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ASSET QUALITY RATIO TO PROFITIBILITY: THE CASE OF SELECTED BRANCHES OF COOPERATIVE BANK OF OROMIA, OROMIA REGIONAL STATE, ETHIOPIA

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Abstract
The asset quality ratio of the bank is imperative in Ethiopia. Although the asset quality ratio has been studied by some researchers but appreciable efforts have not been made on the sectors of cooperative banks. Therefore, the present study was carried out to investigate asset quality ratio of cooperative bank of oromia, selected branches in oromia. The quantitative research approach was employed to accomplish the objectives of this study. The secondary data were collected from eight selected branches of CBO that fulfill the criteria of the data availability from the financial statement during the study period from 2007-08 to 2013-14 G.C. Descriptive statistics model was used to analysis the panel data for the standard determinants of asset quality ratio. The results showed that proxy variables of assets quality ratio has a negative on the profitability of the bank and also indicated that as the bank decreased, assets quality ratio has increased the profitability of the bank. Asset quality performance will be developed from the three broad perspectives: Assets Quality Ratio, Earning Capacity Ratio and Liquidity Ratio. To indicators of asset quality ratio includes: Gross Non-Performing Asset to Gross Assets, Net Non-Performing Assets to Net Assets and Net Non-performing Assets to Total Assets. The beneficiaries of the results of this study was corporate finance academicians whose interest is in the area of asset quality ratio on the profitability of cooperative banks and also helps as a baseline for further studies and the bank managers to understand the asset quality ratio for the management of the banks in Ethiopia.

Key words: Cooperative Bank of Oromia Branches, Profitability, Asset Quality Ratio, Gross Non-Performing Asset, Net Non-Performing Assets, Gross Asset, Net Asset.

Introduction

Cooperative Bank of Oromia Share Company has been established with the authorized capital of Birr 300,000,000 in October, 2004 G.C with the objective to engage in banking service in accordance with the Monetary and Banking Proclamation number 83/1994 E.C and Supervision of Banking Proclamation number 84/1994 of the National Bank of Ethiopia. The bank has started fully fledged banking operation in March, 2005 G.C. CBO's vision is to be competent, reputable and socially responsible bank in Africa. The bank's mission is to provide full fledged and customer responsive banking services for cooperative societies, other entities, and individuals with special emphasis to agricultural and agro based businesses financing, and to maximize shareholders' value through use of competent and disciplined employees, visionary leaders, and modern banking technologies. Cooperative Bank of Oromia upholds the core values and principles which includes respect to socio cultural attributes of the people; integrity, honesty, and loyalty; valuing customers' comment; accountability and social responsibility; and professionalism. The financial statement is prepared under the historical cost convention in accordance with generally accepted accounting standards and the laws and regulation of commercial Code of Ethiopia 1960. Nowadays, CBO's have 122 branches in different city and towns also the bank total capital has reached 697.50 million birr.

Statement of the Problem

The ultimate objective of any firm is to maximize the profit. But, preserving asset quality ratio is an important objective too. The problem is that increasing profits at the financial variables factors can bring serious problems to the bank. Therefore, there must be a trade-off between these two objectives of the bank. If we do not care about profit, we cannot survive for a longer period. On the other hand, if we do not care about financial variables, we may face the problem of insolvency or bankruptcy. For these reasons, asset quality ratio of the bank should be given proper consideration and will ultimately affect the profitability of the bank. The Cooperative Bank of Oromia (CBO) has shown a considerable expansion in its assets, outlaying branches and also involved human capital. The aggressive expansion also forced the Bank to incur considerable costs. In detail to indicate that, except interest expenses, all other costs went up considerably. Employees' salaries and benefits and general administration expenses and also the CBO's profit after tax showed a remarkable increase the profit after tax figure has been constantly on the up over the past few years. The aforementioned facts gives a clue to the Cooperative Bank of Oromia growth in profits is due to underdeveloped nature of the sector. Therefore, this growth may not continue when the finance sector becomes highly developed and the competition become tough, so investigation of the key financial variables that influence the profitability of banks is vital. The main purpose of this study will be to analyze the financial data of cooperative bank of Oromia for the fiscal year from 2008 to 2014 in order to investigate asset quality ratio of bank.

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Review of Related Literature

Several individual researchers had studied a few facets of asset quality ratio of selected CBOB (Cooperative Bank of Oromia Branches) in selected areas. To know how far the ground is already prepared and to identify the gaps therein, and to spell out the issues which need further intensive and comprehensive analysis, an attempt is made to review the related literature.

3.1 Yuqi, (2006), in his study, poor asset quality is the major cause for banks poor profitability. It is evaluated by understanding the performance of assets category wise and estimating future performance factoring in the likely distribution of the assets in future. The bank's experience of loan loss, provisions write off, loan recovery rate, ability to reduce nonperforming assets and extent of weak assets are analyzed in this regard.

3.2 Zewdu, (2010), in his study, the principal profit making activity of bank is making loans to its customers. Lending represents the heart of the industry. Loan is a major asset, income source for banks, and risky area of the industry. Moreover, its contribution to the growth of any country is very clear. Therefore, managing loan in a proper way not only has positive effect on the banks profitability but also on the borrower firms and a country as a whole. The heart of any successful commercial lending function is credit discipline written in loan policy, structured loan approval process and strong loan administration function.

3.3 Belayneh, (2011), in his study, stated that the current real economic growth of the country makes commercial banks to be more profitable. A high aggregate growth rate may strengthen the debt servicing capacity of domestic borrowers, and therefore, contribute to less credit risk. Alternatively, adverse macroeconomic conditions hurt banks by increasing the amount of non-performing loans. Thus, it is expected that an improvement in economic growth enhance bank performance.

3.4 Diaconu and Oanea, (2014), showed that internal factors, namely loans to assets and equity to assets have a higher and significant influence on bank profitability. Moreover, it seems that loans to assets have a positive effect, while equity to asset has a negative effect on bank's profitability.

4. Objectives of the Study

The specific objectives of the present study are:

1. To measure the effect of asset quality ratio on profitability of the bank.
2. To offer suitable suggestions for the development of the CBOBs.

4. Data Source and Collection and Analysis Methods

4.1. Source of data

For this study quantitative data was employed from secondary sources based on the selected bank branches for the study. The secondary data was needed for analysis is mainly obtained from the audited financial statements of Cooperative Bank of Oromia. The financial statement was considered basically on Balance Sheet and profit and loss of consecutive seven years data i.e. 2007-08 to 2013-14 G.C.

4.2. Data Collection Methods

Data collection is an important aspect of any type of research study. So, appropriate attention will be given for it while inaccurate data collection can impact the result of a study an ultimately lead to invalid results. For this study, the researcher will be used mainly quantitative methods for data collection. So, the researcher will collect the secondary data from audited financial statements mostly the balance sheet, income statement and profit and loss of cooperative bank of Oromia for the consecutive seven years (2007-08 up to 2013-14 G.C) data by using data sheet.

4.3. Method of Data Analysis

The collected data was analyzed by using descriptive statistics model. Descriptive analysis is the first step in the analysis; it helps the researcher to describe relevant aspects of variables and provide detailed information about each relevant variable through like mean, standard deviation, minimum and maximum was used to analyze the collected data from 2007-08 to 2013-14 for the variables which included in the study.

5. Sampling

Cooperative bank of Oromia is purposively selected in the study because; it is the first cooperative bank in the country. But the criterion used in selecting the bank branches in the study based on the holding of a complete 7 years financial statement data (2007-08 to 2013-14 G.C), date of establishments that are established before 2010 G.C and the capital they run in business . There are 22 branches operating in this selected bank. The sampling process is based on the availability of financial statements. Among these Bank branches, 8 branches viz. Merkato, Waliso, Ambo, Adama, Shashemene, Burayu, Shanan

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Gibe and Nekemte were selected and collected with data of asset quality ratio. The study analysis was undertaken for 7 consecutive years of operation for the banks.

6. Scope of the study

This study was confined only to know the Major operational of asset quality of Cooperative Bank of Oromia by analyzing the financial statements start from 2007-08 to 2013-14 fiscal years. From the topic in the Major operational of asset quality of the bank the study selects the area of analysis of financial Variables and assesses their relevance in cooperatives bank concept. Even though there are so many banks in Ethiopia, the study was limited to Cooperative Bank of Oromia with the ownership o f cooperatives.

7. Results and Discussion

7.1. Ratio Analysis

The relationship between two figures expressed mathematically is called a ‘Ratio’. It is a numerical relationship between two numbers which are related in some manner. Ratio analysis is technique of analysis and interpretation of financial statements. It is the process of determination and interpretation of various ratios for helping in decision making. Ratio analysis involves three steps.

7.2 Asset Quality Ratio

Asset Quality is one of the most critical areas in determining the overall condition of the bank. The primary factor effecting overall Asset Quality is the quality of the loan portfolio and the credit administration program. Loans are usually the largest of the asset items and can also carry the greatest amount of potential risk to the bank’s capital account. Securities can often be a large portion of the assets and also have identifiable risks. Other items which impact a comprehensive review of asset quality are other real estate, other assets, off-balance sheet items and to a lesser extent, cash and due from accounts, and premises and fixed assets. The Asset Quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other estate owned, and other assets, as well as off-balance sheet transactions. The ability of management to identify, measure, monitor and control credit risk is also reflected here. The quality of assets is an important parameter to gauge the strength of the bank. The main motto behind measuring the Asset Quality is to ascertain the component of Non-Performing Assets (NPA) as a percentage of Total Assets. These NPAs should be considered against not just Total Assets but also against the Advances because NPAs primarily arise from Advances. This indicates what type of Advances the bank has made to generate interest income. Thus, Asset Quality indicates the type of the debtors of the bank.

7.3 Gross Non-Performing Assets to Gross Assets Ratio

The Gross NPAs to Gross Assets ratio is a measure of the quality of assets in a situation, where the management has not provided for loss on NPAs (Non-Performing Assets). Here Gross NPAs are measured as a percentage of Gross Assets. Lower ratio (below 5 percent) indicates better quality of assets.

Table-1.1: Ratio of Gross Non-Performing Assets to Gross Assets

Ratio	Details of Branches	Year							Descriptive Statistics			
		2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Mean	SD	Min	Max
Gross Non-Performing Assets to Gross Assets	Hora Arsade	0.03	0.05	0.13	0.08	0.07	0.07	0.12	0.49	0.70	0.02	3.11
	Waliso	0.02	0.08	0.17	1.27	1.54	1.14	1.50				
	Ambo	0.05	0.07	1.13	1.08	2.07	2.07	3.11				
	Adama	2.02	2.05	1.13	0.08	0.07	1.07	0.74				
	Shashemene	0.07	0.08	0.90	0.08	0.09	0.09	0.23				
	Burayu	0.05	0.04	0.15	0.09	0.08	0.49	0.34				
	Shanen Gibe	0.04	0.06	0.24	0.09	0.09	0.07	0.45				
	Nekemte	0.04	0.06	0.28	0.09	0.07	0.09	0.62				

The gross non-performing assets to gross assets was showing 0.49 percent of mean value it is the highest mean value when compare with other mean value of asset quality parameter. According to Ethiopian context, the banking sectors are required to maintain the ratio GNPAs at least below 5 percent (NBE, 2008). It indicates banks aggressiveness in lending and credit risk of the bank. So, the banks have the efficiency of in assessing credit risk and to an extent in recovering the debt.

7.4 Net Non-Performing Assets to Net Assets Ratio

The net non-performing assets to net assets ratio is the most standard measure of Assets Quality. This ratio measures Net NPAs as a percentage of Net Advances. Net NPAs are Gross NPAs net of provisions on NPAs and interest in suspense account. Lower ratio (below 5 percent) indicates the better performance of banks.

Table-1.2: Ratio of Net Non-Performing Assets to Net Assets

Ratio	Details of Branches	Year							Descriptive Statistics			
		2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Mean	SD	Min	Max
Net Non-Performing Assets to Net Assets	Hora Arsade	0.02	0.05	0.07	0.01	0.01	0.06	0.06	0.33	0.85	0.12	3.94
	Waliso	0.99	0.19	1.66	2.40	3.06	3.40	3.94				
	Ambo	0.04	0.22	0.05	0.03	0.03	0.06	0.08				
	Adama	0.04	0.04	0.08	0.03	0.03	0.07	0.07				
	Shashemene	0.09	0.06	0.09	0.03	0.01	0.06	0.06				
	Burayu	0.09	0.06	0.07	0.02	0.03	0.06	0.08				
	Shanen Gibe	0.03	0.06	0.08	0.03	0.02	0.06	0.07				
	Nekemte	0.50	0.06	0.08	0.02	0.02	0.08	0.06				

The net non-performing assets to net assets was showing 0.33 percent of mean value it is the midlist mean value when compare with other mean value of asset quality parameter. According to Ethiopian context, the banking sectors are required to maintain the ratio NNPAs at least below 5 percent (NBE, 2008). It indicates banks aggressiveness in lending and credit risk of the bank. So, the banks have the efficiency of in assessing credit risk and to an extent in recovering the debt.

7.5 Net Non-Performing Assets to Total Assets Ratio

Net non-performing assets to total assets ratio indicates the efficiency of the bank in assessing credit risk and to an extent recovering the debts. This ratio is arrived at by dividing the Net NPAs by Total Assets. Net NPAs are calculated by adjusting provisions against Gross NPAs. Lower ratio (below 5 percent) indicates the better performance of banks.

Table-1.3: Ratio of Net Non-Performing Assets to Total Assets

Ratio	Details of Branches	Year							Descriptive Statistics			
		2007-08	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14	Mean	SD	Min	Max
Net Non-Performing Assets to Total Assets	Hora Arsade	0.02	0.05	0.07	0.01	0.01	0.03	0.05	0.08	0.09	0.01	0.58
	Waliso	0.22	0.03	0.18	0.24	0.35	0.36	0.59				
	Ambo	0.04	0.08	0.10	0.02	0.02	0.04	0.06				
	Adama	0.05	0.06	0.07	0.03	0.03	0.04	0.08				
	Shashemene	0.05	0.05	0.08	0.03	0.03	0.05	0.06				
	Burayu	0.03	0.06	0.09	0.03	0.03	0.05	0.06				
	Shanen Gibe	0.07	0.09	0.09	0.09	0.03	0.05	0.06				
	Nekemte	0.06	0.07	0.08	0.03	0.06	0.05	0.06				

The net non-performing assets to total assets was showing 0.08 percent of mean value it is the lowest mean value when compare with other mean value of asset quality parameter. According to Ethiopian context, the banking sectors are required to maintain the ratio NNPAs at least below 5 percent (NBE, 2008). It indicates banks aggressiveness in lending and credit risk of the bank. So, the banks have the efficiency of in assessing credit risk and to an extent in recovering the debt.

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7.6. Regression Results Using GLS (Cluster Robust) of Asset Quality Ratio

Random Effect (GLS with Cluster Robust)			
Variables	**Coefficient**	**Std. Error**	**P-value**
GNPA to TA	-0.04	0.05	0.40
NNPA to NA	-0.26	0.13	0.05***
NNPA to TA	-1.37	1.10	0.21
Significant Levels	Level of significance *refers statistically significant at 1%, ** statistically significant at 5% and *** statistically significant at 10%		

Source: STATA output from Cooperative banks' of Oromia financial statements

The variables that is used to measure Asset quality is gross non-performing assets to total asset (GNPATTA), non-performing asset to net asset (NNATNA), net non-performing asset to total asset(NNPATTA) and total investment to total assets(TITTA) . The model that is applied for this regression is:
$ROAit = \alpha_0 + \alpha 1$ GNPA/TAit $+\alpha 2$ NNPA/NAit+α3TI/TAit+ $\alpha 4$ NNPA/ TAit + eit… (1)

As it can be seen from the above table gross non-performing assets to total asset, and net non-performing asset to total asset are statistically not significant at any significant level, but only net non-performing asset to net asset was statistically significant at 10 percent with return on asset. Previous research predicts negative effect between asset quality and profitability of bank branches, similarly from these variables net non-performing asset to net asset and bank profitability is negative relationship. The results are in line with other pervious findings. The coefficient of net non-performing asset to net asset variable is negative and weak relationship, and implies that decrease in the net non-performing asset to net asset is associated with an increase in profitability of a bank branches. The finding indicates that low net non-performing asset against net assets is correlated with high profitability. The result clearly shows that the problem loans may cause bank managers to spend much more time to supervise and resolve the non-value-added loan problems, or to dispose of the problem loans, thus downgrading the operating performance of the banks. It is suggested in this study that managers should not ignore the importance of crediting. Even though and advanced credit investigation maybe costly for loan activities, it will significantly reduce the handling of non-value-added problem loans at later stages. At present, the number of in Ethiopia are too small, resulting in aggressiveness of profit, low risks and high assets quality, because of harmless competition. In future while the bank competition increases the asset quality does not affect only financial condition and operating results, but also the soundness of the entire branches banking system. In this study it is shown that the effect of asset quality on the branches profitability responds not significant meaning it did not contribute much to the performance of the bank branches.

8. Findings
The results showed that there is an assets quality ratio to profitability of Branches of Cooperative Bank of Oromia. It was noted that the effect of financial variables, as it was hypothesized, showed some consistency with an empirical studies. From this view, the implication that the financial variables can influence the profitability of the bank seems to be considered in decision-making process of the bank branches. Further studying of this fact had to be properly taken into consideration while drawing conclusions from the empirical results.

8.1 Ratio of Gross Non-Performing Assets to Gross Assets
The result of descriptive statistics showed that asset quality measured by gross non-performing assets was showing 0.49 percent of mean value it is the highest mean value when compare with other mean value of asset quality parameter below 5 percent.

8.2 Ratio of Net Non-Performing Assets to Net Assets
The result of descriptive statistics showed that the net non-performing assets to net assets was showing 0.33 percent of mean value it is the midlist mean value when compare with other mean value of asset quality parameter below 5 percent.

8.3 Ratio of Net Non-Performing Assets to Total Assets
The result of descriptive statistics showed that the net non-performing assets to total assets was showing 0.08 percent of mean value it is the lowest mean value when compare with other mean value of asset quality parameter below 5 percent.

9. Conclusions
It should be concluded that asset quality is measured by gross non-performing assets to total asset, net-nonperforming assets to total assets is the highest mean value and net non-performing assets to total assets is the lowest mean value across the bank branches. It indicates the quality of assets in a situation, and the efficiency of the bank in assessing credit risk and to an extent

in recovering the debt, where the management has not provided for loss on NPAs. All these variables have a negative relationship with profitability of the bank branches. From these variables net-performing assets to net asset have significant effect on return on asset, which mean any increase (decrease) on the value of these variable leads to an increase (decrease) on profitability of cooperative bank of oromia branches. The negative significant effect of net non-performing asset on profitability shows that the efficiency of the bank in assessing credit risky and to an extent recovering the debts it low.

10. Recommendations

In order to hold up risky surprises and maintaining financial stability, it is vital to identify the effect financial variables that mostly influence the overall performance of Cooperative Bank of Oromia. Therefore, based on the above findings and conclusions the following recommendations are forwarded.

The net-performing asset to net assets has significant effect on the profitability of Cooperative Bank of Oromia across their branches. So the bank branches give great attention on efficiency of assessing credit risk and to an extent recovering the debts. To reduce provision for loss on non-performing assets across their branches.

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