

**CAPITAL STRUCTURE AND FINANCIAL PERFORMANCE OF
NEPALESE INSURANCE COMPANIES**

A Dissertation Proposal

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1. Background of the Study

The insurance companies are non banking financial intermediaries that channelized funds from savers to users. This sector constitutes one of the fundamental building blocks of the global financial system. Insurance companies provide unique services to the growth and development of every economy. The importance given to this sector has been increasing every day in both developed and developing countries. The basic reason for this is the contribution provided on the economic growth process and on the level of national wealth (Kaya, 2015).

The capital structure of a firm describes the way in which a firm raised capital needed to establish and expand its business activities. It is a mixture of equity and debt capital that a firm maintained resulting from the firms financing decisions. In one way or another, business activity must be financed. Capital structure is an important issue from a financial standpoint because it is linked to the firm's ability to meet the objectives of its stakeholders (Simerly & Li, 2000). The capital structure decision is the vital one since the profitability of an enterprise is directly affected by such decision.

Modigliani and Miller (1958) argued that under the perfect capital market assumption that, if there is no bankrupt cost and capital markets are frictionless, if without taxes, the firm's value is independent with the structure of the capital. The theory of capital structure and its relationship with a firm's value and performance has been a puzzling issue in corporate finance and accounting literature since the debt can reduce the tax to pay, so the best capital structure of enterprise should be one hundred percent of the debt. Since then, several theories have been developed to explain the capital of a firm including the Pecking order theory, Static Trade-off theory and agency cost theory. The firm's decision about its source of capital will affect its competitiveness among its peers. Therefore, firm should use the appropriate mix of debt and equity that will maximize its profitability and its value.

Financial performance is a measure of an organization's earnings, profits, appreciations in value as evidenced by the rise in the entity's share price. Financing in capital structure is a most important they are directly related to profitability decision. Financial performance of a firm can be analyzed in terms of profitability, dividend growth, sales turnover, assets base, capital employed among others. However, there is still debate among several disciplines regarding how the performance (Panagiotis & Skandalis, 2010). In insurance Company, performance is normally expressed in terms of annual premium, net premiums earned, and profitability from underwriting activities, returns on

investment and return on equity. These measures can be classified as profit performance measures and investment performance measures. The relationship between capital structure and profitability has been the subject of remarkable milestone over the past decade throughout the irrelevance theory.

Profit is the essential pre-requisite for the survival, growth and competitiveness of business enterprises and the cheapest source of funds. Without profits outside capital cannot be attracted to meet their set objectives in this ever changing and competitive globalized environment. Profit does not only improve upon company`s solvency state but it also plays an essential role in persuading debt holders and shareholders to supply funds to the company. Thus, one of the objectives of company management is to attain profit as an underlying requirement for conducting any business (Chen & Wong, 2004).

The capital structure decision is critical for the continued existence of any business organization so as to maximize returns to stakeholders (Akintoye, 2008). Many studies have been carried out to investigate the relationship that exists between capital structure and performance. Some studies revealed a positive relationship between capital structure and performance (Akintoye, 2008; Dare & Sola, 2010), while other reported a negative relationship between capital structure and performance (Iorpev & Kwanum, 2012). Still, some studies indicated that there is no relationship between capital structure and performance (Prahathan & Rajan, 2011).

2. Problem Statement

Insurance companies contribute significantly to financial intermediation of the economy. As such, their success means the success of the economy; their failure means failure to the economy (Ansah-Adu, Andoh, & Abor, 2012). Friend and Lang (1988) found a significantly negative relation between profitability and total debt ratio. Hence, these types of research findings will be benefited in determining the capital structure to achieve the optimum level of firm`s profitability.

More specifically, the study deals with following issues:

- What is the structure and pattern of capital structure and financial performance variables in Nepalese insurance industry?
- Is there any relationship of total debt ratio and equity to total assets ratio on financial performance of Nepalese insurance companies?
- What is the relationship of firm size, liquidity and assets tangibility on financial performance of Nepalese insurance companies?

3. Objectives of the Study

The general objective of the study is to assess the impact of capital structure on financial performance of Nepalese insurance companies. The specific objectives are as follows:

- To analyze the structure and pattern of capital structure and firm performance variables in Nepalese insurance industry.
- To investigate the relationship of capital structure variables on financial performance variables.
- To examine the relationship of firm size, liquidity and assets tangibility on financial performance.

4. Hypothesis

The study will test following priori hypotheses to reach to the conclusion on the issues raised in research questions.

H1: Total debt to total assets ratio is negatively related to financial performance.

H2: Equity to total assets ratio is positively related to financial performance.

H3: Bank size is positively related to financial performance.

H4: Assets tangibility is positively related to financial performance.

H5: Liquidity is positively related to financial performance.

The bases of developing these hypotheses are discussed in details in section 7.4.

5. Rationale of the Study

Insurance companies plays vital role in the financial service industry in almost developed and developing countries, contributing to economic growth, efficient resource allocation, creation of liquidity, facilitation of economies of scale in investment and spread of financial losses (Haiss & Sumegi, 2008). This study aims to analyze the impact of debt and equity on financial performance in the insurance companies. Determination of optimal capital structure is an important task of effective financial management (Pandey, 2009). Therefore, this study is expected to provide the empirical evidence about the impact of capital structure on financial performance of Nepalese listed Insurance companies.

It provides the applicable and practical understanding to anyone who wishes to understand the important dimension of capital structure and financial performance. This study especially will help the managers to take the financing decision for their firms. The creditors can also take the benefit to minimize their risk. This study will be beneficial to Nepalese insurance company in order to increase the financial performance by determining the optimal capital structure. This study contributes the useful information to the shareholders, promoters, management, regulators and other stakeholders of insurance companies. This study may help the companies and stakeholders to allocate their funds more effectively. Furthermore, the study will also be relevant to the upcoming researcher to investigate the impact of capital structure and firm performance.

6. Review of the Literature

6.1 Theoretical Review

Different books, research papers, articles which deal with theoretical aspects of capital structure and financial performance are reviewed in this sub-section dividing into different sub-headings.

6.1.1 Theories of Capital Structure

In the literature of capital structure, besides theory of capital structure developed by [Modigliani and Miller \(1958\)](#), four main important but conflicting theories have been developed. This includes the trade-off theory, agency costs theory developed by [Jensen and Meckling \(1976\)](#), signaling hypothesis theory developed by [Ross \(1977\)](#) and pecking order theory developed by [Myers and Majluf \(1984\)](#). Apart from that, there are two very recently developed theories/models to explain the capital structure choices of firms, namely, model based on product/input and output market interactions initiated by [Titman \(1984\)](#) and model based on market timing developed by [Baker and Wurgler \(2002\)](#). These theories are discussed below shortly.

6.1.2 Modigliani-Miller's Approach

In their seminal work on capital structure, [Modigliani and Miller \(1958\)](#) show that financing decisions do not matter in perfect capital markets. They argue a firm's operation, and not its financing decisions, determine its total value. The Modigliani and Miller's approach is a cornerstone in corporate finance. They start with the question what is the cost of capital to a firm? They formulate two propositions, Proposition I and II. Proposition I states that the market value of a firm is independent of its capital structure.

That is, the average cost of capital for a firm is completely independent of its capital structure, and it is equal to the capitalization rate of a pure equity stream of its class. Derived from Proposition I, Proposition II states that the expected yield of a share is equal to the appropriate capitalization rate plus a premium related to financial risk equal to the debt-to-equity ratio. Their propositions are based on the following assumptions:

- i. Investment opportunities of the firm remain fixed.
- ii. Investors have homogeneous expectations about future corporate earnings and the volatility of these earnings.
- iii. Capital markets are perfect, e.g., there are no transaction costs, and taxes and investors can borrow at the same rate as the companies.
- iv. There are no bankruptcy and reorganization costs.
- v. Debt is risk free and the interest rate on debt is the risk-free rate.
- vi. The business risk of a firm can be measured by the standard deviation of earnings, and firms can be grouped into distinct business sectors.

In this regards, [Miller \(1991\)](#) explains the intuition of the theorem with a simple analogy. “Think of the firm as a gigantic tub of whole milk. The farmer can sell the whole milk as it is. Or he can separate out the cream, and sell it at a considerably higher price than the whole milk would bring”. He continues, “The Modigliani-Miller proposition says that if there were no costs of separation, (and, of course, no government dairy support program), the cream plus the skim milk would bring the same price as the whole milk”. “The essence of the argument is that increasing the amount of debt (cream) lowers the value of outstanding equity (skim milk) –selling off safe cash flows to debt-holders leaves the firm with more lower valued equity, keeping the total value of the firm unchanged. Put differently, any gain from using more of what might seem to be cheaper debt is offset by the higher cost of riskier equity. Hence, given a fixed amount of total capital, the allocation of capital between debt and equity is irrelevant because the weighted average of the two costs of capital to the firm is the same for all possible combinations of the two”.

6.1.3 Static Trade-Off Theory of Capital Structure

The trade-off theory originated from the debate over the [Modigliani and Miller \(1958\)](#) theorem. This theory, as originally introduced by [Kraus and Litzenberger \(1973\)](#), suggests that firms balance the tax benefits of debt against the deadweight costs of financial distress and bankruptcy. Under static trade-off theory, managers are believed to seek optimal capital structure which could maximize the value of the firm. This optimal

leverage is determined by balancing the benefits and costs associated to debt capital. The benefits of debt capital include the tax deductibility of interest and the reduction of free cash flows. The costs of debt include potential bankruptcy costs and agency cost due to conflicts between stockholders and bondholders.

In their second seminal paper, [Modigliani and Miller \(1963\)](#) incorporate the corporate tax and contend that the value of the firm, if levered, equals the value of the firm if unlevered plus the value of the tax benefit. But they ignore the agency and bankruptcy costs as in their previous work of 1958. To certain limits, the presence of agency and bankruptcy costs of debt will be less than its tax benefits, suggesting that there is some threshold level of debt, under which the value of the firm is maximized. This threshold of debt is generally called the optimal (target) level of debt and is defined by the trade-off between costs of debt and its benefits. More precisely, it is the point where the marginal costs equal to marginal benefits of each unit of debt. Beyond that point the benefits of debt will be less than its cost which reduces the value of the firm.

This theory states that optimal capital structure is obtained by balancing the tax advantage of debt financing and leverage related costs such as financial distress and bankruptcy, holding firm's assets and investment constant. The standard presentation of static trade-off theory is provided by [Bradley, Jarrell, and Kim \(1984\)](#). They made the following conclusion based on their static trade-off model.

- i. An increase in the costs of financial distress reduces the optimal debt ratio.
- ii. An increase in non-debt tax shield reduces the optimal debt ratio.
- iii. An increase in the personal tax rate on equity increases the optimal debt ratio.
- iv. At the optimal capital structure, an increase in the marginal bondholder tax rate decreases the optimal debt ratio.
- v. The effect of risk is ambiguous, even if uncertainty is assumed to be normally distributed. The relationship between debt and volatility is negative.

According to Myers (1984), firms adopting this theory could be regarded as setting the target debt ratio and gradually moving towards achieving it. The static trade-off theory also suggests that higher profitable firms have higher target debt ratio (this contradicts with the pecking order theory which suggests higher profitability firms have lesser debt). Higher profitability firms ensure higher tax saving from debt, lower probability of bankruptcy and higher over-investment and these require a higher target debt ratio.

6.1.4 Agency Cost Theory of Capital Structure

The next important theory mentioned in the literature of capital structure is the agency cost theory. It is worth noting that the tax advantage of debt is not only the sole reason for using debt. As suggested by Jensen and Meckling (1976) and [Jensen \(1986\)](#), using debt is a mechanism to mitigate the agency costs of managers-shareholders conflicts. The agency theory of Jensen and Meckling addresses the incentive problems that could arise due to the separation between ownership and control. This separation may provide them with the incentive to maximize their wealth in a way that may harm stockholders. The managers may conduct actions that are costly to shareholders, such as consuming excessive perquisites or over-investing in unprofitable activities or to overvalue the investment requirements and to take the difference between the dummy value and real value of the investment. The conflict of interest between managers and shareholders and thereby its costs will significantly increase when managers have free cash under control. [Jensen \(1986\)](#) addresses the agency problem in his free cash flow theory where he defines free cash flow as “cash flow in excess of that required funding all projects that have positive net present value when discounted at the relevant cost of capital”. Accordingly, when managers have more cash flow than is needed to fund all of the firm’s available profitable projects, they will have the incentive to invest the excess cash in unprofitable projects. [Stulz \(1990\)](#) calls this cost an over-investment cost of managerial discretion and defines it as “ the expected cost to the shareholders that arise because management invest cash flow in excess of that available to fund positive net present value projects in negative net present value projects”. Hence, profitable firms are expected to experience high costs of free cash flow because the probability of having excess cash for consuming more perquisites or investing in less profitable projects will be high. These firms are expected to have more debt to reduce the amount of funds available under management control.

[Jensen \(1986\)](#) points out that since debt commits the firms to pay out cash, it reduces the amount of discretionary funds available to managers to engage in the type of pursuits that managers want but are not in the interest of equity holders. Hence, using debt forces the managers to meet their promise to pay future cash flows to the debt-holders. By doing so, managers give the bondholders the right to take the firm to the bankruptcy court if they do not maintain their commitment to make the interest and principal payments. Here, debt works as a disciplining tool because default allows creditors the option of forcing the firm into liquidation ([Harris & Raviv, 1990](#)). Furthermore, [Lasfer](#)

(1995) argues that debt finance creates a motivation for managers to work harder and make better investment decision.

However, the benefit of debt in mitigating the agency cost of free cash flow is more effective in firms that generate a substantial amount of free cash flow but have poor investment opportunities, where the probability of investing free cash flow in unprofitable projects is high (Jensen, 1986). While, for rapidly growing firms with large and good investment opportunities but who have no free cash flow, debt will not be effective. It exacerbates the conflict between debt holders and shareholders and thereby its costs. In addition to its role in mitigating the agency cost of free cash flow, debt provides management with the benefit of maintaining control where, a high control benefit includes stockholders to issue debt rather than equity because debt holders have no voting rights as equity (Harris & Raviv, 1990). If it is the case, the firm will prefer debt not equity for balancing the control consideration (Baskin, 1989; Allen, 1993).

In summary, the introduction of debt decreases stockholder-manager agency costs, but as the use of debt increases stockholders and bondholders agency costs arise. For a large amount of debt, these costs will exceed the stockholder-manager agency costs savings.

According to Jensen and Meckling (1976), the trade-off between these costs results in an optimal capital structure. In a traditional tax and bankruptcy model, the stockholder manager agency costs savings and stockholders and bondholders agency costs are not considered. Tong and Green (2005) argue that the modern version of trade-off theory is based on trade-offs among agency costs, implying that value-maximizing firms consider all the costs and benefits of debt when setting their optimal or target capital structure.

6.1.5 Signaling Hypothesis of Capital Structure

Signaling hypothesis of capital structure management is introduced by Ross (1977) who indicates a positive relationship between profitability and leverage against the pecking order theory which states the negative relationship between profitability and leverage. The basic idea of signaling hypothesis is that the choice of capital structure signals outside investors the information of the insiders. According to Ross, managers, whom are known as insiders know the true distribution of firm returns, but investors do not. The managers feel more relax with equity than debt as debt can lead to managers losing jobs if firms go bankrupt. Knowing this fact, if managers keep on adding more debt in the capital structure of the firms, which reflects a 'signal of higher future cash flow' and their managers' confidence of the firms. Investors take high level of debt as a signal of

'higher quality' and therefore, profitability is expected to be positively related to leverage. Mixed results are found in the literature with respect to the effect of signaling on the capital structure decisions.

Jensen, Solberg, and Zorn (1992) show a negative relationship between leverage and signaling. In their study, signaling is represented by the dividend payment and debt issues in this case behave as a substitute in mitigating agency problems. On the other hand, John and William (1985) argue a positive relationship with signaling. A firm with the reputation of dividend payment as the measure of signaling faces with less asymmetric information in accessing the equity market. When dividend payment represents a signal of better financial health, then more debt taking capacity is created and therefore a positive relationship is noted. However, Bhaduri (2002) finds that signaling appeared insignificant in determining leverage.

6.1.6 Pecking Order Theory of Capital Structure

The pecking order theory, first proposed by Myers and Mujluf (1984) and Myers (1984), is based on the notion of asymmetric information between firm insiders and outsiders and the resulting adverse selection problems. This theory is another important theory in the study of capital structure. Managers will have more information about the true value of a firm's assets and future growth opportunities than outside investors, and hence investors closely observe financing decisions to infer information about a firm's prospects. In contrast to the trade-off theory, the pecking order theory has no predictions about an optimal debt ratio. It rather posits that a firm's capital structure is the result of the firm's financing requirements over time and its attempt to minimize adverse selection costs.

Managers as firm insiders tend to have superior information about the value of the firm, and hence they will be reluctant to issue new equity when they feel that the firm is undervalued because issuing new equity leads to a dilution of the shares of existing shareholders. Put differently, new shareholders would benefit at the expense of old shareholders, who are in turn likely to object to the new issue. The only time that a firm issues equity is when managers feel that it is currently overvalued. By announcing an issue, a firm essentially sends a signal to the market that its equity is too expensive, and one indicator for adverse selection costs is the empirically observed drop in share prices

on the announcement day. Accordingly, the optimal decision for a firm to satisfy its financing needs is to use internal funds whenever available; such financing avoids all asymmetric information problems. If internal funds are depleted, a firm will next issue debt because the value of debt as a fixed claim is presumably less affected by information asymmetry than equity, which serves as a residual claim. Hybrid securities, such as junior debt or convertible debt are the next source of financing, while equity only serves as the very last financing alternative. Thus, the pecking order theory ranks financing sources according to the degree they are affected by information asymmetry, where internal funds exhibit the lowest and equity the highest adverse selection costs.

6.1.7 Market Timing Theory of Capital Structure

Market timing theory primarily advocates that capital structure evolves as the cumulative outcome of past attempts to time the equity market (Baker & Wurgler, 2002). They document that market timing efforts have a persistent impact on corporate capital structure and firms prefer equity when the relative cost of equity is low and prefer debt otherwise. They argue that neither the trade-off theory nor the pecking order theory is consistent with the persistent negative effect of a weighted average of a firm's past market-to-book ratios on firm leverage. Instead, the authors suggest that firms time their equity issues to stock market conditions. They contend an ad hoc theory of the capital structure, where the observed capital structure is not the result of a dynamic optimization strategy but merely reflects the cumulative outcome of past attempts to time the equity market.

Empirical studies document that market timing plays an important role in shaping financing activities exacerbates the deviations from leverage targets in the short-run (Leary & Roberts, 2005; Altı, 2006; Kayhan & Titman, 2007). Moreover, these studies indicate that deviations do reverse, suggesting that the trade-offs underlying the target have non-negligible effect on firm value. Overall, these findings support a modified version of the dynamic trade-off theory of the capital structure that includes market timing as a short-term factor.

6.2 Review of Past Studies

Taub (1975) examined the factors influencing a firm's choice of a debt equity ratio. For this study a total of 89 firms from United States were chosen randomly over a period of ten year from 1960 to 1969 and the likelihood-ratio statistics and t-test were used to test

the hypothesis described therein. The empirical results of the study in terms of the expected sign of the co-efficient were mixed. The return to the firm, long term rate of interest and size of the firm revealed a positive influence on firm's debt equity ratio as per the expectation. The impact of tax rate on debt equity ratio was negative which is contrary to both the Traditional view and the Modigliani-Miller approach. The period of solvency had negative relation with leverage although not significant. The tax rate had negative and significant relation with debt equity ratio.

[Poudel \(1994\)](#) analyzed the relationship between capital structure and profitability and found that size, profitability, growth, assets structure and cash flow variability have the influence on the capital structure. The study also observed that size and growth were positively related to leverage and risk, profitability and assets structure were negatively related to leverage.

[Baral \(1996\)](#) found positive relationship of leverage with growth opportunities, profitability, non-debt tax shield (statistically not significant), interest coverage ratio, and operating cash flows; and negative relationship of leverage with business risk. The study further concluded that the capital structures of public enterprises are not sound; debt capital has not been raised to reap advantages of leverage.

[Sunder and Myers \(1999\)](#) analyzed the effect of four factors: assets tangibility, growth opportunities, company's tax status and profitability on the capital structure (debt ratio) of 157 American companies in the period of 1979 to 1981. Research results indicated a significantly positive relationship between assets tangibility with debt ratio and a significantly negative relationship between debt ratios with firm profitability. Moreover, there is no significant relationship between two variables, growth opportunities and the tax status with the debt ratio.

[Gajurel \(2005\)](#) analyzed capital structure management in Nepalese enterprises in order to explain the capital structure pattern and its determinants for a panel set of twenty non-financial firms listed in NEPSE for 1992-2004. By using decomposition analysis, properties of portfolio analysis, econometric analysis and opinion survey of managers, the study found that Nepalese firms are highly levered, however the long term debt ratio is significantly low. The study found that assets structure and size are observed positively related to leverage. The signs of estimate suggest that both pecking order and tradeoff theories are at work in explaining capital structure of Nepalese companies.

[Zeitun and Tian \(2007\)](#) investigated the effect which capital structure has had on corporate performance using a panel data sample representing of 167 Jordanian

companies during 1989- 2003. Return on assets, return on equity and Tobin's Q were used to evaluate the performance of the firms the different debt and equity levels including the short term debt and long term debt. The results showed that all the capital structure variables including short term debt, total debt, long term debt and total equity have a significantly negative impact on firm performance in all performance variables except that short term debt has a positive impact on the Tobin's Q.

[Ebaid \(2009\)](#) examined the capital structure and performance of firms to check the relationship between debt level and financial performance of companies listed at Egyptian stock exchange during the period of 1997 to 2005. Return on assets, return on equity and gross profit margin are the three accounting based measure of performance. The study found that there is negative significant influence of short term debt and total debt on the financial performance measured by the return on assets. Significant relationship is not found between long term debt and this measure of financial performance. The study also proposed that there is not significant influence of the debt (TD, STD AND LTD) on financial performance measured by both gross profit margin and return on equity. The results also indicated that control variable firm size has no significant effect on the firm's performance.

[Safarova \(2010\)](#) analyzed the factors that determine firm performance of New Zealand listed companies and discovered that size is the most important factor determining firm performance, followed by growth and leverage, while other factors such as tangibility, corporate governance, cash on hand and risk appeared to be marginally related to firm operating performance.

[Salim and Yadav \(2012\)](#) examined the influence of capital structure on company financial performance for the 237 Malaysian listed companies over the period of 1995-2011 using panel data analysis. The study used four performance metrics namely, earning per share, return on equity, Tobin's Q and return on asset as dependent variables and three measures for capital structure as independent variables namely, short term debt divided by total assets, long term debt divided by total assets and total debt ratios, while Size and growth used as control variables. The findings indicate that company performance ROA, ROE and EPS, adversely influence on long term debt ratio (LTD), short term debt ratio (STD) and total debt ratio (TD), while growth positively effects on financial performance for all the sectors. In addition, Tobin's Q has a positive and significant impact on short term debt (STD) and long term debt (LTD).

Mohammad, Ebrati, Mohammad, and Bakhshi (2013) investigated the impact of capital structure on firm performance by using four of accounting-based measures of financial performance (i.e. return on equity (ROE), return on assets (ROA), market value of equity to the book value of equity (MBVR), Tobin's Q), and based on a sample of non-financial Iranian listed firms from 2006 to 2011. Results indicated that firm performance which is measured by (EPS and ROA) is negatively related to capital structure.

Goyal (2013) examined the effect of capital structure on the profitability of listed banks in India during 2008 to 2012. The multiple regression analysis is used to determine the relationship between dependent variable (short term debt to total capital, long term debt to total capital, total debt to total capital) on the independent variable (ROA, ROE and earning per shares). The control variables used are firm size (SIZE) and firm asset growth (AG). Results showed there is positive relationship between short-term debt with profitability measured by ROA, ROE and earning per shares (EPS).

Adesina, Nwidobie, and Adesina (2015) analyzed the impact of post-consolidation capital structure on the financial performance of Nigerian quoted banks. The study used profit before tax as a dependent variable and two capital structure variables (equity and debt) as independent variables. The sample for the study consists of ten Nigerian banks quoted on the Nigerian Stock exchange (NSE) and period of eight years from 2005 to 2012. Ordinary least square regression analysis of secondary data showed that capital structure has a significant positive relationship with the financial performance of Nigeria quoted banks.

Shams and Shahid (2016) investigated firm-level characteristics and macroeconomic determinant that influence Capital Structure Decision of insurance industry in Pakistan from the study period of 1999 to 2013. The Hausman's specification and Breusch, and Pagan Lagrange Multiplier Test are employed to find out the most appropriate models among fixed effects, random effect and pooled regression model. The tests confirm that pooled regression model and fixed effect model are the most prominent models for the study. In addition, the findings of the study revealed that profitability and business risk are inversely but significantly related with debt across both estimation techniques. The negative relationship of profitability and business risk with debt confirm Pecking Order Theory. However, tangibility of assets and inflation rate are positive and statistically significantly effect on Leverage, which supports Trade off Theory.

[Naeem, Misbah, Sidra, and Hafiz \(2016\)](#) examined the effect of capital structure (debt to equity) on profitability, liquidity, tangibility, interest rate and growth rate to measure performance of banking sector of Pakistan. The study included five banks annual reports between 2005 and 2015. The study used pooled analysis to summarize the data for correlation and regression. The result showed that there are positive significant relationships between profitability, tangibility, liquidity, interest rate, and growth rate and capital structure.

The Board of Directors or the financial manager of a company should always endeavor to develop a capital structure that would lie beneficial to the equity shareholders in particular and to the other groups such as employees, customers, creditors and society in general ([Pandey, 2009](#)).

[Basnet \(2015\)](#) examined whether standard determinants of capital structure such as profitability, assets tangibility, size, collateral, business risk dividends, gross domestic product growth and inflation impact the capital structure of Nepalese commercial banks. The study concluded that standard determinants of banks' capital structure do affect the market leverage of the banks and capital structure theories- trade-off and pecking order is complementary for the Nepalese commercial banks.

According to [Pradhan and Pokharel \(2016\)](#) capital mix should be managed in optimum level so that the performance can be high. Lack of proper and prompt understanding about the capital structure factors and its effect on the financial performance of commercial banks can lead to bank failure which can be a significant cause of economic degradation. The study is based on pooled cross sectional data analysis of 19 commercial banks listed in NEPSE for the period of 2007/8-2013/14 with 133 observations. The results showed that total assets ratio have negative impact on net interest margin. The study concluded that size and credit risk are the major factors affecting the financial performance of commercial banks in the context of Nepal.

[Parajuli \(2016\)](#) examined the factors influencing the profitability of domestic and foreign commercial banks of Nepal. The return on assets, return on equity and net interest margin are selected as the dependent variables. Capital adequacy, assets quality, liquidity and bank sizes the analysis was based on a panel data set of 18 domestic commercial banks and 6 foreign commercial banks in Nepal over the period of 2008/09 - 2012/13. A multiple regression model has been applied to estimate the relationship between dependent variables with independent variables. The relationship of capital adequacy is positive and significant with return on assets, return on equity and net

interest margin. Similarly, assets quality is positively related to banks profitability. Likewise, liquidity is also positively related to bank profitability and significant with return on assets, return on equity and net interest margin. Similarly, bank size is positively related to domestic and foreign commercial banks return on assets, return on equity and net interest margin.

[Maharjan \(2017\)](#) examined the effect of capital structure on profitability of Nepalese commercial banks. Return on assets, return on equity and net interest margin are selected as firm performance whereas long term debt to equity ratio, total debt to equity, credit risk, bank size and liquidity are selected as capital structure variables. The study is based on 17 commercial banks of Nepal from 2009 to 2014. The study indicated that long term debt to equity ratio, total debt to equity ratio, bank size and liquidity position are negatively related to firm performance. However, there is positive relationship of credit risk with firm performance.

6.3 Research Gap

Capital structure is concerned with the basic financing decision of firms. Such fund is invested in assets to generate revenue and support to fulfill the organizational goal. Efficient capital structure and financial performance are the key components of organizational success. The concept of optimal capital structure has been developed from the literature of developed countries. Same situation holds on financial performance. The study has focused on listed insurance companies of Nepal. Whether the literature on capital structure and financial performance of developed countries is applicable in developing countries like Nepal or not? This study focuses to fill the gap between existing theory and its implication in Nepalese insurance industry by determining the impact of capital structure decision on financial performance of during 2009/10-2018/19.

7. Research Methodology

7.1 Research Design

This study will employ descriptive and causal comparative research designs. The descriptive research design will be adopted for fact-finding and adequate information gathering about the fundamental issues associated with capital structure variables affecting financial performance of Nepalese insurance companies. It explains the real and actual condition, situation and facts.

The study will also adopt causal comparative research design to establish the cause and effect relationship between capital structure and financial performance of Nepalese insurance companies.

7.2 Population and Sample, and Sampling Design

There are 39 insurance companies currently operating in Nepal (Insurance Board, 2019). These 39 insurance companies comprise the total population of the study. In order to examine the impact of capital structure on financial performance of Nepalese insurance companies, this study will contain a sample of 14 insurance companies out of total 39 insurance companies. Seven life insurance companies will be selected based upon operational period of 10 years excluding fully government owned and full foreign investment. Remaining seven nonlife insurance companies will be selected using random sampling method. Respective data will be collected from the time period of 2066/67 to 2075/76 leading to a total of 140 observations. Table 1 presents the list of sample companies that will be selected for the study along with the study period and number of observations. The study is based on the 140 observations.

Table 1

List of the Non Financial Companies of Nepal Selected for the Study along with the Study Period and Number of Observations

S.No.	Name of companies	Study period	Observations
1	Asian Life Insurance Company Limited (ALICL)	2066/67-2075/76	10
2	Gurans Life Insurance Company Limited (GICL)	2066/67-2075/76	10
3	Himalayan General Insurance Company Limited (HGI)	2066/67-2075/76	10
4	Life Insurance Corporation Limited (LIC)	2066/67-2075/76	10
5	National Life Insurance Company Limited (NALIC)	2066/67-2075/76	10
6	Nepal Life Insurance Company Limited (NLIC)	2066/67-2075/76	10
7	Prabhu Insurance Limited (PICL)	2066/67-2075/76	10
8	Premier Insurance Company (Nepal) Limited (PRIC)	2066/67-2075/76	10
9	Prime Insurance Company (Nepal) Limited (PMICL)	2066/67-2075/76	10
10	Prudential Insurance Company Limited (PUICL)	2066/67-2075/76	10
11	Sagarmatha Insurance Company Limited (SGIC)	2066/67-2075/76	10
12	Shikhar Insurance Company Limited (SHICL)	2066/67-2075/76	10
13	Surya Life Insurance Company limited (SLICL)	2066/67-2075/76	10
14	United Insurance Company (Nepal) Limited (UIC)	2066/67-2075/76	10
Total number of observations			140

7.3 Nature and Sources of Data, and the Instrument of Data Collection

This study will be based on secondary data. The variables used in the study are categorized into total debt ratio, equity to total assets, firm size, liquidity ratio, assets tangibility, return on assets and earnings per share. The secondary data and information will be collected from annual reports of the selected insurance companies. The secondary data regarding the dependent and independent variables of the sample companies will be collected and coded with unique code for each sample insurance company so that the data would be easily identified and assessed. The secondary data consists of financial data of sampled companies during the sample period of 2066/67 to 2075/76 covering the period of 10 years.

7.4 Methods of Analysis

Descriptive, co-relation and regression methods of analysis will be used in the study. The descriptive statistics will contain mean, standard deviation, minimum and maximum values of variables that will explain the characteristics of sample firms. The correlation analysis will be used to measure the direction and magnitude of relationship between dependent and independent variables and the regression analysis to find out the influence of independent variable over dependent variable solely and combined with other variables. It will explain the different statistical tests of significance for validation of model like t-test, F-test and linear regression analysis. All models will be tested for individual effects by running F-test using statistical package for social science (SPSS 20).

Model Specification

The econometric models employed in this study tries to analyze the relationship between capital structure and firm performance. The following regression model is used in this study to examine the empirical effect of capital structure on financial performance of Nepalese insurance companies. Thus, the following model equation is designed to test the hypothesis. From the conceptual framework the function of dependent variables (i.e. financial performance) takes the following form:

$$\text{Financial performance} = f (\text{TDR, ETA, LEV, SIZE, LQ, TANG}).$$

More specifically, the given model has been segmented into following models:

Model 1

In this model, the dependent variable is return on assets (ROA) indicated by percentage of net income to total assets. Total debt ratio, equity to total assets, leverage, firm size, liquidity ratio and assets tangibility are independent variables which are tested on return on assets. The model is presented as follows:

$$ROA_{it} = \beta_0 + \beta_1 TDR_{it} + \beta_2 ETA_{it} + \beta_3 LEV_{it} + \beta_4 SIZE_{it} + \beta_5 LQ_{it} + \beta_6 TANG_{it} + e_{it}$$

Model 2

In this model, the dependent variable is earnings per share (EPS) indicated by net income to outstanding share of common stock, in Rupees per share. Total debt ratio, equity to total assets, leverage, firm size, liquidity ratio and assets tangibility are independent variables which are tested on price earnings ratio. The model is presented as follows:

$$EPS_{it} = \beta_0 + \beta_1 TDR_{it} + \beta_2 ETA_{it} + \beta_3 LEV_{it} + \beta_4 SIZE_{it} + \beta_5 LQ_{it} + \beta_6 TANG_{it} + e_{it}$$

Where,

β_0 is the constant term; β is coefficient of variable; ROA=Return on assets; EPS=Earnings per share; TDR=Total debt ratio; ETA= Equity to total assets; LEV=Leverage; SIZE= Firm size; LIQ=Liquidity; TANG=Assets tangibility; and e_{it} = Error term

7.5 Research Framework and Definition of Variables

This section provides the conceptual framework of study and describes about variables that have been used in study and what study has assumed the relationship between the variables. The conceptual framework of this study includes return on assets, and earnings per share used as the dependents variables. Likewise, independent variables are total debt ratio, equity to total assets, firm size, liquidity ratio and tangibility. The relationship between capital structure and firm performance is shown by Figure 1.

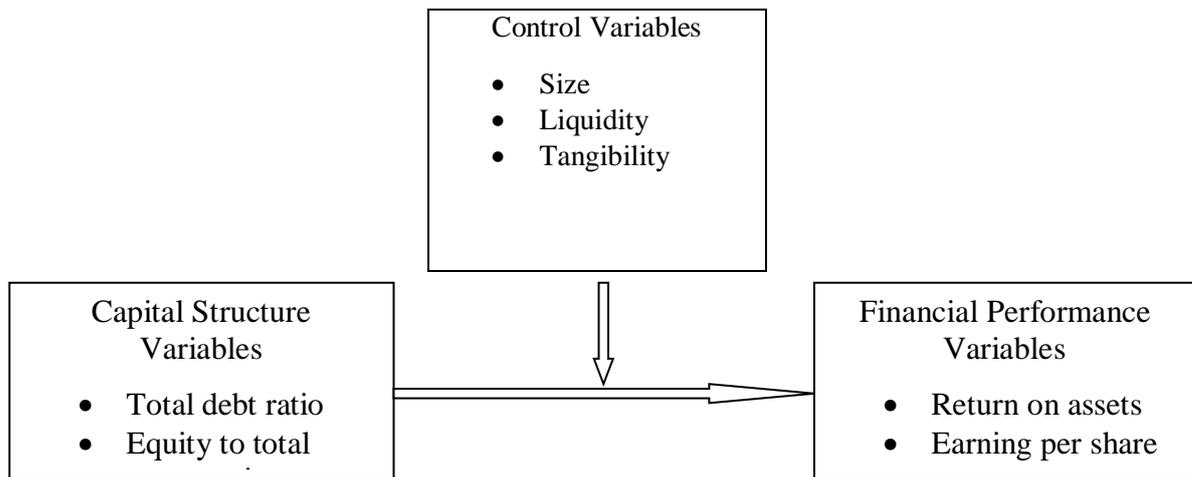


Figure 1. Schematic diagram of factors influencing financial performance of Nepalese insurance companies based upon literature.

Figure 1 exhibits the conceptual framework of the study based on the above literature available. It shows the capital structure variables and control variables (firm specific variables) used in this study to measure the impact on financial performance on Nepalese non depository listed companies. Capital structure is measured with the help of total debt ratio (TDR), equity to total assets (ETA) and leverage (LEV) and control variables which is also regarded as firm specific and macro economic variables as firm size (SIZE), liquidity (LQ), assets tangibility (TANG) and inflation (INF). Financial performance is measured with the help of two variables namely the return on assets (ROA) and earnings per share (EPS).

The dependent variables used in this study are return on assets (ROA) and earnings per share (EPS). Total debt ratio (TDR), equity to total assets (ETA), firm size (SIZE), liquidity (LQ), and assets tangibility (TANG) are used as independent variables. This study seeks to investigate the impact of capital structure on financial performance of Nepalese insurance companies. The detail discussions of variables which have been used in the study are presented below:

Capital Structure Variables

Different capital structure variables are taken in this study such as total debt ratio, equity to total assets ratio.

Total Debt Ratio (TDR)

Total debt to total assets is a measure of the company's assets that are financed by debt, rather than equity. Debt ratio (also known as debt to assets ratio) is a ratio which measures debt level of a business as a percentage of its total assets. It is calculated by dividing total debt of a business by its total assets. The debt ratio compares a company's total debt to its total assets. This provides creditors and investors with a general idea as to the amount of leverage being used by a company. The lower the percentage, the less leverage a company is using and the stronger its equity position. In general, the higher the ratio, the more risk that company is considered to have taken on. [Ebaid \(2009\)](#) found that there is a significant negative relationship between ROA and total debt to total assets ratio. [Mramor and Crnigoj \(2009\)](#) concluded that there is a significant negative relationship between financial leverage (total debt to total assets ratio) and return on assets ratio (ROA). [Zhang \(2011\)](#) found that there was a positive relationship between total debt to total assets and profitability. [Friend and Lang \(1988\)](#) found a significantly negative relation between profitability and debt/assets ratios. Similarly, [Kester \(1986\)](#) revealed significantly negative relation between profitability and debt/ assets ratios. [Petersen and Rajan \(1994\)](#) found that there is a significantly positive association between profitability and debt ratios. Based on it, this study develops the following hypothesis:

H1: Total debt to total assets ratio is negatively related to financial performance.

Equity to Total Assets (ETA)

The ratio of equity to total assets reveals capital adequacy and captures the general safety and soundness of the financial institution. It indicates the ability of finance companies to absorb losses and handle risk exposure with shareholders. Equity is important because it represents the real [value of one's stake in an investment](#). [According to Oladele, Sulaiman, and Akeke, \(2012\)](#), there exists a strong positive relation between equity to total assets and firm profitability. [Borio and Zhu \(2008\)](#) concluded that higher equity capital implies more prudent bank behavior. [Ponce \(2013\)](#) found a positive relationship between bank performance and capitalization. [Ramadan \(2011\)](#) found that higher equity to total assets ratio and investment contributes to higher return on assets. A bank that holds a relatively high proportion of capital is unlikely to earn high profits; yet

is less exposed to risk (Goddard, Molyneux, & Wilson, 2004). Based on it, this study develops the following hypothesis:

H2: Equity to total assets ratio is positively related to financial performance.

Firm Specific Control Variables

Size

The size (total assets) of the firm is factor that determines an insurance company's financial performance. Ozgulbas, Koyuncugil, and Yilmaz (2006) found that big scale firms have a higher performance as compared to small scale firms. Velnampy and Nimalathan (2010) studied the relationship between firm size and profitability and found positive relationship between firm size and profitability. Oser, Hogarth-Scott, and Riding (2000) found positive effect of firm size on financial performance of a firm. The size of the firm affects its financial performance in many ways. Large firms can exploit economies of scale and scope and thus being more efficient compared to small firms. Size can be determined by net premium which is the premium earned by an insurance company after deducting the reinsurance ceded. Dogan (2013) found firm size has a positive link with firm's profitability. Kipasha (2013) concluded that firm size has positive impact on firm performance. Based on it, this study develops the following hypothesis:

H3: Bank Size is positively related to financial performance.

Assets Tangibility

Tangibility of assets is an important variable to describe debt to total assets ratio. Tangible assets explain the capital structure within the firm. Tangible assets include fixed assets, such as machinery and buildings, and current assets, such as inventory. Pouraghajan et al. (2012) found that statistically there is a positive and significant relationship between assets tangibility and ROA and ROE measures. Wabita (2013) found that assets tangibility of insurance company positively affects the firm performance. Mehari and Aemiro (2013) revealed positive and significant impact of tangibility on the performance of Ethiopian insurance companies. Shergill and Sarkaria (1999) found that asset tangibility is positively related to the financial performance. Rusibana (2016) revealed a positive and significant relationship between assets tangibility and performance (ROE) of the firm. Malik (2011) found a positive and significant relationship between tangibility of assets and profitability of insurance

companies. [Himmelberg, Hubbard, and Palia \(1999\)](#) concluded positive and significant relationship between tangibility and profitability of insurance companies. Based on it, this study develops the following hypothesis:

H4: Assets Tangibility is positively related to financial performance.

Liquidity

Liquidity refers to the degree to which debt obligations coming due in the next twelve months can be paid from cash or assets that will be turned into cash. Insurance liquidity is the ability of the insurer to fulfill their immediate commitments to policyholders without having to increase profits on underwriting and investment activities and/or liquidate financial assets. The cash and bank balances are to be kept sufficient to meet the immediate liabilities towards claims due for payment but not yet settled ([Chaharbaghi & Lynch, 1999](#)). [Wang \(2002\)](#) concluded that there is negative relationship of liquidity with the financial performance measured by returns on assets (ROA) or returns on equity (ROE). According to [Dawood \(2014\)](#) examined negative relationship between liquidity and profitability. [Bourke \(1989\)](#) concluded the positive significant relationship between the firm liquidity and profitability. A liquid company is one that stores enough liquid assets and cash together with the ability to raise funds quickly from other source to enable it meet its payment obligation and financial commitment in a timely manner. Based on it, this study develops the following hypothesis:

H5: Liquidity is positively related to financial performance.

Financial Performance Variables

Return on Assets (ROA)

Return on assets is an indicator of how profitable a company is relative to its total assets. It is calculated by dividing net income by total assets. [Saeed and Badar \(2013\)](#) found that long term debt (LTD) has a significantly positive impact on ROA. [Ahmad, Abdullah and Roslan \(2012\)](#) investigated the impact of capital structure on firm performance and found that short term debt (STDR) has a significant negative relationship with ROA. [Wen \(2010\)](#) found higher the ROA; more efficiently the company is using its resources. [Ebaid \(2009\)](#) examined the capital structure and performance of firms and found that there is negative significant influence of total debt (TD) on the financial performance measured by the return on assets. Return on assets shows how efficiently the resources of the company are used to generate the income. It further indicates the efficiency of the

management of a company in generating net income from all the resources of the institution (Khrawish, 2011).

Earnings Per Share (EPS)

Earnings per share (EPS) is the monetary value of earnings per outstanding share of common stock for a company. EPS is calculated by following formula i.e. net income minus preferred dividend divided by number of outstanding share. It measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. Lamont (1998) found that earning have the ability to forecast return and containerization information because they are correlated with the business conditions. According to Aburub (2012), investigated the impact of capital structure on the firm performance and used EPS as depended variable. Earnings per share are also a calculation that shows how profitable a company is on a shareholder basis. EPS is one of the most important factors needed to be considered for a company's profitability.

8. Limitations and Delimitations of the Study

Despite of the continuous efforts made for arriving at meaningful conclusions from the study, the following major limitations have been outlined:

1. There are all together 39 insurance companies in the country, but this study do not cover all the companies. Only14 insurance companies are considered for the purpose of study. Therefore, inclusion of all the insurance companies in this study would provide more valid results.
2. The study has been included only insurance companies and has excluded other financial institutions such as commercial banks, development banks, finance companies, and microfinance
3. The study period includes 10 years' data from the year 2066/67 to 2075/76.
4. In this study for financial performance, only return on assets and earnings per share will be considered as dependent variables.
5. This study assumes levels of homogeneity across insurance companies, which may not be true, since the nature of companies in the study, are different.

6. This study assumes the linear relationship between the dependent variables and independent variables. Thus, this study does not consider the ‘non-linearity’ biases. Hence, the scope of this study is limited.

9. Organization of the Study

This study will be organized into five broad chapters. The first chapter will deal with the general introduction of the study including general background, problem statement, objectives of the study, rationale of the study, limitations of the study and organization of the study. The second chapter will include conceptual review, review of literatures related to studies in global context as well as the review of studies in Nepalese context. This chapter will be closed with the concluding remarks including research gap. The third chapter will focus on the research methodology, which includes research design; population and sample, and sampling design; nature and sources of data, and the instrument of data collection; methods of data analysis; and research framework and definition of variables. Chapters four will focus on the systematic presentation and analysis of data. This chapter will be divided into two sections, namely, results and discussion. In chapter five, first of all, a summary of overview on all works carried out in chapter one through four will be presented. Then, the chapter will include conclusions derived from the study. Finally, the chapter will include implications of the study and scope for future research.

10. Work Plan

The study will take six months period. The work plan for conducting the study is presented below:

SN	Task	Months	1	2	3	4	5	6
1.	Introduction and Literature Review		■	■				
2.	Data Collection, Coding and Entering data			■	■			
3.	Data Presentation and Analysis				■			
4.	Dissertation Writing					■		
5.	Finalization, Dissertation Printing						■	
6.	Dissertation submission and Presentation							■

11. Budgeting

S. No.	Activities	Cost (in rupees)
1.	Stationary	1,000
2.	Books and journals purchase and photocopy of reading materials	3,300
3.	Field visits for data collection (travelling, accommodation and food)	5,300
4.	Report printing, photocopying, and binding	2,300
5.	Miscellaneous	1,000
Total Budget		12,900

In words, rupees twelve thousand nine hundred only.

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