



Impact of internal audit quality on the financial performance of insurance companies: Evidence from Kosovo

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Abstract

Purpose: Increasing financial performance requires the application of adequate internal audit practices. Aiming to this study, was requested to determine the effect of internal audit on financial performance in insurance companies in Kosovo.

Methodology: The return on assets (ROA) ratio was used to measure financial performance. Data for this dependent variable were obtained from the six-month statements of insurance companies operating in Kosovo during the period 2015 - 2021. Internal audit was viewed from the perspective of internal auditing standards, the professional competence of the internal auditor, the independence of the internal auditor and the efficiency of internal audit, which were also taken as independent variables. The researcher applies a survey questionnaire to each member of the target population consisting of members of the Board of Directors, members of the Audit Committee, managers of various departments, internal audit officers, legal officers and finance officers. Also, three control variables (growth, size and age of the company) were taken. As data analysis techniques are used quantitative analysis and regression analysis.

Findings: From the findings, the study concludes that professional competence had a significant positive impact, in contrast to the efficiency of internal audit, which had a negative impact on the financial performance of insurance companies. The study also found that the other two independent variables (internal audit standards and internal auditor independence) had a negative correlation with financial performance but not significant. The size of the insurance company also had a significant positive relationship, in contrast to the age of the company which had a negative and significant impact on the financial performance of insurance companies operating in Kosovo.

Originality/Value: The study aims to increase the importance of internal audit for insurance companies, as in general, the importance is given only to external audit and its reports. It is also hoped that the recommendations will support decision-making authorities in addressing and identifying current problems and taking measures to eliminate them. Based on the above findings, this study provides insights to regulators and policymakers about the importance of audit quality in enhancing financial performance.

Introduction

Insurance market in Kosovo does not have a special history. They were introduced later in the territories of Kosovo compared to other countries. In the form that mainly exists today, the insurance market in Kosovo began to develop immediately after the end of the war in Kosovo, so in 2011 the number of insurance companies reached thirteen, three of which also offered life insurance. Today, the number of these insurance companies is twelve, due to obtaining the license of one of these companies. All these companies have installed the internal audit sector, a requirement of the CBK in accordance with applicable laws.

Like the Institute of Internal Auditors (IIA), which defined the internal audit function as an independent, objective assurance and advisory activity, created to add value and improve an organization's operations (IIA, 2017, p. 3). The CBK Regulation of 2016 regarding internal audit for insurance companies operating in Kosovo, defines the internal audit function as independent, objective and advisory, created to add value and improve the operations of companies insurance. The internal audit function is part of the ongoing observing of internal controls over the operation of insurance companies, ensuring an independent assessment of compliance with the defined policies and procedures of the insurance company. As such, the internal audit function assists senior managers and the board of directors in carrying out their responsibilities effectively and efficiently (<http://bqk-kos.org>). Every insurer must have an internal audit function in order to fulfill its duties and responsibilities. The internal audit function should be independent of the audited activities and the day-to-day processes of internal controls. (<http://bqk-kos.org>).

Overall, this study aims to provide a framework for the impact of internal audit quality on the financial performance of insurance companies in Kosovo. The construction of hypotheses and their verification will provide an appropriate answer to justify the research, namely the effects of IA quality on financial performance of insurance companies taken as a case study.

Literature Review

Audit quality is an active, dynamic concept, with factors that change from time to time and from country to country. DeAngelo (1981 p. 186) defined audit quality as the “market-assessed joint probability that a given auditor will both detect a breach in the client’s accounting system, and report the breach”. Audit quality is vital for companies to achieve efficient and effective resource management because it can lead to the rapid improvement of the company's financial performance. According to Farouki and Hassan (2014), audit quality acts as an essential element in maintaining the financial performance of companies, whereas Ado et al. (2020) emphasizes that objective quality control forms the basis for confidence in the integrity and reliability of reports, which is extremely important for the efficient functioning of markets and also improves financial performance. Matoke and Omwenga (2016) also define the quality of auditing in two dimensions: first, the detection of anomalies and errors in the financial statements and second, the reporting of these anomalies and errors in the financial statements.

Conceptually, there are various determinants and factors that affect audit quality. These factors are classified into factors that directly affect the quality of the audit (financial reporting according to IAS, auditor quality review, company performance, profit quality etc.) and factors that indirectly affect the quality of the audit (audit firm size and characteristics of the audit company, audit mandate, audit fees, auditor independence, auditor competencies etc). Due to the fact that these characteristics are largely unclear, obviously, various reserchears have used various measures of audit quality. Some of the researches, as indicators of audit quality, used the size of the audit firm, auditor experience, audit fees, auditor rotation and auditor independence (Yi-Fang et al., 2015; Matoke and Omwenga, 2016).

A number of studies emphasized the impact of audit quality on the quality of corporate governance (Mohd et al. 2009; Moses et al. 2016; Zalata et al. 2018) while some others presented empirical results on the effect of audit quality on financial performance (Surbakti et al. 2017; Bilal et al. 2018; Amin et al. 2018). A number of other studies have been conducted on the role, function and characteristics of the

internal auditor as well as his role in the financial formation of various companies (Prawitt et al., 2009; Hutchinson and Zain; 2009; Cohen and Sayag, 2010; Lin et al., 2011). Other researchers identifies different metrics as representative of audit quality indicating that higher audit quality affects financial performance (Zureigat, 2010; Heil, 2012; Bouaziz et al., 2012; Farouk and Hassan, 2014).

A number of studies analyzed the impact of audit quality on financial performance based on secondary data. In general, as a dependent variable, for measuring of financial performance, they took the return on assets, while as independent variables they took: the size of the audit committee, independence, activity and quality of external audit (Afza and Nazir, 2014), number of shares owned by different shareholders, age of company, independent board members and institutional investors as independent variables, audit fees and rotation of audit firms (Sayar et al. 2018). audit size, audit fee, and growth rate (Tom and Ying, 2018).

Most research on the impact of internal audit quality on financial performance is based on individual surveys of respondents (Dellai and Omri, 2016; Dahir and Omar, 2016; Matoke and Omwenga, 2016; Albkour and Chaudhary, 2017). All of them researched the impact of internal audit on the performance of the organization by distributing surveys to a significant number of respondents, to analyze the impact of internal audit quality on financial performance.

Barzan (2018), investigates the factors that affect internal audit and its relationship to organizational performance. Multiple regression was used to assess the degree of impact of the independent variables identified in the conceptual framework on organizational performance. Ahmad (2018) with sample of 364 employees, examines the effect of internal audit on the organizational performance of leading Jordanian banks. Various researchers investigated the impact of internal audit quality on the financial performance of commercial banks in different countries. El Gharbou and Chraibi (2021) in their research cite Enekwe et al. (2020), whose to measure the impact of internal audit on the financial performance of manufacturing companies in Nigeria, take the independent variables: the independence of the internal auditor and the internal audit committee, concluding that the quality of the audit positively

affects and significantly affect financial performance. They also cite Hazaea et al. (2020), who to conduct a study on the impact of internal audit quality on the financial performance of Yemeni commercial banks, as independent variables: internal auditor independence, compliance with internal audit standards, application of the principles of governance, size of department internal audit and frequency. of audit committee meetings, concluding that the quality of internal audit has a positive and significant impact on financial performance (El Gharboui and Chraibi, 2021). Phan et al. (2020) conducted an empirical investigation on the effect of audit quality on the performance of companies in Vietnam, while to conduct a comprehensive analysis, they took data from 228 companies, to come to the results that show that audit quality positively affects in the financial performance of companies, especially in loyalty, customer satisfaction and employees of those companies.

Research Methodology

The study was based on the survey research model and involves using the sample to obtain the opinion of the number of respondents. It is a research design that studies the information collected from the study population which consists of eleven (11) insurance companies operating in Kosovo, respectively; Elsig, Dukagjini, Prisiq, Scardian, Security, Sigma, Ilyria, Ilyria Life, Sigkos, Sigal and Kosova e Re. The population element consists of board members, members of the audit committee, department managers, internal audit officers, legal officers, and finance officers. Also, data on the dependent variable are obtained from secondary data sources, namely from the 6-month financial statements of insurance companies operating in Kosovo. The survey method was used to conduct the study, in which case the questionnaire was distributed using the Customized Design Method. The questionnaire contains questions that originate and derive from the objectives, research questions and hypotheses of this study. The study used the 5-point Likert scale to ask respondents to express their opinion on the statements made. To test the hypotheses related to the quality of internal audit and the impact on the financial performance of insurance companies in Kosovo, was used the modified general linear regression model as proposed by Ondieki (2013), Matoke and Omwenga (2016) and Ado et al. (2020).

This model brings together several potential determinants that affect the performance enhancement of the companies analyzed in the case study. The model is in linear form as follows:

$$FP = \beta_0 + \beta_1AUDST + \beta_2AUDCOM + \beta_3AUDIND + \beta_4AUDEF + \beta_5Age + \beta_5Sz + \beta_5Fgrowth + \varepsilon$$

FP - Financial performance of insurance companies measured through ROA,

β_0 - Regression constant,

$\beta_1, 2, 3, 4$ - Coefficients of independent variables,

AUDST = Impact of internal audit standards on FP,

AUDCOM = Impact of professional internal audit competence on FP,

AUDIND = Impact of internal audit independence on FP,

AUDEF = Impact of internal audit efficiency on FP,

Age - Age as the ratio of total liabilities to total assets (control variable),

Sz - Company size as a natural logarithm (ln) of total assets (control variable),

Fgrowth - Company growth as $(PG(t) - PG(t-1)) / PG(t-1)$ (control variable)

In order to create the conditions for fair evaluation of independent variables and non-distortion of findings, control variables such as size, age and growth of the insurance company were used. Independent variables express respondents' views while responses are given using Likert scales (1 to 5). Based on the literature review and the applied model, the following hypotheses have been formed:

H1: Implementation of internal audit standards has no significant effect on the performance of insurance companies in Kosovo,

H2: The independence of internal audit has no significant effect on the financial performance of insurance companies in Kosovo,

H3: The professional competence of internal audit has a significant effect on the financial performance of insurance companies in Kosovo,

H4: The effectiveness of internal audit has a significant effect on the financial performance of insurance companies in Kosovo.

Data Analysis

To measure the consistency between the questions posed in the questionnaire as well as the accuracy and reliability of the data from the questionnaire when using the Likert scale, we applied the Cronbach Alpha test. Cronbach's alpha is a measure of internal consistency that shows how closely a group of items are grouped together. From our calculations presented in Table 1, the value reached 0.76309, which is an acceptable percentage. While the percentage achieved while using the questionnaires is over 60%, it is considered that the results achieved should be trusted.

Table 1. Statistics accuracy

No. of questions	No.of items	Standardized Cronbach's Alpha	Cronbach Alpha
28	154	0.78910	0.76309

Correlation results

To establish the relationship between the variables in the study, a correlation analysis was performed. FP is used to express financial performance. Pearson correlation coefficients were created for all variables with the findings as shown in Table 2. The study results show that there is a positive correlation between auditor competence ($r = 0.247$; $p < 0, 05$), audit efficiency ($r = 0.270$; $p < 0.05$), company size ($r = 0.310$; $p < 0.05$) and company age ($r = 0.298$; $p < 0, 05$) on the one hand, and financial performance on the other. These findings reveal that the auditor's competence, audit efficiency, size and age of the insurance company are positively correlated with FP, indicating that an improvement in one or all of these variables would result in an improvement in financial performance. However, the relationship between auditing standards ($r = - 0.015$; $p > 0.05$) and internal auditor independence ($r = 0.196$; $p > 0.05$) with financial performance was negligible and insignificant.

Table 2: Correlation analysis

		FP	AUDST	AUDIND	AUDCOM	AUDEF	FSz	FAge	FGrowth
FP	Pearson Correlation	1	-,015	,196	,247*	,270*	,310*	,298*	,002
	Sig. (2-tailed)		,905	,118	,048	,030	,013	,018	,985
	N	154	154	154	154	154	154	154	154
AUDST	Pearson Correlation	-,015	1	,042	,127	-,084	-,099	-,079	,093
	Sig. (2-tailed)	,905		,614	,121	,311	,438	,536	,474
	N	154	154	154	154	154	154	154	154
AUDIND	Pearson Correlation	,196	,042	1	-,043	,092	,272*	,295*	,032
	Sig. (2-tailed)	,118	,614		,604	,263	,030	,018	,805
	N	154	154	154	154	154	154	154	154
AUDCOM	Pearson Correlation	,247*	,127	-,043	1	,073	,136	,125	,103
	Sig. (2-tailed)	,048	,121	,604		,374	,284	,324	,431
	N	154	154	154	154	154	154	154	154
AUDEF	Pearson Correlation	,270*	-,084	,092	,073	1	,974**	,900**	-,023
	Sig. (2-tailed)	,030	,311	,263	,374		<,001	<,001	,861
	N	154	154	154	154	154	154	154	154
FSz	Pearson Correlation	,310*	-,099	,272*	,136	,974**	1	,974**	-,008
	Sig. (2-tailed)	,013	,438	,030	,284	<,001		<,001	,953
	N	154	154	154	154	154	154	154	154
FAge	Pearson Correlation	,298*	-,079	,295*	,125	,900**	,974**	1	,010
	Sig. (2-tailed)	,018	,536	,018	,324	<,001	<,001		,939
	N	154	154	154	154	154	154	154	154
Firm Growth	Pearson Correlation	,002	,093	,032	,103	-,023	-,008	,010	1
	Sig. (2-tailed)	,985	,474	,805	,431	,861	,953	,939	
	N	154	154	154	154	154	154	154	154

** Correlation is significant at the 0.05 level (2-tailed).

Regression results

Regression analysis was performed with independent variables that were auditing standards, auditor competence, auditor independence and audit efficiency. Estimates on the independent variables (1- Strongly Disagree, 2 - Disagree, 3 - Neutral, 4 - Agree and 5 - Strongly Agree) were used as parameters in the regression analysis.

The summary table of the model reports the strength of the relationship between the model and the dependent variable. **R**, the multiple correlation coefficient, is the linear correlation between the observed values and predicted by the dependent variable model. The dependent variable was the financial performance measured using the return on assets (ROA).

Table 3: Model summary - Determination coefficient

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	,356 ^a	,126	,061	,056339
2	,473 ^b	,224	,115	,054685
a. Predictors: (Constant), AUDEF, AUDCOM, AUDST, AUDIND				
b. Predictors: (Constant), AUDEF, AUDCOM, AUDST, AUDIND, Firm Growth, FAge, FSz				

The R-squared for the regression model was 0.126 (for the independent variables) and 0.224 (for the control variables) as shown in Table 3. Therefore, the model explains 12.6% of the change in FP using four independent variables. These findings show that the four independently selected variables (IA standards, IA independence, IA competence and IA efficiency) can explain 12.6% of the differences in the financial performance of insurance companies operating in Kosovo.

The importance of the overall model in providing any predictive value was assessed using the test f. The results from the analysis of variance are given in Table 4. The results show that the overall regression model has no predictive value ($f = 3,519$; $p < 0.05$). These findings indicate that independent variables used in the regression have a value, but not a significant predictor on FP, so they can be used with caution to predict financial performance of insurance companies.

Table 4: Significance of regression model

Model		Sum of Squares	Mean Square	F	Sig.
1	Regression	,054	,010	3,519	,005 ^b
	Residual	,149	,003		
	Total	,203			

The test of statistical significance of the independent variables in the model was done using T-tests. The results are presented in Table 5 which shows that internal audit competence has a positive coefficient when used as a predictor of insurance companies performance in the regression model ($\beta = 0.0307$; $t = 2.034$; $p < 0.05$) indicating that increasing the competence of internal audit would have a positive and significant effect on the performance of insurance companies measured through ROA. The T-test also found that the competence of internal audit is an important predictor of the financial performance of insurance companies. This finding also confirms the third hypothesis. These findings are consistent with the findings also found by

Ondieki (2013) and Alfahat (2017). Internal auditing standards were not a significant predictor of insurance companies' financial performance ($\beta = - 0.0011$; $t = - 0.103$; $p > 0.05$). These findings indicate that the application of internal auditing standards does not have a significant effect on the financial performance of insurance companies. The same statement applies to the independence of internal audit ($\beta = - 0.00174$; $t = - 0.116$; $p > 0.05$). These two findings do not prove the first and second hypotheses.

Further findings show that the efficiency of internal audit has a negative and significant impact on the financial performance of insurance companies ($\beta = - 74488$; $t = - 2,144$; $p < 0.05$). This finding confirms the fourth hypothesis. Firm size was also found to be positively and statistically significantly related to financial performance, while firm age, negatively and statistically significantly related to financial performance at the significance level of 5%. Previous empirical studies show that company size positively affects company performance (Haji, 2014; Pervan et al.2012; Legoria et al. (2018) and Grediani (2019). The third control variable, FGrowth do not have any important links with the financial performance of insurance companies in Kosovo.

Table 5: Significance test of independent variables
Dependent variable: FP, OLS

	Coefficient	Std.error.	t-Statistics	Prob.	
const	-4,60198	2,16528	-2,125	0,0386	**
AUDST	-0,00110	0,01071	-0,103	0,9180	
AUDIND	-0,00174	0,01489	-0,116	0,9075	
AUDCOM	0,03070	0,01509	2,034	0,0474	**
AUDEF	-0,74488	0,34743	-2,144	0,0370	**
FGrowth	-0,00280	0,00282	-0,991	0,3264	
FSz	10,6316	4,97306	2,138	0,0375	**
Fage	-2,18880	1,07006	-2,045	0,0386	**
R - squared	0,223631		Mean dependent var.	-0,006914	
Adjusted R-squared	0,114940		S.D. dependent var.	0,058127	
S.E. of regression	0,054685		Akaike info criterion	-2,847021	
Sum squared residual	0,149521		Schwartz criterion	-2,262822	
F - statistic	2,057486		Hannan-Quinn criter.	-2,726319	
Prob. (F-statistic)	0,065868		Durbin-Watson stat.	1,774631	

Note: Model 1: Pooled OLS, using 154 observations, included 11 cross-sectional units, Time-series length = 7, Dependent variable: ROA

Conclusions

The main objective of the research is to explore the impact of audit quality on the financial performance of insurance companies in Kosovo. In the study, Return on Assets (ROA) was used as a variable to measure financial performance, while the following were used as independent variables: IA standards, IA independence, IA competence and IA efficiency. In order to create the conditions for fair evaluation of independent variables and non-distortion of findings, control variables such as size, age and growth of the insurance company were used. Based on the result of the OLS analysis, the competence of IA was found to be positively and significantly related to financial performance. These results are in line with Ondieki (2012), Enekwe (2021) and Bengrich and El Ghadouia (2020), while the efficiency of IA was found to be negatively related and significant with financial performance. The other independent variables, AUDIND, were found to be negative and insignificant with FP. The same results were found in Akande (2019) and Farouk and Hassan (2014), while opposite results were encountered in Ado et al. (2020). AUDST also has non-significant links to ROA. Opposite results have been encountered in Ondieki (2012). Such negative and insignificant connections are: first, as a result of the mandatory application of internal audit standards as well as the de facto dependence (not independence) of the internal auditor on management although legally this issue is regulated.

The study also had its limitations. One of the main limitations was the small number of companies operating in Kosovo, so we were obliged to take as secondary data, the 6-month statements of these companies. A second limitation which could have impact on the quality of the study, was the number of respondents that could have been higher. Also, a degree of subjectivity was inevitably present in the answers given by the respondents which could have influenced the results of the study towards the verification of the hypotheses put forward by the authors.

Given the above findings, this study provides insights for regulators and policymakers about the importance of audit quality in enhancing financial performance. Also, due to the importance of having a high quality internal audit, further studies should explore areas related to the quality of this type of audit.

Further studies may also be conducted to examine the potential value of audit quality for other stakeholders and in particular to determine whether the quality of internal audit has an impact on the external auditor's reports, given that the audit of external to these companies rarely takes into account the findings and recommendations given by the internal auditor.

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