International Journal of Accounting Research (IJAR)
Vol. 2, No. 9, 2016
***Publisher**: ZARSMI, UAE, and Regent Business School, South Africa*

RELATIONSHIP OF LIQUIDITY AND PROFITABILITY WITH MARKET VALUE OF LIFE INSURANCE COMPANIES IN PAKISTAN

Aaliya Noreen
International Islamic University, Islamabad (Pakistan)
Email: aaliyah.w.abbasi@hotmail.com

Abstract

The purpose of this paper is to examine the performance of insurance industry in Pakistan. To find out the real opportunity in this field and whether the insurance firms safeguard the rights of their policy holders or they just exploiting them. This paper is totally based on the published data of insurance firms. The same data is also available to the policy holders but here we try to extract and give meaning to different scenarios by using the same information. Findings suggest that the performance of insurance companies is dependent upon certain factors. The findings are also helpful is establishing a relationship between the dependent and independent variables.

Keywords: Life Insurance companies, Liquidity, Profitability, Market Value

1. INTRODUCTION

Insurance can be defined as a defense mechanism which protect individuals against losses and from cost that will arise in a particular situation. Infect it is a foresightedness of individuals to meet their future needs even before they arises. We can say that insurance is a form of attitude that generate as a result of request and wishes to meet the future needs. Financial reports prepared by insurance companies is different from the financial reports of other firms, operating in commercial and industrial field. The insurance companies, as compared to other firms compose their accounts in a manner, so that it includes the details of various services offered by the insurance firms to insurer. Insurance industry comprises of two main categories. Life insurance companies and non-life insurance companies. Both type of insurance companies have their own unique cash flow structure and the difference is totally dependent upon the duration of assets and liabilities. Historically, both life and non-life insurance companies were managed as separate entities but in some countries like Germany and Switzerland, there are legal implications to manage them separately. We choose insurance industry for our research because there is little work done on this growing sector. We try to provide an insight to general public about insurance industries and help them in decision making. Out of the insurance industry, we selected life insurance sector because we find both the categories of insurance companies are different from each other.

Due to uncertain security conditions, people in Pakistan take life insurance companies in large number and this trend is expected to be continue for years. Due to increasing number of policies or clients, the profits also rose all-time high. High profits also convert this sector into a charming one for the investors.

We took 3 life insurance companies listed in Karachi Stock Exchange (KSE) for our research. These three companies are the top performers in this particular category and have the most market share. So these companies can best resemble the outlook of industry. From the past available data and also the past trends shows that there was a positive relationship between the dependent and independent variables which we have selected. This means that if independent variable increases then the dependent also increases and vice versa. The extent of increase in dependent variable with respect to independent variable is totally dependent upon the strength of relationship between the variables. Stronger the relationship between the two, the more will be the dependency on independent variables and vice versa.

2. LITERATURE REVIEW

Operating cash flows that will generate from assets have an impact on firm's liquidity (Soenen, 1993). Firms that have less current assets will face problems in continuing their operations but if firm have much more current assets than required, then it indicates that return on investment is not good (Horne and Wachowicz, 2000). Current ratio and quick ratio are two important components of liquidity ratio. Despite of that, in most bankruptcy and default cases, the companies do not try to improve their liquidity problem and due to this negligence, they reach at this stage (Nicholas, 1991). Profitability can be defined as the ability of the firm to generate revenues or earnings (Gibson Ch. H. (1998:385)). While according to Brigham EF, Gapenski LC, Ehrhardt, (1999), profitability is actually the net result which is possible due to various policies and decisions. This profitability represents the net operating result liquidity, asset management and debt management together. Profitability is basically the ability to invest capital and then receive income on that invested capital. To evaluate that return, margins of return and rate of returns were used (Petrescu S. (2008)). In the eyes of Crecana C. (2002), the return could be the intrinsic ability to receive profit. Inputs should be used efficiently whether the market condition is strict or not and return determines the survival condition of the company and it has the ability to avoid bankruptcy.

Companies with high book-to-market equity are supposed to be more risky because they have a greater risk of distress. These firms will continuously face a problem of low earnings. They have high financial leverage and more uncertainty regarding earnings and they more likely to cut dividends (Fama & French (1995), Chen & Zhang (1998)). On the other hand, Dichev (1998) proposes that firms facing a financial distress have more chances of bankruptcy and these firms stock returns eventually decreases. Now there is a contradiction between the results of different authors. Dichev results showed that firms which have high BE/ME will earn more return and this return is a premium for its financial distress.

3. METHODOLOGY

The research study includes only secondary data which is taken from the Annual Financial Statements of the Insurance Industry. Data is extracted from the financial statement of top three top ranked listed life Insurance Companies in Pakistan. These are "Jubilee Life Insurance", IGI Life Insurance", "and EFU Life Insurance ". These companies are listed in Karachi Stock Exchange. The sample interval is six years of data from 2008-2013. Ratio analysis was chosen to measure the performance of the Insurance industry based on the last six years of data. This analysis provides methods for assessing the financial strengths and weaknesses of the firm's performance using information found in its financial statements. Through this research we checked out the relationship of Profitability and Liquidity on Market value of Insurance Industry. To check out these relationships we used Correlation Method. The ratios Gross Profit Margin, Net Profit Margin, Return on Assets, and Return on Equity are used to check out the Profitability. The ratios Gross Working Capital, Net Working Capital, Current Ratio, and Quick Ratio are used to check out the Liquidity Ratio and the ratios Dividend per Share, Earnings per Share, Book Value per Share, Dividend payout Ratio, Dividend Yield, Price/Earnings Ratio were used to check Market Value Ratio. In our research study there are two independent variables Profitability and Liquidity and one dependent variable. We use correlation analysis to check out the relationship between profitability and Liquidity on the Market Value of Insurance Companies We assume that,

3.1 Null Hypothesis

There is no relationship of Profitability and Liquidity on the Market value of Life Insurance Industry.

3.2 Alternate Hypothesis

There is a relationship of Profitability and Liquidity on the Market value of Insurance Industry.

3.3 Alternate Hypothesis

The components of profitability and liquidity will also have some kind of relationship with market value.

4. FINDINGS

Analysis of our variables reveal that there is a variety of relationship between our independent variables and dependent variables. Pearson correlation method shows that there is a positive relationship between liquidity ratio and market value ratio, and also between profitability ratio and market value ratio. Market value is more strongly correlated with liquidity ratio as compared with profitability. The analysis shows that if there is 100% increase in liquidity than market value increases by only 15.5%. Market value increases by only 16%, when compared with profitability. So, there is a positive relationship between independent and dependent variables but it is a weaker one. This means there are some other variables too, which also affect market value.

The sig. 1 tailed test also proves that there is a positive relationship between dependent and independent variables, and this relationship is bit stronger. This test shows that market value is positively correlated with liquidity by 0.283 and with profitability by 0.277. (See table. 1)

Table 1:

Correlations

		Market Value Ratio	Liquidity Ratio	Profitability Ratio
Pearson Correlation	Market Value Ratio	1.000	.155	.160
	Liquidity Ratio	.155	1.000	.114
	Profitability Ratio	.160	.114	1.000
Sig. (1-tailed)	Market Value Ratio	.	.283	.277
	Liquidity Ratio	.283	.	.337
	Profitability Ratio	.277	.337	.
N	Market Value Ratio	16	16	16
	Liquidity Ratio	16	16	16
	Profitability Ratio	16	16	16

Market value ratio is also correlated with the components of independent variables. Pearson correlation indicates that market value is positively correlated with current ratio, quick ratio, return on assets (ROA) and return on equity (ROE) but it is negatively correlated with net profit margin. The dependent variable is weakly correlated by 0.055 with current ratio and quick ratio, and this equal relation also proves that in service businesses like life insurance companies, there is no inventory. Hence, their current assets and quick assets were equal all the time. Beside that ROE is also in positive relation with dependent variable, and it is also a weaker one, that is of only 0.188 and ROA with 0.072. Net profit margin is very weekly negatively correlated with market value. Its value is -0.32. This shows that whenever market value increases, the profits margin decreases and vice versa.

On the other hand, the sig. 1-tailed test shows a positive relationship between dependent and independent variables. The variables of liquidity ratios are correlated with 0.417. While net profit margin and market value are correlated by 0.452, ROA by 0.392 and ROE is correlated with market value by 0.235. Their relationship is bit weaker but it is a positive one. Hence, we can say that there is a relationship between our dependent variables and independent variable, but there may be other variables too, which also have a relationship with market value.

Table 2:

Correlations

		MarketValueRatio	Current Ratio	Quick Ratio	Net Profit Margin	Return On Assets	Return On Equity
Pearson Correlation	MarketValue Ratio	1.000	.055	.055	-.032	.072	.188
	Current Ratio	.055	1.000	1.000	-.223	-.271	.106
	Quick Ratio	.055	1.000	1.000	-.223	-.271	.106
	Net Profit Margin	-.032	-.223	-.223	1.000	.563	.269
	Return On Assets	.072	-.271	-.271	.563	1.000	.569
	Return On Equity	.188	.106	.106	.269	.569	1.000
Sig. (1-tailed)	MarketValue Ratio	.	.417	.417	.452	.392	.235
	Current Ratio	.417	.	.000	.195	.146	.343
	Quick Ratio	.417	.000	.	.195	.146	.343
	Net Profit Margin	.452	.195	.195	.	.009	.148
	Return On Assets	.392	.146	.146	.009	.	.009
	Return On Equity	.235	.343	.343	.148	.009	.
N	MarketValue Ratio	17	17	17	17	17	17
	Current Ratio	17	17	17	17	17	17
	Quick Ratio	17	17	17	17	17	17
	Net Profit Margin	17	17	17	17	17	17
	Return On Assets	17	17	17	17	17	17
	Return On Equity	17	17	17	17	17	17

5. CONCLUSIONS

The analysis help us to know that there is a relationship between our variables. So, we didn't accept our null hypothesis, which says that there is no relationship between dependent and independent variables. Instead we select our alternate hypothesis, which says that there is a relationship between independent and dependent variables. We also select our second alternate hypothesis, which suggest that there is a weaker relationship between components of independent variables and dependent variables. The results of our research enables us to prove that market value of life insurance companies is somewhat dependent upon liquidity and profitability of the company. But there might be other variable too, which also have a relationship with market value of life insurance companies.

6. LIMITATIONS

Current and future economic conditions of economy and society's view about life insurance would be the limitations of this research. We only focused on top 3 listed life insurance companies in Karachi Stock Exchange (KSE), but other companies are also present in the industry. So, this will also imposed a limitation on the findings of this research.

7. SUGGESTIONS

We suggest to new researchers in this field to account for the present economic condition of the country before conduction their research. Also if they want to get more accurate results, they must have to predict the future pattern and also have to critically analyze the preferences of the people with in the society.

REFERENCES

[1] International Research Journal of Finance and Economics ISSN 1450-2887 Issue 19 (2008)
[2] Liquidity-profitability tradeoff: an empirical investigation in an emerging market. International Journal of Commerce & Management Publication Date: 01-JUN-04
[3] Halpern P., Fred Weston J., Brigham E.F- Finanţe manageriale, Editura Economică, Bucureşti, 1998; Efficiency
[4] Petrescu S., Apostol C, Analiza prin crearea de valoare Valoarea economică adăugată, Supliment of Theoretical and applied economics, Bucharest, 2009;
[5] Cyrus A. Ramezani, Luc Soenen and Alan Jung
[6] Gowth, Corporate Profitability and Value Creation", Financial Analyst Journal, Nov/Dec2002, Vol. 58 Issue 6, p56, 11p, 2002;
[7] Petrescu S Analiză şi diagnostic financiar –contabil, Ghid teoretic şi aplicativ, Ed. CECCAR, Bucureşti, 2008;
[8] Chen, Nai-Fu and Feng Zhang 1998, risk and return of value stocks, journal of business 71, 501-535
[9] Fama, Eugene. F, and Kenneth R. French, 1992, the cross section of expected stock returns, Journal of Finance 47, 427-465
[10] Ohlson, James. A, 1980, Financial Ratios and the probabilistic prediction of bankruptcy, Journal of Accounting Research 18, 109-131.