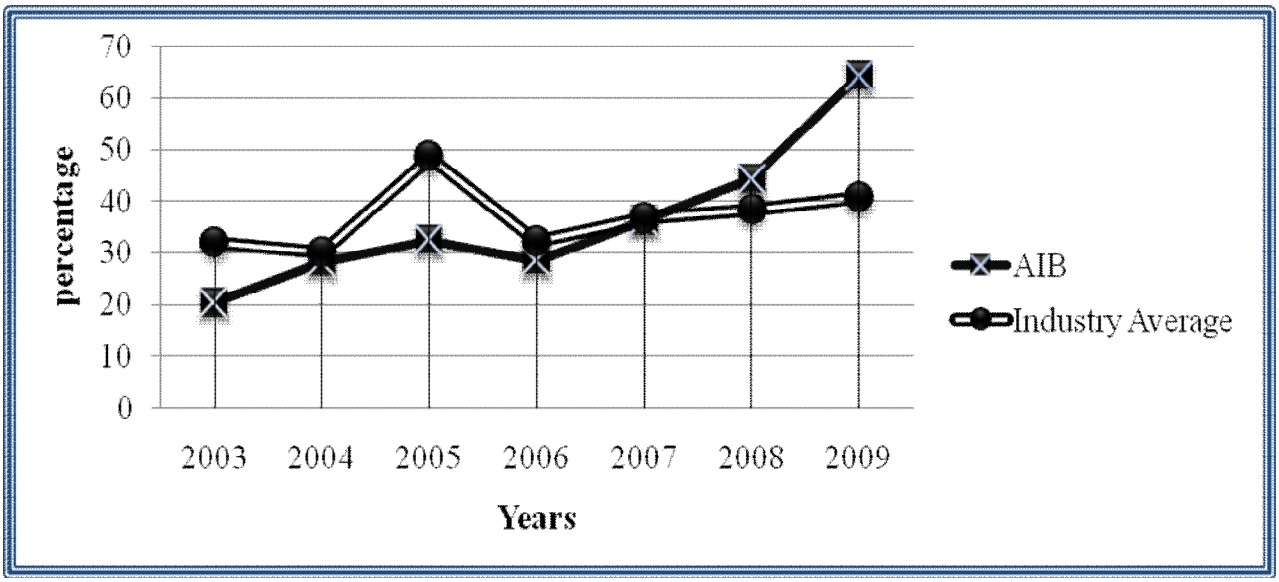
Table 4.2: Cash Deposit Ratio (CDR)

	2003	2004	2005	2006	2007	2008	2009	Mean
AIB	20.53	28.27	32.53	28.48	36.25	44.29	64.20	36.36
Industry Average	31.98	30.11	48.54	32.24	36.71	38.35	40.72	36.95

Source: researcher's own computation from financial statements

As per the table 4.2 , and figure 4.6 indicate that AIB is slightly less liquid as compared to industry average over the time period of 2003-2007. Since 2007, an increasing trend in CDR indicates that liquidity position of AIB is improving over time as a consequence of percentage of total cash and bank balance increasing at an increasing rate (see appendix 4). The CDR of AIB was 20.53% in 2003, which ascended to 64.20 % in 2009. However, these adversely affect the profitability of the bank as excess cash which has earned no interest reserved in the bank. The average CDR of AIB 36.36% is slightly less than mean CDR of industry average 36.95%, which reflect AIB is to some extent less liquid than industry average over the years under the study

Figure 4.6: Cash Deposit Ratio (CDR) Trend



Source: researcher's own computation from financial statements

4.2.1.3 Loan to Asset Ratio (LAR)

The loans to assets ratio measure the total loans outstanding as a percentage of total assets. The higher this ratio indicates a bank is loaned up and its liquidity is low. The higher the ratio, the more risky a bank may be to higher defaults.

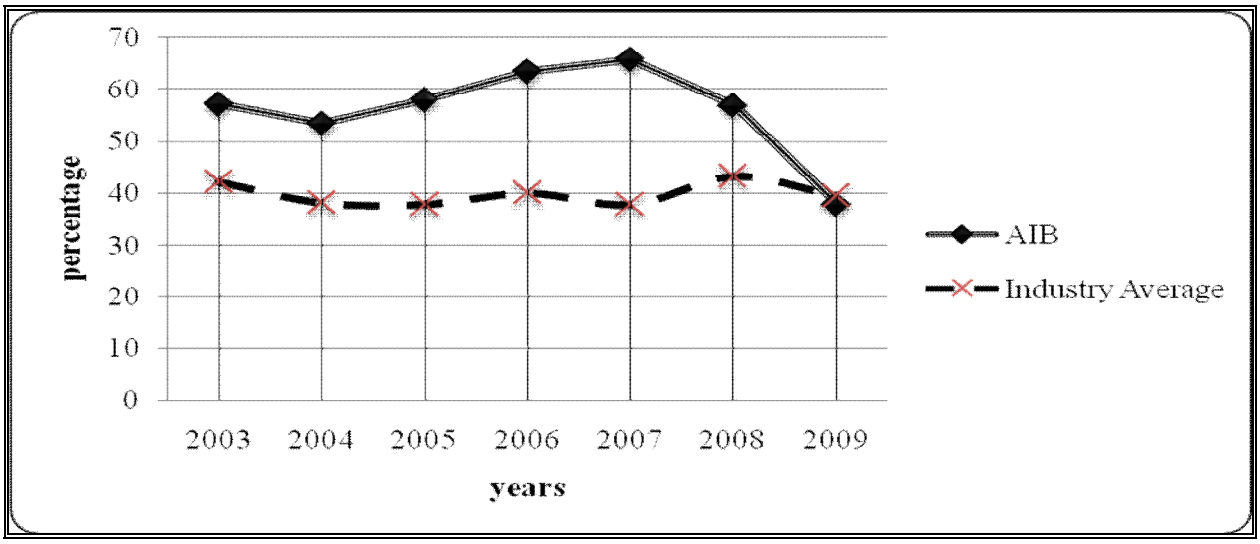
Table 4.3: Loan to Asset Ratio (LAR)

	2003	2004	2005	2006	2007	2008	2009	Mean
AIB	57.10%	53.45%	57.95%	63.37%	65.59%	56.80%	38.04%	56.04%
Industry Average	42.18%	38.20%	37.88%	40.07%	37.87%	43.28%	39.54%	39.86%

Source: researcher's own computation from financial statements

Table 4.3 and Figure 4.7 shows that, LAR of AIB is on decreasing trend over the years under the study except it increase in 2004 to 2007 whereas LAR of industry average is swinging between 42.18 % and 39.54%. LAR of AIB increased to 65.59 % in 2007 from 53.45 % in 2004. This increasing trend of AIB LAR during the period is palpable evidence of more financial stress, which AIB is taking by making excessive loans and holding less liquid assets during the periods. However, this is an indication of potential betterment in profitability and conforms to our results drawn from profitability ratios of AIB for the period. The average LAR of AIB (56.04 %) is higher than that of industry average (39.86%) during the seven years (2003-2009) of study. Therefore, Overall result of LAR indicates that AIB is less liquid than the industry average during the seven years (2003-2009) of study.

Figure 4.7: **Loans to Asset Ratio (LAR)**



Source: researcher's own computation from financial statements

Overall results of all liquidity measures show that AIB is less liquid than industry average.

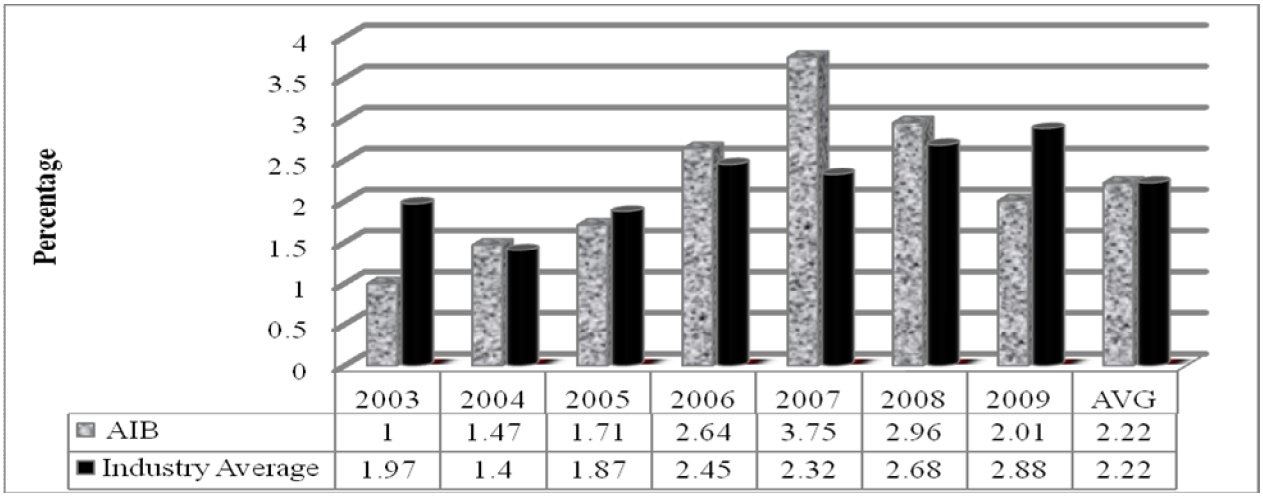
4.2.2 Profitability Ratios

Profitability is a management concept with the objective of assessment bank's results from efficiency point of view both for entirely activity and for differently management compounds. From conceptual point of view, profitability represents the modality to achieve the major goal of bank's activity, respectively the maximization of profit in minimization risk conditions. In order to see how AIB has profitable in comparison with the industry average over seven years under the study, the study uses five profitability ratios namely, Return on assets (ROA), Return on Equity (ROE), Profit Expense Ratio (PER), Return on Deposit (ROD), and Net Interest Margin (NIM).

4.2.2.1 Return on Assets (ROA)

ROA is defined as the ratio of profit after tax to total asset. It reflects the efficiency with which banks deploy their assets. The higher the ROA, the most profitable is the bank. The result indicates several important points of comparison of ROA between Awash International bank and industry average. As it can been seen from Figure 4.8, First, ROA of AIB has been greater than industry average during the years 2004, 2006, and 2008 by 0.07%, 0.19%, and 0.28% respectively. Second, ROA of AIB increased drastically during 2004, 2005, 2006, and 2007 by 47%, 16%, 54.39%, and 42.04% respectively. Since 2007, ROA of AIB is consistently on decreasing trend over the years under the study as a result of percentage decrease in net interest income (see appendix 3) by reason of loan limit to all banks in the country by national bank of Ethiopia. On the other hand, ROA of industry average decreased considerably during 2003-2004 from 1.97% to 1.40% (28.93% decreases). After having drastic decrease in 2003-2004, industry average recovered their ROA in 2004-2005. However, it again decreased by 5% during 2007 from 2006 and then consistently on increasing trend over the years under the study. Not surprisingly, on average, ROA of AIB (2.22%) is equal to ROA of industry average (2.22 %) during the period under the study.

Figure 4.8: Return on Assets (ROA)



	2003	2004	2005	2006	2007	2008	2009	AVG
AIB	1	1.47	1.71	2.64	3.75	2.96	2.01	2.22
Industry Average	1.97	1.4	1.87	2.45	2.32	2.68	2.88	2.22

Source: researcher's own computation from financial statements

4.2.2.2 Return on Equity (ROE)

This ratio indicates how bank can generate profit with the money shareholders have invested. The higher value of this ratio shows higher financial performance. Like ROA, this ratio is also indicator for managerial efficiency.

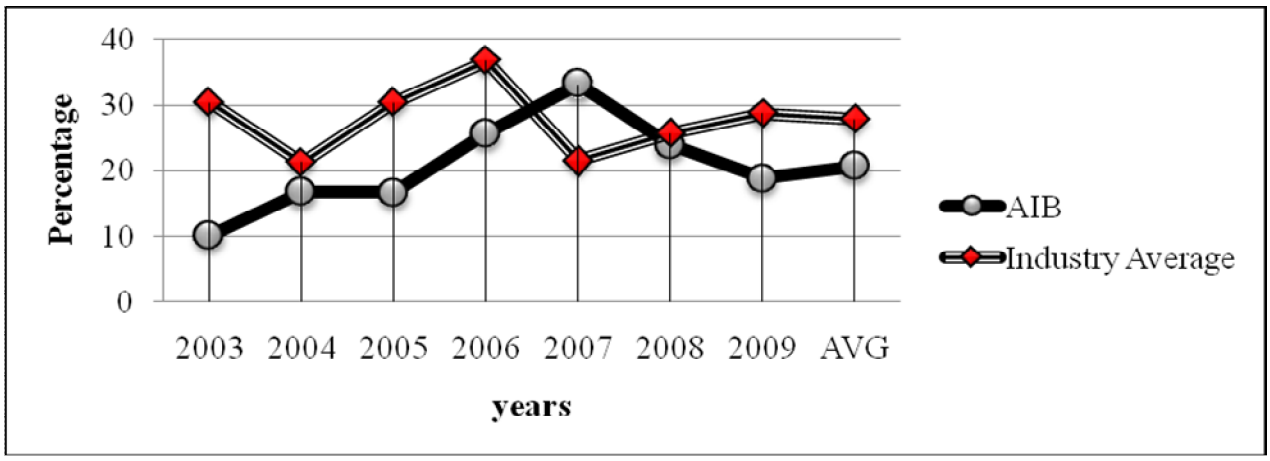
Table 4.4: Return on Equity (ROE)

	2003	2004	2005	2006	2007	2008	2009	Average
AIB	10.22%	16.77%	16.67%	25.66%	33.10%	23.92%	18.82%	20.74%
Industry Average	30.38%	21.31%	30.4%	36.67%	21.57%	25.66%	28.72%	27.82%

Source: researcher's own computation from financial statements

Similar to ROA, from the study of ROE of both Awash International Bank and industry average under the study, the researcher underpin some important points to consider. The result shows (see table 4.4 and Fig 4.9) that ROE of AIB has been less than industry average over the years under the study except year 2007 in which AIB ROE (33.1%) slightly surpassed industry average ROE (21.57%) because of greater percentage of net profit for the period (50.98 percent) (see appendix3)**.** In year 2003, the difference was huge which decreased considerably during 2004-2007. This momentous decrease in difference of two ROEs is essentially due to overall increasing trend in ROE of AIB and decreasing trend in ROE of industry average during 2003-2009. ROE of AIB increased from 10.22% in 2003 to 18.82% in 2009, whereas, ROE of industry average decreased from 30.38% to 28.72% in 2009. Nevertheless, ROE of AIB has improved; ROE of AIB is lagging behind the industry average as yet except in year 2007. An average ROE of the AIB is 20.74%, whereas the mean ROE of industry average for the same periods is 27.82%.

Figure 4.9: Return on Equity (ROE) Trends

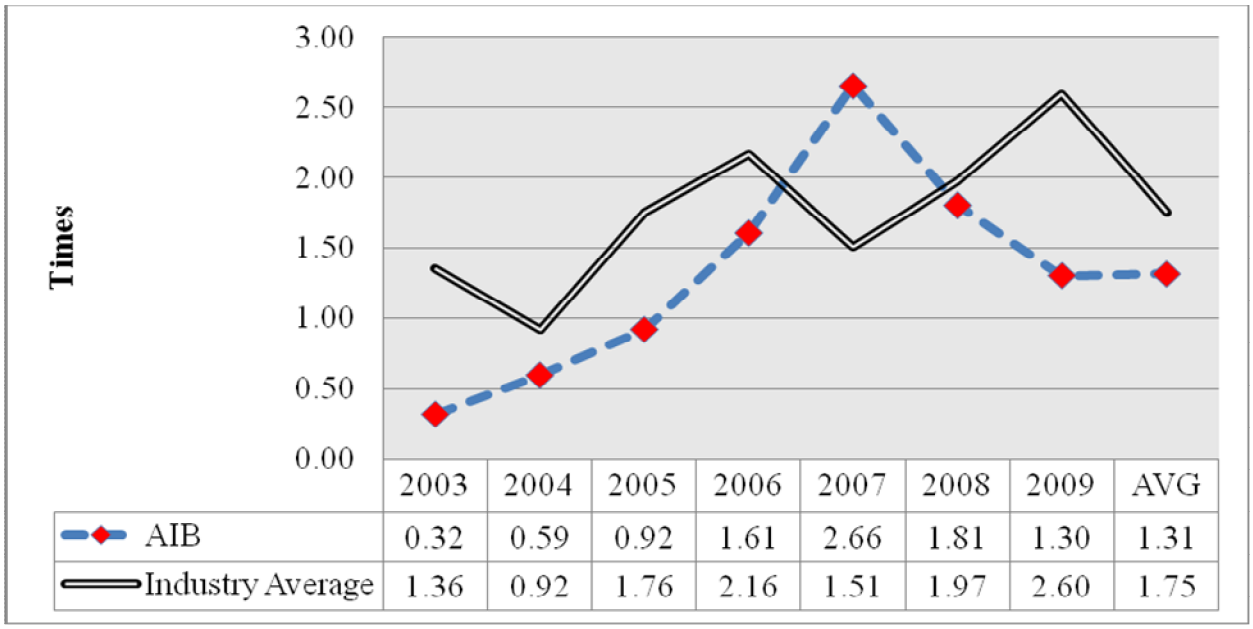


Source: researcher's own computation from financial statements

4.2.2.3 Profit Expense Ratio (PER)

This ratio indicates profitability of the firm with regard to its total expenses. A high value of this ratio indicates that bank could make high profit with a given expenses. Parallel to ROE, PER reveals that the AIB to be less profitable in terms of PER as compared to industry average over the time period of 2003-2009 except year 2007 in which AIB PER (2.66) slightly exceeded industry average PER (1.51) (see fig 4.10) as a result of lower percentage of total non-interest expense in 2007 (27.35 percent) (see appendix 3). The analysis of PER of AIB also indicates that from 2003-2005 the bank has generated lower profits and afterwards the bank have generated consistently higher profits for every one birr of expense spent. PER of AIB was 0.32 in 2003 which increased by 306% from 0.32 in 2003 to 1.30 in 2009. This increase in PER of AIB is far greater than increase in PER of industry average during the same time period. PER of industry average increased to 2.62 in 2009 from 1.36 in 2003 accounting for only 92.65% increase. However, Mean PER of the AIB is 1.31, which is less than industry average mean PER of 1.75, which reveal that the AIB to be less profitable in terms of PER as compared to the industry average over the years under the study.

Figure 4.10: Profit Expense Ratio (PER) Trend



Source: researcher's own computation from financial statements

4.2.2.4 Return on Deposit (ROD)

This ratio shows percentage return on each dollar of customers' deposit. In the other words, it indicates the effectiveness of bank in converting deposit into net earnings

Table 4.5: Return on Deposit (ROD)

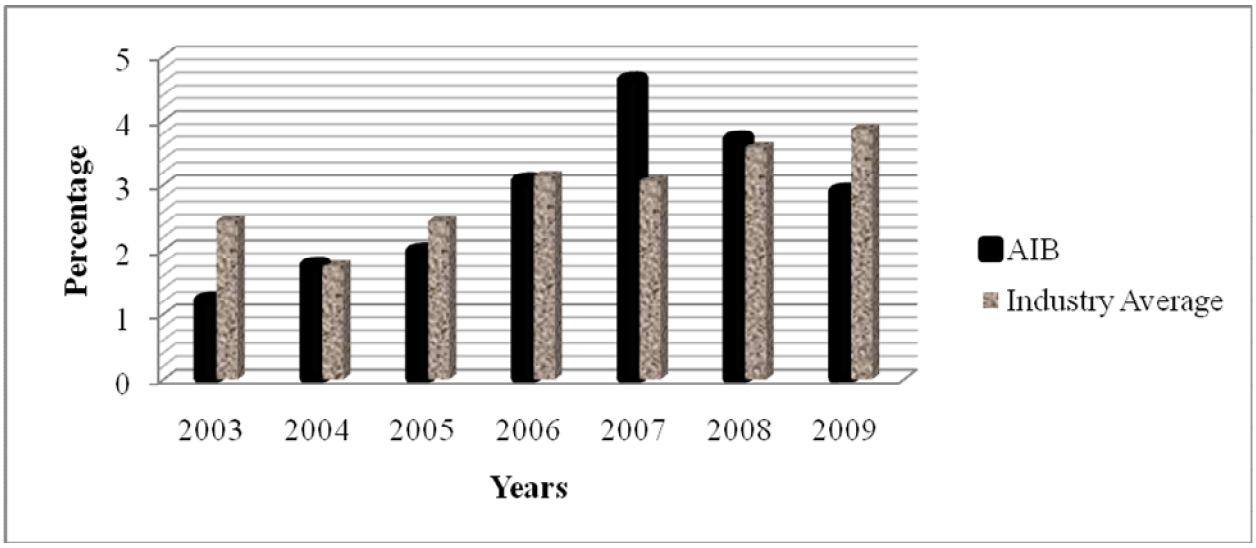
	2003	2004	2005	2006	2007	2008	2009	Mean
AIB	1.20%	1.74%	1.96%	3.04%	4.61%	3.69%	2.88%	2.73%
Industry Average	2.45%	1.75%	2.44%	3.13%	3.06%	3.58%	3.86%	2.90%

Source: researcher's own computation from financial statements

ROD ratio for AIB and industry average shown in table 4.5 and Fig 4.11 indicate that AIB is less profitable compared with industry average, over the time period of 2003-2009 except year 2007 in which AIB ROD (4.61%) slightly exceeded industry average ROD

(3.06%) because of a greater percentage of net profit in 2007 (50.98 percent)(see appendix 3). However, AIB is consistently improving and performing better in making good returns customers' deposits during the period under the study. The ROD of AIB was 1.20 % in 2003, which ascended to 3.69% in 2009. The average ROD of AIB 2.73% is less than average ROD of industry average 2.90%, which reflect AIB is less profitable than industry average over the years under the study.

Figure 4.11: Return on Deposit (ROD) Trend



Source: researcher's own computation from financial statements

4.2.2.5 Net Interest Margin (NIM)

Since traditional banking is the business of funding loans with deposits, a bank's net interest margin is a key performance measure that drives ROA. Net Interest Margin (NIM) measures the amount of operating income to earning asset. Higher the NIM ratio, higher is the quality of the management decision. Because higher operating income is the result of higher interest income or comparative lower interest expense, which is charged upon the earning assets such as Short-term Investment, loans and investment.

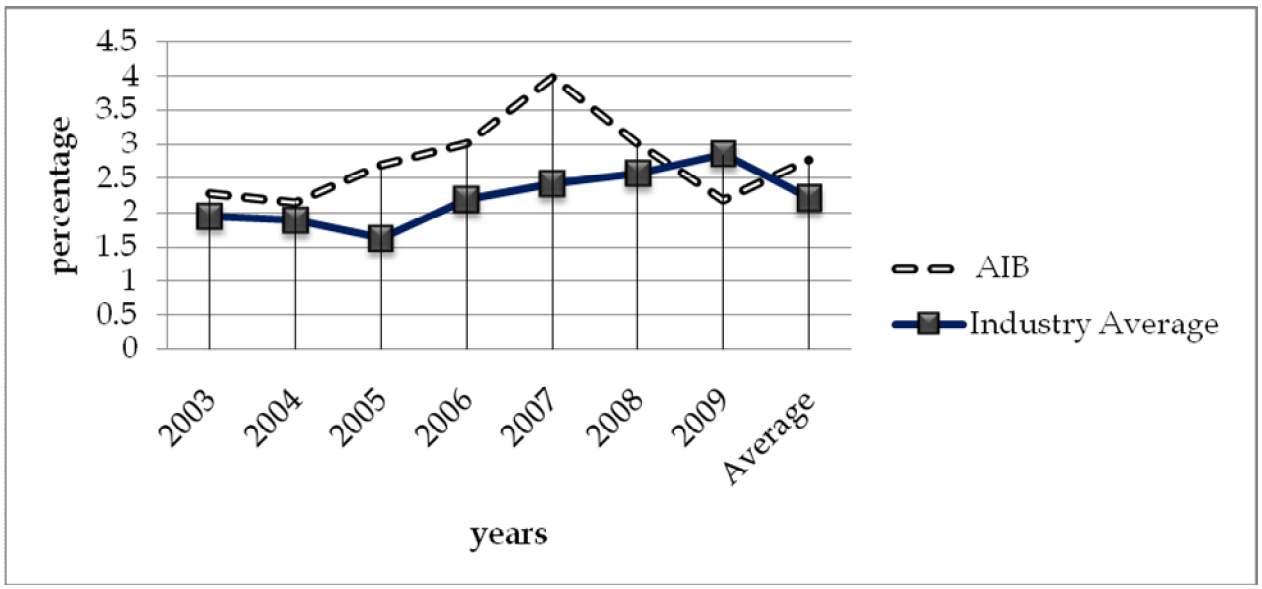
Table 4.6: Net Interest Margin (NIM)

	2003	2004	2005	2006	2007	2008	2009	Mean
AIB	2.28%	2.15%	2.70%	3.01%	3.98%	3.01%	2.19%	2.76%
Industry Average	1.95%	1.89%	1.63%	2.19%	2.42%	2.57%	2.85%	2.21%

Source: researcher's own computation from financial statements

Table 4.6 and Fig 4.12 presents NIM of AIB increased from 2.28%in 2003 to 3.98%in 2007 but followed downward trend afterwards due to percentage decrease in net interest income during the period (see appendix 3). The average NIM of AIB 2.76% is greater than average NIM of industry average 2.21%. Accordingly, considering the last seven years trend in NIM, AIB is more profitable with compared to industry average.

Figure 4.12: Net Interest Margin (NIM) Trend



Source: researcher's own computation from financial statements

4.2.3 Risk and Solvency Ratios

The risk and solvency ratios measure the extent to which a firm relies on debt financing rather than equity financing. These ratios are also referred to as gearing, debt, or financial leverage ratios. These ratios determine the probability that the firm default on its debt contacts. The more the debt a firm has the higher is the chance that firm will become unable to fulfill its contractual obligations. The following ratios measure for risk and solvency were used for the study.

4.2.3.1 Debt to Equity Ratio (DER)

This ratio indicates the proportion of assets financed with debt. A high value of this ratio provides indication that firm involves in more risky business.

Table 4.7: Debt to Equity Ratio (DER)

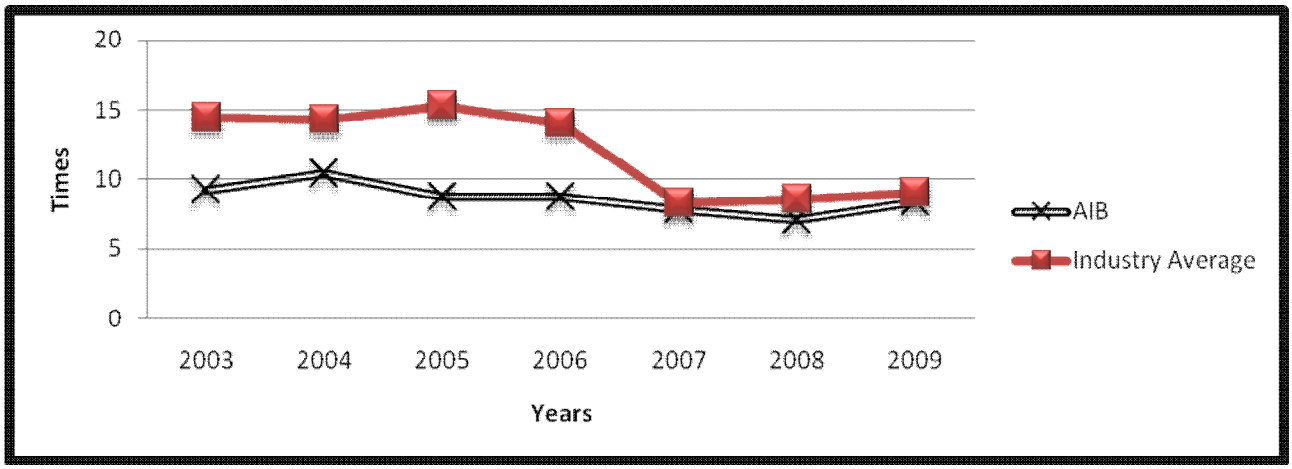
	2003	2004	2005	2006	2007	2008	2009	Mean
AIB	9.23	10.42	8.76	8.72	7.83	7.07	8.38	8.63
Industry Average	14.44	14.27	15.29	13.99	8.30	8.58	9.04	11.99

Source: researcher's own computation from financial statements

Debt to equity ratio of AIB increased from 9.23 times in 2003 to 10.42 times in 2004 but followed a downward trend until 2008 and ended at 8.38 times in 2009. Decreasing trend in DER for AIB indicates that deposits base of the bank is decreasing more than its equity base i.e. AIB is more reliance on equity financing as compared to debt and less deposits base (see appendix 4). Noticeably, table 4.7 and figure 4.13 shows DER of AIB is less than DER of industry average. Consequently, the researcher finding of profitability and risk & solvency perfectly fit in this risk-return profile and allow him to conclude

that AIB is less profitable, also less risky, and more solvent than industry average. Average DER of AIB is 8.63 times as compared to 11.99 of the industry average.

Figure 4.13: Debt to Equity Ratio (DER) Trend



Source: researcher's own computation from financial statements

4.2.3.2 Debt to Total Assets Ratio (DTAR)

DTAR measures ability of the bank capital to absorb financial shocks. This ratio indicates the proportion of assets financed with debt. A high value of this ratio provides indication that firm involves in more risky business.

Table 4.8: Debt to Total Assets Ratio (DTAR)

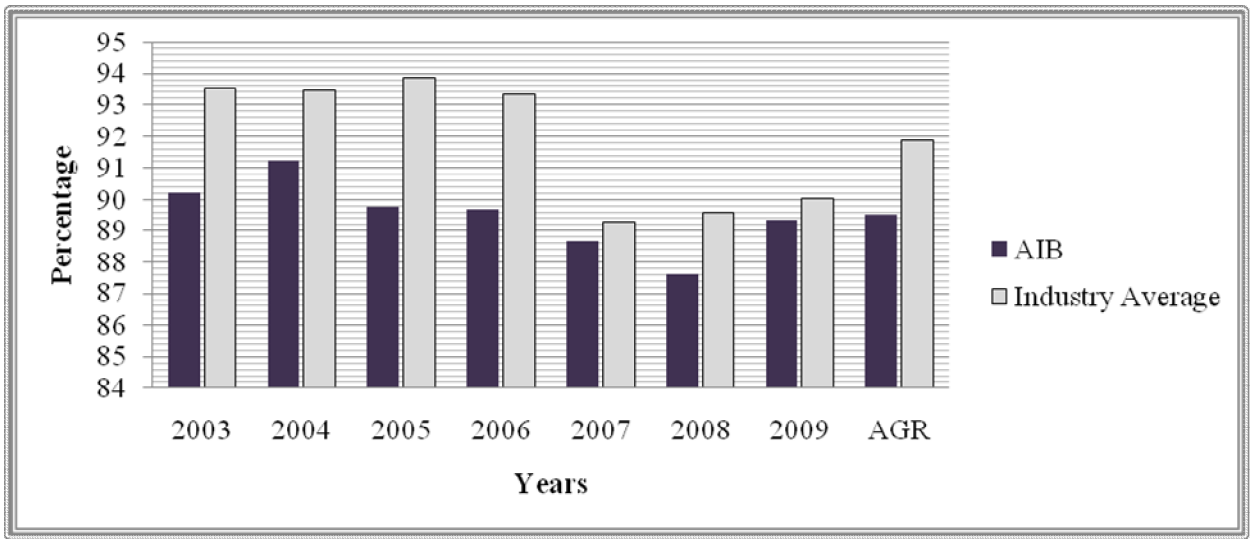
	2003	2004	2005	2006	2007	2008	2009	Mean
AIB	90.22	91.24	89.76	89.71	88.67	87.61	89.34	89.51
Industry Average	93.52	93.45	93.86	93.33	89.25	89.57	90.04	91.86

Source: researcher's own computation from financial statements

The results of debt to total assets ratio conform to our results of DER. The results show that DTAR of the AIB is consistently lower than industry average making once again AIB to be less risky and more solvent than industry average. AIB DTAR has slightly

decreased during 2003-2009. It was 90.22% in 2003, which descended to 89.34% in 2009. The comparison of means of DTAR for risk measure for both AIB and industry average in Table 4.8 and Fig 4.14 reveals that the average DTAR of AIB is 89.51% whereas the average DTAR of industry average is 92. 78%.

Figure 4.14: Debt to Total Assets Ratio (DTAR) Trend



Source: researcher's own computation from financial statements

4.2.3.3 Equity Multiplier (EM)

This ratio shows how many dollars of assets must be supported by each dollars of equity capital. The higher value of this ratio indicates signal for risk failure

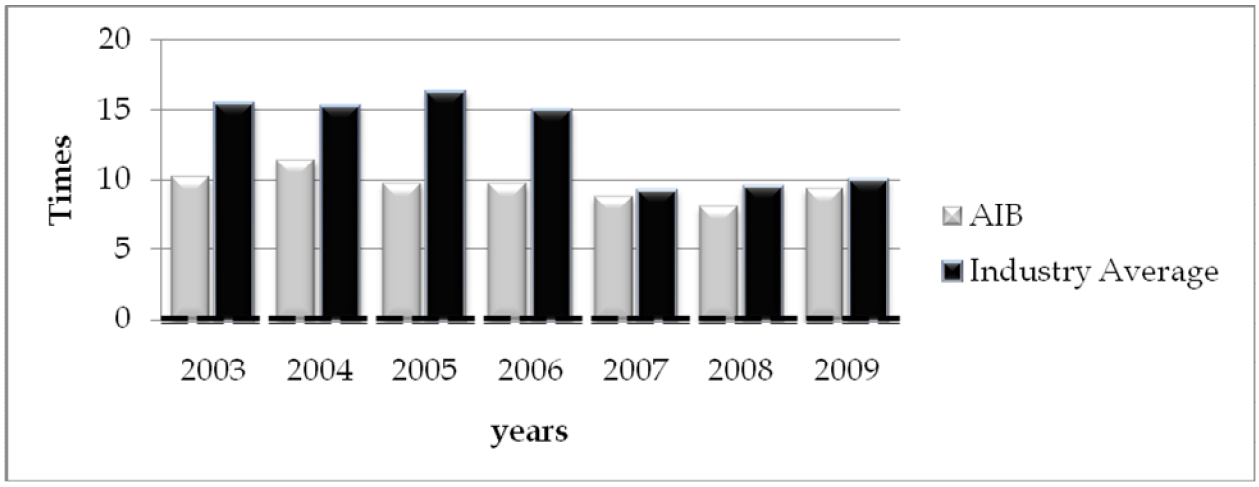
Table 4.9: Equity Multiplier (EM)

	2003	2004	2005	2006	2007	2008	2009	AGR
AIB	10.23	11.42	9.76	9.72	8.84	8.07	9.38	9.63
Industry Average	15.44	15.27	16.29	14.99	9.30	9.58	10.04	12.99

Source: researcher's own computation from financial statements

The analysis of equity multiplier further proves AIB banks to be less risky and more solvent as compared to industry average. This result is consistent with our results found in DER and DTAR for AIB. Not surprisingly, AIB EM is exhibiting similar behavior as of DER, which further verifies that relative to debt, equity base is increasing more in AIB banks (see appendix 4). EM decreased from 10.23 times in 2003 to 9.38 times in 2009 and from 15.44 times in 2003 to 10.04 times in 2009 for AIB and industry average respectively. Table 4.9 and Fig.4.15 shows Average EM of AIB is 9.63times as compared to 12.99 of the industry average.

Figure 4.15: Equity Multiplier (EM) Trend



Source: researcher's own computation from financial statements

4.2.3.3.4 Non Performing Loans to Total Loan Ratio (NPTL)

NPTL ratio is one of the most important criteria to assess the quality of loans or asset of a commercial bank. It measures the percentage of gross loans which are doubtful in banks' portfolio. The lower the ratio of NPTL, the better is the asset/credit performance for the commercial bank.

Table 4.10: Non Performing Loans to Total Loan Ratio (NPTL)

	2003	2004	2005	2006	2007	2008	2009
AIB	5.50	7.72	6.20	4.91	4.34	4.64	5.49
Industry Average	20.45	16.63	13.78	10.04	8.19	5.63	4.13

Table 4.10 reveal that the NPTL ratios for AIB has been decreased from 2003 to 2009 which imply asset quality slightly improved over the period under the study, as the non-performing loan (NPL) ratio edged down from 7.72 percent in 2004 to 5.49percent in 2007 . The non performing loans to total loan ratio of the AIB is below the industry average in the previous seven years which further proves AIB banks to be less risky and as compared to industry average.

Overall analysis of the results of all risk and solvency measures indicates Awash International bank to be less risky and more solvent than industry average during the seven years (2003-2009) of study.

4.2.4 Efficiency Ratios

These ratios measure how effectively and efficiently the firm is managing and controlling its assets. A firm is technically efficient if it produces a given set of outputs using the smallest possible amount of inputs (Falkena et al, 2004). Outputs could be loans or total balance of deposits, while inputs include labour, capital and other operating costs. Ratios used to measure efficiency of the AIB are Asset Utilization (AU), Income to Expense Ratio (IER), and Operating efficiency (OE).

4.2.4.1 Asset Utilization (AU)

This ratio measures capability of firm to generate revenue with its asset. The high value of this ratio indicates the high productivity of firm's asset.

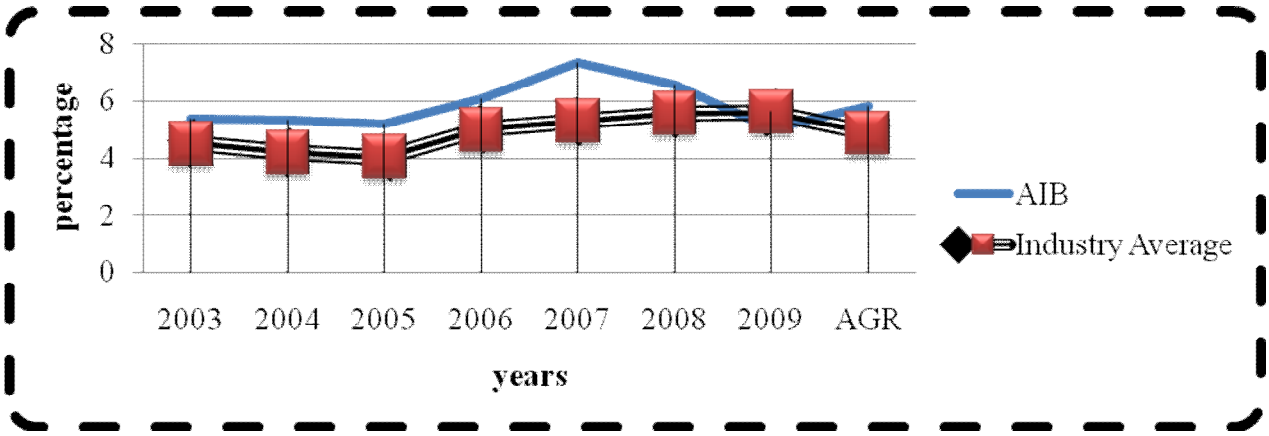
Table 4.11: Asset Utilization (AU)

	2003	2004	2005	2006	2007	2008	2009	Average
AIB	5.35	5.31	5.17	6.09	7.35	6.58	5.01	5.84
Industry Average	4.51	4.19	4.05	5.00	5.30	5.57	5.62	4.89

Source: researcher's own computation from financial statements

The behavior of the two lines in Table 4.10 and Fig 4.16 reveals some useful information about AU of AIB and industry average. Having decrease from 5.35% in 2003 to 5.17% in 2005, AU of Awash banks showed an upward trend and increased from 5.17% in 2005 to 7.35 % in 2007 but followed a downward trend afterwards and ended at 5.01 % in 2009(see also Fig.4.16) specially due to decreasing trend of net interest income during the period(appendix 3). However, AU ratio of AIB is consistently higher during 2003-2009 than industry average and the mean of AU ratio of AIB (5.84%) is higher than industry average (4.89%). This proves that Awash International bank is comparatively more efficient in utilization of the assets in generating total income (revenue) than industry average.

Figure 4.16: Asset Utilization (AU) Trend



Source: researcher's own computation from financial statements

4.2.4.2 Income to expense Ratio (IER)

Income to expense is the ratio that measures amount of income earned per dollar of operating expense. This is the most commonly and widely used ratio in the banking sector to assess the managerial efficiency in generating total income vis-à-vis controlling its operating expenses. High IER is preferred over lower one as this indicates the ability and efficiency of the bank in generating more total income in comparison to its total operating expenses.

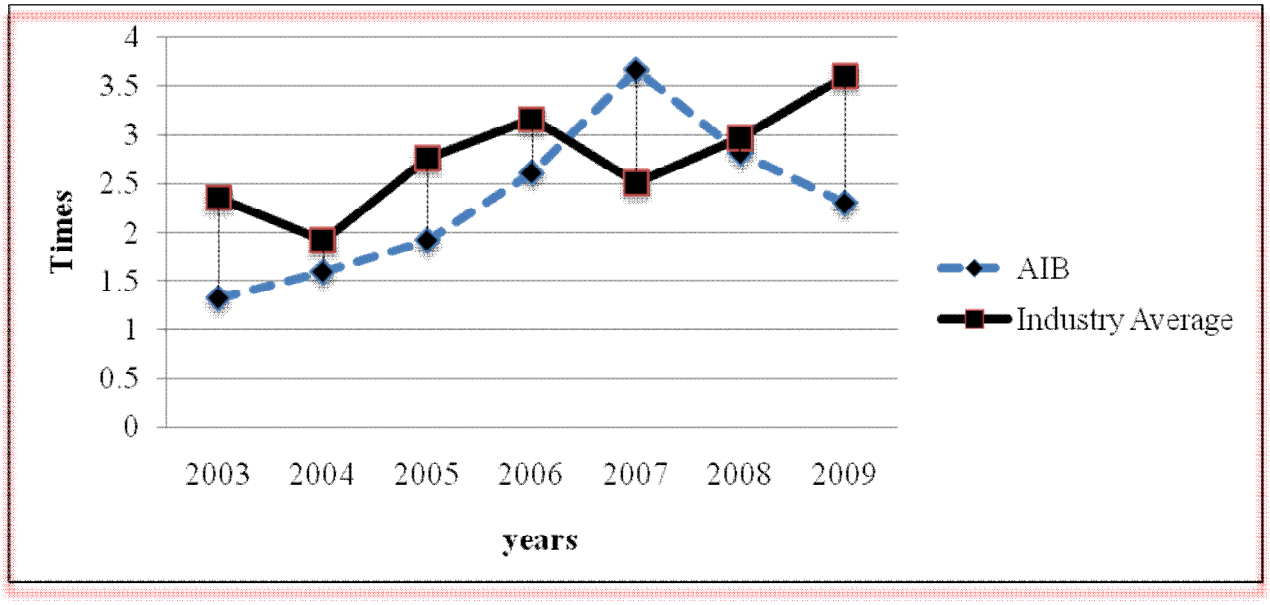
Table 4.11 Income to Expense Ratio (IER)

	2003	2004	2005	2006	2007	2008	2009	AGR
AIB	1.32	1.59	1.92	2.61	3.66	2.81	2.30	2.31
Industry Average	2.36	1.92	2.76	3.16	2.51	2.97	3.60	2.75

Source: researcher's own computation from financial statements

Table 4.11 exhibits the behavior of income to expense ratio for both AIB and industry average. The results show that IER of AIB is lower than industry average during the 7-years under the study except 2007, in which AIB exceeded the industry average as a result of lower percentage of total non-interest expense in 2007 (27.35 percent) (see appendix 3). Compared with industry average, AIB is generating less income for every 1 birr of expense spent. However, the results also show that IER of AIB increased from 1.32 times in 2003 to 3.66 times in 2007 but decreased afterwards and ended at 2.30times in 2009. Further analysis of financial statement reveals that the decreasing trend since 2007 is due to increase in interest expenses, which is more than increase in income of the bank causing the IER to rise. The Mean IER of AIB is 2.31times, which is less than mean IER of 2.75times for industry average shows AIB is generating less income for every 1 birr of expense spent than commercial banks

Figure 4.17: Income to expense Ratio (IER) Trend



Source: researcher's own computation from financial statements

4.2.4.3 Operating Efficiency (OE)

Operating efficiency is the ratio that measures the amount of operating expense per dollar of operating revenue. It measures managerial efficiency in generating operating revenues and controlling its operating expenses. In other words, how efficient is the bank in its operations. Lower OE is preferred over higher OE as lower OE indicates that operating expenses are lower than operating revenues

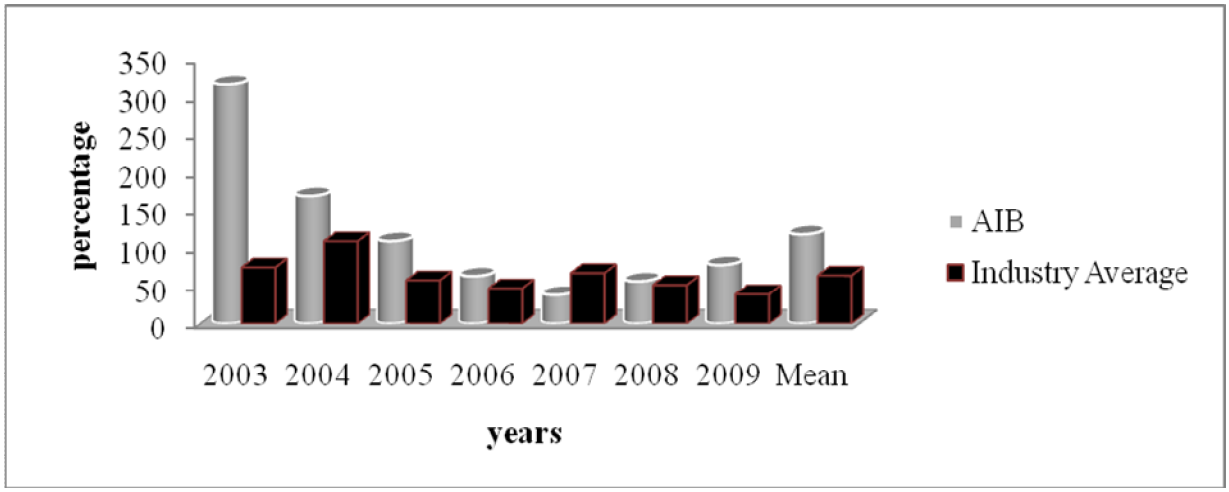
Table 4.12 Operating Efficiency (OE)

	2003	2004	2005	2006	2007	2008	2009	Mean
AIB	316.67	168.57	109.09	62.16	37.65	55.39	76.73	118.04
Industry average	73.74	109.02	56.85	46.21	66.28	50.64	38.53	63.04

Source: researcher's own computation from financial statements

Operating efficiency analysis further strengthens IER result that AIB is less efficient than industry average in managing its operating expenses and generating less operating revenues. Particularly, in 2003, the difference in performance was huge which, however, reduced drastically in 2009 and the variation in ratios of AIB and industry average was 242.93% in 2003, which reduced to 38.2% in 2009. Moreover, in 2007, AIB OE (37.65%) decreased below industry average (66.28%) turning AIB into comparatively better efficiency position mainly because of lower percentage of total non-interest expense (see appendix 3). Furthermore, the AIB is improving considerably in managing its operations (see Fig 4.18 below). The Average OER of AIB is, 118.04%, which is more than OER of 63.04% for industry average is evidence for AIB is less efficient than industry average in managing its operations over the years under the study.

Figure 4.18: Operating Efficiency (OE) Trend



Source: researcher's own computation from financial statements

An overall analysis of all efficiency measures reveals that AIB is less efficient in asset utilization, income generation, and managing its expenses. However, the results also show the AIB is improving overtime considerably in these efficiency measure

CHAPTER V
CONCLUSIONS AND RECOMMENDATIONS

In chapter four, the actual performance of the company has evaluated. Here are the researcher conclusions and recommendations based on the analysis of the previous chapter.

5.1. CONCLUSIONS

At this point, the financial analysis has been made in attempting to draw some rough conclusions on the performance of AIB. One of the main points to understand about the financial analysis is that all the information that would be conclusive judgment about what is going on in the company is found in the financial statements and interview with the concerned staff.

From the brief explanation and illustrations of seven years, financial statements of AIB have been used to analyze the financial performance and their trend for the years under study (2003-2009).

Examination of the empirical analysis makes it possible for the researcher to shed some light on his findings and draw some conclusions. Some of the findings of the study include the following:

- From the common size analysis of Income Statement, Operating income before Tax in 2007 was very high comparing to the other years. This was because of low Interest Expense, Salaries and benefits, and general and administrative expenses in this year.
- From the common size analysis of Balance Sheet, except in 2009, Total Loans, and Advances of the bank had covered largest portion of total assets in all the years under the study despite the percentage showed a downward trend in the later years

(in 2008 and 2009). On the other hand, Total Deposit had covered largest portion of total liabilities in all the years under the study.

- The researcher analysis of liquidity measures indicates that AIB is less liquid than industry average in all liquidity measurements. Findings also show that while Loan to Deposit Ratio (LDR) of the industry average is increasing from 52.47% in 2003 to 53.38% in 2009, LDR of AIB is decreasing from 68.73%in 2003 to 54.66% in 2009. This decreasing trend is due to increase in its deposits base, which can be considered a positive, and a good sign for the AIB in that it is making inroads into the society. Moreover, this shows that level of trust and confidence of the people is increasing in AIB with the passage of time. However, on average AIB was exposed to higher liquidity risk than the industry average over the years under the study.

- Examination of all profitability measures, Return on assets (ROA), Return on Equity (ROE), Profit Expense Ratio (PER), Return on Deposit (ROD), and Net Interest Margin (NIM) indicates that AIB is less profitable than industry average during the period under the study except year 2007 in which AIB profitability ratios exceeded CBs. Overall, the trend of all profitability ratios are found rising for AIB during 2003-2007. Since 2007, the profitability ratios of AIB are consistently on decreasing trend over the years under the study.

- Having found AIB to be less profitable than industry average, what we expect when it comes to risk and solvency measures is according to the basic rule of finance "the higher the expected return the higher the risk". Our findings of profitability and risk & solvency perfectly fit in this risk-return profile and allow us to conclude that AIB is less profitable, also less risky, and more solvent than industry average. Analysis of the results of all the risk and solvency measures, Debt Equity Ratio (DER), Debt to Total Assets ratio (DTAR), Equity Multiplier (EM), and Non Performing Loans to Total Loan Ratio (NPTL) indicates AIB to be less risky and more solvent than industry average.

- Like in profitability, and risk & solvency measures, AIB is found to be less efficient in terms of generating income or Income Expense Ratio (IER) and managing their expenses or Operating Efficiency (OE) as compared to industry average. In contrast, AIB is more efficient in terms of utilization of their assets or Asset Utilization (AU) ratio. Although, Income Expense Ratio (IER), and Operating Efficiency (OE) suggest that AIB is significantly less efficient but increasingly converging towards that of industry average, during 2003-2009. This gives us some insight regarding AIB's improvement in generating income, utilization of assets, and effective management in controlling expenses.

5.2. RECOMMENDATIONS

The following recommendations, based on the above research findings, are forwarded below in order to enhance the financial performance of commercial banks:

Loan to deposit ratio of AIB decreased from 68.73%in 2003 to 54.66% in 2009. This overall declining trend in LDR of AIB indicates the tendency of comparatively more increase in deposits than loans. This may indicate that AIB has conservative lending policy over the period under the study. This may be solved by revising the lending policy of the bank, such as maximizing the approval limit of branches and districts, appointing trained managers and loan officers.

Since 2007, Loans and advances of AIB decreased because the National Bank of Ethiopia set a maximum outstanding loan limit to all banks in the country to control inflation. If this continues, the bank may become more liquid and be obliged to discourage deposit to decrease their interest expenses and this will adversely affect the overall economy. The regulatory body has to think over it and take a corrective action.

Overall, all results of profitability measures results indicate that AIB is less profitable compared with industry average, therefore the bank should work on it and move towards good return because this is the means to assure its survival in the market.

The number of commercial banks has been increasing from time to time. The intensive and continuous increasing competition in the financial service market creates a need for an access to information that would allow evaluating commercial banks operating in this market. In Ethiopia there is no adequately compiled data and bench marks to evaluate the performance of commercial banks. The regulatory body (National Bank of Ethiopia) or other concerned bodies have to take the responsibility.

Finally, the financial performance indicators, i.e. financial ratios, independently are not enough to measure the performance of commercial banks. Thus, alternative financial measures such as Data Envelopment Analysis (DEA) shall be considered by further researchers.

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APPENDIX

Appendix A- 1: Selected Financial Elements with Growth Rate

ELEMENTS[1]	2003	2004	2005	2006	2007	2008	2009	AVG
Total Deposits	1164	1493	1940	2567	3112	3870	4963	
Growth		28.26	51.98	120.53	167.35	232.47	326.37	**154.50**
Interest Income	58	68	94	137	214.5	251	276	
Growth		17.24	62.07	136.21	269.83	332.76	375.86	198.99
Net Interest Income	32	38	60	89	152.5	145	156	
Growth		19	88	48	377	353	388	212
Total Income	75	94	115	180	281.5	317	357	
Growth		25.33	53.33	140.00	275.33	322.67	376.00	198.78
Interest Expense	26	30	34	48	62	106	120	
Growth		15.38	26.67	84.62	138.46	307.69	361.54	155.73
Total Expenses	83	89	94	117	139	219	275	
Growth		7.23	13.25	40.96	67.47	163.86	231.33	87.35
Net Profit	**14**	**26**	**38**	**78**	**143.5**	**142.8**	**143**	
Growth		85.71	171.43	105.26	925.00	920.00	921.43	521.47
Total Loans & Advances	800	946	1290	1872	2512	2738	2,713	
Growth		18.25	61.25	134.00	214.00	242.25	239.13	151.48
Net Loans & Advances	756	873	1210	1780	2403	2611	2,564	
Growth		15.48	60.05	135.45	217.86	245.37	239.15	152.23
Total Assets	1,401	1770	2226	2954	3830	4820	7,132	
Growth		26.34	58.89	110.85	173.38	244.04	409.06	170.43
Shareholders' Equity	137	155	228	304	433.5	597	760	
Growth		13.14	47.10	33.33	42.60	37.72	27.30	33.53

Source: Data retrieved from financial statements of Awash International bank. Growth rates are calculated taking 2003 as the base year.

[1] All figures expressed in millions and growth rates are expressed in percentage.

Appendix A- 2: Descriptive Statistics of Selected Financial Elements[2]

Variable	Obs.	Mean	Std. Dev.	Min	Max
Total Deposits	7	2729.857	1358.001	1164	4963
Interest Income	7	156.9286	89.80926	58	276
Net Interest Income	7	96.07143	54.76954	32	156
Total Income	7	202.7857	115.0449	75	357
Interest Expense	7	60.85714	37.83926	26	120
Total Expenses	7	145.1429	73.91082	83	275
Net Profit	7	83.61429	59.0108	14	143.5
Total Loans & Advances	7	1838.714	837.1047	800	2738
Net Loans & Advances	7	1742.429	804.1134	756	2611
Total Assets	7	3447.571	2014.257	1401	7132
Shareholders' Equity	7	373.5	235.4462	137	760

Source: Calculated data from financial statements of AIB using SPSS

[2] All figures expressed in millions except number of observations.

Appendix A-3: Common Size Income Statement[3]

Description	2003	2004	2005	2006	2007	2008	2009
Interest Income	77.33	72.34	81.74	76.11	76.20	79.18	77.31
Interest Expense	(34.67)	(31.91)	(29.57)	(26.67)	(22.02)	(33.44)	(33.61)
Net Interest Income	42.67	40.43	52.17	49.44	54.17	45.74	43.70
Commission Income and Services Charges	22.67	22.34	29.57	26.67	17.05	18.93	18.77
Other Income	34.67	37.23	18.26	23.89	28.60	35.33	37.54
Total Non-Interest Income	57.33	59.57	47.83	50.56	45.83	54.26	56.30
Total Operating Income	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Employees Salary and Benefits	18.67	17.02	19.13	16.67	13.50	15.14	18.77
Administrative and General Expenses	25.33	25.53	25.22	21.67	13.85	20.50	16.53
Total Noninterest Expense	44.00	42.55	44.35	38.33	27.35	35.65	35.29
Profit Before Provision	56.00	57.45	55.65	61.67	72.65	64.35	64.71
Provision For Doubtful Loans	(32.00)	(20.21)	(7.83)	-	-	-	(8.12)
Operating income Before Tax	24.00	37.23	47.83	61.67	72.65	64.35	56.58
Provision For Tax	(5.33)	(9.57)	(14.78)	(18.33)	(21.67)	(19.31)	(16.53)
Net Profit After tax And Provision	18.67	27.66	33.04	43.33	50.98	45.05	40.06

Source: Calculated data from financial statements of AIB using Microsoft office Excel

[3] All figures expressed in percentage.

Appendix A-4: Common Size Balance Sheet[4]

Description	2003	2004	2005	2006	2007	2008	2009
Total Assets	100%	100%	100%	100%	100%	100%	100%
Total Cash and Bank Balances	17.06	23.84	28.35	24.75	29.45	35.56	44.67
Treasury Bills	22.56	19.04	10.56	6.70	-	2.70	-
Total Other Investment And Debit Balances	2.36	3.62	3.37	5.25	5.20	4.85	7.36
Total Loans and Advances	57.10	53.45	57.95	63.37	65.59	56.80	38.04
Customers' Liabilities for (L/C)	-	-	-	-	-	-	9.96
Fixed Assets	4.07	4.18	3.37	3.05	2.61	2.72	2.06
Total Liabilities	90.22	91.24	89.76	89.71	88.68	87.61	89.34
Total Deposit	83.08	84.35	87.15	86.90	81.26	80.29	69.59
Other Credit Balances	5.21	5.31	0.72	0.61	5.59	5.15	4.57
Margins Held On Letters of Credit	1.93	1.24	1.89	2.20	1.83	2.18	4.75
Provision For Taxation	-	0.34	-	-	-	-	0.48
Bank's Liabilities For (L/C)	-	-	-	-	-	-	9.96
Total Capital And Reserves	9.73	8.76	10.24	10.29	11.32	12.39	10.66

Source: Calculated data from financial statements of AIB using Microsoft office Excel

[4] All figures expressed in percentage.

Appendix A-5: Consolidated Balance Sheet of Awash International Bank

AWASH INTERNATIONAL BANK SHARE COMPANY

CONSOLIDATED BALANCE SHEET

AT 30 JUNE

(In millions of birr)

CURRENCY: BIRR

ASSETS							
Cash And Bank Balances							
Cash On Hand	76	100	129	125	181	272	478
Cash At Bank	2	0	2	2	1	1	99
Reserve Account With NBE	61	206	233	237	520	909	1,771
Deposits With Foreign Banks	100	116	267	367	426	532	838
Treasury Bills	316	337	235	198		130	
Other Investments	3	3	3	3	3	4	4
Other Debit Balances	30	61	72	152	196	230	521
Total Other Investment And Debit Balances	33	64	75	155	199	234	525
Total Loans And Advances	800	946	1290	1872	2512	2738	2,713
Less Provision For Doubtful Debts	44	73	80	92	109	127	149
Net Loans And Advances	756	873	1210	1780	2403	2611	2,564
Customers' Liabilities For Commercial Letters Of Credit And Acceptances, As Per Contra(L/C)	0						710
Fixed Assets	57	74	75	90	100	131	147
Total Assets	**1401**	**1770**	**2226**	**2954**	**3830**	**4820**	**7132**
Liabilities							

Deposits							
Demand Deposits	245	287	422	574	603	825	1133
Savings Deposits	875	1141	1437	1833	2223	2792	3649
Fixed Deposits	44	65	81	160	286	253	181
Total Deposit	1164	1493	1940	2567	3112	3870	4963
Other Credit Balances	73	94	16	18	214	248	326
Margins Held On Letters Of Credit	27	22	42	65	70	105	339
Provision For Taxation		6					34
Bank's Liabilities For Commercial Letters Of Credit And Acceptances, As Per Contra							710
Total Liabilities	**1,264**	**1,615**	**1,998**	**2,650**	**3,396**	**4,223**	**6,372**
Capital And Reserves							
Share Capital	111	127	155	188	252.5	368	445
Legal Reserve	19	23	32	43	67	99	152
General Reserve	2	3	7	8	7.5	13	
Retained Earnings							11
Profit And Loss Account	5	2	34	65	106.5	117	152
Total	137	155	228	304	433.5	597	760
Total Liabilities And Capital	**1,401**	**1,770**	**2,226**	**2,954**	**3,830**	**4,820**	**7,132**

Appendix A- 6: Consolidated profit and Loss account of Awash International Bank

AWASH INTERNATIONAL BANK SHARE COMPANY

CONSOLIDATED PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 30 JUNE

(In millions of birr)

CURRENCY: BIRR

	2003	2004	2005	2006	2007	2008	2009
Description							
Interest Income	58	68	94	137	214.5	251	276
Interest Expense	26	30	34	48	62	106	120
Net Interest Income	32	38	60	89	152.5	145	156
Commission Income And Services Charges	17	21	34	48	48	60	67
Other Income	26	35	21	43	80.5	112	134
Total Noninterest Income	43	56	55	91	129	172	201
Net Interest Income And Noninterest Income	75	94	115	180	281.5	317	357
Employees Salary And Benefits	14	16	22	30	38	48	67
Provision For Doubtful Loans	24	19	9				29
Administrative And General Expenses	19	24	29	39	39	65	59
Total Noninterest Expense	57	59	60	69	77	113	155
Net Profit Before Tax (Operating)	18	35	55	111	204.5	204	202
Provision For Tax	4	9	17	33	61	61.2	59
Net Profit After-tax And Provision	**14**	**26**	**38**	**78**	**143.5**	**142.8**	**143**

Appendix A-7: Consolidated Balance Sheet of commercial banks

COMMERCIAL BANKS

CONSOLIDATED BALANCE SHEET

AT 30 JUNE

(In Millions of Birr)

CURRENCY: BIRR

	2003	2004	2005	2006	2007	2008	2009
ASSETS							
Cash And Bank Balances							
Cash On Hand	1046	849	1341	1301	1670	2912	4473
Cash At Bank	392	383	337	251	933	915	1306
Reserve Account With NBE	3,664	4789	13017	8554	11983	15444	19984
Deposits With Foreign Banks	3153	3132	2884	3514	4230	4270	4906
Treasury Bills	8062	11088	4845	12784	14362	6648	5415
Other Investments	2514	2864	5682	4608	8015	14445	19893
Other Debit Balances	0	0	22	0	0	19	0
Total Other Investment And Debit Balances	2133	2416	3232	3050	2238	3076	5420
Total Loans And Advances	13,547	14564	17900	21673	25589	35488	40205
Less Provision For Doubtful Debts	2771	2422	2467	2177	2096	1999	1662
Net Loans And Advances	10,776	12142	15433	19496	23494	33489	38543
Customers' Liabilities For Commercial Letters Of Credit And Acceptances, As Per Contra(L/C)						0	710
Fixed Assets	370	462	461	531	647	786	1,030
Total Assets	**32,110**	**38,125**	**47,254**	**54,089**	**67,572**	**82,004**	**101,680**
Liabilities							
Deposits							
Demand Deposits	12373	14677	16859	18533	24554	28660	34903

Savings Deposits	11664	14372	17298	20427	23403	29333	37009
Fixed Deposits	1153	1227	1624	3124	3212	3374	3388
Total Deposit	25190	30276	35781	42084	51169	61367	75300
Foreign Bank their A / C	627	125	433	159	78	0	0
Trust funds	0	0	0	0	15	15	15
total deposit	25817	30401	36214	42243	51262	61382	75315
Other Credit Balances	3580	3166	4933	5460	6270	9140	8274
Margins Held On Letters Of Credit	251	1637	2770	2178	2104	2545	4054
Long term loans	158	150	116	109	78	65	53
Provision For Taxation	201	234	320	491	528	315	1179
state dividend payable	23	40	0	0	0	0	1966
other Provisions	0	0	0	0	64	0	0
Bank's Liabilities For Commercial Letters Of Credit And Acceptances, As Per Contra	0	0	0	0	0	0	710
Total Liabilities	30,030	35,628	44,353	50,481	60,306	73,447	91,551
Capital And Reserves							
authorized and paid	1282	1366	1594	1912	5959	6668	7312
Legal Reserve	735	749	881	1212	711	1252	1999
General Reserve	7	77	170	101	103	49	44
Retained Earnings	42	278	190	284	343	393	523
Profit And Loss Account	14	27	66	99	152	196	253
Total	2080	2497	2901	3608	7268	8558	10131
Total Liabilities And Capital	**32,110**	**38,125**	**47,254**	**54,089**	**67,574**	**82,005**	**101,682**

Appendix A-8: Consolidated profit and Loss account of commercial banks

COMMERCIAL BANKS

CONSOLIDATED PROFIT AND LOSS ACCOUNT

FOR THE YEAR ENDED 30 JUNE

(In millions of birr)

CURRENCY: BIRR

	2003	2004	2005	2006	2007	2008	2009
Description							
Interest Income	1016	1151	1263	1790	2366	3273	4261
Interest Expense	391	432	495	607	732	1166	1366
Net Interest Income	625	719	768	1183	1634	2107	2895
Commission Income And Services Charges	181	241	628	481	559	724	1555
Other Income	643	639	516	1038	1387	1735	1267
Total Non-interest Income	824	880	1144	1519	1946	2459	2822
Net Interest Income And Non-interest Income	1449	1599	1912	2702	3580	4566	5717
Employees Salary And Benefits	206	253	295	368	464	623	803
Provision For Doubtful Loans	192	305	85	88	162	257	116
Administrative And General Expenses	217	276	313	398	801	655	671
Total Non-interest Expense	615	834	693	854	1427	1535	1590
Net Profit Before Tax (Operating)	834	765	1219	1848	2153	3031	4127
Provision For Tax	202	233	337	525	585	835	1217
Net Profit After-tax And Provision	632	532	882	1323	1568	2196	2910