

## EFFECT OF LIABILITY MANAGEMENT POLICIES ON ORGANIZATIONAL PERFORMANCE OF INSURANCE COMPANIES IN KENYA

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### ABSTRACT

The purpose of the study was to establish the effects of liability management policies on organizational performance of insurance companies in Kenya. The study adopted descriptive research design. The population of the research consisted of the 49 licensed insurance companies in Kenya as at 2013 which constituted the units of analysis. The study used both secondary and primary data. Secondary data was for the organizational performance of the companies while primary data was for the information on the financial management practices used by insurance companies in Kenya. Statistical Package for Social Sciences (SPSS) was used in the analysis of data and results were presented on frequency tables to show how the responses for the various variables and indicators posed to the respondents. Reliability and validity tests were conducted to determine the internal consistencies of the variables under investigation. Analysis of Variance (ANOVA), multiple regression and correlation analysis was carried out to test the hypothesis. The data was analyzed by use of descriptive and inferential statistics. Descriptive statistics produced

frequencies, trends, means and percentages while inferential statistics produced regression and correlation results which show the relationship among the variables. The study findings indicated that production of monthly financial statements was important in monitoring liability management of the company, the company management was particular about monthly targets for each department as guided by departmental targets, the management conducted variance analysis every month as a way of monitoring performance. In addition the companies had put in place claims settlement policies to curb fraud and the company ensured that the correct procedures are followed in settling claims. Regression results indicated that there was a positive relationship between liability management policies and organization performance of insurance companies in Kenya. The study concluded that managers can increase profitability by putting in place good credit policy, short cash conversion cycle and effective cash flow management procedures. It is suggested that insurance companies be encouraged to better manage their reliance on equity capital. Management of insurance companies should also strategize on best possible means of ensuring there are minimal adverse effects of non current assets management and capital structure management practices on the company's financial performances.

**Key Words:** *Liability Management Policies, Financial Management Practices, Organization Performance, Insurance Companies*

## 1. INTRODUCTION

Insurance is an important growing part of the financial sector in virtually all the developed and developing countries (Das et al., 2003). A resilient and well regulated insurance industry can significantly contribute to economic growth and efficient resource allocation through transfer of risk and mobilization of savings. In addition, it can enhance financial system efficiency by reducing transaction costs, creating liquidity and facilitating economies of scale in investment (Bodla, et al., 2003).

The insurance sector appears to have weathered the challenges of 2011 well. Despite losses caused by an exceptional series of natural catastrophes in the Asia and Pacific region, non-life insurers and reinsurers appear to have recovered most of their capital over the course of the year. At the same time, declining interest rates and a widespread recovery of equity markets benefited the year-end valuation of financial assets held by life and non-life insurers (Bodla et al., 2003)

According to Swiss Republic (2004) important factors that determine the growth of the insurance business are the distribution of wealth, legal systems and property rights, the availability of insurance products, regulation and supervision, trust and risk awareness. Other non-economic factors have an impact on the development of insurance: religion, culture and education. Specific factors are identified for life insurance and non-life insurance. For non-life; regulation (compulsory insurance) claim awards, exposure to natural disasters, and the public sector's role in health. Diacon et al. (2002) mention that an insurer's efficiency or ability to produce a given set of outputs (such as premiums and investment outcome) via the use of inputs such as administrative and sales staff and financial capital.

McMahon, Holmes, Hutchinson and Forsaith (2013) and McMahon (2003) summarize their review of financial management practices in Australia, the UK and the USA. In their review the context of financial management practices includes the following areas: accounting information systems, financing decisions, investing decisions. However, these previous researchers though looked into financial management; they did not include other key areas like working capital management which would include accounts receivable, inventory, cash management and accounts payable management financial practices.

## 2. STATEMENT OF THE PROBLEM

The focus on the determinants of organizational performance and profitability measures for the insurance sector of a specific country is underscored by virtue of the fact that most countries have an intermediation-based financial system that have individual or firms such as agents that link customers with the organizations (Insurance Regulatory Authority, 2013). The relation between financial management practices and performance becomes extremely important when considering the fundamental role in value generation and distribution. Insurance companies today find themselves juggling a variety of challenges as they work to improve profitability, growth, and compete (Insurance Regulatory Authority, 2013).

According to Mudaki and Wanjere (2012) eight insurance companies in the last two decades had either been liquidated or placed under official receivership. The latest casualty being Concord insurance company which was placed receivership in 2013 (IRA, 2013). Most empirical evidences on financial management practices and characteristics came from the developed economies such as the United States of America and there seems to be a lack of evidence from less developed countries like Kenya. Furthermore there has been little research examining the effect of financial management practices on profitability (McMahon, et al., 1993). This lack of empirical evidence from less developed economies and the lack of examination of the effect of financial management practices on organizational performance are major gaps in the knowledge of financial management.

Based on previous research findings and recognition of these gaps, a study of the effect of financial management on profitability is justified and the effect of financial management practices and financial characteristics should be developed and tested by using empirical data from less developed economies (Kieu, 2004). Existing Studies cover developed and emerging countries while most of the studies done in Kenya did not address the effect of financial management practices on organizational performance of insurance companies. As outlined above, it is evident that organizational performance continues to demand strategic approaches to manage financial practices. The extent empirical literature on the financial management practices and organizational performance of insurance companies appears somewhat limited for the underdeveloped countries and this study contributes to the existing literature in Kenya. So far no known study by the

researcher has attempted to study the effect of liability management policies on organization performance of insurance companies in Kenya.

### **3. PURPOSE OF THE PAPER**

The purpose of this paper was to establish the effects of financial management practices on organizational performance of insurance companies in Kenya.

#### **3.1 Specific Objective**

This study was guided by the following specific objective:

- i) To determine the effect of liability management policies on organizational performance of insurance companies in Kenya.

### **4. LITERATURE REVIEW**

Cash flow analysis examines a firm's liquidity and how a firm is managing its operation, investment and financing cash flows. Cash flow analysis can provide managers with in-depth information about a firm's operation, investment and financial policies (Palepu, Healy & Bernard, 2000). It also provides support to the information obtained from a firm's income statements and balance sheet. In addition, cash flow analysis can help maintain sufficient cash for future payments. It can indicate either a problem with current cash flow or opportunities for future investments.

Eling and Luhnen (2010) conducted an efficiency comparison of 6,462 insurers from 36 countries. They found a steady technical and cost efficiency growth in international insurance markets from 2002 to 2006, with large differences across countries. Denmark and Japan had the highest average efficiency, whereas the Philippines had the least efficient. Regarding organizational form, the results were not consistent with the expense preference hypothesis, which claims that mutual's should be less efficient than stocks due to higher agency costs. Only minor variations were found when comparing different frontier efficiency methodologies (data envelopment analysis, stochastic frontier analysis).

Using a sample in US property-liability insurance companies that had an IPO during the period 1994 to 2005 and a benchmark sample of private insurers, Xie (2010) finds that the likelihood of an IPO significantly increases with size and premium growth. IPO firms experience no post-issue underperformance in efficiency, operating profitability, or stock returns; they register

improvement in allocative and cost efficiency; and they reduce financial leverage and reinsurance usage. Moreover, IPO firms are active in follow-on SEO issues and acquisition activities. The findings are mostly consistent with the theory that firms go public for easier access to capital and to ease capital constraints.

Cummins and Xie (2008) examine efficiency, productivity and scale economies in the US PC insurance industry over the period 1993-2006. They found that the majority of firms below median size in the industry are operating with increasing returns to scale, and the majority of firms above median size were operating with decreasing returns to scale. However, a significant number of firms in each size decile had achieved constant returns to scale. Over the sample period, the industry experienced significant gains in total factor productivity, and there was an upward trend in scale and allocative efficiency. However, cost efficiency and revenue efficiency did not improve significantly over the sample period. Regression analysis showed that efficiency and productivity gains had been distributed unevenly across the industry. More diversified firms, stock insurers, and insurance groups were more likely to achieve efficiency and productivity gains than less diversified firms, mutual's, and unaffiliated single insurers. Higher technology expenditures increased the probability of achieving optimal scale for direct writing insurers but not for independent agency firms.

Liebenberg and Sommer (2008) developed and tested a model that explains insurers' performance as a function of line-of-business diversification and other variables using a sample of property-liability insurers over the period 1995-2004. The results indicated that undiversified insurers consistently outperform diversified insurers. In terms of accounting performance, the diversification penalty is at least 1 percent of return on assets or 2 percent of return on equity. Using a market-based performance measure (Tobin's Q) the authors found that the market applies a significant discount to diversified insurers. The existence of a diversification penalty (and diversification discount) provides strong support for the strategic focus hypothesis. The authors also found that insurance groups underperform unaffiliated insurers and that stock insurers outperform mutuals.

Ma and Elango (2008) investigated the relationship between property-liability insurers' international operations and their risk-adjusted returns using cross-section and time-series data for the years 1992 through 2000. The findings indicate that the relationship between international

operations and performance is contingent upon the degree of product diversification. Insurance companies with focused operations in terms of product lines achieved higher risk-adjusted performance as they increase their exposures to international markets. However, insurers who are highly diversified across product lines faced declining returns with greater exposure to international markets.

## **5. METHODOLOGY**

The study used correlational research design. The target population of this study was all 49 units of analysis which are the licensed insurance companies in Kenya (IRA, 2013) from which the target and accessible population was drawn. The study population which represent unit of observation comprised of 316 senior management employees and 749 middle management employees both totaling to 1065. This study used stratified and simple random sampling method on all the insurance companies. Stratified random sampling was used in each insurance company to group respondents into two strata. The strata were that of senior management and middle management employees. Within each of the two strata simple random sampling was done to identify individual respondents who were issued with a questionnaire to respond to research statements.

A sample of 282 respondents was determined through the use of a formula for small population as recommended by Mugenda and Mugenda (2003). The sample size of 282 constitutes 26% of the target population which was adequate based on the recommendation by Kothari (2004) who assert that a sample of at least 10% to 15% is able to lead to meaningful generalizations about the general characteristics of a study population.

The study used primary data specifically questionnaires. Data was collected, coded and analyzed using SPSS version 20.0. The findings were presented in form of tables and pie charts and discussions and interpretation of the same given.

## **6. RESULTS AND DISCUSSIONS**

### **6.1. Response Rate**

The number of questionnaires, administered to all the respondents, was 282. The questionnaires were distributed to the respondents in the 49 unit of analysis which are the insurance companies. A total of 221 questionnaires were properly filled and returned from the insurance company

employees while 61 questionnaires. This represented an overall successful response rate of 78%. According to Mugenda and Mugenda (2003), a response rate of 50% or more is adequate. Babbie (2004) also asserted that return rates of 50% are acceptable to analyze and publish, 60% is good and 70% is very good.

## 6.2. Reliability Analysis

Cronbach's Alpha was used to verify the reliability of the proposed instrument. The findings indicated that organizational performance had a coefficient of 0.891 and liability management policies had a coefficient of 0.802. All the constructs depicted that the value of Cronbach's Alpha were above the suggested value of 0.7 thus the study was reliable and all the items were worthy retention (Saunders Lewis and Thornhill, 2009; Christensen, Johnson and Turner, 2011).

**Table 1.1: Reliability Statistics**

Variable	Cronbach's Alpha	Comment
Organization Performance	0.891	Accepted
Liability Management policies	0.802	Accepted

## 6.3. Descriptive Statistics

The objective of the study was to determine the effect of liability management policies on organizational performance of insurance companies in Kenya. The results show that 74.7% of the respondents agreed that production of monthly financial statements was important in monitoring liability management of the company, 92.8% agreed that their company management was particular about monthly targets for each department as guided by departmental targets and 75% agreed that management in their company conduct variance analysis every month as a way of monitoring performance. In addition, 80.1% of the respondents agreed that their company had put in place claims settlement policies to curb fraud, 87.7% agreed that their company ensures that the correct procedures are followed in settling claims and 75.1% agreed that liability management policies was a key driver of company's financial performance. The mean score for responses for this section was 4.07 which indicates that majority of the respondents agreed that liability management policies was a key determinant of organization performance of insurance companies. On average 81% of the respondents agreed while 6.2% disagreed and 12.8% were neutral that liability management policies influenced organization performance of insurance companies.



The study findings agree with those of Pottier and Sommer (2006) who investigated whether certain insurers were inherently more difficult to evaluate than others. They identified certain insurer characteristics that were associated with greater difficulty in financial strength evaluation, as proxied for by the level of rating disagreement by Moody's and Standard and Poor's. Specifically, the empirical results indicated that insurers that exhibit the following characteristics were more difficult to assess in terms of financial strength: smaller insurers, stock insurers, insurers with a history of reserving errors, insurers that use less reinsurance, insurers with greater levels of investment in stocks and low grade bonds, and insurers that were more geographically diversified.

## 7. REGRESSION ANALYSIS

Regression analysis was conducted to empirically determine whether liability management policies were a significant determinant of organizational performance of insurance companies in Kenya. The coefficient of determination  $R^2$  and correlation coefficient ( $r$ ) shows that the degree of association between the independent variable and organizational performance. The results of the linear regression indicate  $R^2 = .089$  and  $R = .298$  as shown in Table 1.2. The results show an indication that there is a weak relationship between independent variable; liability management policies and the dependent variable organizational performance.

In the model summary table 1.2, adjusted  $R^2$  was 0.070 which indicated that liability management policies explains 7% of variations in organizational performance. Therefore further research should be conducted to investigate these other factors that affect organizational performance in insurance companies.

**Table 1.2: Model Summary for Liability Management Policies**

Indicator	Coefficients
R	0.298
R Square	0.089
Adjusted R Square	0.070
Std. Error of the Estimate	1.723367670

In the table, an F statistic of 4.595 indicated that the overall model was significant as it was larger than the critical F value of 3.88 with (1, 48) degrees of freedom at the  $P=0.05$  level of significance. The findings imply that liability management policies were statistically significant in explaining organization performance of insurance companies in Kenya.

**Table 1.3: ANOVA for Liability Management Policies**

Indicator	Sum of Squares	df	Mean Square	F	Sig.
Regression	13.648	1	13.648	4.595	0.037
Residual	139.590	47	2.970		
Total	153.238	48			

The liability management policies coefficients are presented in Table 1.4. The results show that liability management policies contribute significantly to the model since the p-value for the constant and gradient are less than 0.05. The fitted equation is as shown below

$$Y = 12.383 + 0.470X_4$$

The findings imply that one positive unit change in liability management policies led to a change in organization performance at the rate of 0.470. This confirms the positive effect of liability management policies on organization performance of insurance companies in Kenya.

**Table 1.4: Coefficients of Liability Management Policies**

Variable	Beta	Std. Error	t	Sig.
Constant	12.383	2.694	4.596	0.000
Liability Management	0.470	0.219	2.144	0.037

## 8. CONCLUSIONS

Following the study findings it is possible to conclude that insurance companies were found to have put in place robust financial management practices in the form of financial report analysis, liability management and internal controls.

Liability management policies had a significant impact on organization performance and it was concluded that managers can increase profitability by putting in place good credit policy, short cash conversion cycle and effective cash flow management procedures.

## 9. RECOMMENDATIONS

It is therefore recommended that the management of insurance companies to consider putting in place the recommended steps seen as probable ways of ensuring that their financial management practices are improved for better return on assets. For instance they should enhance the process of preparation and publication of the company's financial statements, improve the company's capital structure and ensure that the companies fully utilize their debt facility according to their capabilities.

Further, it is suggested that insurance companies be encouraged to better manage their reliance on equity capital. Management of insurance companies should also strategize on best possible means of ensuring there are minimal adverse effects of non current assets management and capital structure management practices on the company's financial performances.

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