

Performance Appraisal Through Value Added Approach: A Case Study on Mercantile Bank Limited.

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Abstract

The study on Performance Appraisal through Value Added Approach: A Case Study on Mercantile Bank Limited (MBL) revealed some important findings namely (i) Both the value added & economic value added of MBL showed an increasing trend during 2006 as compared to 2005; (ii) But in terms of market value added, the selected bank showed a decreasing trend in 2006 as compared to 2005; (iii) All the value added ratios showed an increasing trend in 2006 as compared to 2005 excepting net profit value added ratio, net profit to economic value added ratio & market value added to total revenue ratio; (iv) The performance of MBL in 2006 had been poor as compared to 2005 in terms of the above three ratios which play the vital role in the performance of the bank; & (v) Factors responsible for poor performance of MBL were identified as shortage of adequate working capital, lack of requisite research & development activities, shortage of skilled manpower, lack of proper responsibility and accountability, limited market for products.

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1. Introduction

Bangladesh being one of the developing countries has low level of per capita income and in return, low standard of living. In 2005-06, GDP growth was 6.71%¹ which was below the target. The resultant effect of lower rate of internal resource mobilization had been the rising trend of dependence on foreign aid for financing development works since independence.

Commercial banking sector plays an important role in mobilization of the countries scattered savings and channelizing the same into various desirable sectors of the national economy. The government policy of denationalizing some of the erstwhile Nationalized Commercial Banks (NCBs) and allowing the entrepreneurs for establishing of banks in private sector had been to create a competitive banking environment in order to achieve the objective of greater mobilization.² Among 52 private banks³, Mercantile Bank Limited was incorporated on May 20, 1999 and launched its business on June 2, 1999 with the strategic objectives to achieve positive economic value added each year; to be market leader in product innovation and one of the top three financial institutions in Bangladesh in terms of cost efficiency and one of the top five financial institutions in Bangladesh in terms of market share in all significant market segments we serve as well as with financial objectives to achieve a return on shareholders' equity of 20% or more, on average.⁴

Performance means accomplishment of an expected course of action. Appraisal which is variously known as evaluation, measurement, assessment etc. refers to an ongoing evaluation of equity, quantity, style and determinants of the present performance, growth potential etc. to provide control information leading to an action program and enabling feedback aimed at performance improvement, growth and satisfaction.⁵ The overall performance of an organization can be measured in terms of several indicators.

However, the performance of a business enterprise, especially the private sector ones, is measured in terms of profit earned which can be assessed in absolute term or it may be measured in terms of percentage on sales or return on investment and the like. Such performance measurement in terms of profits can be useful to owners and lenders.⁶ But profit as a yardstick of measurement is not free from criticism especially in the context of public enterprises irrelevance to their socio-economic obligations. For public enterprises, multiple criteria are considered suitable on the ground that such technique acts as a hedge against any possible threat to validity of assessment.⁷ However, in recent year there has been a considerable interest in 'Value Added' technique as an alternative or additional approach to measure the operational efficiency of a business.⁸ In fact, contribution made by an enterprise, whether it is in the public or in private sector can be measured in terms of value added which may be of performance to national income accounting and to the owners, managers and employees of the concerned enterprise alike.

The concept of value added is not a new one, since long the concept is used in estimating national income. But in performance evaluation of business concern interest in it has increased since the publication of "Corporate Report" by the Accounting Standard Steering Committee, London in 1975 and the "Future of Company Reports" a consultative document of the British Government, published by HMSO, London in 1975⁹ although the concept was first applied in U.S.A. in 1940 and in Europe in 1974. Moreover, the concept is more important as it brings closer the accountant's approach and economist's approach to profit although there are a bit differences in these approaches.

In Bangladesh, Value Added concept is used in national income computation. Business enterprises in general, except a few, do not use the concept in their performance evaluation. However, this technique can be used beneficially to serve the purpose of all interested parties and the introduction of Value Added Tax (VAT) warrants the introduction of this concept in our business enterprises urgently.

2. Objectives of the Study

- i. To examine the value added approach towards banking industry performance.
- ii. To identify various value added ratios relevant to performance appraisal.
- iii. To apply value added ratios in evaluation of performance of the sample bank.
- iv. To identify the factors responsible for poor value added of the selected banks.
- v. To suggest measures as to improve the value added in the bank.

3. Methodology

To achieve the set of objectives of the study secondary data have been used during 2005 to 2006. These data were collected from the Annual Reports and website of MBL. Though a number of techniques are available to appraise the performance of a bank, but in this study we have used the relevant ratios of value added.

4. Necessity for using VA Index

In general net profit after tax (NPAT) is looked upon as an index of business and managerial performance.¹⁰ It is often compared with capital, sales, assets and like to draw relationship. But the fact that it has some limitations too by the way in which it is computed are discussed based on Sinha's analysis¹¹

- i. The increase or decrease in the value of NPAT significantly depends on the fluctuation in the aggregate of all other factors of payment. Thus, if all the factors or any one of them are paid less than their legitimate dues, the numerator will be unduly inflated revealing an apparent increase in managerial performance and vice versa.

- ii. Interest accrued on owned capital which is mingled with accounting profit need to be identified separately (as in VA). Otherwise comparison of net profit between high geared company and low geared company would fail to reveal the real picture.

5. Theoretical framework of Value Added Approach

Value added for manufacturing enterprise indicates that it is the difference between output value and the value of inputs purchased.¹²

$$V_A = V_T - V_R$$

Where, V_A = Value added

V_T = Value transferred to other units through sales

V_R = Value from units through purchase.

In, banking enterprise value added is the difference between value creation and distribution among different stakeholders of the bank.

$$V_A = TR - K - PLF - OE$$

Where, VA = Value added

TR = Total revenue (i.e. sum of interest income and non-interest income)

K = Cost of financing

PLF = Provision for loans and fixed assets

OE = Other expenses

Economic Value Added (EVA) indicates the true economic profit of a company and it is an estimate of the amount by which earnings exceed or fall short of required minimum return for shareholders at comparable risk.

$$EVA = TR - E - T - C$$

Where, EVA = Economic value added

TR = Total revenue

E = Expenses

T = Corporate tax

C = *Capital charges

* Capital charges= Required rate of return * total capital

Required rate of return (10%)= Return on 364-days treasury bills (7%)
+ Risk premium (3%)

Market Value Added is the difference between the market value of equity of a company and the book value of equity invested in the company. A high MVA indicates that the company has created substantial wealth for the shareholders.

6. Value Added Ratios as Indicators of Performance

- i. Value Added to Capital Employed (CE) Ratio: It shows the value generation power of each unit of money representing capital employed (sum of equity & long-term borrowing).

$$VA \text{ to CE} = (VA/CE) * 100$$

- ii. Value Added to Total Revenue (TR) Ratio: It indicates value added by each unit of Tk. total revenue i.e. interest income and non-interest income.

$$VA \text{ to Revenue Ratio} = (VA/TR) * 100$$

- iii. Value Added to Interest Income (I) Ratio: It indicates value added by each unit of Tk. interest income.

$$VA \text{ to I Ratio} = (VA/I) * 100$$

- vi. Value belongs to Employees (VE) to Value Added Ratio: It represents the share of employees to value added of an organization. Value belongs to the employees includes wages and salaries and other benefits given to the employees.

$$VE \text{ to VA} = (VE/VA) * 100$$

- v. Value belongs to government (VG) to Value Added Ratio: It represents the share of government to value added of an organization.

$$VG \text{ to VA} = (VG/VA) * 100$$

- vi. Value belongs to shareholders (VS) to Value Added Ratio: It represents the proportion of shareholders to value added of an organization.

$$VS \text{ to } VA = (VS/VA)*100$$

- vii. Net Profit to Value Added Ratio: It shows the owner's share to the total pool.

$$NP \text{ to } VA = (NP/VA)*100$$

7. Types of Value Added Ratios

□ Economic Value Added (EVA) Ratios

- i. Economic Value Added to Capital Employed (CE) Ratio: It shows the economic value generation power of each unit of money representing capital employed (sum of equity & long-term borrowing).

$$EVA \text{ to } CE = (EVA/CE)*100$$

- ii. Economic Value Added to Total Revenue (TR) Ratio: It indicates economic value added by each unit of Tk. total revenue i.e. interest income and non-interest income.

$$EVA \text{ to } Revenue \text{ Ratio} = (EVA/TR)*100$$

- iii. Economic Value Added to Interest Income (I) Ratio: It indicates economic value added by each unit of Tk. interest income.

$$EVA \text{ to } I \text{ Ratio} = (EVA/I)*100$$

- iv. Net Profit to Economic Value Added Ratio: It shows the owner's share to the total pool.

$$NP \text{ to } EVA = (NP/EVA)*100$$

□ Market Value Added (MVA) Ratios

- i. Market Value Added to Capital Employed (CE) Ratio: It shows the market value generation power of each unit of money representing capital employed (sum of equity & long-term borrowing).

$$MVA \text{ to } CE = (MVA/CE)*100$$

- ii. Market Value Added to Total Revenue (TR) Ratio: It indicates market value added by each unit of Tk. total revenue i.e. interest income and non-interest income.

$$\text{MVA to Revenue Ratio} = (\text{MVA}/\text{TR}) * 100$$

- iii. Market Value Added to Interest Income (I) Ratio: It indicates market value added by each unit of Tk. interest income.

$$\text{MVA to I Ratio} = (\text{MVA}/\text{I}) * 100$$

- iv. Net Profit to Market Value Added Ratio: It shows the owner's share to the total pool.

$$\text{NP to MVA} = (\text{NP}/\text{MVA}) * 100$$

8.0 Findings and Their Analysis

8.1 Position of Value Added

The following table shows the position of Value Added of the selected bank during the study period 2005 to 2006.

Table-1: Statement of Value Added

(figures in million Tk.)

Particulars	2006	2005
Total Revenue	4,631.41	3,472.51
Cost of Financing	(2,662.58)	(1,987.16)
Provision for Loans and Fixed Expenses	(123.64)	(222.73)
Other Expenses	(275.81)	(194.91)
Value Added	1,569.38	1,067.74
Distribution:		
Government	30.32	29.64
Shareholders	36.91	40.09
Employees	30.13	27.43

Source: Annual Report of MBL 2006

The table -1 depicts that Value Added to the bank stood at Tk. 1,569.38 million as of December 31, 2006 as against Tk. 1,067.74 in 2005, registering a positive growth of 46.98% over the previous year. The highest percentage of Value Added went to the pocket of shareholders of the Bank. The portion of shareholders in Value Added stood at 36.91% in 2006 as against 40.09 % in 2005, registering a negative growth of 7.93% over the previous year. The portion of employees in Value Added stood at 30.13% in 2006 as against 27.43 % in 2005, registering an upward growth of 9.84% over the previous year.

The portion of government in Value Added stood at 30.32% in 2006 as against 29.64 % in 2005, registering an upward growth of 2.36% over the previous year.

8.2 Position of Economic Value Added

The following table shows the position of Economic Value Added of the selected bank during the study period 2005 & 2006.

Table-2: Statement of Economic Value Added

(Figures in million Tk.)

Particulars	2006	2005
Total Revenue	4,631.41	3,472.51
Expenses	(3,576.29)	(2,727.98)
Corporate Tax	(475.90)	(316.50)
Capital Charges	(255.43)	(204.59)
Economic Value Added	323.79	223.44

Source: Annual Report of MBL 2006

The Table -2 reveals that Economic Value Added to the bank stood at Tk. 323.79 million as of December 31, 2006 as against Tk. 223.44 in 2005, registering a positive growth of 44.91% over the previous year.

Capital charges stood at Tk. 255.43 million as of December 31, 2006 as against Tk. 204.59 in 2005, registering an upward growth of 24.85% over the previous year. Corporate tax stood at Tk. 475.90 million as of December 31, 2006 as against Tk. 316.50 in 2005, registering an upward growth of 50.36% over the previous year. Expenses stood at Tk. 3,576.29 million as of December 31, 2006 as against Tk. 2,727.98 in 2005, registering a positive growth of 31.10% over the previous year. Total Revenue stood at Tk. 4,631.41 million as of December 31, 2006 as against Tk. 3,472.51 in 2005, registering an upward growth of 33.37% over the previous year.

8.3 Position of Market Value Added

The following table shows the position of Market Value Added of the selected bank during the study period 2005 & 2006.

Table-3: Statement of Economic Value Added

(Figures in million Tk.)

Particulars	2006	2005
Market Value of Total Equity	4,259.87	3,904.63
Book Value of Total Equity	(2,554.29)	(2,045.85)
Market Value Added	1,705.58	1,858.78

Source: Annual Report of MBL 2006

Table-3 depicts that Market Value added to the bank stood at Tk. 1,705.58 million as of December 31, 2006 as against Tk. 1,858.78 in 2005, registering a negative growth of 8.24% over the previous year. Book value of total equity stood at Tk. 2,554.29 million as of December 31, 2006 as against Tk. 2,045.85 in 2005, registering a positive growth of 24.85% over the previous year. Market value of total equity stood at Tk. 4,259.87 million as of December 31, 2006 as against Tk. 3,904.63 in 2005, registering an upward growth of 9.10% over the previous year.

8.4 Position of Relevant Value Added Ratios

The following table shows position of relevant Value Added Ratios:

Table-4: Results of Value Added Ratios

(Figures in million Tk.)

Particulars	2006	2005
Value Added to Capital Employed Ratio	61.44	52.19
Value Added to Total Revenue Ratio	33.89	30.75
Value Added to Interest Income Ratio	44.86	39.25
Value belongs to Employees to Value Added Ratio	30.13%	27.43 %
Value belongs to government to Value Added Ratio	30.32%	29.64 %
Value belongs to shareholders to Value Added Ratio	36.91%	40.09 %
Net Profit to Value Added Ratio	31.49	36.23

Source: Income Statement & Balance Sheet of MBL 2006 shown in Appendix 1 & 2.

Table -4 reveals that VA to CE ratio has been increased to 61.44% in 2006 from 52.19% in 2005 which shows an increasing trend in the current year as compared to the previous year in this ratio. VA to TR ratio has been increased to 33.89% in 2006 from 30.75% in 2005 which shows an upward trend in the current year as compared to the previous year in this ratio. VA to I ratio has been increased to 44.86% in 2006 from 39.25% in 2005. Value belongs to Employees to VAR has been increased to 30.13% in 2006 from 27.43 % in 2005 which shows an upward trend in the current year as compared to the previous year in this ratio. Value belongs to govt. to VAR has been increased to 30.32% in 2006 from 29.64 % in 2005 which shows an upward trend in the current year as compared to the previous year in this ratio. Value

belongs to shareholders to Value Added Ratio has been increased to 36.91% in 2006 from 40.09 % in 2005 which shows a downward trend in the current year as compared to the previous year. NP to VA ratio has been decreased to 31.49% in 2006 from 36.23% in 2005 which shows a downward trend in the current year as compared to the previous year in this ratio.

8.5 Position of Relevant Economic Value Added Ratios

The following table shows position of relevant Economic Value Added Ratios:

Table-5: Results of Economic Value Added Ratios

Particulars	2006	2005
Economic Valued Added to Capital Employed Ratio	12.68	10.92
Economic Value Added to Total Revenue Ratio	6.99	6.43
Economic Value Added to Interest Income Ratio	9.25	8.21
Net Profit to Economic Value Added Ratio	152.64	173.00

Source: Income Statement & Balance Sheet of MBL 2006 shown in Appendix 1 & 2.

Table-5 depicts that EVA to CE ratio has been increased to 12.68% in 2006 from 10.92% in 2005 which shows an upward trend in the current year as compared to the previous year in this ratio. EVA to TR ratio has been increased to 6.99% in 2006 from 6.43% in 2005 which shows positive trend in the current year as compared to the previous year in this ratio. EVA to I ratio has been increased to 9.25% in 2006 from 8.21% in 2005 which shows an upward trend in the current year as compared to the previous year in this ratio. NP to EVA ratio has been decreased to 152.64% in 2006 from 173.00% in 2005 which shows a downward trend in the current year as compared to the previous year in this ratio.

8.6 Position of Relevant Market Value Added Ratios

The following table shows position of relevant Market Value Added Ratios:

Table-6: Results of Market Value Added Ratios

Particulars	2006	2005
Market Value of Total Equity	4,259.87	3,904.63
Market Valued Added to Capital Employed Ratio	66.77	90.86
Market Value Added to Total Revenue Ratio	36.83	53.53
Market Value Added to Interest Income Ratio	48.75	68.32
Net Profit to Market Value Added Ratio	28.97	20.81

Source: Income Statement & Balance Sheet of MBL 2006 shown in Appendix 1 (A) & (B).

Table-6 reveals that MVA to CE ratio has been decreased to 66.77% in 2006 from 90.86% in 2005 which shows a downward trend in the current year as compared to the previous year in this ratio. MVA to TR ratio has been decreased to 36.83% in 2006 from 53.53% in 2005 which shows a downward trend in the current year as compared to the previous year in this ratio. MVA to I ratio has been decreased to 48.75% in 2006 from 68.32% in 2005 which shows a downward trend in the current year as compared to the previous year in this ratio.

NP to MVA ratio has been increased to 28.97% in 2006 from 20.81% in 2005 which shows an upward trend in the current year as compared to the previous year in this ratio.

9. Factors responsible for poor performance of the MBL

Analysis of tables 4, 5, & 6 indicate that the performance of MBL during 2005 to 2006 appeared to be poor in terms of net profit to value added, net profit to economic value added & value added to total revenue ratios. Because all these three significant ratios showed a

decreasing trend in the current year (2006) as compared to the previous year (2005). Actually speaking, these three ratios are the vital ratios which play a great role on the performance of any enterprise. Thus we can conclude that the performance of MBL appeared to be poor in 2006 in terms of these three ratios.

Factors responsible for poor performance of MBL in order of importance are mentioned below:

- i. **Shortage of Adequate Working Capital:** This factor tops the list of all the factors of poor value added since it ranks first, the weighted average score being 4.33 in the 5 point scaling.
- ii. **Lack of Requisite Research & Development Activities:** This factor ranks the second position, the weighted average score being 4.17.
- iii. **Lack of Proper Responsibility and Accountability:** This factor ranks the third position, the weighted average score being 3.83.
- iv. **Shortage of Skilled Manpower:** This factor ranks the fourth position, the weighted average score being 3.50.
- v. **Limited Market for Products:** This factor ranks the fifth position, the weighted average score being 3.33.

10. Suggestions put forwarded by Respondents

- i. Optimal working capital should be maintained.
- ii. The sample bank should make more investment for research & development purpose.
- iii. Accountability and responsibility should be ensured among the bank personnel.
- iv. More efficient & specialized manpower should be recruited & existing personnel should be given requisite training.
- v. Market should be expanded through introducing diversified and lucrative products.

11. Implication of the Study

The findings of the study especially lower net profit to value added, net profit to economic value added and value added to total revenue ratios would be of great use to the concerned authority of MBL. This findings might have an adverse impact on the relevant stakeholders namely owners, creditors, fanciers and govt. agencies. Therefore, every possible step should be taken by the concerned bank authority to remove the problems responsible for such poor performance of the bank.

12. Conclusion

The study reveals that the performance of MBL in 2006 had been poor as compared to 2005 in terms of the three significant value added ratios viz, net profit to value added, net profit to economic value added & value added to total revenue ratios. In order to improve the performance of MBL, the problems must be removed as early as possible.

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Appendix- 1(A)

Mercantile Bank Limited**Comparative Balance Sheet**

(figures in million Tk.)

Particulars	2006	2005
PROPERTY & ASSETS		
Cash	2943.55	1878.41
Cash in hand (including foreign currencies)	345.15	208.91
Balance with Bangladesh Bank &		
Sonali Bank (including foreign currencies)	2598.40	1669.51
Balance with other banks and financial institutions	237.96	118.19
In Bangladesh	130.16	48.43
Outside Bangladesh	107.80	69.77
Money at Call and short notice	395.00	625.00
Investments	5407.90	3517.68
Govt.	4136.09	2549.19
Others	1271.81	968.49
Loans and advances	26842.14	21857.05
Loans, cash credit, overdraft etc.	24200.03	20065.17
Bills purchased and discounted	2642.11	1791.88
Fixed assets including premises, furniture and fixtures	467.99	366.80
Other assets	865.12	527.34
Non-banking assets	-	-
TOTAL ASSETS	37159.65	28890.48

(figures in milion TK.)

Particulars	2006	2005
LIABILITIES & CAPITAL		
Borrowing from other banks, financial institutions & agents	-	640.00
Deposits & other accounts	32462.49	24661.15
Current accounts & other accounts	4386.66	3684.67
Bills payable	451.79	415.45
Savings bank deposits	1894.61	1473.58
Fixed deposits	13182.98	8787.53
Bearer certificates of deposits	23.26	21.34
Deposits under schemes	12523.19	10278.58
Other liabilities	2444.53	1760.15
TOTAL LIABILITIES	34907.02	27061.30
Capital/ Shareholders' equity		
Paid -up capital	1199.12	999.27
Statutory reserve	726.73	532.55
Other reserves	24.86	45.68
Surplus in profit & loss account	301.92	251.69
TOTAL SHAREHOLDERS' EQUITY	2252.63	1829.19
TOTAL LIABILITIES & SHAREHOLDERS' EQUITY	37159.65	28890.48

Source: Annul Report of MBL 2006

Appendix- 1(B)

Mercantile Bank Limited**Comparative Income Statement**

(figures in million Tk.)

Particulars	2006	2005
Interest-income	3129.55	2405.44
Less- Interest paid on deposits, borrowings etc.	2662.58	1987.16
Net interest income	466.97	418.28
Investment income	369.12	314.93
Commission, exchange and brokerage	793.76	559.81
Other operating income	338.98	192.32
Total	1501.86	1067.07
TOTAL OPERATING INCOME	1968.83	1485.3
Salaries & allowances	447.37	278.13
Rent, taxes, insurance, electricity etc.	86.06	69.65
Legal expenses	5.05	2.48
Postage, stamps, telecommunication etc.	23.13	16.22
Stationary, printings, advertisements etc.	44.67	33.37
Chief executives salary & fees	5.50	4.75
Directors fees	1.75	1.35
Auditors fees	0.25	0.25
Depreciation & repair of fixed assets	41.39	30.33
Other expenses	134.91	81.59
TOTAL OPERATING EXPENSES	790.07	518.12

(figures in million Tk.)

Particulars	2006	2005
Profit before provision	1178.76	967.23
Provision against classified loans	71.00	180.20
Provision against unclassified loans	85.00	41.20
Provision for diminution in value of investment	10.14	-
Other provision	42.50	42.50
Total Provision	208.64	263.90
Total profit before taxes	970.12	703.33
Provision for taxation	475.90	316.50
NET PROFIT AFTER TAXATION	494.22	386.83
Retained surplus brought forward from previous year	1.87	5.52
Total	496.10	392.36
Appropriation		
Statutory reserve	194.18	140.67
Retained surplus	301.92	251.69
Total	496.10	392.36
Earning per share (figure in Tk.)	41.22	32.26

Source: Annul Report of MBL 2006

The following table shows factors responsible for poor Value Added of MBL in order of importance as opined by the respondents. Appendix -1(C):Importance of major factors of poor Value Added MBL.

S.L.	Major Problems	Responses' Scale Importance					Weighted Average Score	Remarks
		Not at all important	Below average important	average important	Above average important	Extremely important		
1	Shortage of adequate working capital	-	-	1(17)	2(33)	3(50)	4.3	1
2	Shortage of skilled manpower	-	1(17)	2(33)	2(33)	1(17)	3.7	3
3	Lack of requisit R and D activities	-	-	2(33)	1(17)	3(50)	3.75	2
4	Lack of proper responsibility and accountability	-	1(17)	1(17)	2(33)	2(33)	3.65	4
5	Limited markets for products	-	-	1(17)	2(33)	3(50)	3.60	5

Notes : i) Figures in the margin indicate percentage positions.
 ii) Weighted average score is calculated using of 1 for "not all important" and 5 for "Extremely important."

Source : Field survey