

AUDIT COMMITTEES IN BANKS AND THEIR RESPONSIBILITY TO INTERNAL AUDIT FUNCTION - THE CASE OF THE REPUBLIC OF NORTH MACEDONIA

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Abstract: *Audit committees are responsible for overseeing internal controls and internal audit functions, as well as the external financial reporting process in banks. They are one of the most important organizational structures in the banks after the board of directors, and certain functions in the banks report directly to the audit committees. The paper analyzes the audit committees and internal audit function in the five largest banks in North Macedonia, whether they work efficiently and effectively, and whether the committees fulfill their responsibility to the internal audit function as best they can. The research was conducted through a structured questionnaire sent to the largest banks, namely to members of the audit committees, as well as employees of the internal audit department in those banks. All the results of the research are summarized in a conclusion that assesses the placement and adequacy of audit committees and internal audit function in the banks, as well as the extent to which the audit committees exercise their responsibility to the internal audit function.*

Keywords: *Audit Committee, Internal Audit, Banks*

Introduction

The importance of audit committees in financial institutions has been increasing in the past few years and has played a crucial role in the good governance of these institutions. Audit committees are becoming a key aspect in determining the efficiency, controls, professionalism, and transparency of companies in the need to increase financial performance. In North Macedonia, audit committees are defined by the Law on Audit, and specifically in banks, the audit committees are more closely defined in the Law on Banks. According to the Law on Banks, one of the bodies of the bank is the audit committees, and the same law sets the minimum requirements for the competencies and responsibilities that audit committees have in banks. For banks' audit committees to be adequate, they need to be very well structured, they need to work efficiently, effectively and with high performance, and they need to best fulfill their responsibilities. These mentioned issues together form the adequacy of audit committees.

The audit committee has too many responsibilities that can be classified into several components. One of those responsibilities is overseeing the banks' internal audit function. Internal audit staff work closely with the audit committee and are expected to have the most information related to the committee. The audit committee through its relationship with the internal audit function in the banks tries to reduce the asymmetry of the information between the managers and the stakeholders. A very important function of an internal audit is to help the audit committee effectively perform its responsibilities and improve its ability to monitor the performance of managers. The relationship between the audit committee and the internal auditors should be strengthened by extending the committee's responsibilities to include an audit of the effectiveness of the internal audit functions. This would entitle the committee to hold meetings with external and internal auditors even without the presence of other staff and directors.

This paper contributes to the literature in several ways. First, to the best of our knowledge, no research has been conducted so far to analyze the audit committees and internal audit functions in the banking sector in North Macedonia. Second, this is an empirical study that explores and analyzes the placement and adequacy of audit committees and internal audit functions in banks in North Macedonia. Third, the paper includes two main sections dealing with issues related to audit committees and internal audit functions in banks, and issues related to the responsibilities of audit committees in relation to internal audit functions. Respectively, the paper consists of five parts and is organized as follows. Following the introduction, section 2 provides an overview of the relevant literature related to audit committees and internal audit function in the banking system. Section 3 describes the data and the methodology used in the paper. Section 4 analyzes the results obtained and Section 5 summarizes the results of the paper.

Literature review

In North Macedonia does not have sufficient studies related to research on the set-up and adequacy of audit committees in the banking sector, their general competencies, as well as their responsibility to the internal audit function. More broadly, however, the literature on audit committees and their responsibilities is very rich and well researched. Audit committees can be defined as an administrative structure that supports the independence of internal auditors and assists independent auditors (Uzay, 2003). It is a subset of the management function in companies, but it must be borne the fact that the committee does not replace internal or external audit functions, nor does it interfere with the operational responsibilities of the management. Instead, the committee's role is to ensure the existence of effective systems of internal control, risk management, and financial reporting. To do so, the committee relies on management, internal audit, accounting, risk management, and the external audit function (Camilleri, et al., 2007).

A large group of studies has analyzed the audit committee in terms of its independence and performance. Thus, Akyuz (2008) has stated that certain performance criteria should be established first in order to measure the performance of the committee, and the results should be monitored by the Board of directors (Akyuz, 2008). KPMG (2013) concludes that the audit committee needs to understand how digitalization and social media are changing the business environment. Their study also found that the effects of digitalization and social media on corporations and the supervisory role of the Board of

directors need to be understood by audit committees (KPMG, 2015). Dogan (2016) identifies that audit committees increase the quality of financial reporting (Dogan, 2016). According to DeFond and Jiambalvo (1994), companies that have not established an audit committee are more vulnerable to prepare fraudulent financial statements (DeFond & Jiambalvo, 2014).

Before linking the audit committees with the internal audit function in the banks, it should be noted that the internal audit function plays a key role in the ongoing maintenance and evaluation of internal control systems, processes, risk management and management systems and processes. - areas in which supervisory authorities have a strong interest. The internal audit function should develop an independent and informative view of the risks faced by the bank based on their access to all bank records and data (Bank for International Settlements, 2011). Furthermore, the internal audit function should be able to discuss their views, findings, and conclusions directly with the audit committee and the board of directors, which would help the audit committee to oversee the senior management of the bank.

It has been suggested by various reports, such as the Blue-Ribbon Committee Report (BRC, 1999) and the Toronto Stock Exchange Committee on Corporate Governance (TSECCG, 1999), that the internal audit activity and the audit committee should communicate directly regarding review and examination. on basic issues. Also, the communication between the audit committee and the internal audit services is found in the study of Goodwin (2003), which analyzes the situations when the audit committee cooperates with the internal audit and when they act separately (Goodwin, 2003).

For large banks as well as internationally active banks, the audit committee is typically responsible for providing oversight of the bank's internal auditors (Bank for International Settlements, 2011).

The oversight function of the audit committee includes ensuring that the internal audit function can carry out its responsibilities independently. It also includes reviewing and approving the audit plan, its scope, and the bank's internal audit budget (Bank for International Settlements, 2011).

Research objectives and development of the questionnaire

As defined in the literature review, the existence of the audit committee in banks is of particular importance, as well as its responsibilities to the internal audit function. On the one hand, there should be an objective and completely independent audit committee that will work successfully, and on the other hand, there is the internal audit function that is important in the overall operation of the bank. The questionnaire used in the research consists of all the most important aspects related to the audit committee, the internal audit function, and their connection. The research is based on three main objectives:

- To analyze the opinion and attitude of the members of the audit committees and the employees in the internal audit department in the banks, related to the overall operation and adequacy of the audit committee itself, the internal audit and their connection;
- Do the internal auditors believe that the members of the audit committees are completing their responsibilities in a good way and that they are competent to do the job;
- Are both parties satisfied with the way each other functions, in order for the bank to operate successfully?

The target group of respondents was the members of the audit committees and the employees of the internal audit departments in the five large banks in North Macedonia. In North Macedonia, 14 banks have received a work permit from the National Bank of The Republic of North Macedonia and they can be divided into three categories, according to the amount of assets of a particular bank, as follows:

Table 1: Structure of the banking system in North Macedonia

Group of large banks (assets greater than 37.95 billion MKD as of December 31, 2019)	Group of medium-sized banks (assets between 9.45 and 37.95 billion MKD as of 31.12.2019)	Group of small banks (assets less than 9.45 billion MKD as of 31.12.2019)
five banks	six banks	three banks

Source: National Bank of the Republic of North Macedonia, 2021

Considering that North Macedonia is a small country wherein the assets of the 5 largest banks in North Macedonia is as much as 75% of the total assets of all banks in the banking system in North Macedonia. Thus, this paper investigates the adequacy of audit committees through a structured questionnaire in the five major banks in North Macedonia. The number of responses received from the members of the audit committees and internal audit function is 29, but although this number seems small at first glance, it represents 55% of the total number of members of the audit committees and employees of the internal audit functions. or more specifically 32% of the committees' members answered the questionnaire and 75% of the internal audit staff.

The questionnaire was intended to take no more than 10 minutes. 95% of the questions were answered from 1 to 5 (Likert scale), where 1 refers to "strongly disagree" and 5 refers to "strongly agree". The questionnaire contains an introduction, as well as preliminary general questions related to the work engagement in the bank (a member of the audit committee or employee of the internal audit department), years of work experience in that position, level of education, and whether they have a license/certificate related to the audit. In table no. 2 descriptive statistics of the characteristics that refer to the respondents are given.

Table 2: Descriptive statistics of the characteristics of the respondents

Feature	Description	Number	Percent
Education	Intermediate	0	0.00%
	High	17	65.52%
	Master	8	27.59%
	PhD	4	6.90%
	Total	29	100.00%
Work engagement	Audit Committee	8	27.59%
	Internal Audit Department	21	72.41%
	Total	29	100.00%
License / Certificate (Certified Auditor, ACCA, etc.)	Yes	15	51.72%
	No.	14	48.28%
	Total	29	100.00%
Work experience in the position	1-5	12	41.38%

	6-10	7	24.14%
	11-15	0	0.00%
	over 15 years	10	34.48%
	Total	29	100.00%

Source: Author's calculation

Before starting any analysis, the Cronbach's alfa coefficient of 0.92 was calculated and shows that there is a high internal consistency and all items are significant to maintain.

RESEARCH APPROACH TO ANALYSIS OF ANSWERS AND RESULTS

As previously stated in the paper, the main purpose of the research is to provide empirical evidence for the placement and adequacy of the audit committee in the banks in North Macedonia. The research was conducted with the research method - survey, by distributing an online questionnaire to the members of the audit committees and the employees of the internal audit departments in the five largest banks in North Macedonia. The questionnaire was mostly distributed to the respondents via LinkedIn, but a small part of the respondents also received the questionnaire via e-mail. The questionnaire was implemented in the period from 15.12.2020 to 10.01.2021, and it was answered by a total of eight members of audit committees and twenty-one employees in the internal audit departments of banks. The following Table 3 covers the descriptive statistics of the whole questionnaire.

Table 3: Descriptive statistics of the questionnaire

	N	Min	Max	Mean	Std. Deviation	Variance
Audit Committee (AC) Questions						
8. The AC reviews the financial statements of the bank and takes care of the accuracy and transparency of the published financial information for the operation of the bank in accordance with the accounting regulations and the international accounting standards.	29	4.0	5.0	4,862	.3509	.123
9. The AC reviews and evaluates the internal control systems.	29	4.0	5.0	4,897	.3099	.096
10. The AC monitors the audit process of the bank and evaluates the work of the audit company	29	4.0	5.0	4,966	.1857	.034
11. The AC adopts the accounting policies of the bank;	29	2.0	5.0	4,345	1.0446	1,091
12. The AC monitors the compliance of the bank's operations with the regulations related to accounting standards and financial statements	29	3.0	5.0	4,621	.7277	.530
13. The AC holds meetings with the Board of Directors, the Internal Audit Department, and the Audit Company regarding identified non-compliances with the regulations and weaknesses in the bank's operations.	29	3.0	5.0	4,828	.4682	.219

14. The AC reviews the reports of the Risk Management Committee	29	3.0	5.0	4,828	.5391	.291
15. The AC proposes the appointment of the audit company and termination of the concluded contract with the audit company	29	2.0	5.0	4,586	.8667	.751
16. The AC informs the Bank's Supervisory Board about its work at least once in three months.	29	3.0	5.0	4,793	.5593	.313
17. The AC submits a semi-annual and annual report on its work to the Supervisory Board of the bank.	29	3.0	5.0	4,897	.4093	.167
18. The AC ensures that the internal control system is examined according to international models (COSO etc.)	29	2.0	5.0	4,276	.9963	.993
19. The members of the AC have sufficient experience and knowledge in the banking sector, their responsibilities, banking activities, culture, and organizational structure.	29	3.0	5.0	4,724	.5914	.350
20. The members of the AC have enough time and are generally in the bank to fulfill their responsibilities.	29	1.0	5.0	4,138	1.1565	1,337
21. The members of the AC have experience in areas related to their responsibilities such as finance, auditing, internal system, and professional certification.	29	3.0	5.0	4,759	.5766	.333
22. The members of the AC have professional skepticism and adhere to a code of conduct	29	3.0	5.0	4,690	.5414	.293
23. The members of the AC are independent and objective in performing their tasks.	29	4.0	5.0	4,759	.4355	.190
Internal Audit Department (IAD) Questions						
The IAD performs a permanent and complete audit of the legality, regularity, and timeliness of the bank's operations through (refers to questions 1 to 8):						
1. assessment of the adequacy and efficiency of the internal control systems;	29	5.0	5.0	5,000	0.0000	0.000
2. assessment of the implementation of risk management policies;	29	4.0	5.0	4,897	.3099	.096
3. assessment of the location of the information system;	29	3.0	5.0	4,793	.4913	.241
4. assessment of the accuracy and reliability of trade books and financial statements;	29	3.0	5.0	4,586	.6278	.394
5. checking the accuracy, reliability, and timeliness of the reporting in accordance with the regulations;	29	3.0	5.0	4,690	.6038	.365
6. monitoring compliance with regulations, code of ethics, policies, and procedures;	29	4.0	5.0	4,862	.3509	.123
7. evaluation of money laundering prevention systems	29	4.0	5.0	4,897	.3099	.096
8. assessment of the services that the bank receives from the ancillary services companies of the bank	29	3.0	5.0	4,621	.6219	.387

9. The IAD carries out its activities in accordance with the principles and standards for internal audit, the bank's code of ethics, and the policy and procedures for the operation of the service.	29	4.0	5.0	4,897	.3099	.096
10. The persons in the IAD are employees of the bank and perform activities only in the service. At least one of the employees of the department is a certified auditor.	29	5.0	5.0	5,000	0.0000	0.000
11. The IAD prepares an annual work plan of the service, which is approved by the Supervisory Board.	29	5.0	5.0	5,000	0.0000	0.000
12. The plan must state the subject of the audit with a description of the content of the planned audit in certain areas and the schedule of controls during the year with the planned duration of the controls.	29	4.0	5.0	4,897	.3099	.096
13. The IAD prepares a semi-annual and annual report and submits it to the Supervisory Board, the Board of Directors, and the Audit Committee of the bank.	29	4.0	5.0	4,931	.2579	.067
14. The IAD informs the Supervisory Board and the Board of Directors if during the control it determines: non-compliance with the risk management standards due to which there is a possibility for disturbance of the bank's liquidity or solvency and that the Board of Directors does not comply with the regulations, general acts and internal procedures of the bank	29	5.0	5.0	5,000	0.0000	0.000
Responsibilities of the AC to IAD (AC_IAD)						
1. The AC ensures the independence of the IAD.	29	1.0	5.0	4,345	1.1734	1,377
2. The AC provides the necessary resources for the IAD to be able to fulfill its responsibilities.	29	1.0	5.0	3,828	1.3381	1,791
3. The AC supervises the scope and adequacy of the risk assessment made by the IAD.	29	1.0	5.0	4,103	1.2348	1,525
4. The AC requests separate audits from the IAD in addition to periodic and risk-based audits.	29	3.0	5.0	4,103	.8170	.667
5. The AC evaluates the professional education of the internal auditors, the level of adequacy, independence and objectivity, in order to fulfill their responsibilities in accordance with the professional standards.	29	1.0	5.0	3,828	1.3646	1,862
6. The AC provides a communication channel for internal auditors to communicate directly with the Audit Committee.	29	1.0	5.0	3,931	1.3870	1,924
7. The AC meets with the internal auditors at least 4 times a year.	29	3.0	5.0	4,621	.6769	.458
8. The AC provides a communication channel for the bank employees to inform the internal	29	1.0	5.0	3,897	1.3718	1,882

audit department about control problems and suspicious cases.						
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Source: Data analysis using SPSS

The analysis of the questionnaire was made based on a structured sample in two groups - members of the audit committees in the banks (8) and employees in the internal audit departments in the banks (21). It should be emphasized at the very beginning of the analysis that all AC members and all internal audit staff fully agree that the internal audit department performs a constant and complete audit of the legality, regularity, and timeliness of the bank's operations by assessing the adequacy and efficiency of the internal control systems (Q1-IAD), then that the persons in the internal audit department are employed in the banks and all perform work only in the service (Q10-IAD), the internal audit department prepares an annual work plan, which is approved by the Supervisory Board (Q11-IAD), as well as that the department notifies the supervisory and board of directors if during the control it finds non-compliance with the risk management standards or that the board of directors does not comply with the regulations, general acts and internal procedures of the bank (Q14-IAD). All these questions have answers with a mean value of 5.00 and normally, the conclusion based on the ANOVA analysis (Appendix 1) is that there is no difference between the groups regarding those questions.

Furthermore, most of the answers given related to the competencies of the audit committee and the internal audit department are highly reliable (mean value above 4.5), which ANOVA analysis confirms that there is no difference between the groups in the answers given. Regarding the fact that the audit committee ensures that the internal control system is examined according to the international models (COSO) (Q18-AC), the average value is 4.276, but there is a significant difference in the answers between the groups (ANOVA analysis).

The last group of questions regarding the responsibilities of the audit committee towards the internal audit department in banks deserves special attention.

Regarding the answers to the question of whether the audit committee requests special audits from the internal audit department in addition to the periodic and risk-based audits (Q4-AC_IAD), there is a significant difference in the given answers of the groups. From this part, it can be concluded that there is room for improvement, which both groups agree on, more specifically in terms of providing the necessary resources by the audit committee of the internal audit department to be able to fulfill its responsibilities (Q2-AC_IAD), then in the evaluation by the audit committee of the professional education of the internal auditors, the level of adequacy, independence, and objectivity of the internal auditors (Q5-AC_IAD), and there is a need for the audit committee to make efforts in establishing a communication channel for the bank employees to be able to inform the internal audit department for control problems and suspicious cases (Q8-AC_IAD).

A positive conclusion from the analysis is that the members of the audit committees have sufficient experience and knowledge in the banking system, their responsibilities, banking activities, culture, and organizational structure. Furthermore, the members have sufficient time to fulfill their responsibilities, as well as to have professional skepticism at work and to be independent and objective in carrying out their tasks.

On the other hand, the employees in the internal audit department carry out their activities following the principles and standards for internal audit, the bank's code of ethics, and the policy and procedures for the operation of the service. Appendix 1 of the paper provides the ANOVA analysis of the received answers.

Conclusion

This research seeks to examine the set-up of the audit committee and internal audit departments in the five largest banks in North Macedonia, as well as the committee's accountability to the internal audit function. The focus was on three main objectives. In response to the objectives, from the conducted research and the results obtained from the questionnaire, it can be concluded that the set-up and adequacy of the audit committees and internal audit departments in the banks are following the legal regulations, rules, and standards, and the members of the audit committees are competent, and with the necessary work experience in the field to perform their competencies. The link between the audit committees and the internal audit departments of banks is high, and the results suggest that audit committees largely ensure the independence of internal audit function and hold frequent meetings, but little improvement is needed in setting up a communication channel for bank employees to report internal audit department to problems or suspicious cases. However, this paper has its limitations, which refer primarily to the sample that was covered by the questionnaire (55%), as well as the time period when the research was conducted, ie the situation with the COVID-19 Pandemic. A major limitation is the lack of similar research available in the country to compare the results obtained.

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APPENDIX 1

Table A-1: ANOVA Analysis

		Sum of Squares	df	Mean Square	F	Sig.
AC_fin_reports	Between Groups	.210	1	.210	1,753	.197
	Within Groups	3,238	27	.120		
	Total	3,448	28			
AC_internal_control	Between Groups	.118	1	.118	1,241	.275
	Within Groups	2,571	27	.095		
	Total	2,690	28			
AC_external_audit	Between Groups	.013	1	.013	.372	.547
	Within Groups	.952	27	.035		
	Total	.966	28			
AC_acc_policy	Between Groups	4,742	1	4,742	4,961	.034
	Within Groups	25,810	27	.956		
	Total	30,552	28			
AC_compliance	Between Groups	.714	1	.714	1,367	.253
	Within Groups	14,113	27	.523		
	Total	14,828	28			
AC_meetings	Between Groups	.025	1	.025	.110	.743
	Within Groups	6,113	27	.226		
	Total	6,138	28			
AC_risk_management	Between Groups	.328	1	.328	1,135	.296
	Within Groups	7,810	27	.289		
	Total	8,138	28			
AC_audit_firm	Between Groups	1,892	1	1,892	2,668	.114
	Within Groups	19,143	27	.709		
	Total	21,034	28			
AC_reporting_AB	Between Groups	.473	1	.473	1,541	.225
	Within Groups	8,286	27	.307		
	Total	8,759	28			
AC_annual_reports	Between Groups	.118	1	.118	.698	.411
	Within Groups	4,571	27	.169		
	Total	4,690	28			
AC_COSO	Between Groups	3,966	1	3,966	4,494	.043
	Within Groups	23,827	27	.882		

	Total	27,793	28			
AC_experience	Between Groups	.007	1	.007	.020	.888
	Within Groups	9,786	27	.362		
	Total	9,793	28			
AC_knowledge	Between Groups	.139	1	.139	.100	.754
	Within Groups	37,310	27	1,382		
	Total	37,448	28			
AC_areas	Between Groups	.150	1	.150	.441	.512
	Within Groups	9,161	27	.339		
	Total	9,310	28			
AC_prof_skepticism	Between Groups	.046	1	.046	.153	.699
	Within Groups	8,161	27	.302		
	Total	8,207	28			
AC_independence	Between Groups	.197	1	.197	1,042	.317
	Within Groups	5,113	27	.189		
	Total	5,310	28			
IAD_internal_control	Between Groups	0.000	1	0.000		
	Within Groups	0.000	27	0.000		
	Total	0.000	28			
IAD_risk_management	Between Groups	.005	1	.005	.052	.822
	Within Groups	2,685	27	.099		
	Total	2,690	28			
IAD_IT	Between Groups	.312	1	.312	1,308	.263
	Within Groups	6,446	27	.239		
	Total	6,759	28			
IAD_fin_reports	Between Groups	.921	1	.921	2,460	.128
	Within Groups	10,113	27	.375		
	Total	11,034	28			
IAD_regulations	Between Groups	.040	1	.040	.107	.746
	Within Groups	10,167	27	.377		
	Total	10,207	28			
IAD_monitoring_policies	Between Groups	.139	1	.139	1,132	.297
	Within Groups	3,310	27	.123		
	Total	3,448	28			
IAD_money_laundering	Between Groups	.237	1	.237	2,612	.118
	Within Groups	2,452	27	.091		
	Total	2,690	28			
IAD_ancillary_services	Between Groups	.000	1	.000	.001	.982
	Within Groups	10,827	27	.401		
	Total	10,828	28			
IAD_ethics	Between Groups	.005	1	.005	.052	.822
	Within Groups	2,685	27	.099		
	Total	2,690	28			

IAD_employees	Between Groups	0.000	1	0.000		
	Within Groups	0.000	27	0.000		
	Total	0.000	28			
IAD_annual_plan	Between Groups	0.000	1	0.000		
	Within Groups	0.000	27	0.000		
	Total	0.000	28			
IAD_audit_subject	Between Groups	.005	1	.005	.052	.822
	Within Groups	2,685	27	.099		
	Total	2,690	28			
IAD_report	Between Groups	.053	1	.053	.784	.384
	Within Groups	1,810	27	.067		
	Total	1,862	28			
IAD_reporting	Between Groups	0.000	1	0.000		
	Within Groups	0.000	27	0.000		
	Total	0.000	28			
AC_IAD_independence	Between Groups	.867	1	.867	.621	.437
	Within Groups	37,685	27	1,396		
	Total	38,552	28			
AC_IAD_resources	Between Groups	3,311	1	3,311	1,909	.178
	Within Groups	46,827	27	1,734		
	Total	50,138	28			
AC_IAD_supervision	Between Groups	3.005	1	3.005	2,045	.164
	Within Groups	39,685	27	1,470		
	Total	42,690	28			
AC_IAD_audits	Between Groups	3.005	1	3.005	5,173	.031
	Within Groups	15,685	27	.581		
	Total	18,690	28			
AC_IAD_education	Between Groups	4,995	1	4,995	2,861	.102
	Within Groups	47,143	27	1,746		
	Total	52,138	28			
AC_IAD_communication	Between Groups	3,576	1	3,576	1,920	.177
	Within Groups	50,286	27	1,862		
	Total	53,862	28			
AC_IAD_meeting	Between Groups	.185	1	.185	.395	.535
	Within Groups	12,643	27	.468		
	Total	12,828	28			
AC_IAD_commun_chanel	Between Groups	4,023	1	4,023	2,232	.147
	Within Groups	48,667	27	1,802		
	Total	52,690	28			

Source: Data analysis using SPSS



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