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The effect of the supervision by the Audit Committee, Internal Audit, External Audit and Corporate Financial Soundness on Profitability

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ABSTRACT: *Insurance and reinsurance companies are required to maintain a sound financial standing and comply with the provisions on the company's equity as stipulated by the government. To achieve such equity, the company must retain their profitability. Under a supervision system supported by the Audit Committee, Internal Audit and External Audit, it is expected that the insurance companies shall be able to fulfill their obligation in complying with all the prevailing regulations. If these companies fail to do so, the companies shall be subject to the supervision of the government. This study was conducted on insurance and reinsurance companies listed in the Indonesian Stock Exchange in 2012 (11 companies). Thirty eight top executive of the company were interviewed as respondents. By applying the SPSS program the results showed that simultaneously and partially, the Audit Committee, the Internal Audit, the External Audit and the Corporate financial soundness, have influences on the company's profitability.*

KEY WORDS: *Audit Committee, Internal Audit, External Audit, Financial Soundness, Profitability.*

I. INTRODUCTION

Background of Research

To establish a sound and competitive insurance industry, it is necessary to improve the governance of the business players in such industry. The insurance companies are required to apply the principles of good corporate governance and are obligated to appoint an Independent Commissioner in their company. (Government Regulation No. 39 of 2008).

The Financial Service Authority (OJK) has issued the Regulations of the Financial Service Authority No.2/ POJK.5/2014 on Good Corporate Governance in Indonesia. OJK requires insurance and reinsurance companies to establish their own Audit Committee, Internal Auditor and External Auditor.

This government regulation on insurance companies requires all insurance companies maintain a sound financial position based on the risk-based capital ratio. In complying with this regulation, the insurance companies should be able to run their business professionally and fulfill their obligation as committed in the insurance policy that they have issued.

The risk-based capital ratio is essential in assessing the financial security and the soundness of the insurance companies. The higher the ratio of the risk-based capital of an insurance company, the healthier the company is. The risk-based capital ratio is the minimum capital that should be made available by the insurance company to cover all the potential risks in managing the assets of the company. All insurance companies in Indonesia are required to report the risk-based capital ratio to the Government on a quarterly basis and must maintain a risk-based capital ratio of 120%. If an insurance company a risk-based capital ratio less than 120%, then the company would be subject to the supervision of the government.

If the company has an adequate equity, the insurance company would be able to expand and compete in the global era. At the time this regulation on the minimum risk-based capital ratio was issued, most of the insurance companies had an equity level below the minimum requirement. The sound financial condition with an adequate equity position is essential in supporting the company's profitability in the longterm.

Profitability is the ratio to assess the company's ability to generate profit. This ratio can also be used to assess the effectiveness of the company in generating profit. To achieve the equity level as required by the government, the insurance companies should continually improve the ability to generate profit.

Identification of Issues

Insurance and reinsurance companies are required to maintain sound financial condition using the risk-based capital ratio method (Regulation of the Financial Minister No. 53 of 2012). By the end of 2014, the insurance companies have the obligation to have a minimum equity of Rp 100 billion and Rp 200 billion for reinsurance companies (Goverment Regulation no 81 of 2008). Although many insurance and reinsurance companies have maintained a risk-based capital ratio of 120 %, this ratio is considerd as quite burdensome for the companies.

Regulation of the Financial Service Authority no. 2 of 2014 requires the insurance companies to establish an Audit Committee, an Internal Audit unit within the company and appoint an External Auditor. By applying a supervisory system that is supported by an Audit Committee, an Internal Audit dan External Audit, the company is expected to perform well and maintain a risk-based capital ratio with a profitability that is managed in compliance with the Government Regulation.

Limitation of Issues

The independent variables that are applied in this research are: the Audit Committee, Internal Audit and the External Audit. The dependant variables in this study is Profitability. In this study, the financial soundness of the insurance and reinsurance companies listed in the Indonesian Stock Exchange is assessed by applying the risk-based capital ratio method and the Profitability is calculated based on the *Return on Equity* (ROE) and Return on Investment (ROI).

Problem Statement

Considering the background of this research as mentioned above, the problems identified in this research are as follows:

What is the influence from the Audit Committee, Internal Audit, External Audit and the Corporate Financial Soundness either partially or simultaneously towards the Profitability of insurance companies?

Objectives of the Study

The objectives of this research are to understand the following issues:

The effect of the Audit Committee, Internal Auditor, External Auditor and the Financial Soundness partially as well as simultaneously towards the profitability of the insurance companies.

II. THEORY & HYPOTHESIS

The theory applied as a conceptual framework for this research is explained as follows:

Audit Committee

The Audit Committee is a Committee established by the Board of Commisioners to assist their duty and function of supervising the company as stipulated in the Corporate Law that serves to protect the interest of all the stakeholders. The interest of the stakeholders is reflected in the company’s management that produces accurate, complete, reliable and timely financial reports (Alijoyo, Darwin, Gunadi, 2006).

In implementing effective supervision, the Audit Committee among others must be independentt, competent and experienced, transparent and communicative and adopt the Internal Auditor Charter (Arens, 2006, KNKG, 2009).

Internal Audit

According to Agoes (2007), the Internal Audit is an examination conducted by the company’s Internal Auditor, to assess the company’s financial soundness and accounting records and the company’s compliance with management policy. The examination by the internal auditor is usually more detailed than the examination by the Public Accountant. The Internal Auditor Internal does not provide an opinion on the fairness of the financial report, since the Internal Auditor is considered not independent. The Report of the Internal Auditor may present audit findings on some discrepancy or fraud, the weaknesses of the internal control and the recommendations for improvement. In compliance with the Head of the Supervisory Board for Capital Investment and Financial Institutions number: kep 496/BL/2008, dated: 28 Nopember 2008, the issuers or the Public companies are obligated to establish an Internal Audit Charter**.**

External Audit

According to Agoes (2007), having external audit provides an added value to the financial report of the company, since the public accountant is considered as competent, and independent. At the end of the examination, the auditors will report the fairness of the financial condition of the company, the profit, the change of equity and the cash flow report. The external audit is conducted by a Public Accountant as an independent party to assess the fairness and the accuracy of the report submitted by the Board of Directors. The appointed Public Accountant should be accountants that are registered in the supervisory institution of the government and comply with prevailing Law, and is recommended by the Board of Directors to the Board of Commissioners to be further approved by the General Meeting of the Shareholders. (KNKG, 2009).

Corporate Financial Soundness

Insurance companies function as guarantors to transform uncertainty to become certainty for the insurance policy holders. Insurance companies would not be able to provide certainty to other parties if the company itself is not financially secured. Therefore, the issue of security of the insurance company is of public interest and it is the main reason for the intervention of the government as a regulator to ensure financial soundness of companies and assess whether the company is sound or not.

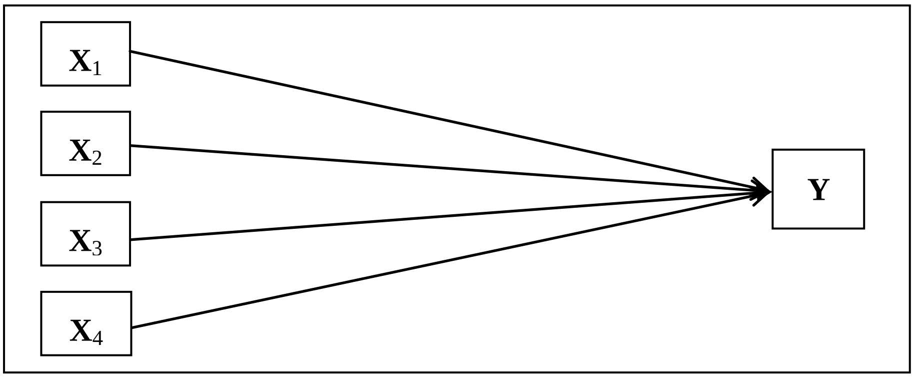
The financial soundness is assessed by applying the risk-based capital ratio, which is to measure the essential *solvability* of insurance companies. The risk-based capital ratio is the minimum capital made available by every insurance company to cover any failure of asset management and other various risks.

Profitability

The performance of the company reflects the achievement of a company in reaching its target, objectives, vision and misson as incorporated in the strategic plan for a certain period of time (Komala, 2009). In this context, the profitability ratio measures the company's ability to generate profit (Sensi, 2006).

Conceptual Framework

Figure 1: Conceptual Framework



Remarks: x_1 = Audit Committee; x_2 = Internal Auditor; x_3 = External Auditor; X_4 = Financial Soundness; Y = Profitability

The Audit Committee, Internal Audit and External Audit and the corporate financial soundness are independent variables that effects profitability. The Audit Committee has three dimensions in its role, namely: duty and responsibility, the member organization structure, reporting system, work correlation and performance assessement using several indicators. The Internal Auditor works also in three dimensions namely: accountability, authority and auditor qualification assessed by several indicators. The role of the External Auditors has two dimensions namely: general standard and reporting standard that is assessed using several indicators.

The financial soundness assessed using the Risk-based Capital also has two dimensions, namely the financial aspects and the non-financial aspect and it is assessed using several indicators. Meanwhile the profitability is a reflection of the achievement of the company in reaching its financial target performance and has two dimensions namely: financial aspects (return on equity and return on investment) and non-financial aspects, that is assessed using several indicators.

Hypothesis

The Audit Committee, Internal Auditor, External Auditor and the financial soundness, partially and simultaneously have an effect on the Profitability of the insurance companies.

III. RESEARCH METHOD

This research is aimed to test the hypothesis on the effect of Audit Committee, Internal Audit, External Audit and the corporate financial soundness as indicated by the: solvability (risk-based capital ratio) on the Profitability of insurance company in Indonesia. This research is an explorative research involving insurance companies that are registered at the

Indonesian Stock Exchange (11 companies). The research targeted 5 high officials of each company *(top management),* namely: The President Director, Financial Director, Independentt Commisioner, Audit Committee and Internal Auditor who will fill in the questionnaire sent to them (55 respondents), however only 38 questionnaires were returned and processed for the research.

IV. RESULT & DISCUSSION

The Audit Committee, Internal Auditor, External Auditor and financial soundness partially and simultaneously are estimated to have an effect towards the company's profitability.

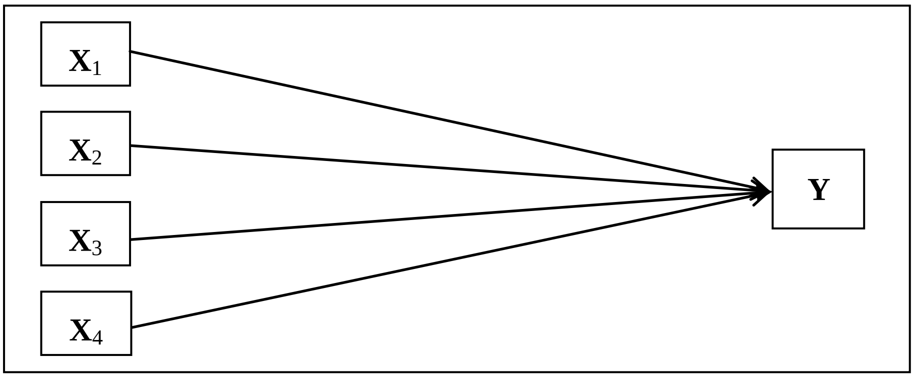


Figure 4: The Effect of the Audit Committee (X_1), Internal Audit (X_2), and External Audit (X_3) and financial soundness (X_4) and its impact towards profitability (Y)

Testing the third hypothesis on simultaneous or joint effort

The hypothesis in this test is:
H_0 : β_i=0, in which i= 1,2,.....n meaning that the joint (simultaneous) efforts of all the independent variables have no significant effect towards the dependent variable.
Ha : $\beta_i \neq 0$, in which i= 1,2,......n ; meaning that at least there is one independent variable with a joint/simultaneous effort that has a a significant effect towards the dependent variable.

Table 1: The effect of the simultaneous effort of the Audit Committee, Internal Audit, External Audit, and Financial Soundness towards the company's Profitability

Adjusted R^2	**F_{hitung}**	***p-value***	**Ho_i**	**Ha_i**
0,67	19.807	0.000	Rejected	Accepted

Source: Author (result from data analysis)

The effect of joint effort of the Audit Committee (X1), Internal Auditor (X2), External Audit (X3), and the financial soundness (X4) towards the company's profitability is 67 %, and there is a significant effect with a *p-value* 0.000. The remaining 33 % is affected by other factors other than the Audit Committee, Internal Auditor, External Auditor, and financial soundness. The effects may be caused by the operations of the company management.

Testing the third hypothesis of separate effort
The hypothesis presented in this test is as follows:
Ho : β= 0, each independent variable has no significant effect on the independent variable.
H_a : $\beta \neq 0$, each independent variable significant effects the dependent variable.

Table 2 : The Effect of the Indivdual/Separate (partial) effort of the Audit Committee, Internal Audit, Audit External dan Financial Soundness as variables towards profitability

Independent variable	B	T count	P value	Hypothesis Ho	Conclusion
C	-63.166	-1.499	0,143	Ho accepted	Non significant
X_1	-0,100	-1.830	0,076	Ho rejected	Significant at α = 0,10
X_2	0,133	0.360	0,017	Ho rejected	Significant at α = 0,05
X_3	0,445	0.510	0,000	Ho rejected	Significant at α=0,01
y	0,249	0.262	0,022	Ho rejected	Significant at α=0,05

The above table shows the Intercept (C) value which is p value = 0.143, and that the hypothesis Ho is accepted. Therefore, it is understood that there is no significant effect towards the profitability. The p value of the Audit

Committee (X_1) is 0.076, so that the Ho hypothesis is rejected, and it is concluded that the individual (partial) effort of the Audit Committee has significant effect on the profitability variable at a confidence level of 0.10. The p value of the Internal Audit (X_2) is 0.017 so that Ho is rejected, and that separate (partial) effort of the Internal Auditor has a significant effect on the company's profitability with a confidence level of 95%. The p value of the effect of the External Auditor (X_3) is 0,000, so that Ho is rejected, and it can be concluded that the External Audit has a siginifcant effect on the profitability variable with a confidence level of 99%. The p value of the financial soundness (X4) is 0.022, so that Ho is rejected, and that it can be concluded that the financial soundness variable has a significant effect on the profitability at a confidence level of 95%.

Discussion

The Audit Committee, Internal Audit, External Audit and corporate financial soundness have an effect towards profitability. The profitability of the company is affected by the joint (simultaneous) effort of the Audit Committee, Internal Audit, External Audit and corporate financial soundness of the company. This means that if the Audit Committee and the Internal Auditor are independent, competent and effective in supervising the company in compliance with the *Charter*, and the External Auditor also upholds consistently their independency and maintain the quality of the audit with *full disclosure* in the financial report and if the company complies with the regulations on financial soundness, then the profitability of the company can be achieved as targeted. The other variables -that were not the subject of this research- are the economical aspects and the role of the management that may affect the company's profitability. The **effect of the individual (partial) role of the Audit Committee** towards the company's profitability is significant. The **effect of the individual (partial) role of the Internal Audit** towards the company's profitability is significant. The Internal Audit -as part of the structural organization- has an active role in directly supporting the management in evaluating the internal control, evaluating the risk management, evaluating *governance* policies, examining the accounting and financial department, examining the operations of the company, evaluating the ethical conduct and values of the company, detecting fraud and investigating, providing objective information and providing recommendations, so that the company's profitability can be well-managed. The Audit Committee in supervising the company shall coordinate the supervision with the Internal Audit. **The effect of the individual (partial) role of the External Audit** towards the company's Profitability is significant. This means that the quality of the audit, the independency and the disclosure in the reports particularly related to the company's profitability can motivate the company management to increase the company's profit. **The effect of the individual (partial) role of the** financial soundness towards the company's profitability is significant. This means that the components in calculating the financial soundness can motivate companies to maintain the composition of its admitted assets, and to offer prudent underwriting and manage operation risks so that the company can achieve the required solvability margin. Therefore, the revenue from the gross premium, the claim ratio, operation costs and investment proceeds can be well-managed to incease profitability.

V. CONCLUSION AND RECOMMENDATION

Conclusion

The Audit Committee, Internal Audit, External Audit and the corporate financial soundness have an effect towards the profitability of the company. Working jointly (simultaneously), the Audit Committee, Internal Audit, the External Audit and the corporate financial soundness have a significant effect on the company's profitability. **The effect of the individual (partial) role of the Audit Committee** towards the company's profitability is significant. **The effect of the individual (partial) role of the Internal Audit** towards the profitability of the company is significant. **The effect of the individual (partial) role of the External Audit** towards the company's profitability is significant. **The effect of the individual (partial) role of the financial soundness** towards the company's profitability is significant.

Recommendation

1. The Audit Committee, the Internal Audit and the External Audit should consist of independent, professional and highly committed personnel in accordance with the *Charter*, to achieve the objectives of the company.
2. It is necessary to seek other theory concepts to improve the fnancial soundness and profitability of the company of insurance companies, in addition to the existing concepts applied in this research.
3. For further future studies, it is necessary to provide the Audit Committee, Internal Audit dan External Audit with other dimensions or indicators that are more appropriate to disclose the level of contribution or effect towards the profitability of the company.
4. To maintain and achieve the company's profitability, the Audit Committee and Internal Audit should enhance its role in supervising the operations of the company in compliance with the Charter, and should take these following steps:

- Focus on the duties and responsibilities in several operational aspects of the company such as: finance, compliance, corporate governance, risk management, internal control, acceptance, claim and reinsurance.
- Enhance the independency of the members.
- Conduct regular internal meetings every month.
- Improve the competence of the personnel in understanding the operations of the insurance business, accounting standard and calculation of financial soundness based on risk-based capital ratio.
- Understand the government regulations on insurance companies.
- Provide recommendations and advice related to the development of the the company's profitability and financial soundness.
- Update the Charter.

6. The External Audit should strongly uphold the independency principles and maintain the quality of the audit results and financial report. The External Audit should disclose in the audit report the financial soundness and the admitted assets. To comply with the Regulation of the Minister of Finance (PMK) no. 53 of 2012 on financial soundness, the External Auditor should enhance their understanding on the regulations on insurance business to be able to provide sound opinion on the compliance audit of the insurance companies.
7. Supervision of the financial soundness of the company should be enhanced since the financial soundness of the insurance companies is one of the main issues in fulfilling the company's obligation as agreed in the insurance poilicy. The insurance company needs to analyze the factors that can increase the admitted assets and that can effect the calculation of the Minimum risk-based capital ratio (MMBR).
8. Supervision on the profitability of the insurance companies also needs to be strengthened, to support the company in fulfliing its obligation to have sufficient own capital (Government Regualtion no 81 of 2008).

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