WORKING CAPITAL MANAGEMENT IN INSURANCE FIRMS: A CASE STUDY OF SELECTED INSURANCE COMPANIES IN NIGERIA.

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JULY 1999.

DECLARATION

, AGBOOLA O.F. hereby declare that this project is a record of my research work and s written by me.

To the best of my knowledge, it has not been previously presented in any application or a degree.

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CERTIFICATION

This project entitled "Working Capital Management in Insurance Firms: A case study of selected insurance companies in Nigeria by AGBOOLA OLADIPO FOLOUNSO meets the regulations governing the award of the degree of Masters in Business Administration (MBA) of Ahmadu Bello University, Zaria and is approved for its contribution to knowledge and literary presentation.

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DEDICATION

I dedicate this project to my wife, Olamide and my brother David, for their invaluable contributions.

ACKNOWLEDGEMENT

This project came to fruition as a result of the co-operation and contributions of some organisations and individuals. I therefore wish to sincerely acknowledge the co-operation I enjoyed from the Kaduna branches of Guinea Insurance Plc; UNIC Insurance Plc and First Nigerian Insurance Company Ltd. I quite appreciate the information and data you made available to me, without which it wouldn't have been possible to accomplish this work.

I express my profound gratitude to the staff of Nigerian Stock Exchange, Kaduna office for allowing me into their library when ever I needed to.

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I thank my wife, who was a part and parcel of my entire effort at obtaining a Masters Degree in Business Administration (MBA). May God's grace continue to keep you a virtuous wife.

I also thank Mr. Kolawole Odeyemi for his numerous assistance towards the success of this work.

I also appreciate the contributions of my friends and colleagues to the success of this project.

Finally, and most importantly, to God be all the glory, for His provisions, protection and grace upon my life.

ABSTRACT

The management of working capital in insurance firms was undertaken using three selected companies as a case study, namely: Guinea Insurance Plc; UNIC Insurance Pic; and First Nigerian Insurance Company Ltd.

The work was guided by the following hypothesis:

(i) That Insurance companies can accurately quantify the amount of premiums and claims in a given accounting period,

(ii) That the management of accounts receivable under the current liquidity squeeze is determined largely by external factors,

(iii) That there is a growing trend of diversification of investment of current assets by insurance firms.

Data collected, using personal interview and questionnaire and ratio analysis of the selected companies for a period of four years were used to test the hypothesis.

The results obtained show that it is possible to accurately quantify the amount of premiums and claims in a given accounting period. It also revealed some difficulties with the collection of premiums, the low values of accounts receivables ratios obtained for these companies confirmed this. It was also discovered that insurance companies are not diversifying their investments as such, rather, they are increasing their levels of investments in marketable securities. This work therefore confirms two of the three hypothesis.

Finally, the following recommendations were made:

(i) New Methods and Strategies that will enhance the collection of premiums should be developed and in addition, incentives can be introduced to encourage regular payment of premiums,

(ii) The period of claims settlement should be shortened and some of the rigours policy holders undergo before getting their claims should be eliminated,

(iii) The level of expenses on premium is very high, something should be done to reduce it.

(iv) Lastly, other avenues of investing idle cash other than bank deposit and securities should be exploited.

TABLE OF CONTENT **PAGE**

TITLE

DECLARATION i

CERTIFICATION ii

DEDICATION iii

ACKNOWLEDGMENT iv

ABSTRACT v

TABLE OF CONTENTS vi - ix

LIST OF FIGURES x

LIST OF TABLES xi

CHAPTER ONE: INTRODUCTION

1.0 PREAMBLE 1 - 3

1.1 OBJECTIVE OF THE STUDY 3

1.2 SCOPE AND LIMITATION OF THE STUDY 3 - 4

1.3 HYPOTHESIS 4

1.4 DEFINITION OF TERMS 4 - 5

CHAPTER TWO: RESEARCH DESIGN AND METHODOLOGY

2.0 INTRODUCTION 6

2.1 RESEARCH DESIGN 6

2.2 DATA COLLECTION 6 - 7

2.2.1 PRIMARY SOURCES OF DATA COLLECTION 7

2.2.2 SECONDARY SOURCES OF DATA COLLECTION 7

CHAPTER THREE: LITERATURE REVIEW

3.1	THE DEVELOPMENT OF INSURANCE IN NIGERIA	8 - 10
3.2	A BRIEF OVER-VIEW OF THE OPERATIONS OF THE INSURANCE COMPANIES	
	3.2.1 INTRODUCTION	10 - 11
	3.2.2 LEGAL ISSUES INVOLVED IN INSURANCE TRANSACTION	11 - 12
	3.2.3.1 LIFE ASSURANCE	12
	3.2.3.2 NON-LIFE INSURANCE	13
	3.2.4. FORMALISING A POLICY AND CLAIMS PAYMENTS	
	3.2.4.1 FORMALISING AN INSURANCE POLICY	14
	3.2.4.2 MAKING CLAIMS	14
3.3	THE CONCEPT OF WORKING CAPITAL MANAGEMENT	15 - 16
3.4	THE IMPORTANCE OF WORKING CAPITAL MANAGEMENT	17 - 18
3.5	THE COMPONENTS OF WORKING CAPITAL	18 - 19
	3.5.1 MANAGEMENT OF CASH	19 - 20
	3.5.1.1 OBJECTIVES OF CASH MANAGEMENT	20
	3.5.1.2 TOOLS FOR CASH MANAGEMENT	20 - 21
	3.5.1.3 REASONS FOR HOLDING CASH	21 - 22
	3.5.1.4 REASONS FOR NOT HOLDING CASH	22
	3.5.1.5 CASH CONTROL	22 - 24
	3.5.1.6 CASH PLANNING	24 - 25
	3.5.1.7 DETERMINATION OF MINIMUM CASH	26 - 27
	3.5.1.8 MANAGEMENT OF EXCESS CASH	27 - 28
	3.5.2 MANAGEMENT OF MARKETABLE SECURITIES	28

3.5.2.1 TYPES OF MARKETABLE SECURITIES 28 - 29

3.5.2.2 MANAGEMENT OF MARKETABLE SECURITIES 29 - 30

3.5.3 MANAGEMENT OF ACCOUNTS RECEIVABLES 30

3.5.3.1 FACTORS THAT DETERMINE RECEIVABLES 30 - 32

3.5.3.2 BENEFIT AND RISK OF TRADE CREDIT 32 - 33

3.5.3.3 MANAGEMENT AND CONTROL OF ACCOUNTS RECEIVABLES 33 - 35

3.5.4 MANGEMENT OF INVENTORY 35 - 36

3.5.5 MANAGEMENT OF CURRENT LIABILITIES 36

3.5.5.1 COMPONENTS OF CURRENT LIABILITIES 36 - 37

3.5.5.2 CONTROL AND MANAGEMENT OF CURRENT LIABILITIES 37 - 38

3.6 FACTORS THAT DETERMINE WORKING CAPITAL 38 - 39

3.7 DETERMINATION OF WORKING CAPITAL REQUIREMENTS 39 - 40

3.8 FINANCING WORKING CAPITAL REQUIREMENT 40 - 42

CHAPTER FOUR: DATA TREATMENT AND ANALYSIS

4.0 INTRODUCTION 43

4.1 DATA TREATMENT 43

4.2 DATA ANALYSIS 43

4.2.1 GUINEA INSURANCE PLC

4.2.1.1 CASH MANAGEMENT 43 - 44

4.2.1.2 MANAGEMENT OF MARKETABLE SECURITIES 47

4.2.1.3 MANAGEMENT OF INVENTORY 47

4.2.1.4 MANAGEMENT OF ACCOUNTS RECEIVABLES 47 - 48

4.2.1.5 MANAGEMENT OF CURRENT LIABILITIES 48

4.2.2 UNIC INSURANCE PLC

4.2.2.1 CASH MANAGEMENT 48

4.2.2.2 MANAGEMENT OF MARKETABLE SECURITIES 51

4.2.2.3 MANAGEMENT OF INVENTORY 51

4.2.2.4 MANAGEMENT OF ACCOUNTS RECEIVABLES 51

4.2.2.5 MANAGEMENT OF CURRENT LIABILITIES 52

4.2.3 FIRST NIGERIAN INSURANCE CO. LTD

4.2.3.1 CASH MANAGEMENT 52

4.2.3.2 MANAGEMENT OF MARKETABLE SECURITIES 52

4.2.3.3 MANAGEMENT OF INVENTORY 55

4.2.3.4 MANAGEMENT OF ACCOUNTS RECEIVABLES 55

4.2.3.5 MANAGEMENT OF CURRENT LIABILITIES 55

4.3 RATIO ANALYSIS 55 - 65

4.4 VERIFICATION OF HYPOTHESIS 65

CHAPTER FIVE: SUMMARY, RECOMMENDATION & CONCLUSION

5.1 SUMMARY 66

5.2 RECOMMENDATION 66 - 67

5.3 CONCLUSION 67 - 68

REFERENCES 69 - 70

APPENDIX

LIST OF FIGURES

Figure		Page
3.1	Fixed and Current Assests and their financing	16
3.2	Matching Financing to Asset performace	16
3.3	Control Limit Model	26

LIST OF TABLES

Table		Page
4.1	Reponse to questionnaire and extracts from annual reports (1993 - 1996) for Guinea Insurance Plc.	45 - 46
4.2	Response to questionnaire and extracts from annual reports (1993 - 1996) for UNIC Insurance Plc.	49 - 50
4.3	Response to questionnaire and extracts from annual reports (1993 - 1996) for First Nigerian Insurance Company Ltd.	53 - 54

CHAPTER ONE: INTRODUCTION

1.0 PREAMBLE

Working Capital Management is the administration of a firm's current accounts (current assets and liabilities) within its policy guidelines. The proper management of this component of a firm's total assets has a lot of impact on the success of the business. The existence of an individual or business enterprise cannot be divorced from risk although the level and type vary for individuals and business enterprises. For example, a driver involved in inter-city bus service faces greater accident risk than the one who is involved in intra-city service. A commercial farmer faces the risk of greater loss than a petty farmer in the vent of a natural disaster like locust invasion or over flooding. Also, a tanker owner faces the risk of loosing his vehicle to fire when loaded with petroleum products, and so on. Because of these possibilities of suffering losses whether total or partial, the existence of risk assumed some importance both from a private and industrial stand point. This, overtime, lead to the development of a risk transfer mechanizm (whereby the individual or business enterprise shifts some of the uncertainty of life onto the shoulders of others) called insurance.

The existence of insurance does not eliminate risk, rather it offers some financial assistance to those who suffer the effects of risk. Without insurance, the world as of today would certainly have been much more miserable as most risk averse individuals would have preferred to simply put their money in the banks and earn interests rather than take the risk of establishing business outfits. The consequences of this should not be left unmentioned: an unimaginable level of unemployment, and underdevelopment just to mention a few - all these would obviously have resulted into a higher level of poverty and crime.

As mentioned earlier, the existence of insurance offers individuals certain degree of financial security and this serves as an encouragement for them (especially the risk averse individuals) to go into business and other risky

ventures. It also offers financial assistance to the families of people who die as a result of accidents, ill-health and other risk related activities.

However, the idea of being able to insure raises a lot of issues: what sort of risks can be insured, what will be charged, will a contract be necessary, how will claims be met, how will insurance cost be calculated, what sort of conditions will be necessary, and so on. [1] The practical implementation of these issues makes insurance itself business oriented. Today, the conditions for insuring an individual or a business enterprise as formulated by the insurer, incorporated as insurance company, is known as insurance policy.

Insurance companies are manned by trained insurance personnels and agents together with service personnels like administrators, accountants and others. The agents, who are the field workers go out to sell the company's insurance policy to potential customers - the end of which results into a series of economic events called transactions that serve as building blocks of an accounting and financial system. Here, the transactions involve an agreement between the insurer (represented by the insurance agent) and the insured (the customer) for the payment of premium in exchange for security.

In summary therefore, the whole idea of insurance revolves around the payment of premiums by customers, payment of claims and investment of excess liquidity by the insurance company. However, if payment of premiums are not properly supervised, the continuous survival of the company will be threatened, leading to unprofitability and eventual collapse - since no business organisation can operate indefinitely at a loss. On the other hand, if premiums collected are not effectively managed, payment of claims and other financial obligations will be impaired, this of course raises the problem of insolvency, bankruptcy and eventual collapse.

From the above, the importance of effective and efficient management of working capital (made up of cash, inventory, marketable securities, receivables and payables) in the insurance firms can be appreciated.

This project therefore seeks to study how insurance firms represented by: Guinea Insurance Plc, UNIC Insurance Plc and First Nigeria Insurance Co. Ltd. manage their working capitals to the satisfaction of shareholders and the survival of the companies.

1.1 Objective of the Study

The purpose of this project include the following:

(a) To present an up to date activities of the insurance firms, especially as it is practiced in Nigeria.

(b) To analyse the management of working capital in the insurance firms using the following insurance companies as case study:

  (i) Guinea Insurance Plc

  (ii) UNIC Insurance Plc

  (iii) First Nigeria Insurance Co. Ltd.

(c.) To hi-light (if any) differences in the management of working capital in public liability insurance companies, represented by i & ii in 'b' above and limited liability insurance companies, represented by iii in 'b' above.

(d) From the findings of 'b' and 'c.' above, draw appropriate conclusions and recommendations.

1.2 Scope and Limitation of the study

Although this project is meant to study working capital management in the insurance industry, it is constrained to use: Guinea Insurance Plc, UNIC Insurance Plc and First Nigeria Instance Co. Ltd. as a case study.

A period of four accounting years i.e. 1993 - 1996 is selected for the study because it is inconceivable to undertake the study for an indefinite period. The study is limited by the following factors:

(a) It covers only three out of the many insurance companies in the country.

(b) A period of four years in the life of an organisation may not be sufficient to draw a final conclusion about the operations of that organisation.

(c.) The use of ratio analysis in performance evaluation has been found to have its own limitations; some reasons for this being:

(i) Imperfection of industrial ratios as a result of the effect of different environmental factors on individual firms.

(ii) An above average performance of a company within an industry that has less than satisfactory overall financial performance can be misleading.

(iii) The effect of difference in sizes of companies within the same industry.

The above-mentioned limiting factors tend to suggest that a sweeping generalisation of findings to cover the entire insurance firms has to be done with caution.

1.3. Hypothesis

In order to have a guided approach to data collection as well as undertake this study objectively, the following hypothesis will be tested:

(a) That the insurance company can accurately quantify the amount of premiums and claims in a given accounting period.

(b) That the management of accounts receivable is largely determined by external factors because of the liquidity squeeze, recession and high level of inflation in the country (economy).

(c.) That their is a growing trend of diversification of investment of current assets by the insurance firms.

1.4 Definition of terms

(i) **Insurance:** This is the conversion of risk into a fixed cost as a means of providing against loss that results from the occurance of unpredictable events.

(ii) **Agents:** These are insurance sales executives employed to act for the insurance business on behalf of their principals (the insurance companies).

(iii) **Premiums:** These are regular payments made to insurance companies by clients.

(iv) **Working Capital:** This is the gross current assets used for the day-to-day running of the firm.

(v) **Risk Aversion:** This is the tendency of an individual or business organisation to avoid taking risk.

(vi) **Policy:** A document which contains the terms of the contract between the insurance firm and the client.

(vii) **Claim:** The amount paid to the insured by the insurance firm in the event of a loss.

(viii) **The Insured:** A policy holding customer of an insurance company, i.e. a person covered by insurance.

(ix) **The Insurer:** A registered insurance company, that undertakes to make payment in case of loss.

(x) **Indemnity:** A legal cover that guarantees that the insured is placed in the same position he or she occupied immediately before a loss, i.e. the insured is not allowed by law to recover more or less than his/her actual financial loss.

CHAPTER TWO: RESEARCH DESIGN AND METHODOLOGY

2.0 INTRODUCTION

The title of this work already suggested the use of the case study method of research which involves focussing on only a marginal part of the population in order to make or draw inferences from them for the population. In this work, the population is the entire insurance industry while the marginal part is represented by: Guinea Insurance Plc, The United Nigeria Insurance Plc (UNIC PLC) and First Nigeria Insurance Company Ltd.

It is perhaps important to emphasis that being a case study, care will be taken to avoid unguided generalisation.

2.1 Research Design

The research is designed to use both primary and secondary data. Questionaire and personal interview were used as a means of collecting primary data. One type of questionaire was prepared in which, four answers (a,b,c,d) were provided for each question. The respondent was requested to circle or thick the chosen answer.

Secondary data were obtained from documented transactions of the three companies.

2.2. Data Collection

For this work, three of the commonest methods of collecting data were used namely: questionaire, interview and documented data. The main sources of documented data were the annual financial reports of two out of the three companies (that is Guinea Insurance Plc and UNIC Plc). These annual financial reports were obtained from the library of the Nigerian Stock Exchange, Kaduna. Because First Nigeria Insurance Co. Ltd. is not quoted on the stock exchange market documented data for it were obtained from their head office situated along Ahmadu Bello Way, Kaduna. Relevant information were extracted from files under different sub-headings.

The sub-heading for some of the files used are: Death claim file, maturity claim file, surrender value claim file, reinsurance cover file and medical examination file.

Data collected for the companies covered the period under study, that is 1993 - 1996.

The structured type of questionaire was used to obtain data (Appendix 1). The forms were administered by direct distribution to managers of the three companies in Kaduna and one other employer each of the companies. In order to prepare a suitable questionaire, the assistance of an accountant, who also has years of working experience with a reputable insurance company in Kaduna was solicited. Personal interviews were conducted with the accountants of these firms and with one agent each of the companies.

2.2.1 Primary Sources of data collection employed

The sources of primary data for this research work are questionaire and personal interview. The questionaire was designed in such a way as to provide the information needed for the researcher to have adequate insight into the management of working capital in the insurance firms. Personal interviews were also conducted in such a way as to augment the questionaire. In summary therefore, primary data for this project work were obtained from information provided by the respondents to the questionaires administered and the personal interviews conducted.

2.2.2 Secondary Sources of data collection

Secondary data is that which is meant for a purpose other than the research but which is also relevant to the research. Data extracted from annual reports and filed documents were used in this project. The information extracted were those strictly relevant to the execution of this work.

CHAPTER THREE: LITERATURE REVIEW

3.1 The Development of Insurance in Nigeria

Risks, hazards and uncertainty have become part and parcel of everyday life, the world over, Nigeria inclusive. According to Irukwu, "Our modern living conditions and our social and business activities expose us to the endless risk of sustaining losses which may be small or large". [2]

In our own society (Nigeria) such risk to losses abound, coming either through robbery, fire, motor accident, out break of disease, flooding, etc. Since it is not possible to eradicate totally, the occurrence of these events, it became sensible for people to seek protection against them. Today, one of the most effective weapons/methods of handling this risk problem is the modern concept of insurance.

The practice of modern insurance in Nigeria began less than 100 years ago and was mainly by early British traders. As a result and couple with the fact that most of the pioneering insurance companies in the country were either parthy or wholly British owned, the theory and practice of insurance in Nigeria have largely followed the British pattern. This is not to deny the existence of crude or unsophisticated forms of mutual and social insurance schemes in the territory (now Nigeria) as there was a lot of organised trading activity then. The extended family system, traditional unions and age-grade associations acted as mutual insurance societies to their members on much the same lines as the English ancients guilds.[2] The age-grade associations, for example, maintained funds built up from members periodic contributions. From the funds so accumulated, funeral expenses for deceased members were met. If dependents of the deceased were in critical financial crisis, these associations were also known to take over the responsibility of maintaining the deceased member's dependents until they are able to stand on their own.

These types of associations, including the extended family system still exist in Nigeria, but most of their insurance functions have been taken over by the modern insurance industry.

Since the early European traders who came into the country had no need for the traditional social insurance system in existence, at the time of their arrival (around the end of last century), they started insuring their trading companies with established insurers on the London Insurance Market. It was therefore these European traders (mostly British) who introduced modern insurance into the business life of Nigeria.

As time went on, some British insurers appointed agents to represent their interests in Nigeria. These agents were given powers of attorney to obtain insurance business, issue cover and service claims on behalf of their principals in London. Initially, the agents were mainly expatriate banks and traders, but later Nigerian traders and merchants were appointed agents. These agencies later gave way to full branch offices of the parent companies. Virtually all British insurance companies in Nigeria developed in this way. That is, first a Nigeria-based agent is appointed to represent the principal in London, then the agent later gives way to a branch office of the parent company in Lagos, with sub-offices throughout Nigeria. With time, some of these companies give birth to Indigenous ones with close links with the parent company in Britain. [2]

In 1921, Royal Exchange Assurance became the first insurance company to have a full branch office in Nigeria. It remained the only insurance company in the country until 1949 when three others were registered. Since then, more and more were registered and as at today, more than 100 insurance companies have been registered or incorporated in Nigeria. [2]

In the early days of insurance in Nigeria, there was hardly any form of governmental control of the insurance industry. Thus the companies were allowed to function in an atmosphere of complete freedom but only needed to conform with the ordinary commercial law of the country. However, the freedom

was soon to be abused and government had to take steps to control and regulate the activities of insurance companies so as to protect the interests of both the insurer and the insured. The first legislation on insurance business by government was the insurance companies Act 1961, followed by the Marine Insurance Act of the same year. Presently, the business of insurance is controlled and regulated under five main legislations, namely: The companies Act 1968; The Marine Insurance Act 1961; The Insurance Decree 1976 and its regulations; The Nigerian Reinsurance Corporation Decree 49 of 1977 and the Insurance (Special provision) Decree, 1988.

The companies Act, 1968 is the statute that controls and regulates the activities of all incorporated companies in the country. Since insurance companies are generally incorporated under the companies Act, they are bound by the provisions of this Act in addition to the special laws under the other statutes which apply specifically to insurance transactions. [2]

3.2 A Brief over-view of the Operations of Insurance Companies

3.2.1 Introduction

In a contract of insurance, the insurer, who, in Nigeria is usually an incorporated insurance company, undertakes to provide the insured against a stated risk for a consideration called "a premium" and subsequently provides him with a policy.[2] The premium is a sum certain in money and the policy is a document which contains the terms of the contract. The insured is normally required to fill a proposal form before entering the contract and if the insurer is satisfied with the contents of the proposal, he will signify acceptance by issueing a policy to the insured. In the event of loss, the insured notifies the insurer, who in turn investigates the claim and if everything is in order, it pays the sum it has agreed to pay. The theory of insurance is based on the principle that by collecting premium from a large number of people wishing to transfer the same type of risk, a company can accumulate a sizeable fund from which the people who are contributors to the scheme can be paid for any loss against which they have been insured.

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In a well managed insurance firm, the premium charged for each risk is a true reflection of the degree of exposure introduced into the insurance fund by the particular risk. Thus, in calculating the premium rate to apply to a particular risk, the principle is that each person pays a premium commensurate with the risk he introduces into the insurance scheme. Therefore, the higher the risk and therefore the potential liability, the higher the premium. Also, in fixing the premium rates, equity from the standpoint of both the policyholder and shareholder is guaranteed. The premium should therefore be adequate to settle all claims, administrative costs and still leave a small margin of profit to meet other obligations. Some insurance companies now invest excess fund in both short-term and long-term securities in order to improve their profitability.

3.2.2 **Legal issues involved in insurance transaction**

Insurance is a contract or agreement between two or more parties which is enforceable at law in case of default by any of the parties involved. Because it is legally enforceable, it must comply with the ordinary laws of the land which apply to all contracts for the purpose of validity and also must comply with those universally accepted rules of law which apply to insurance contracts.

It is also required by law that the insured must have an insurable interest in the subject-matter of the insurance, that is to say, the insured stands to lose financially if the event insured against happens or if the property insured is lost or damaged or if the life or person insured dies.

There is also the issue of indemnity whereby in the event of a loss arising from an insured peril, the insured is placed in the same position that he occupied immediately before the happening of the event insured against. In other words, the insured is not allowed by law to recover more than his actual financial loss.

Another important legal issue which applies to all insurance transactions is the principle of utmost good faith. This requires that each party to such contracts must not only refrain actively from misleading the other, but must

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disclose and not conceal any material information relating to the risk proposed for insurance as this will enable the insurer to decide whether to grant the insurance cover and if so, on what terms.

Finally, there is the issue of proximate cause which makes the insurer liable to indemnify the insured under the policy once it is established (from common sense view point) that the insured peril was the actual, real, effective or dominant cause of the loss.

3.2.3 Classification of Insurance

There are different ways of classifying insurance but for the purpose of this study, we choose to classify insurance under two broad groups: life and non-life insurance.

3.2.3.1 Life Assurance

The primary purpose of life assurance is to insure against the loss of future income which may arise as a result of the premature death of the income producer. There are three basic types of life assurance, they include:

(a) **The Term Assurance:** - This is an assurance for a fixed period in which the assurer in return for a premium undertake to pay the sum assured in the event of the life assured dying within the period or term stated in the policy.

(b) **Whole Life Assurance:** - Under a whole life assurance contract, the assurer undertake to pay the sum assured when ever the person whose life is assured dies.

(c.) **Endowment Assurance:** - This policy provides that the assurer will pay the sum assured when the life assured reaches a certain age or when he dies, whichever occurs first.

3.2.3.2 Non-Life Insurance

Non-life Insurance business are sub-divided into the following categories;

(a) **Personal Accident Insurance:** - This policy provides for the payment of a specified sums in the event of accidents to the person insured.

(b) **Fire Insurance:** - A fire policy covers the policy holder against loss of, or damage to the insured property, resulting from an accidental fire. The main risk insured against is fire but in recent years this has been extended to cover risk arising from flood, storm, earthquake and others.

(c.) **Marine Insurance:** - This type of insurance is taken to provide against loss arising from perils at sea either to the ship, cargo or freight on board the ship, ship insurance is usually issued for a twelve-month period.

(d) **Motor Vehicle Insurance (Act of 1950):** - There is a statutory obligation for all motor vehicle owners to take out a third party insurance. This is to insure against economic loss in the event of death or disablement arising from the use of the vehicle. The assured could insure against more risks than stated above, by taking a comprehensive insurance which apart from the above provides against theft, accident, third party property, medical expenses etc.

(e) **Fidelity Guarantee Insurance:** - This type of policy gives an employer an indemnity against loss of money or stock by the fraud or default of his employee named in the policy, (policy holders) such employees may be cashiers managers, etc.

(f) **Miscellaneous Insurance Business:** - This type of policy covers those that were not mentioned above. They include, Engineering Insurance, Goods-in-transit Insurance, Professional indemnities and livestock insurance.

3.2.4 Formalising a Policy and Claims Payments

3.2.4.1 Formalising an Insurance Policy

The starting point of an insurance contract is for a prospective client to go to an insurance office; approach an insurance agent or seek the assistance of an insurance broker. Once the client has made up his mind to buy a policy, a formal offer is made by him to the insurance company by the completion of a proposal form. In this form, the amount of insurance cover required, actual value of property being insured and other relevant terms are stated.

The client is required by law to fill the form in accordance with the principle of utmost good faith as it is the information supplied in this form that give the insurers a knowledge of the risk they want to assume.[2]

On receipt of the completed proposal form, the insurers will decide whether or not to accept the risk proposed for insurance and if they accept, the premium is fixed and communicated to the insured.

When both parties have reached agreement on the terms of the insurance contract a policy is issued, in which the terms of agreement is stated. This policy is renewable depending on the conditions of the contract.

3.2.4.2 Making Claims

In the event of a loss, a policy holder reports such to his insurers, who in turn investigate the incidence. If the investigations reveal an actual loss in line with the conditions of the insurance contract, and a decision is taken to settle the loss, a discharge receipt is sent to the insured for completion. When that is done and returned, the insurer will then forward a cheque in settlement of the claim to the insured. This is the general procedure for claim settlement in Nigeria, although there may be variations here and there depending on the type or size of the claim.

3.3 The Concept of Working Capital Management

The term working capital originated at a time when most industries were closely related to agriculture. Processors would buy crops in the fall, process them, sell the finished product and end up just before the next harvest with relatively low inventories. Bank loans with maximum maturities of one year were used to finance both the purchase and the processing costs, and these loans were retired with the proceeds from the sale of the finished products. [3]

This situation (in an idealised manner) is depicted in figure 3.1, where fixed assets are shown to be growing steadily over time, while current assets jump at harvest season, then decline during the year, ending at zero just before the next crop is harvested. Current assets are financed with short-term credit, and fixed assets are financed with long-term funds. Working Capital Management consists of decisions relating to the top section of the graph i.e. managing current assets and arranging the short-term credit used to finance them.

As the economy became less oriented towards agriculture, the production and financing cycles of typical businesses changed. Although seasonal patterns still existed and business cycles caused asset requirements to fluctuate, it became apparent that current assets rarely, if ever, dropped to zero i.e. there is always a minimum level of working capital maintained so as to carry on operations at any time. This realisation led to the development of the idea of permanent current assets, diagramed in figure 3.2. The diagram shows that both permanent current assets and fixed assets are financed with long-term credit while the variable current assets are financed with short-term credit. The argument in support of this kind of financing is that, it reduces the risk of the firm being unable to pay off its maturing obligations. [3]

Figure 3.1.; Fixed and Current Assets and their Financing[3]

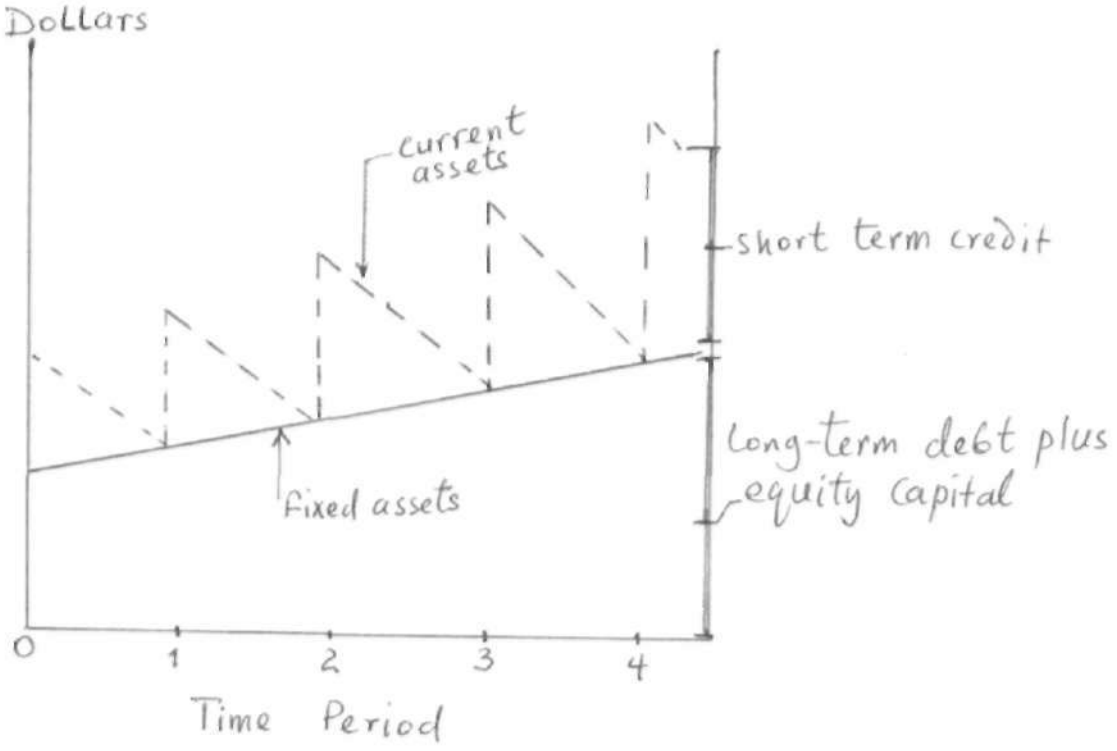
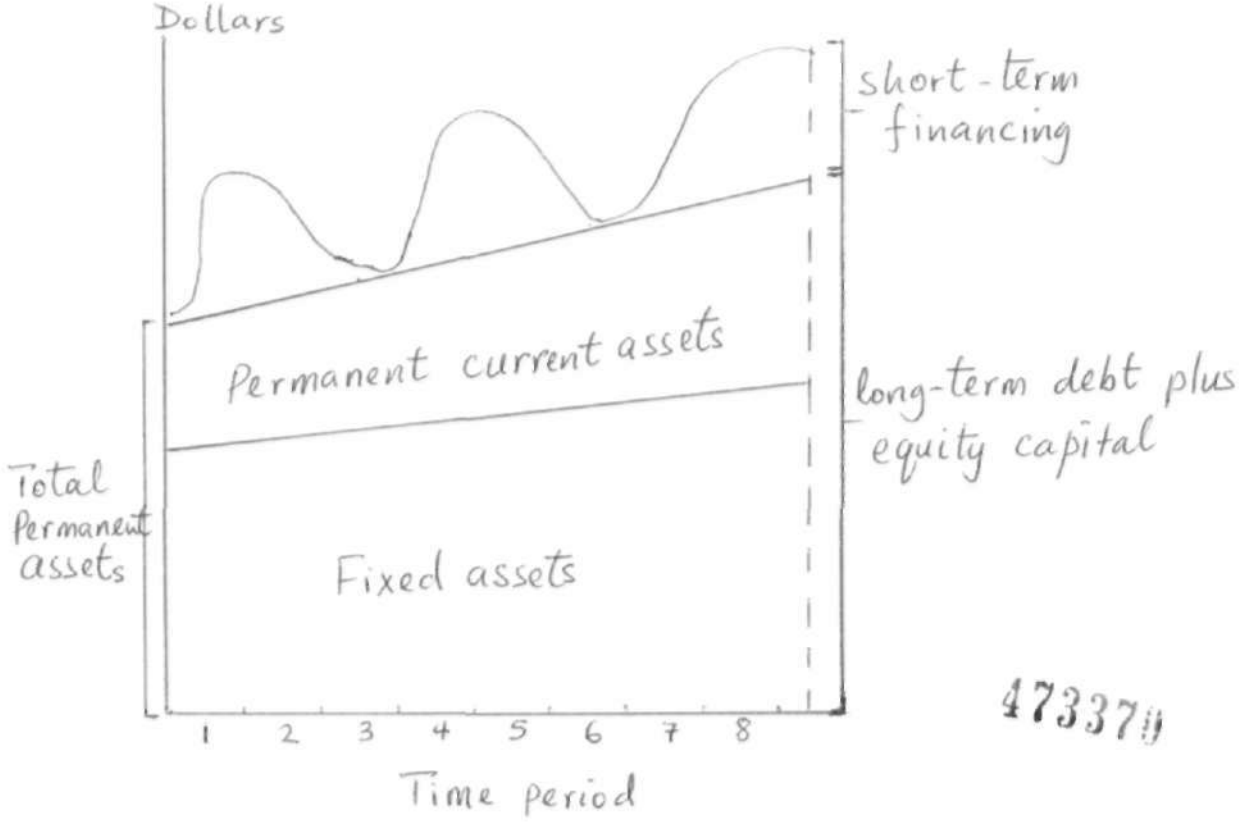


Figure 3.2; Matching Financing to Asset Permanence[3]



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3.4 The Importance of Working Capital Management

The importance of working capital management, which is a firm's investments in short-term assets can not be over-emphasized. This is especially so in the insurance industry where over 70% of total assets is current. Working Capital Management entails all aspects of the administration of both current assets and liabilities. It has two main functions:

(a) To adjust to changes in the firm's level of sales activity caused by seasonal, cyclical and random factors. This function is vital because a firm with favourable long-run prospects may experience severe difficulties and losses due to adverse short-run developments.

(b) To apply valuation concepts: Current assets holding, for instance, should be stretched to the point where marginal returns on increases in such assets are just equal to the cost of capital required to finance the increases. Current liabilities should be used in places of long-term debt whenever their use lowers the average cost of capital.

The following points high-light the importance of working capital management:

(a) Surveys indicate that the largest portion of a financial manager's time is devoted to the day-to-day internal operations of the firm, which can appropriately be sub-sumed under the heading of working capital management.

(b) Current Assets represent more than half the total assets of a business firm. Because they represent such a large investment and because this investment tends to be relatively volatile, current assets are worthy of the financial manager's careful attention.

(c.) Small firms can minimise investments in fixed assets through renting or leasing of equipment and plant but cannot avoid investment in cash, receivables and inventories. Therefore, current assets are particularly significant for the financial manager of a small firm.

Furthermore, since a small firm has relatively limited access to the long-term capital markets, it necessarily relies heavily on trade credit and short-term bank loans, both of which affect net working capital by increasing current liabilities.

(d) The relationship between sales growth and the need to finance current assets is close and direct. Sales increases produce similar immediate needs for additional inventories and perhaps for cash balances. All such needs must be financed; and since they arise so quickly, it is imperative that the financial manager keeps aware of developments in the working capital segment of the firm.[3]

3.5 The Components of Working Capital

Working Capital is composed of cash, marketable (short-term) securities, accounts receivable, inventory. (represent the left hand side of the balance sheet) and current liabilities - notes payable, accounts payable, short-term loans and accruals (which represent the right hand side of the balance sheet).

A lot of arguments have been generated in time past as to whether current liabilities should be one of the components of working capital. Dileap R. Mehta [4] in his book on working capital management has found the inclusion of current liabilities in the definition of working capital rather ambiguous. He argued that he had not found in any financial literature a systematic and general treatment of current liability components on their own. He therefore implored his readers who may not agree with him to substitute and treat working capital as current assets.

Weston and Brigham [5] refer to working capital as a firm's investment in current assets. They however, conclusively agree that working capital management is the administration of both current assets and current liabilities.

Vanhorne James [6] in his own contribution argues that although most of the working capital components are confined to the left hand side of the balance sheet, working capital management by accounting definition involves the administration of current assets and current liabilities. He explained that the concept of decisions concerning cash, marketable securities, inventory, accounts receivable and current liabilities was in keeping with an objective of maximising the overall value of the firm. The success of the management of these components therefore mean the success of working capital management that is, it is a residual fall-out from current assets and current liabilities management. He concluded that working capital (current assets less current liabilities) is a misnomer a largely accounting artifact.

From the arguments above one can conclude that the inclusion of current liabilities in working capital components is not abnormal. This is obvious from the point of view of the importance of current liability itself. For instance, capital invested in current assets generally came from the creation of current liabilities among others. Also, the solvency of a business depends upon its ability to meet its obligations when they are due. Measurement of this ability depends, interalia, on management of the current assets in the light of the current liabilities and in conclusion, current liabilities like all other contractual obligations must be honoured before or at the end of one year if the firm is to maintain its financial integrity by providing the werewithal for the discharge of maturing debts. [7]

3.5.1 Management of Cash

Organisations, whether business oriented, governmental or international require cash for the day to day running of their activities and for the execution of projects with long-term durations, lack of cash will obstruct the smooth running of the operations of an organisation and on the other hand, excess cash will result in wastages and low returns. [8]

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It is therefore necessary to put in place measures that will ensure availability of adequate cash at all times. According to Vanhorne James,[6] "Cash management involves managing monies of the firm in order to attain maximum cash availability and maximum interest income on idle funds".

Cash is about the most important component of working capital as far as insurance business is concerned, so the researcher intends to dwell as much as literatures at his disposal on the subject would permit.

3.5.1.1 Objectives of Cash Management

The objectives of cash management include:

(a) Ensuring that the cash position of the business or set-up does not go down beyond a pre-determined minimum level at any given time. It is ideal for cash to form at least 30 - 50 percent of the value of total current asset of a firm and what could be fixed as minimum cash balance to be maintained will vary from industry to industry and from company to company, depending on their circumstances. [8]

3.5.1.2 Tools For Cash Management

(a) **Synchronization:** This involves the removal of discrepancies between cash inflow and outflows. If firms could arrange cash receipts and payments (that is, cash inflow and outflows) to coincide, then they can hold their transactions balance to the minimum.

(b) **Speeding-up Collections of Cheques received:** It is possible (and necessary) to speed up the processing of cheques collected for greater efficiency. This is achieved by means of concentration banking, lock-box system, etc.

(c.) **Using Float:** Another effective tool for cash management is the float. This is the difference between the business recorded amount and the amount credited to the business by the bank. It takes place as a result of time lag between the time a cheque is written and the eventual clearing of the cheque against a corporate bank account. A float is important

because usually a company cannot make withdrawal on a deposit until the cheques in that deposit are collected.

(d) **Efficient Inventory Production Management:** This entails minimising cash and increasing the inventory turnover rate.

(e) **Stretching Accounts Payable:** This means the extension of debts owed creditors as much as possible. And still on accounts payable, firms are advised to zero-in on liabilities for taxes, dividends, payroll and other expenditures over a naira amount that appears significant in order to manage the liability. All cash discounts should also be taken. [9]

(f) **Accruals:** When accruals are increased, payments are delayed.

(g) **Cash Budgeting Forecasting:** This is the process of projecting cash receipts and expenditures over a period of time, so as to accurately project needs for cash or investment for excesses in cash balances, that is, it is a tool used to give the prospective future cash position of an organisation.

3.5.1.3 **Reasons for Holding Cash**

The reasons why business organisations hold cash are:

(a) **Transactionary Reason:** This reason views cash strictly as a medium of exchange to finance transactions necessary to conduct business such as payment of purchases, wages, taxes, dividend and so on. Were perfect synchronisation between cash receipts and payments possible, this reason would not have arisen. Unfortunately however, certain cash balance has to be kept to breach the gap between a firm's expected payments and anticipated receipts.

(b) **Precautionary Reason:** This entails holding money for the purpose of emergency rainy days, unforeseen circumstances, contingencies or unexpected expenses. The decision by a firm to keep money for precautionary measures is influenced by its income, interest rate on savings and its ability to borrow at short notice.

(c.) **Speculative Reason:** This is cash kept for the purpose of buying something or investing in a venture should prices fall in near future. It is influenced by interest rate and income.

(d) **Trade Discount:** Sufficient cash enables a firm to take the benefits of discount. A credit term e.g. 3/10 net 30, gives a 3% discount if the invoice is paid within the first 10 days; if payment is not effected within 10 days, then 3% discount will be lost, that is, full payment will be made.

3.5.1.4 **Reasons for Not Holding Cash**

No prudent investor likes to keep cash. The reason being that when kept it does not yield on its own. Any cash that is kept idle earns nothing and for this reason, investors usually like to invest cash in quick return securities or deposit cash in a savings account in the bank. By so doing, cash can be withdrawn at short notices to meet expenditure. This is true also for insurance firms, investigations conducted confirm that only petty cash is kept for administrative purposes.

3.5.1.5 **Cash Control**

Management of cash involves a strong system of both internal and external control. Effective and efficient control of cash is crucial to the success of every business. The liquidity of cash compared to other assets makes it extremely susceptible to fraud, waste and misappropriation.

This is particularly true for insurance firms since their activities (premium collections, deposit in bank, purchases, claim payments. etc) revolve around cash.

In as much as it is accepted that it is impossible to eradicate the negative vices associated with cash in business organisations, measures can be put in place, however, to minimise them.

Cash control measures include the following:

(a) Detailed planning of cash inflows and cash out flow, this is discussed in 3.5.1.6.

(b) **Prescribed accounting flows for cash receipts and disbursements:** it is recommended that all cash collected be deposited in the bank on daily basis, or at least, within 24 hours of collection. This is supposed to

be the case in the insurance firms but this is not strictly enforced. This is dangerous as it is known to have encouraged the embezzlement of collections while using subsequent collections to make up for the embezzled ones. This is known in audit parlance as "teeming and lading". [10]

Also all payments should be made with cheques, that is, disbursements should be made from cash already deposited in the bank.

(c.) **Use of receipts and local purchase orders (LPO):** The use of receipts and LPO in cash control is highly important especially for insurance companies. The procedure in the insurance companies is for agents to issue receipts for all cash transactions. In addition, he is expected to complete a daily remittence form and banking sheet at the close of the day. In this form, financial information about the day's activities are documented and filed for further scrutiny by the financial manager and the auditors. To ensure control in the area of purchase, LPO are used. For it to be effective however, the financial manager should ensure that LPO are checked with delivery invoices before payments. This will eliminate a situation where incorrect quantity and quality of goods ordered were supplied.

(d) **Separation of Duties:** To minimise the possibility of fraud, waste and other negative vices associated with cash, careful delegation of authority for handling cash receipts and payments is necessary. This may be done by dividing the responsibility for a sequence of related operations among a number of employees, some insurance companies for example are known to have a procedure whereby the premiums collected are given to the accountant who then pays into the bank. Also, it is suggested that all underwriting should be proceeded by proper pre-underwriting surveys. Sufficient investigation should be carried out before a claim is honoured, this may be done by a private investigator or loss adjuster.

(e) **Regular Cash Report:** It is necessary to prepare daily cash report, which will include all cash accounts and contacts should be made each day with banks with whom transactions are made to obtain bank balances and

available fund balance. Also, bank reconciliation procedure should be carried out timely and the preparation should be properly scrutinised, to ensured that credits due to the company are not only made but are made on time, that is all lodgement tellers should be confirmed with the bank statement. All these will assist the firm's financial manager to be up to date with the cash flow activities of his firm and also aid in identifying surprises that may have occured in the past which were not previously documented.

(f) A computerised system of cash will also assist in the proper control of cash. Here, imput/output verification procedures should be done for each day's imputs

3.5.1.6 **Cash Planning**

Cash planning is a schedule of the expected cash inflow and outflow relating to defined period of time. Cash is required in order to facilitate the achievement of a firm's plans and intentions. Without an adequate flow of liquidity, an otherwise efficient and profitable firm may be severely hampered in its activities. Assumption should not be made that because a firm is profitable it will automatically produce sufficient liquidity for its needs at all times.

The procedure for cash planning is for the financial manager to discover expected receipts and payments for a defined period and make use of these information to compute the expected cash position of the firm within that period. The benefits to be derived from cash panning are:

(a) **Identification of periods of potential deficit or surplus:** If the period and extent of surpluses or deficits can be identified then appropriate measures can be pursued to take advantage of or to alleviate the situation.

(b) **Enables the financial feasibility of plans to ascertained:** By formulating the financial effect of plans it can be determined whether and to what extent those plans are feasible. If, because of the financial implications of the original plans, those plans require alteration then the effect of these alterations can also be readily ascertained.

(c.) **Indicates the financial effects of policies within the firm:** The detailed cash budget is an ideal mechanism for indicating to non financial management the importance of, for example, obtaining payment from customer in good time, or obtaining premiums from the insured promptly.

(d) **Provides the base for monitoring actual activity:** The frequent comparison of actual cash flows with budget will enable up to date information to be incorporated into budget revisions.

Cash planning is generally referred to as cash budgeting in most firms. Basically, the principle of budgeting is the same for business organisations, the only difference is the period covered by the budgeting since this usually varies with the cash position of the company. If the inflow and outflow of cash are more or less stable throughout the year, then the cash budget may be prepared annually, otherwise, it may be half yearly, quarterly, etc. as the situation warrants.

For insurance industry generally, the elements for computing cash inflow budget are:

- Premiums
- Interest on Investments
- Dividends
- Sale of fixed assets
- Issue of shares and debentures
- Loans
- Sale of Investment

Cash outflow is budgeted based on the following:

- Payments of claims to the insured
- Payments to creditors of various types of overhead expenses.
- Wages and salaries
- Capital expenditure (purchase of equipment and fittings)
- Dividend (in the case of privatized ones)
- Loans
- Donations and gifts
- Income tax
- Investments.

3.5.1.7 Determination of Minimum Cash

Since it is absolutely necessary to keep cash for genuine business reasons, the problem however is how to determine the optimum cash to keep. If enough cash is not kept, the smooth operation of the firm cannot be guaranteed. On the other hand, excess cash in hand means keeping cash which would otherwise have been invested to generate more income for the firm. The following are the methods used to determine minimum cash balance:

(a) Baumol Inventory Model [6]

This model assumes that the firm has a steady demand for cash over a specific period of time.

The optimal level of cash (c.) can be computed as

$$C = \sqrt{\frac{2bT}{I}} \quad \text{- equation 3.1 [6]}$$

Where:

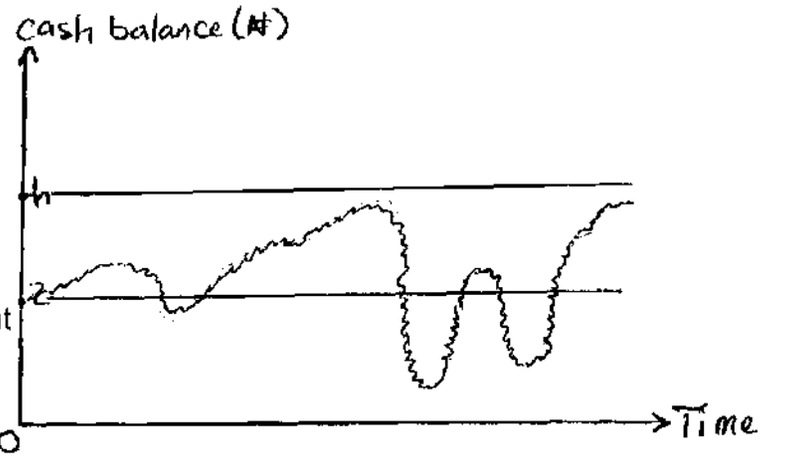
T - Total demand for cash

I - Interest obtained

b - Fixed cost per order of security.

(b) **The Miller-Orr Model (control theory model):** [6] This model is used when cash balance fluctuate randomly, and the demand for cash cannot be predicted in advance. Control limits are then set such that when cash reaches an upper limit a transfer of cash to marketable securities is consummated and when it hits a lower limit a transfer from marketable securities to cash is effected. (Fig 3.3). [6]

Figure 3.3: Control limit model. [6]



h - upper limit, Z - return point

o - lower limit

Figure 3.3 above shows that when the cash balance (represented by the fluctuating line) touches the upper limit (h), excess cash is invested in the purchase of a portfolio and cash balance is restored to Z. And when cash balance touches the lower limit (o), marketable securities are deployed to fetch enough cash to restore balance.

The optimal value of Z, the return to point for security transactions is:

$$Z = \sqrt[3]{\frac{3b\sigma^2}{4i}} \qquad \text{Equation 3.2 } [6]$$

Where:

b - fixed cost associated with a security transaction

σ^2 - Variance of daily net cash flows

I - Interest rate per day on marketable securities.

The optimal value of h is simply 3Z. The average cash balance can be determined in advance, even though not exactly. It is approximately equals to (Z+h)/3. [6]

3.5.1.8 Management of Excess Cash

The best way of managing excess cash is to invest in an instrument that promises the highest return, with minimum exposure to risk and within the shortest possible time. Most business organisations seem to follow this simple principle, even though some are not allowed to pursue it without hindrance. The insurance industry, for example, is hindered by section 21 of the Insurance Decree 1991 which states among other things that the insurer shall keep at least 35% of its funds in low yielding investments. [11]

In addition to the above, section 18 of the Insurance Act 1976 controls insurance companies investment. The Act permits insurance companies to invest in the following properties and assets;

(a) Government Securities and Instruments.

(b) Shares in or other securities of a society registered under any law relating to co-operative societies.

(c.) Loans to building societies approved by the commissioner.

(d) Loans on real property, machinery and plant in Nigeria.

(e) Loans on life policies within their surrender values.

(f) Cash on deposits in or bills of exchange accepted by licensed banks.

(g) Such other investments as may be prescribed.

3.5.2. Management of Marketable Securities

Marketable Securities represent an opportunity for investment of excess cash so as to get returns. The periods of investment may range from over-night to several months. Although, the disposal of marketable securities have attendant transaction costs, yet investing in them is more rewarding than holding cash.

3.5.2.1 Types of Marketable Securities

There are several types of marketable securities of which Treasury securities, commercial paper, certificates of deposit, Equity Stocks and Bankers Acceptances are very popular.

(a) **Treasury Securities:** These are short and long term investments in risk free government instruments usually for a period ranging from one month to over 7 years. The rate of return is comparatively low and not subjected to with-holding tax. The return may be received up-front. There are several types of treasury securities including treasury bills, treasury notes and treasury bonds.

(b) **Commercial papers:** These consist of insecured promissory notes with maturities of a year or less; usually 4 to 6 months.

(c.) **Certificates of deposit:** A certificate of deposit is a receipt for a short term deposit made in a bank. There are two classes of certificate of deposit: (i) Demand (ii) Time.

Demand certificate of deposit is payable by the bank on demand while time certificate of deposit is payable on a specific date. Most certificates of deposit are negotiable and therefore the holder may sell it before it matures if

the funds are needed. These certificates bear interest and mature in periods ranging from one month to one year.

(d) **Equity Stocks:** This is a security representing residual ownership in a corporation. It guarantees the right to participate in the sharing of the earnings of an organisation when there is profits. If an organisation is listed on the stock exchange market its stocks are called quoted stocks and if not listed they are called unquoted stocks.

(e) **Bankers Acceptances:** These are drafts accepted by banks for financing foreign and domestic trade.

Insurance firms invest mostly in common shares and debentures. These securities are known to have higher rate of return than other types of securities most of which are government instruments.

The features of common shares include:

(i) Last claims on the dividends of the firm.

(ii) Last claims on the assets of the organisation in the event of liquidation.

(iii) Voting rights

(iv) Right to transfer their ownership by selling their shares without the consent of the corporation.

A Debenture is a written promise by government or a business company to pay a debt and a fixed rate of interest on the debt. It is unsecured and as such no lieu against specific property as security for the obligation is required. Debentures holders are called general creditors whose claims are protected by property not otherwise pledged. The general credit standing of the organisation is the investors only source of security.

3.5.2.2 Management of Marketable Securities

Since a company invests in marketable securities with the aim of getting returns for idle cash, meeting predictable financial requirement and for reasons of precaution in cases when inflow is less than outflow, the management of this aspect of working capital becomes necessary to meet this aim.

In the insurance industry, the management of marketable securities is carried out by the investment department of these firms. They perform this function by:

a. Getting information about which securities are available in the market and those that are profitable to invest in - this also involves a careful analysis of the company's audited accounts so as to know how well the company is doing. The outcome of this is a guide as to whether or not to invest in its shares.

b. Proper monitoring of share prices, especially those which the firm is currently holding. If prices fall below their face values, they are sold off.

c. Monitoring of rates of returns of the shares that make up the firm's portfolio - if rate of return of a particular share is becoming lower than expected, them holding is reduced or it is given up completely.

3.5.3 Management of Accounts Receivable

Receivables are asset accounts representing amounts owed to the firm as a result of the sale of goods or services in the ordinary course of business.[12] For it is practically impossible to get cash from customers for all sales made. The common occurrence is for the firm to carry a receivable for a customer for 10 to 60 days (up to 90 days for insurance firms). Therefore, receivables represent a significant current asset that must be financed on a continuing basis. In insurance firms, premiums from insurance brokers, individuals and co-operate bodies; claims from reinsurance companies; loans to policy holders and agents make up accounts receivable. Its management has to do with the way and manner credit is extended to customers.

3.5.3.1 Factors that Determine Receivables

The level of accounts receivable is determined by a number of factors. These factors include the volume of credit sales and the average collection period.

Generally speaking, the level of receivable is directly proportional to the volume of sales, in other words, a firm within an industry having a large volume of sales is expected to have a larger level of receivables than one with a small volume of sales - this however is not a law. Sales level can be used to forecast changes in receivables. If a firm predicts an increase of 20 percent in its credit sales for the next period, it will probably also experience a 20 percent increase in receivables.

The average collection period depends upon external and internal factors. The external factor has to do with the economic condition of the environment where the firm is located. Studies show that during recession or period of tight monetary policy, customers may be forced to delay payment. The internal factor has to do with firm's credit policy variables. These include:

a. **Credit Standard:** This is the maximum riskiness of acceptable credit account. This depends on who the firm extend its credit to. If the firm does not make credit sale to its strongest customer(s), it means there wouldn't be bad debt losses. On the other hand it will probably be losing sales and profit which might be more than the cost it has avoided. Therefore, an optimal credit standard involves equating the marginal cost of credit and marginal profit on increased sales. Since credit cost and credit quality are correlated, it is important to be able to judge the quality of an account which can be defined in terms of the probability of default. To evaluate credit risk, credit managers consider five things, character, capacity, capital, collateral and condition.

   Character: This refers to the probability that the customer will honour his obligations. The moral factors plays an important role here.

   Capacity: This is concerned with the ability of the customer, measured by his past records and supplemented by physical observation of the customer's factory, shop and business method.

   Capital: This is measured by the financial position of the firm as indicated by its financial ratio analysis.

   Collateral: This refers to the asset that the customer may offer as a security for the credit extended to him.

Conditions: This refers to the impact of general economic trend on the firm or to special development in certain areas of the economy that may affect the customer's ability to meet his obligation.

b. **Term of Credit:** This specifies the length of time for which credit is granted and discount if any is given for early payment. Some firms allow certain discount if payment is made within a specified period before the date of payment.

c. **Cash Discount:** The aim of granting cash discount is to speed up payments by debtors. It may also attract customers who want to take discount, thereby increasing sales. The optimal discount is established at the point where costs and benefit are exactly off setting.

There is a cost in foregoing a cash discount. This is because in order to delay paying its bills for an additional number of days, the firm must forego an opportunity to pay less for the items it has purchased. The annual percentage cost of foregoing the cash discount can be calculated by the equation below:

$$\text{Cost of foregoing cash discount} = \left(\frac{CD}{1-CD} \times \frac{360}{N}\right) \times 100 \quad \text{- equation } 33^{(6)}$$

where:

CD - the stated cash discount in percentage terms

N - the number of days payment can be delayed by foregoing cash discount.

Decision in favour of taking cash discount is taken if the cost of borrowing is greater than that of foregoing the discount

d. **Collection Policy:** This is concerned with the firm's established procedures for the collection of over-due accounts. A letter or two may be sent to the debtor before the issue is handed to a collection agency.

3.5.3.2 Benefit and Risk of Trade Credit

Firms that extend trade credit to their customers stand the chance of increasing sales volume. The reason being that trade credit is a form of financing granted to customers. This obviously will attract even potential customers who ordinarily would not have had enough cash to go into such

ventures. When translated, an increase in sales simply means an increase in profit and this is the primary aim of business.

Unfortunately, trade credit carries with it some measure of risks. These risks are those related to the reduction of receivables turnover (or increase in average collection period). They have the potential of increasing the cost of financing credit at the expense of its profitability. Consequently, losses to bad debts may also increase.

3.5.3.3 Management and Control of Accounts Receivable

The management and control of accounts receivable differ from industry to industry and infact from company to company - depending on their individual policies as it affects credit sales or services. It is the prerogative of every company to decide who enjoys credit sales, the amount of credit and its duration. This is true since the act of credit extension is a form of risk bearing, as such, it is not out of place for the firm to decide whose risk to bear and under what conditions.

In the insurance industry, the main component of accounts receivable (that is premiums, claims, loans) are controlled and managed. We will now take a closer look at how thus is done.

a. **Control and Management of Premiums:** The following measures are used to control the extension of premium credits to customers:

- Credits are given to clients based on their financial strength. Customers strengths are assessed overtime and this could be based on personal recognition in the case of new clients.
- Another control measure is the use of the slogan "no premium, no cover" by insurance firms - this seem to warn customers to go and pay up their premiums which are due or else there will be no claims in the event of a loss.

Insurance firms manage premium credits by sending reminder to policy holders in order to persuade them to pay the amounts due. After sending one or two of such a reminder and there is no response from the customer, another formal letter is written to inform such customer of the revocation of the contract.

b. **Control and Management of Claims:** Claims receivable come mainly from re-insurance companies. Strict control are not exerted but these claims when not paid in time are used in off-setting premiums due to the re-insurance companies in subsequent periods. They are managed in such a way as not to allow them build-up or accumulate.

c. **Control and Management of Loans:** Loans are extended to policy holders and agents by insurance firms. These loans are usually spread to cover a given period, say one to two years. The major area of control here is to determine how much loan to grant to an applicant. For a policy holders, loan is not granted above the premium already paid. For example, a client having a policy of N20,000, who wants a loan after paying a premium of N16,000 will not be given more than ninety percent of the premium he has paid ($\frac{16000}{100} \times 90 = 14{,}400$) that is N14,400.00.

Also if he defaults in payment, he automatically forfeits his entitlements under the policy contract to the tune of the loan, that is he gets only the balance of the contract upon maturity.

Loans to agents on the other hand are determined from the total commissions earned in previous periods or on commissions yet to be processed. Repayment of loan and interest are deducted from commissions earned.

The managements of loan receivable are done by the use of ageing analysis (schedule). Here outstanding accounts are classified by vintage and expressed as percentage of total uncollected balances on the analysis of date. Thereafter, any indicated collection period can be interpolated to know how much percentage of receivables fall due.

Also once the loan is beyond recoverable age and it is certain that it can no longer be recovered, it is classified as irrecoverable and written off as bad debt in the subsequent year.

3.5.4 Management of Inventory

Inventory may be defined as the goods held for eventual resale by the firm. As such, inventories are a vital element in the efforts of the firm to achieve desired sales levels. Depending on the nature of the industry and firm, inventory may be durable or non-durable, perishable or non-perishable, valuable or in expensive.

Three types of inventories may be identified:

(a) **Raw Materials:** These are goods that are necessary for production.

(b) **Goods in Progress:** This category includes those raw materials that have been committed to the production process but have not been completed.

(c.) **Finished goods:** These are completed products awaiting sales.

The primary methods of inventory control are the perpetual inventory system and the periodic inventory system. The management of inventory bothers on when orders for acquisition should be placed or needed and the size of order. The relationship between these concerns has led to various techniques for managing inventories. They include the fixed-order system and the fixed-period system. On the whole, inventory is managed such that the firm does not experience stock-outs and does not tie up its funds in redundant or excess inventory.

For insurance firms, inventories are not that popular except for printed documents, stationeries and motor spare parts. Most of these printed documents are security documents (certificates) and are printed in bulk for use for several years. This also carries the advantage of unit cost reduction.

The quantity of stationary required for a given financial year and the intervals of purchase are usually determined based on past experiences and demand.

Issues for usage of inventory (in insurance firms) are made through requisition by departments to the store keeper. The head of departments are sole signatories to such requisitions and when ascertained to be genuine, the items are issued. Usage of inventory are monitored so as to reduce wastages. This is done by keeping a record of usage in which inventory collected are accounted for.

3.5.5 Management of Current Liabilities

Current liabilities are the debts of the firm that must be paid during the current accounting period, usually within one year. The solvency of a firm is measured by its ability to meet its obligation when they fall due. And for a firm to possess this ability at all times, its current assets must be managed in the light of its current liabilities. If the management of these two items. (that is, current assets and current liabilities) are not properly syncronised, situations will arise when the firm may not be able to meet its obligations or else it might be the other situation where current assets held are in excess of current liabilities, thus keeping idle resources.

3.5.5.1 Components of Current Liabilities

The components of current liabilities include:

(a) **Accounts payable:** when a firm makes purchases on credit, it has to pay for the goods according to the terms of the contract. Before this credit purchases are paid for, they are called accounts payable in the firm's financial records.

(b) **Notes payable (short-term):** This is money owed to creditors against promissory notes that mature during the next financial year.

(c.) **Other payables:** The firm may also owe money that are due for payments either during or at the end of the financial year. Examples include: Wages payable, taxes payable, loans payable (short-term loans), etc.

For insurance firms, current liabilities include the following; claims due to policyholders, premium due to re-insurance companies, taxes due to government, wages due to workers, retirement benefits, dividend to share holders (for those of them that are public owned), etc.

3.5.5.2 **Control and Management of Current Liabilities**

The main ways of controlling current liabilities are:

- Maintaining a proper procedure of highlighting payments whenever they are due. This will help in off setting payments on time.
- Centralisation of payable and disbursement procedures. In addition to these, other specific control measures used by insurance companies include those employed in claims payment to policy holders and premiums payment to re-insurance companies.

Before claims are settled, they are passed through some underwriting procedures. These procedures are meant to ascertain the genuineness of claims by policy holders.

Life claims are paid only after a death certificate in the name of the deceased is produced and found to be authentic upon investigation.

For non-life claims, loss or damage are throughly investigated and assessed by a registered loss adjuster before settlement is made.

Premium obligations to re-insurance companies are controlled by the simple knowledge that when premiums on insured risks due for re-insurance are not paid, there is no cover. In addition to this, re-insurance departments are created and saddled with the responsibilities of matters concerning re-insurance. Such matters may include, a quarterly compilation of risks due for re-insurance,

SALIM IBRAHIM

providing information on dates when premiums are due for payment, etc.

Current liabilities are not managed in isolation, rather they are managed in the light of current assets.

3.6 Factors that determine working Capital

The following factors determine the working capital requirements of a firm:

(a) **Size of business (volume of sales):** There is a direct relationship between the size of a firm and the size of its current assets, in other words, the bigger the firm, the larger the working capital. When sales volume are fairly steady it is possible for a firm to also predict (from past records) and keep a steady level of working capital. A situation however where there is growth in sales, there has to be a commensurate growth in production and hence in the level of working capital. On the other hand, when sales are declining, a reduction in working capital can be expected.[12] This factor is true for insurance firms because the more the policy holders, the more claims will be paid both in respect of losses and as premiums to re-insurance companies. Also more inventory will be consumed for formalities and documentations.

(b) **Seasonal and cyclical factors:** Most firms experience seasonal fluctuations in the demand for their products and services. For example, when the economy is undergoing a recession as it is the case with Nigeria presently, a firm's sales or services may temporarily decline thus reducing the need for inventories and the level of receivables. Also when there is high inflation in the economy, the purchasing power of people within that economy drops and this automatically affects sales and services - there is a general decline. This is also currently the case in Nigeria.

The insurance industry is not isolated from this factor as individuals and corporate bodies see survival as primary and other things, such as an insurance policy, as secondary.

(c.) **Changes in Technology:** Changes in the means of production (that is equipments, machines, etc) can have sharp impact on the need for working capital. For example, if the introduction of a new plant gives rise to faster rate of production, if other conditions are constant, then there will be need to acquire more inventory; thus increasing the working capital. On the other hand if it had resulted in the production of the same units of products but with less consumption of raw materials, then less inventory and hence working capital will be required. This factor is not all that important in the operations of insurance firms.

(d) **Policies of the firm:** A firm may change its policies as it affects credit extension to customers, production or cash at hand, each of this has a corresponding effect on the working capital. For example, if a firm changes its credit policy from net 30 to net 60, additional funds may be permanently tied up in receivables. If it changes production policies, inventory requirements may be permanently or temporarily affected. If it changes its safety level of cash on hand, permanent working capital may increase or decrease. Some aspects of this policy changes are relevant to the insurance industry.

3.7. Determination of Working Capital Requirements

What had been discussed in the proceeding sub-heading is relevant here but now we shall pay attention more to the amount of working capital needed by the firm for its day to day operations.

If we take cash for a start, it may not be correct to assume straight away, that the bigger the size of a firm, the more cash it has to hold. On the contrary, a big firm having many customers may not keep much cash since it has many sources of funds, whereas, a small firm with fewer customers, hence fewer sources of cash inflow, needs to keep extra cash to cushion failures by some of its customers. In the same way, a firm that has easy assess to credit from banks (usually most big firms do) does not have to hold a large amount of cash to meet its obligations.

The attitude of a firm towards risk also plays a vital role in the amount of working capital a firm is willing to hold. The greater the amount of capital, particularly cash and marketable securities, the lower the risk of liquidity problems. Firms that do not wish to incur even the slightest risks of liquidity deficiencies may keep extra cash. Other firms accept the risk to earn profits and may not always keep adequate cash to pay bills on time.[12] Prevailing interest rate levels also affect the amount of working capital a firm is willing to hold.

High interest rate levels encourage firms to reduce levels of cash, receivables and inventory. This minimizes financing costs for working capital and a drop in interest rates encourages firms to maintain higher levels of working capital.

Generally speaking, cash and inventory levels can be determined by a number of well known models most of which were already mentioned in the preceeding sub-headings.

3.8 Financing Working Capital Requirement

Working Capital financing can be by external sources or by internal policies that can improve the liquidity position of the firm.

One possiblity is to increase the speed of stock turnover. If stock is at present turned over four times in a year, pushing this to four and a half times would boost the flow of funds through the company. The stock turnover could be accelerated either by increasing sales revenue or by reducing the level of stocks being carried. [12]

To increase sales revenue it may be necessary to drop the sales price. Usually, firms with a high stock turnover or asset turnover are working with lower profit margins than companies with a low turnover.

Another tool for improving liquidity is for the firm to delay paying its creditors. Also, accelerating the process of debt collection can improve a company's liquidity - this can be done by chasing up late payers and by making the rewards for early payment more attractive.

External short-term financing are funds obtained by firms for short periods of time (say three months), from external creditors. Options abound as to which external short-term borrowing a firm will go for. We shall now look very briefly at each of these options:

(a) **Bank Borrowing:** This is a short-term borrowing made available to firms by clearing banks in the form of overdrafts. This form of borrowing is comparatively cheap because the risk to the lender are less than on long-term loans and all loan interest is tax-deductible expenses.

(b) **Trade Credit:** This si a short-term financing extended by one company to another on the purchase and sale of goods and equipment. The use of trade credit has increased in recent years parthy because of difficulties in borrowing and high interest rates.

(c.) **Factoring:** Factoring involves raising funds on the security of the company's debts, so that cash is received earlier than if the company waited for the debtors to pay. Most factors offer three services. One is sales ledger accounting, the sending out of invoices and making sure the bills are paid. Two is credit insurance, the guarantee against bad debts. Three is the provision of finance, advancing clients up to 80% of the value of the debts they are collecting.

(d) **Invoice discounting and credit insurance:** This arrangement is beneficial to the liquidity position of the user. It is designed to overcome the problem of tying up working capital in book debts. A firm can convert an invoice into cash by discounting the invoice through specialised finance companies.

(e) **Deferred tax payments:** This is credit supplied by the tax authorities. This is created by the interval that elapses between the earning of the profits by the firm and the payment of the taxes due on them.

As long as the firm continues to earn stable or expanding profits, tax payment differed in this way comprises a virtually permanent source of finance.

Other forms of short-term but which could also be medium-term financing include; Leasing, Mortgaging property, Sale and Lease-back, Hire-purchase, Project finance and Acceptance credit. [12]

CHAPTER FOUR: DATA TREATMENT AND ANALYSIS

4.0 INTRODUCTION

In this chapter, data gathered from both primary and secondary sources are analysed. The analysis included all components of working capital, with a view to arriving at a reasonable estimation of working capital in the insurance industry. Attempt was also made to cross-examine the validity or otherwise of the hypothesis stated earlier in chapter one.

4.1 Data Treatment

Primary data were obtained using questionaire and personal interviews, while secondary data were extracted mainly from the annual financial reports of the firms concerned except for First Nigerian Insurance Company Ltd. where secondary data were extracted from filed documents. The data were then sorted for each of the firms and presented in tabular forms, (see tables 4.1, 4.2 and 4.3 below).

4.2 Data Analysis

Data were analysed for all components of working capital and separately for each firm in the following order: Guinea Insurance Plc., UNIC Insurance Plc and First Nigerian Insurance Co. Ltd.

4.2.1 GUINEA INSURANCE PLC

4.2.1.1 Cash Management

As highlighted earlier, the main source of income for insurance firms is premiums paid by the insured. Cash is usually the mode of payment although cheques are also honoured. It was gathered from our respondents that premiums are collected by agents of Guinea Insurance Plc (hereafter referred to simply as company or firm) and issue out receipts to the tune of the amount collected. At the end of each day every agent fills a daily remittence and

banking sheet. This sheet contains information about each contract entered into by the agent on behalf of the company. Such information include: name of insured, policy number, name of agent, receipt number, amount paid, etc. When this has been done the agent submits the receipt book-let and remittence sheet to the accountant for verification and payment into the company's account within twenty four hours.

A look at table 4.1 shows that the firm keeps a reasonable amount of money in hand and at the bank. Six to ten million naira is definitely a good precautionary measure to meet short notice claims.

Extracts from the firm's annual reports indicate that cash at bank and in hand combined hovers around seven and twelve percent of total investment in current assets. This is also reasonable in the view of the researcher.

Table 4.1: Response to questionaire and extracts from annual reports (1993 - 1996) for Guinea Insurance, Plc.

Question	Response
How many bank accounts do you operate?	3
What level of cash do you maintain in your account?	₦6 - 10m
What level of cash do you keep at hand?	<₦ 1m
How do you meet cash obligations when the need arises?	Security trading
In recent times, what has been the average cash requirement for short notice claims?	Over ₦10m
What constitutes major investment of excess fund by your firm?	Marketable Securities
To what extent is credit control put into use by your firm?	Frequently
To what extent is default minimised?	Averagely minimised
Do you carry out age analysis of your receivables periodically?	Yes
What percentage of total assets is working capital in your firm?	< 50%
What constitutes the bulk of your account payable?	Unpaid claims
Is your firm able to accurately estimate claims for a given financial period?	Yes
Which claim is most frequent in recent times?	Burglary
What are the components of working capital in your organisation (please assign percentages)?	Cash 45% Securities 30% Inventory 3% A/C Receivables 10%

Components of Working Capital	1993		1994		1995		1996	
	₦	%	₦	%	₦	%	₦	%
(a) **Current Assets**								
Debtors	59,747,824	71.64	80,757,622	81.02	88,044,903	85.51	87,347,275	83.03
Sundry Stock	155,464	0.19	1,157,662	1.16	2,281,547	2.23	2,118,028	2.01
Short Term Investments	13,230,293	15.86	7,601,416	7.63	5,382,567	5.22	7,100,957	6.75
Cash at Bank and in hand	10,262,357	12.31	10,157,224	10.19	7,251,814	7.04	8,636,982	8.21
Total	**83,395,938**	**100.00**	**99,673,924**	**100.00**	**102,960,831**	**100.00**	**105,203,242**	**100.00**

(b) **Current Liabilities**								
Guinea Trustee Ltd.	531,723	0.95	1,341,171	2.14	-	-	-	-
Claim Outstanding	7,543,872	13.44	10,577,265	16.94	8,549,764	10.91	16,353,107	19.39
Amount due to insurance company	5,020,455	8.95	16,179,825	25.91	32,962,004	42.08	30,087,486	35.67
Agent Balances	18,372,867	32.75	21,700,627	34.76	21,813,448	27.85	22,290,195	26.42
Sundry Creditors and accrued charges	19,222,637	34.26	4,737,258	7.58	4,798,739	6.12	9,146,484	10.84
Taxation	750,000	1.34	1,302,151	2.08	7,602,796	9.71	6,476,783	7.68
Dividend: Payable	-	-	223,301	0.35	2,605,522	3.33	4,189	0.01
Proposed	2,233,014	3.98	2,605,184	4.17	-	-	-	-
Bank Overdraft	2,432,622	4.33	3,791,640	6.07	-	-	-	-
Total	56,107,190	100.00	62,431,422	100.00	78,332,273	100.00	84,358,244	100.00
Net Current Asset	**27,288,748**		**37,242,502**		**24,628,558**		**20,844,898**	

4.2.1.2. Management of Marketable Securities

Going by the response to the questionaire administered, investment in marketable securities by Guinea Insurance Plc is suppose to be about 30% of the firm's working capital. This certainly sounds adequate. However, data extracted from the company's annual reports indicate that short term investment constitutes 15.86% of total investment in current assets in 1993. This then declined to 7.63% in 1994, 5.22% in 1995 and picked up to 6.75% in 1996 (Table 4.1). These figures show certain level fo inadequacy and inconsistency in short-term investment. Management should check this unfavourable situation otherwise, the firm stands the risk of relying heavily on bank overdraft and other sources of short-term borrowing to meet its cash obligations.

4.2.1.3. Management of Inventory

Investment in inventory by the firm from both primary and secondary data is adequately low. The actual figure obtained is between 2% and 3% of investment in current asset. Since no stock other than printed documents are needed in the day to day running of the insurance business, it is only wise not to tie up too much capital on this.

4.2.1.4 Management of Accounts Receivables

The lower the level of accounts receivables the better for the firm. This will make money available to meet short-term obligations, create avenue for investment and reduce the level of bad debts. Reponses to the interview and questionaire indicate that credit control is frequently put into use by the firm. Indeed, the respondents put the percentage of accounts receivables at only 10%. However, figures extracted from the firm's annual reports show that accounts receivables are well above 80%. In other words, only about 20% of expected revenue was actually collected during the period under investigation. This is a very serious problem . So many things must have gone wrong with the debt collection mechanizm of the company. This, coupled with the firm's low

investment is short term ventures threatens the solvency of the firm in near future. This situation has to be reverse.

4.2.1.5 Management of Current Liabilities

Respondents to the questionaire have said that unpaid claims constituted the bulk of the firm's payables. This is not supported by data from the firm's annual report, which indicate a rather moderate level (11% - 19%) of unpaid claims. Which ever is the case, the firm should ensure prompt payments of verified claims in order not to send a discouraging signal to intending customers and policy holders. Agent balances and amount due to insurance company are high. This is a good strategy, if they don't attract high interest and or penalties. The percentage level of sundry creditors and accrued charges are reasonable except for 1993 when it was 34.26%. The strategy of maintaining a high level of these items has its good sides but a middle path should be followed to aviod labour unrest and a bad credit image.

4.2.2. UNIC INSURANCE PLC

4.2.2.1 Cash Management

The study showed that UNIC Insurance Plc (hereafter refered to as 'Company or firm') transacts most of its businesses by cash through its agents. These agents collect premiums from customers and issue receipts to cover the amount received. At the end of the day's activities, they pay money realised directly into the firm's bank account and submit bank tellers to the accountant for confirmation of lodgement. Table 4.2 shows that cash in hand is above five million naira, while cash at the bank is over ten million naira. Both amount seem reasonable enough to meet short-term claims.

Table 4.2: Response to questionaire and extracts from annual reports (1993 - 1996) for UNIC Insurance, Plc.

Question	Response
How many bank accounts do you operate?	3
What level of cash do you maintain in your account?	Over ₦10m
What level of cash do you keep at hand?	Over ₦5m
How do you meet cash obligations when the need arises?	Security trading
In recent times, what has been the average cash requirement for short notice claims?	Over ₦10m
What constitutes major investment of excess fund by your firm?	Marketable Securities
To what extent is credit control put into use by your firm?	Very Frequent
To what extent is default minimised?	Highly Minimised
Do you carry out age analysis of your receivables periodically?	Yes
What percentage of total assets is working capital in your firm?	Over 70%
What constitutes the bulk of your account payable?	Unpaid claims
Is your firm able to accurately estimate claims for a given financial period?	Yes
Which claim is most frequent in recent times?	Motor Insurance
What are the components of working capital in your organisation (please assign percentages)?	Cash 40% Securities 45% Inventory - A/C Receivables 15%

Components of Working Capital	1993		1994		1995		1996	
	₦	%	₦	%	₦	%	₦	%
(a) **Current Assets**								
Amount due from Agents and Companies	58,278,000	45.79	87,090,000	39.27	119,884,000	31.82	171,018,000	33.74
Stock	-	-	-	-	-	-	-	-
Other debit balances and accrued interest	38,331,000	30.12	94,948,000	42.81	130,146,000	34.54	196,807,000	38.82
Amount due from associated companies	11,642,000	9.15	7,800,000	3.52	954,000	0.25	9,351,000	1.84
Cash at hand and in Bank	15,987,000	12.56	31,085,000	14.02	125,782,000	33.39	129,741,000	25.60
Taxation	3,021,000	3.37	841,000	0.38	-	-	-	-
Total	**127,259,000**	**100.00**	**221,764,000**	**100.00**	**376,766,000**	**100.00**	**506,917,000**	**100.00**

(b) **Current Liabilities**								
Out-standing Claims:								
Fire	13,994,000	5.95	12,259,000	3.92	6,588,000	1.63	15,789,000	3.19
Motor	46,640,000	19.84	36,126,000	11.54	38,827,000	9.59	48,072,000	9.72
Other Accident	33,254,000	14.15	30,685,000	9.80	34,560,000	8.53	33,199,000	6.72
Marine and Aviation	11,276,000	4.80	14,469,000	4.62	13,286,000	3.28	18,206,000	3.68
Amount due to agents, reinsurance companies and others	75,473,000	32.11	128,438,000	41.02	175,230,000	43.27	241,448,000	48.84
Other Creditors and Accruals	49,200,000	20.93	74,694,000	23.86	90,047,000	22.24	109,876,000	22.23
Proposed dividend	-	-	-	-	7,560,000	1.87	10,500,000	2.12
Unpaid dividend	3,347,000	1.42	1,347,000	0.43	62,000	0.01	254,000	0.05
Bank over-draft	1,303,000	0.56	6,798,000	2.17	21,894,000	5.41	3,580,000	0.72
Amount due to an assoicated company	569,000	0.24	4,382,000	1.40	9,384,000	2.32	3,875,000	0.78
Amount due to life fund	-	-	3,890,000	1.24	-	-	-	-
Taxation	-	-	-	-	7,514,000	1.85	9,566,000	1.94
Total	235,058,000	100.00	313,088,000	100.00	404,952,000	100.00	494,365,000	100.00
Net Current Asset	**(107,799,000)**		**(91,799,000)**		**(28,186,000)**		**12,552,000**	

From the firm's annual reports (Tab. 4.2) cash in hand and in bank for 1993 and 1994 which stand at 13% and 14% of total investment in current assets are reasonable. But the figures for 1995 and 1996, (33% and 26%), are on the high side. In these cases, it is the view of the researcher that too much fund was tied up in idle use.

4.2.2.2 Management of Marketable Securities

The issue of short-term investment is taken very seriously by the company going by the interview conducted. This is supported by the questionaire administered and the annual reports of the firm for the years under investigation. Going by the response to the questionaire, forty five percent of investment in current asssts goes to securities and the annual reports allocate about 40% of current assests to short-term investment. This situation is quite satisfactory.

4.2.2.3 Management of Inventory

No amount featured for inventory in the response to questionaire and in the annual reports. Upon enquiry, it was gathered that this is probably so because expenditure on inventory is negligible when compared with the total investment in current assets.

4.2.2.4 Management of accounts receivables

The respondents to the questionaire asserted that credit control is frequently put into use by the frim. Extracts from the firm's annual reports also indicate a satisfactory level of accounts receivable: Apart from the 46% recorded in 1993, the other years recorded below 40% receivables (see table 4.2).

4.2.2.5 Management of Current Liabilities

Even though respondents to the questionaire are unanimous that unpaid claims constitute the bulk of the firm's account payables, this view tallies only with the 1993 annual report, which aportioned about 44% of total current liabilities to outstanding claims. From 1994 to 1996, unpaid claims dropped significantly while re-insurance premiums, amount due to agents and others rose steadily to 49%, (table 4.2).

4.2.3 FIRST NIGERIAN INSURANCE CO. LTD

4.2.3.1 Cash Management

First Nigerian Insurance Co. Ltd. keeps about one million naira in hand and between one to two million naira at bank. Considering the size of the firm and its volume of business, these amounts are satisfactory. Extracts from filed documents reveal that the percentages of cash in hand and at bank when compared with total investment in current assets is moderate. The exception to this is in 1994 when the firm held about 35% cash both in hand and at bank (table 4.3)

4.2.3.2 Management of Securities

Investment by this firm in securities is quite high as revealed by both the responses to the questionaire and extracts from filed documents. Indeed, over 70% of investment in current assets goes to short-term investment. Interview conducted also revealed that this firm has a department whose duty it is to advice management on securities to invest in and those to dispose of when the need arises.

Table 4.3: Responses to questionaire and extracts from filed documents (1993 - 1996) for First Nigerian Insurance Company Ltd.

Question	Response
How many bank accounts do you operate?	16
What level of cash do you maintain in your account?	₦1 - 2m
What level of cash do you keep at hand?	< ₦ 1m
How do you meet cash obligations when the need arises?	Security trading
In recent times, what has been the average cash requirement for short notice claims?	< ₦5m
What constitutes major investment of excess fund by your firm?	Bank Deposit
To what extent is credit control put into use by your firm?	Very Frequent
To what extent is default minimised?	Averagely minimised
Do you carry out age analysis of your receivables periodically?	Yes
What percentage of total assets is working capital in your firm?	< 50%
What constitutes the bulk of your account payable?	Re-insurance Premiums
Is your firm able to accurately estimate claims for a given financial period?	Yes
Which claim is most frequent in recent times?	Maturity Claims
What are the components of working capital in your organisation (please assign percentages)?	Cash 16% Securities 63% Inventory 2% A/C Receivables 19%

4233 70

Components of Working Capital	1993		1994		1995		1996	
	₦	%	₦	%	₦	%	₦	%
(a) **Current Assets**								
Debtors and Prepayments	700,000	10.44	599,917	7.36	421,442	4.30	708,284	8.40
Stock	195,770	2.92	129,213	1.59	143,960	1.47	131,937	1.56
Short Term Deposit	5,370,730	80.07	4,600,730	56.42	8,575,000	87.42	6,900,000	81.80
Cash in hand and at Bank	441,065	6.57	2,824,010	34.63	667,891	6.81	694,605	8.24
Total	**6,707,565**	**100.00**	**8,153,888**	**100.00**	**9,808,293**	**100.00**	**8,434,826**	**100.00**

(b) **Current Liabilities**								
Policy holder balance	186,903	17.84	532,355	33.13	674,459	42.94	68,673	6.16
Staff pension fund	144,326	13.78	158,747	9.88	142,605	9.08	122,848	11.03
Accrued charges	287,087	27.41	603,405	37.56	448,798	28.58	498,187	44.71
Deferred income	429,151	40.97	295,964	18.42	304,686	19.40	404,876	36.33
Bank Over-draft	-	-	16,250	1.01	-	-	19,683	1.77
Total	1,047,467	100.00	1,606,721	100.00	1,570,548	100.00	1,114,267	100.00
Net Current Asset	**5,660,098**		**6,547,167**		**8,237,745**		**7,320,559**	

Since a single ratio in itself does not indicate favourable or unfavourable conditions, this study has been designed to evaluate a number of ratios and for a period covering four years (1993 - 1996).

Consideration was also given to the use of insurance industry ratio averages as a standard of comparism, unfortunately, it is not to be as there is no predscribed averages for the industry. Consequently, the ratios obtained for each of the case study firms were evaluated based on their internal measuring standards and theoretically accepted norms.

The financial ratios evaluated include the following:

(a) **Net Working Capital (NWC):** This ratio gives the solvency position of a firm.

NWC = Current Assets - Current Liabilities:

For Guniea Insurance Plc.

NWC 93	=	₦27,288,748
NWC 94	=	₦37,242,502
NWC 95	=	₦24,628,558
NWC 96	=	₦20,844,898

For First Nigerian Insurance Co. Ltd.

NWC 93	=	₦5,660,098
NWC 94	=	₦6,547,167
NWC 95	=	₦8,237,745
NWC 96	=	₦7,320,559

For UNIC Insurance Plc.

NWC 93	=	(₦107,799,000)
NWC 94	=	(₦91,324,000)
NWC 95	=	(₦28,186,000)
NWC 96	=	₦12,552,000

The net working capital for Guniea Insurance Plc and First Nigerian Insurance Co. Ltd. indicate a good margin of safety to meet short term liabilities. This is not the

4.2.3.3 **Management of Inventory**

Investment in inventory by the firm is reasonably low. Data from the different sources allocated just about 2% of total investment in current assets to inventory.

4.2.3.4. **Management of Accounts Receivables**

The accounts receivables position of the firm is excellent. 1993 recorded about 10% while the other years recorded even less. The success of the firm in this regard is attributable to its aggressive premium collection policy, said one respondent. To this end, policy holders are constantly reminded about the insurance slogan of "no premium, no cover". Apart from this, he claimed that letters of reminder are sent out to clients from time to tme about the need to pay their premiums as soon as they are due.

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4.2.3.5 **Management of Curent Liabilities**

The level of outstanding claims for 1994 and 1995 are quite high (33% and 43% respectively). By 1996, however, it dropped to about 6%. A high level of outstanding claims is not good for the progress of the firm even though this seemed to have been addressed in the 1996 financial year. Accrued charges on the other hand increased from 27% in 1993 to 38% in 1994 and then dropped to 29% in 1995; it again rose sharply to 45% in 1996 (Tab 4.3). Urgent steps should be taken to reverse the trend, otherwise, the integrity of the firm could be jeoperdised. Labour unrest is also a likely fall out.

4.3 **Ratio Analysis**

Financial analysis deals primarily with the evaluation of a firm's financial statements. For this study, only those components of working capital will be evaluated. The outcome of such analysis gives a picture of a firm's financial performance over a period of time or its present position, both within an industry and among industries depending on the interest of the user - who could be researchers, creditor, investors and managers.

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case with UNIC Insurance Plc, which has a negative margin of safety for all the years except 1996.

(b) **Current Ratio:** This measures the ability of a firm to pay its bills on time. A 2:1 ratio is generally considered as adequate and acceptable for most firms.

Current Ratio = Total Current Assests / Total Current Liabilities

For Guinea Insurance Plc:

Current Ratio 93 = 83,395,938 / 56,107,190 = 1.49

Current Ratio 94 = 99,673,924 / 62,431,422 = 1.60

Current Ratio 95 = 102,960,831 / 78,332,273 = 1.31

Current Ratio 96 = 105,203,242 / 84,358,244 = 1.25

For First Nigerian Insurance Co. Ltd.

Current Ratio 93 = 6,707,565 / 1,047,467 = 6.40

Current Ratio 94 = 8,153,888 / 1,606,721 = 5.08

Current Ratio 95 = 9,808,293 / 1,570,548 = 6.25

Current Ratio 96 = $\frac{8,434,826}{1,114,267}$ = 7.57

For UNIC Plc.,

Current Ratio 93 = $\frac{127,259,000}{235,058,000}$ = 0.54

Current Ratio 94 = $\frac{221,764,000}{313,088,000}$ = 0.71

Current Ratio 95 = $\frac{376,766,000}{404,952,000}$ = 0.93

Current Ratio 96 = $\frac{506,917,000}{494,365,000}$ = 1.03

First Nigerian Insurance Co. Ltd's current ratio of about 6.0 on the average is very favourable. On the other hand, both Guinea's and UNIC's averages of about 1.5 and 0.8 respectively are inadequate. Infact UNIC's average is grossly inadequate and this is an indication that the firm did not make profits from its investments during the period under consideration.

(c.) **Quick (Acid) test ratio:** This ratio is considered as a more precise measure of liquidity as it excludes inventory (stock) from current assets.

A 1 : 1 ratio is generally considered adequate for most firms.

Quick test ratio = $\frac{\text{Current assets - Inventory}}{\text{Current liabilities}}$

For Guinea Insurance Plc.

Quick test ratio 93 = $\frac{83,395,938 - 155,464}{56,107,190}$ = 1.48

Quick test ratio 94 = $\frac{99,673,924 - 1,157,662}{62,431,422}$ = 1.58

Quick test ration 95 = $\frac{102,960,831 - 2,281,547}{78,332,273}$ = 1.29

Quick test ratio 96 = $\frac{105,203,242 - 2,118,028}{84,358,244}$ = 1.22

For First Nigerian Insurance Co. Ltd.

Quick test ratio 93 = $\frac{6,707,565 - 195,770}{1,047,467}$ = 6.22

Quick test ratio 94 = $\frac{8,153,888 - 129,231}{1,606,721}$ = 4.99

Quick test ratio 95 = $\frac{9,808,293 - 143,960}{1,570,548}$ = 6.15

Quick test ratio 96 = $\frac{8,434,826 - 131,937}{1,114,267}$ = 7.45

For UNIC Plc: The quick test ratios are assumed to be equal in values to the current ratios. This is logical since stock did not feature in the balance sheet of the firm for the period under study.

The results obtained for both Guinea Insurance and First Nigerian Insurance Co. Ltd. are above unity indicating a favourable solvency position. For, UNIC insurance, the results remain as in 'b' above, still indicating a bad solvency position.

(d) **Accounts receivables turn-over ratio:** This ratio is used to measure the liquidity of a firm's accounts receivables. A low ratio indicates that the firm has

a large receivables balance and difficulty in collecting its money. A high ratio means that the firm has a low receivables balance as a result of strict credit policy and aggressive collection procedure. It is calculated as follows:

Accounts receivables turn-over = Sales / Acc. Receivables

(Where: Sales = Premium written; & receivables = debtors)

For Guinea Insurance Plc:

a/c receivables turn-over ratio 93 = 69,223,925 / 59,638,339 = 1.16

a/c receivables turn-over ratio 94 = 87,973,675 / 80,757,622 = 1.09

a/c receivables turn-over ratio 95 = 107,644,304 / 88,044,903 = 1.22

a/c receivables turn-over ratio 96 = 94,227,312 / 87,347,275 = 1.08

For First Nigerian Insurance Co. Ltd.

a/c receivables turn-over ratio 93 = 5,275,574 / 700,000 = 7.54

a/c receivables turn-over ratio 94 = 5,217,968 / 599,917 = 8.70

a/c receivables turn-over ratio 95 = 6,238,096 / 421,442 = 14.70

a/c receivables turn-over ratio 96 = 9,022,049 / 708,284 = 12.74

For UNIC Insurance Plc:

a/c receivables turn-over ratio 93 = 181,040,000 / 58,278,000 = 3.11

a/c receivables turn-over ratio 94 = 273,789,000 / 87,090,000 = 3.14

a/c receivables turn-over ratio 95 = $\frac{370,709,000}{119,884,000}$ = 3.09

a/c receivables turn-over ratio 96 = $\frac{478,947,000}{171,018,000}$ = 2.80

See comments after average collection period.

(e) **Average Collection Period:** This measures the debtors turnover. It is calculated by first finding the average daily sales and then daily sales are divided into trade debtors to find the number of days sales is tied up on debtors.

Average collection period = $\frac{\text{accounts receivables}}{\text{daily sales}}$

(Where daily sales = annual sales ÷ 360 days)

∴ Average collection period = $\frac{\text{accounts receivables x 360}}{\text{sales}}$

For Guinea Insurance Plc

Average collection period 93 = $\frac{59,747,824 \times 360}{69,223,925}$ = 311 days

Average collection period 94 = $\frac{80,757,622 \times 360}{87,973,675}$ = 330 days

Average collection period 95 = $\frac{88,044,903 \times 360}{107,644,304}$ = 294 days

Average collection period 96 = $\frac{87,347,275 \times 360}{94,227,312}$ = 334 days

For First Nigerian Insurance Co. Ltd

Average collection period 93 = $\frac{700,000 \times 360}{5,275,574}$ = 48 days

Average collection period 94 = $\frac{599,917 \times 360}{5,217,968}$ = 41 days

Average collection period 95 = $\frac{421,442 \times 360}{6,238,096}$ = 24 days

Average collection period 96 = $\frac{708,284 \times 360}{9,022,049}$ = 28 days

For UNIC Insurance Plc

Average collection period 93 = $\frac{58,278,000 \times 360}{181,040,000}$ = 116 days

Average collection period 94 = $\frac{87,090,000 \times 360}{273,789,000}$ = 115 days

Average collection period 95 = $\frac{119,884,000 \times 360}{370,709,000}$ = 116 days

Average collection period 96 = $\frac{171,018,000 \times 360}{478,947,000}$ = 129 days

An accounts receivables ratio of stightly above unity for Guinea Insurance Plc is quite low. This seems to suggest that the firm has difficulty with premium collection and contrary to the information given by one of the respondents to the questionaire on this matter, application of credit control does not seem to be strictly observed by the management of the firm. This point is further butressed when we take a look at the results of the average collection period for the firm. The results show clearly that debts owed the firm are not promptly collected.

First Nigerian insurance Co. Ltd's result for receivables turnover ratio and average collection period are good enough.

UNIC Insurance results are satisfactory, the firm should ensure stricter application of its credit policy to obtain better results.

(f) **Gross Profit Margin:** This ratio tells us the profit of the firm relative to sales after deducting the cost of producing the goods sold. It indicates the efficiency of operations as well as how products are priced.

Gross Profit Margin = $\frac{\text{sales - cost of goods sold}}{\text{sales}}$

For Guinea Insurance Plc

Gross profit margin 93	=	69,223,925 - 61,775,730 / 69,223,925	=	0.11
Gross profit margin 94	=	87,973,675 - 75,610,846 / 87,973,675	=	0.14
Gross profit margin 95	=	107,644,304-106,659,619 / 107,644,304	=	0.01
Gross profit margin 96	=	94,227,312- 91,709,463 / 94,227,312	=	0.03

For First Nigerian Insurance Co. Ltd

Gross profit margin 93	=	5,275,574 - 5,041,300 / 5,275,574	=	0.04
Gross profit margin 94	=	5,217,968 - 4,030,948 / 5,217,968	=	0.23
Gross profit margin 95	=	6,238,096 - 5,335,207 / 6,238,096	=	0.14
Gross profit margin 96	=	9,022,049 - 6,971,311 / 9,022,049	=	0.23

For UNIC Insurance Plc

Gross profit margin 93	=	181,040,000-198,467,000 / 181,040,000	=	(0.10)
Gross profit margin 94	=	273,789,000-254,101,000 / 273,789,000	=	0.07
Gross profit margin 95	=	370,709,000-326,038,000 / 370,709,000	=	0.12
Gross profit margin 96	=	478,947,000-431,684,000 / 478,947,000	=	0.10

The gross profits for the three companies are quite poor. For UNIC Insurance Plc, in 1993, negative value was obtained as expenses on premium was higher than premium collecated for the year. All the three firms, for the period under investigation have expenses on premium running neck to neck with premiums collected. Urgent steps should therefore be taken to reduce expenses in order to improve on their gross profit margins.

(g) **Net Profit Margin:** This measures the relative efficiency of the firm after taking into account all expenses and income taxes. The higher this ratio, the better.

Net profit margin = net income after taxes / sales

For Guinea Insurance Plc

Net profit margin 93 = 3,203,968 / 69,223,925 = 0.05

Net profit margin 94 = 4,015,650 / 87,973,675 = 0.05

Net profit margin 95 = 8,098,791 / 107,644,304 = 0.08

Net profit margin 96 = 3,750,326 / 94,227,312 = 0.04

For First Nigerian Insurance Co. Ltd

Net profit margin 93 = 125,499 / 5,275,574 = 0.02

Net profit margin 94 = 1,007,624 / 5,217,968 = 0.19

Net profit margin 95 = 675,476 / 6,238,096 = 0.11

Net profit margin 96 = 1,712,04 / 9,022,049 = 0.19

For UNIC Insurance Plc

Net profit margin 93	=	(13,459,000)	=	(0.07)
		181,040,000		
Net profit margin 94	=	17,198,00	=	0.06
		273,789,000		
Net profit margin 95	=	44,549,000	=	0.12
		370,709,000		
Net profit margin 96	=	56,238,000	=	0.12
		478,947,000		

Net profit margins for the three firms are equally quite poor. However, the problem does not seem to arise from over taxation or high expenses on items outside those on premium. This is obvious when we look jointly at the two ratios (i.e. gross profit margin and net profit margin) for each firm in the same accounting period.

4.4 Verification of Hypothesis

Respondents to questionaires confirm the first hypothesis (3.1a). Two respodents each, one of which was an accountant with the firms attested to the fact that insurance firms can accurately quantify the amount of premiums and claims in a given accounting period.

The accounts receivables ratios for Guinea Insurance Plc and UNIC Insurance Plc are low, indicating difficulties with premium collection, this may not be unconnected with the liquidity squeeze, economic recession and high inflation prevalent in the country. This situation is beyond the control of the insurance firms, as such, they are external. And despite the satisfactory values of the accounts receivables ratios for First Nigerian Insurance Co. Ltd, hypothesis two can be said to be valid.

Lastly, the study did not reveal any appreciable diversification of investments in current assets. Almost all investible capital in short-term ventures are tied to marketable securities. Although these securities may belong to different companies, the fact still remains that marketable securities are not the only short-term investment opportunity available to investors. Hypothesis three is therefore not valid.

5.0 CHAPTER FIVE: SUMMARY, RECOMMENDATIONS AND CONCLUSION

5.1 SUMMARY

The project was a case study of some selected insurance companies and their management of working capital. The study covers four financial years i.e 1993 - 1996.

Chapter One explains the objective of the study after an introduction of the topic.

The chapter also high-lights the scope and limitations of the study and finally advances some hypothesis to serve as guides in the prosecution of the research project.

The design and methodology of carrying out the project was treated in chapter two. The chapter dwelt principally on the methods of data collection. The third chapter was devoted to the review of literature on the management of working capital in business organisations in general and where possible, narrowed down specifically to insurance firms.

In chapter four, data collected was treated, analysed and interpreted for each of the insurance companies under study. The verificatiosn of hypothesis were also carried out n this chapter.

This was followed by conclusion and recommendation in the last chapter.

5.1 RECOMMENDATIONS

From the findings of this work, the following are recommended:

(1) Insurance firms should work to create better awareness about their activities and particularly, enlighten the citizenry on the advantages of taking up insurance policies.

(2) New methods and strategies that will enhance the collection of premium should be developed and in addition, incentives can be introduced to encourage regular payment of premium.

(3) The period of claims settlement should be shortened and some of the rigours policy holders undergo before getting their claims should be eliminated.

(4) The level of expenses on premium is very high, something must be done to reduce it.

(5) The current low level of investment in inventory (about 2% of total investment in current assets) should be reduced further.

(6) Insurance firms should set up a committee of experts to work out industrial ratio averages for the industry.

(7) Lastly, other methods of investing idle cash (besides bank deposit and investment in securities) should be exploited, investment in securiteis should be increased.

5.2 CONCLUSION

Working Capital Management involves the effective and efficient management of all the components of working capital. With proper management of working capital, a firm should be able to maintain an optimum level of net working capital i.e a reasonable excess of current asset over current liabilities. The research findings show that not all the components of the working capital are properly managed by the firms used as a case study.

A situation where cash retained at hand and Bank amounted to over 30% of the total current asset is, in my judgement, a faulty financial strategy. While it is wise to have sufficient cash to meet demands, it is a financial blunder to hold up funds amounting to over 30% of current asset in 'idle' use. Part of this money should be put into a more profitable use.

Investment in marketable securities is gaining grounds in the insurance industry going by the findings of this research. However, this policy may lack consistency in the insurance industry as an entity. For instance, one of the firms investigated had investment in short-term securiteis averaging over 70% of current assets; another has a steady decline from 15.86% in 1993 to 5.22% in 1995 with a slight pick to 6.75% in 1996. Having 6.75% of total current assets as investment in short term securities is grossly in adequate. Since most transactions in this industry are mainly in cash and since it is financially unadvisable to keep cash idly, it is the

opinion of the researcher that a large proportion of idle cash should be tied up in short term investments. This has a dual advantage of meeting short-term cash requirement and profit generation.

There is unanimity as far as investment in inventory is concerned among the firms investigated. This averaged about 2.0% of the total investment in current asset. This is a good approach as no stock other than printed documents are generally needed for the day to day running of these companies. Infact, the bearest minimum fund should be tied up here since printed documents can be ordered within the shortest possible time.

The level of accounts receivables should not be high, idealy, the lower the better. However, it is important to bear in mind that customers would naturally prefer a firm with a better line of credit, but is should not be at the detriment of business has problems. Findings show that Guinea Insurance has problems with the management of this component of its working capital. For instance its receivables rose from 71.64% in 1993 to 83.03% in 1996 (see table 4.2). On the other hand, that of First Nigerian Insurance is quite low, the company can extend more credit facilities in order to get more patronage.

The average collection period for both UNIC and First Nigeran Insurance are satisfactory and good respectively. In the case of Guinea Insurance the situation is bad. The company has an average collection period of over 300 days.

The figures of the gross and net profit margins for the three firms are poor. The main reason being the huge expenditure on premiums. For the three firms, expenses on premiums exceeded 80% of the premiums collected. Definite steps must be taken to address this situation if the insurance industry is to survive.

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APPENDIX 1

QUESTIONNAIRE FOR WORKING CAPITAL MANAGEMENT

Please read the following questions carefully and circle or tick one of the answers provided. This exercise is purely academic and will be treated confidentially.

What is your position?.....
What is the name of your firm?.....

1. In what year was your company incorporated? 19.....

2. Do you have an account/Finance department in your firm?
   (a) Yes (b) No
3. How many bank accounts do you operate? .....
4. What level of cash do you maintain in your bank account (averagely)?
   a. Over ₦10m
   b. ₦6 - 10m
   c. ₦3 - 5m
   d. ₦1 - 2m
5. Do you hold cash in your organisation? (a) Yes (b) No
6. What level of cash do you keep?
   a. Over ₦5m
   b. ₦3m - 5m
   c. ₦1 - 2m
   d. Less than ₦1m
7. If cash required is more than cash at hand and in the bank account, how is the shortfall usually sourced?
   a. Through overdraft
   b. Through bank-loan
   c. Security trading (i.e. selling of securities)
   d. Factoring
8. Can you accurately estimate claims for a given financial period?
   (a) Yes (b) No
9. In the last six months, what has been the average cash requirement for short notice claims?
   a. Over ₦10m
   b. ₦5m - 10m
   c. Less than 5m
10. Which of the following classes of claims is most frequent in recent times?
    a. Death claims b. Maturity claims
    c. Consequential loss claims d. Burglary claims

11. To what extent is credit control put into use in your firm?
    a. Very frequently
    b. Frequently
    c. Not Frequently
    d. No credit control at all

12. With your credit control in operation, to what extent is default minimized?
    a. Highly minimized
    b. Averagely minimized
    c. Not minimized

13. Do you carry out age analysis of your receivables periodically?
    (a) Yes (b) No

14. What constitutes the bulk of your accounts payable?
    a. Unpaid claims
    b. Reinsurance premium
    c. Wages due to workers
    d. Taxes due to Government

15. Which of the following constitute the major area(s) of investment of excess fund by your firm?
    a. Commodity trading
    b. Real estate
    c. Marketable securities
    d. Bank deposit

16. What percentage of total assets is working capital in your firm?
    a. Less than 50%
    b. 50 - 70%
    c. Over - 70%

17. Which of the following make up the working capital in your organisation?
    a. Cash
    b. Securities
    c. Inventory
    d. Accounts receivable

18. Please assign percentages to '17' above.