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2.1 INTRODUCTION

PERFORMANCE EVALUATION is composed of two words performance and Evaluation. Performance indicates how the management of an enterprise has been accomplishing the goals which they had set for the business firms. Performance is a measure of the degree to achieve its objective. Evaluation is a technique to evaluate past, present and projected performance of a concern. Evaluation is closely related to scrutiny of the working systems of a company as a whole.

"The measurement of business performance is more complex and difficult, since it must deal with the effectiveness with which capital is employed, the efficiency and profitability of operations, and the value and safety of the various claims against the business”.

Mr. Erich L. Kohler refers to performance as, "A general term applied to a part or all of the conduct or activities of an organization over a period of time often with references to past or projected costs, efficiency, management responsibility, or the like."

"Performance is used to mean the efforts extended to achieve the efficiently and effectively the achievement of targets involves the integrated use of human, financial and natural resources." This statement quoted by Mr. Robert Albanese.

The above definitions describe that the word performance refers to presentation with quality and result achieved by the management of company. It carries in to account the accomplishment of objectives as well as goals settings for the company comparing the present progress to the past. Although, in the context of the present.

Evaluation refers to a critical review with the view to improving performance. It includes the act to examine, to measure, to interpret and to draw conclusions.
Achievement involves an integrated use of human, financial and natural resources.

However, evaluation can be defined as a systematic procedure of drawing conclusions. Every enterprise is assessed on the basis of its activities in the various areas.

It is a powerful applied tool to examine, to measure, to interpret and to weigh critically and draw outputs. Evaluation done by different specialists who examine the specific problem with their company.

However, no single attempt can give firm results of betterment of performance of business firm. Business conditions differ according to location, type of facilities products and services, plant capacity, capital structure, according to policies, caliber of management and levels of efficiency in the event of business organizations the performance of business organization.

"Performance evaluation as a concept is purely a developmental tool for a company. As a developmental tool, it is not merely the end product or the final assessment. It is improvement as a whole process of evaluation."

2.2 PROCESS FOR PERFORMANCE EVALUATION

Performance Evaluation involves a broad area of coverage. The perspective throughout is on the effective management of company resources. Performance evaluation can be done through a careful and critical analysis of the financial statements of a business firms. Usually the financial statement of business concern comprises two statements; one is balance sheet and second is profit and loss account or income statement. However, in big concerns two more statements are prepared. They are profit and loss appropriation account and funds flows statements.
According to B. B. Howard and Miller Upton, "Any formal statement expressed in terms of money values might be taken as a financial statement, but the term 'financial statement' has come to be limited by most accounting and business writers to balance sheet and profit and loss account."

R. N. Anthony writes, "They are admittedly a storehouse of the most valuable information. Essentially, financial statements are interim reports, presented annually, and reflect a division of the life of a business firm into more or less arbitrary accounting periods, more frequently a year."

They are overall general purpose entity statements, as they report the financial position and operating results of an entire business at the end or an accounting period. In other words financial statements are the blueprints of the financial affairs of a business firm.

Individual's business transactions are recorded in the books of original entry. The impact of this transaction on the financial position and progress of an enterprise is recorded and presented in financial statements.

John N. Myer saw that, "Financial statements provide a summary of the accounts of a business firm, the balance sheet reflecting the assets, liabilities and capital as on a certain date and the income statement/ or profit and loss account showing the results of operating during a certain period."

In a broad sense, financial statements are the only source for drawing meaningful conclusion about the economics position of any business.

The overall performance of a business cannot be judged without a systematic analysis and interpretation of its financial statements. The advantages of such an analysis are as under given below:

The first advantage is the results based on proper financial analysis are more scientific and logical; so there is less possibility of their being wrong.
The second advantage is such decisions are not subjective. The complexities, depth, interdependence and multi-decision attitude of various modern business activities are not easy to understand without a rational approach or criticism.

The third advantage is no doubt, experience is a good teacher, but the facts and decisions taken merely on the basis of observation and experience can be rectified only if they are supported with a proper financial analysis.

The forth advantage is such an analysis makes the information more understandable even to a nonprofessional. Decisions based on it are more rational and practical.

The parties stated given below are more interested in a systematic and sound financial analysis and interpretation than any other parties.

   a) Government Authorities
   b) Customers
   c) Employees Union
   d) Investors
   e) Debenture Holders
   f) Economics and Financial Analysis
   g) Creditors and Suppliers of Company
   h) Company Law Boards
   i) Foreign Investors and Institutions

2.3 MEANING OF PERFORMANCE EVALUATION

Performance Evaluation may be defined as an assessment of the various activities, the different area of operations, of a business firms. A periodical evaluation of the operations of a business firms is essential for financial strength and good profitability just like a regular check up for physical fitness. In the case of a bad or deteriorating situation, it indicates the areas of improvement whereas in a good situation the way to improvement in the
performance is a process of evaluation the efficiency and effectiveness of a business firms.

The performance is closely linked with the its various activities, as shown in above chart 1. The owners or management or shareholders or creditors or financial institutions of a business firms are interested in the performance evaluation of the business firm. Definition The accomplishment of a given task measured against preset known standards of accuracy, completeness, cost, and speed. In a contract, performance is deemed to be the fulfillment of an obligation, in a manner that releases the performer from all liabilities under the contract.

2.4 SIGNIFICANCE OF PERFORMANCE EVALUATION

In modern business organization, the analysis of business firm has become of general interest to gain insight into operating and financial problems confronting the business. Each examines the performance of the firm with different objective in the mind, has a different point in analyzing the performance of firm, and draws its own conclusion.

The main interested parties in performance evaluation are given below:

1. Investors
The first group that maintains an interest in the financial conditions of a concern is composed of investors and shareholders who by the capital stock from which they hope to receive dividends and an increase and safely of their investments. Investors are always interested in the liquidity, safety and appreciation of their investments. They wants to study the trend of turnover during the last couple of years, the company's place on the industrial map and its long term financial soundness just to evaluate the economic well-being of their investments.
2. Management
The management is main the internal user. The management can measure the effectiveness of their own policies and decisions, determine the advisability of adopting new policies and procedures, and document to the owners the results of their efforts. Effective planning and control are the watchwords in the dictionary of management, and they in turn depend on the financial aspect of the undertaking. Administrators and executives are always interested in the capital structure, liquidity, and profitability, earning capacity, solvency, turnover and financial soundness of the business firm which can be observed only through a look at the various ratios.

3. Employees
A company must be capable enough of paying their employees salary time to time. Ratio analysis helps them in increasing their collective bargaining. Evaluating the implication of various financial ratios, they may make a demand for more salaries, incentives and such more facilities likes housing, travelling, educational, medical etc. They are always interested in the financial soundness and earning capacity of the business firms.

4. Society
Financial statements are also valuable to people who are interested in the prospects of a business firms in such a way. It is the securities of the enterprise alone that are bought and sold on stock exchanges and the public is interested mostly in their financial position in business world.

5. Creditors and Debenture Holder
Performance evaluation is very useful to creditors and debenture holders. They are mainly interested in information that is relevant from their point of view. They are always interested in the liquidity position of a concern and judge its short-term solvenency through current and quick ratios. Debenture holders evaluate its long-term solvenency through the debt-equity ratio, the proprietary
ratio and the earning capacity of the business firms. Their only interest is to judge the earning capacity and performance of the business firms.

6. Government
Financial analysis is of great help in the various financial and economic policies of the any government. Government also takes decision regarding its current policies is in favors of industry or not. Profitability ratio and turnover ratios are mostly used studied by various governmental agencies for the purpose of taxation, regulation, expansion, protection, subsidization suggestions, and nationalization.

7. Economics
The economics may judge the spread to which the current economic climate has affected a business routine works and its financial position. They are able to take a decision regarding problems of business climates which may affect a business firm.

8. Research Scholars
Research scholars are interested in financial statements for establishing certain principles. Through these statements, a research scholars or financial expert can look into the financial policies framed by the management the financial malady, if diagnosed.

2.5 AREAS FOR FINANCIAL PERFORMANCE EVALUATION

Performance Evaluation is closely related with the measurement of the progress which has to do with the efficiency and effectiveness of a business firms. The progress can be measured by assessing the various activities performed by it in the different areas of operation. The areas of operations may be called as the areas of Performance Evaluation.

The important areas of Performance Evaluation are discussed as given below:
1. Profitability
Profitability is the main important area of performance which indicates the ability to earn profit. Business is conducted primarily to earn profit. This statement means matching revenues. Since profit is the main object of conducting a business, it is a very important measured by analyzing the profit and loss account and by computing the various ratios of profit and profitability.

2. Fixed Assets
Analysis of fixed assets throws a flood of light on their structure and average annual growth, on the impact of gross block upon sales and operating profits, on efficiency in the use of fixed assets, on depreciation provision and financing of fixed assets. Thus evaluation fixed is of paramount important in performance evaluation. In a broader sense, it may be said that the financing of fixed assets shows the financial soundness of a business firms.

3. Working Capital Management
The role of working capital in a business is as vital as that of the heart in a human body. An appraisal of efficiency as regards the utilization of working capital is one important aspect. To analyses the working capital position of a business enterprise, various ratios can be computed.

2.6 TECHNIQNES FOR PERFORMANCE EVALUATION OF CAMEL MODELS

2.6.1 INTRODUCTION
It is days customary to use CAMEL rating. The authorities assessing bank performance also use these ratios. The padmanabhan committee appointed by the reserve bank of India is 1995 has suggested that the following six aspects can be broadly divided in to two groups of three easy capital adequacy; asset quality and profitability are ascertainable from balance sheets. Liquidity
management systems and contras will involve certain subjective evaluations. The padmanabhan Report says that each of these six groups will be rated on a scale of 1-5. The total thus arrived at will give a rating A to E. one develop appoint system and rate one own bank.

The system takes into account the natures and aspects of the uniform formwork for assimilating and evaluating all significant financial, operational and compliance factors inherent to a bank’s working. Enables the regulators to assign to each banking organization a composite rating that indicates the institutions overall condition.

In conclusion, bank must jealousy guards their recently worm freedom. The only way ensures this is by avoiding deliberate mischief and more positively by proving themselves worthy of their new responsibilities, Greater the degree of supervision. Lesser is the level of belief in the capacity of bankers to manage and take care of the institutions in their care.

The CAMEL covers five areas of performance measurement viz, ’c’ for capital Adequacy, ’A’ for liquidly; ’M’ for management capacity; ‘E’ for earning available and ‘L’ for liquidity. This performances measurement technique has an edge over the previous of performance. Now the ratios covered by this system for different areas of performance measurement are presented in the following matter. CAMELS

C= Capital Adequacy Ratio.
A= Assets quality Ratio.
M= Management earnings Ratio.
E= Earning ability Ratio.
L= Liquidity & system control Ratio
2.6.2 What is the CAMEL rating system?

The Uniform Financial Institution Rating system, commonly referred to the acronym CAMEL rating, was adopted by the Federal Financial Institution Examination Council on November 13 1979, and then adopted by the National Credit Union Administration in October 1987. It has proven to be an effective internal supervisory tool for evaluating the soundness of a financial firm, on the basis of identifying those institutions requiring special attention or concern. (The United States Uniform Financial Institutions Rating System 1997)

Barr et al. (2002 p.19) states that “CAMEL rating has become a concise and indispensable tool for examiners and regulators”. This rating ensures a bank’s healthy conditions by reviewing different aspects of a bank based on variety of information sources such as financial statement, funding sources, macroeconomic data, budget and cash flow. Nevertheless, Hirtle and Lopez (1999) stress that the bank’s CAMEL rating is highly confidential, and only exposed to the bank’s senior management for the purpose of projecting the business strategies, and to appropriate supervisory staff. Its rating is never made publicly available, even on a lagged basis. CAMEL is an acronym for five components of bank safety and soundness:

- Capital adequacy
- Asset quality
- Management quality
- Earning ability
- Liquidity
2.6.2.1 Capital Adequacy

➢ Fundamentals of Capital Adequacy

Capital adequacy is the capital expected to maintain balance with the risks exposure of the financial institution such as credit risk, market risk and operational risk, in order to absorb the potential losses and protect the financial institution’s debt holder. “Meeting statutory minimum capital requirement is the key factor in deciding the capital adequacy, and maintaining an adequate level of capital is a critical element” (The United States. Uniform Financial Institutions Rating System 1997,).

Karlyn (1984) defines the capital adequacy in term of capital-deposit ratio because the primary risk is depository risk derived from the sudden and considerably large scale of deposit withdrawals. In 1930, FDIC created a new capital model as capital-asset ratios since the default on loans came to expose the greatest risk instead of deposit withdrawals. To gauge the capital adequacy, bank supervisors currently use the capital-risk asset ratio. The adequacy of capital is examined based upon the two most important measures such as Capital Adequacy Ratio (CAR) or Capital to Risk-weighted Assets ratio, and the ratio of capital to assets.

C= Capital Adequacy Ratios

The capital adequacy is estimated based upon the following key financial Ratios, and to be considered as good banks in U.S., they must meet certain criteria detailed below:

<table>
<thead>
<tr>
<th>Ratios</th>
<th>Formula</th>
</tr>
</thead>
</table>
| Return on Capital Employed (ROCE)   | \[
\text{Earning Before Interest &Tax} \times 100 \quad \text{Total Capital} \] |
| Borrowing to net worth Ratio        | \[
\frac{\text{Borrowing}}{\text{Net Worth}} \times 100 \] |
Rating of Capital Adequacy

Each of components in the CAMEL model is scored from 1 to 5. In the context of capital adequacy, a rating of 1 indicates a strong capital level relative to the financial institution’s risk. Meanwhile, the rating of 5 indicates a critical deficient level of capital, in which immediate assistance from shareholders or external resources is required (Uniform Financial Institutions Rating System, 1997).

2.6.2.2 ASSET QUALITY

Fundamentals of asset quality

According to Grier (2007), “poor asset quality is the major cause of most bank failures”. A most important asset category is the loan portfolio; the greatest risk facing the bank is the risk of loan losses derived from the delinquent loans. The credit analyst should carry out the asset quality assessment by performing the credit risk management and evaluating the quality of loan portfolio using trend analysis and peer comparison. Measuring the asset quality is difficult because it is mostly derived from the analyst’s subjectivity.

Frost (2004) stresses that the asset quality indicators highlight the use of non-performing loans ratios (NPLs) which are the proxy of asset quality, and the allowance or provision to loan losses reserve. As defined in usual classification system, loans include five categories: standard, special mention, substandard, doubtful and loss. NPLs are regarded as the three lowest categories which are past due or for which interest has not been paid for international norm of 90 days. In some countries regulators allow a longer period, typically 180 days. The bank is regulated to back up the bad debts by providing adequate provisions to the loan loss reserve account. The allowance for loan loss to total
loans and the provision for loan loss to total loans should also be taken into account to estimate thoroughly the quality of loan portfolio.

The asset quality is estimated based upon the following key financial ratios, and to be considered as good banks in U.S., they must meet certain criteria detailed below:

\[ A = \text{Assets quality Ratio.} \]

<table>
<thead>
<tr>
<th>Ratios</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rate of return on total assets Ratio</td>
<td>( \frac{\text{Net Profit}}{\text{Total Assets}} \times 100 )</td>
</tr>
<tr>
<td>Interest Earned To Total Asset Ratio</td>
<td>( \frac{\text{Interest Earned}}{\text{Total Assets}} \times 100 )</td>
</tr>
</tbody>
</table>

**Rating of Asset Quality**

Each of the components in the CAMEL rating system is scored from 1 to 5. In the context of asset quality, a rating of 1 indicates a strong asset quality and minimal portfolio risks. On the other hand, a rating of 5 reflects a critically deficient asset quality that presents an imminent threat to the institution’s viability.

**2.6.2.3 MANAGEMENT EARNINGS**

**Fundamentals of management Earnings**

Management quality is basically the capability of the board of directors and management, to identify, measure, and control the risks of an institution's activities and to ensure the safe, sound, and efficient operation in compliance with applicable laws and regulations (Uniform Financial Institutions Rating System 1997, p. 6).
Grier (2007) suggests that management is considered to be the single most important element in the CAMEL rating system because it plays a substantial role in a bank’s success; however, it is subject to measure as the asset quality examination.

\[ M= \text{Management Earnings Ratios} \]

<table>
<thead>
<tr>
<th>Ratios</th>
<th>Formula</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Expense On Total Fund Ratio</td>
<td>Operating Expense ×100 Total Fund</td>
</tr>
<tr>
<td>Net Profit per on Total fund Ratio</td>
<td>Net Profit ×100 Total fund</td>
</tr>
</tbody>
</table>

**Rating of Management**

Each of components in the CAMEL rating system is scored from 1 to 5. In the context of management, a rating of 1 is assigned to note the management and board of directors are fully effective. On the other hand, the rating of 5 is applicable to critically deficient management. Replacing or strengthening may be needed to achieve sound and safe operations.

**2.2.2.4 EARNING ABILITY**

**Fundamentals of earning ability**

This rating reflects not only the quantity and trend in earning, but also the factors that may affect the sustainability of earnings. Inadequate management may result in loan losses and in return require higher loan allowance or pose high level of market risks. The future performance in earning should be given equal or greater value than past and present performance.
E= Earning Ability Ratio Analysis

<table>
<thead>
<tr>
<th>Ratios</th>
<th>Formula</th>
</tr>
</thead>
</table>
| Interest Income to Business Ratio | \[
|                                 | \frac{\text{Interest Earned}}{\text{Business}} \times 100 \] |
| Net profit to Business Ratio    | \[
|                                 | \frac{\text{Net profit}}{\text{Business}} \times 100 \] |

Rating of Earning Ability

Each of the components in the CAMEL rating system is scored from 1 to 5. In the context of earning, a rating of 1 reflects strong earnings that are sufficient to maintain adequate capital and loan allowance, and support operations. On the other hand, a rating of 5 experiences consistent losses and represents a distinct threat to the institution’s solvency through the erosion of capital.

2.2.2.4 LIQUIDITY

Fundamentals of liquidity

There should be adequacy of liquidity sources compared to present and future needs, and availability of assets readily convertible to cash without undue loss. The fund management practices should ensure an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner; and capable of quickly liquidating assets with minimal loss.

Rudolf (2009) emphasizes that “the liquidity expresses the degree to which a bank is capable of fulfilling its respective obligations”. Banks makes money by mobilizing short-term deposits at lower interest rate, and lending or investing these funds in long-term at higher rates, so it is hazardous for banks mismatching their lending interest rate.

L= Liquidity Ratios Analysis

<table>
<thead>
<tr>
<th>Ratios</th>
<th>Formula</th>
</tr>
</thead>
</table>
| Quick ratio | \[
|          | \frac{\text{Quick Assets}}{\text{Current Liabilities}} \times 100 \] |
Rating of Liquidity

Each of the components in the CAMEL rating system is scored from 1 to 5. In the context of liquidity, a rating of 1 represents strong liquidity levels and well-developed funds as the institution has access to sufficient sources of funds to meet present and anticipated liquidity needs. On the other hand, the rating of 5 signifies critical liquidity-deficiency, and the institution demands immediate external assistance to meet liquidity needs.
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