



## The Relationship between the Weakness of Internal Control and the Auditor's and Legal Inspector's Report in Insurance Industry

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**Abstract:** This research analyzes the relationship between the weakness of internal control and the reports of auditing and legal inspector in insurance industry. The library method was used in setting theories and main concept of research, and evaluating the data related to weakness of internal control system along with auditor's and legal inspector's reports. Statistic tools such as Chi-square, Excel, and SPSS to measure the directly observed data. To achieve this goal, 95 audit and legal inspector reports in insurance company from 2008 to 2012 were chosen. The result of the study shows that the main reasons of unacceptable auditor and legal inspector's reports include weakness or lack of internal control system in debt section of mentioned companies.

**Keywords:** Weakness of Internal Control, Auditor's Report, Legal Inspector, Insurance Industry

### INTRODUCTION

The internal control systems in business units of private and government section mostly do not have a pleasant condition, so in order to achieve the main goal of business community, it is necessary to have modification in this field. Employing appropriate instruments to evaluate internal control system is a good way to begin this modification. Moreover, abiding by law which is of high priority in government policies is not feasible without enough facilities such as a consistent and qualified internal control system.

The owners, government creditors, and other consumers need valid, relevant, and comprehensible information to decide about purchasing, selling, holding on to shares, loaning, evaluating managers' performance, and other important economic decisions. The internal control system is a system which is set to gain trust towards the effective and practical realization of the activities, report reliability, and rule observation .

Managers are all trying to establish the best internal control system in their companies, because they know that without having an effective internal control system; it would be difficult to realize the main goal of the company. Moreover, having internal audit control system causes an increase in the performance and reduces the risk of losing capital and gains the confidence from financial statement reliability<sup>1</sup>.

Accordingly, internal control is a management control which is created within a unit as a part of the infrastructure of management control in order to contribute to the manager in carrying out the task of unit and achieving the goal of that based on a consistent framework. As a result, the key factor in helping to achieve the goal and minimize performance problem is internal control. Internal control is an indispensable factor in running the organization which provides confidence in helping the organization to achieve the goal<sup>2</sup>.

Internal control is an important part of an organization which includes plans and applicable methods to achieve goals and intentions. In other words, supporting the management is based on performance and is also the first defense line in protecting the properties, preventing and detecting errors and cheating<sup>3</sup>.

### **Theoretical concepts**

Top managers of economic units continuously try to find out better ways and methods in internal control due to the important impacts of internal control system on performance, efficiency, and decision making about a business unit. Managers know that without having an effective internal control system, realizing the main goal of the organization, maintaining profitability, and minimizing unexpected events would be too difficult. Managers employ internal control system in confronting rapid changes, economic and competitive atmosphere, changes in demands and customers' taste, and restoring the structure for future growth so that they can react to the problems at the right time. In addition, internal control increases the applicability and reduces the risk of losing properties and causes reasonable confidence from financial statement reliability and rule observation. In order to achieve most of major goals, employing internal control is unavoidable, so there is an increasing demand for more efficient internal control system.

#### **1. Internal control**

Internal control is an important evidence in auditors' comment in audit report, so any kinds of weakness or fault in internal control of companies, in case it is effective in financial operation and presentation of result and incorrect financial reports, can cause unacceptable audit reports .

The variables related to the research includes different kinds of weakness in internal control, such as not doing transactions based on a general or special license, not recording transaction in the right time, not providing financial statement based on the standards of accounting, not being able to compare and any kinds of embezzlement in recorded properties, might be unacceptable audit reports of insurance companies.

### **Literature review**

#### **1. Researches done in Iran**

1. the analysis of the impact of weakness in the internal control of companies accepted in stock exchange on auditor's and legal inspector's report in

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audit company investigates the detection of weaknesses in internal control in order to submit acceptable audit reports and present guidance for suppliers of financial statement by regarding the detection of weaknesses in internal control and helping finance managers to remove the weakness in internal control system which causes the issuance of unacceptable report from auditor and legal inspector in audit reports<sup>4</sup>.

2. The profitability of independent auditing of financial statement: in this research the profitability of independent auditing of financial statement from the perspective of the finance managers of the companies accepted in Tehran stock exchange, were analyzed. The results of the research shows that from managers' perspective independent auditing is useful and effective in reducing the probability of the occurrence of violation, illegal actions, and precise evaluation of bases of auditing assessment. However, it is not effective in improving internal control system, detecting and reducing probability of error occurrence, cheating, and presentation of the basis for evaluating the hypothesis of consistency of the activity of economic agency.

### **Researches done out of Iran**

1. Chi Chen<sup>5</sup> and his colleagues concluded that internal auditing had an effect on the general performance of Taiwanese companies and there was direct relationship between these effects and inefficient performance of board of director. Moreover, it plays a vital role in controlling top managers who are independent and professional.

2. Fadzil Haron and Jantan<sup>6</sup> analyzed the impact of internal auditing and fortify internal control. He claimed that the management of internal audit unit, the professional abilities and impartiality of internal auditors and in internal control system has a considerable effect on companies consistency, and it also affects some parts of auditing were are done by evaluating internal control system.

This can also cause some changes in dangers which are resulted by auditing. Finally, he concludes that independent audit report strongly affects different activities of internal control system especially internal audit system. He also claims that although the evolution of internal audit and the changes in it have been slow in the past one hundred years, the expansion and applicability of internal audit unit have grown rapidly and the effects of internal audit unit on improving internal control has raised.

### **Population**

The population consists of all insurance companies from 2008 to 2012, by regarding the point that the end of financial year of the company is March 29, financial statement of the company are audited every year and the number of observation is 95 auditor's and legal inspector's reports with 432 paragraphs with different subjects are provided. In research which is not natural library methods, researches have restored to library method. In this kind of research such as

descriptive, correlational, and experimental, the researcher needs to study the literature of the subject so we need to use library method.

**Statistic methods used to test the hypothesis**

Because the research data is presented with two variables and there is a kind of correlation with categorical variables, and the observations have been independent of each other, the data recorded in the table is Exclusive agreement. So in order to test the data Chi- square is used as follows.

$$\chi^2_{\alpha,df} = \sum_{i=1}^r \sum_{j=1}^c \frac{(F_o - F_e)^2}{F_e}$$

**F<sub>o</sub>**: the observed distribution

**F<sub>e</sub>**: expected distribution

**R**: the number of rows

**C**: the number of columns

**α** = 5% The level of significance

(C-1)(R-1) = df

In this research, the dependent variable is audit report and the independent variable is the weakness of internal control system of the company.

**RESULTS**

**The result of testing the first hypothesis**

**Hypothesis:**

There is a relationship between the weakness of internal control system and the issuance of unacceptable audit reports.

The result of the hypothesis:

The results were tested and computed at the confidence level of 0.95. The table of computation of testing the H<sub>1</sub> is based on Chi-square formula at 0.05 alpha level of significance.

	<i>X<sup>2</sup> value based on the critical value of Chi- square distribution</i>				
⇒	⇒	,1	3.84,	$\chi^2_{\alpha}, df$	$\chi^2_{5\%} \chi^2_{\alpha}$
	<i>X<sup>2</sup> value based on computations</i>				
⇒	⇒	,1	0.01	$\chi^2, df$	$\chi^2_{5\%}$

**Table1.**The table of the calculation of expected distribution and the percentage related to asset section with unacceptable reports

explanation	comment		sum
	conditioned	no comments and rejected	
consistent	observed distribution	15      4	<b>19</b>
	expected observation	15.2      3.8	<b>19</b>

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assets	assets	prproperties percentage	%78.9	%21.1	<b>%100</b>
	recieved payments	observed distribution	76	19	<b>95</b>
		expected	75.8	19.2	<b>95</b>
		assets percentage	%80	%20	<b>%100</b>
sum		observed distribution	91	23	<b>114</b>
		expected distribution	91	23	<b>114</b>
		asset distribution	%79.8	%20.2	<b>%100</b>

**Table2.**The table of Chi-square calculation for testing the distribution of H<sub>1</sub>

column	observed distribution	expected distribution	(F <sub>o</sub> - F <sub>e</sub> )	(F <sub>o</sub> - F <sub>e</sub> ) <sup>2</sup>	(F <sub>o</sub> - F <sub>e</sub> ) <sup>2</sup> / F <sub>e</sub>
1-1	15	15.2	-0.2	0.04	<b>0.002</b>
2-1	4	3.8	0.2	0.04	<b>0.01</b>
1-2	76	75.8	0.2	0.04	<b>0</b>
2-2	19	19.2	-0.2	0.04	<b>0.002</b>
	sum				<b>01. 0.01</b>

**Table3.**Chi-square Tests

	Value	df	Asymp.Sig. (2-sided)
<b>Pearson Chi-Square</b>	0.011 <sub>a</sub>	1	0.917
<b>Continuity...</b>	0	1	1.000
<b>Likelihood Ratio</b>	0.011	1	0.917
<b>Fisher's Exact Test</b>			

#### The analysis of the H<sub>1</sub> results:

Since the computed statistic  $X^2 = 0.01$  does not exceeds the critical value of the distribution table of Chi- square, we cannot reject the H<sub>0</sub> at the alpha significance level of 0.05, so with 0.95 level of confidence we can say that there is not a significant relationship between the weakness of internal control system and unacceptable audit reports in debt section.

#### The results of the analysis of H<sub>2</sub>:

H: there is a relationship between the weaknesses of internal control system and issuance of unacceptable audit reports in debt section.

Result of the hypothesis:

The results of the H<sub>2</sub> are computed at the confidence level of 0.95, regarding the categorical data in the table.

The table the computed result of the testing H<sub>2</sub> based in Chi-square formula at a=0.05 is as following.

**Table4.** The table of the calculation of expected distribution of the percentage related to debt section with unacceptable report

	description		comment		sum
			conditioned	no comments amd rejected	
debts	business creditors	observed distribution	8	6	<b>14</b>
		expected distribution	11	3	<b>14</b>

fiscal debts and other payments	debt percentage	%57.1	%42.9	%100
	observed distibution	21	2	15
	expected distibution	18	5	15
	debt percentage	%91.3	%8.7	%100
sum	observed distibution	29	8	37
	expected distibution	29	8	37
	percentage debt	%78.4	%21.6	%100

**Table5.** The table of the Chi-square calculation for testing the distribution of H<sub>2</sub>

culumn	observed distribution	expected distribution	(F <sub>o</sub> - F <sub>e</sub> )	(F <sub>o</sub> - F <sub>e</sub> ) <sup>2</sup>	(F <sub>o</sub> - F <sub>e</sub> ) <sup>2</sup> / F <sub>e</sub>
1-1	8	11	-3	9	0.8
2-1	6	3	3	9	3
1-2	21	18	3	9	0.5
2-2	2	5	-3	9	1.8
sum					6.1

**Table6.** Chi-Square Tests

	Value	Df	Asymp. Sig. (2-sided)
<b>Pearson Chi-Square</b>	5.993 <sup>a</sup>	1	0.014
<b>Continuity Correction</b>	4.147	1	0.042
<b>Likelihood Ratio</b>	5.922	1	0.015
<b>Fisher's Exact Test</b>			

*X<sup>2</sup> value based on the critical value of Chi- square distribution*

$$\chi^2_{\alpha, df} \quad \chi^2_{5\%, 1} \quad 3.84$$

*X<sup>2</sup> value based on computations*

$$\chi^2_{\alpha, df} \quad \chi^2_{5\%, 1} \Rightarrow 5.993$$

The analysis of H<sub>2</sub> results:

Since the computed statistic X<sup>2</sup>= 5.993 exceeds the critical value of the distribution table of Chi-square, then we can reject H<sub>0</sub>at the alpha significance level of 0.05. In other words, we cannot accept H<sub>2</sub> at the confidence level of 0.95, so we can say that there is a significant relationship between the weakness of internal audit control in debt section and the invalid report of auditors and legal inspectors.

**The analysis of testing the H<sub>3</sub>**

H: there is a relationship between the weakness of audit control and issuance of unacceptable audit reports in equity.

Results: the results of H<sub>3</sub> were computed and tested at the confidence level of 0.95, regarding the categorical data in the table. The table of the results of H<sub>3</sub>

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based on Chi-square statistic model at the alpha significance level of 0.05 is as following.

**Table7.**The table of the calculation of expected distribution and the related percentage in the equity section with unacceptable reports

description		commnet		sum	
		conditiones	no comment and rejected		
equity	not observing rule	observed distribution	72	12	91
		expected distribution	76.6	14.4	91
		percentage	%86.8	%13.2	%100
	inability in management	observed distribution	8	1	9
		expected distribution	7.6	1.4	9
		percentage	%88.9	%11.1	%100
	other defect factors	observed distribution	34	8	42
		expected distibuution	35.4	6.6	42
		percentage	%81	%19	%100
managers' violation	observed distribution	23	6	29	
	expected distribution	24.4	4.6	29	
	percentage	%79.3	%20.7	%100	
sum	observed distribution	144	27	171	
	expected distribution	144	27	171	
	percentage	%84.2	%15.8	%100	

**Table8.**The table of the Chi-square calculation for testing the distribution of H<sub>3</sub>

column	observed distribution	expected distribution	(F <sub>o</sub> - F <sub>e</sub> )	(F <sub>o</sub> - F <sub>e</sub> ) <sup>2</sup>	(F <sub>o</sub> - F <sub>e</sub> ) <sup>2</sup> / F <sub>e</sub>
1-1	79	76.6	3.6	12.96	0.12
2-1	12	14.4	-2.4	5.76	0.2
1-2	8	7.6	0.4	0.16	0.02
2-2	1	1.4	-.4	0.16	0.1
1-3	34	35.4	-1.4	1.96	0.05
2-3	8	6.6	1.4	1.96	0.3
1-4	23	24.4	-1.4	1.96	0.08
2-4	6	4.6	1.4	1.96	0.4
sum					1.47

**Table9.**Chi-Square Tests

Value	df	Asymp.Sig. (2-
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			sided)
Pearson Chi-Square	1.471 <sub>a</sub>	3	.689
Continuity...	1.453	3	.693
Likelihood Ratio	1.302	1	.254
Fisher's Exact Test	171		

$\chi^2$  value based on the critical value of Chi-square distribution

$$\chi^2_{\alpha} \rightarrow f \quad \chi^2_{5\%} \rightarrow 1 \quad 7.815$$

$\chi^2$  value based on computations

$$\chi^2_{\alpha} \rightarrow f \quad \chi^2_{5\%} \rightarrow 1 \quad 1.47$$

### The analysis of the result of H<sub>3</sub>

since the computed statistic  $\chi^2=1.47$  exceeds the critical value of distributional table of Chi-square, then we cannot reject the  $H_0$  at the significant level of 0.05, so we can say by 0.95 level of confidence that there is not a significant relationship between the weakness of internal control system in equity and the unacceptable reports of the auditor and legal inspector.

### The analysis of H<sub>4</sub> results

H: there is a relationship between the weakness of internal control and issuance unacceptable audit reports in other defect factors and not observing other rules and regulations.

The results of H<sub>4</sub> were computed and tested at the confidence level of 0.95, regarding the categorical data in the table. The table of the results of H<sub>4</sub> based on Chi-square statistic model at the alpha significance level of 0.05 is as following.

**Table10.**The table of the calculation of the expected distribution and the percentage related to other defect factors with unacceptable reports.

description			comment		sum
			condition	no comment and rejected	
other factors	not observing rules	observed distribution	63	7	70
		expected distribution	61.7	8.3	70
		percentage in other factors	%90	%10	%100
	lack of management ability in other factors	observed distribution	34	6	40
		expected distribution	35.3	4.7	40
		percentage in other factors	%85	%15	%100
sum		observed distribution	97	13	110
		expected	97	13	110

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	distribution			
	percentage in other factors	%88.2	%11.8	<b>%100</b>

**Table11.**The table of the Chi-square calculation for testing the distribution of H<sub>4</sub>

column	the observed distribution	the expected distribution	(F <sub>o</sub> - F <sub>e</sub> )	(F <sub>o</sub> - F <sub>e</sub> ) <sup>2</sup>	(F <sub>o</sub> - F <sub>e</sub> ) <sup>2</sup> / F <sub>e</sub>
1-1	63	61.7	1.3	1.69	<b>0.02</b>
2-1	7	8.3	-1.3	1.69	<b>0.2</b>
1-2	34	35.3	-1.3	1.69	<b>0.04</b>
2-2	6	4.7	1.3	1.69	<b>0.35</b>
sum					<b>0.61</b>

**Table12.**Chi-Square Tests

	Value	Df	Asymp. Sig. (2-sided)
<b>Pearson Chi-Square</b>	0.611 <sup>a</sup>	1	0.435
<b>Continuity Correction</b>	0.225	1	0.635
<b>Likelihood Ratio</b>	0.595	1	0.441

*X<sup>2</sup> value based on the critical value of Chi- square distribution*

$$\chi^2_{\alpha=0.05, df=1} = \chi^2_{5\%, df=1} = 3.84$$

*X<sup>2</sup> value based on computations*

$$\chi^2_{\alpha=0.05, df=1} = \chi^2_{5\%, df=1} = 0.611$$

the analysis of H<sub>4</sub> results:

since the computed statistic value X<sup>2</sup>=1.037 exceed the critical value of distributional table of Chi-square, then we cannot reject the H<sub>0</sub> at the significant level of 0.05, so we can say by 0.95 level of confidence that there is not a significant relationship between the weakness of internal control system in other defect factors and the unacceptable reports of the auditor and legal inspector.

## CONCLUSION

The main goal is to help finance managers in order to remove internal control system which causes inappropriate reports and unacceptable comments from auditors and legal inspectors in audit reports:

Detecting the weakness of audit control in order to issue acceptable audit reports. Providing necessary guidance for financial statement suppliers.

Helping the managers of the business units (especially finance managers) in order to remove the weakness of internal control system which causes issuance of unacceptable reports and comments from auditors and legal inspectors in audit reports.

**The results are as following:**

**The conclusion and the analysis of H1**

According to explanation and computations we conclude that there is not a significant relationship between the issuance of unacceptable audit reports and the weakness of internal control system in finance section. however, it does not mean that there is not any weakness in internal control system in finance section or if it exists, it does not have any effects on unacceptable auditor's and legal inspector's reports, but the effects of the mentioned weaknesses are not to the extent that we can mention a significant relationship between weakness in internal control system in finance section and unacceptable reports. Therefore, by regarding the results of testing H1, we noticed that it lacked the ability to remove the weakness of control system.

### **the conclusion and analysis of H2**

Based on the results of the test carried out on every part of the weakness of internal control in debt section which included business creditor, financial debt, and other payments , the greatest weakness of internal control system which causes the issuance of unacceptable audit reports was related to business creditors and after that to fiscal debt and other payments.

### **the conclusion and analysis of H3**

According to the explanations and computations, we can conclude that there is not a significant relationship between the issuance of unacceptable audit reports and the weakness of internal control system in equity. However, it does not mean that in the equity section the weakness of internal control system does not exist, or in case it exists, it does not have any effects on unacceptable reports of auditors and legal inspectors. While, the effect of the mentioned weaknesses are to the extent which we cannot mention a significant relationship between the weakness of internal control system in the equity section and unacceptable reports. As a result with regarding the results gained from testing H3 we can conclude that it is not necessary to focus on removing the weakness of internal control system in the equity.

### **The conclusion and analysis of H4**

Based on the explanations and computations, we can conclude that there is not a significant relationship between unacceptable audit report and the weakness of internal control system in other sections; however, it does not mean that the weakness of internal control system does not exist in other defect factors ( such as not observing rules and regulations), or if it exists it does not have any effects on unacceptable auditor 's and legal inspector's report, but it is meant that the effect of the above mentioned weaknesses are not to the extent that we can say for sure that there is a relationship between the weakness of internal control system in other defect areas and unacceptable reports. Therefore, we can conclude that it is not necessary to focus on removing the weakness of internal control system in other defect areas.

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### **Recommendations:**

According to the obtained results, the followings are suggested:

The recommendations related to the debt section:

**1.** The headline of payments in debt section :

When we consider the internal control of payments, we should remember that the payments of a company are the received payment of the other companies. So, there is a narrow chance for an error to be hidden forever. Because the employer's creditors usually keep complete documents and if they do not receive their money, they inform the employers about it. This debt feature helps the auditors with finding violations, except the time that the offender is a person who can both receive the creditor's submitted pay request and respond to them. So a lot of companies deeds to rely on creditors' notices about the delay in employers' payments, rather than keeping complete documents about debts.

This reaction is not because of the defect or inaccuracy in received payment, but it is due to the weakness of internal control system in received payments.

**2.** The headline of fiscal debt in debt section :

The deducted tax of employees, which is not paid to the ministry of finance on the date of the balance sheet, is a debt which auditors need to review. Taxes that must be paid from salary or wages can be audited at the same time too. This includes tracking the deducted taxes to the list of salary and wage, testing the computation of deducted taxes and their realization, making sure about the payment of deducted taxes based on rules and regulations, and analyzing fiscal declarations.

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