IJER © Serials Publications
12(5), 2015: 2077-2091
ISSN: 0972-9380

THE IMPACT OF CORPORATE GOVERNANCE MECHANISMS ON AUDIT QUALITY OF SHARI'AH COMPLIANT COMPANIES

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Abstract: *This study examines the effectiveness of corporate governance mechanisms on audit quality which is proxied by audit fees. Specifically, this study investigates the effect of corporate governance mechanisms on audit quality of Shari'ah compliant companies in Malaysia.Higher quality audit is defined as a higher credibility offered by auditors in their audit work which improved the reliability of financial statements. Corporate governance mechanisms for this study focuses on the board of directors and includes board size, CEO-duality, independent directors, and the financial expertise of the audit committee and internal Shari'ah committee. The sample consists of 100 top Shari'ah compliant companies in Malaysia based on market capitalization by Bursa Malaysia. Using multiple regressions, the significant relationship with audit quality and board size, and their positive relationship shows the higher the board size, the better the audit quality. The control variable used in this study, i.e. leverage,also has a significant positive relationship with audit quality. The findings show that highly leveraged firms demand quality audits. Apart from contributing to past literature on corporate governance and audit quality, this study provides inputs to regulators to encourage strict enforcement for Shari'ah compliant companies to incorporate governance practices, especially concerning board structure and it provides information for directors to become more resourceful in order to improve their relationship with auditors.*

Keywords*: Audit quality, board size, CEO-duality, independent, financial expertise and Shari'ah committee.*

1. INTRODUCTION

Annual audit is one of the key elements of corporate governance (Cadbury Report, 1992). An audit provides assurance to the company that their financial statements are presented fairly based on the company's performance. It will benefit shareholders and creditors as financial auditsserve as a monitoring tool. However, the effectiveness

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and efficiency of financial audits is based on the company's corporate governance (Holm & Laursen, 2007). That is why corporate governance has become a topic of much accounting and financial research. Every country has drafted their own code of corporate governance to set out the excellent code of corporate governance to be referred to by companies in enhancing transparency and promoting a good corporate governance culture.

According to Carson & Simnett (1997), the issue of corporate governance drawsthe attention of shareholders as the directors and companies are held accountable for the use of shareholder funds. Every county cannot depend on one fix for corporate governance. This is because the development of corporate governance keeps abreast with the changing business environment. Previous corporate governance might not be reliable for current business practices. The Malaysian Code on Corporate Governance (2012) defines corporate governance as the process and structure used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realising long-term shareholder value, whilst taking into account the interest of other stakeholders.

Corporate governance is not only applicable to conventional companies but also to Islamic Capital Markets.Malaysia as an Islamic hub took introduced Shari'ah compliant companies to attract foreign investors and Islamic banks to invest in the country. This is because investors are not solely focused on what is profitable but are more concerned on what makes their investment ethical (Ulrich & Marzban, 2008).

Investors, particularly Muslim investors are more alert of their investment as they will make sure that the investments follow Shari'ah principles. They will not invest capital in non-Shari'ah compliant companies. With the early introduction of Shari'ah compliant companies, only 272 companies were classified as Shari'ah compliant comprising 37% as at 31 December 1998 (Ousama& Fatima, 2010). However, the number has increased to 653 out of 914 which is 90% of companies listed in Bursa Malaysia as of November, 2012 (Securities Commission Malaysia, 2013). The drastic increase of Shari'ah compliant companies has motivated this study by focusing on how corporate governance mechanisms affectthe audit quality of such companies. Thus, the primary objective of this paper is to identify the effect of corporate governance mechanisms on the audit quality of Shari'ah compliant companies in Malaysia.

This paper is presented in six sections. The second section explains agency theory and corporate governance mechanisms. Section three discusses audit quality and its measurement. Section four describes the development of hypotheses and research methodology used in this study, while section five elaborates on the findings and concludes the research.

2. AGENCY THEORY AND CORPORATE GOVERNANCE MECHANISMS

Among the corporate governance mechanisms, this study focuses on board size, CEO-Chairman duality, independent directors, and the financial expertise of the audit

committee and internal Shari'ah committee. According to agency theory, there can be conflict of interest between the owners and managers due to the separation of ownership and control. In order to minimise the potential conflict, corporate governance mechanisms are used as tools to close the gap between the interests of both parties. Better corporate governance mechanisms require higher board size, non-CEO duality, more independent directors, more financial expertise in the audit committee, and having an internal Shari'ah committee.

In Malaysia, the average number of board members is 7.51 (Yatim et al., 2006). According to Salmon (1993), in order to ensure sufficient expertise in the board, its size should be large enough. However, too many board members can lead to poor coordination and an ineffective board. In the case of CEO duality, there should be two different persons for the CEO and board chairperson. If one person holds two posts, there will be no check and balance of the CEO's performance (Daily & Dalton, 1993). Thus, the majority of corporate governance systems often recommend separating between the chairman of board of directors and CEO. Regarding independent directors, there should bemore independent directorsto ensure that the board is independent from themanagement (Fama & Jensen, 1983). One of the main functions of the audit committee is the companies are able to implement strong internal control in order to provide reliable financial reporting. Hence, if the audit committee has more experts in finance, it will be better for the companies (Yatim et al., 2006).

The business activities of Shari'ah compliant companies must be in line with Shari'ah. Hence, the existence of an internal Shari'ah committee is essential. In the context of Shari'ah compliant companies, the Shari'ah governance framework does not state that it is applicable to them.However, the framework could be a guideline since it also complies with Shari'ah. A two-tier governance structure also applies to Shari'ah compliant companies whereby for them they have 1) the centralized SAC at the Securities Commission level and 2) the internal Shari'ah committee form for Shari'ah compliant companies. SAC is responsible for issuing a list of Shari'ah compliant securities twice a year. Large companies which have more resources are able to have their own internal Shari'ah committee to ensure their operations comply with Shari'ah. One unique feature of the Shari'ah governance structure is Shari'ah committee. It is a different feature from conventional corporate governance. Despite its important role, there are minimal studies on internal Shari'ah committees among Shari'ah compliant companies. Many prior studies focused on Shari'ah governance structure among IFIs and Takaful companies(Ramli et al., 2014; Bukhari, Awan, & Ahmed, 2013; Kasim et al., 2013; Abu Kasim, 2012; Sawari, Hassan, & Abdullah, 2011).

3. AUDIT QUALITY AND ITS MEASUREMENT

Due to corporate accounting scandals, the role of auditing has become more important to ensure the quality of financial reports. De Angelo (1981) defined audit quality as the joint probability of auditor to detect and disclose problems in the accounting system.

Bradshaw et al. (2001) extended the definition of misstatements by stating that audit quality is the auditor's willingness to report any material misstatement found which would increase on going concern and material uncertainties. Thus, audit quality could be defined as variation in credibility offered by auditors (J. W. Lin & Hwang, 2010). Many factors could affect auditors' credibility in performing audits. One such factor could be corporate governance structure. The objective of corporate governance structure is to govern and manage the business in enhancing business prosperity and business accountability (Malaysian Code on Corporate Governance, 2012). A good corporate governance structure will assist auditors audit a company. This is because good corporate governance will enhance the quality of financial reporting, thus increasing the credibility of auditors in performing their duties (detecting and report misstatements). Consistent with this definition, prior studies explained that audit quality will increase the trustworthiness of financial reports (Francis & Krishnan, 1999; Maijoor & Vanstraelen, 2006; Lin & Hwang, 2010). For example, quality audit will result in less errors and irregularities in financial reports (Defond & Jiambalvo, 1991). In addition, Chen et al. (2011) stated that high audit quality will reduce the information risks where the higher audit quality, the greater reduction in earnings management.

The measurement of audit quality still varies. There is a lack of consensus regarding the measurement of audit quality. Many prior researches use the Big Four/Non-Big Four as proxy ofaudit quality. Even though Boone et al. (2010) stated that audit quality is higher among Big 4, other factors still need to be considered such as size of audit firm (Al-Ajmi, 2009; Adeyemi & Fagbemi, 2010), audit specialization (Almutairi, 2013),auditor reputation (Piot, 2001; Makni et al., 2012), auditor experience (Johnstone & Bedard, 2004), and ICT used in audit procedures(Bedard, Jackson, Ettredge, & Johnstone, 2003).

Boone et al. (2010) suggested that litigation costs and reputation loss are the two primary drivers for audit quality. Auditors want to avoid litigation costs as it reflects the poor quality of audit and reputation loss would be the long-term consequence for insufficient audit quality.Most common indicators for audit quality are auditor size (Al-Ajmi, 2009; Makni et al., 2012),audit fees (O'Sullivan, 2000; J. W. Lin & Hwang, 2010), and auditor reputation (Hope, Kang, Thomas, & Yoo, 2008; Makni et al., 2012). These indicators are relevant to Big Four auditors. This is because they are known for their reputation and high price despite being the largest audit firms in the world. In fact, Hay, Knechel, & Wong (2006) mentioned that Big Four auditors are commonly used as a proxy of audit quality. A number of empirical studies support that the Big Four auditors are related to high auditing quality (De Angelo, 1981; Defond et al., 1993; Francis, 2004; Dechow, Ge, & Schrand, 2010; Dehkordi, 2011).

Even though there is evidence that the use of the Big Four is related to audit quality, this study preferred to use audit fees as proxy ofaudit quality because audit fees more likely reflect the auditors' effort since the audit market is regulated and the opportunity to gain on the fees is limited (Kanagaretnam et al., 2011).

Yasin & Nelson (2012) also adopted audit fees as the proxy of audit quality. They mentioned that higher audit fees indicates that auditors provide more efficient audit services to clients compared to lower audit fees. According to O'Sullivan (2000), thorough investigationsrequiring audit specialization and hours will lead to higher audit fees. Thus, it is expected that higher audit fees indicates higher audit quality since more audit work is required to ensure financial statements are free frommaterial misstatements (Yasin & Nelson, 2012).

4. DEVELOPMENT OF HYPOTHESES AND RESEARCH METHODOLOGY

4.1. Hypotheses development

Based on agency theory, it can be assumed that better corporate governance mechanisms such as adequate board size, CEO-Chairman non-duality, higher proportion of independent directors on the board, higher proportion of financial expertise on the audit committee and having aninternal Shari'ah committee should have a positive impact on audit quality. Hence, the following hypotheses in an alternative form are developed.

H1: There is a positive relationship between board size and audit quality.

H2: There is a negative relationship between CEO-duality and audit quality.

H3: There is a positive relationship between independent directors and audit quality.

H4: There is a positive relationship between financial expertise of audit committee and audit quality.

H5: There is a positive relationship between internal Shari'ah committee and audit quality.

4.2. Regression Model

Multiple regressions are used to test the hypotheses developed in this study. This regression is the most popular model among researchers for analysing corporate governance mechanisms and audit quality (Al-Ajmi, 2009; Kane & Velury, 2005; Yasin & Nelson, 2012). Thus, the following regression model is used to examine the relationship between audit quality and corporate governance mechanisms.

$$AUD\_Q = b_0 + b_1B\_SIZE + b_2DUAL + b_3IND\_D + b_4FIN\_AC + b_5ISC + b_6LEVt + e$$

Where,

Dependent variable

AUD_Q = Audit quality used natural log of audit fees as proxy (excluding non-audit fees)

Independent variables

B_SIZE = Total number of directors in the board

DUAL = A dummy variable which 1, if the CEO is also the chairman ofthe board or 0, otherwise

IND_D = Number of independent directors divided by total number of directors in the board

FIN_AC = Number of financial experts divided by total number of audit committee

ISC = A dummy variable which 1, if company has its own internal Shari'ah committee or 0, otherwise

Control variable

LEV = Total debts divided by total assets

b_0 = Constant

4.3. Sample and Data

This study is carried out by using the sample of Shari'ah compliant companies identified from the Securities Commission website using Shari'ah Index as of 30th November 2012. The sample comprises 100 top Shari'ah compliant companies based on their market capitalization ranking from Bursa Malaysia. This study focuses on companies from eight industries in Malaysia. The sample selection process did not cover finance-related companies since they have unique characteristics and have different regulations.

The data was collected by using primary and secondary data. Primary data is collected for the existence of Shari'ah committee in a company via phone and email inquiries. This is because the existence of Shari'ah committees might not be stated in the annual report since there is no regulation to do so. Secondary data includes 2012 annual reports of selected companies collected from Bursa Malaysia's website as of 24th April 2014. Non-financial and financial data (i.e. board composition, firm size and leverage) are extracted from the annual reports. The year 2012 was chosen because that was the recent year with most data available.

Based on 100 samples of Shari'ah compliant companies, eight different industries were included in this study.They are trading and services, industrial products, infrastructure / IPC, plantation, consumer products, properties, construction, and technology.

5. FINDINGS

5.1. Descriptive Statistics and Normality Test

The aim of presenting descriptive statistics is to identify the distribution of the data. Descriptive statistics could explain the level of corporate governance mechanisms among Shari'ahcompliant companies signified by independent variables. Table 1

provides the frequency and percentage of companies having CEO-duality and internal Shari'ah committees. The table indicates that only 8% of selected companies have the same person for the position of CEO and chairman of the board. This indicates that the level of CEO-duality is considered low among Shari'ah compliant companies and most corporate governance systems recommend separate positions for CEO and chairman of the board. In addition, only 2% of selected companies has their own internal Shari'ah committee. The low percentage of internal Shari'ah committee shows that companies do not prefer to establish their own internal Shari'ah committee due to not being a requirement.

Table 1
Descriptive statistics of DUAL and ISC

Variables	*Frequency*	*Percentage (%)*
CEO-duality		
Yes	3	6.0
No	47	94.0
Total	50	100.0
Internal Shari'ah committee		
Yes	2	4.0
No	48	96.0
Total	50	100.0

Table 2 provides descriptive statistics for all variables in this study. Among the independent variables, CEO-duality and the presence of Shari'ah board are highly skewed.However, the data will not be changed despite the skewness of 3.144 for CEO-duality and 6.962 for the presence of a Shari'ah board. This is because both data are dummy and not continuous variables.

On the other hand, the skewness and kurtosis (6.884; 56.781) of the dependent variable, the proxy of audit quality (audit fees) are high. In order to reduce the problem, audit fees, which represent audit quality, are transformed into log forms and all further analyses of the proxy of audit quality are performed in their log forms. When logged, the value for skewness and kurtosis was <1 which are .47 and .462 respectively.Table 4.4provides the results for Kolmogorov-Smirnov and Shapiro-Wilk statistics and show the significance level greater than .05 that is .065 and .206 respectively indicating that it is normally distributed. Histogram, Normal Q-Q Plot and Boxplot of audit quality after transformation can be accessed in Appendix C.

Table 2 reveals that the sampled firms have a minimum of five directors and a maximum of 13 directors with mean and median of 8.56 and 9.00 respectively.The standard deviation of board size is 1.756. Out of this, the board composition of independent directors has a mean (median) of 89% (100%) with standard deviation of .142. In addition, the average of financial experts of audit committee in our sample is 29% and the average leverage among the sample firm is 39.59% with standard deviation of .2133.

Table 2
Descriptive Statistics of variables

	Min	*Max*	*Mean*	*Std. Dev.*	*Kurtosis*	*Skewness*
AUD_Q	0.048	21.7	1.143	2.386	56.781	6.884
B_SIZE	5	13	8.56	1.754	-0.085	0.299
DUAL	0	1	0.08	0.273	8.043	3.144
IND_D	0.67	1	0.888	0.142	-1.542	-0.561
FIN_AC	0.13	0.56	0.288	0.095	-0.222	0.486
ISC	0	1	0.02	0.141	47.418	6.962
LEV	0.002	0.935	0.396	0.213	-0.303	0.291

Overall, the level of corporate governance mechanisms among Shari'ah compliant companies is considered moderate since the results are mixed. For instance, the mean board size is 8.56 which falls between the maximum of 13 and minimum of five. Further, the mean of .29 for financial experts of audit committee indicates that Shari'ah compliant companies only appoint financial experts in audit committees to comply with MCCG 2012. According to the Malaysian Code on Corporate Governance (2012), the majority of the board must comprise independent directors and at least one member in the audit committee should be an MIA member. This member requires wide accounting knowledge and expertise. In our study, financial experts in the audit committee could be comprised of MIA members. However, the board independence represented by the number of independent directors in the board is considered high. This is because 89% of directors in our sample are independent. This is in line withrecommendation 3.5 by Malaysian Code on Corporate Governance (2012) stating that the board must comprise a majority of independent directors to reinforce independence in the board.

Table 3
Test of normality before logarithm transformation

	Kolmogorov-Smirnov[a]			*Shapiro-Wilk*		
	Statistic	*df*	*Sig.*	*Statistic*	*df*	*Sig.*
AUD_Q	.323	100	.000	.373	100	.000

a. Lilliefors Significance Correction

Table 4
Tests of normality after logarithm transformation

	Kolmogorov-Smirnov[a]			*Shapiro-Wilk*		
	Statistic	*df*	*Sig.*	*Statistic*	*df*	*Sig.*
TAUD_Q	.086	100	.065	.982	100	.206

a. Lilliefors Significance Correction

5.2. Correlation Analysis and Multicollinearity

Table 5 presents the correlation analysis of all variables using Pearson Correlation Tests. The aim of presenting this correlation analysis is to identify whether empirical specifications of the data will be influenced by the problem of multicollinearity.

Table 5
Correlation matrix

	TAUD_Q	*B_SIZE*	*DUAL*	*IND_D*	*FIN_AC*	*ISC*	*LEV*
TAUD_Q	1						
B_SIZE	.273**	1					
DUAL	-.033	-.200*	1				
IND_D	.112	.177	.170	1			
FIN_AC	.029	-.129	.007	.013	1		
ISC	.056	.036	-.042	-.181	.074	1	
LEV	.302**	.148	-.088	-.028	.077	.107	1

It is clear that there are significant correlations between some variables. Based on Table 4.5, board size and leverage are positively and significantly correlated to audit quality. Board size measured by number of directors in the board reveals significant positive association to audit quality ($r = .273$, $p < 0.01$). It reflects a positive association between board size and audit quality. Leverage represented by ratio of total debt to total assets was significant to audit quality. ($r = .302$, $p < 0.01$). This indicates that highly leveraged firms demand high audit quality.

However, there was significant negative correlation between board size and CEO-duality ($r = -.2$, $p < 0.05$). This indicates that as the size increases in the number of board members, the tendency of CEO-duality is decreased or maintained. Large board size increasesa company's monitoring ability (Jensen, 1993) to better uphold independence in the board. CEO-duality will reduce board efficiency since there will be barriers in separation of control and decision-making. Hence, large board size which hold power will ensure independence in the board by abiding with recommendation 3.4 (Malaysian Code on Corporate Governance (2012)which recommends the position of Chairman and CEO should be held by different persons.

With regards to the potential problem of multicollinearity, the sample correlation between all the independent variables in the empirical model shows that the problem of multicollinearity would not pose a severe threat to our empirical modelling since most of correlations among independent variables are highly insignificant being less than 0.60.

5.3. Multiple regressions analysis

Sekaran & Bougie (2009) explained multiple regression as a statistical technique used to analyse the relationship between single dependent variable and several independent variables. To provide evidence on how board structure is related to audit quality, we examine board size, CEO-duality, independent directors, financial experts in audit committee, internal Shari'ah committee and leverage in multiple regressions and discuss the findings below. Multiple regressions allow simultaneous application for all six independent variables at one single run to find relationships with the dependent variables.

Table 6 reports the multiple regression results for the variables. The results in this study shows that audit quality is associated with board size measured by number of directors in the board ($p< 0.05$) and leverage ($p< 0.05$). Thus, Hypothesis 1 (H1) and Hypothesis 6 (H6) are accepted.

Table 6
Results of multiple regressions

	Coefficient	*t*	*Sig.*
(Constant)		-3.472	0.001
B_SIZE	0.227	2.221	0.029
DUAL	0.023	0.234	0.815
IND_D	0.081	0.797	0.428
FIN_AC	0.034	0.355	0.723
ISC	0.32	0.327	0.745
LEV	0.267	2.731	0.008
R^2	0.153		
Adjusted R^2	0.099		
F value	2.807		

As far as corporate governance is concerned, large board size has a positive significant association with audit fees, supporting H1. The result of this study indicates that bigger board size has a positive significance to the audit quality ($p = .029$). This result suggests that firms with larger board size would demand higher audit quality. This result is consistent withMakni *et al.* (2012) which provided significant evidence between the size of the board and audit quality. Lennox (2005) and Kane & Velury (2005) also suggested that board size has a significant impact on the choice ofhigher quality auditor. Although this result contradicts the study carried out byHoseinbeglou *et al.* (2013), it supportsAndres & Vallelado (2008) which stated that large board size enhances the monitoring role of the board.

Besides that, this study also supported H6 which predicts the association between higher audit quality and leverage. The results show that leverage measured by ratio of total debt to total assets has a positive significance on higher audit quality ($p = .008$). This result suggests highly leveraged firms demand quality audit to protect their stakeholders. This is consistent with Sulong et al. (2013)which found a positive relationship between leverage and audit quality thereby supportingPiot's (2001) argument that companies with a higher proportion of debt are more likely to demand high quality audit as auditing is one of their monitoring mechanisms and might reduce agency cost.

However, audit quality is not significant to Hypothesis 2 (H2), Hypothesis 3 (H3), Hypothesis 4 (H4), and Hypothesis 5 (H5). H2 predicts that there is a negative relationship between CEO-duality and audit quality. It indicates that the presence of CEO-duality in the board will reduce audit quality. The result of this study shows that there is no relationship between the two variables ($p = .815$).

Further, H3 predicts a significant relationship between independent directors and audit quality. As mentioned earlier, the results of this study shows insignificant relationship with p = .428. This value rejects the hypothesis (H3). The result contradictsLennox (2005), Carcello et al. (2002), andBeasley & Petroni (2001) which found that outside directors demandhigh quality audit to ensure the credibility of financial reporting and reduce information asymmetries. Thus, the hypothesis is rejected.

Next, H4 proposed that audit committeespossessing accounting and finance expertise might cause higher audit quality. The result presents an insignificant relationship between audit committee expertise and audit quality (p = .723). This result is consistent withIsmail et al. (2008)which found that audit quality is not significantly related to financial literacy of audit committee.

An additional independent variable in this study is the presence of internal Shari'ah committee in the company. H5 predicts that there is a significant relationship between the presence of internal Shari'ah committee and audit quality. When regression analysis was run, the result provides a P value of .745. The possible reason behind the result is that the presence of internal Shari'ah committee in the company is not related to the audit quality or there is no relationship between internal Shari'ah committee and audit quality. Most Shari'ah compliant companies in Malaysia prefer to rely on SAC at Securities Commission level rather than having their own Shari'ah committee. No requirement to have a Shari'ah committee at the company's level discourages companies to have their own Shari'ah committee. Some companies claimed that even though they do not have an internal Shari'ah committee, the management team does from time to time monitor the Shari'ah compliance criteria. Hence, this result rejects our hypothesis.

According to Park (2013), deviance between observed value and expected values is used instead of using R^2 which is used to calculate the overall fit of linear regression. In addition, Field (2013) stated that Cox and Snell R Square can be explained as R^2 in linear multiple regression and must not reach the maximum value of 1. This is in line with the results of board characteristics which do not support H2, H3, H4 and H5. This is the confirmed reason for the low adjusted R^2 = .153 and the F-value of 2.807. This means that the model explains only 15.3% (which represent the two variables) with regard to board characteristics. The table below provides a summary of the research results.

6. CONCLUSION

This study evaluated the impact of corporate governance mechanisms on audit quality among Shari'ah compliant companies in Malaysia. From the study, we conclude that the level of corporate governance mechanisms among Shari'ah compliant companies is moderate. A minority of boards have independent directors. However, the level of CEO-duality is low and at least one member of the audit committee has finance

knowledge and expertise. Using multiple regressions, two hypotheses were supported, which are board size and leverage. The findings show that firms with larger boards are associated with higher external audit fees and indicate higher audit quality. It suggests that larger board size has a positive impact on audit quality by requiring more expertise and increased board efficiency.The finding also shows that there is a positive association between leverage with audit fees, thus suggesting that highly leveraged firms would demand higher audit quality.

However, the results show that other variables (CEO-duality, independent directors, financial experts in audit committee and internal Shari'ah committee) have a non-significant positive relationship with audit quality. Overall, the results describe how external audit fees vary with corporate governance mechanisms. Indeed, large firms facing higher risks will increase their organisational monitoring and ask auditors to run extensive audits which result in improved audit quality, as shown by higher audit fees. Board structure (board size) and leverage are also associated with variations in the external audit fees.

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