



## ***INTERNAL CONTROL SYSTEM IN ENHANCING THE CORPORATE GOVERNANCE IN LISTED INSURANCE COMPANIES IN NEPAL***

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### **ABSTRACT**

*This study aims to show the role of internal control in enhancing the corporate governance of insurance companies in Nepal. To attain the study's objectives, four independent variables risk assessment, monitoring and supervision, control environment, and internal audit have been considered as well three dependent variables independent directors, transparency, and responsibility are taken. A descriptive research design has been used in the study. Fifteen insurance companies in Nepal have been chosen using the convenience sampling technique. Primary data has been collected from the staff of insurance companies in Nepal. A total of 384 respondents' information is used in the research. Descriptive and inferential statistics are used for data analysis using SPSS and Excel software. Based on the result of the analysis, it was found that risk assessment elements positively enhance the corporate governance elements of transparency and responsibility. Elements of monitoring and supervision have a positive role to enhance the independent directors and transparency but a negative role on responsibility. Likewise, a controlled environment enhances the independent directors in a positive direction. Internal audit positively enhances the independent directors but responsibility has been affected negatively. The success of corporate governance is affected by the internal control activities in insurance companies in Nepal.*

**Key Words:** *Corporate Governance, Internal Control, Insurance Companies, Nepal*

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### **INTRODUCTION**

Corporate governance is the process of directing and governing an organization. Firms cannot be held responsible to their various investors without corporate governance. Several studies have described corporate governance as a trait that highlights a basic element of corporate governance. A framework for governing and controlling enterprises and organizations can be characterized as corporate governance. (Amarneh, 2014). The success of internal control and corporate governance leads to the success of insurance companies. Internal control and corporate governance are internal factors of the organization which can be better managed by efficient management practice.

In this competitive period, corporate governance became an important phenomenon in every organization. Corporate governance plays a vital role to maximize the performance of insurance companies. Corporate governance in insurance companies requires specific attention and specialized methods for monitoring, supervising, and evaluating its performance. According to the insurance for International Settlements, effective corporate governance is critical to achieving



and maintaining public trust and confidence in the insurance sector. The general public's trust and confidence are the most important factors in premium utilization.

Insurance is a contract, represented by a policy, in which a policyholder receives financial protection or reimbursement against losses from an insurance company. The following are the features of insurance policies. First, It is a kind of risk management plan to use an insurance policy as a hedge against an uncertain loss. Second, An insurance policy does not mitigate the magnitude of loss one may face. It only assures that the loss is shared and distributed among multiple people. Third, Insurance policies can be provided for life and non-life i.e., medical expenses, vehicle damage, property loss/damage, etc. depending on the type of insurance. Fourth, Premium, policy limit, and deductible are the main components of an insurance policy. The policy buyer should check them thoroughly while buying an insurance policy

The insurance sector has faced poor corporate governance practices, poor quality of services, rising fraudulent activities, low insurance coverage and penetration, under insurance, misspelling and force selling, and lack of qualified insurance personnel.

The biggest challenges for insurance companies are: Lack of trust among people towards insurance; High competition; Mismanagement of the companies; Economic instability of the country; Weak manpower in the insurance company; and Excessive politicization of the insurance industry.

A system of internal control is the policies combined with procedures created by management to protect the integrity of assets and ensure the efficiency of operations. The system prevents losses and helps management maintain an effective means of performance. There are five interrelated components of an internal control framework: control environment, risk assessment, control activities, information and communication, and monitoring.

The primary purpose of internal controls is to help safeguard an organization and further its objectives. Internal controls function to minimize risks and protect assets, ensure accuracy of records, promote operational efficiency, and encourage adherence to policies, rules, regulations, and laws.

Inaam (2015) showed that a strong commitment to all aspects of internal control helps to improve the corporate governance pillars. A high level of dedication to each area of internal control also helps to improve the corporate governance pillars. Ghimire (2020) in his study concluded that the Nepalese insurance industry experienced slow growth, limited coverage, and low penetration and density over the long period before 2001 which gradually increased thereafter. Similarly, the regulatory issues in the insurance sector are crucial as the industry has faced poor corporate governance practices, poor quality of services, rising of fraudulent activities, low insurance coverage, and penetration, under insurance, miss-selling and force selling, lack of qualified insurance personnel.

In this regard, the objective of this study is to find the role of internal control in the enhancement of corporate governance in insurance companies in Nepal. The objective of this study is to find the role of internal control in the enhancement of corporate governance in insurance companies in Nepal.



## LITERATURE REVIEW

Internal controls are the mechanisms, rules, and procedures implemented by a company to ensure the integrity of financial and accounting information, promote accountability, and prevent fraud. Besides complying with laws and regulations and preventing employees from stealing assets or committing fraud, internal controls can help improve operational efficiency by improving the accuracy and timeliness of financial reporting. Internal control plays a critical role in a company's internal controls and corporate governance (investopia).

In general, internal controls fall into one of three categories (Published July 20, 2022 • By Reciprocity):

- i. Preventive Controls: As the name implies, preventive controls prevent issues including accounting errors, material misstatements, fraud, or cyber-attacks before they have a chance to happen. Such controls are essential because they help to lower the costs of errors or malicious actions. Some common preventive controls are:
  - a. Segregation of duties, especially in accounting and financial reporting
  - b. System access controls
  - c. Employee training
  - d. Authorization and approvals of invoices and expenditures
  - e. Physical security controls
- ii. Detective Controls: Detective controls find errors and irregularities that have already occurred. They are essential because they show whether preventive controls are operating as intended and because they help improve process quality and prevent the recurrence of errors.
  - a. Monthly reconciliations of transactions
  - b. Organizational performance reviews, particularly budget-to-actual comparison
  - c. Physical inventories of cash, goods, or raw materials
  - d. External and internal audits
- iii. Corrective Controls: Corrective controls resolve existing issues that may lead to or exacerbate fraud, financial losses, or reputational damage. They include:
  - a. Software patch management
  - b. Updated policies for information systems
  - c. Disciplinary action
  - d. Ledger verification

The best way to implement and integrate these controls into business processes is to use an established internal control framework such as the framework developed by COSO. The COSO internal control framework consists of five components that work together to create an effective system of internal controls. This system supports your organization's mission, vision, business strategy, and objectives (Published July 20, 2022, • By Reciprocity).

**Control Environment:** The control environment provides a structure and discipline for internal controls. It aligns business processes with applicable laws, compliance requirements, and industry-standard practices. It also assures that the company operates responsibly, ethically, and reliably while reducing its legal exposure.

The environment sets the stage for the other elements of your internal control system. It describes the organization's culture and ethics, the management's philosophy and commitment to internal control policies, and the direction provided by the board of directors. It also incorporates all these elements:

- a. Employees' competence and ethical values
- b. Management's operating style
- c. Assignment of authority and responsibility
- d. People development processes



**Risk Assessment:** Regular risk assessments (say, once a year) allow the organization to identify risks and implement plans for risk elimination or mitigation. This step involves assessing each risk's possible impact and likelihood to minimize the potential for damage or losses. Such evaluations can help you understand how risks relate to business objectives and implement appropriate controls against them.

**Control Activities:** Control activities are the policies and procedures to carry out proper risk responses and management directives. These controls help the organization achieve its business objectives while keeping risks low. They can occur at all levels and in all functions.

- a. Segregation of duties
- b. Transaction verifications and reviews
- c. Reviews of operating performance
- d. Inventory counts
- e. Employee training sessions
- f. Physical and digital security
- g. Data backups

**Information and Communication:** Effective communication is a vital element of the internal control framework because it helps to assure that the right controls are in place and working as expected. It's vital to share risk information throughout the organization in a timely manner, and in a form that people can understand and use to take action.

**Monitoring:** Internal or external auditors must regularly monitor all internal controls to evaluate the control system's performance and effectiveness and to assure that controls are followed throughout the organization. Regular spot checks can help you identify control gaps and fix them before they can harm the organization.

**Corporate Governance** refers to the way in which companies are governed and to what purpose. It identifies who has power and accountability, and who makes decisions. It is, in essence, a toolkit that enables management and the board to deal more effectively with the challenges of running a company. Corporate governance ensures that businesses have appropriate decision-making processes and controls in place so that the interests of all stakeholders (shareholders, employees, suppliers, customers, and the community) are balanced.

Governance at a corporate level includes the processes through which a company's objectives are set and pursued in the context of the social, regulatory, and market environment. It is concerned with practices and procedures for trying to make sure that a company is run in such a way that it achieves its objectives while ensuring that stakeholders can have confidence that their trust in that company is well founded.

As the home of good governance, the Institute believes that good governance is important as it provides the infrastructure to improve the quality of the decisions made by those who manage businesses. Good quality, ethical decision-making builds sustainable businesses and enables them to create long-term value more effectively, Chartered governance institute the UK and Ireland (2021)

Seven pillars of corporate governance

- a. Clear Organizational Strategy
- b. Effective Risk Management
- c. Discipline and Commitment
- d. Fairness to Employees and Customers
- e. Transparency and Information Sharing
- f. Corporate Social Responsibility
- g. Regular Self-Evaluation

Al-Zwyalif (2015) studied the role of internal control factors (control environment, risk assessment, control activities, communication and information, and monitoring) in building the



corporate governance pillars was explored (accountability, fairness, responsibility, and transparency). In the instance of Jordanian insurance companies, the study looked at how much commitment had a role in the establishment of those pillars. To achieve the study's objectives, a questionnaire was prepared and distributed to a sample of non-executive members of the board of directors, financial managers, heads of accounting departments, and internal auditors from 27 Jordanian insurance businesses. A total of 162 questionnaires were distributed, with 123 returned and valid for data processing, resulting in a response rate of around 76%. The findings showed that a strong commitment to all aspects of internal control helps to improve the corporate governance pillars. A high level of dedication to each area of internal control also helps to improve the corporate governance pillars, according to the report. According to these findings, internal control played a critical role in the establishment of the corporate governance pillars in Jordanian insurance companies, and corporate governance success is interwoven in compliance with all internal control components.

Drogalas et al. (2016)) examined the internal audit has been identified as a fundamental driver of corporate disclosure, to improve financial data quality, ensure financial reporting transparency, and develop management-shareholder trust. Several researchers have looked at the new framework of corporate governance and its relationship to the internal audit process as a result of the necessity to establish effective governance systems. Few research on the link between corporate governance and internal auditing has been conducted in Greece. The study looked at the above-mentioned link in firms registered on the Athens Stock Exchange. Internal audit was studied in terms of audit quality and consulting function to highlight the new management-oriented and value-adding scope of internal audit. Data was collected using a survey questionnaire approach, and it was analyzed using regression analysis. Internal audit's advising function, internal audit quality, and the audit committee were all linked to corporate governance, according to the findings.

Al-Matari & Mgamal (2019) examined the present corporate governance system, with a focus on the interaction between internal audit and management practices. A descriptive study investigation using a quantitative methodology was conducted on a sample of listed enterprises on the Athens Stock Exchange for the year 2016. The methodological research instrument was based on COSO's (2013) Internal Control-Integrated Framework. Corporate governance was driven to management excellence and effective governance by internal audit processes, risk assessment, control activities, information and communication, and monitoring activities, according to the research. By explaining the main features of a well-functioning internal control system and its relationship to management performance, the study contributed to the body of knowledge on corporate governance. The recommended future research directions should be taken into account.

Amponsah et al. (2016) in their study assessed the internal controls system in the insurance companies in Ghana. The main finding was that there is a statistically significant difference among categories of insurance companies on the combined dependent variables (internal control variables-Control Activities, Monitoring, Information and Communication, Control Environment, and Risk Analysis). When the results for the dependent variables were considered separately, the variables that contributed to the statistical significance are the Control Activities, Monitoring, Control Environment, and Risk Analysis.

Christina et al. (2021)) studied the efficacy of internal audit was evaluated in terms of its contribution to corporate governance. The study's purpose was to determine how internal audit support for corporate governance was changed by professionalization. Internal audit's contribution to corporate governance was projected to be linked to elements connected to internal audit professionalization, according to the study. The study combines data from a survey of 49 publicly traded businesses on the Athens Stock Exchange with publicly accessible information from annual reports to investigate the claims. Internal audit's impact on corporate governance was

better for businesses where the internal audit function followed internal auditing criteria and internal auditors had professional certificates, according to empirical findings. Internal audit's contribution to corporate governance was also affected by several company-specific factors, such as CEO duality and audit committee quality, according to the findings.

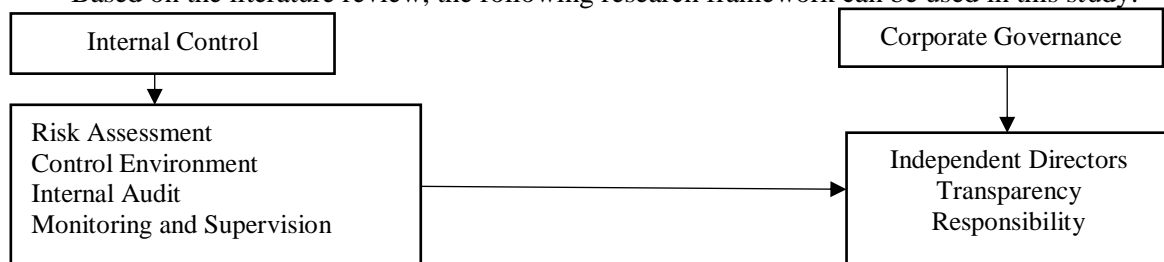
Aldurrah W. K. (2021) found that the importance of internal controls and board characteristics has been necessary for the success and sustainability of firms. And the findings of this paper are beneficial for small and medium-sized firms to implement good corporate governance to ensure the success and sustainability of their product and services.

The main objective of the study conducted by Ashiagbor et al. (2018) is to examine the effect of internal control mechanisms on the performance of life insurers in Ghana. Their finding was that internal control mechanisms have a positive and unique contribution to explaining the performance of life insurance companies in Ghana. Life insurance companies are very crucial in the mobilization of financial resources in a country and therefore have a tremendous impact on the economic growth and financial stability of the country. The importance of internal control mechanisms in achieving these goals cannot be overemphasized. Despite the growing trend in internal control systems in financial institutions, there is little knowledge of the internal control practices that exist within life insurance companies in Ghana and how these influence their performances.

Al-Zwyalif and Al-Zaytoonah (2015) in their study aimed to examine the role of internal control elements: control environment, risk assessment, control activities, communication and information, and monitoring, in enhancing the corporate governance pillars, which are: accountability, fairness, responsibility, and transparency. The study also seeks to determine the extent to which this commitment contributes to strengthening these pillars in the context of Jordanian insurance companies.

Ghimire (2020) in his study aims to analyze the current situation of insurance services offered by different institutions in Nepal and explore the opportunities and challenges of the insurance sector. It also discusses the regulatory and development issues in the insurance sector. The study concludes that the Nepalese insurance industry experienced slow growth, limited coverage, and low penetration and density over the long period prior to 2001 which gradually increased thereafter. There is the domination of commercial insurers in the insurance industry, the domain of social insurance and social security programs also growing immensely but deposit insurance and insurance services by noninsurance organizations are on a small scale. The regulatory issues in the insurance sector are crucial as the industry has faced poor corporate governance practices, poor quality of services, rising in fraudulent activities, low insurance coverage, and penetration, underinsurance, mis - selling and force selling, and lack of qualified insurance personnel. Insurance is a pillar of the financial system, a permanent source of funds for the banking sector and capital market. For financial stability and sustainable economic growth, there should be sound coordination among the regulatory authorities and market players.

Based on the literature review, the following research framework can be used in this study:



**Figure 1.** Theoretical Framework, (Cohen & Sayag 2010)



## METHODOLOGY

This study is focused to find the role of internal control in the enhancement of corporate governance in Nepalese insurance companies. The study is based on a descriptive and survey research design. The total listed life insurance companies in Nepal are 19 out of which fifteen life insurance companies are selected as a sample through the convenience sampling technique. The theoretical framework of the study is based on Cohen & Sayag (2010) with some changes. For the collect data, a structured questionnaire was prepared. The questionnaire has been divided into three parts, the first part is demographic information of the respondent while the second part is related to internal control and the third part consists of the questionnaire on corporate governance. To determine the reliability of data, a pre-test of the questionnaire was done in a few insurance companies. A total of 400 questionnaires have been distributed to the administrative and assistant staff of fifteen insurance companies in Nepal out of which only 384 questionnaires were complete and usable. Questionnaires were based on a 5-point Likert scale. Where, 5 = strongly agree, 4 = agree, 3 = neither agree nor disagree, 2 = disagree, and 1 = strongly disagree. The response of the respondents was analyzed using SPSS software version – 23. To show the role of internal control in the enhancement of corporate governance in insurance companies multiple linear regression analysis was used. To see the role of the internal control system in the enhancement of corporate governance in Nepalese insurance companies following linear regression equation models were used:

$$\begin{aligned} ID &= \beta_0 + \beta_1 RA + \beta_2 MS + \beta_3 CE + \beta_4 IA + e_t \dots\dots\dots I \\ TR &= \beta_0 + \beta_1 RA + \beta_2 MS + \beta_3 CE + \beta_4 IA + e_t \dots\dots\dots II \\ RE &= \beta_0 + \beta_1 RA + \beta_2 MS + \beta_3 CE + \beta_4 IA + e_t \dots\dots\dots III \end{aligned}$$

Where,

- ID = Independent directors,
- TR = Transparency,
- RE = Responsibility,
- RA = Risk Assessment,
- MS = Monitoring, and supervision,
- CE = Control environment,
- IA = Internal audit.

## RESULTS AND ANALYSIS

*Table 1. Descriptive Analysis of Variables*

Variables	Min.	Max.	Mean	SD
<b>Independent Directors</b>	3.00	4.67	3.91	.461
<b>Responsibility</b>	1.00	4.00	3.24	.433
<b>Transparency</b>	2.50	4.67	3.99	.472
<b>Risk Assessment</b>	2.50	4.75	4.06	.503
<b>Monitoring and Supervision</b>	2.80	4.60	4.01	.464
<b>Control Environment</b>	2.00	4.33	3.83	.468
<b>Internal Audit</b>	1.50	4.75	3.95	.519

Note: Survey Report 2022

Table 1 shows that min., Max. SD and Mean value of the variables. The highest minimum value is 3.0 and the lowest is 1.0 are independent directors and responsibility respectively. The highest value of Maximum is 4.75 and the lowest value is 4.00 are risk assessment and responsibility respectively. The highest mean value is 4.06 and the lowest value is 3.24 are risk assessment and responsibility. Moreover, SD's highest value 0.519 and the lowest SD value is 0.433. This descriptive table shows that employees of insurance companies in Nepal bear less responsibility. In addition, risk assessment is highly supportive of corporate governance in insurance companies.

*Table 2. Correlation Coefficient of the Variable*

Variables	ID	RE	TR	RA	MS	CE	IA
<b>ID</b>	1						
<b>RE</b>	0.62	1					
<b>TR</b>	0.87	0.90	1				
<b>RA</b>	0.82	0.91	0.98	1			
<b>MS</b>	0.91	0.84	0.98	0.98	1		
<b>CE</b>	0.89	0.81	0.94	0.92	0.95	1	
<b>IA</b>	0.67	0.94	0.92	0.95	0.89	0.87	1

Note: Survey Report 2022

Table 2 shows that there is a high positive correlation between independent directors and internal control variables (risk assessment, monitoring and supervision, control environment, and internal audit) i.e. 0.82, 0.91, 0.89, and 0.67 respectively. Likewise, the correlation between responsibility and internal control variables has a high positive correlation was a minimum value of 0.81. Moreover, there is a high correlation between transparency and risk assessment (0.98), monitoring and supervision (0.98), control environment (0.94), and internal audit (0.92).



*Table 3. Regression Analysis Between Independent Directors and Internal Control*

Variables	B	Un std. SE	Std. Beta	t	Sig.	VIF
(Constant)	.096	.040		2.372	.018	-
Risk Assessment	-.786	.084	-.858	-9.353	.000	4.966
Monitoring and Supervision	1.869	.079	1.880	23.762	.000	1.331
Control Environment	.239	.036	.243	6.697	.000	4.980
Internal Audit	-.356	.039	-.400	-9.011	.000	2.493
<b>Adj. R<sup>2</sup> = 0.97, F. Stat. = 2753.76, F. Sig. = 0.000, DW = 0.58</b>						

Dependent Variable: Independent Directors.

Table 3 shows the impact of independent variables on independent directors. Adjusted R<sup>2</sup> 0.97 explains that internal control variables are taken in this study explain the independent directors by 97%, F. sig. 0.000 means this econometric model is fit at a 1% level of significance and DW 0.58 says that there is a positive autocorrelation between the independent variables. A rule of thumb is that DW test statistic values in the range of 1.5 to 2.5 are relatively normal. All the values of VIF are less than 5, therefore there is no multicollinearity. Variable risk assessment and variable internal audit have a negative and significant effect on independent directors, it means that a 1-unit increase in risk assessment decreases the impact of independent directors by 0.786. Likewise, 1 unit increases in internal audit effect on independent directors by -0.356. Furthermore, the variables monitoring and supervision and control environment have a positive and significant effect on independent directors with P- values of 0.000 and beta values (1.869 and 0.239). This means that improvement in monitoring and supervision and control environment increases the corporate governance in Nepalese insurance companies.

*Table 4. Regression Analysis Transparency and Internal Control*

Variables	B	Un Std. SE	Std. Beta	t	Sig.	VIF
(Constant)	.067	.036		1.843	.066	
Risk Assessment	.414	.076	.442	5.476	.000	5.966
Monitoring and Supervision	.477	.071	.468	6.734	.000	1.331
Control Environment	.054	.032	.054	1.692	.092	4.980
Internal Audit	.031	.036	.034	.858	.391	2.493
<b>Adj. R<sup>2</sup> = 0.97, F. Stat. = 3591.48, F. Sig. = 0.000, DW = 0.20</b>						

Dependent Variable: Transparency.

Table 4 explains the regression coefficient of independent variables (risk assessment, monitoring, supervision, control environment, and internal audit), and the dependent variable transparency is shown. There is an adjusted R<sup>2</sup> of 0.97, which says that the dependent variable transparency is explained in 97% by 4 independent variables and the model is also fit (p = 0.000) at a 99% confidence interval. Durbin Watson's value of 0.20 means there is a positive autocorrelation between the variables. There is no multicollinearity because the highest VIF value is 5.96. The results of this model say that there is a positive and significant effect of risk assessment and monitoring and supervision on transparency. Improving the risk assessment and monitoring and supervision of the Nepalese insurance companies can increase transparency as well as corporate governance.

*Table 5. Regression Analysis Responsibility and Internal Control*

Variables	B	Un Std. SE	Std. Beta	T	Sig.	VIF
<b>(Constant)</b>	.196	.068		2.895	.004	
<b>Risk Assessment</b>	.497	.141	.578	3.536	.000	4.966
<b>Monitoring and Supervision</b>	-.220	.132	-.236	-1.676	.095	1.331
<b>Control Environment</b>	-.105	.060	-.113	-1.749	.081	4.980
<b>Internal Audit</b>	.584	.066	.699	8.835	.000	2.493
<b>Adj. R<sup>2</sup> = 0.89, F. Stat. = 801.92, F. Sig. = 0.000, DW = 0.22</b>						

Dependent Variable: Responsibility.

Table 5 explains the role of internal control in the enhancement of responsibility in Nepalese insurance companies. Four Internal control variables explain the responsibility of 89% where the Adjusted R<sup>2</sup> is 0.89. Similarly, this econometric variable shows the role of internal control in the enhancement of responsibility is fit at a 1% level of significance for the study, where  $p = 0.000$ . There is a significant positive effect of risk assessment and internal audit on responsibility. The result explains that risk assessment and internal audit help to enhance the responsibility of the employees in insurance companies. VIF values of all independent variables are less than 5 and there is no multicollinearity.

## DISCUSSION

The main findings of this research were that employees of insurance companies in Nepal bear less responsibility and risk assessment is highly supportive of corporate governance in insurance companies. Similarly, another finding was monitoring, supervision, and control environment increases the corporate governance in Nepalese insurance companies, these were similar to the findings of Al-Zwyalif and Al-Zaytoonah (2015) i.e., the role of internal control elements: control environment, risk assessment, control activities, communication and information, and monitoring, in enhancing the corporate governance. Andreas G. K. & Evangelia A. (2018) also examined that corporate governance was driven to management excellence and effective governance by internal audit processes, risk assessment, control activities, information and communication, and monitoring activities, according to research.

The findings of the present research i.e., risk assessment and internal audit help to enhance the responsibility of the employees in insurance companies which was similar to the findings of George D., Konstantinos A., & Evgenia A. (2016) and Christina V., Michalis B., & Andreas A. (2020) who have looked at the new framework of corporate governance and its relationship to the internal audit process as a result of the necessity to establish effective governance systems

## CONCLUSION

This research is conducted to explore the role of internal control in the enhancement of corporate governance in insurance companies in Nepal. The findings of the study explained that risk assessment activities in insurance companies positively enhance transparency and responsibility but independent directors are adversely affected. Monitoring and supervision have a positive role to enhance the role of independent directors and transparency. Internal audit has a negative role to enhance corporate governance through the independent directors but a positive role to enhance corporate governance through responsibility.



## IMPLICATIONS

This study is based on only four internal control variables risk assessment, monitoring and supervision, control environment, and internal audit. The future researcher can also consider the other independent variables like budgeting and control activities in further studies. Primary data for one month has been collected from the respondent in this research of insurance companies in Nepal; further research can be conducted by collecting the information for long periods. Only statistical tools have been applied to analyze the results but the researcher can use various tools to conclude whether internal control enhances the corporate governance in the firm or not.

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