THE RELATIONSHIP BETWEEN LIQUIDITY AND PROFITABALITY ANALYSIS OF LIFE INSURANCE COMPANANIES IN NEPAL

A Thesis Proposal

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1 Introduction

1.1 Background of the study

Insurance companies provide unique financial services to the growth and development of every economy. In Nepal the business of insurance plays significant intermediary roles in terms of risk transferring, enhancing private investment, creation of job opportunities and ensuring various development related projects. Insurance business creates capital fund and promotes development, growth and prosperity of a country. In Nepal insurance business is regulated by insurance Board (Beema Samiti). The first insurance company was established in Nepal 1947.Before that some insurance companies from India were operating in Nepal. However, in Nepal the rise in insurance industry showed a turn around after the dreading earthquake of 2015. The number of insurance companies in 2018 totaled 39 including 18 companies dealing with life insurance, 20 with non life insurance and one with re-insurance (Insurance Board 2018).

Liquidity is the ability to meet expected and unexpected demands for cash. Specifically, it is a company's ability to meet the cash demands of its policy and contract holders without suffering any (or a very minimal) loss. The liquidity profile of a company is a function of both its assets and liabilities. Liquidity risk is inherent in the financial services industry and one must understand measure, monitor and manage this risk. There are different levels of liquidity management. There is day-to-day cash management, which is commonly a treasury function within a company. There is ongoing cash flow management, which typically monitors cash needs for the next six to twenty-four months. The third category of liquidity management addresses the stress liquidity risk, which is focused on the catastrophic risk.

Management can earn profit by making use of all the available resources in the market. Harward and Upton say, "Profitability is the ability of a given investment to earn a return from its use." However, the term 'profitability' is not synonymous to the term 'Efficiency'. Profitability is an index of efficiency and is regarded as a measure of efficiency and management guide to greater efficiency. Though,

profitability is an important indicator for measuring the efficiency, the extent of profitability cannot be taken as a final proof of efficiency.

Profitability and liquidity are the most prominent issues that management of each organization should take studying and thinking about them into account as their most important duties. Liquidity refers to the ability of a firm to meet its short term obligations. Liquidity plays a crucial role in the successful functioning of a business firm. A study of liquidity is of major importance to both the internal and external analysts because of its close relationship with day to day operations of a business (Bhunia, 2010). A weak liquidity position poses a threat to the solvency as well as profitability of a firm and makes it unsafe and unsound. Profitability is a measure of the amount by which a firm's revenues exceeds its relevant expenses.

Potential investors are interested in dividends and appreciation in market price of stock, so they pay more attention on the profitability ratios. Managers on the other hand are interested in measuring the operating performance in terms of profitability. Hence, a low profit margin would suggest ineffective management and investors would be hesitant to invest in the company.

The liquidity and profitability goals are contradictory to each other in most decisions which the finance manager takes. For example, the firm by following credit policy may be in a position to increase its sales, but its liquidity may tend to worse. In addition to this, referring to the risk return theory there is a direct relationship between risk and return. Thus, firms with high liquidity may have low risk and then low profitability. Conversely, firm that has low liquidity may face high risk results to higher return. Consequently, a firm is required to maintain a balance between liquidity and profitability in its day-to-day operations.

According to Ross, Westerfield& Jordan (2007) there is a negative relationship between liquidity and profitability. It therefore becomes a dilemma for managers to balance the two hence the need for a tradeoff between high amounts of net working capital and maximizing profitability. This is referred to as the liquidity-profitability trade-off. This dilemma would be a consequence of the fact that high values used in

current assets tend to generate costs for maintenance, not directly adding value to the company and thereby generating profitability. According to Panigrahi (2012) current assets are liquid so holding more current assets refer to high liquidity but on the other hand current assets include such items such as cash which diminish firm's profitability.

1.2 Problem statement and research question

Maintaining a proper liquidity indicates that funds are confined to liquid assets thereby making them unavailable for operational use or for investment purposes for higher returns. Thus, there is an opportunity cost associated with the maintenance of those liquid assets and this might affect the overall profitability of the firm. In other words, increasing profitability would tend to reduce firm's liquidity and too much attention on liquidity would tend to affect the profitability (Smith, 1980). Therefore, firms should always strike to maintain a balance between conflicting objectives of liquidity and profitability. The firm's liquidity should not be too high or too low. Excessive dependence on liquidity indicates the accumulation of idle funds that don't fetch any profits for the firm (Smith, 1980). On the other hand, insufficient liquidity might damage the firm's goodwill, deteriorate firm's credit standings and that might lead to forced liquidation of firm's assets. Hence, the present study is initiated to identify the relationship between liquidity and profitability of listed insurance company in Nepal.

There is a trade-off between liquidity and profitability; gaining more of one ordinarily means giving up some of the other. For example if a company's balance sheet is listed in order of liquidity with five items namely cash, marketable securities, accounts receivables, inventory and fixed assets it can be observed that moving from cash to fixed assets decreases liquidity. However, as you move from fixed assets to cash profitability increases. In other words profitable investment for a company is normally its fixed assets and the least profitable investment is cash.

i) What is the profitability and liquidity position of life insurance companies in Nepal?

ii) What is the relationship between liquidity and profitability of life insurance companies in Nepal?

iii) Does liquidity affect the profitability of life insurance companies in Nepal?

1.3 Objective of the study

i) To measure the profitability and liquidity position of insurance company in Nepal.

ii) To examine the relationship between liquidity and profitability of life insurance companies in Nepal.

iii) To determine the effect of liquidity on profitability of life insurance companies in Nepal.

1.4 Rationale of the study

The nature of the relationship exists between liquidity and performance may vary from sector to sector, but the existence of a relationship cannot be ignored. Managerial perspective is very important for better profitability and efficient management of liquidity. The favorable liquidity and performance growth are helpful indicators to drive stakeholders' behaviors (Manyo & Ogakwu, 2013). A diminishing movement of profitability indicates a poor strategy of the liquidity management. This study will attempt to identify the nature of the relationship between liquidity and profitability variables. This identification will help to carefully devise trade policies. Further, this study will help management to know the most important factors to be in focus minutely to make sound decisions for better management of liquidity and profitability matters.

1.5 Limitation of the study

The limitations of the study are as follows:

i. Only limited financial and statistical tool (i.e ratio analysis, mean, CV, correlations, as well as multiple regression).

ii. In this study including profitability ratio (i.e. ROA, ROE,) and other liquidity ratio (i.e Quick ratio, current ratio, and leverage ratio).

iii. In this study only 8 life insurance companies are selected as a sample.

iv. Its span of study period as only for 5 fiscal years i.e from 2070/71 to 2074/75

2 Literature review

2.1 Theoretical review

Tradeoff and pecking order theories center the importance of the thought of liquid assets. Tradeoff1 advocates an inverse relationship between liquidity and profitability that center the cost and benefit of every decision. Whereas, pecking order advocate the positive relationship between liquid assets and performance.

Dynamic Theory of Profit According to Clark (1902) profit accrues because the society is dynamic by nature. Since the dynamic nature of society makes future uncertain and any act, the result of which has to come in future, involves risk. Thus profit is the price of risk taking and risk bearing. It arises only in a dynamic society which means in a society where changes does not occur that is, it is static by nature the risk element disappears and hence the profit element does not exist there.

Theories of Liquidity Management, This theory states that the bank can manage its liquidity through the appropriate directing of the granted loans, and the ability to collect these loans when due in a timely manner and to reduce the possibility of delays in repayment at the maturity time. This theory posts that bank's management can plan its liquidity based on the expected income of the borrower, and this enables the bank to grant a medium and long-term loans, in addition to short-term loans as long as the repayment of these loans are linked by the borrowers expected income to be paid in a periodic and regular premiums, and that will enable the bank to provide high liquidity, when the cash inflows are regular and can be expected.

Baumol (1952) developed an inventory management model which was applicable in determining the level of cash to be held by the business firms. He described the holding costs and the ordering costs of cash in a fashion similar to those costs associated with inventory. His conclusion was that the rational individual will, given the price level, demand cash in proportion to the square root of the value of these transactions.

2.2 Empirical review

Lartey, Antwi & Boadi (2013) conducted a study on the relationship between liquidity and profitability of listed banks on the Ghana Stock Exchange for the period 2005-2010. Seven out of the nine listed in nature. It adopted the longitudinal time dimension, specifically, the panel method. Document analysis was the main research procedure adopted to collect secondary data for the study. The financial reports of the seven listed banks were studied and relevant banks were involved in the study. The study was descriptive liquidity and profitability ratios were computed. The trend in liquidity and profitability were determined by the use of time series analysis. The main liquidity ratio was regressed on the profitability ratio. It was found that both the liquidity and the profitability of the listed banks were declining. Again, it was also found that there was a very weak positive relationship between the liquidity and the profitability of the listed banks in Ghana.

Shafana (2013) examined the degree and pattern of determinants of liquidity on profitability of financial institutions in Sri Lanka for the period from 2009 to 2013. The study covers 16 Banks and Finance Companies listed on the Colombo Stock Exchange. For these objectives, the study used Cash Position Indicator (CPI), Capacity Ratio (CR) and Total Deposit Ratio (TDR) as independent variables to measure the liquidity level to examine its determinants on Return on Assets (ROA) of financial institutions in Sri Lanka. The correlation and regression model were used as statistical tools for hypotheses testing to draw final conclusions. The findings revealed that CPI and TDR have significant determinants on ROA with sign of positive and negative respectively while CR has insignificance on ROA of Banks and Finance Companies in Sri Lanka. The overall finding from regression model is that 30% of variation in profitability (ROA) is explained by variation of liquidity of Banks and Finance Companies in Sri Lanka. Further, the liquidity has negative and significant impact on profitability of financial institutions in Sri Lanka. The finding is more useful to finance decision makers of financial institutions for taking sound decisions on proper trade-off between liquidity and profitability.

3. Research methodology

Research methodology is the way to solve systematically about the research problem.

3.1 Research design

The study uses descriptive and analytical research design. Descriptive research design is a research design concerned with finding out who, what, where, or how of the research. It describes a population with respect to important variables. Descriptive research design is use for various purposes one of which is to determine relationships between variables. A descriptive research design is adopt in the study to explain the relationship between liquidity and profitability. Descriptive research design is use to determine financial position because descriptive research consists of surveys and fact finding inquiries of different types. Analytical research design is an impact measurement research design. The study adopted an analytical model to analyze the result of this study by determining the effect of liquidity on profitability of life insurance companies in Nepal. Analytical research designs are use to facts or information already available, and analyze these to make a critical evaluation of the subject.

3.2 Population and sample

Population involves all element, individuals, or units that meet the selection criteria for a group to be studied and firm which a representative sample. Sample is taken for detailed examination. The population of the study comprised of the 18 life insurance companies registered with as at insurance board. This study adopts convenience sampling method. In this research total 8 life insurance companies are selection for five financial period 2070/71 -2074/75.

3.3 Sources of data

The paper will be based on published literature and secondary data. Data are obtained from the annual reports of insurance companies and Insurance Board. Insurance Act, Regulation, Directives, Guidelines and Circulars are also consulted for literature review. Most of the information is available from the official websites Insurance Board and companies.

3.4 Data collection and processing procedure

The study employed secondary data and the variables were deduced from the audited financial statements of the 8 registered life insurance firm for five financial periods

2070 to 2074. The required information collection from annual report, journal, articals, research report as will as insurance Board websites.

3.5 Data analysis tools and techniques

Ratio analysis will chose to measure the position of liquidity and profitability of the life insurance companies on the basis of income statement and balance sheet. Profitability will be measure by ROA, ROE, while liquidity measure by Current ratio, Quick ratio and leverage ratio. The factor liquidity Influence on profitability indicators will be express through correlation analyses. Multiple linear regressions will used to determine the relationship between liquidity (independent variable) and profitability (dependent variable). The collected data will analyze descriptive statistics which employs tools such as percentages, mean, standard deviation coefficient of variation to help the researcher describe data.

4. Chapter plan

A chapter plan is an outline that helps us to organize material is a way that is easy to comprehend. It can be a very useful tool in helping to find the main points of the chapter. This report has been divided into five chapters.

Chapter 1: Introduction

Chapter one gives detail about the study area and the concept note about the research problem under study. It includes background of the study problem statement, objectives, significance of the study, limitations and the conceptual framework.

Chapter 2: Literature review

Review of literature gives the investigator a throughout and profound knowledge of the research topic. It provides guidelines to use statistical methods for analysis of collected data.

Chapter 3: Research methodology

This chapter discusses in detain the research methodology applied in the context of this study. It includes research design, data sources, variables, population sample and sampling techniques, research tools and techniques and plan for data analysis.

Chapter 4: Results and discussion

This chapter includes the presentations and analysis of relevant data and applying various statistical tools, tables and also interpreted to accomplish the objective of the study. The details about the analysis and interpretation of the findings are described here.

Chapter 5: Summary and conclusions

This chapter presents the brief background of the study, objectives, literature review and methodologies. Chapter focuses on the major findings and compares them with theory and other empirical evidence to extend possible.

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