

# EFFECT OF INTERNAL AUDIT ON FINANCIAL PERFORMANCE OF COMMERCIAL BANKS IN RWANDA: A CASE OF BANK OF KIGALI (BK)

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**Abstract:** Bank of Kigali headquarters in Nyarugenge District served as a case study for this study, which examined the financial performance impact of internal audit. Any financial organization's internal audit department plays a key role in its financial success. It was the primary objective of this research to examine the impact of internal audit on the financial performance in Rwanda, specifically at the Bank of Kigali. The researcher used a descriptive, correlational, and explanatory study methodology and asked 76 participants from various Bank of Kigali departments to complete a questionnaire. The study employed a universal sampling technique that does not include everyone in the population equally profitable in the sample. Primary and secondary data were both employed in this study to gather the information needed for it. The acquired data was analyzed using a descriptive and correlation study approach. Analyzing data necessitated using metrics like the mean, SD, and Pearson correlation. The data acquired through surveys was analyzed with the help of SPSS version 22.0. The correlation ( $r$ ) between respondents' views on the impact of internal audit on financial performance was found to be equal to .78. In order to ensure that projects, programs, activities, and functions are efficient and effective, the researchers recommend that Bank of Kigali management make performance audit independent. They also recommend that the bank's financial audit be strengthened by encouraging internal auditors to improve audit procedures such as interviews, observation, and so on.

**Keywords:** Internal Audit and Financial performance.

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## 1. GENERAL INTRODUCTION

An internal audit is a simple administrative scheme that mostly involves inspecting papers, conducting operational reviews, and presenting the findings to a group of executives, board, or external auditors. By improving the objectives and talks across and among organizational departments, internal audits have been shown to have an impact on the company's value (Raja, 2002). This financial performance is therefore examined by internal audit in accordance with modern day procedures because of the fusion of numerous forces that led to a quiet revolution in the profession. Due to a lack of cash, companies now need internal audits to be able to demonstrate greater expertise in identifying and reducing risk (Raja, 2002) Understanding how internal auditing affects a company's financial health is critical for everyone in the organization. Management's system for monitoring the organization's actions is directly linked to the organization's internal audit (CIMA, 2008).

Internal audit has benefited from the proliferation of technology, which has made it easier for auditors to monitor and review data more quickly. An organization's financial data can be improved by modifying an existing internal audit. Changes in the organization's structure are required to move from merely following regulations to providing added value. According to (Chun, 2016).

There is a growing understanding that the Internal Audit function has the capacity to provide previously unrivaled services to management. In the new definition of internal auditing from the Institute of Internal Auditors, this potential has been converted into a challenge and personified (the IIA). To improve the financial performance of commercial banks, banks have realized that internal audits are crucial to better management of the banks' assets (Chun, 2016).

Throughout the world, there is a skepticism about the potential of the internal audit function to provide hitherto unheard-of benefits to an organization's financial performance. The Institute of Internal Auditors used this latent deviation as a provocation and was able to actualize the meaning of internal audit (the IIA). By utilizing internal audits to increase the oversight of financial institutions' resources, financial institutions have been able to improve their fiscal performance, according to (Chun, 2016).

Many theories have been proposed to explain the impact of internal audits on an organization's profitability. This is the underlying thesis, which holds that the separation of ownership and management contributes to openness in the internal audit process. Financial risks intrinsic to a company's nature should be taken into account by an internal audit, according to this notion. Performance outcomes are the defined measure of satisfaction in the stakeholder theory. Literature reviews have delved more into these theories.

A recent study (Ondieki, 2014) looked into the impact of internal audit on bank financial performance. He found that internal audit techniques had a beneficial impact on financial performance. It was found that the study focused on internal control requirements, internal audit independence, and professional competence. As a result of this, the present study will focus on financial institutions and see if similar results can be found.

An independent and objective assurance and consulting activity meant to improve an organization's operations, internal auditing has become a global phenomenon. Understanding how internal auditing affects a company's financial health is a vital first step. Management's system for monitoring the organization's actions is directly linked to the organization's internal audit (CIMA, 2008). It is also important to have independent auditors in any corporate organization—especially commercial banks—to ensure that the banks' financial statements are truthful and complete. According to CIMA (2008)

It is appropriate to define internal auditing in accordance with IIA (2016) as actions that provide value to the organization's overall operations while also providing objective assurance, independence, and consultation. When it comes to internal audits, the primary purpose is to assist executives in their duties by giving them with the necessary inspection, evaluation, and approvals for their work (Ondieki, 2014).

It has been suggested (Chun, 2016) that the in-house control organization structure includes a considerable portion devoted to internal auditing. With the assurance of the highest possible degree of assessment and evaluation of diverse activities within a company, this promotes successful internal auditing and reporting. Whether a company has a good or bad reputation is totally dependent on the quality of its internal audit function, which means that auditing functions aim to improve service quality (Raja, 2002).

Internal auditing is a value-adding, objective assurance and consulting activity performed by an organization's own internal auditors on a local level. Risk management, control, and governance systems are evaluated and improved in a methodical and disciplined manner to help an organization achieve its goals. Internal auditors are trained in accounting, but their primary responsibility is to evaluate the organization's operational, risk management, internal control, and governance systems. In the banking industry, inadequate internal audits can lead to a bank's failure, as Deutsche Bank discovered. It took action and published regulations under the Banking and Commercial Banks Act (2006) to require all commercial banks to implement an operational internal audit mechanism to improve banks' financial performance after the collapse of Tanzania's central bank in 2006. An effective system of bank internal audit was one of the controls. Nevertheless, South Africa An internal audit can have a significant impact on a company's financial success. A company's internal auditors help to identify the most important risk factors. As a result, the business is better able to foresee problems in the future and pinpoint current flaws. There are also opportunities to improve processes and controls that are not performing well, which can be discovered through the use of this tool. As of 2019, (Lalkhen)

It is critical for all employees to grasp the audit concept and how it can aid in the development and growth of an organization, according to (Lalkhen, 2019). To ensure that their governance, risk management, and internal control systems are adequate, all managers should consider conducting audits. For further information on Anderson, see (2013) Rwanda is another example. To make sure that financial reporting practices are sound and up to standard, the audit committees and the panel of executives, according to Hutchinson and (Anderson, 2013), are responsible for overseeing the firm's internal audit. It took some time for internal auditors' contributions to be recognized as vital in a service-

oriented management context, as they had been in previous years as part of the accounting department (Hutchinson & Zain, 2009). There are several ways in which an internal audit can contribute to an organization's success, according to Beyanga (2011), such as by employing strategic techniques to determine how valuable or effective a company's governance systems are and how they might be improved.

Internal audit standards, auditor independence, internal controls, and auditor competence are all part of the operationalization of internal audit, according to (IIA, 2016). As stated in the article of the Institute of Internal Auditors (IIA, 2016), adherence to internal audit standards is critical to improving the efficiency of the process. Professional competence is a critical factor in the detection of fraud (KPMG, 2015), as well. Furthermore, the firm's internal controls must be adhered to in order to ensure that the program's operations are organized, directed, planned, and controlled, as well as the systems put in place to report, measure, and monitor financial performance (Lindsay, 2015)

In accordance with national criteria for internal auditors, professional accountants must maintain their independence and objectivity in order to carry out their duties properly. An internal auditor's responsibilities include conducting an appraisal of the organization, verifying that certain departments are adhering to applicable laws and regulations, and determining the validity of financial statements prior to their review by external auditors (MINECOFIN, 2007)

The government of Rwanda is particularly concerned about the financial health of both commercial and public entities in the country. In order to meet this goal, most commercial banks in the country will need to implement procedures and systems such as internal audits (IMF, 2008)

A bank's performance can be examined in a variety of ways. According to (Anderson, 2013), a bank's profitability is critical.

### **1.1 Statement of the Problem**

According to the author (Parikh, 2011), In an internal audit, a company's own employees conduct a thorough examination of the company's operations and financial records. It is a post-transaction evaluation conducted by the organization's paying personnel to ensure that records are accurate and that operations are running smoothly. The definition of "internal audit" is the process of conducting a forensic examination of an organization's financial, accounting, and other business operations in order to ensure that they are operating in a safe and effective manner. In this form of control, the effectiveness of other controls is measured and evaluated. Despite the fact that internal audits are usually focused on accounting and financial difficulties, they can also be used to examine operational issues. (Parikh, 2011, p. 63)

There have been two reasonable but discordant results as a result of the recent corporate accounting scandals. Officers and directors of corporations are increasingly being scrutinized for their ethical and legal practices. Investors' concerns about the financial reporting system are at the heart of each of these movements. However, there has been a lack of adherence to the findings and recommendations of internal audits.

No matter how well BK's internal audit is implemented, does it have a good effect on its financial performance?

According to Chun (2016), the influence of risk-based audits on commercial banks in Rwanda's financial performance has been studied. For her, effective and efficient internal auditing is dependent on suitable risk-based audit processes. The study indicated that risk-based auditing, including risk assessment, risk management, annual risk-based planning, internal auditing standards, and internal auditing staffing, should be improved. Rwandan commercial banks were analyzed for their performance (Raja, 2002) and their role in enterprise risk management (Peursem, 2017) was investigated (Raja, 2017).

This study differs from the others in that it focuses particularly on internal audit as a factor affecting a bank's financial health. They focused on risk management and corporate governance in the studies above. These findings were based on a study that looked at internal audit and asset management in banking organizations, as well as their impact on financial performance.

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### **1.2. Specific Objectives of the Study**

The study has the following specific objectives:

- i. To analyze the effect of the finance audit in the financial performance of Bank of Kigali
- ii. To examine the effect of performance audit on financial performance of Bank of Kigali
- iii. To examine the effect of compliance audit in financial performance of Bank of Kigali

### **Theoretical Foundation**

## **2. LITERATURE REVIEW**

Independent and objective audits of financial reporting systems and financial reporting are conducted by financial auditors. This assurance is the primary goal of financial audits for the benefit of investors, regulators, directors, and managers. As of this writing (Hawks, 2018)

Financial audits provide a decent level of certainty, but they do not provide absolute guarantees. Financial auditors use a number of techniques, including interviews, observation, and testing, to assess if the controls and systems necessary to produce accurate financial statements exist. For this reason, they can conclude that the financials are safe. The Hawks (Hawks, 2018)

The year is 2017 (Roy), and In order to provide a judgment on whether "financial statements" (the information being verified) are stated according to defined standards, financial audits are performed. However, auditors may undertake audits of financial statements generated on the cash basis or some other accounting basis that is acceptable for the organization. As part of the audit process, the auditor gathers information to determine if the financial statements are presented fairly in compliance with accounting rules. It's (Roy, 2017)

In most cases, financial audits are carried out by accounting firms that specialize in financial reporting. Assurance services supplied by accounting firms include financial audits. Internal auditors are employed or hired by many organizations, but they do not certify financial reports but rather focus on the internal controls of the company. Depending on the circumstances, external auditors may opt to put less trust in the work of internal auditors. If an organization's financial statements were audited, it is likely that the company would not be able to hide its illegal activities. It's (Roy, 2017)

Ingram (2019) states that "(Ingram) When a company claims that its financial statements accurately portray its position and performance to its stakeholders, an audit is necessary to verify that claim. Other parties, such as tax authorities and banks, regulators, suppliers, customers and employees, may also have an interest in knowing that the financial statements are presented fairly, in all material aspects, for the benefit of the company's shareholders. While an audit does not guarantee accuracy of the financial statements because it relies on sampling rather than examining every transaction and balance, it does lessen the possibility of a major financial statement mistake, whether due to fraud or error. Ingram (2019) states that "

As of 2018, (Dittenhofer, 2018) As a result of an impartial evaluation of a government or non-profit institution's programs, functions, operations, and management systems and processes, a performance audit assesses whether the entity is maximizing its efficiency, effectiveness, and economy. The examination is objective and systematic, often utilizing established and professional techniques.

The scope of performance audits may include the discovery of fraud, waste, and abuse, but these are often not covered. There must be an auditor's scope and plan in place before he or she can begin conducting a performance audit. As of 2018, (Dittenhofer, 2018) Evaluation of a firm's procedures and processes in terms of efficiency and effectiveness. In this case, it is not an assessment of the company's financial results. In the words of Elgar (2018a):

In 2018, (Kenton, 2018), As an impartial assurance service, a performance audit provides assurance on the performance of a wide range of projects and programs in terms of economic and operational efficiency and effectiveness, but also in terms of environmental and equity considerations. It is the goal of a performance audit to make recommendations for improvement and to determine the potential impact that these changes will have. Financial audits, monitoring, and assessment are all necessary components of sound financial management. Different yet complimentary topics are addressed by each of them.

In 2018, (Kenton, 2018), Competition in the private sector drives the demand for performance audits in the private sector. A performance audit is more beneficial to our client's business the more competitive the marketplace is. As with internal audit, controls and dashboards, performance audit is a management tool that aims to improve the quality of the company. Our client's organization, as well as its procedures and processes, are examined during a performance audit. Because we care about the environment and equity, we strive to show our clients how to get the most bang for their buck by making the most efficient and effective use of their resources. In 2018, (Kenton, 2018),

(Kelly, 2017) ) A compliance audit examines all aspects of a company's compliance with legal requirements. Complying with regulations, safeguarding personal information, and managing risk are all examined during a compliance audit in an audit report. In Kelly's words, " To put it another way: A "compliance audit" is an audit that focuses on whether or not an organization is adhering to local laws and regulations. Another aspect that is examined in a compliance audit is compliance with company policies, rules, regulations, and procedures. In order to avoid penalties or a fine, an organization must abide by local laws and regulations. Some fines are limited to a specific amount of money, while others necessitate the closure of a business.

There is a (Salomon, 2016) According to this definition, a "compliance audit" is a complete evaluation process that examines an organization's compliance with certain regulations and/or terms of an agreement. Depending on the structure of the company and the scope of the audit, the entity conducting the audit may be different. Depending on the type of audit, it could be carried out by a public accountant for financial matters, a security specialist for compliance audits focusing on security, or an IT consultant for IT infrastructure and other relevant audits.

As stated by Salomon in 2016, Accredited public accounting firms and CPAs are typically hired to conduct an investigation into compliance issues. Auditors meet with both parties in the contract and agreement before the audit begins and are given precise instructions or recommendations on what parts they should be checking during the compliance audit. Auditors will visit with the parties involved again when the audit is complete to discuss their findings. An internal audit is another type of compliance audit, and it is performed to see if the company's employees and other stakeholders are adhering to the company's standard operating procedures. As stated by Salomon in 2016,

There was a statistically significant correlation between a company's internal control system and its financial success (Peursem, 2017). This is in line with the overall goal of the investigation. A company's financial statements and other records are more reliable, and the danger of asset loss is lower thanks to internal controls, which also aid in efficiency and regulatory compliance. (Pickett, 2014) discussed the importance of internal controls in achieving financial reporting, operational efficiency, and compliance with applicable laws and regulations. Findings by Anderson (2013) indicated that companies with more difficult-to-audit levels of control have lower quality earnings, and that these findings explore the connections between the public revelations of material weaknesses and fraud, earnings management or restatement. Effective internal controls are one way to deal with agency issues, according to Lindsay (2015). Banks with good internal controls are better able to deal with agency issues, reduce the expenses of agencies, and guard against scandalous profits reporting that could result in the loss of valuable resources.. As a result of the concerns outlined, Bank profitability suffers.

An essential and unquestionable factor in economic development is the banking sector, which directs the flow of capital from surplus economic units to deficit economic units (Khan, 2007). It's impossible to ignore the banking industry's performance measurement because it's such a crucial component of the financial sector. Schumpeter acknowledged the importance of banks and financial institutions in the development of a country's economy in 1911. Economic growth is accelerated by the activities of financial institutions, such as the mobilization of savings from the surplus units of an economy and the measurement and management of risks, complicated transactions, and evaluation of business projects, he argued (King & Levine, 2010). He also argued that financial institutions are crucial to the expansion of an economy in his economic development theory (Samules, 2012).

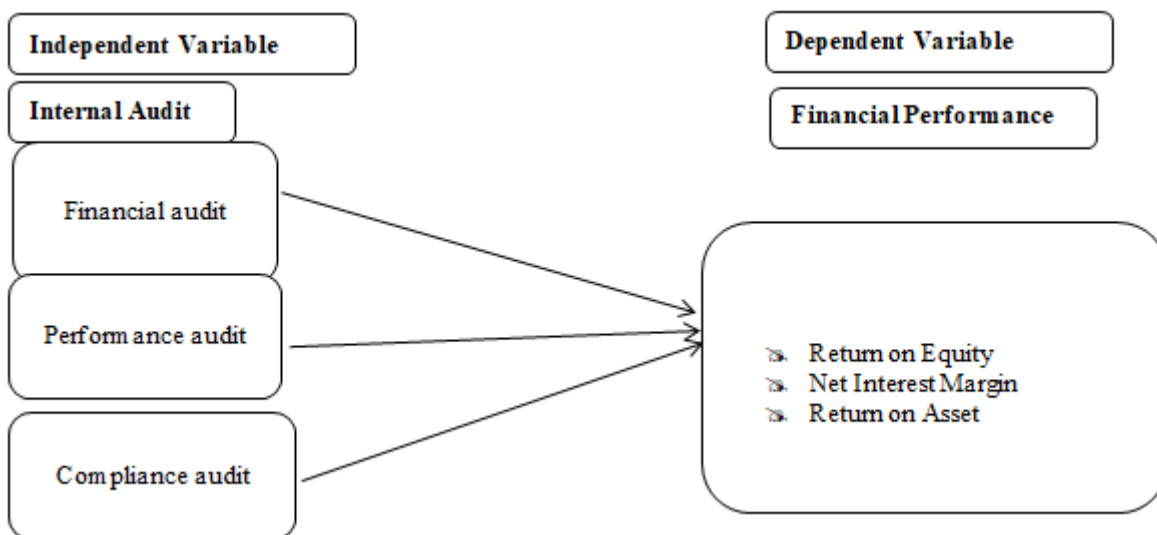
It has also been suggested by Goldsmith (2011) that financial system size has an important role to play in economic development. Goldsmith (2011) supported this claim by doing research in 35 countries and finding a strong association between the two. Some researchers disagree with the correlation between financial sector growth and economic growth, and there are a few others who support it. Three Nobel Prize winners and experts in the field of development economics are to blame for this conundrum. Colin Clark, Hirschman Lewis Myrdal Prebisch Rosenstein-Ro

**Empirical Review**

Financial audit a third-party examination of a company's financial records and reporting activities. An audit may be conducted for disclosure, compliance, taxation, legal or other purposes. The examiner will check for accuracy and full representation of financial activities and claims. Performance auditing differs from performance measurement, the latter being the responsibility of management of the entity. (Lindsay, 2015)

A compliance audit is the types of audit services that their performance is mainly focusing on whether the entity complying with local law, regulation, and related rule. A compliance audit also reviews whether entity complying with internal rule, regulation, policies, decisions, and procedures. An entity required to comply with the local law and regulations or they will face with penalties or fine. Some fine is only for certain monetary amount and some fine require to close operation. (Peursem, 2017)

However, internal audit may result to improved financial performance through strict adherence to its auditing aspects. Internal audit standards will lead to improved financial performance as a result of auditors carrying out the functions within the criteria approved, being professional and objective for improved risk management through complying with rules and regulations for the purpose of smooth operation. (Anderson, 2013)



Source: *Researcher (2021)*

**Figure 1: Conceptual framework**

**Research Gaps**

The effectiveness of internal audit has only been evaluated in a few academic studies, and even fewer have explored the topic empirically. A permanent internal audit role is recommended by the Basel Committee report (2002) in order to fulfill the bank's tasks and responsibilities. Efforts should be made to ensure that the bank has a sufficient internal audit

function commensurate to its size and the nature of its operations. These strategies include giving the necessary resources and manpower to the internal employees.

Eighty percent of the 695 executives surveyed by Ernst & Young stated that their company's internal audit department could use some improvement. Strong risk management is seen as having a favorable impact on long-term earnings by 75 percent of the study participants. Equal numbers of respondents believe that their internal audit function has a favorable impact on their overall risk management activities. Internal auditors are increasingly expected to have abilities that go beyond the more typical technical skills, such as the capacity to collaborate with management and business units on relevant business challenges, as the job of the auditor grows.

It was shown that risk-based auditing has a positive impact on the financial performance of commercial banks in Rwanda. Although her research focused on risk-based auditing, she noted that financial performance needed suitable, effective, and efficient internal auditing... Risk-based auditing could be improved through internal audit standards and staffing in order for companies to better identify risks at an early stage, hence increasing transparency and accountability, and thus improving financial performance, according to the study's conclusions. This proved that there is a link between financial performance and internal audit.

Ndege (2012) conducted a study on the performance and financial ratios of commercial banks in the Rwandan capital city. In his research, he sought to discover the elements that influence bank performance as assessed by ROA and ROE ratios (ROE). Using ROA and ROE, he argued that Rwandan banks' financial performance can be measured. Internal audit activities and recommendations have a long-term impact on a company's operations, but they are also the foundation of a company's success or failure. To ensure its long-term existence, management should emphasize its effectiveness and acceptability at all levels.

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### **3. RESEARCH METHODOLOGY**

#### **Research design**

This study used descriptive, correlation and explanatory research design. As indicated (Andrews, 2005) the descriptive method allows the researcher to collect and analyse qualitative data from the selected commercial bank; such as Bank of Kigali main branch which serve as Pilot study.

In case of this research, the main driving factor that prompted the researcher to conduct this study is the need to generally find out whether the information provided by the internal audit can be used to increase financial performance of Bank of Kigali main branch in Rwanda. The correlation was used in order to measure the extent of relationship between of internal audit and financial performance. Finally, the explanatory was used in financial ratios analysis.

### Target Population

The population is defined as the total collection of elements about which wish to make a sum (Donald and Schindler, 2006). The sampling technique that the researcher used in this study is universal sampling. According to (Richard & Margaret , 2015) Universal sampling refers to the selection of sample where not all the people in the population have the same profitability of being included in the sample and each one of them, the probability of being selected is unknown.

The researcher prefers to use universal sampling technique to select respondents from Internal Audit Department, Credit Department, Finance Department, marketing and sales Department, IT and department, Human Resource department because they are the ones who may provide the useful information to test the hypothesis of this research. That are all possible elements that can be studied during the survey. The population of this study included staff in different department of the main branch of the Bank of Kigali which were totaling to 76 employees as showed below:

**Table 1: Research population and sample size**

Department	Population	Sample size
Internal Audit and Department	6	6
Credit Department	20	20
Finance Department	14	14
Marketing and sales Department	18	18
IT department	9	9
Human Resources and Administration	9	9
Total	76	76

**Source: Research 2021**

### Sample Design

Designing a sample is an important part of conducting research. To choose things for sampling, researchers would use a variety of methodologies and procedures. Sample design can also specify the number of objects in the sample, as well as the sample size. A study published in 2003 by Mugenda O. M. and Mugenda A. G. found that the prevalence of syphilis in Uganda was significantly higher than previously thought.

Prior to the collection of any data, the sample design must be decided upon. A study can pick from a wide variety of sample designs. Some designs are more exact and easier to implement compared to others. When conducting a study, the researcher must come up with a suitable sample design that can be relied upon.

### Stratified sampling

The frame can be divided into "layers" if the population consists of a number of diverse groups. Individual elements can then be randomly selected from each stratum of the population.

Using the same sampling fraction for all strata assures proportionate representation in the sample, while stratification and altering the sampling percentage between strata ensures enough representation of the minority subgroup of interest. As a final point, because each stratum is viewed as a distinct population, different sampling methods can be applied to each stratum.

### Non-Probability

The judgmental sample is one that is selected based on the knowledge of a population and the purpose of the study. The subjects are selected because of some specific characteristic the research is looking for and depending what is investigated.



#### **4. SUMMARY OF MAJOR FINDINGS**

This study summarizes the most important findings from the field, as well as the conclusions and recommendations that were drawn from them. For additional investigation, the researcher referred to "the influence of internal audit on financial performance" as a case study with the Bank of Kigali as an example. For this study, the primary goal is to determine the impact of internal and how those inputs, if valued, could affect the financial performance of the Bank of Kigali in particular.

A total of five chapters were included in the final product. The introduction was the opening chapter of the book. The literature review was the subject of the second chapter. The third chapter focused on the design and methods of the study. The presentation, analysis, and interpretation of data comprised the fourth chapter. In the fifth and last chapter, we summarized our findings, concluded, and offered our suggestions.

The poll was conducted in the Bank of Kigali's offices, with 76 participants who answered all of the questions. The conclusions of the study were summarized in this way:

We wanted to see if internal auditing had an impact on Bank of Kigali's financial performance. How does Bank of Kigali's financial performance compare to other banks in terms of its internal audit standards? What impact does the Bank of Kigali's internal audit have on the bank's financial performance? What impact does Bank of Kigali's internal controls have on the bank's financial performance?

The study's population included 76 employees of the Bank of Kigali's main branch in Rwanda. The researchers adopted a qualitative method in which they tapped into the bank's whole workforce. Data from both primary and secondary sources were used in this research study to gather the information needed for the investigation.

The data was analyzed using a descriptive and correlational study approach. The analysis was based on the mean, standard deviation, and Pearson correlation. The data acquired through surveys was analyzed with the help of SPSS version 22.0.

##### **To analyze the effect of the finance audit in the financial performance**

Results showed that the majority of the respondents indicated that finance audit effect the financial performance at very great extent.

##### **To examine the effect of performance audit on financial performance**

Results showed the majority of the respondents indicated that performance audit effect the financial performance at great extent.

##### **To examine the effect of compliance audit in financial performance**

Results from table 15 showed the majority of the respondents indicated that compliance audit effect the financial performance at very great extent.

#### **5. CONCLUSION**

From the findings as indicated in chapter four, it is reflected that internal audit and financial performance in Bank of Kigali are related, as shown by the respondents, who were employees in headquarter. The results show that internal audit have an impact on financial performance. The set questions were responded by the respondents on position of showing that internal audit, finance audit, performance audit and compliance audit are valuable factors of good financial performance. The research was achieved since respondents have demonstrated that there is relationship between internal audit and financial performance of an organization.

#### **6. RECOMMENDATIONS**

1. In reference of findings, BK management should make performance audit independent in order to audit of services for assurance of projects, programs, activities and functions to ensure efficiency and effectiveness.
2. BK management should strengthen financial audit by encouraging internal auditors to improve on audit procedures used such as interviews, observation and so on.
3. BK top management should consolidate or boost BK compliance audit by encouraging daily operation management to carry compliance audit strictly and regularly.

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