Essays on the interplay between directors’ social networks and reputation capital, corporate reporting, and demand for audit quality.

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This dissertation examines the role of directors’ social networks and reputation in corporate reporting and the demand for audit quality. The board of directors are the central actors in the firm’s corporate governance, thus, they are responsible for the quality of corporate reporting and overseeing the external auditors. The first essay examines whether the reputation capital of the boards of directors is associated with the demand for external auditing, whereas the second and third essay examine the role of directors’ social networks in sustainability reporting and financial reporting, respectively. In all three essays the data consists of Finnish companies. The findings of the first essay suggest that reputed directors protect their reputation by demanding better audit quality. The findings of the second essay imply that information flow in directors’ social networks influence sustainability reporting practices of firms. More specifically, better connected boards are more likely to report on their sustainability issues and follow sustainability reporting guidelines. The results, furthermore, indicate that less connected boards are more likely to buy external assurance on their sustainability reports. The third essay continues examining directors’ social networks and finds that information flow in director networks improve firms’ accruals quality and has a positive impact on audit fee.

Overall, the findings of this dissertation provide insights into the role of directors’ reputation capital and social networks in the context of corporate reporting and audit quality.
Tiivistelmä
Tämä väitöskirja tutkii hallituksen jäsenten sosiaalisten verkostojen ja mainepääoman, yritysraportoinnin ja tilintarkastuksen laadun kysynnän välisestä vuorovaikutuksesta.

Avainsanat
Hallituksen maine, hallituksen sosiaaliset verkostot, tilintarkastuksen laatu, tilintarkastuspalkkio, kestävyysraportointi

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Anila Kiran
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List of Abbreviations and Symbols

CSR  Corporate social responsibility
GRI  Global reporting initiatives
ISA  International standard on Auditing
OLS  Ordinary least squared
SEM  Structural equation modeling
List of Essays

This dissertation thesis consists of introductory chapter and the following three essays.


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Author’s Contribution


Anila Kiran was greatly involved in each step of the project. She was heavily involved in developing the research idea. She was also responsible for the literature review and research design. She was primarily responsible for the data collection and management, empirical analysis, and writing the paper. She presented the paper in various seminars and conferences in Europe, USA, and New Zealand. She was involved throughout the publication process.


Anila Kiran was responsible for the data collection and management, and the empirical analysis. She did the literature review and wrote the early drafts of the paper. She continued to revise the manuscript together with the co-authors. She presented the findings of the manuscript in various seminars and conferences.


Anila Kiran is the sole contributor of the essay.
1. Introduction

This dissertation focuses on a central actor of corporate governance, the board of directors. More specifically, this thesis examines the role of directors’ reputation capital and directors’ social networks in the demand for audit quality and corporate reporting. The board of directors are the key players in the firm’s corporate governance and their objective is to ensure that the firm produces higher-quality financial reports (Cohen, Krishnamoorthy, & Wright, 2004). Because the board of directors oversee corporate governance practices implemented by the management, they are thus responsible for overseeing the external auditors (Carcello, Hermanson, Neal, & Riley, 2002). Not only are the boards responsible for the quality in their financial reports, but the boards also have been increasingly responsible for non-financial reports, i.e., sustainability reports. The literature suggests that the boards are the drivers in setting goals and achieving objectives related to sustainability reporting (Elkington, 2006; Jamali, Safieddine, & Rabbath, 2008). Thus, the role of the board of directors in financial and sustainability reporting has been at the center of discussion among academics, standard setters, and practitioners. Overall, the purpose of the three essays that comprise this dissertation is to examine the role of the board’s reputation capital, and the social networks regarding the demand for audit quality and sustainability reporting.
The first essay examines whether reputable directors protect their reputation by demanding more effort from the external auditor. Directors rely on external auditors to lower the risk of misstatements in financial reports and the risk of fraud, thereby protecting their own reputations as trustworthy and vigilant monitors of the firm. We argue that directors could use external auditors to protect their own reputation. In conjunction with the data from listed companies in Finland during the years between 2007 and 2016, we measure the director’s reputation capital with multiple directorships and their compensation from these directorships; the findings of this essay suggest that the demand for audit quality increases with the level of directors’ reputation. Particularly, we find that audit fees increase with directors’ reputation capital, and that boards with a higher reputation capital choose auditors with larger client portfolios. We also find that the effect of reputational capital on audit fees is stronger in companies with an audit committee, and that the company’s reputation capital matters when it comes to choosing their auditor. Overall, the results of this study provide evidence that the demand for audit quality increases with the reputation capital of directorships.

The second essay investigates the role of board of director social networks in sustainability reporting practices. More specifically, the essay explores whether the directors’ networks are associated with a choice to (1) report on sustainability issues, (2) follow GRI guidelines on their sustainability reports, and (3) buy external assurance on sustainability reports. Prior literature shows that director networks are channels of information flow that enable directors to get timely information, e.g. on environmental practices (Amin, Chourou, Kamal, Malik, & Zhao, 2020). As it
is still largely voluntary, especially during our investigation period, sustain-
tability reporting involves a great deal of uncertainty on how and what to report. Given this uncertainty, the directors would benefit from the in-
flux of information within their networks. Therefore, we expect that di-
rectors’ social networks play a role in sustainability reporting practices.

Using the data on Finland’s listed and unlisted firms during the years be-
tween 2008 and 2016, our results support the argument that the net-
works of directors shape the firm’s sustainability reporting practices. We
find an association between board networks and the firms’ choice to re-
port on sustainability issues. However, this association is stronger in the
subsample of firms with smaller boards, suggesting that the network ben-
efits are more important to smaller boards than larger boards. Further-
more, we find that director networks are positively associated with the
firm’s choice to follow GRI guidelines on their sustainability reports. Fi-
ally, we document that less connected boards are more likely to buy as-
surance on their sustainability reports. Overall, this study provides in-
sight on how the corporate governance, especially the directors’ social
networks, shape firms’ sustainability reporting.

The third essay explores whether directors’ social networks are associ-
ated with audit fees. Using the data on large Finnish (listed and unlisted)
companies from 2008 to 2016 and employing a path analysis, the study
examines, in addition to the direct effect of director social networks on
audit fee, the indirect effect through accruals quality. By doing so, this
study addresses two research questions: (1) is there a direct effect of di-
rector social networks on audit fee and, (2) is there an indirect effect of
director social networks on audit fee through accruals quality? Directors’
social networks are seen as channels of information that enable directors
to get timely information on the best practices and industry trends (Larcker, So, & Wang, 2013). The information flow in director networks enables directors to be better monitors of the financial reporting process (Omer et al., 2019), thus improving the monitoring strength of boards (Intintoli, Kahle, & Zhao, 2018). I argue that the overall information flow in director networks enhances the director’s monitoring strength. Well-connected directors are better monitors of the financial reporting process, and are able to demand more from the external auditors. In other words, better monitoring mechanisms lead to better quality in accruals, and more demand from the external auditors. Thus, it could be expected that director networks are positively associated with the accrual quality and audit fees. Furthermore, the prior literature suggests that the audit risk increases with the level of discretionary accruals, leading to a higher audit fee (Gul, Chen, & Tsui, 2003). Building on this, I expect that the directors’ social networks would have a negative indirect effect on the audit fees that goes through the accrual quality. Regarding the direct effect, I expect a positive association between the directors’ social networks and audit fee, increasing audit fees, and a negative indirect effect of the networks on audit fee that goes through accruals quality, decreasing audit fee.

Results of this study indicate that director networks have a positive and direct effect (in the path) with audit fees and the accrual quality. Moreover, the quality of accruals negatively and indirectly affects the association between director networks and audit fees. However, the results of the indirect effect are albeit weak. Overall, these results suggest that connected directors are better monitors of the financial reporting process, improving the accrual quality and demanding more from external
auditors. This study adds to the literature on the role of social networks of directors in auditing and outcomes related to financial reporting (Intintoli et al., 2018; Johansen & Pettersson, 2013; Omer et al., 2019).

Collectively, the findings of this dissertation contribute to the literature on the role of the board of directors’ characteristics in auditing, financial reporting, and sustainability reporting. The inferences from the first essay underline the role of reputable directors in enhancing the firm’s audit quality. The second and third essays focus on directors’ social networks and discuss how networks facilitate the spread of information among directors, playing a role in shaping the firm’s financial and sustainability reports. The results of this dissertation have some practical implications. Firstly, in order to ensure the directors’ ability to perform their duties, there have been critics on multiple directorships; and it has been suggested to limit the number of directorships that the directors can hold. On the contrary, our findings imply that directors serving on multiple boards ask for more monitoring from external auditors, ultimately benefiting investors and other financial providers for the company. Secondly, the concerns of governance experts about the negative effects of board networks, including “old boy network” and reduced independence, is not supported by the findings on the director social networks, audit fees, and the accrual quality. In fact, the results suggest that board networks improve the governance quality, benefiting the firms and its stakeholders.

The remainder of the introductory chapter is structured as it follows. Section 2 briefly describes the literature on the director’s reputation and director social networks for directors. Section 3 summarizes the three essays.
2. Directors’ reputation and social networks

This section provides a comprehensive overview of the state of the art regarding the director’s reputation capital and the director’s social networks in accounting research.

2.1. Directors’ reputation capital

Reputation matters for both the corporations and leaders of corporations. Corporate reputation is a fragile asset, which is directly proportional to its delicacy (Dowling, 2006). Corporate reputation matters as studies linking reputation building to the performance and success of the company show (Gotsi & Wilson, 2001; Gray & Balmer, 1998). For example, Roberts & Dowling (2002) a positive relationship between corporate reputation and financial performance. Schwaiger, Raithel, & Schloderer (2009) studied the stock market’s performance in a portfolio comprising the top 25% of reputation leaders and found that the portfolio with reputation leaders outperformed the stock market index by up to 45%. Corporate reputation also matters in debt and equity financing activities, along with the stakeholder’s perception. Documenting a reputation effect, Diamond (1991) that borrowers with a high reputation are more likely to be offered loans from banks. Filbeck & Preece (2003) that the market reacts positively to the firms that are characterized as ‘Fortune’s 100 best companies to work for. Companies with higher reputation are less likely to misstate their financial statements and produce higher-quality financial reports (Cao et al., 2012) because higher-reputation firms suffer more from reputational damages due to the media coverage and inspections.
from oversight boards. In essence, firms are incentivized to build and manage their reputation.

Corporate reputation, however, can easily be destroyed, as we have examples of Enron and WorldCom, followed by the case of Lehman Brothers. Reputation can be viewed similarly to a brand name, which works as a collateral against any opportunistic behavior and this collateral is lost if “promises are not kept”.

Reputation capital also matters at the level of individual leaders within the companies. The top management’s reputation plays a vital role in their remuneration. For example, Tien et al., (2012) and Milbourn (2003) that the CEO’s personal reputation is positively associated with the CEO’s total remuneration and stock-based compensation. Moreover, firms with poorer reporting quality hire reputed CEOs as they require superior skills of more reputed CEOs (Francis et al., 2008). The negative impact of losing their reputation is not limited only to firms, but it also affects the individuals associated with the firms. For example, Fich & Shivdasani (2007) find a decline in board seats held by the directors of firms that faced lawsuits due to financial fraud. This is because the top management has more to lose in terms of their own human capital. This incentivizes boards to protect their reputation, as they bear the cost of damage to their reputation capital.

What could directors do to protect their reputation capital? We argue in our first essay that directors could demand more from the external auditors to improve the quality of internal controls and financial reporting, thereby protecting their own reputation as vigilant monitors of the firms. This is supported by the prior literature (Hay, 2013) that finds a positive association between the audit fees and the internal control and corporate
governance, thereby linking the quality of corporate governance to the
demand for audit quality. As such, the first essay examines the role of the
director’s reputation in the demand for audit quality. A brief summary of
this essay is discussed in section 3.

2.2. History of social networks

The history of social networks originates from the prehistoric era,
when human beings collaborated and formed relationships for hunts,
shelter, and survival. The earliest social networks were formed through
relationships among the bloodlines, which later emerged into tribes,
kingdoms, and nations. Not only did relationships grow through families
and work, but connections also have been formed through politics, reli-
gion, trade, and other factors. With the emergence of technology and
trade, countries became connected. Although the history of social net-
works goes back to prehistoric humans history, the scientific research
originated only at the end of the 19th century. In the 1890s, scholars doc-
umented that shared roles, beliefs, values, indirect interactions, and im-
personal roles can connect individuals and form social ties (Tönnies,
1887). The term “social networks” and “social network analysis” was first
introduced by Georg Simmel in the early 20th century. Georg Simmel
wrote about his studies regarding the patterns of relationships that con-
nect social actors. Many of the concepts, such as tie (connection), vertex
(node), walk (sequence of connections that join nodes), and distance and
dyadic relationships, measure the extent to which connections of a target
individual are controlled by other individuals in the network.
Later in the 1900s, researchers studied networks, such as marriages, kinships, schoolmates, and group work (Bott, 1957). These studies concentrated on local networks in small regions, and were typically conducted through surveys. In the mid to late 1900s, the social network research was expanded to study concepts, such as six degrees of separation as a part of the ‘small world’ experiment (Migram, 1967), the strength of weak ties (Granovetter, 1973), and the centrality and power of vertex (Freeman, 1977; Bonacich, 1987). Since the mid-1900s, graph theory methods were utilized, expanding the research scope from local to global, and from real networks to hypothetical networks. Recently, an emerging stream of literature in economics and finance has utilized the analysis of social networks to study the impact on accounting and auditing outcomes (Bhandari, Mammadov, Shelton, & Thevenot, 2018; Johansen & Pettersson, 2013; Larcker & Tayan, 2010) documenting that directors’ social networks facilitate the influx of information, thereby improving the governance quality of firms.

2.3. Directors’ social networks

Director networks are a type of social networks that involve companies or individuals forming connections. Director networks are formed when board of directors sit on different corporate boards. In other words, when directors share common boards. These connections are mapped at either the individual or board level. Individuals or boards are known as nodes, and the connections among them as ties. What’s central to these connections is the flow of information and exchange of ideas.

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2 Directors can also be linked through social connections, such as alumni networks and club memberships, which are seen as informal social connections. However, this dissertation focuses on formal connections that are formed through board connections.
Director networks occur for two reasons: company motivation and personal motivation. Mizruchi (1996) presents a comprehensive review of the research on director networks and classifies the determinants of director networks into: (1) monitoring, (2) legitimacy, and (3) collusion. The monitoring explanation suggests that director networks are established for the interfirm dependence on resources, which is manifested in better performance. Overall, the results for this argument remain mixed. Burt (1983) finds a positive association between director networks and corporate performance, however, Lang & Lockhart (1990) find the opposite. More recent studies (Zona, Gomez-Mejia, & Withers, 2018) suggest that director networks may exhibit positive or negative effects on the firm’s performance, depending on the firm’s relative resources and ownership structure. The legitimacy argument suggests that appointing networked directors who are perceived as reputable directors leads to more trust from investors and capital providers (Scot, 1992). Collusion purposes are another reason for the company’s motivation to form director networks. Critics of board networks argue that networks between competitors provide a means of restricting competition. In fact, this debate led to the U.S. establishing the Clayton Act in 1914, which eventually prohibited interlocking directorates in the railroad industry, competing firms, and banks.

Director networks occur for individual reasons as well. Prior research shows that career advancement is one of the prominent reasons why director networks are formed. Zajac (1988) and Stokman et al., (1988) show that directors join other boards for reasons related to prestige and compensation. More recent studies (Kirchmaier & Kollo, 2011) confirm these
earlier findings, suggesting that prestige and education contribute to the expansion of director networks.

An important benefit of director networks is the value of information. Directors who are better connected in their networks have quicker and more access to information and resources available in their network. In other words, director networks serve as channels of information flow. Consistent with this argument, the recent research in accounting and finance find that board networks impact managerial compensation (Renneboog & Zhao, 2011), the firm’s performance (Larcker et al., 2013), financing opportunities (Javakhadze, Ferris, & French, 2016), financial restatements (Omer et al., 2019), earnings management (Fang, Francis, Hasan, & Wu, 2021), and auditor choices (Johansen & Pettersson, 2013). Building on this research, the second essay examines the association between the director’s social networks and sustainability reporting; and the third essay examines the association between the director’s social networks and audit fees. A brief summary of these essays is discussed in section 3.

3. Summary of the essays

The overarching objective of this dissertation is to investigate the role of the director’s reputation and the director’s social networks in audit quality, along with financial and sustainability reports. This section summarizes the three essays that comprise this dissertation. A brief overview is provided in table 1.
3.1. Reputation capital of directorships and demand for audit quality

The first essay explores whether the boards of directors use external auditors to protect their reputation capital. More specifically, the paper examines whether the demand for audit quality is associated with the director’s reputation capital. Reputation capital is valuable not only as a competitive advantage, but also as a collateral that is lost if ‘promises are not kept’ (Benjamin & Leffler, 1981). Once a reputation is damaged, it takes plenty of time to restore it. The reputation of directors serves as a collateral against opportunistic behavior. This argument is supported by Fich & Shivdasani, (2007) who found a decline in the number of directorships held by the directors of firms that faced a lawsuit due to alleged financial fraud.

Prior studies have examined the role of the top management’s reputation in executive compensation and financial reporting quality (Francis et al., 2008; Tien, Niap, & Taylor, 2012). These studies suggest that managers are concerned about their reputation and attempt to protect it. We argue in our paper that directors use external auditors to protect their own reputation capital, and hypothesize that the demand for audit quality increases with directors’ reputation capital. We use data on Finnish listed companies for a period of 2007-2016 to test our hypothesis. We measure the demand for audit quality with audit fees, the firm’s choice of individual auditor in-charge, and the financial reporting quality. We measure the reputation capital of directorships with the number of directorships in different firms and the director’s compensation from those directorships.
We find consistent results with our hypothesis that the demand for audit quality increases with the reputation capital of the board of directors. In particular, we find that the audit fee increases with the increase in a director’s reputation capital. Furthermore, we find that boards with a higher reputation capital choose auditors with large client portfolios. More interestingly, this reputational effect on the audit fee is stronger for the firms with audit committees. Finally, we find some evidence that the reputation capital is positively associated with abnormal working capital accruals.

This study contributes to literature on corporate governance and audit quality. Our results enhance our understanding of the role of auditing in the corporate governance mosaic (Cohen et al., 2004), and the demand for audit quality in general. We also add to the literature on the reputation capital in the context of corporate governance. Our results have some practical implications. Our results suggest contrary to the concern of multiple directorships impairing boards ability to be effectively monitor managers. In fact, our findings suggest that directors serving on multiple boards ask for more effort from external auditors, thereby benefiting the firm. Therefore, our results do not support the proposition by some critics to limit the number of multiple directorships directors can have.

3.2. Directors’ social networks and sustainability reporting practices

The second essay investigates whether the board of director networks shape firms’ sustainability reporting practices. In particular, it examines whether connected boards are more likely to (1) report on their sustaina-
bility issues, (2) follow global reporting initiative guidelines on their sustainabil-
ity reports, and (3) buy external assurance on their sustainability report.

Prior research has mainly investigated the role of board characteristics in corporate social responsibility (Al-shaer & Zaman, 2016; Fernandez-Feijoo, Romero, & Ruiz-Blanco, 2014; Frias-Aceituno, Rodriguez-Ariza, & Garcia-Sanchez, 2013). These studies suggest that larger boards, boards with expertise on environmental issues, and those with more female directors are more likely to report on sustainability issues. Board gender diversity is also positively associated with the quality of these reports. The prior research has also provided evidence about the effects of board networks in corporate social responsibility performance and environmental performance (Amin et al., 2020; Homroy & Slechten, 2019). However, there is limited empirical evidence on how the board of director networks shape sustainability reporting practices in firms.

The social network theory suggests that network connections are channels of information flow that enable boards to get timely information on the best practices. Well-connected directors are well-informed on various strategies and decisions other boards make, making them better advisors in their own firms. Through their network ties, directors can ease the access to novel information on good environmental practices used in other firms. Directors who sit on different boards are exposed to various sustainability strategies, and can exchange information on sustainability issues. The role of director networks in sustainability reporting is of particular interest because sustainability reporting is still voluntary, and the reporting framework is vague in nature. A wide range of voluntary frameworks are in use, and firms are faced with uncertainty to choose from
multiple frameworks. These frameworks are also costly for firms to implement with a high level of complexity and limited benefits. Given the uncertainty, we expect that directors rely on the information influx from other boards in their networks, and hypothesize that the director’s social networks are positively associated with the firm’s choice to report on sustainability issues, their choice to follow GRI guidelines on their sustainability reports, and their choice to buy external assurance on sustainability reports.

The second essay uses a sample of 5,058 company-year observations from the largest firms in Finland for over a period of 2008-2016. Employing the logistic regression, the findings reveal a positive association between the board networks and firms’ likelihood of reporting on their sustainability in the subsample of smaller boards. Furthermore, the results reveal a positive association between board networks and the firm’s choice to follow GRI guidelines on their sustainability reports. Finally, the results reveal that less connected boards are more likely to buy assurance on their sustainability reports. These results are robust to additional tests when we split the sample into listed firms and non-listed firms, and firms with smaller and larger board sizes. Overall, this study suggests that the board of director networks is associated with sustainability reporting, their choice to follow GRI guidelines on sustainability reporting, and their choice to buy assurance on their sustainability reports.

3.3. The association between directors’ social networks and audit fees: A path model approach.

Prior literature shows that networks are channels of information that enable directors to get timely information (Larcker et al., 2013). Prior studies that examine the role of board networks in accounting show that
information flow through social networks increases the boards’ monitoring over financial reporting processes, thus enhancing the financial reporting quality (Omer et al., 2019). Furthermore, well-connected board members are better able to access superior information from their networks, enhancing their monitoring strength (Intintoli et al., 2018). Building on this, I argue that the overall information flow in director networks improves the director’s monitoring strength. Well-connected directors are better monitors of the financial reporting process, and are able to demand more from the external auditors. Put differently, better monitoring mechanisms lead to better accrual quality and more demand from the external auditors. Connected directors utilize the available information in their network to thoroughly evaluate the accounting issues, while actively involving the external auditors in the assurance of financial reports. Thus, it could be expected that director networks are positively associated with the quality of accruals and audit fees. Prior literature (Gul, Chen, & Tsui, 2003) shows a positive association between discretionary accruals and audit fees. As such, I expect that the audit risk increases with the level of discretionary accruals: better accrual quality (lower discretionary accruals) reduces the audit risk and lowers audit fees. All in all, my overall expectation regarding the directors’ social networks having a direct effect on audit fees is positive as it increases audit fees, and that the networks’ indirect effect on the audit fee that goes through the accrual quality is negative as it decreases the audit fee.

Much of the research on the effect of the director’s social networks and accounting outcomes has adopted a ‘direct effect’ approach from director networks for accounting and audit outcomes. Less attention has been
paid to the interplay between the director’s social networks, accrual quality, and audit fees. To fill this gap in literature, I address two research questions: (1) is there a direct effect of director social networks on audit fee and, (2) is there an indirect effect of director social networks on audit fee through accruals quality?

To address the research questions, the study uses data on listed and unlisted firms in Finland for a period of 2008-2016 and employs a structural equation model (SEM) to conduct a path analysis. Path analysis results show that the directors’ social networks are directly (in path) and positively associated with audit fees and accrual quality. Moreover, the results provide somewhat weak support on the indirect effect of accrual quality on the association between director networks and audit fees. These results indicate that the director’s social networks improve the quality of accruals, which further reduces the audit fee. These findings suggest that the information flow in director networks reduces discretionary accruals, which reduces the inherent risk associated with the audit risk and thus results in a lower audit fee. Overall, the results of this study provide evidence on both the demand for auditing and the risk-based supply view of auditing.

This study contributes to the growing literature on the role of board networks in accounting and audit outcomes (Intintoli et al., 2018; Johansen & Pettersson, 2013; Omer et al., 2019). While the focus in prior studies has been on the role of social networks of boards in their financial reporting quality and audit fees, little is known about how board networks interplay with the accrual quality to affect audit fees. Overall, the results from this study enhance our understanding of the role of the director’s networks and accrual quality in improving audit outcomes. The
results of this study have practical implications. Governance experts are concerned about the negative effects of board connections, including the “old boy network”, reduced independence, or a back-scratching culture (Larcker & Tayan, 2010). However, when it comes to studying the quality of accruals, the results of this study show contradictory conclusions: director networks can facilitate the governance quality, benefiting the firms and its stakeholders.
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