The Impact of Auditing on the Performance of Insurance Companies in Kosovo

Yllka Ahmeti and Etem Iseni

ABSTRACT

This study analyzes the impact of auditing on the financial performance of insurance companies in Kosovo. The data of the companies that are used are for the period 2015-2020. The data are panel type. Through Gretl software, with OLS we tested our hypotheses. As a dependent variable (measure of financial performance) we used ROA, while as independent variables we took the leverage, firm age, firm size, firm capital, tangible assets, liquidity and firm growth. We also tested the ROA ratio as a variable dependent on specific factors of insurance companies (independent variables). While their relationship with the audit was tested using the following three variables as representatives for the audit: the size of the audit firm, the mandate / term of the audit firm and the relationship between the audit firm and the insurance firm (rotation). From all the models we have tested, trying to exhaust all the possibilities of testing for the possible impact of external audit on the performance of insurance companies in Kosovo, we have noticed that the most important or statistically significant variables are the size of the firm, leverage, and growth of the firm. From audit variables, only the audit mandate has turned out to be positive and significant, in the performance of audit companies in Kosovo. Therefore, insurance companies in Kosovo should pay significant attention to these variables, of course trying to increase the role of external audit in their performance.

Keywords: Audit, Insurance Companies, Financial Performance, Kosovo.

I. INTRODUCTION

The insurance industry is an important part of the financial system and its proper functioning can provide energy for other industries and economic development. To do this, the insurance business must be financially healthy and strong, as well as profitable in its operations. In view of this, due attention should be paid not only to the assessment of the financial performance of insurance businesses, but also to a number of factors that affect the financial performance of the insurance industry.

The development of a sustainable insurance system is a prerequisite for the development of an economy. The insurance market in Kosovo has undergone a relatively positive development over the last decade and has been characterized by continuous reforms, especially with the entry of new companies offering new services. The insurance market in Kosovo is regulated by law 05 / L-045. Such a market is considered as a consolidated market that offers a wide range of products for which it is considered that they have the capacity and space for market development.

At the end of 2011, thirteen licensed insurance companies had activities in Kosovo, of these, ten of them did not offer life insurance and three were life insurance companies. As in most countries, also in Kosovo, non-life insurance and life insurance companies are subject to different regulatory regimes. The main reason for this is that the life insurance business tends to be long-term, often covering several decades, while non-life policies are usually shorter and with clearly defined periods. According to the evidence provided by the Kosovo Insurance Bureau, at the end of 2020, 11 insurance companies operated in Kosovo.

Regarding research in the field of insurance and in particular in the field of auditing and its role in the financial performance of these companies, previous research focused mainly on banks and not on insurance companies, and only on financial performance and not on the factors that affect financial performance, and even less on the role of audit in this financial performance. Given all this previous research, this research will focus on the role of auditing in the financial performance of insurance companies in Kosovo. Moreover, a large number of parties will benefit from the study findings. The main purpose of the study is to identify and review the role of auditing in the financial performance of insurance companies operating in Kosovo. The data will be obtained from the 6-month financial statements of these companies within the period 2015-2020. So, the primary goal is to determine the impact of the audit on financial performance of insurance companies in Kosovo. The paper continues with section II Literature, then econometric models and variables are explained in detail in section III. Methodology. This section also provides detailed explanations of the data. Section IV. Results include comments on the results and their comparison with other authors, and section V Conclusions.
II. LITERATURE REVIEW

Auditing financial statements is a monitoring tool that serves to reduce information asymmetry and protect the interests of various stakeholders, ensuring that management financial statements are free from material misstatement (Farouk and Hassan, 2014). The task of auditors should be to make a major contribution to improving financial performance by reducing the possibility of reporting serious anomalies and ensuring that financial statements are prepared in accordance with Accounting Standards and established norms and regulations. Because one purpose of financial management is to maximize the owner's wealth and profitability, which in turn shows superior financial performance, profitability is one of the most significant objectives of financial management.

Research on the performance of insurance companies is mainly focused on (1) determining the factors that affect performance, (2) the impact of internal audit on performance as well on the (3) impact of audit quality on firm value and financial performance. The first group, using the secondary data provided by the financial statements using as independent variables a number of specific factors of insurance companies such as: firm size, leverage, firm growth, firm age, asset tangibility, long and short debt ratio, ROA, ROE etc. (Čurak et al., 2011; Kozak, 2011; Salim and Yadav, 2012; Wabita, 2013, Kripa and Ajaíslari, 2016, Ortyński, 2016, Almajali and Shamsuddin, 2019).

The second group of authors analyzes the impact of internal audit on financial performance by analyzing the factors related to the internal auditor: IA independence, IA competence, IA quality, IA committee, IA effectiveness and efficiency, follow-up IA standards etc. (Ramachandran et al., 2012, Mohamed and Habib, 2013, Olalekan, 2019, Al-ahdal et al., 2020).

The third group focused on audit quality and financial reporting quality (Bouaziz, 2012, Farouk and Hassan, 2014; Afza and Nasir, 2014; Sayar, 2015; Phan et al. 2020). They analyzed the financial performance ratio measured mainly by ROA and other factors such as: firm size, firm age, firm tenure, audit fees, audit firm size, audit firm rotation, auditor independence etc.

Several other authors have analyzed the impact of audit quality on the detection and reporting of mismanagement and misuse as well as financial statement fraud (Okolie, 2014, Salehi and Mansoury, 2009, Boskou et al., 2019, Kaawaase et al., 2021). Studies have also examined the determinants of audit quality, as results show that large auditing firms provide high-quality auditing services (Lakhal, 2015; Sakka & Jaroui, 2015; Al-Bassam et al., 2018).

Many researchers have focused on several dimensions of corporate governance such as the ownership structure, board of directors, and the external audit and audit committee. Studies also confirm the relationship between corporate governance and agency costs (Chu and Saw-Imm, 2016; Sabeena & Suganya, 2016; Al-Bassam, et al., 2018), and highlights the impact of corporate governance on solving agency problems and mitigating its conflicts (Chiraz, 2014). As well as the relationship between the various agency problems and the quality of the external audit, and the quality of financial reports (Alrashidi, 2020). Studies have also assumed that companies tend to use a high level of corporate governance mechanisms with high agency costs (Chiraz, 2014), in order to reach a consensus of interests between investors and management (Zraaqat, 2019). In addition to the companies that use large auditing offices (BIG4), the level of governance application is greater than other companies (Al-Bassam et al., 2018; Lakhal, 2015; Al-Janadi et al., 2013; Zureigat, 2011).

III. DESIGN AND METHODOLOGY

This section begins with some stories elaborating in detail the models for testing the impact of external audit on the performance of insurance companies. Several different models were used in the study, in order to examine all the possibilities of testing for the possible impact of independent variables on the performance of insurance companies in Kosovo. The reasoning for the selected sample, the explanation of the variables and the hypotheses are elaborated further. We use Gretl software, and we test our result with OLS regression.

In our models, we have included those variables which are accessible to us from the websites of insurance and auditing companies. In the first model based on the model of several authors (Ahmed et al., 2011, Sambisivam and Ayele 2013, Muriga 2014, Derbeli, 2014, Burca and Batrinca, 2014), we have taken to test the variables for which we have data on the websites of insurance companies in Kosovo, excluding in this model, the variables that express the characteristics of audit companies:

\[ ROA = \alpha + \beta_1LEV + \beta_2AGE_{ELN} + \beta_3SIZE_{ELN} + \beta_4EQ_{LN} + \beta_5LIQ_{RAR} + \beta_6FGR + \epsilon \] (1)

Based on the purpose of our topic, for the possible impact of the audit on the performance of insurance companies, the study tests the impact of the variables that represent the characteristics of the audit companies in ROA. The variables included in 2nd model are based on these authors as: Sayyar et al. (2015); Rahman et al. (2019); Aca et al. (2020); Nwoye, Anichee, and Osegbue, (2021).

\[ ROA = \alpha + \beta_1BIG4 + \beta_2TURNover + \beta_3R_{audit\ company} + \epsilon \] (2)

In our third model, all variables are combined to test their potential impact on the performance of insurance companies. This model is based on the models of the authors Farouk and Hassan (2014); Ado et al. (2020); Sayyar et al. (2015); Matoke and Omwenga (2016); Aca, Musa and Garba (2020).

\[ ROA = \alpha + \beta_1LEV + \beta_2AGE_{ELN} + \beta_3SIZE_{ELN} + \beta_4EQ_{LN} + \beta_5LIQ_{RAR} + \beta_6FGR + \beta_7BIG4 + \beta_8TURNover + \beta_9R_{audit\ company} + \epsilon \] (3)

Through purely linear regression we will test all preliminary models. The following table includes all the variables of these models, and explanations for their calculations.

Data panel regression testing was evaluated by simple linear regression using Gretl statistical software. The following section will provide a detailed description of the variables, their reference sources and hypotheses.
The data we have used are panel data for the period (2015-2020), obtained from the websites of insurance companies and their respective auditors. Since the insurance market is new in Kosovo, we have taken only those insurance companies which have data from 2005 onwards. As for the audit companies, in Kosovo they are obliged to report on their data only from 2009, so we are “forced” to create dummy variables. “The audit firm that `conducts audits of companies in Kosovo, pursuant to Article 5, paragraphs 10 and 11 of this Law, publishes an annual transparency report no later than four (4) months after the end of every financial year. This transparency report is published on the website of the auditor or audit firm and remains available on this website for at least five (5) years from the date of its publication on the website”, (p. 10. Law on Reporting).

Table II presents the testing of independent variables that represent the characteristics of the firm as well as the ROA as a measure of financial performance. From the results of model 1, we confirm that the size and age of the firm have a positive impact and are statistically significant, while leverage has a significant negative impact.

As mentioned above, to test the audit variables we have divided them into a separate model. The results of the fifth model are presented in Table III below.

Of the three audit variables, only the Audit Mandate has resulted positive and significant in the performance of insurance companies in Kosovo. Of course, audit variables can be somewhat similar to each other and can reduce the likelihood of good results, based on the R and R squares of these results. To see their impact, we also tested a recent model by testing them along with other independent variables for potential impact on ROA.

The following Table IV presents the results of the 3rd model which includes all variables.

### TABLE I: STUDY VARIABLES AND DESCRIPTION

<table>
<thead>
<tr>
<th>Variables</th>
<th>Abbreviations</th>
<th>Estimates</th>
<th>Authors</th>
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<tbody>
<tr>
<td>Return on assets</td>
<td>ROA</td>
<td>Profit before interest and taxes divided by</td>
<td>Farouk and Hassan (2014); Sambasivam and</td>
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<td></td>
<td></td>
<td>total assets</td>
<td>Ayele (2013); Ado et al. (2020); Kaguri,</td>
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<td></td>
<td></td>
<td></td>
<td>(2013); Burca and Batrinca, (2014).</td>
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<tr>
<td>Characteristics of insurance companies (independent variables)</td>
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<tr>
<td>Leverage</td>
<td>LEV</td>
<td>Total debt divided by total assets</td>
<td>Farouk and Hassan (2014); Sambasivam and</td>
</tr>
<tr>
<td>Age of the firm</td>
<td>AGE</td>
<td>Ln of firm age</td>
<td>Ayele (2013); Kaguri, (2013); Batrinca,</td>
</tr>
<tr>
<td>Size of the firm</td>
<td>SIZE</td>
<td>Log of the firm assets</td>
<td>(2014)</td>
</tr>
<tr>
<td>Tangibility</td>
<td>TA</td>
<td>Fixed assets divided by total assets</td>
<td>Sambasivam and Ayele (2013); Kaguri, (2013);</td>
</tr>
<tr>
<td>Liquidity</td>
<td>LIQ</td>
<td>Liquid assets divided by liquid liabilities</td>
<td>Sambasivam and Ayele (2013); Kaguri, (2013);</td>
</tr>
<tr>
<td>Firm growth</td>
<td>FGr</td>
<td>(PG (t) - PG (t-1))/PG (t-1)</td>
<td></td>
</tr>
<tr>
<td>Audit company size</td>
<td>BIG4</td>
<td></td>
<td>Ado et al. (2020); Aca et al. (2020);</td>
</tr>
<tr>
<td>Mandate / Term of the</td>
<td>TENURE/</td>
<td>This will be measured by the length of the</td>
<td>Rahman (2017); Afza and Nazir (2014)</td>
</tr>
<tr>
<td>Audit company</td>
<td>TURNOVER</td>
<td>audit-client relationship (contract). Code “1”</td>
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<tr>
<td>Relationship between</td>
<td>F_Audit_C</td>
<td>This mate, researching whether the auditor</td>
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<td>the audit company and the</td>
<td>OM</td>
<td>has changed after each year by the insurance</td>
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<tr>
<td>insurance company (Rotation)</td>
<td></td>
<td>company. Code “1” will be used if changed</td>
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<tr>
<td></td>
<td></td>
<td>after each year of our period, and “0” if</td>
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<td></td>
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<td>otherwise.</td>
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Source: Authors.

### IV. DATA PRESENTATION AND ANALYSIS

The data we have used are panel data for the period (2015-2020), obtained from the websites of insurance companies and their respective auditors. Since the insurance market is new in Kosovo, we have taken only those insurance companies which have data from 2005 onwards. As for the audit companies, in Kosovo they are obliged to report on their data only from 2009, so we are “forced” to create dummy variables. “The audit firm that `conducts audits of companies in Kosovo, pursuant to Article 5, paragraphs 10 and 11 of this Law, publishes an annual transparency report no later than four (4) months after the end of every financial year. This transparency report is published on the website of the auditor or audit firm and remains available on this website for at least five (5) years from the date of its publication on the website”, (p. 10. Law on Reporting).

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As mentioned above, to test the audit variables we have divided them into a separate model. The results of the fifth model are presented in Table III below.

Of the three audit variables, only the Audit Mandate has resulted positive and significant in the performance of insurance companies in Kosovo. Of course, audit variables can be somewhat similar to each other and can reduce the likelihood of good results, based on the R and R squares of these results. To see their impact, we also tested a recent model by testing them along with other independent variables for potential impact on ROA.

The following Table IV presents the results of the 3rd model which includes all variables.
The results were tested, including the standardized coefficients of the variables, the values t and the p-values for the linear regression equations. Moreover, Fisher’s statistics of 3,0543 which are significant in one percent indicate that the financial performance model is appropriate. Therefore, we can rely on the results of this study. While the R-square has coefficient 0.329251 which means that 32.92% of the changes in ROA come as a result of the key variables we have included in the model.

The positive relationship between company size and ROA means that size is used to capture the fact that larger insurance companies are better at utilizing economies of scale in transactions and enjoy a higher level of profits. Authors such as Sambasivam, and Ayele (2013), Vijayakumar and Tamizhselvan (2010) have similar results. The study also recommends a high consideration of increasing the assets of companies. This is because the size of the company is an important factor as it affects its competitive power. Small companies have less power than large ones; therefore, they may find it difficult to compete with large firms especially in highly competitive markets. This variable also confirms that the size of the firm has a positive and significant impact on the performance of the company. The result of the variable is 0.239, see table above.

The variable which measures the leverage of insurance companies is negative and significant, which confirms the finding that there is a positive and significant relationship between it and ROA. The author Kaguri (2013) has similar results. Great attention should be paid to leverage as companies with high leverage may be at risk of bankruptcy if they are unable to pay their debt; they may also not be able to find new lenders in the future. On the other hand, borrowing can increase the return of shareholders on their investments and make good use of the tax advantages associated with borrowing (Kaguri, 2013).

The variable which measures the age of the insurance company and its impact on performance, is confirmed in this model through the negative coefficient of the age variable (-0.0485), which is not significant. Consequently, new companies are no longer dynamic and stable in their growth experience than old companies. The age of the company does not bring greater stability although they can learn more accurately their market positioning, cost structure and their efficiency levels.

Other results in Table III illustrate that variables such as: asset tangibility, liquidity and company growth, have a positive but not significant effect on ROA measured with a beta coefficient and value of t respectively 0.4180, 1.195 and 0.7872 and p-value of 0.6776, 0.2370 and 0.4345 which are not statistically significant at 5%. In addition, the Durbin-Watson Test is meant to check for automatic correlation between study variables. The Durbin-Watson value is 2.08 which is more than 2 gives and a proof of possession of auto-correlation between variables.

The variable which tests the ratio of the size of the audit firm and the performance of insurance companies shows that it has no impact on the performance of the audit (t = 0.65, preliminary table) Therefore, the size of the audit firm does not have any significant impact on annual performance of insurance companies in Kosovo. In the audit mandate variable, we measure it by the length of the audit-client relationship. Code "1" will be used if the ratio is 3 years and "0" if otherwise. This variable is positive and not significant. Of course, insurance companies in Kosovo do not change auditors for up to five years, but due to the short period, we have taken three years, as we find in the literature. Exactly the law states: “The external auditor, approved by the CBK, may perform the audit with the same insurer, for a period not longer than five (5) uninterrupted years and may participate again in the audit of the the same insurer, after the expiration of the term of at least two (2) years” (p.50 Insurance Law). Authors Aca et al. You have similar results with us. (2020). According to them, insurance companies should equally reduce the number of years that the same audit firm serves as the longer stay of the audit firm negatively affects the value of the firm (Aca et al., 2020).

The relationship between the change or rotation from year to year of the auditing company with the performance of the insurance companies is negative (-0.000103), which confirms a negative relationship between it and ROA. The rotation of the audit firm from period to period does not guarantee the auditor's independence to the extent that there should be a limit to recognition in order to avoid threats. The auditor's relationship with the company is not expected to decrease with the audit firm's rotation. Consequently, the quality of the
audit is unlikely to increase in the first year of the audit term and decrease with the position of the audit firm in subsequent years. Although it can be considered that the level of familiarity of the audit firm with the management is low in the early period and that the level of independence is higher, as the auditor’s mandate with the company increases, it does not mean that the audit firm will lower the level of its work and of the independence and overall quality of the audit.

From all the models we have tested, trying to exhaust all the possibilities of testing for the possible impact of external audit on the performance of insurance companies in Kosovo, we have noticed that the most important and statistically significant variables are the size of the firm, leverage and firm age. Therefore, insurance companies in Kosovo should pay close attention to these four variables, of course trying to increase the role of external audit in their performance. The variables that represent the characteristics of audit companies in Kosovo are positive (except rotation), which means that they have a weak correlation with the performance of insurance companies, but we can not conclude that they are explanatory variables for their impact on performance by considering the base and poor performance of these companies in Kosovo.

V. CONCLUSIONS

The study examined the relationship between audit and financial performance for insurance companies in Kosovo for period of 2015-2020. An extensive review of literature on audit fees, auditor size, financial performance and net profit margin was undertaken. We have noticed that the most important or statistically significant variables are the size of the firm, leverage the age of the firm, and growth of the firm. Of the three audit variables, only the variable which is the Audit Mandate, has turned out to be positive and significant, in the performance of audit companies in Kosovo. From the results, we can conclude that the management of insurance companies, to perform the audit, should engage one of the 4 major audit firms and where this is not possible, the management should move towards an audit firm, character and integrity of which is indisputable. Audit firms that have a strong reputation will be less likely to hire auditors who will be willing to compromise their position. The audit firm itself would not want to engage in any activity that would tarnish its image and tarnish its name. This is a positive sign for the management of insurance companies but also shareholders, to be sure that their interests will be properly protected.

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