



## INTERNAL AUDIT FUNCTION AND FINANCIAL STATEMENT OF INSURANCE COMPANIES IN NIGERIA

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**ABSTRACT:** *The survival of any firm is predicated on the efficient functioning of the internal audit constituted by management for safeguarding of the company's assets. It has been argued that several instances of doctored financial statements of quoted firms in Nigeria abound leading to scandals with dire consequences on investors' confidence. The study examines the relationship existing between internal audit function and the financial performance of insurance companies in Nigeria. The study made a return on assets as a function of audit committee size, audit committee independence, audit committee financial expertise and firm size. The data culled from the financial statements of selected firms, National Insurance Commission Facts Books and the Nigerian Stock Exchange covers the period 2011-2020. Multiple regression techniques were used to explore the contemporaneous dynamics. The study finds evidence of a significant positive impact of audit committee size, audit committee independence and audit committee financial expertise on financial performance, contrary to the significant negative impact of firm size. Therefore, the paper recommended that the various elements of audit committee characteristics, which include audit committee size, independence, and financial expertise, should be strengthened to enhance financial performance in the insurance sector.*

**KEYWORD:** Internal Audit Function, Audit Committee Characteristics, Financial Performance, Nigeria



## INTRODUCTION

The survival of every organisation is hinged on effective internal audits required to prevent unethical practices where vital information is deliberately omitted to allow for the occurrence of fraudulent activities. In most cases, financial statements are doctored, resulting in scandals capable of damaging investors' confidence and potentially weakening the capital market (Ajao & Oluwadamilola, 2020). A number of accounting scandals have occurred around the world in the cases of Enron 2001, Cadbury Nigeria 2006, WorldCom 2002, AIG 2005, as well as the Waste Management of 1998 readily come to mind. It has been argued that the occurrence of such scandals was a result of an inefficient internal control system in the organisation, thereby necessitating stringent regulations with a view to enhancing adequate standards which will guide the conduct of auditing and accounting as well as corporate governance issues. Internal auditing is an essential ingredient for the effective functioning of any firm, such as insurance companies, as it helps in quality decision-making for the organisation. It offers the assurances that informed decisions have been made that mirror the information contained in financial statements as reliable, implying that assets are valued correctly and protected while the execution of key duties is holistically undertaken. In the absence of reliable internal auditing practices, strategic processes of goal-seeking and communication procedures of the firms may be threatened, whilst information processes are likely to be compromised (Ajao & Oluwadamilola, 2020).

According to the Companies and Allied Matters Act (CAMA) of 1990, the presence of an audit committee in an organisation is necessary. It stipulates an audit committee not exceeding six members where one member must be an executive director while the chairman must be a non-executive director. The Act further requires the committee to hold the meeting at least three times within a year. The internal audit usually submits an interim report to the committee for consideration during their meeting. Accordingly, the accounting and reporting policies are examined by the committee to ensure it is in tandem with the company's ethical procedures and legal requirements where the occurrence of every audit logjam with management is resolved (Araoye, 2019).

On the other hand, the insurance sector in Nigeria is replete with not-too-satisfactory performance as, over time, insurance companies have refused to indemnify their clients by giving flimsy excuses. This, therefore, puts the reliability of their financial report into questionable circumstances, which has tended to affect the potential for growth of the industry, a situation which calls for an internal control mechanism. This prompted the National Insurance Commission (NAICOM), established in 1997, to issue codes of business ethics and good corporate governance to guide the operations of the insurance business in Nigeria. The NAICOM's code of conduct stresses the importance of internal control processes with functional risk management that can engender significant improvement in the financial report of the insurance industry. The introduction of the code was informed by the fact that risks and eventualities constitute Nigeria's biggest challenge for insurance activities.

The growth and development of any economy are predicated on financial service provided by an insurance company through the underwriting of risks that facilitates the mobilisation of large funds for long-term investment premium. For the capital market, it helps promote financial stability and enables economic entities to enjoy some level of peace. For most economies, the insurance industry is seen as a cornerstone for growth and development, as it is hoped that economic growth will be unlocked through the services provided by the industry.



Accordingly, all insurance companies doing business in Nigeria are incorporated by law to operate in areas such as life, non-life, brokerage, re-insurance as well as loss adjuster. The industry went through some transformation in the last few decades in that recapitalization exercises occurred in the same way as the banking sector. This led to a reduction in the number of insurance companies operating in Nigeria. As of the last count in May 2020, the number of insurance businesses in Nigeria has risen to include 14 life insurance companies, 28 non-life insurance companies, 13 composites (life and non-life) insurance companies, 2 re-insurance companies, 34 licensed loss adjuster companies, 457 licensed insurance brokerage companies, 2 takaful insurance companies and a number licensed agents numbering over 200 (Ajao & Oluwadamilola, 2020). The Insurance Act of 2003 regulates the operations of all insurance companies in Nigeria. According to Ajao and Oluwadamilola (2020), the Commission was saddled with ensuring effective administration, supervision, regulation and control of the insurance business in Nigeria. Also, it has the mandate to protect insurance policyholders, beneficiaries and third parties to insurance contracts.

In the corporate world, every company is expected to prepare financial statements that should be audited by the internal auditor, who then issues a report. Generally, the auditor is required to audit the company's financial statements and therefore satisfy that the documents comply with the required laws and accounting principles which should reflect a true and fair view of the company's financial operations (Okolie, 2014). The auditor's role does not include preparing financial statements but rather checking and verifying the reports. A holistic adherence to this role by the auditor enhances effective communication existing between the internal audit, external audit and the board of directors. Meanwhile, the audit committee is an extension of the board of directors. It is required to point out observations in the audit reports and subsequently make presentations to members of the board to ensure fairness and transparency in the documents (Ibrahim & Collins, 2016).

Unarguably, quite a number of studies exist in the extant literature that have documented the relationship between internal audit function and the financial performance of quoted firms in the financial and non-financial sectors. However, only a few of these studies focused on the insurance industry, where some authors find a positive relationship (Mare'L, 2009; Tanja, Julija & Tatjana, 2016; Amoh, 2017). On the contrary, some other authors find a negative relationship (Ibrahim & Collins, 2016; Araoye, 2019). Also, some authors could not find any relationship, such as Ebere and Ibanichuka (2016). Amidst these controversies, the current study is undertaken. The rest of the paper is organised as follows. Section two presents a brief review of related literature, while the model is highlighted in section three. In section four, the results of the findings are presented, and section five concludes the study with recommendations.

## **Problem Statement**

There is no doubt that reforms undertaken in the banking and insurance industries in recent times as a result of business failures led to the recapitalization of operational activities in these industries. Prior to the recapitalization exercises, a good number of insurance companies lack full internal audit function, essentials of corporate governance as well as internal control, which made many firms close down their business while there were mergers and acquisitions. A number of factors were adduced for the increasing rate of business failure in the insurance industry in Nigeria. These include but are not limited to ownership structure, absence of required legal framework, size of the insurance firm, weak capital base, unhealthy competition,



poor financial performance and poor management. At the heart of the problem, the industry failed to recognise internal audit functions as mandatory units that every listed company in Nigeria should operate. In some cases, an internal auditor which is normally a member of staff in the company, is used by corrupt top management staff to prepare financial statements lanced with fraudulent activities that external auditors find difficult to detect. In other instance, top management does the financial reports of the internal auditors or advice, thereby undermining the independence of the internal auditors. This development led to the closure of many insurance firms in Nigeria with huge loss of income while a good number of people were thrown into the labour market. These unwholesome practices led to poor financial performance, thereby crippling most of the insurance companies in Nigeria in the process. This is even more worrisome when one considers that available funds in the industry are being poorly utilised, leading to poor financial reporting in Nigeria.

### **Objective of the Study**

The specific objective of the study is:

To assess the impact of internal audit function on the financial performance of insurance companies in Nigeria.

### **Research Question**

In light of the above problems, the following research question is pertinent to the study.

To what extent does the internal audit function affects the financial performance of insurance companies in Nigeria?

### **Research Hypothesis**

The study tested one null hypothesis, namely:

Ho: Internal audit function has no impact on the financial performance of insurance firms in Nigeria.

### **Significance of the Study**

The research is significant for a number of reasons. This study shall be beneficial to individuals, stakeholders, companies and intending research in the field. In particular, insurance firms will greatly benefit from the findings and the recommendation in the study as it will enable them to realise the importance of internal audit function in running a profitable organisation. The findings of the study shall be of great interest to investors and fund providers in the insurance industry as the parameters necessary for assessing the viability and investment worthiness are presented. Finally, the board of directors, management of insurance firms and other allied businesses will also benefit as the study will make them understand the importance of internal audit functions and therefore place some degree of reliance with a view to improving their financial performance.



## LITERATURE REVIEW

### Conceptual Issue

Internal audit or internal control has been interchangeably used in financial accounting literature. However, internal auditing has been conceptualized as the functioning of managerial control and the way of evaluating the effectiveness of such control (Ajao & Oluwadamilola, 2020). The Consultative Committee of Accounting Bodies (CCAB) in the United Kingdom defines internal control as “the whole system of control, financial and otherwise, established by management in order to carry on the business of the enterprises in an orderly and efficient manner, safeguard the asset and secure as far as possible the completeness and accuracy of the record”. Meanwhile, CAMA (1990) cited in Araoye (2019) sees audit as “the independent examination of, and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation”. Siyanbola, Oyebamiji and Ibrahim (2016) note that two elements of internal control systems exist in the literature, namely internal audit and internal check.

In the case of internal audit, it is a strategy constituted by the management of an organisation to guide against any unethical practices that can undermine the operationalization of the business by reporting the same as quickly as possible. Although the auditor performing the internal audit function is a member of the staff of the organisation, its appraisal activities in the organisation are normally independently carried out in reviewing any financial and accounting as well as safeguarding assets as his service to management (IIA Inc, 2009 cited in Siyanbola et al., 2016). The internal audit, therefore, encompasses service function to management by an officer with a required skill appointed and referred to as an internal auditor. This officer periodically evaluates the organisation's accounts and other internal control processes (Siyanbola et al., 2016).

On the other hand, there is the internal check which, according to Ajayi and Olusona (2007), is the normal day-to-day routine rituals of administrative controls in which work done by one person must complement that done by another. Thus, there is an independent examination in the course of the accounting duties. This implies that during any transaction, no single person does the work from the beginning to the end without any other person being involved. The purpose is to prevent or at least minimise any unethical accounting anomalies that are likely to occur in the enterprise. If any deliberate mistake is allowed to foster full-blown fraud, it is capable of sending the organisation into permanent extinction (Siyanbola, 2013).



## **THEORETICAL ISSUE**

### **Agency Theory**

This is one of the oldest theories in the accounting literature, which was originally developed by Alchain and Demsetz in 1972 and expanded by Jensen and Meckling (1976). The Agency theory explains the relationship that exists between the principals and the agents. In this regard, the principal is the stakeholder, while the agent is the company management. The belief of those who took to the theory was that the principals or shareholders, who are the owners of the company, hire the agents to work. The principals then delegate the agents, who are the directors and managers, to run the business on their behalf in order to ensure that the shareholders' objectives are met. Clark (2004) notes that the underlining assumption of the theory is that information asymmetry exists between the principals and the agents, which hinders the ability of the principals to monitor the activities of the agent in the running of the companies and, therefore, unable to say precisely if the interest of the principals is properly protected. A study by Cao, Thi, Thanh and Cheung (2010) on internal audit and the quality of financial statements observes that internal audit reduces information asymmetry affecting the quality of financial reporting.

### **Stewardship Theory**

The stewardship theory regards managers as stewards who should be motivated the running of the business in the interests of the principals (Donaldson & Davis, 1991). The theory avers that organisations that want to survive must strive to maintain a balance by taking to heart the interests of various stakeholders, making sure some level of satisfaction is achieved by the different interest groups. Accordingly, as management sees itself as stewards to the owners, they are to run the business in such a way that the various groups share a common goal.

### **Contingency Theory**

The theory was the brainwork of Fred Fiedler in his 1964's thesis. The contingency theory believes that there is no best way by which an organisation can be run, or decisions are made. The theory goes further to submit that the best course of action is predicated on the internal and external situation available to the organisation. The internal and external factors refer to the crucial role played by the audits in ensuring a good work environment.

### **Empirical Issue**

In the literature, several studies seek to examine the relationship between internal audit function and firm financial performance in Nigeria. Meanwhile, the empirical assessment of this relationship in the insurance sector is being scarcely pursued. Thus, Mare'L (2009) avers that internal audit acts as a cushion for the survival of any business entity. His research thesis examines how audit committees could improve internal audit functions for insurance firms in Jordan. The study finds evidence of the significant impact of audit committees on the financial performance of Jordanian insurance companies. In Ghana, Tornyera and Wereko (2012) scrutinize the impact of corporate governance on firm performance using evidence from the insurance sector. The study observes that the presence of an audit committee enhances the corporate performance of insurance companies in Ghana. Olajide (2013) assesses the extent to which information and communication technology affect the financial performance of



insurance companies in Nigeria. The study finds a significant positive impact of the explanatory variable on the level of financial performance of insurance firms in Nigeria.

Furthermore, Siyanbola et al. (2016) document the role of the internal audit function in influencing the performance of insurance companies in Nigeria. A pilot survey of five active insurance companies operating in Adamawa State was chosen for the study. The study, which utilised Pearson correlation, finds evidence of a positive relationship existing between internal audit function and the performance of insurance firms in Nigeria. In Libya, Ibrahim and Collins (2016) examine how the effectiveness of the internal audit function affects the organisation's corporate governance. The study uses a survey of 41 internal auditors in the banking sector and insurance companies listed in the Libyan Stock Exchange. The study, which was anchored on Wilcoxon signed test and Z-test, finds evidence of limited skills in the auditor use of IT and also in the preparation of international financial reporting. Tanja et al. (2016) use a survey of 24 companies comprising four sectors, such as insurance, banking, manufacturing and services sectors, to examine the impact of audit committee function on the quality of financial reports of listed firms at the Stock Exchange of Montenegro. Using the regression technique, the study finds evidence of a significant relationship between audit committee function and the quality of financial reporting of listed companies in Montenegro. Ebere and Ibanichuka (2016) use a sample of ten insurance firms in Nigeria to investigate the response of financial performance to changes in audit committees in listed companies in Nigeria covering the period 2008-2014. The research uses two proxy variables to capture financial performance: return on asset and equity. Utilizing a regression approach, the finding indicates the absence of a significant impact of audit committee function on the financial performance of insurance companies in Nigeria.

In Kenya, Amoh (2017) assesses the impact of audit quality on the financial performance of companies quoted at the Nairobi Stock Exchange. The study uses return on assets as a function of auditor independence, professional proficiency and quality of work. Using a regression technique, the study finds that audit quality statistically impacted the financial performance of listed firms in Kenya. Araoye (2019) scrutinizes how audit committee size affects the financial performance of listed insurance companies in Nigeria using a data scope, 2004-2015. The study, which utilised the regression technique, finds evidence of a significant negative impact of audit committees on the financial performance of insurance firms in Nigeria during the period of review. Ajao and Oluwadamilola (2020) submit that the extent to which the internal control system of a firm is efficient helps in no small measure in ensuring a reasonable improvement in the quality of financial reports. Their study assesses how internal control systems determine the quality of financial reporting in insurance companies in Nigeria. Using a questionnaire method on SPSS, a regression technique was conducted. The study finds that effective control systems, information and communication, risk assessment and monitoring had a significant positive impact on financial reporting in insurance companies in Nigeria.

## Research Gap

An insight into the reviewed literature shows a paucity of studies on the impact of internal audit function on financial performance in the insurance industry, especially in Nigeria. Also, most of the studies that were conducted on the insurance sector with regard to internal audit function were much more interested in primary data because of the inability to conceptualise a proxy variable. Accordingly, the current study tends to close the lacuna by focusing on the likely impact of internal audit function on the financial performance of the insurance sector in Nigeria using historical data.



## RESEARCH METHODOLOGY

Longitudinal data were used by the study to assess the relationship among the variables. In what follows is the application of multiple regression techniques for the examination of the analysis. The study uses secondary data that were culled from the annual financial statement of the selected insurance firms, National Insurance Commission Fact Books, and the Nigeria Stock Exchange Fact Books for 2011-2020. As of December 2020, about 17 insurance companies were listed on the Nigeria Stock Exchange floor. Accordingly, they made up the population of the study. A purposive sampling technique was used for the research by which a sample of five insurance firms was selected, including AIICO Insurance Plc, Cornerstone Insurance Plc, Guinea Insurance Plc, Prestige Assurance Plc and Regency Assurance Plc. The study employs a secondary method of data collection. A linear regression technique was utilised by the study to assess the impact of internal audit function on the financial performance of insurance firms. Theoretically, an internal audit is an extension of an audit committee, having several characteristics, usually constituted by management. Thus, prior studies used the audit committee characteristics as proxy variables (Tornyera & Wereko, 2012; Tanja et al., 2016; Ebere & Ibanichuka, 2016; Amoh, 2017; Araoye, 2019). The model is specified as follows:

$$ROA = f(ACS, ACI, ACF, FMS) \dots \dots \dots (3.1)$$

$$ROA_t = \beta_0 + \beta_1 ACS_t + \beta_2 ACI_t + \beta_3 ACF_t + \beta_4 FMS_t + \varepsilon_t \dots \dots \dots (3.2)$$

Where: ROA = return on assets (a proxy for financial performance), ACS = audit committee size, ACI = audit committee independence, ACF = audit committee financial expertise, FMS = firm size (control variable),  $\beta_0$ ,  $\beta_1$ - $\beta_4$  are constant and parameters to be estimated respectively. Likewise,  $t$  is the time trend, while  $\varepsilon$  refers error term. An increase in any of the explanatory variables is expected to lead to an increase in return on assets.

## PRESENTATION OF RESULTS AND ANALYSIS

The presentation is done by first examining the reliability of the data using descriptive statistics and correlational matrix. Accordingly, Table 1 is the descriptive statistics of return on assets, audit committee size, audit committee independence, audit committee financial expertise and firm size for the period 2011-2020.

**Table 1: Descriptive Statistics**

	ROA	ACS	ACI	ACF	FMS
Mean	66.01	1.44	1.34	3.54	3.14
Median	70.21	2.61	5.22	4.37	6.54
Max	81.24	7.16	6.23	8.74	9.34
Min	63.31	4.54	4.32	5.46	5.22
Std. Dev.	2.21	3.02	1.15	2.46	2.30
Skewness	2.32	1.22	3.33	2.78	3.21
Kurtosis	1.77	2.30	1.64	2.51	2.42
Jarque-Bera	1.52	1.41	3.28	4.66	1.31
Prob	0.64	0.61	0.75	1.47	0.65

Source: Extracted from Eview 9.0





Thus, Table 1 indicates that ROA had an average performance of 66%, which ranges from 63 to 81%, with a standard deviation of 2%. Similarly, the audit committee size averaged 1.4% with a minimum of 4.5%, a maximum of 7.2%, and a standard deviation of 3%. Likewise, audit committee independence had a performance average of 1.3% and varied from a minimum of 4.3% to a maximum of 6.2% with a standard deviation of 1.1%. In the case of audit committee financial expertise, its performance averaged 3.5%. It ranges from a minimum of 5.5% to a maximum of 8.7%, with a standard deviation of 2.5%. Similarly, firm size had a mean of 3.1% and ranged from a minimum of 5.2% to a maximum of 9.3%. It has a standard deviation of 2.3%. Meanwhile, the variables are positively skewed around their mean even as normal bell shape distributions were observed. However, the kurtosis displays both peakedness and flatness. For the Jarque-Bera, it reveals normal distribution for the variables since the p-values exceed the significant level of the test or 5%.

**Table 2: Correlation Matrix**

	ROA	ACS	ACI	ACF	FMS
ROA	1.00				
ACS	0.21	1.00			
ACI	0.44	0.41	1.00		
ACF	0.64	0.31	0.54	1.00	
FMS	0.12	0.33	0.22	0.23	1.00

Source: Author's computation using Eview 9.0

Table 2 contains the correlation matrix indicating a positive correlation between return on asset and all determinants. For example, audit committee size had a correlation of 21%, while audit committee independence had a 44% correlation with ROA and so on. This means that a change in any of the explanatory variables triggers a change in ROA.

**Table 3: Regression Results**

**Method: Least square**

**Dependent Variable: ROA**

Variables	Coefficient	Std error	t-statistics	Prob
Constant	0.57	0.23	2.48	0.05
ACS	0.38	0.15	2.53	0.05
ACI	0.14	0.03	4.67	0.00
ACF	1.12	0.25	4.48	0.00
FMS	-0.68	0.27	-2.52	0.05
$R^2 = 0.74$ , F-stat = 4.13, DW = 1.92				

However, a stronger relationship is exhibited when the values of the coefficients are smaller. Table 3 contains the results of the relationship between ROA (a proxy for financial performance), and internal audit function disaggregated into audit committee size, audit committee independence, audit committee financial expertise and firm size. It can be observed from the Table that the fit of the model is relatively robust as it shows that the explanatory



variables account for 74% variation in return on assets. Likewise, the DW statistic indicates the absence of serial correlation, while the F statistic shows that the model is statistically significant. Accordingly, Table 3 reveals that all four independent variables are statistically significant in explaining changes in the financial performance of firms in the insurance industry. Specifically, return on assets is significantly and positively responsive to changes in audit committee size (0.38%), audit committee independence (0.14%) and audit committee financial expertise (1.12%) contrary to its negative changes of 0.68% in firm size. The positive relationship is in line with Olajide (2013), Siyanbola et al. (2016) and Ajao and Oluwadamilola (2020), who had earlier reached similar findings. Contrariwise, the negative relationship gives credence to the findings of Araoye (2019). Meanwhile, the findings of the study could not support the work of Ebere and Ibanichuka (2016).

## SUMMARY AND RECOMMENDATIONS

The study assesses the extent to which internal audit function affects the financial performance of insurance companies in Nigeria. The study avers that in several instances for listed firms in Nigeria, financial statements are doctored, leading to scandals that normally damage investors' confidence with implications on the capital market. The study uses return on assets as a proxy for financial performance, and the explanatory variables comprise of audit committee size, audit committee independence, audit committee financial expertise and firm size. The study uses multiple regression techniques to scrutinise the analysis. The study finds that audit committee size, audit committee independence and audit committee financial expertise had a significant positive impact on financial performance. In contrast, the effect of firm size is significantly negative. Accordingly, it is recommended that the various elements of audit committee characteristics, such as audit committee size, independence, and financial expertise, should be strengthened to enhance financial performance in the insurance sector. Also, the size of the firm should be such that it does not constitute an unnecessary financial drain so as to allow the revenue to grow, thereby increasing profit.

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