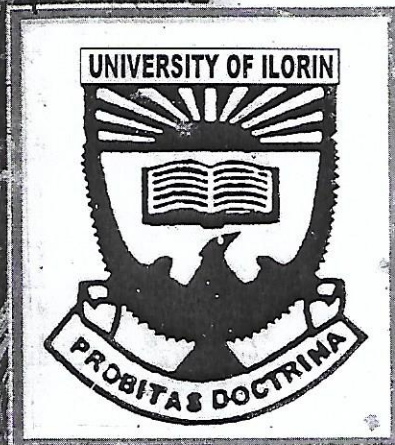




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Olumuyi T. A
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BANKRUPTCY PREDICTION THROUGH FINANCIAL STRENGTH ANALYSIS: A CASE STUDY OF TRADE BANK PLC;

BY: OLANIYI T. A

Department of Accounting and Finance University of Ilorin, Ilorin

Abstract

Loss of depositors funds, loss of jobs, insecurity of property and investment as well as consequential loss of confidence coupled with other concomitant effects of bank failure had reduced the value of Nigerian banks as the live-wire on which the payment system relies.

This study measures the bankruptcy status of Nigerian banks with a view to determining their potential of failure using Trade Bank Plc; as a case study.

The study however, made use of secondary data only which were obtained from the published annual financial statements over a period of five years ended 2002, while the analysis was carried out through the use of Altmans Multiple Discriminant Analysis model (Z Scores)

It was concluded that the bank has a high potential of failure as evidenced by poor operational performance, low Zeta score and recommends a drastic redress in terms of profitability, liquidity and effective credit management.

Introduction

The growth and expansion aspects of banks have received much attention since evolution of money and banking in eighteen centuries while the subject of death or bankruptcy have been neglected for a long time such that its occurrence caught us unawares especially in the Nigerian environment. However, devoting similar efforts towards companies' failure prediction will constitute a desirable effort, as Jimoh (1993) pointed out that the failure of any bank could shake the confidence and trust on which the financial system of a country is based.

Most corporate strategies involve determining the goals and objectives of an organization and formulating appropriate policies for achieving the set objectives. In this wise, managers should be equipped with necessary tools for present and future assessment of the status/ performance of their companies either for improvement or corrective actions.

In the words of Ologun (1994) "the importance of the banking sector in any economy derives from its roles of financial intermediation, provision of efficient payment system and facilitating the implementation of monetary policies". The sector also employs the highest percentage of Nigerian graduates today as a result of the CBN deregulation (expansion) covering all clearing zones in Nigeria (CBN monetary policy guidelines 2002/2003).

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For the banking system of any economy to achieve these objectives, it must be stable and sound but instability is what our banking system is known for. Thus, banks could no longer serve as safe depositories while most economic transactions are carried out on a cash and carry basis. A cash based economy not only hampers efficient resource allocation and financial intermediation but also encourages distortion in money supply and macro-economic management (Ebhodaghe 1996). By inference therefore, the monetary policies will lose its effectiveness if the banking sector is unstable.

The efforts of the Nigerian government through the Central Bank of Nigeria and Nigeria Deposit Insurance Corporation (CBN and NDIC) had proved inadequate to curb bank failure in the country as scams about liquidity problem are revealed by business times concurrently.

However, if no country of the world is immune to bank failure (Ogunleye 2002) and insolvency/failure of companies are undesirable occurrences (Adedeji and Iyagba 2000), then, depositors and tax payers as well as other stakeholders in the banking sector desire a tool for their investment and decision making banking ventures.

Importance of the study

Performance evaluation aiming at determining potential of failure of an organization is desirable to avoid the innumerable consequences of liquidation ranging from loss of deposits by depositors, loss of job by employees, loss of revenue by government to loss of confidence in the system and eventual retardation of the country's economic growth.

Although, the construction industry laid the infrastructure for development, the banking sector finances this development. This financing function is a crucial responsibility such that the impending failure of the banking industry that undertakes such needs being detected early for corrective or improvement actions.

The current privatization efforts of Nigerian government also require a sound banking system, this process of development may be interrupted by failure in the banking sector.

Objective of the study

Bank failure could have been arrested if warning signals (bankruptcy signs) could be detected early. If the management of these banks could not protect depositors and other stakeholders either through their ignorance or unwillingness, they should find a means of solving their problems. It is in line with this that this study aims to evaluate the performance of Nigerian banks with a view to determines potential of failure through the use of Multiple Discriminant Analysis.

Justification for the study

Desirable though, is the prediction of bankruptcy potential in the Nigerian banking sector, one finds none in the local scene except that of Adefila (2002) who did so using Trade Bank Plc. as a case study but over a 3 year period.

However, one finds this three years study grossly inadequate for any meaningful conclusion, hence, a five year period is considered in this study for the same bank. This will give enough latitude for eradication of unnecessary fluctuations in performance and obtaining a reliable evidence.

Methodology for the study

Bearing in mind the nature of this study, secondary data was used to evaluate financial performance and determine bankruptcy potential in Trade bank Plc. To achieve

this, a five year annual audited accounts and reports (1997 to 2002) were analyzed using:

(a) **Performance evaluation**

This segment evaluates Trade Bank's performance in terms of 'liquidity' which measures the ability of a bank to meet its on-demand depositing at request usually given by the current asset ratio, i.e. current assets/current liabilities. The acceptable ratio is 1:1

(b) **Profitability ratio – measures the ability of an organisation to generate adequate returns**

Most common profitability ratios used are profit margin ratio and return on total assets ratio.

(c) **Management performance ratio**

Measures the average ability of the management deliver the goods. i.e., achieve the corporate objectives of the organisation.

Bankruptcy prediction

This segment evaluates the potential of failure in the bank using multiple discriminate analysis (MDA) given by zeta as:

$$Z = 0.12x_1 + 0.014x_2 + 0.033x_3 + 0.006x_4 + 0.999x_5$$

Where:

X_1 = Working capital ÷ Total assets

X_2 = Retained earnings ÷ Total assets

X_3 = Earnings before interest and Tax ÷ Total assets

X_4 = Equity ÷ Total book debt

X_5 = Gross earnings ÷ Total assets

While x_1 , x_2 , x_3 and x_4 should not be less than one whole number, x_5 can be any number.

Decision rule

This Zeta [z-score] is used to determine a company's short-term outlook or future viability in such a way that if:

$Z > 3.0$ - strong

$1.8 < Z < 3.0$ - in danger

< 1.8 - near death

Data presentation

Table 1. Extracts from annual audited accounts and reports

	Variables	1997 N' m.	1998 N' m	2000 N' m	2001 N' m	2002 N' m
1	Gross earnings	698	1068	2000	2245	3387
2	Receivables	1007	1788	2702	3392	3561
3	Fixed assets	118	177	201	222	302
4	Current assets	3691	5114	6529	10570	11002
5	Total assets	3809	5291	6730	10792	11304
6	Current liabilities	3209	4655	6032	10018	9638
7	Interest paid	264	391	946	1045	1447
8	Total debts	3209	4655	6032	10018	9638
9	Net income	20	97	68	210	411

10	EBIT	284	488	1014	1255	1858
11	Earnings after tax	20	87	63	178	370
12	Net worth	600	635	698	774	1666
13	Liquid assets	2241	2077	3000	5575	5761
14	Working capital	482	459	497	552	1364
15	Retained earnings	71	107	169	225	354
16	Equity	600	635	698	774	1666
17	Interest received	534	736	2000	2245	3274

Source: Extracts from annual audited accounts and reports.

Data analysis

Table 2. Computed traditional ratios for trade bank plc

	Ratios	1997	1998	2000	2001	2002
1	Current asset ratio	1.15:1	1.10:1	1.08:1	1.06:1	1.14:1
2	Profit margin ratio	3%	9%	3%	9%	12%
3	Return on total assets ratio	0.5%	1.6%	1.0%	1.6%	3%
4	Return on net worth ratio	3%	14%	9%	23%	22%
5	EPS	3k	9k	7k	18k	19k
6	DPS	-	5k	-	10k	10k

Source: Researcher's computation from annual reports and accounts.

Table 3. Summary of zeta 'Z' scores for Trade Bank Plc

		1997	1998	2000	2001	2002
1	X_1 = Working capital to total assets	0.13	0.09	0.07	0.05	0.12
2	X_2 = Retained earning to total asset	0.02	0.02	0.03	0.02	0.03
3	X_3 = EB17 to total assets	0.08	0.09	0.15	0.12	0.16
4	X_4 = Marking value of equity to total book debt	0.19	0.14	0.12	0.08	0.17
5	X_5 = Turnover to total assets	0.18	0.20	0.30	0.2	0.30
	Zeta 'Z' values	0.20	0.22	0.31	0.21	0.32

$$Z = 0.01966$$

Source: Researcher's computation from annual reports and accounts.

Discussion of findings

Table 3 above shows the performance of Trade Bank Plc; measured in terms of its strength and weaknesses. Evidenced in this table for the years covered are liquidity, profitability and operational status of the bank.

The liquidity performance of the bank was nothing to write home about as the ratio measuring such (current asset ratio) was all below the conventionally acceptable ratio of 2:1. As revealed by table 2 above, the computed ratios are: 1.15, 1.10 and 1.08 in 1997, 1998 and 2000 respectively while in 2001 and 2002, 1.06 and 1.14 are recorded in that order. This by extension would make it difficult for the bank to discharge its obligations to customers in relation to honouring cash/call demand without notice. Any attempt to cover this inadequacy might cause cash trap for the bank.

So also is the gross margin (profitability) ratio, which ranges between 35% and 12% (3% each in 1997 and 2000, 9% each in 1998 and 2001 while the rate was 12% in 2002).

The spiral effect of this poor profit condition transformed into a worse operational performance. This is explained by the return of total asset ratio that showed a dangerous

trend of 0.5% and 1.0% in 1997 and 2000 respectively while 1.6% each was recorded in 1998 and 2001 but in 2002, a 3% rate was recorded. These by normal standard are unsatisfactory and too low.

The only commendable result exhibited by the bank was that of return on net worth ratio which although was low in 1997, 1998 and 2000 respectively but got a leap in 2001 and 2002 when the ratios were 23% and 22% respectively.

The security/share performance of the bank were not encouraging but highly disappointing as the 3kobo and 7kobo earnings per share was insufficient to pay even a penny as (dividend) to shareholders during 1997 and 2000.

However, the earnings per share jumped to 18k and 19kobo in 2001 and 2002 respectively which resulted in the payment of only 10kobo dividend per share in both years, an amount adjudged to be incommensurate with the present trend of dividend payment in the banking industry. This is extremely dangerous considering the fact that every shareholder wants value for its invested funds. The potential of movement of funds from non-rewarding company of this nature to a blue chip company is high and better not imagined. Worse still, the era of ignorance has gone and most investors are better informed about investment performances and rewards due to the technological advancements that enhanced the activities/operation of the Nigerian stock exchange. This culminated in easy accessibility to all share indexes and share prices every then and now. All these are in line with the popular 'strong market hypothesis' in which share prices reflect all information either available or not for the past, present and future time periods (Pandey 2002).

One can easily estimate what will happen to the bank if investors move their shares in it to a more rewarding bank. The impact of capital flight on the capital base of the bank especially now that the capital base of all banks have been increased to N25billion naira is better not imagined.

The bankruptcy status of the bank as shown in table 4 by Z scores revealed 0.20, 0.22 and 0.31 respectively for 1997, 1998 and 2000 respectively while the Z values for 2001 and 2002 were 0.21 and 0.32 in that order.

Going by these scores, the banks operational performance lies within the bankruptcy region simply because the Z scores for all the five years covered were less than 1.81, the figure above which a company must score for it to be adjudged financially sound and healthy.

Conclusion and recommendation

The results of the various traditional ratios computed summarily indicated that the operational performance of Trade Bank Plc., for the period covered was poor. Admist this lachrymal performance was deteriorating trend/fluctuations in the current asset ratio, profit margin ratio and return on net worth as well as return on total assets. One available but insufficient evidence that might be responsible for such performance between 1998 and 2000 was change of accounting date by the bank from a period ending [January to December] to a period of (April to March), thereby consuming 1999 accounting year while 2000 became a 15- month operating year instead of the usual 12 calendar months.

Furthermore, the results of zeta scores computed as 0.20, 0.22, 0.31, 0.21 and 0.32 for the five accounting years imply that the operational performance of the bank was exceptionally poor, meaning that the bank is unhealthy and has a high potential of failure in the nearest future. This result however does not contradict but support Adefila study 2002. Going by these assessments, I am convinced that Trade Bank Plc; cannot operate

for more than the next two years before it fails.

It is hereby recommended that a drastic redress is desirable by the bank for it to navigate safely in the present terrain of financial conditionalities in Nigeria. Hence the banks liquidity, profitability and asset usage must be improved upon for it to survive and satisfy its customers, employees, investors simultaneously; a performance that is commensurate with maximization of shareholders wealth (Olowe 1996).

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