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ADDIS ABABA UNIVERSITY SCHOOL OF COMMERCE SCHOOL OF GRADUATE STUDIES

ASSESSMENT OF PROJECT APPRAISAL PRACTICE IN INTEREST FREE
BANKING SYSTEM: THE CASE OF COMMERCIAL BANK OF ETHIOPIA

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A Project Submitted to the School of Graduate Studies in Partial Fulfillment of the
Requirements for the Degree of Masters of Arts in Project Management

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Declaration

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Abstract

This paper focuses on assessing the project appraisal practice of Islamic banking system (IBS) and the sharia values and principles incorporated in the appraisal practice of IFB of CBE. The study took commercial bank of Ethiopian (CBE) as its case study. The appraisal practice of the Interest Free Bank (IFB) of CBE was assessed to check whether each aspects (the technical commercial, financial, managerial and risk analysis) are duly evaluated or not. Descriptive research design is used and qualitative method was applied. Population of the study composed of interviewees in IFB of CBE project appraisal office in which data is collected using census survey. The study assessed and analyzed technical aspect of projects by evaluating technology to be used by the project, raw material, technical knowhow availability, selection of product mix, selection of plant and machinery, evaluation of plant layout and assessment of project scheduling in which every aspect is well considered for the most part in the project appraisal practice of the bank. Commercial evaluation is assessed by checking parameters of demand for the product, marketing plan and strategy and analysis of competition. In assessing financial viability the result of the analysis show that the bank use cash flow statement and highly reliant on discounted cash flow analysis. Even though the bank establish cost of capital which is profit rate by taking equivalent rate of conventional banks interest rate, its criticized as its not fully in line with sharia principles. Regarding managerial capability of project the study found out that the banks well assess the hard skills while soft skills are neglected. The bank in evaluating risk of proposed project they have robust risk management plan. Regarding the incorporation of sharia vales in the appraisal framework of IFB banks, the finding of the analysis show that the addition of sharia screening in the initial stage of the appraisal framework is a major aspect as it serves IFB of CBE in making sure all proposed projects are fully compliant to sharia principles/ ruling.

Key words: *project appraisal, project appraisal frame work, Islamic banking, Interest free banking, CBE*

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Acronyms

IBS: Islamic Banking System

IFB : Interest Free Banking

IFC: International Finance Corporation

CBE: Commercial Bank of Ethiopia

CRM: Customer Relation Manager

NBE: National Bank of Ethiopia

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CHAPTER ONE

1. Background of the study

1.1 Introduction

Islamic banks have begun out with the inception of Mit-Ghamar initiated by Ahmed al Naggar within the early sixties. The project is primarily based on profit and loss sharing agreement of Islamic economics, yet the first primary Islamic financial institution to function as business was in Dubai, the Dubai Islamic bank, in 1975. Since then, the Islamic banking enterprise has advanced with more tempo. Some of the predominant question confronted through interest free banking and other Islamic financial institution are the question of interest, uncertainty or garar and moral investments that have created tons of arguments within the industry.

Islamic bank is an organization that mobilize finance and invest them in effort to acquire predetermined acceptable Islamic social and economic objectives. Interest free banking window service is an enterprise version where in traditional banks provide Islamic banking service and products from their current department network. It is a state of affairs where in conventional banks offer a number of Islamic banking products or services (Sanusi L., 2011).

In Ethiopia, Islamic banking was introduced when National Bank of Ethiopia allows Banks to exclusively offer the services within a conventional bank by using Interest Free Banking (IFB) window on 1st day of October 2011 under Directive Number SBB/51/2011 (NBE Directive). There are more than 18 private and government owned banks functioning within inside Ethiopia (www.nbe.gov.et). Among them commercial bank of Ethiopia is the first to begin interest free banking service. CBE is the government owned organization established in 1942 and a pioneer to introduce present day banking to the country. The record of CBE date bank to the established order of the state bank of Ethiopia. The bank has been operating the service under all its districts using organized IFB windows and launched the service with aim of attracting commercial enterprise of Muslim community who are out of conventional banking system in addition to non-Muslim business organization who are looking for differentiating their portfolio or increasing their investment in projects.

Investment projects typically occur through the selection, design and implementation of specific projects to achieve development goals or policies. Development projects cannot be accepted unless they are appraised for their economical, institutional and financial feasibility.

A project appraisal is therefore analysis or assessment of proposed projects to determine its acceptability and soundness based on predetermined established criteria. It is a means by which project initiators can choose best project to help them achieve their goal and help in justifying the money that will be spend on the project. The process checks projects feasibility against the resource committed, objectives that are set and macroeconomic factors time (Sang, 1995; UNIDO & IDCAS, 1980).

According to Eric McConnell (2011), A project appraisal is a constant method of reviewing proposed project for its viability to accept or reject it via assessing the problems that need to be addressed through undertaken and producing alternatives for fixing the problem, choosing the maximum possible option, conducting feasibility study for the option, developing answer statement and figuring out each personal and companies involved or who are affected by a given project and its anticipated outcome. It try and justify the proposed project via evaluating if the project is feasible and cost effective.

The framework for project appraisal practice presented in nowadays in the conventional banking system might not be cable to lead authorities, managers and other stakeholders to most desirable project alternatives from Islamic view point. There are numerous most important aspect bearing the concern that want reinterpretation and reconsideration to make clear the Islamic role on such issues.

1.2 Statement of the problem

Monitoring and Evaluation (M&E) offers project officials, development managers, the private and public sector and civil society with higher method for learning from experience lesson learned documents, enhancing service delivery, making plans and allocation of resource demonstrating results as part of duty to key stakeholders (International Finance Corporation(IFC), 2008). It brings institutional development which refers to the creation or the capacity of an institution to reflect systematically and rigorously upon its role and function, and better enable them to carry out their responsibilities. It reflects an attempt to introduce change and development in the way the institution is organized so that it is better able to meet its mission (World Bank, 2005).

Project evaluation/appraisal is the first phase where the process of project monitoring and evaluation begins. It is a series of decision making that will result in accepting or rejecting

competing project alternatives to guarantee both public and private profit as well as to ensure efficient utilization of scarce resource. Government and individuals are confronted with limitation of resource in reaching their respective goal. Project assessment and evaluation process assist in rationalizing and allocating this resource among competing project alternatives. In another way, it justifies the use of resource in realizing specific objectives. Several studies have suggested that the proper use of project appraisal methodology impacts the success of a project (Peerasit, 2010). On the contrary, the inappropriate techniques of project appraisal or ill appraised projects results in adverse and counterproductive outcomes to project (Peerasit, 2010).

Project appraisal from Islamic perspective is highly influenced by the projects analysts and decision maker's capabilities and experience in the Islamic banking project appraisal process. Islamic financial system deals with the question of allocation of resource, production and exchange of goods and services and the distribution of wealth in fair, equitable and socially beneficial way. It is also value loaded or value based system of which some of the values are not incorporated in the mainstream economics. In the system finance (money) itself is not allowed to be an income generating activity unless it is combined with some real economic activity or unless it is backed by real asset. It involves bearing the requisite risk associated with investment transactions which leads to proportional profit and loss sharing (Nikonova Tatiana, Kokh Igor, SafinaLiliya, 2015). Since the system is based on profit and loss sharing, Islamic banks have to pay greater attention to developing project appraisal and evaluation. Islamic banking system fundamental business function is engaging in partnership business in they perform their own project appraisal for a given project to assess it its soundness and feasibility before proceeding and accepting a given business proposal.

Aside from methodological frame work that has been developed in conventional economics that is very useful on this process, there are numerous subjects which are of considerable significance in Islamic economics project appraisal practice that needs discussion; among them are the Maslaha concept and Islamic principles. The uniqueness of Maslahah or sharia objectives as put forward predominantly through al-Ghazali and Al-Shatibi may have tremendous effect at evaluating projects in an Islamic framework. Moreover because the Islamic financial system is value-loaded or primary based on asset backed system, there are numerous Islamic values and principles that could have relevance on the process of interest free banking system project appraisal framework of which this concept are not present in the mainstream economics project appraisal framework.

Several researches have been conducted in Ethiopia regarding the project appraisal system of conventional banks. This studies focus on the challenges that exist in the appraisal process and also whether or not the appraisal process encompass the appropriate measurement parameters and their efficiency towards selecting the best project alternative. In contrast as far as the researcher's know how, there is no research study that has been conducted so far regarding the project appraisal system of Islamic banks in Ethiopia. As a result based on the above stated problems, the study will focus on assessing how project appraisal practice is undertaken/going under the Islamic banking system and the methodology that is applied to appraise projects and whether this appraisal methodologies are effective enough in incorporating Islamic values and principles or not.

1.3 Research Questions

The study attempt to answer the following research questions:

How does interest free bank of commercial bank of Ethiopia appraise projects in its fully-fledged interest free banking system?

- How the technical viability of proposed projects appraised in IFB of CBE banking system?
- How the financial viability of proposed projects appraised in IFB of CBE banking system?
- How the commercial/market viability of proposed projects appraised in IFB of CBE banking system?
- How the management capability of proposed projects appraised in IFB of CBE banking systems?
- How the risk attached to projects analyzed and managed in IFB of CBE banking systems?
- Which Islamic principles and values are incorporated in the appraisal framework of interest free banking system of commercial bank of Ethiopia ?

1.4 Objective of the Study

1.4.1 General Objective of the Study

From the above research questions, the general objective of the study is to assess the practice of project appraisal and sharia principles and values that are included in the appraisal framework in IFB of CBE.

1.4.2 Specific Objectives of the Study

Specific objectives of the study are:

1. To assess the technical appraisal practice of projects in IFB of CBE banking system.
2. To assess the financial viability of proposed projects appraised in CBE banking system.
3. To assess the commercial/market viability of proposed projects appraised in IFB of CBE banking system.
4. To assess the management appraisal practice of projects in IFB of CBE banking system.
5. To assess the risk attached to projects analyzed and managed in IFB of CBE banking system.
6. To assess the Islamic principles and values that are incorporated in the appraisal framework of interest free banking system of commercial bank of Ethiopia ?

1.5 Significance of the study

The significance of this research thus lies in the possibility of adding another perspective on project appraisal techniques in banking sector in particular the interest free banking service in the country at large and as well as proposing solutions to the inherent problems associated with the affirmation to Sharia law in the management and appraisal of projects.

The study will help to enable project participants of commercial bank of Ethiopia decide on the issues related evaluation of projects. The study is also important in such a way that it can provide ideas on the current practices of evaluation of projects so that the project participants can take corrective action to minimize ill-conceived projects and granting finance to this kind of projects and use the opportunities identified in a better way.

The research is significant in various respects. Firstly, the study will draw some conclusions and identify for all practitioners and academicians by providing useful information about the assessment of Islamic banking project appraisal practice in CBE. It is useful for organization's management by providing information about the important appraisal attributes and offers directions for understanding relationship with the bank's evaluating directives and clients and most importantly to benefit banking industry, customers and governing body to understand how projects are appraised according to Islamic law and sharia objective and the benefits that comes with it.

Additionally, it will help as a source of reference and a stepping-stone for those researchers who want to make further study on the area afterwards the study could be used as an initiation for those who are interested to conduct a detailed and comprehensive study.

1.6 Scope of the study

The study is only focused on assessing interest free banking project appraisal practice and the sharia values incorporated in interest free bank of commercial bank of Ethiopia. Throughout this study a project in Islamic banking system are those in which the bank enters into sales and purchase transaction or participating in equity based investments. The study is conducted at the head office in interest free banking project appraisal department. The research is on the prevailing practice of projects that the bank engages in. it also checks the Islamic values that the bank considers while conducting its appraisal process.

1.7 Limitation of the study

Islamic banking system in Ethiopia is a recent phenomenon and it is in its infancy stage. Till the day the study been conducted, there are only two independent Islamic banks i.e. Zamzam and Hijra banks which are still under establishment and affiliates of other non-Islamic banks functioning as fully fledged Islamic banks branches who have been in the industry for only 3 years. This factor was the basic limitation of the study as it was very difficult to find enough secondary data that would help in assessing Islamic project appraisal frame work and the practice. There is also no previous research conducted in appraisal practice of Islamic banks in Ethiopia and the international practice on similar topic is limited to few studies.

Additionally due to Covide-19 pandemic it was difficult to convince interviewee personnel's to conduct a face to face interview which made the data collection process difficult.

1.8 Organization of the study

This study/ project work is classified into five main chapters. Chapter one of the study is focused on introduction of the background of the study , stamen of the problem, research question, objective of the study significance of the study, the studies scope and the basic limitation of the study. Chapter two focuses on literature: both theoretical and empirical literatures are through reviewed and conceptual framework is presented and lastly research gap is presented. The third chapter is about the methodology by which the study employed. This chapter focuses approach of the research, research design, data type and method of data

collection, sample and population of the study, method of data analysis procedures, validity of the study and ethical considerations.

Chapter four of the paper discusses the data ,analysis of the data and interpretation of the data. The last chapter focuses on the findings of the study, conclusion and recommendation of the study.

CHAPTER TWO

2. Review of Related Literature

2.1 Introduction

In this chapter literatures related to the study are reviewed. Both theories and empirical literatures are presented in a manner that can show the conceptual framework and finally research gap is presented.

2.2. Theoretical review

2.2.1. History of Islamic Banking and financial institution

Islamic banking is the financial industry which has played an important role in the economy. The history of Islamic banking began during the time of Prophet Muhammad. He was a businessman who trade from one country to another by dealing business using a Sharia law (Monica, Ng, Low, & Nur, 2016). During Medieval times (1,000 – 1,500 AD), Middle East people in trade activities tackled to financial transactions based on Sharia rules. European companies also started to launch banking service which was interest based in Middle Eastern and Asian countries as trading association between the two countries increases (Savalan I. I., 2012). With the escalating significant mission Western countries began to attend in the world economy, traditional financial centers tended to prevail (Molyneux & Iqbal, 2005). During the period of ottoman empire the Arabs and Spanish had a strong business relationship by setting up financial regulations which functions on profit and loss sharing agreement without including any form of interest based business transaction (Savalan I. I., 2012). After the Industrial Revolution, the entire banking system in all Muslim countries was designed according to the western banking model, the latter being inconsistent with Islamic law (Shahrukh, 1987).

Establishment of Islamic banking is mainly motivated and pushed by growing number of Muslim communities who desire to guide their lives in consistent with the sharia, the legal code of Islam (Greuning & Iqbal, 2009). In the middle of the 20th century some organizational entities were found to offer financial services that comply with Islamic laws. In late 1950 the first Islamic banking institution was established in Pakistan which charged no interest on its lending. Nevertheless the first modern Islamic bank come to existence in 1963 in Egypt to attract individuals who lacked confidence in state owned banks and this motive lead to establishment of Mit-Ghamr bank. MitGhamr is a saving institution that operated under

cooperative basis, allowed their depositors to take out small portion of loan for productive usage and to provide possible return on the money of depositors (Nur, Monica, Ng, & Low, 2016). Malaysia also began the first Islamic financial service in September 1963 which was established for the purpose of assisting Muslims to save their expenses to pilgrimage to Mecca (Savalan I. I., 2012). In 1975, the Islamic Development Bank was set up with the mission to provide funding to projects in the member countries (Warde I. , 2000).

The concept of profit sharing based Islamic banking is intended to substitute for interest based banking by the end of 1970s. In 1979, the first Islamic and Commercial Bank started in Egypt for the purpose of providing funding to support financial activities and in 1980s much of its analytic underpinnings and theoretical justifications were developed). Islamic banking acquired additional endorsement within 1980s while the Islamic republic of Iran and Pakistan followed baking structure the removed interest and recognized them constitutionally (Zamir and Abbas, 1998).

The scopes of the Islamic Banks are no longer narrowed with small business profiles, rather big conventional Banks stated to offer Islamic financial products via their “Islamic Windows” (Savalan I. I., 2012). As a result, the investment stated to show growth and Islamic financial products were offered rapidly. Within a span of five decades; Islamic banking has been successfully developing into a viable alternative banking framework all over the world. It was announced that assets under management in its Sharia compliant Islamic Investment Fund has hit the \$1trillion mark and estimated to come close around \$1.6 and \$5 trillion in 2012 and 2015 respectively (Savalan I. I., 2012). Also, Mamman (2005) states that there are over 75 countries operating Interest-Free Banks with an annual growth rate of 12-15% per annum (Mamman, 2005).

Ziyad (2010) outlined four reasons why Islamic banking is the fastest growing sector in global finance (Ziyad, 2010).

- Increasing demand for Sharia-compliant product.
- Demand for diversification from conventional clients.
- Regulatory amendments and increasing flexibility towards Islamic finance and
- Seeking an alternative to volatile interest-driven markets

2.2.2. Concepts and Definition of Islamic Banking

Islamic banking is a banking system that is in compliance with Islamic Law – Sharia. Sharia means Islamic law and Islamic finance is known as Sharia-compliant finance. That’s why Islamic banking and finance is secured by Sharia and its interpretation (Fiqh) (El-Gamal,

2006). The rules and practices under Islamic banking are in accordance with the primary sources of Shariah Law, such as Quran and Sunnah (Nur, Monica, Ng, & Low, 2016). The missions of Islamic Sharia Finance are to provide financial instruments and transactions for Muslims not to commit with usury, interest payment and gambling in their business life (Savalan I. I., 2012).

Different authors defined Islamic banking in different ways. Islamic banking system is defined as those banks that claim to follow Shariah (Islamic law) in their business transactions. Shariah requires these transactions to be in lawful (Halal) form and prohibits transactions that involving interest (Riba) (Maali, Peter, & Christopher, 2006). Sanusi (2011) views Islamic banking as an alternative form of financial intermediation that is based on profit motive (Sanusi L., 2011). Islamic banking is market driven like any other banking system but with ethical principled and Islamic values that function based on sharia transaction laws. Siddiqi (1983) conceived an Islamic Bank as a financial middleman that mobilize financial resource from the general public and advance capital to marketers or entrepreneurs on the base of mudaraba financing. Ashan(1988) additionally described an Islamic banks as a monetary and social organizations whose targets and operations in addition to principles and practice ought to agree to idea of sharia and which keep away from the usage of interest in any of its operations. Furthermore, Marimuthu, et al. (2010) defines Islamic Bank as the conduct of banking based on Sharia principles. According to Akram, et al. (2011),Islamic banking is financing system that run according with the Islamic legal guideline and sharia board.

Convectional banking system which is introduced by western countries was constructed based upon the notion of debtor – creditor relationship with interest being the rate of credit and reflecting the opportunity cost of money. Hence, money is a commodity. This position is contrary to Islamic finance which views money as a means to an end and not an end in itself (Mohamed, 2016). The conventional banks features and functioning modes are primarily and totally based upon manmade principles which are largely capitalist in nature as opposed to Islamic finance whose mode of operation is based on the principles of Islamic Sharia (Mohamed, 2016).Islamic banking differs from conventional banks as they are governed by sharia laws that prohibit some aspects that is allowed in the mainstream banking system. The IFB banks neither they pay nor they receive any form of interest since it's not allowed to generate money using money. But in conventional banking the collected resources are used to finance any type of business by granting it as a loan with the intention of charging interest. The main distinguish point is that Islamic Finance is structured on Islamic Shariah and all

financial transactions, dealings, businesses, investment portfolios and financial products are designed according to Islamic law that is opposite to most sectors procedures of conventional financial system (Lewis, 2001). Banks serve as financial intermediaries which is acceptable in Islamic society. What is not acceptable is sharia ruling regarding interest charging in the process of financial transaction (Ziauddin, 1994). The predominant characteristics of Islamic financial institutions is the free banking system and profit and loss sharing aspect.

while Islamic banking promotes risk sharing between the investor and the entrepreneur, conventional banking holds that the investor or lender has a guarantee of a predetermined rate of interest or return (Mohamed, 2016). Interest free banking is consistent with the Sharia (Islamic law) which prohibit Muslims to invest in business that are considered haram (forbidden or sinful) such as sell alcohol, pork, produce un-Islamic media, uncertainty or exploitation, collecting riba (interest) and trading in financial risk which are seen as gambling (El-Hawary, Grais, & Iqbal, 2004). Islamic banking does not allow excessive earning that does not involved with real hard work and productivity. The investments under Islamic financial institutions involved with real assets instead of financial assets (Nur, Monica, Ng, & Low, 2016). There isn't any legal restrictions for obtaining income from business as long as the earning is reasonable and ethical. The objective of IFB is not only to earn profit, but to do good things and bring welfare to the people. In order for IFB system to be different from conventional banking system, most importantly it must be free from any sort of interest and all practices must be in line with Islamic law. In the current banking system, as money is exchange for money with excess and delay, it falls under the definition of Riba (interest) which has been prohibited in Islam (Audu&Mika'illu, 2014).

2.2.3. Products of Islamic Banking

According to Haidi& Malik (2006), Islamic banking products are increasing day by day and previous studies found that Islamic banking products are on a par with conventional banking products (Haidi& Malik, 2006). There are some common Islamic products that will be discussed briefly in this section.

Musharakah

Musharakah is an Arabic word which means sharing. It is a relationship established by the parties through a mutual contract. Emphasizes practical participation of parties in the partnership business in the form of joint enterprise in which partners of the joint venture share profit and loss (Nakhooda 2019) Profits are shared based on agreed ratio which need not be equal to their individual capital contribution, but loss is shared strictly based on

individual capital contribution. So, Islamic Bank will act as a partner in this case in order to contribute in the capital formation as well as in sharing profits and loss (Audu&Mika'llu, 2014).

Murabahah (mark-up)

Murabahah is sales agreement where the sale is made at a specified profit margin. The bank acts as an intermediary and buys the goods ordered by the customer. The bank will later sell the goods to the customer in a buy-and-sell transaction, where the lender resells to the borrower at a higher price agreed upon by both parties (Noor, Monica, Ng, & Lou, 2016). In this contract, the bank (seller) disclose actual cost incurred and then adds a profit margin to it which is based on mutual consent. The customer can either pay the cost in installments or in a specific time period (Nakhooda 2019).

Mudarabah (trust financing)

Mudarabah is a special form of partnership agreement where one party (rab al-mal) offers finance to the other party (mudarib). In this partnership agreement the Mudarib assumes the role of the entrepreneur through effective management while rab al-mal is the sleeping partner in the partnership contract(Nur, Monica, Ng, & Low, 2016).The parties involved share the profit of the business based on agreed percentage but if any loss is incurred the rub-ul-mal will solely be accountable because the mudarib doesn't contribute any form of financial asset except for his labor (Nakhooda 2019).

2.2.4. Islamic Banking Service Models

Islamic Banking Window Service

The Islamic Banking Window service model is a window within traditional bank through which the customer can do business using sharia-compliant tools only (Sole, 2007). In addition, the Islamic Banking Window is a copy of the organization where convectional banks offer Islamic banking services and products from the current division network (Sanusi L., 2011).

Subsidiary/Branch Islamic Banking Service

A branch model is like that of the window model in which the subsidiary can create its own process and independent operating structure that offer only sharia compliant products. In this

model dedicated branch are created by conventional banks which fully applies the sharia principles in which activities are overseen by sharia advisory board.

Full-fledged Islamic Banking Service

The Full-fledged Islamic Bank is the bank that operates on Sharia-based policies and all products or service provided are free of interest. Gosau (2000) says that the full banking system, along with participation in interest-free transactions, must be inclusive of all sharia principles and avoid all other prohibited activities by Islam sharia transaction law. Only Sharia-compliant forms of investment and financing is offered (Ziyaad, 2009). The difference between the interest window model and full fledge mode is that the latter is autonomous of any other conventional banks that function independently providing wider variety of products.

2.2.5. Definition of Project

There are several definition of projects. Project is unique endeavor undertaken to acquire deliberated objective (Alam 2016). It specific cycle of Initiation, Definition, Planning, Execution and Closure to create a unique product, service, or result through novel organization and coordination of human, material and financial resources (PMI, 2008).

As defined by (Mishra 2013) a project is a group of unique, interrelated activities that are planned and executed in a certain sequence to create a unique product or service, with a specific time frame and according to clients specification with in a budget.

Projects are characterized by their defined scope, time, cost, and quality. They are constrained by limited resource, involves many people with different skill and, usually progressively elaborated throughout its life cycle (Turner, 2013).

On the other hand, Weiss and Wysocki (1992) follows an explanation that defines the characteristics of a project separately as follow:

- Complex and numerous activities
- Unique
- a one-time set of events
- Finite
- with a begin and end date
- Limited resources and budget
- Many people involved, usually across several functional areas in the organizations
- Sequenced activities

- Goal-oriented
- End product or service must result

Finally, IPMA Competence Baseline (2006) defines a project as a time and cost-constrained operation to release a set of defined deliverables (the scope is to fulfill the project’s objectives) up to quality standards and requirements.

After understanding what the project is, the next issue that needs to be defined and explained is what project management is. Accordingly project management is the application of knowledge, skills, tools, and techniques to project activities in order to meet or exceed stakeholder objectives and expectations from a project (A Guide to the Project Management Body of Knowledge, PMI, 1996).

PMI (six edition)IPMA Competence Baseline (2006) makes a more detailed project management definition and defines it as the planning, organizing, monitoring and controlling of all aspects of a project to achieve its objectives safely and within agreed criteria of time, cost, scope and performance/quality. It is crucial to optimize the parameters of time, cost and risk with other requirements and to organize the project accordingly.

2.2.6. Project Management Life-Cycle and Phases of Project Management

2.2.6.1. Project Management Life-cycle

A projects life cycle is a collection of logically related project activities that a project passes through from its inception to is final completion that provides frame work for managing the project(PMI, 2008). The concept of a project life cycle provides a useful framework for looking at project dynamic overtime. On the other hand, Weiss and Wysocki (1992) defines project management life-cycle in five groups respectively: Define, Plan, Organize, Control, Close; and twenty-five action steps under the five main phases.

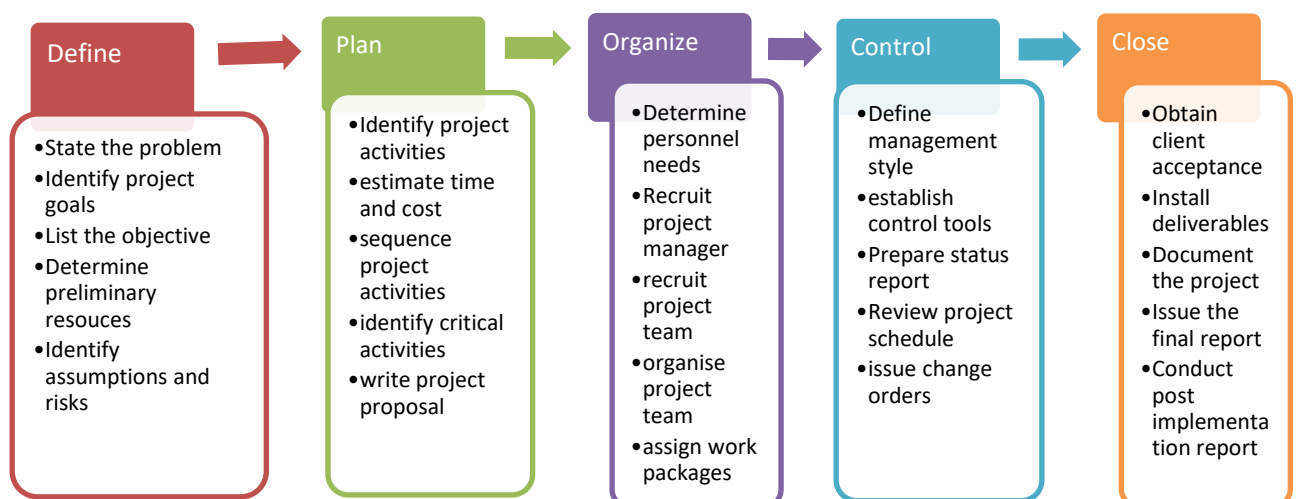


Fig. 1 Project Management Life-cycle

Source: Weiss and Wysocki (1992)

2.2.6.2. Project phase

A project phase is a collection of logically related project activities that add up to the completion of one or more deliverables of the project. Project phases maybe established based on various factors including: management needs, nature of the project, the unique characteristics of the organization or the industry, project elements and the decision making points (PMI,2008)

There can be different ways to separate the different phases of a project. However, there is usually a tendency to separate it into five or six different phases. For example, Baars (2006) collocates six different phases of a project as follows: Initiation phase, Definition phase, Design phase, Development phase, Implementation phase, Follow-up phase

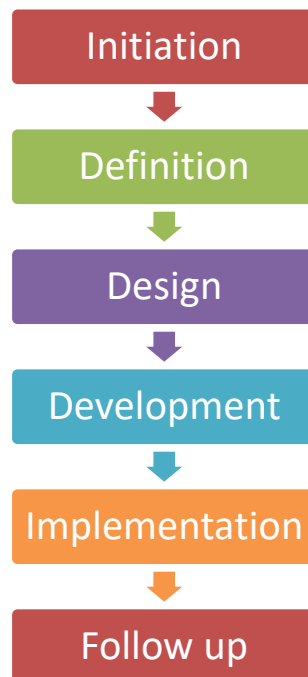


Fig 2: project Phase

Source: Baars (2012)

In the initiation phase, the idea is created. Later on, what is going to be made during the project should be defined. It has to be followed by the design phase and the ways that will be started which content the planning od implementation and the implementation of the project itself. Finally, follow-up phase concludes the project with the maintenance of it. Project appraisal in the main stream economics

2.2.7. Project appraisal system

Definition of project appraisal

Project appraisal is a systematic analysis of the viability of the proposed project using financial and economic assessment tools to determine the cost-effectiveness of proceeding with the project (Lester, 1986)

Another definition by (Nagarajan, 1993) states that project appraisal is assessment of cost and benefit analysis of different aspects of proposed projects with the objective of checking its viability to help select the best project alternatives among the competing projects. For interest free banking systems that engage in profit and loss sharing agreement, project appraisal is conducted to assess profitability of partnership agreement before extending finance to the project.

The purpose of project appraisal is to establish whether a project is worthwhile in the light of its cost, in terms of resource commitment and expected benefits. It's an ex ante assessment of a project and is an important decision making process as to whether or not to proceed with a given project or not. (Alam 2016)

Evaluation or appraisal of feasibility of a project requires a sophisticated process of inquiry which covers assessment of technical viability, market feasibility, financial assessment, management capability and uncertainties related to a given project (Alam, 2016).

For any financial institutions project appraisal is a technique wherein a main financing organization makes an impartial and objective evaluation of numerous components of investment options for arriving at investment decision and its aim is towards figuring out the viability of the proposed project (Sharma, 2016).

2.2.7.1. Steps in projects appraisal

The European Commission discussed its update on the "Cost Benefit Analysis Guide for Investment Projects" (2014) seven steps to be followed as a standard cost-benefit analysis for investment projects. This Project appraisal steps are:

1. Description of the context
2. Definition of objectives
3. Identification of the project

4. Technical feasibility & Environmental sustainability

5. Financial analysis

6. Economic analysis

7. Risk assessment.

As per the guideline of European commission for project appraisal the first step of projects feasibility study is describing the context of projects in which it will be implemented.

Describing Context of Projects is composed of:-

- the socio-economic condition of the region that are important for successful implementation of the project .
- the next part is the political and institutional aspect that deals with countries economic policy and its development plan and the capacity of institution involved.

Definition of projects objective

The second step in the appraisal process of projects is definition of objective. Objectives of projects should be quantified using indicators and targets. This aspect is important as it helps to verify the projects relevance by comparing with and without the project. It's also helpful in identifying the effect of projects that will be further evaluated in the analysis.

Identification of the project

It is a stage where different relevant project ideas which include analysis of stakeholders , target groups and beneficiaries are identified. In practice a project is clearly identified when the physical elements and the activities that will be implemented to provide a given output and to achieve a well-defined set of objectives, consist of a self-sufficient unit of analysis; the body responsible for implementation often referred to as 'Project promoter' or 'beneficiary' is identified and its technical, financial and institutional capacities analyzed; and the impact area, the final beneficiaries and all relevant stakeholders are duly identified

Technical feasibility and environmental sustainability

Once a project is clearly identified, the technical feasibility and environmental sustainability of projects needs to be duly assessed. This are among the elements of information that need to be provided in the funding request for major projects as per the guide-line of European commission.

Technical feasibility and environmental sustainability is composed of :-

- demand analysis
- option analysis
- environmental and climate change consideration
- technical design, cost estimation and implantation schedule

demand analysis is performed to justify the need for an investment by assessing the current demand for the project and as well as its future demand that is forecasted based on reliable demand forecasting modules.

Option analysis undertaking a project entails simultaneous decision of rejecting other feasible option. Therefore in order to assess the technical, economic and environmental convenience of a project and adequate range of options should be considered for comparison.

Environmental and climate change consideration environmental consideration are undertaken to check if the project may have adverse effect on the environment or not.

Technical design, cost estimation and implantation schedule a given project should include a summary of:

- Location: Description of project location including graph (map) should be stated . The availability of land is a key aspect: evidence should be provided that the land is owned (or accessible) by the beneficiary, who has a full title to use, or to be purchased (or rented) through an acquisition. In the latter case, the terms of the acquisition should be described. The administrative process and the availability of relevant permits for the execution of the works should also be explained.
- Technical design: Description of key work components, approved technology, design standards and specifications. The main output indicators, defined as the main physical quantities produced (e.g. kilometers of pipelines, the number of overhead quantities, the number of trees planted, etc.), should be provided.
- Production plan: Describe infrastructure capacity and expected usage rate. These elements describe the provision of services by supply. The scope and size of the project should be justified in the context of the expected future demand.
- Cost estimates: Estimation of capital need for the realization of the projects is important factor in order to perform financial analysis. Evidence should be provided as to whether cost estimates are investor estimates, bid prices, or conversion costs.

- Implementation timing: A realistic project schedule should be provided along with the implementation schedule, including the Gant chart along with the planned work. A reasonable amount of detail is needed to enable the assessment of the proposed timetable.

Financial analysis

The fifth step in the process of project appraisal as per the European guideline is financial analysis. Financial analysis of projects are performed to asses projects profitability and financial sustainability. A profitability analysis is a measure return on the capital put into a project regardless of source of financing (UNIDO & IDCAS,1988) . financial analysis consists of liquidity and capital structure analysis. Liquidity analysis checks the possibilities of cash deficiency in the years of a project's life (Sang, 1995).Projects financial analysis is performed using two methods:-

1. Discounted cash-flow method
2. Simple method (non-discounted)method

As per the module AAU for project identification, analysis and approval (MBAP606) projects financial feasibility involves estimating projects cash flow, establishing the cost of capital and applying suitable decision rule to accept or reject the given project.

Economic analysis

Economic appraisal is a key factor in assessing projects contribution towards public profit. It uses a shadow price to measure and reflect the social opportunity cost of goods and services for a given project. Social cost benefit analysis means to analyze the social cost and total social benefits if we accept any given project. It is performed whether return/benefit on investment projects are more than its cost from societies perspective.

Risk Analysis

In accordance with the guideline, the last aspect is risk assessment. Risk assessment for a given project is required to deal with the uncertainty that always permeates investment projects, including the risk that the adverse impacts of climate change may have on the project. The risk assessment process involves risk management planning, Risk identification, Risk analysis (Qualitative and Quantitative), Risk responses planning and Risk monitoring and control. The most practiced risk repose analysis method used by the bank risk rating matrix, sensitivity risk analysis and based on the analysis risk prevention and mitigation

strategy are developed. The final step is the continuous periodic risk review for any outstanding risks that they might encounter (European Commission 2014).

Market/ commercial Appraisal

Market and demand analysis for a given project is essential as it aids in planning the capacity of the project and selecting the location in line with the market requirements. A mistake in the analysis of commercial/ market assessment can lead to a major capital expenditure which is not reversible. Commercial analysis for a given project is conducted by performing primary market research through surveys and demand forecasting method. The analysis of the market also include evaluation of distribution channels, pricing of the product and marketing mix and analysis of competition (R. Mishra, 2013).

Management Appraisal

Proper management is a key factor for success or failure a given project. Managerial analysis of proposed project aid in the assessment of capability and business knowledge of the promoter's. A good project at the hands of poor management may fail while ill-conceived project become successful at the hands of an effective management. As a result banks and financial institution lay more emphasis on the competency of project consultants and promoters to management appraisal of proposed projects (R. Mishra, 2013).

2.2.8. Project appraisal from Islamic view

Potential competing projects need to be prioritized and resource should be allocated based on their contribution to the social welfare(public benefit) and their financial attractiveness. In Islamic law one is obligated to utilize the available resource in the right way within the law of the sharia. Therefore project appraisal is given much emphasis in in Islamic banking project appraisal practice to insure public benefit and rational use of available resource.

(Al Masri and Al Qardawi, 1999) stated that Islam highly condemns the unjustified use of resource. In the hadith narrated by AL-Nasari, a bird that is killed for no reason will condemn to Allah in the hereafter by saying “Oh Allah: this man has killed me for no reason and not for any benefit”. From sharia perspective every project is prioritized based on its urgency of need, its importance and value it creates to society (Al-Qardawi, 2000).

2.2.8.1. Main issues of project appraisal from Islamic stand point

The student researcher reviewed three main issues that are significant and that need assessment from sharia perspective. This is done in view of the vastness of the subject and the limitations of this study and in order to make the research focused and to make it within the scope the study. These major issues that are related to project evaluation are:

1. The need to be in line with sharia principles
2. The need to accommodate sharia objective (Maslahah)
3. The principle of time value of money

2.2.8.2. Principles of Islamic Banking in appraising projects

Islamic banking is a unique type of banking system that refrain all forms of transactions that are prohibited in Islam. So for any Bank to be classified as Islamic Bank, the following basic principles must be adopted for its operations (Greuning&Iqbal, 2008; Sanusi L., 2011).

Prohibition of Riba (Interest) or Usury

Interest means a fixed predetermined amount in addition to the principal. All forms of interest are prohibited in Islam. According to Holy Quran, interest (riba) is prohibited and considered as a major sin, in both payment and receipt of interest. Prohibition of interest is a manner to set up justice among the financier and entrepreneur. with interest, financier is assured of profit without sharing any form of risk (Zineldin, 1990). Under Islamic finance transaction, it is strictly disallowed the charging and receiving of interest between both parties. This is because interest is deemed as profit which had been generated without involving the actual productivity (Nur, Monica, Ng, & Low, 2016). Interest is likewise believed to be exploitative and unproductive due to the fact it is taken to consideration to symbolize positive benefits or gains to the lender with no chance of loss in addition to reward for no work. These factors are believed to lead, in turn, to inflation and unemployment and to stifle the social and infrastructural development of a nation (Balla, Zaha, & Abdulbasit, 2009). For any Bank to be called Islamic Bank, it must not engage in any interest related transactions, but rather, profit and loss sharing transactions (Audu&Mika'illu, 2014).

According to Warde (2000), there are three main reasons for prohibition of interest (Warde I., 2000).

- ✓ **Riba is unfair:**-Traditional relationship between borrower and lender is on interest, borrower has chance to receive all the profit or the risk to face all the losses that occur, whereas lender earns money what so ever (Warde, 2000).
- ✓ **Riba is exploitative:**- It is exploitative due to the fact that it favors rich, as surplus of cash and it pressures poor to borrow (Warde, 2000).
- ✓ **Riba is unproductive:**-Money must be utilized in business activity and make contribution to the financial system enhance public welfare (Warde, 2000).

Prohibition of uncertainty (gharar)

When entering into a contractual relationship, the parties must fully disclose their intentions and information to each other, because the transaction that contains gharar or information asymmetry will be prohibited. A transaction where the subjects of contract, price of the sale and ability to deliver are not stated is considered to be suspicious by the Shariah. In addition the counter values of the contract to the parties involved should as well be stated for the contract to be considered lawful from Islamic perspective. Islam condemns obtaining unilateral advantages by more informed party of the contract (Nur, Monica, Ng, & Low, 2016).

Prohibition of Maisir

Prohibition of speculative behavior “maysir”. An Islamic financial and commercial system bans transactions featuring any form of speculation and gambling.(Iqbal,2009). Operations based on the random event or chance and speculation will result in gain of one party at the expense of the other party and this does not contribute to the welfare of the society.(Nur, Monica, Ng, & Low, 2016).

Profit, loss and risk sharing

Since interest is prohibited in Islam, the providers of funds and the entrepreneur in an Islamic banking settings share the business risk and profits based on mutual agreement. This act will equitably distribute income, enhance social justice, and alleviate poverty (Adu&Mika'illu, 2014).

Sanctity of contracts

Islam upholds contractual obligations and the disclosure of information as a sacred duty. This feature is intended to reduce the risk of asymmetric information and moral hazard (Iqbal, 1997).

Ethical Standard & Shariah-approved activities

Under Islamic investment, it is crucial for the investors to clarify whether the invested company or businesses are compliance with Shariah. Certain activities are strictly forbidden to be invested in Islamic banking (Nur, Monica, Ng, & Low, 2016). Only commercial enterprises that do not violate the guidelines of sharia qualify to be financed through Islamic banking. For example any funding in enterprise that deal with alcohol, gambling, or casinos is prohibited (IQBAL 1997).When investors would like to make investment, they have to overview the background of the potential company, including the company's policy, products and services produced, method for company to operate the business and the positive or negative impacts of the products or services contributed to the society (Nur, Monica, Ng, & Low, 2016).

2.2.8.3. The Concept of *Maslahah* in appraising projects

The literal meaning of maslaha is public interest or public welfare. The concept as described by Al-Ghazali, it is the preservation of the ends of sharia. Fundamentally the concept of maslaha lies in the preservation and protection of faith, life, prosperity, intellect and wealth (Al-Ghazali, 1973). In the Interest free banking system the concept Maslahah is considered as the first or top priority in their project appraisals. (Jalil 2003) argue that project appraisal in Islamic financial institution should incorporate the concept of Maslahah or sharia objectives in their project evaluation framework in order for the proposed project to be desirable from Islamic stand point. The addition of Maslahah concept in the project evaluation framework help in prioritizing proposed projects according to their importance to society, the value it adds from national perspective and mostly its contribution to realization of the sharia objectives (Al-Ghazali, 1973). while banks appraising projects, they shod not go beneath necessitates as it implies underutilization of resource while societies existence depend on it. In the same manner Islamic financial institution should not go beyond refinement projects as it wasteful in appraising projects using concept of Maslahah. Spending more than what is required is referenda's Israf and spending in activities of lower importance while there is need for necessities is highly condemned in Maslahah concept. Likewise underutilization of resource while welfare of the society is not fulfilled is referred as AL- Taqtir or niggardliness which is also forbidden from Islamic principles (Al-Ghazali, 1973).

The importance of incorporating Maslahah concept in project evaluation practice as outlined by (Jalil,2003) are :-

- like that of sharia screening could serve as qualitative screening to filter out forbidden projects from among projects competing project alternatives .
- It includes moral cultural and spiritual aspects of projects which are usually neglected in the conventional banking project appraisal practice
- It help in incorporating projects that gives value to public welfare than private wealth maximization.

Categorization of Projects according to the Concept of Maslahah

Broadly classifying projects into either its halal (lawful) or haram (unlawful) isn't sufficient to decide and prioritize projects. This necessitates bringing maslahah concept into the project appraisal framework in Islamic banking system. The concept classifies and prioritize projects into three fundamental categories in the appraisal framework. They are:

- Essentials (*Daruriyyat*)
- Complementary (*Hajiyyat*)
- Refinements (*Tahsiniyyat*).

Essentials (*Daruriyyat*)

Projects under this category are the ones which is required for bringing existence and retaining the very life of man's five vital elements i.e., Religion, Life, Mind, Offspring and Wealth. This includes projects that are necessary for protecting these elements from destruction (Khan & Ghifari, 1992). It also includes projects that are necessary for the achievement of the maintenance and protection of these five elements. According to Islamic legal ruling : *"Whatever is indispensable for the performance of an obligation is also obligatory"* (Zarqa', 1984).

Complementary (*Hajiyyat*)

In today's actual world situation, most projects and economic activities are included in the category of conveniences (Meera, n.d.; Zarqa', 1984). The execution of such projects is strongly encouraged in Islam up to the extent sufficient to get rid of problems or gain conveniences in life ('Afar, 1992; Zarqa', 1982 & 1984). As a guideline , projects that make contribution to the development of the essential areas and make Man's activities less difficult and eliminate the problem dealing with them are Complementary projects ('Afar, 1992; Zarqa, 1984).

Refinements (*Tahsiniyyat*)

Projects fall under this category are those which pass the limits of Conveniences on condition that they are carried out moderately (Zarqa', 1984). Such projects should be given least priority, particularly if the first two categories have not been satisfied (Meera, n.d.). The discharge of projects under this category is either recommended or permissible in Islam (Zarqa', 1982).

Relationship governing the concept of maslahah

As a general rule, a project that falls under the category of Necessities should be preferred to that of Complementary in an Islamic framework. Similarly, a project that is considered as a Complementary must be preferred to that of Refinements (Khan & Ghifari, 1992; Meera, n.d.). The three categories of Maslahah in evaluating projects are governed in a way that necessity projects are more valued and given precedence than that of convenience projects and likewise complimentary projects are preferred than that of refinement projects. The hurdle rate for necessity projects is a lower them complementary projects and the hurdle rate of for complementary projects are lower than that of refinement projects and in order for the concept of Maslahah to work this precedence relationship should be uphold (Jalil 2003).

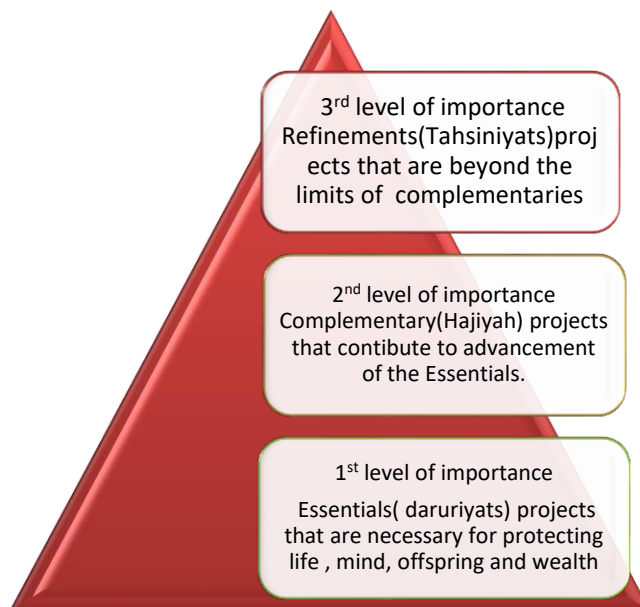


Fig. 3 The logic of Maslahah based on its hierarchical relationship

2.2.8.4. The principle of time value of money

Time value of money is a concept in which some of money which is owned in the present has greater value than the value of the same money which is received in the future. Time value of money is important factor as choice of investment decision from among several project alternative relies on discounting future earnings of projects into their present value and assess their financial attractiveness which is applicable in today financial and banking industry (Marina, 2017). The three basic notion behind time value of money is that; Present conception is better than future conception and in order to give up todays conception/utility one should get more in the future. The second issue is regarding inflation in which values of currency decreases over time, in this case the difference is that the value of one dollar today and a dollar in the future is not the same. Thirdly there also the issue of risk related to earnings and cash flows in the future. One cannot be sure of the stability of earnings as they can be deteriorated and affected by negative risk factors that they might encounter(Marina, 2017).

The concept time values and time preference in conventional banking system results from interest rate but this notion is not compatible with the sharia principles which prohibits any form of interest (IQBAL 1997). Money in Islamic financial system serve only to value of assets or real economic activity and as a result transaction can't be independent of real assets or services and money cannot be considered as commodity by itself (IQBAL 1997).

The Qur'an explains that every aspect of life be it activities related to fiancé and economics or any other life activity through the verse below (Yusuf Ali, 2008):

“Nothing have we omitted from the Qur'an, and they all shall be gathered to their Lord in the end” (Qur'an 6:38).

Controversy about time value of money rise by the element of riba or interest. In the mainstream economy, the interest rate is the time value of money. It represents the price of using money for a certain period of time. The problem here is that how to assess the time value of funds in the Islamic economy without using the interest rate? (Jedidia 2017)

Time value of money from Islamic perspective is divided into two which are economic time value of money and social time value of money. Social time value is related to non-monetary rewards that one gets in the hereafter while economic time value is related to value of money in the present life which existence in sales or partnership agreements in Islamic financial

institution. Economic time value of money upholds that present utility of money is greater than future utility if its backed by real economic activity and so long as it is not predetermined value and if it is not loan contract. Economic time value money is determined in Islamic economics by generating a discount rate or profit rate which is generated by assessing the market conditions of a given project within as specific industry and risk associated with the investment decision (Jedidia,2017).

2.3. Empirical review

A study conducted by (Kuma 2018) on the appraisal practice of Dashin bank for project financing which assessed by evaluating technical commercial financial managerial and risk of project. The finding of the study shows that appraisal practice of the bank is good for the most part however plant layout, selection of plant and machinery are not well evaluated and the bank is over relying on discounted cash flow analysis in apprising financial viability of the project the assessment of management aspect also have got little attention in the project evaluation process. The bank also don't have any defined risk prevention and mitigation plan for negative uncertainties that the project might encounter.

In assessing government priority projects in development bank of Ethiopia by (getu 2018) the study focus on reviewing the share of manufacturing industries projects in DBE credit portfolio, the effectiveness of DBE priority project appraisal system especially related to the manufacturing industry project. From the total projects financed by the bank, manufacturing projects comprises 68.26%.The study finds out there is lack of effectiveness of project appraisal system in DBE, poor follow up and control throughout the implementation period which lead to high non-performing loan ratio and there is lack of team based project appraisal process system in the bank.

A study on post implantation challenges of IFB projects in CBE by Meskerm Bati which focus on investigating post implantation challenges, their effect and measure taken to reduce those challenges. The study found out that various challenges which are lack of awareness and negative attitude by the community regarding IFB system, lack of legal, supervisory and regulatory frame work, absence of Islamic insurance to assure IFB system, lack of sharia advisory board and scarcity of skilled manpower with needed expertise in IFB are the main factors affecting the Islamic banking system.

A comparative analysis of risk in IFB versus Convectional banks in Kenya by (Barissa 2012) which aim at checking whether IFB banks in Kenya are riskier than conventional banks or not. Results of the study states that Islamic banks were riskier than conventional banks in terms of return on equity and operational risk while conventional banks were riskier than the Islamic bank in terms of credit risk and liquidity risk. The risk of IFB banks are attributed to the loss encountered during the three year period in which the study conducted in. Besides the risk encountered on the period the study conducted in, the researcher concluded that risk factors are independent of the type of banks in Kenya.

2.4. Conceptual Framework

The conceptual framework for this study is developed based on the reviewed literature described above. As stated in the literature review, a project appraisal process according to the mainstream economics has several steps. This steps are evaluating projects objective, performing commercial profitability analysis, performing investments profitability analysis, performing social-cost benefit analysis, evaluating uncertainty/ risk of projects and evaluating projects overall merit. The above literature also shows the importance of Maslahah concept for the way projects are assessed and valued from Islamic banking system project appraisal stand point. So the Maslahah(sharia objective) is the intervening factor in the appraisal process by classifying projects based on their nature into a necessity, convenience and refinement projects. As a result the conceptual framework for comparison of project appraisal practice in the two banking system is developed based on this.

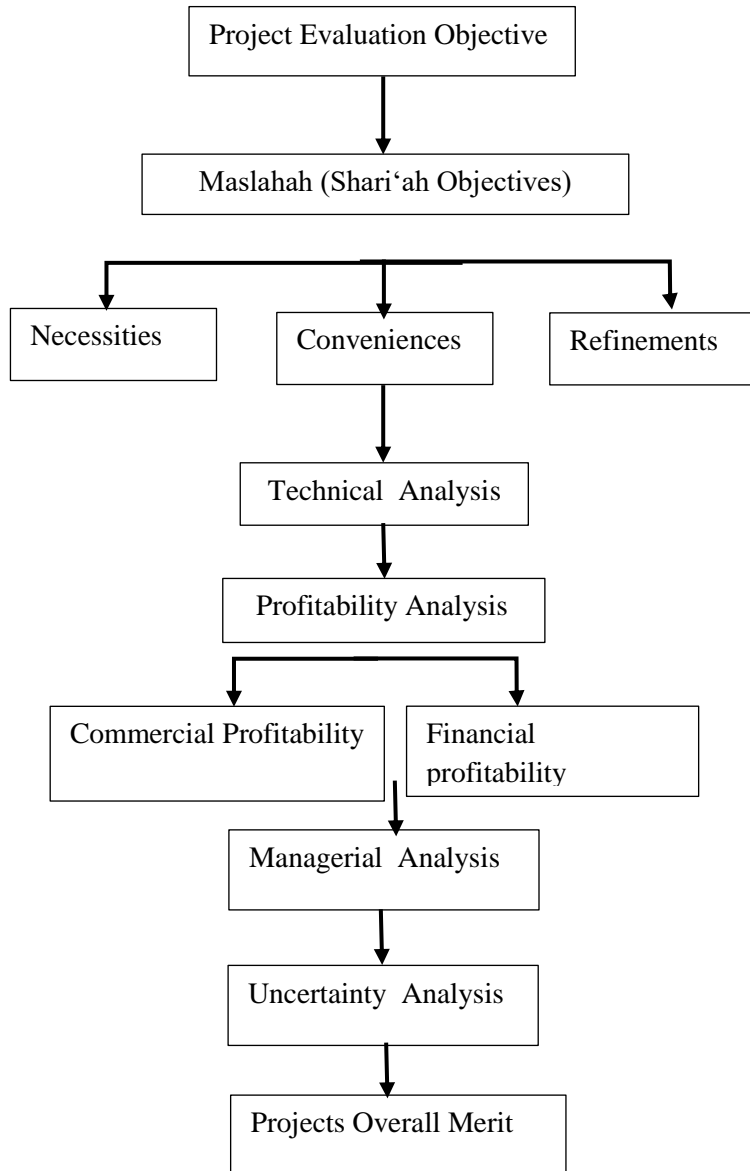


Fig. 1 Conceptual framework

Source: Abdullah Bin Jalil (2003) and modified by the student researcher

2.5. Research gap

There have been limited researches regarding the assessment of project appraisal practice in Ethiopia banking industry even though Interest free banks are active since 2011. various studies have been conducted with respect to the appraisal of conventional banking system i.e. (Kuma, 2018) conducted emperical assessment of the appraissal practice and the callenges incountered in the process of dashin bank and (Getu, 2018)assessed the effectiveness of the project appraisal practice for government prooirity projects in of development bank of ethiopia. However there is no studies conducted with regard to the appraisal practice of

interest free banking system as a result this study fills this gap by providing empirical data on the current practice of project appraisal in IFB of CBE.

On the other hand (Jalil, 2003) conducted a study on the theoretical framework of project appraisal practice for interest free banking system. The study identifies the importance of sharia objectives and their impact on Islamic project appraisal framework which greatly distinguishes it from the mainstream one. But the study did not consider which of the sharia objectives and values that are incorporated in the current frame of IFB projects. With this regard this study fills the gap by assessing sharia principles and values that are included in the appraisal framework in IFB of CBE.

CHAPTER THREE

3. Research Methodology

3.1. Introduction

The researcher has conducted a literature review in the previous chapter. This chapter aims to describe the research methods and procedures used to implement the experimental part of this thesis. It includes different sections which covers approach of the research, research design, data type and method of data collection, sample and population of the study, method of data analysis procedures, validity of the study and ethical considerations.

3.2. Research approach

Based on the type of data used there are three types of research approach. These are quantitative, qualitative and mixed approaches. Although qualitative and quantitative approaches are seen as separate and polar opposites to one another, they are interlinked and represent a different end to a continuum. (Newman & Benz, 1998) as cited by (Croswell,2009). Qualitative research is a way to explore and understand the meaning that individuals or groups attribute to a social or human problem. Qualitative studies are seeking descriptive data through a holistic viewpoint and examine several variables, but only in a small population. In qualitative research data's are usually collected in participant's setting and data analysis process build inductively from details to general topics, and a researcher makes interpretations of the meaning of data (Croswell, 2009). This study aims at assessing project appraisal practice of IFB of CBE and it tried to check which Islamic principles and values are incorporated in the appraisal framework of interest free banking system of commercial bank of Ethiopia in which the data was collected using interviews and secondary documents. Therefore the student researcher applied qualitative approach in conducting the study.

3.3. Research design

A research design is a blue print for collection, measurement and analysis of data. It links the data to be collected to the research question in the study (Kathari, 2004). It is a research plan and procedure that extend decisions from general assumptions to detailed methods of data collection and analysis. The choice of research design is also based on the nature of the research problem or issue being addressed, the personal experiences of researchers, and the

masses of the study (Croswell, 2009). Throughout the study the student researcher used descriptive type of research to assess project appraisal practice in interest free banking system of commercial bank of Ethiopia and the interest free banking principles and values that can be incorporated in the appraisal framework that relates to the research problem. Since the intention of the study was to assess and check whether they incorporate Islamic principles and values in their appraisal framework, the method applied was suitable and helpful in examining and answering the research question.

3.4. Data type and data source

Both primary and secondary data was applied to attain the study goals. The primary data collection has been obtained through semi structure interview questions. The semi structured interview was administered to the project management officials and project appraisal teams in IFB of commercial bank of Ethiopia. It has been conducted to gather detailed information from general managers of CBE Islamic banking branch and project feasibility analysis officials. The secondary data that has been assessed was CBE project appraisal practice guideline and project term loan appraisal guideline and IFB guideline for finance analysis. Different literatures were also assessed; journals and articles that are published associated with project appraisal practice of interest free banks, related documents, books and other secondary data's were also included.

3.5. Sample and Population of the study

Sampling is a way to choose individuals or a subset of a group from population . It enables the researcher to study a relatively small number of units rather than whole entire population, and to obtain data that is representative of the target population (Croswell, 2009). The target population of the study was composed of all individuals who work at CBE IFB financing appraisal office in the head office. This individuals were one general manager and seven project feasibility study officials in IFB of CBE. The interviewees were five men respondents and three female respondents. Most of the respondents have more than six and half years of experience in the bank. Therefore all relevant people to answer the research question were included and considered as sample of the study, which is census survey.

3.6. Methods of data analysis

Content analysis is a qualitative data analysis method which is used to gather and analyse the content of the text. Content refers to word, meaning, ideas , themes or any message that can

be communicated whereas text refers to anything that is written or spoken that form as medium of communication (Croswell, 2009). Using the content analysis the student researcher was able to assess the content of the data that were gathered through semi-structured interview and official data of CBE regarding project appraisal practice in the interest free banking system. Descriptive analysis was used to analyse and summarize the result of content analysis to see how appraisal practice of IFB of CBE is conducted and to check the Islamic principles and values are incorporated in the appraisal framework of interest free banking system of commercial bank of Ethiopia.

3.7. Validity of the Instrument

Validity in qualitative research means that verifying the accuracy of the results by employing certain procedures in the study (Croswell, 2009). To check the accuracy of the findings the student researcher applied two strategies. The first one was triangulation of different data source and examining evidence from the source and using it to build a coherent justification for themes and the second one was the use of member check the of final report or the themes back to the participants and determining whether the participants feel they are accurate or not.

3.8. Ethical considerations

According to Resnik (2015) many of the ethical norms help to ensure that researchers can be held accountable to the public. Therefore, this research takes this in to account & be responsible to keep the interests of the public it dealt with. Participants were asked if they are voluntary to participate in the study. In addition, Anonymity of individuals who participated in conducting the interview remained anonymous throughout the study. Information collected from the respondents was kept confidential and not to be used for any other purpose.

CHAPTER FOUR

4. Data Presentation, Analysis and Interpretation

4.1. Introduction

This chapter presents the data and analysis of the data analysis of the collected data. The objective of the study was to assess how project appraisal practice is undertaken going under interest free banking system in CBE and the additional Islamic values incorporated by the banks project appraisal practice. Primary data was collected through survey method using semi- structure interviews of director of IFB project appraisal department and project appraisal analyst in the head office. Then after the data collected was analyzed in way that researcher will be able to answer the research question.

4.2. Background of participants

The target population included in the study where project financing officials of IFB of CBE Noor financing appraisal in the head office. The researcher applied survey method since there were eight project analysts and one project appraisal director. The demographics of the interviewees are five men respondents and three female respondents. All of the interview respondents are MA holders in accounting and finance and project management. Except for two participants the respondents have more than six and half years of experience in the bank and the two participants have five years of experience. Since the IFB of CBE has been functioning for almost three years, all of the participants have more than 2 years of experience as IFB project financing analyst.

4.3. Technical appraisal aspect of the project

How is the technical viability of proposed projects appraised in IFB of CBE banking system?

The study in this section asked respondents to show how the technical aspect of the projects are appraised. The technical evaluation process consists of the technology to be used by the project, operating scale, raw materials, technical knowhow available, selection of product mix, selection and purchase of plant and machinery, evaluation of plant layout and evaluation of project scheduling. Each of these aspects mentioned above is evaluated on the basis of specific criteria within, which they are included in the following section.

a) Technology adopted

When asked about the technology adopted by the project, the respondents stated that the bank measures technology of proposed project based on several checklist. The first thing the bank considers is that the justification for selecting the given technology and its acquisition process and it checks whether the adopted technology is available in the local market or not. Secondly it make sure whether it uses locally available raw material or not. The third point that is assessed is if the technology adopted is in tune with social and cultural norms and its appropriateness in protecting ecological balance of the society.

The other point considered in acquiring a given technology is the price of acquisition in terms of licensing technology maintenance and upgrading and mitigation plan in case it became obsolete. The bank also make sure whether there is contractual agreement between supplier and the purchaser to see if the supplier provides after sale service to the buyer.

This statements of the interviewee is supported by the secondary data records of IFB project analysis guideline document checklist of commercial bank of Ethiopia in which almost all of the specification stated in the record is practiced by the appraisal team of the bank.

From the above statements we can conclude that the interest free of CBE appraisal team is accustomed to evaluate each and every aspect that need to be considered in appraising the technology adopted by the proposed project.

b) Scale of operation and product mix

In determining operational capacity and product mix of the proposed project the interviewee stated that the financing institution looks for the description of the base for selecting a specific capacity utilization. In determining operational capacity, the financing institution looks for availability production inputs to evaluate input- output ratio. This capacity is evaluated by comparing it with similar products producers or with the market potential.

The other point evaluated by the study here was that proposed projects product mix. The interviewee stated that the bank assess the base for product mix and its flexibility with the market condition. The production program in terms of product mix and plant capacity utilization for each year of the proposed projects life is among the factors considers in the appraisal process.

c) Machinery selection and procurement

One of the main aspects considered in technical appraisal process is assessment of machinery selection and its procurement process. In assessing the plant whether the same equipment and machinery produce different product or not, interviews response show that the bank engineers analyze the reason for selecting specific machinery, the basic engineering, capacity of the machine procured and power and other utility conception are duly assessed by checking the proforma invoice.

The bank also evaluates the arrangement for the installation, erecting and commissioning by visiting the site through observations. The project analyst assesses the payment terms and delivery schedule of the machine along with detailed terms and conditions for its purchase.

d) Raw material

While assessing the raw material; required in the proposed project, the respondent cited that the bank make sure the availability of raw material, type of raw material, source of raw material, its cost and continuous availability for the project. This is done by assessing supply side market.

The bank also evaluate list and cost of packaging materials, transportation facilities for the raw material and availability of suitable storing required utility source, type and quantity demand, their cost and sustainable availability are among the factors considered in assessing raw material for the proposed project.

e) Location and civil work layout

Reason for selection of location for the project is duly evaluated based on its proximity to the raw materials required by the proposed project, infrastructure facilities and also to the market. If the project's products are designed for export market, its proximity to trade route is also checked by the project analyst.

If proposed project is agricultural one, developed land and areas to be developed, suitability of the area climatically and political stability and soil type and if the proposed project requires acquisition of buildings estimated cost of building by bank engineers is assessed.

f) Organizational structure and human resource analysis

The commercial bank of Ethiopia IFB credit analysis have several check list states that in evaluating technical capacity of a given project. Organizational set up with description of

various department and relationships, availability of skilled, semiskilled and un skilled manpower as per the demand, profile of key management and their qualification along with their experience and external consultancy service availability are the main issues assed in this stage.

Likewise the respondent cited that in assessing technical know-how for a given project, the project analyst evaluates the experience of relevant staff and availability within the project promoter organization to execute the proposed project, insuring the availability of consultants that have the relevant knowledge and experience and making sure of the proper agreement is in place are the main issues checked which is essential for successful implantation and completion of the project.

g) Plant layout

The proper management of plant layout ensures study flow production which increase productivity and reduce overall cost. In this section the study asked if the bank make sure of appropriate plant layout designs are in place to increase efficiency of manufacturing industries which is highly dependent on material flow distance and material handling cost.

The interviewees response in this regard was, since the main financing service provided by the IFB of CBE is through murabaha or cost plus markup agreement and the bank is engaged in buying machinery and equipment and the like and selling them for profit, they are not giving much attention to plant layout design in the appraisal process.

The study also didn't find any records in CBE IFB finance appraisal guideline or credit analysis documents checklist that is set as a guide to evaluate proposed projects plant layout arrangements.

From the statements analyzed above the study concludes that both primary and secondary data's show the bank is not applying any evaluation criteria in assessing the plant layout of a give project in the appraisal process.

h) Project scheduling

A project schedule is a detailed plan that shows when the project deliverables will be competed along with the final results defined in the project scope it helps to manage resource efficiently and guide the project to its final completion. It shows the activity to be performed, their sequence and time it takes for each activity in different stages (PMBOK Guide 2017).

The respondents answer for the study question whether the bank checks if a proper project implementation schedule is in place or not was that the project analyst checks documents of proposed projects that want to be financed if they incorporate project schedule showing each activity to be performed, the project deliverables at each stage and project milestones in chronological order up to final completion of the project.

Assessment of technical viability of project by the bank	Remark
Technology adopted	Duly assessed
Scale of operation and product mix	Duly assessed
Machinery	Duly assessed
Selection and procurement of equipment	Duly assessed
Raw material location and civil work	Duly assessed
Organizational structure and human resource availability	Duly assessed
Plant lay out	Not well considered
Project scheduling	Duly assessed

Table 1: summary of technical assessment of IFB of commercial bank of Ethiopia

4.4. Commercial/market analysis

How is the commercial/market viability of proposed projects appraised in IFB of CBE banking system?

Success of a given project depends ultimately on products or services market profitability. The study under this section asked respondent how they assess commercial feasibility of a given project in IFB of CBE.

Commercial feasibility is assessed based on several checklist in IFB of CBE. These checklist that are identified by the respondent in the interview are:-

1. Determination of demand for the product
2. Marketing plan and strategy

3. Analysis of competition

a) Demand for Product

Demand for the product is determined using survey method by assigning officials that will physical observe if there is shortage in the market and if the product is new they check if there is potential customers for the product being produced. Further the forecasted demand presented by the project is checked whether its generated based on reliable source or not. meaning the bank will check if the organizations that produce the data is the base of the furcate is duly assessed.

b) Marketing plan and strategy

The respondent stated that any given project proposal marketing mix is evaluated by comparing it with competitor experience in the market. Further way of promotion selected by the project are assessed if they are in line with sharia ruling. The pricing of the firm is also compared with similar products of other business in the market that locally produce product, with imported goods in the market and also with price of substitute goods.

Data's from secondary data source show that the bank checks for type of product/Service mix, main customers and suppliers of the business and reliability and sustainability of supply of inputs. The availability of alternative market for the product and the status or position of the proposed project within the sector is also among factors considered in assessing marketing plan and market positioning of the project.

Lastly the bank performs business visit to verify and evaluate the factual information contained in customers project financing application document to make an objective assessment of the business through observation.

c) Analysis of competition

Records from secondary data shows that key suppliers in the market that produce and supply similar products are evaluated by the bank. This is done by identifying the specific product supplier available in the market and their operating capacity. Trend of local production volume and imported volume of substitute and complementary products for the past five years is assessed by the bank in evaluating market feasibility of the proposed project'

From the above statements that are discussed the IFB of CBE appraise each aspect of commercial feasibility of a project. The data from interview is supported by the secondary

data's and insures the bank is evaluating each checklist under the market analysis and all are well considered accordingly without neglecting any aspect of it.

4.5. Financial viability of projects

How is the financial viability of proposed projects appraised in IFB of CBE banking system?

Financial attractiveness and feasibility of a given project is the core of conducting project appraisal practice to going forward and proceed with the proposed project or reject it. In this section the researcher asked the respondents how they conduct their financial analysis and what parameters they consider while conducting financial viability of proposed projects.

Islamic financial institutions request business to bring their financial statements for at least the repayment period of the finance. These statements are requested to perform various financial analysis and to assess whether the project will be able to repay its financial obligation and check source of repayment and also to evaluate profitability of the project proposal.

In appraising financial viability of projects, the researcher has raised three questions that have been assessed thoroughly. These aspects are:-

1. Whether the IFB of CBE use cash flow statements to evaluate profitability of projects?
2. How the bank establish cost of capital or profit rate knowing IFB system do not use interest as cost of capital?
3. Which method of cash flow is applied in determining projects feasibility?

a) The use of cash flow statement

In assessing whether the bank uses cash flow statements to evaluate profitability of projects, the interviewee stated that the bank requires all existing business that want to be financed through IFB shall bring their cash flow statement for the last three consecutive years. All new business enterprises must also present forecasted cash flow statement for at least the repayment period of the finance provided. Unlike conventional banks financial statement, the respondent stated that IFB cash flow statements are adjusted in the analysis as interest income are regarded as profit and interest expense as other expense or cost.

Records from secondary data source also confirms that the bank make use of cash flow statement to conduct financial analysis. IFB financing business procedure under its required

document to finance project states that IFB customer relation managers must ensure applicants has submitted all the necessary financial statements which include the balance sheet, income statement and cash flow stamen. The procedure also states that the statements can be actual/ or projected ones.

The interviewee stated that the bank use financial statements presented by project promoter to compute different ratios as the main toll of financial analysis. The appraisal officers mainly conduct three ratios. These are activity ratios to reflect the increase or decrease in sales level of projects from one period to another, Profitability ratios to check efficiency of business operation and measure cash generating ability of the business and liquidity ratio to assess the ability of the business to meet its obligation as they fall due and also check appropriateness of financing structure of the business in terms of matching maturity of assets and liabilities.

What we can conclude from the above statements is that results from both data sources show the bank uses cash flow statement to conduct different financial evaluations and check financial viability of projects

b) The establishment of cost of capital in IFB

Cost of capital in Islamic financial institution is the cost of finance required to acquire physical capital/or asset. It determines the minimum rate of return required to finance a give project. In this regard the interviewee stated that cost of capital in IFB of CBE is a profit rate which is generated by taking the equivalent rate of the conventional banking interest rate. This profit rate is flat throughout the repayment period of the mark up in IFB system.

The respondent also stated the sharia advisory board's ruling in the application of the equivalent rate of conventional banking interest rate as cost of capital in Islamic banking system. The ruling states that so long as the transaction itself don't contain business transactions that are prohibited under sharia law and they are in line with sharia objective and business can apply the equivalent rate of conventional banking interest rate.

In contrast this statement is argued by (Jalil 2003) which states that even though profit rates and interest rates can be used as discounting factor in performing financial analysis, it does not justify that both can be used in Islamic financial institution. He states that the use of interest rates as an ideal for halal business is not desirable and it's not in line with the basic philosophy of Islamic economy and proposes cost of capital can be measured without referring to predetermined fixed interest rate.

The data from the interview is not in line with other secondary data's and Islamic values which shows that the IFB of CBE is not generating its own alternative profit rate to the conventional bank's interest rate.

c) Cash flow method applied by the bank

There are two widely known types of cash flow methods which are simple method or non-discounted and discounted cash-flow method. These methods are used to conduct different cash-flow analysis. Within the two methods there are several techniques used to assess the and evaluate financial viability of the project.

1. Simple method (non- discounted method):- from among several technique the response of the interviewee was that the IFB of CBE applies the payback period as the only means to perform cash-flow analysis and no additional method is applied by the bank. Some of the other non-discounted techniques of analysis are ranking by inspection, accounting rate of return and output capital ratio.
2. Discounted cash flow method:- the most widely used and well known discounted cash-flow analysis technique are the net present value and the internal are of return. The interviewees response regarding whether the bank applies any type of discounted cash-flow analysis was that the IFB of CBE applies both analysis techniques on carrying out financial evaluations.

From the statements above we can conclude that the bank is mostly applying non- discounted method of analysis rather than the simple method. The application of the discounted method has got several advantage to the bank. The method considers risk of future cash flows through cost of capital and considers time value of money and will untimely tells whether the investment will increase firms value or not. Therefore the banks reliance on the second method is reasonable and justified.

4.6. Managerial analysis

How the management capability of proposed projects appraised in IFB of CBE banking systems?

The interviewee response regarding the process of evaluating managerial practice of the bank was that the IFB of CBE gives much emphasis to this aspect due to the fact that evaluation of managerial capability of project manager is of greater importance as a feasible project might fail due to the lack of competency of project managers. The capacity and hard skills of top

level managers of proposed project is evaluated by the bank using three parameters. These are:-

- Experience of managers in managing related line of business
- Educational qualifications of top level managers
- Succession plan of the proposed project organization

Despite the facts stated above the interviewee cited that there is no mechanism applied to check project managers soft skills like leadership capability, problem solving ability, result orientation, conflict management capability and decision making ability which have positive impact for successful project completion.

We can understand from the above discussion that in evaluating managerial aspect of projects the bank recognizes its importance and gives it due consideration for the most part even though some are neglected.

4.7. Risk analysis

How the risk attached to projects analyzed and managed in IFB of CBE banking systems?

The study in this section asked the interviewee how risks are managed by CBE IFB system. Risk management is a process of identification , assessment and prioritization of risks followed by coordinated and economical application of resource to monitor and control the probability and or likely hood impact of unfortunate events or to maximize realization of objectives (PMBOK Guide 2017).

Risk management practice of the bank is assessed based on several check lists. This are how does the bank categorize risks of proposed project, which method of risks analysis are applied by the bank , what response plans are developed by the bank for risks that are likely to occur and whether the bank review project risks periodically or not .

The interviewees response in this regard was that the first thing that CRM of IFB CBE preform in managing the risk is to categorize them based on documentation review of proposed project and interview that conducted to project promoters by customer relationship management of CBE IFB system. This categories are financial risks, market or industry risks, managerial risks and customer relationship risks. The bank then checks whether the data's

presented are reliable and check the if the financial statements presented are audited and up to date.

Secondly after the risks are categorized the interviewee cited that he bank perform both qualitative and quantitative risk analysis technique. The method selected and used by the bank are impact risk rating matrix and sensitive analysis which is developed and measured jointly by customer relation manager and the project analysis's.

CBE IFB business procedure states that all costumers that wants to be financed through IFB system except for new or newly established business meaning business with less than one year of experience upon application should be rated graded on the impact rating matrix. Newly established business or applicants without prior financing relationship with the bank shall be automatically rated as Grade 3. This risk rating process in IFB of CBE is done by project analysis's and its verified by another project analysts and the whole process is closely monitored by director of IFB appraisal.

The interviewee stated that the risk rating system serve the bank to maintain application of uniform risk rating standards across all proposed projects that want to be financed. It's also useful to monitor and control all risk factors to keep quality of financing, timely manage early warning signals and design a risk response plan and at the end it help in the process of making financing decision.

The IFB of CBE have eight risk grading stages ranging from exceptionally low risk which is bankable to default risk which is not bankable. The risk grading is done based on parameters developed by the bank. The source of those parameters are data's presented by the proposed project which should be average of the recent 3 years and if the business is new average of the available data are considered. This parameters are strength of proposed projects financial statements which is measured using profitability ratios, liquidity ratios, leverage and debt service coverage. The second parameter is business industry risk which is measure using business outlook and growth whether its favorable , stable or unfavorable and market share of the business i.e. is the business dominate player , average or week player. The third one is management risks which are measured using experience in related line of business and qualification of management. The forth parameter is account performance risk which is measured using repayment period and capacity of business. The last parameter is customer relationship risks measured using length of financing relationship and integrity, honesty and cooperation of business customers with bank.

The table here below show how the eight stage of proposed projects impact rating matrix based on the five parameters stated above.

Risk	Grade Risk Level	Risk Explanation
1	Exceptionally low Risk (Bankable)	Fully secured financing by cash and cash substitute regardless of the status of the finance The customers has strong repayment capacity and is not subjected to any criticism.
2	Very low Risk (Bankable)	Not as strong as grade 1 customers in terms of risk parameters The customers have strong repayment capacity and low leverage rate Business demonstrates strong earning und stable cash flow The customers has well established and strong market share CBE has confidence on the management The financing is performing in accordance with the contractual terms and conditions
3	Low Risk (Bankable)	These customers are not as strong as grade 2 in terms of risk parameters but the business still demonstrate consistent earning, cash flow and have good track of records The business have adequate liquidity and low leverage The business has acceptable market share and management capability The financing is performing in accordance with the contractual terms and conditions management

		capability
4	Bankable	<p>These customers are not as strong as grade-3 in terms of risk parameters</p> <p>Financing show sign of irregularities and facilities have been inactive</p> <p>They have above average risks strangled liquidity, higher than normal leverage and inconsistent earning along with tin cash flow</p> <p>Have a chance to incur loss</p>
5	Moderate risk Bankable	<p>Customers are lower than Grade 4 in terms of risk parameters</p> <p>Business manifest potential weakness that deserve CBE's close attention and if they are left alone they may result in deterioration of repayment prospect of the applicant</p> <p>The financing show extended irregularities or have arrears</p> <p>Severe management problem exist</p> <p>Facilities show sustained deterioration in financial conditions i.e. consecutive loss negative net worth and excessive leverage</p>
6	Potential Risk Exceptionally Bankable	<p>Financial condition is weak and capacity or inclination of repay is in doubt</p> <p>These weakness jeopardize the full settlement of the facility</p>
7	Very high risk	Full repayment of the principal and mark up is unlikely and possibility of loss is extremely high

	Not bankable	Due to identifiable pending factors such as litigation and liquidation procedures or capital injections the asset is not yet classified as loss
8	Default (not Bankable)	<p>The facilities has been long outstanding with no progress in obtaining repayment or on the verge of liquidation</p> <p>Prospect of recovery is poor and legal options has been perused</p> <p>Proceeds expected from the liquidations or realization security may be awaited</p> <p>CBE's criteria for timely write-off shall be adhered to apply</p>

Table 2: Stage of risk rating / grading interpretation

Source: CBE IFB financing business procedure.

The second type of risk analysis technique applied by the bank as stated by the interviewee is sensitivity analysis. This technique is applied to assess and determine to what extent will the risk factors impact the repayment of financing facility provided if they mature. It checks if the business still remains feasible and project will still be able to repay is principal and markup on time if earnings drop or if cash flow are unstable or if the market share for the proposed project drops. The respondent also cited that this method is usually used to monitor and control ongoing projects and to periodically review for any outstanding risks.

Risk response plan

The risk responses devised by the IFB of CBE as stated by the interviewee are risk avoidance and risk retention. The bank apply risk avoidance as action plan for projects rated at grade 7 and 8 on risk rating matrix. This projects have higher inherent risks and repayment capabilities of the proposed project are highly in doubt. The bank will avoid this risk and projects are not bankable.

The bank also use risk retention as mitigation technique for proposed project that have low to moderate risk. The bank retains a reserve fund for the purpose of offsetting risks that might

arise. The bank also hold collaterals as way of insuring repayments for projects that are retained.

From the above analysis we can see that the bank have a robust risk management plan. The response from the interviewing is in line with secondary data records in evaluating risk of proposed projects by the IFB of CBE. The result show that the bank have defined risk identification, analysis, monitoring and risk response plan and each aspect are evaluated and considered in detail.

4.8. Islamic values incorporated in project appraisal practice

Which Islamic principles and values are incorporated in the appraisal framework of interest free banking system of commercial bank of Ethiopia ?

The study asked respondents in this section the different Islamic values and principles that they incorporate in the appraisal framework. The interviewees response in this regard was the interest free banking system adds in its appraisal practice another aspect to the mainstream project appraisal practice which is sharia screening in the IFB system. Any business transaction is carried out so long as they are not in conflict with sharia/ interest free banking laws and principles. This factor necessitates the development of sharia screening for business that want to be financed in the interest free banking system. The sharia screening helps in the process of identifying business that are in line with the sharia law. All proposed projects that wish to be financed by IFB of CBE must pass this Screening point in order for them to be considered for further evaluation. The sharia screening has two main parts that are sharia industry screening and sharia financial screening.

a) Sharia industry screening

Sharia industry screening refers to the types of industries in which sharia doesn't allow individual and business entities to engage in. In these process the bank checks for proposed projects business activities and it insures if they are eligible or not. The sharia industry screening involves:-

- Applicants engaged in manufacturing and/ or distribution of alcoholic products
- Applicants engaged in manufacturing and or distribution of arms and weapons
- Applicants engaged in production, packaging, processing or any other activity related to pork or pork products and other non halal meat like dead animals meat

- Financial institutions or individuals that are engaged in extending loan or borrowing money or interest
- Any other activities not permissible under sharia as determined by SAC

The purpose of unlawful income criterion is to meant to ensure that any impermissible income is limited to minimum according to the principle of Islamic law whether these income are generated through interest or any other impermissible activity.

Quran Al-Mu'minin :verse 51 which states that all Muslims are commanded to participate in good things and to work for righteousness.

b) Sharia financing screening

The second part of sharia screening is sharia financial screening.

It is the process of appraising proposed projects financial statement of business to make sure that they are compatible with sharia law and objectives. It have three main components which is mandatory for all business enterprises shall pass the financial screening in order for them to pass to future stage and to appraise other aspect of proposed project.

These three components of financial sharia screening are:-

- Impure income earned through interest versus total income; the ratio between them shall not pass 5% of the total income
- Debt versus total asset : the companies debt should be less than 50% of the existing total asset
- Debt versus equity:- the ratio of debt and shareholders' equity shall not exceed more than 33%

Sharia'h screening

Sharia industry screening	Remark
Is the applicant engaged in manufacturing and or distribution of alcoholic products ?	
Is the applicant engaged in manufacturing and or distribution of arms and weapons?	
Is applicant engaged in producing packaging, processing or any other activity related to pork products, and other non-halal meat like dead animals meat?	

Is the applicant engaged in any other activity not permissible under sharia'h as determined by SAC?	
Is the applicant a financial institution or individual engaged in extending loan or borrowing money on interest?	
Sharia'h financial screening	
Impure income earned through interest versus total income; is the impure income of the applicant is greater than 5% of the total income?	

Table 3 : Sharia screening in project appraisal guideline of IFB of commercial bank of Ethiopia

The response from the interview and the secondary data's show that the bank is giving due diligence to sharia screening in apprising proposed projects. The interviewee also states that all projects must pass the screening in order for them to be appraised for other aspects of project appraisal.

The interviewee emphasized the importance of sharia screenings as its mandatory for projects that are going to be financed must be in line with the sharia principles and its addition in the appraisal practice help the bank in upholding those sharia transaction rulings. The sharia screening serves IFB of CBE the purpose of filtering out companies and business that are generating income and engaged in sharia impermissible activities. It's also helpful in excluding business with unacceptable level of debt that are financed through conventional bank interest based financing and involved in interest based business activities. Ultimately the application of sharia screening help filter out business that are not in line with sharia principle and accept only those business that are sharia- compliant for further evaluation.

The respondent also add that all projects that have been evaluated, approved and financed so far by the IFB of CBE has passed the sharia industry screening and sharia financing screening and the bank is applying this methodology uniformly for all proposed projects.

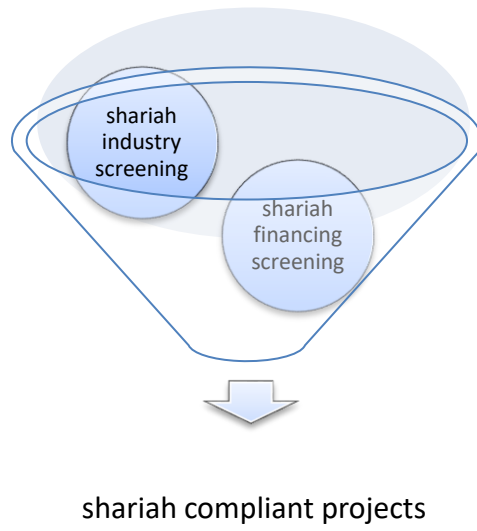


Fig. 5 Sharia's screening in the project appraisal practice

CHAPTER FIVE

5. FINDING, CONCLUSION AND RECOMMENDATION

5.1. Findings of the study

The major findings concerning the assessment of project appraisal practice of IFB of CBE mentioned as follows:-

Technical appraisal of the project by IFB of CBE

The study assessed and analyzed technical aspect of projects by assessing and evaluating technological aspect to be used by the project, raw material, technical knowhow availability, selection of product mix, selection of plant and machinery, evaluation of plant layout and assessment of project scheduling.

- The bank strongly evaluates technology adopted by the project, its scale of operation and product mix, availability of raw material and selection of location and civil work. The banks assessment of technology used by checking the rationale behind selecting given technology and its reasonableness, checking the existence of contractual agreement between supplier and purchaser to assess the existence of aftersales service and assessing whether it uses raw materials that are available in the local market which are continuously accessible. The bank closely monitor main aspect of technical parameters if they are soundly conceived, realistic and technical feasible
- Evaluation of machinery, selection and procurement of equipment and organizational structure of human resource availability are well considered in the project appraisal practice
- Project scheduling aspect is also considered in the appraisal practice but it need more attention considering its effect in managing resource deployed in the project and as it shows different project activities that is going to be performed in sequential format with the final deliverable of the project.
- Plant layout for a give projects is not considered at all in the appraisal practice of the bank

Commercial appraisal of project in IFB of CBE

Commercial evaluation is assessed from three aspect in the IFB bank. These are determination of demand for the product, marketing plan and strategy and analysis of competition.

- The bank determine demand for the product using survey method and the forecasted demand for proposed project is crosschecked if the organization producing the data to generate those forecasts is reliable or not.
- Marketing mix of projects is also assessed by comparing it with competitors experience in the market.
- Pricing of project is assessed for its reasonableness in the same manner by comparing it with similar products in the market.
- Analysis of competition evaluated by identifying specific product suppliers in the market and their operating capacity.

Financial appraisal practice of the bank

The bank assess Financial viability of projects based on three parameters. These are the use of cash flow statements to analyze projects financial viability, whether it establish profit rates and method of cash flow used to determine projects feasibility.

- In this regard the study found out that the bank make use of cash flow statement to conduct financial analysis to assess the sales level of project and measure cash generating ability of business.
- The establishment of cost of capital in IFB of CBE is based on the equivalent rate of conventional banks interest rate but this statements is agued by (Jalil 2003) in which the use of equivalent rate of interest rate is not acceptable from sharia perspective .
- The bank applies both simple method and discounted method of cash flow analysis but the discounted method is mostly applied technique. Payback period is the only simple method used and the other techniques are neglected and are not applied by the bank. Whereas the net present value and internal rate of return are the most widely practiced techniques by the bank.

Appraising managerial capability of the project

The study found out that the bank assess managerial capability of a project by evaluating experience of managers in managing related line of business, their educational qualification

and succession plan of the project organization are well considered in the assessment process while other soft skilled are neglected in the evaluation process by the bank.

Appraising risk of a project

The bank have robust risk management plan with regard to evaluating risk of a proposed projects. Risk analysis of the bank is evaluated based on how the bank categorize risks of project, which method of analysis is applied by the bank, the risk response plan developed by the bank and whether the bank review risk periodically or not.

- The findings of the study in this regard was that the bank categorize risk into four main groups. These are financial, market/industry, managerial and customer relationship risks.
- Risk analysis of the project is performed both qualitatively and quantitatively which are risk rating matrix and sensitivity analysis respectively.
- Based on the result of risk analysis, the bank develops two risk response plan. These are **risk retention** for projects that are bankable and **risk avoidance** for projects that are not bankable
- The bank also performs a periodical review of project risks for any outstanding risks that they might encounter throughout the financing period of the project.

Islamic values incorporated in project appraisal practice

Sharia screening in the project appraisal practice of the bank

The major findings of this study was the incorporation of sharia screening which is the first step in the appraisal practice of the bank. The bank included the sharia screening in its appraisal practice of project to identify and screen out business that are not in line with the sharia law and sharia transaction principles. The sharia screening is classified into two parts. This are sharia industry screening and sharia financing screening which evaluates business activities that project engaged in and financial activities of the project respectively.

The main purpose of the screening is to provide guideline to screen projects that are compliant to sharia ruling for further evaluation and screen out those project that are non-compliant to the sharia law.

The study of other scholars (Jalil, 2003) adds one other addition to the methodological difference in the appraisal practice of projects. This appraisal aspect is the concept of

Maslahah which classifies projects into three categories based on their level of importance to society and its contribution to social welfare. Nonetheless this evaluation criteria is not included in the appraisal practice of IFB of CBE.

5.2. Conclusion

The assessment of project appraisal practice in IFB system is a vast topic covering a lot issues. But this study only concentrates on the assessment of the framework for project appraisal practice and the Islamic values that are incorporated in the case of commercial bank of Ethiopia in its fully fledged IFB system.

The banks technical appraisal practice of projects for the most part show great diligence in evaluating each technical aspect like technology it adopts, its scale of operation and product mix, continuous availability of raw material, selection of location and civil work, choice of machinery and organizational structure and human resource availability. Whereas regarding project scheduling and plat layout design evaluation process need to be improved.

The market analysis of the project is appraised by identifying demand for the product using survey method and verifying the data source used to generated the forecasted demand presented by proposed project. The bank also performs a sound evaluation of marketing mix of project, pricing strategy and competitors analysis.

In the case of financial analysis, the bank applies both discounted and non-discounted cash flow methods to appraise financial viability of projects but the discounted method is the most practiced one by the bank as a result it miss the advantage of non-discounted method which is simple to compute, save time to analyze among various project alternatives. In the case of cost of capital the banks application of equivalent rate of the conventional banks interest rate is argued by other scholars and it's not in line with sharia principles.

More or less the bank also have god managerial evaluation practice of proposed projects even though its deficient in assessing the soft skills of managers which impacts successful completion of proposed projects.

The IFB of CBE have a strong risk analysis and management plan for proposed projects. The bank applies risk rating matrix and sensitivity analysis and based on the analysis the bank either avoids the risk or retains it as a response plan.

The structure of interest free banks project appraisal framework differs from the mainstream economics once, as their projects should fully comply to sharia principles or rulings. The

main principle that is incorporated in the appraisal framework from interest free banking view point is the addition of sharia screening. This Islamic value is incorporated in the initial stage of project appraisal process and its main purpose is to assess business activities of proposed project compliance to sharia industry and financing screening.

5.3. Recommendations

The current project appraisal practice of the IFB of commercial bank of Ethiopia is well assessed for the most part considering its been only three years in the banking industry.

Having discussed how the cost of capital or profit rate is established currently in the interest free banking system of commercial bank of Ethiopia, the researcher suggests that the bank needs to reconsider the way they the establishment of cost of capital. The banks reliance on interest to determine profit rate is not in line with the sharia rulings. This application of equivalent rate of interest as profit rate should be phased out and abolished in an Islamic framework as it holds back in fully applying sharia principles in the appraisal system. Therefore the IFB of CBE should develop its own profit rate to evaluate financial viability of projects by assessing the performance of the equity market without relying on predetermined interest rate as benchmark.

The basic Islamic values that are incorporated in the appraisal frame work of IFB of CBE is the aspect of sharia screening. But the Islamic values and principles are not limited to sharia screening only. It further adds on the concept of which is discussed in this study on the literature part. Yet this concept it is not included in the appraisal framework of IFB of CBE. the concept ensure the alignment of project alternatives with sharia objectives in prioritizing and selecting projects. It is border than the sharia screening as it incorporates all Islamic philosophies, principles and objectives in appraising proposed projects. Like that of sharia screening it assess the compliance of projects with sharia ruling but beyond that it gives preference to national wealth to private wealth maximization and focus on the need and welfare of the society. It gives balance between niggardliness and extra luxurious spending and ultimately it ensures coherence of selected project with sharia objective as a whole. As a result the bank should consider incorporating the Maslahah concept in the appraisal process.

5.4. Further Research Suggestion

The researchers suggest that further studies should be conducted on the applicability of the concept of Maslahah in appraising, prioritizing and selecting a given project as its main objective relies on addressing social welfare and national wealth. The other important area that need to be studied is on the challenges that are affecting project appraisal practice of IFB of CBE as it is new practice in the baking industry.

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ANNEX-1

SEMI STRUCTURED INTERVIEW

Addis Ababa University School of Commerce

Interview Guide

Research Questions

Introduction

Dear sir / madam, my name is Elham Sufian. I am a graduate student in project management program at Addis Ababa university. I'm conducting my project on the title " comparative study of project appraisal practice in conventional versus Islamic banking system in commercial bank of Ethiopia."

The purposes of this project work is to assess project appraisal practice in Islamic and make comparison of the conventional banking system of CBE and IFB of CBE to check if the two banking system use same or different appraisal practice using scientific way. This being said, the data that is going to be collected will be kept confidential and it will be used for the purpose of the study only. Lastly, the researcher would like to thank you in advance for your kind cooperation in answering the following interview question.

Background of respondents

- Educational level
 - Year of experience in the bank
 - Current position
 - Year of experience in current position
 - Designated department
1. In appraising technical aspect of the project does the bank look for :-
 - The technology to be used by the project ?

is it locally available

- Scale of operation-
availability of production inputs, operating cost and plant size and transportation problem
 - machinery selection and procurement
 - Raw material – cost, continuous availability with the required quality and quantity and location
 - Location and site analysis
 - Organizational structure and human resource analysis - Whether the consultant has the requisite knowledge and experience in executing similar projects successfully.
 - Selection and procurement of plant and machinery - Output planned, machine hour required for each types of operation, and the real capacity of the machine.
 - Plant layout and project scheduling
2. In assessing commercial aspect of projects, how does the bank determines the demand for the product : demand-supply gap analysis

Survey method

Statistical approach

How does the bank assess marketing plan and analysis of completion of proposed projects?

3. Does the bank use estimate of cash flow statement to check financial viability of the project?
4. Does the bank establish cost of capital IFB of CBE?
5. Which method between the discounted and non- discounted method of cash flow is applied by the bank?
6. From the non-discounted cash flow methods which technique is applied by the bank to estimate cash flow?

The payback period

Accounting rate of return (IRR)

Output - capital ratio

7. From the discounted cash flow methods which technique is applied by the bank to estimate cash flow?

The net present value (NPV)

The internal rate of return of a project (IRR)

8. Does the bank make sure that hard and soft skills required by managerial staff of project and follow up team of the bank present, considering its outcome on the project

9. While assessing risk which methods are used in the Bank

Sensitivity analysis; Qualitative risk analysis

10. Does the bank have risk prevention, risk mitigation and risk response plan?

11. Is the bank applying different project appraisal methodology in its Islamic banking system to finance projects than conventional banking project appraisal methodology?

* If the answer is yes, what are those methodologies that are applied differently from the conventional banking system?

* If the answer is No, how do you see the fact that applying the same project appraisal methodology in both banking systems? What are your thoughts in this regard ?

12. How is the understanding of the participant staffs about project appraisal practice in both conventional and Islamic banking system?

13. Can we say that the projects selected so far have passed the proper appraisal methodologies?

Thank you!