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Performance Measurement the case of banks in Ethiopia

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Abstract
In a dynamic business world, to function successfully an organization depends upon the decision- making ability of its managers, who in turn, depends up on the availability of useable information. Large organizations have a variety of activities which they carry out in different locations and most of these organizations such as manufacturing and banking industry adopt branch structures. The way a company is organized, which depends on such things as the culture of its home country and the philosophy of its top managers, influences its reporting systems. It is palpable that the banking firms have adopts a branch structure. The style in which branch performance is controlled and measured is, therefore, of particular meaning. A central issue of responsibility accounting is whether a branch manager should be held accountable for transactions that he or she cannot influence by his or her actions. This research focuses on the use of financial performance measures in evaluating branch managers' performance; and describes the relative importance attached to financial performance measures versus non financial performance measures that are used to evaluate branch managers' performance. The study adopted a descriptive research design as it aims to investigate in depth and describe features of the population under study. Thus, to achieve the stated objectives both quantitative and qualitative research was employed. This study presents the research findings of the survey relating to the branch performance measurement in Ethiopian banks. Thus, in general the finding of this study indicates that financial measure were considered to be important than non financial performance measures in evaluating the performances of branch performances.
Keywords: Branches, Performance, branch performance, financial, non financial

1. INTRODUCTION

In a dynamic business world, to function successfully an organization depends upon the decision- making ability of its managers, who in turn, depends up on the availability of useable information (Banker, Dervaj, Sinha, and Schroeder, 1979 cited in Tapanya, 2004). Banker, Dervaj e.t.l states that Information about performance is important in different ways to the various stockholders within a business. Managers look at the performance of a company's sub units as a way of prioritizing the allocations of resources.

The performance literature states that measuring performance is a fundamental part of every organization, whether it is run by a private or a public. Thus, a performance measurement system is highlights whether the organization is on track to achieve its desired goals or not and Performance measures are primarily used to evaluate organizational, as well as employee performance.

According to Aghion and Tirole (1997), Roberts (2004) cited in BOUWENS (2007)**,** to encourage rapid and relevant decision making, firms move towards organizational designs in which authority over operations and strategy is assigned to business unit managers .It is conjecture that different performance measures play different and distinct roles in evaluating the performance of business unit managers according to the organizational design of the firm. It is apparent that the majority of banks in these countries have adopted branch organizational structures. The way in which branch performance is controlled and measured is, therefore, of particular significance.

The issue of appropriate performance measures is thus a very significant one to consider, not solely because it can affect the commercial success of banking firms but also because, in the present economic climate, many banking firms will be looking for appropriate information about their internal activities or process to facilitate a sound decision making which in turn go inline with the interests of the owners.

A central issue of responsibility accounting is whether a branch manager should be held accountable for transactions that he or she cannot influence by his or her actions (for example, Horngren et al. 1997, p. 192; Merchant, 1987, p. 316, cited by Drury and Shishini,2005). The management accounting literature (for example, Merchant, 1998) distinguishes between the economic performance of a branch and the performance of its manager, advocating that the evaluation of a manager's performance should consist of only those factors under a manager's control. Therefore, branch performance measures (whatever the measure in use) should include only the items controllable by branch managers. In other words, performance measurement should be based on the application of the controllability principle.

The choice of appropriate measures of branch managerial performance has been widely debated in management accounting literature. The other issue is whether based on the application of the controllability principle different performance measures should be used to evaluate the performance of branch managers and the economic performance of the branches, or whether a single measure should be used for both purposes.

Though distinguishing between branches managerial and economic performance requires the application of the controllability principle, the findings of this study indicates that majority of the responding banks did not apply the controllability principle in evaluating managerial and economic performance. In addition the finding of this paper indicates that in evaluating branch performances the banks in Ethiopia are more depends on financial measures.

The main objective of the paper was to describe the branch performance measurements of some selected banks in Ethiopia and to forward some recommendations based on the existing literature. In light of this, the specific objectives of the research include the following: To look into the use of financial performance measures in evaluating branch managers' performance; to describe the relative importance attached to financial performance measures versus non financial performance measures that are used to evaluate branch managers' performance.

With the above objectives, this paper answers the following general questions, which are useful in evaluating the branch performance measurement of the banks: What type of branch performance measures are used to evaluate the performance of branch managers and the business unit? How should branch profitability be measured?

In order to achieve the objectives information was collected relating to uncontrollable factors such as uncontrollable common resources costs, group general and administrative costs, and the external environment. A major feature of the study was to isolate uncontrollable factors. Uncontrollable common resource costs therefore exclude partially controllable and fully controllable common resource costs.

2. Review of literature

The way a company is organized, which depends on such things as the culture of its home country and the philosophy of its top managers, influences its reporting system. Different organizational structures result in different groupings of responsibilities. That is, the way a company is structured affects the areas controlled by individual managers (Dominiak and Lauderback, 1997).

Traditionally, literature has advocated that branch financial performance measurement should distinguish between the performance of branch mangers and the economic performance of the branch unit (Dearden, 1987; Drury, 2000, p. 796 cited in Drury and Shishini, 2005). To evaluate the economic performance of branches, corporate management requires a periodic reporting system providing attention-directing information. If the purpose is to evaluate the performance of branch managers, only those items that are controllable, or influenced by the branch manager, should be included in the performance measure.

According Drury and Shishini , 2005 the need to distinguish between branch managerial and economic performance leads to three different profit measures – branch controllable profit, branch contribution to corporate sustaining costs and profits, and branch net income.

According to the management accounting literature, there are four different alternative profit measures that we can use to measure divisional performance: variable short-run contribution margin, controllable contribution, divisional contribution and divisional net profit before taxes.

According to Drury and Shishini, 2005; in measuring managerial performance the variable short-run contribution margin is inappropriate for performance evaluation, because it does not include fixed costs that are controllable by the divisional manager. The controllable contribution includes controllable fixed costs such as non-variable labor, equipment rental and the cost of utilities. It is the most appropriate measure of a divisional manager's performance, since controllable contribution measures the ability of managers to use the resources under their control effectively. This measure should not be interpreted in isolation if it is used directly to evaluate the performance of a divisional manager. Instead, the controllable contribution reported by a division should be evaluated relative to a budgeted performance, so that market conditions can be taken into account.

Though there are numerous measures of a branches' financial performance, the ROI, and RI, which are the most informative that reflects the aspects of profitability and capital employed (Keef and Roush, 2001 cited in Rantatunga and Montali, 2008). Surveys of methods used by companies to evaluate the performance of divisional managers indicate a strong preference for ROI over RI[1]. The UK survey by Drury reported that the following measures were used (in %) (Drury, 2004, P.240 cited in Burksaitiene):

A target ROI set by the group	55
Residual income	20

ROI and RI cannot stand-alone as a financial measure of branch performance. Short-run profitability is only one of the factors contributing to a company's long-run objectives. ROI and RI are short-run concepts that deal only with the current reporting period, whereas managerial performance measures should focus on future results that can be expected because of present actions (Burksaitiene, 2008).

Successful bank operation requires managers to weigh complex trade-offs between growths, return, and risk.

In recent years banks increasingly have adopted innovative performance metrics such as the economic value added (EVA), which assist managers in making such difficult and complex decisions (Kimball, 1998).

The need to integrate financial and non-financial measures of performance and identify key performance measures that link measurements to strategy led to the emergence of the 'balanced scorecard'. The balanced scorecard aims to provide an integrated set of performance measures derived from the company's strategy that gives top management a fast but comprehensive view of the organizational unit.

According to Kaplan and Norton, 1993, 1996, 2001 cited in Drury and Shishini, 2005 the balanced scorecard philosophy assumes that an organization's vision and strategy is best achieved when the organization is viewed from the following four perspectives: Customer perspective ('how do customers see us?'); Internal business perspective ('what must we excel at?'); learning and growth perspective ('Can we continue to improve and create value?'); and Financial perspective ('how do we look to shareholders?').

The balanced scorecard involves establishing major objectives for each of the four perspectives and translating each objective into specific performance measures. Kaplan and Norton recommend targets be established for each performance measure. For feedback reporting, actual performance measures can also be added. In order to minimize information overload and avoid a proliferation of performance measures, the number of measures used for each of the four perspectives should be limited to critical measures (cited in Tapanya, 2004).

3. Methodology of the Study

3.1. Research design

As this study is concerned with the manner in which branch performance is controlled and measured, a mixed method approach has been adopted. Both primary and secondary data were used. The primary data were collected through face-to-face interviews, and questionnaires. The secondary data were obtained from journals, manuals of the company, articles, websites and different published and unpublished documents.

The study adopted a descriptive research design as it aims to investigate in depth and describe features of the population under study.

3.2. Population and Sampling techniques

The population consists of the total 16 banks found in the country. The non probability sampling techniques were used and 10 banks were purposively selected from 16 banks found in the country by basing the age of the banks.

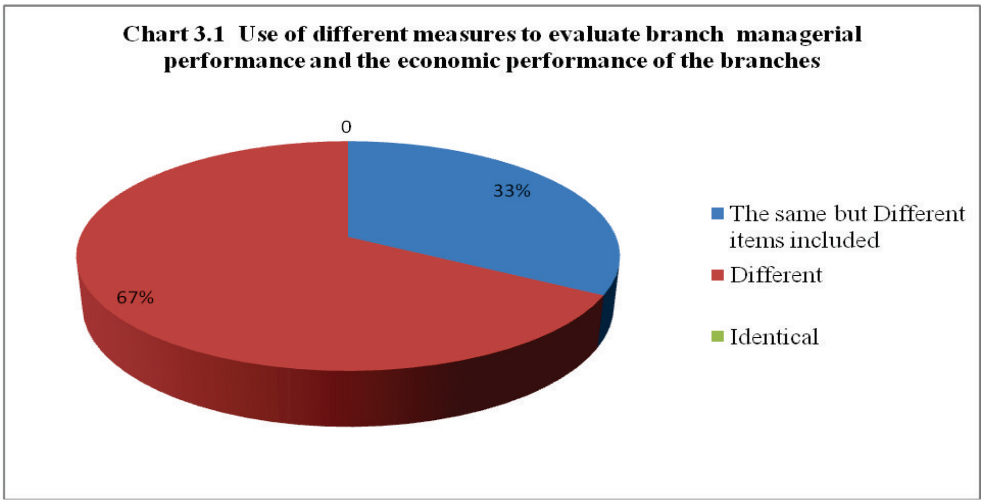
Information collected through review of documents, personal interview, and questionnaires were analyzed within the framework of the study objectives. To present the findings, the issue that were addressed in the related literature namely the Return on Investment (ROI), Residual income (RI), and Economic Value Added (EVA), were used as a tool to analyze the data.

Thus, since the data collected is more of qualitative in nature, the data obtained through both questionnaire and interviews were analyzed by using descriptive analysis. In addition, in order to answer the study questions specified in the objective of the study sections of this research, tables and percentages were used. Percentages for these data were calculated in order to facilitate the analysis and to make it presentable for the readers

4. Result and Discussions

4.1. The use of different performance measures to evaluate branch managerial performance and the economic performance of the branches

Following the line of argument that companies may use different performance measures to evaluate branch managerial performance and the economic performance of the branches, the respondents (branch operation managers and corporate planning and evaluation managers) were asked to indicate in the first Question which of the following methods describe the use of performance measures of their banks and the responses are summarized as:



The above pie chart (chart 3.1) implies the percentage responses to the question (six banks). Thus, all of the banks would appear to distinguish between the economic performance of the branches and the performance of the branch managers. The above findings suggest that variations do exist in the application of the controllability principle. For the first performance measurement category described above uncontrollable costs were specified within Question B1 as an example of an item that might be excluded from the managerial performance measure, but included within the economic performance measure. This would suggest that 33% of the respondents ticking this box are indicating that some uncontrollable items are excluded from the performance measure when evaluating branch managerial performance.

In contrast, the responses to the second category described above do not necessarily imply that the controllability principle is being applied. The responses may indicate that a non-ratio performance measure for instance net income, controllable profit etc. is used to measure managerial performance and a ratio measure (e.g. ROI) for economic performance, or vice-versa. Both types of measures may, or may not, include uncontrollable. Thus, some doubt exists as to whether the responses to the second category indicate that the controllability principle is being applied.

According to the interviews made with the branch operation managers, even though different performance measures are used for evaluating the performance of branch managers and the economic performance of the branches, this does not mean that the banks are applying the controllability principle. For example, the economic performance of the branches are measured based on the profit that the branch generates and the branch managers are evaluated on the deposit mobilized, and loans performed during the period without considering any uncontrollable factors.

But, though 67% of the respondents used different performance measures to evaluate the performance of branch managers and the economic performance of the branches, they are not applying the controllability principle.

The conclusion from the above findings is that the responses provide evidence of 33% of the respondents applying the controllability principle and 67% does not provide any evidence to suggest whether the controllability principle is extensively applied or is being merely applied to a small extent, and as supported by interview this implies that the majority of banks does not apply the controllability principle.

4.2 The relative importance of different financial measures

According to management literature, more than one financial measure may be used to evaluate the performance of branch managers. The respondents were given a list of measures that have been identified in literature as measuring performance of branch managers and they were asked to rank, in order of importance, the three most important measures. The responses are:

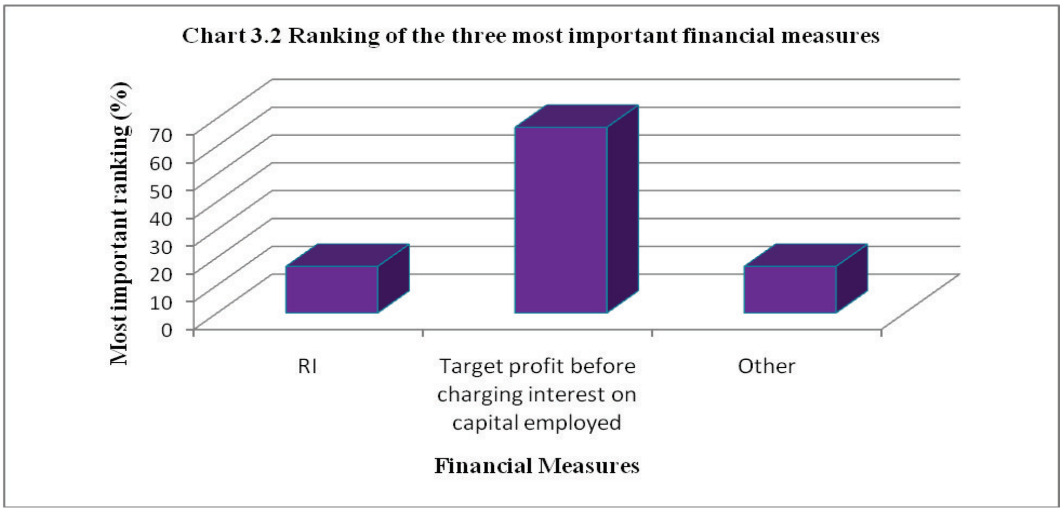


Chart 3.2 depicts that the target profit before charging interest on capital was considered to be the most important measure by 66.6% of the banks. The second most important ranked are both a target profit after charging interest on capital employed (residual income) and other by 16.7% for each. The ROI which is widely cited by the previous researcher was not selected under the first most important ranking. The question also provided the opportunity for respondents to insert measures other than those listed. Of the total respondents to this question, two inserted an unlisted measure as the important financial measure. Measures specified were target profit before tax (one respondents inserted under the first most important and the second respondents inserted under the second most important ranking).

It should be noted that previous studies (Reece and Cool, 1978; Scapens and Sale, 1985; Francis and Minchington, 2000 cited in Drury and Shishini, 2005) have reported that a target ROI is extensively used. However, these studies did not require the respondents to rank the relative importance of the different measures.

Comparing the results of this study, based on rankings, with the previous studies that did not incorporate rankings, a different picture emerges. It would appear that an absolute measure of performance is preferred to a ratio measure. A possible explanation of this observation is that central head offices require branch managers to focus on maximizing an absolute value rather than a percentage return. Also, the survey required that responses should be related to managerial performance evaluation, whereas other studies have not distinguished between managerial and economic performance.

For managerial performance evaluation, there appears to be a strong preference for comparisons to be made with profit budgets that take into account the projected potential of the resources being managed. Targets set in absolute terms at the planning stage for the forthcoming period that take into account the potential returns on the assets – and which can easily be disaggregated by revenue and expense categories – may provide a more appropriate basis for managerial performance evaluation. ROI may be used more extensively for evaluating branch economic performance over a longer-term period, involving comparisons with similar units outside of the organization.

4.3. Economic Value Added usage

EVA is a fairly recent innovation. The survey required to ascertain the extent of its use and relative importance. From all banks only one bank was ranked as the third most important financial measures. With regard to EVA usage no one respondent indicated that it was used as a method of evaluating the performance of branch managers. The responses also indicated that only one bank (17%) planned to introduce EVA within the next two years and 83% indicated that EVA is not used and were no plans to use it within the next two years.

Although EVA is a recent innovation that focuses on increasing the shareholder value, almost for all Ethiopian banks the EVA approach is a new concept and even they don't know what EVA is all about. As interviews were made they are solely relying on traditional financial performance measure.

4.4. The Influence of branch management and head office management in setting financial targets.

From the previous studies an interesting issue raised was that financial targets, in terms of targeted performance measures, are imposed by the headquarters (Scapens et al, 1982; Tomkins, 1973 cited in Drury and Shishini, 2005). Therefore, the survey sought to ascertain the extent to which headquarters management and branch management participate in setting the financial targets specified in Table 3.1. The responses indicated that 83% corporate headquarters management participate in setting the financial targets to a considerable extent whereas 0nly 17% participate to a small extent.

Similarly 83% of the responses also indicated that branch management was participating in setting the financial targets to a considerable extent and 17% were not at all. Thus, from the above finding it is apparent that the influence of branch manager and head office management in setting financial target is equally balanced.

4.5. Non-financial measures

Currently, many companies are giving greater emphasis on non-financial measures such as customer satisfaction, innovation measures, on time delivery, market share, product/service quality, and productivity (Ittner et al., 1998b; Kaplan et al., 1996a; Kaplan et al., 2001a; Lev and Zarowin, 1998; Maisel, 1992 cited in Tapanya, 2004).

Similarly, Kaplan and Norton, 1996 cited in shishini, 2001 states that in recent years mounting attention has been given to incorporating within the performance measurement system those non-financial performance measures that provided feedback on the key variables required to compete successfully in a global economic environment. The respondents were asked whether non financial measures such as customer satisfactions, productivity, quality, innovations etc are used to evaluate divisional performance or not. 67% of them used non financial measures to evaluate their branch performance and 33% of the responses were not.

In addition, the respondents were also asked to indicate the extent to which their bank uses both financial and non financial measures to determine bonuses for branch managers in evaluating the branch manager's performance. 67% responds that they are using to a considerable extent and where as 33% was not at all.

Finally, beside the above findings, the respondents were asked to indicate the importance attached to financial versus non-financial measures for evaluating branch performance. The responses are summarized in chat 3.3.

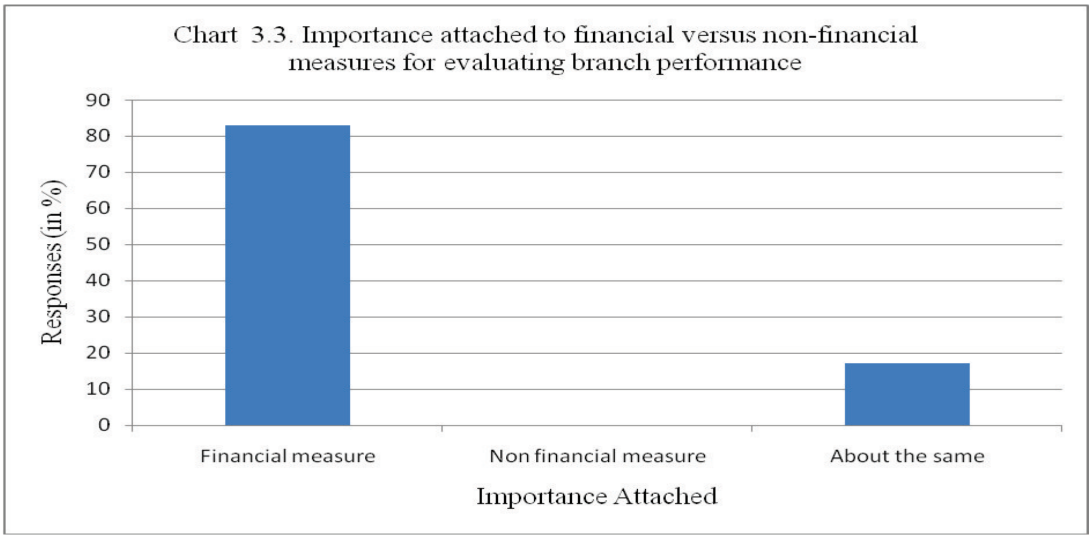


Chart 3.3 summarizes that of the total respondents 83% responds that financial measures are considerably more important than non financial measures; 17% responds they are about the same importance and non- of the respondents were responds to non financial measures are considerably more important than financial measures. From this one can conclude that in evaluating branch performances the banks in Ethiopia are more depends on financial measures.

Though, in the real world more attentions are given to non financial performance measures to evaluate the performance of divisions, the findings of this study is different from the real world.

The findings tend to reject the views that Kaplan and Norton (1996) have observed and objected to that financial measure should be de-emphasized on the grounds that, by making fundamental improvements to the key non-financial measures, the financial measures will take care of themselves. In other words, financial success should be the logical consequence of favorable key non-financial measures.

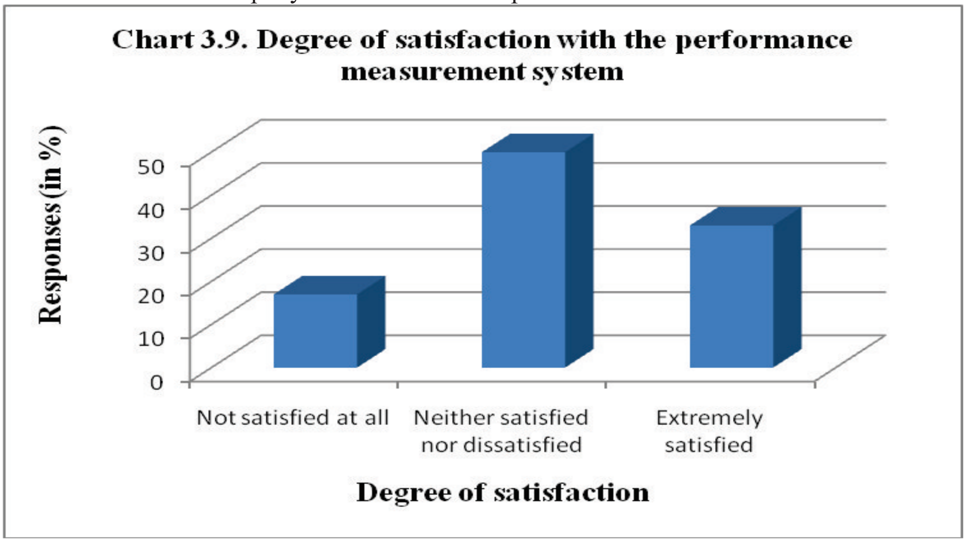
In addition to the usage of non financial performance measures the respondents were asked whether balanced score card is used to evaluate the performance of divisions or not. Of the total respondents 83% responds that the balanced scored approach is not used in their banks to evaluate the performance of their branch managers. In contrary 17% responds that the balanced score card approach is used in their banks to evaluate the performance of their branch managers.

According to Drury and Shishini, 2005 the need to integrate financial and non-financial measures of performance and identify key performance measures that link measurements to strategy led to the emergence of the 'balanced scorecard'. The balanced scorecard aims to provide an integrated set of performance measures derived from the company's strategy that gives top management a fast but comprehensive view of the organizational unit. But, the finding of this study tends to reject the argument that Drury and Shishini stated.

4.6. Degree of satisfaction with the performance measurement system

The degree of satisfaction with the performance measurement system was also measured. The survey gauged the respondents' satisfaction with the approach to allocating the costs of common resources and general and administrative expenses for performance evaluation. Another survey question was concerned with the system of performance evaluation that is used to judge performance evaluation.

The respondents were asked to indicate their degree of satisfaction with the system of performance evaluation that is used in their company to evaluate branch performance.



Their responses were categorized in to three (not satisfied at all, neither satisfied nor unsatisfied, and extremely satisfied). Thus, of the total responses 17% were not satisfied at all, 50% were neither satisfied nor dissatisfied, and the remaining 33% were extremely satisfied.

Previous research suggests that managers who have greater autonomy will tend to be more satisfied with the performance measurement/control system than managers with less autonomy (Dittman et al, 1978 cited in Drury and Shishini, 2005). Managers with greater autonomy also have the opportunity to use external resources and so avoid the allocation of common resource costs. Common resource costs are, therefore, more likely to be controllable in these circumstances. Thus, according to Dittman the relationship between the degree of branch managers' autonomy and their degree of satisfaction with the performance measurement system is matters.

A greater use of non-financial performance measures provides more dimensions to managers' performances and compensates for the uncontrollable items included in the financial performance measures. It is also likely that the level of application of the controllability principle has an impact on the degree of satisfaction with the performance measurement system. It has been shown in Chapter two that management accounting literature advocates that branch managers should not be held responsible for non-controllable items. Therefore, it can be argued that both the extent of use of non-financial measures, and the level of application of the controllability principle, will be positively related to the degree of satisfaction with the performance measurement system.

5. Conclusions

To achieve the first objective, it was necessary to pursue the line of argument that companies may use different performance measures to evaluate branch managerial performance and the economic performance of branches. The responses indicated that 33 percent attempted to apply the controllability principle and distinguish between managerial and economic performance.

In contrast, 67 percent of the responding bank indicates that different performance measures are used for evaluating the performance of the branches. Even though banks used different measures, as interviews were made with branch operation manager, it does not imply that the controllability principle is being applied. Because according to the respondents, they are not considering the uncontrollable factors. Of the total responding banks most of them are solely focusing on the amount of profit generated during the period.

Given that more than one financial measure may be used to evaluate the performance of branch managers, respondents were given a list of measures that have been identified in literature as measuring overall branch performance. They were asked to rank, in order of importance, the three most important measures. The results indicated that target profit before charging interest on capital was considered to be the most important measure by 66.6 percent of the banks. Both a target profit after charging interest on capital employed (residual income) and other are considered as the second most important with a 16.7 % each. The widely cited target return on capital employed measure was ranked as the most important measure by 16.7 % and no one bank ranked EVA as the most important measure.

These findings provide additional insights into the relative importance of financial measures. Almost all of previous studies have not distinguished between managerial and economic performance. They have also focused on whether various financial measures are used for evaluating branch performance rather than ascertaining their importance relative to each other. The findings from these studies indicate that a target rate of return (ROI) is extensively used.

However, as cited in section B and section C of the questionnaire this study focused particularly on branch managerial performance. The findings indicated a strong preference for an absolute target performance measure rather than a ratio/percentage measure. Presumably, companies seek to encourage divisional managers to focus on maximizing absolute profits rather than percentage returns and prefer to compare managerial performance against budget targets that take into account the potential of existing resources. This observation may explain why the emergence of EVA in the 1990s has attracted so much attention (Drury and Shishini, 2005). Nevertheless, the findings indicate that no banks used EVA as a method of evaluating the performance of branch managers.

No one out of the six respondents ranked EVA as the most important method of evaluating the performance of divisional managers, but one bank planned to use it within the next two years. This suggests that these banks are using other traditional financial measure rather than EVA measure.

Currently, many companies are giving greater emphasis on non-financial measures such as customer satisfaction, innovation measures, on time delivery, market share, product/service quality, and productivity.

Kaplan and Norton, 1996 also states that in recent years mounting attention has been given to incorporating within the performance measurement system those non-financial performance measures that provided feedback on the key variables required to compete successfully in a global economic environment. The respondents were asked whether non financial measures such as customer satisfactions, productivity, quality, innovations etc are used to evaluate divisional performance or not. 67% of them used non financial measures to evaluate their branch performance and 33% of the responses were not.

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Finally, the respondents were asked to indicate the importance attached to financial versus non-financial measures for evaluating branch performance. Of the total respondents 83% responds that financial measures are considerably more important than non financial measures; 17% responds they are about the same importance and non- of the respondents were responds to non financial measures are considerably more important than financial measures.

6. Recommendations

Based on the findings, the following possible recommendations may help the banks in Ethiopia in measuring or evaluating the performance of their branches: Regarding financial measures –It is advisable to banks in Ethiopia to use different performance measures to evaluate branch managerial performance and the economic performance. It is more appropriate to use ROI for evaluating the economic performance of a division than managerial performance. Instead of focusing purely on the absolute size of a division's profits, most company focuses on the ROI of a division (that is, profit as percentage of the investment in division). Previous research supports that companies tend to use ROI in order to make inter division and inter firm comparison; though financial performance measure is only one source of information to decision makers, as cited in Drury and Shishini, 2005, linking divisional performance to economic value added motivates managers to focus on increasing shareholder value. Besides, the economic value added concept extends the traditional measure by incorporating adjustments to the divisional financial performance measure for distortions introduced by GAAP. Thus, it is better to use EVA which incorporates adjustment to the divisional financial performance measure in evaluating the branch managers; Incorporating Non financial performance measure- Financial performance measures cannot stand alone as a measure of divisional performance. Profitability is only one of the factors contributing to a company's objectives. An incorporation of non-financial measures, such as competitiveness, customer satisfactions, productivity, quality, innovation and flexibility in responding to changes in demand, creates the need to link financial and non-financial measures of performance. Thus, it is recommendable to banks that branch performance measurement should be based on a combination of financial and non-financial measures using the balanced scorecard approach.

There is a need for a further study to provide empirical evidence how Ethiopian banks use financial performance measurement, nonfinancial performance measurement, and application of controllability principle to measure or evaluate the performances of their branches.

7. Scope for further study

The study would be more fruitful if it were conducted widely by including all banks in Ethiopia and other similar firms. Thus, more intensive researches on the area should be undertaken especially on both service and manufacturing sectors by including controllability principle.

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