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INSURANCE INDUSTRY AND ITS FINANCIAL RATIOS

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Abstract

Financial statements tell the financial health of a company, and people with finance background can make conclusionon firms' performance based on these financial statements. However, audience with almost any background canget a good understanding of company's performance, its performance relative to its peers or industry, simply by reviewing financial ratios of the company. Financial ratios arein-fact often used by people in management or in the accounting or finance areaswho have to make business decisions.These ratios providequick summary of most important financial information, touches every aspect of business, and comprehend financial statements in a most meaningful way that is precise and to the point and help decision makers reach right conclusions.

Balance sheet and Income statement are the most important financial statements and financial ratios can help interpret these statements. There are financial ratios that help understand how liquid a company is, how quickly a company can liquidate its assets if it has to, and whether it can pay off its short term and long-term debts on time. Financial ratios can also tell how much return stakeholders are getting in return for their investment, and can shed a light on management's performance. Financial ratios can also help understand how efficiently a company is rotating its inventory, collecting its dues from customers, or leveraging the credit provided by suppliers to the company.

We will discuss various financial ratios used in the financial sector with focus on an insurance industry. Insurance industry uses some ratios that are very industry specific and help understand performance of insurance companies.

Key Words: Financial Ratios, Insurance, Financial Statements, Balance sheet, Profit & Loss statement.

Financial Ratios

Financial ratios not just help understand growth and performance of a company but also help understand its performance relative to its peers and to its industry as well. This is important that a company be analyzed in relation to its peers or industry as that help understand whether the high returns a company is making is outstanding or not or whether the losses a company is making is due to management's inefficiencies or there is something going on that is impacting the whole industry. Financial ratios are grouped mainly into four major categories namely Profitability, Efficiency, Liquidity, and Leverage. We will discuss these financial ratios one by one in detail in this article.

One of the most important profitability ratio used in an insurance industry is the Combined ratio. Combined ratio shows whether a company is profitable or not. If the combined ratio is more than 100% then the company is making loss,and if the combined ratio is less than 100% then a company is making profit. Profit or loss is the difference between 100% minus the combined ratio.

Combined ratio comprises of two ratios i.e. Loss ratio and expense ratio. Insurance companies earn premium from policies it write but has to pay losses that arise from claims that these policies may bring. Loss ratio provides a measure of claims company pay against the premiums earned and it is calculated as claims paid divided by premium earned.

Insurance companies make underwriting expenses that are associated with acquiring, underwriting and servicing premiums. Expense ratio provide measure of such expenses against premiums written and is calculated as underwriting expenses divided by the written premiums.
While Premiums generate revenue for the company, claims or expenses are cost to insurance companies. Another revenue source is the investment income that a company generate by investing premiums it receives from policyholders. Thoughpremiums, expenses, and losses find their way in the combined ratio but investment income is not reflected in an combined ratio and could be due to the fact that investment income does not arise from core insurance business. Other important ratios are described below.
Profitability of an insurance companyis measured using ratios mentioned below.

1. Net profit margin
2. Return on Assets (ROA)
3. Return on equity (ROE)

Net Profit Margin help understand what percentage of total sales is left after operating expenses, taxes, interest and preferred stock dividends are taken out. Net Profit Margin is calculated by dividing net income from total revenues. By simply looking at this ratio, one can tell how a company is performing relative to its peers or its industry.

Return on Assetsor ROA is one of the most widely used ratio thatprovides an idea of how efficiently management is using assets in producing returns. ROA is calculated by dividing net income from total assets. There are well established industry benchmarks when it comes to ROA and merely comparing one company's ROA with the benchmark ratio, one can conclude performance of a company. This ratio is widely used by management, investors, and analysts in making company related decisions.

Return on Equity or ROE is another widely used ratio that provide an idea of how efficiently management is using shareholders' equity in producing returns. ROE also has established benchmarks per industry that can be used while evaluating ROE of a particular company. ROE is calculated by dividing net income from shareholders' equity.

Efficiency of company's management is measured using below ratios:

1. Accounts receivable turnover
2. Asset Turnover
3. Inventory Turnover

Accounts receivable turnover measures how efficiently or quickly a firm receive its credit back from its customer, it measures how aggressive a firm is in collecting back the credit it has given to its customer. Every firm or a company would like to keep this credit outstanding to minimum but because of business terms, firms has to give outstanding to its customer to begin with but a company need to make sure that those getting credit do not start misusing it as generally the case becomes. Accounts receivable turnover ratio can be calculated by dividing the net value of credit sales during a given period by the average accounts receivable during the same period.

Asset Turnoverhelp measure how efficiently a company is utilizing its assets and is generating revenue. Asset turnover is calculated as sales divided by average total assets. In other words, it aims to measure sales as a percentage of average assets to determine how much sales is generated by each dollar of assets. A simple example would be of a manufacturing unit where if machines installed are used only during day shift and product demand is more than production that asset turnover ratio can be further improved by using machines during evening or night shift as well to increase production and meet higher demand thus increasing revenues with everything else remain constant.

Inventory Turnover measures how efficiently or how quickly a company is selling or rotating its inventory that help company recoup its money quickly it spend on its inventory. If a company is not able to sell its inventory quickly then the cash remain invested in the inventory and a company can face cash crunch. Higher an inventory turnover better it is.

Below are the liquidity ratios used in the industry:

1. Current Ratio
2. Quick Ratio

Current Ratio

It is very important for a company to remain liquid otherwise it will have difficulty getting debt or paying upcoming debt timely if something untoward happens. Current ratio help measure liquidity of a company by comparing its current assets to its current liabilities, and is calculated by dividing current assets by current liabilities. Creditors heavily use this ratio to measure company's liquidity or ability to pay off short-term debts.

Quick Ratioratio is another liquidity ratio that is even more conservative than the current ratio. Quick ratio helps measure how quickly a company can liquidate its assets to pay its immediate debts. Quick ratio is computed as (Cash + Marketable Securities + Accounts Receivable) / Current Liabilities.

Whether a company is efficiently leveraging the debt can be measured using below ratios:

1. Debt-to-equity

2. Debt-to-assets

Debt-to-equity is a debt ratio that measure company’s financial leverage. This ratio indicate how much debt a company is using to finance its assets relative to the value of shareholders' equity. Debt-to-equity is calculated by dividing company's total liabilities by stockholders' equity. A high debt/equity ratio suggest that a company is aggressive in financing its growth with debt but the downsize is that company has to pay higher interest rate and faces higher default risk in case something goes wrong, whereas, a lower percentage means a company is using less leverage and has a stronger equity position.

Debt-to-assets is another debt ratio that provide the percentage or proportion of total asset financed by creditors, liabilities, or debt. The debt to total assets ratio is calculated by dividing corporation's total liabilities by its total assets.

Financial ratios help understand growth of a company over the past years, and possibility of profitable growth in the coming years. Management utilizes such ratios to understand current issues and then make strategies that help resolve those issues. Investors uses these ratios to understand returns they get on their investments and whether they should remain invested in the company or not. So basically,it becomes critical for everyone, who want to understand company’s finances and make wiser decisions, to have a better understanding of ratios covered in this article.