

AUDIT COMMITTEE CHARACTERISTICS AND NON-PERFORMING LOANS IN NIGERIAN DEPOSITS BANKS

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ABSTRACT

This study examined empirically the impact of audit committee characteristics on non-performing loans in Nigerian Deposits banks. For the purpose of this research work, secondary data was used and the instruments of data collection were financial statements. The study adopts Ex-postfactor research (after the fact) design. The population of the study is 15 banks according to the Nigerian Stock Exchange. The sample size is the entire population of the study. The Study made use of multiple regression analysis and specifically the panel data regression technique. The Hausman test was used to determine the suitable regression. The result of the Hausman test showed the random effect. The findings suggested that the inclusion of financial expertise in audit committee leads to reduced level of non-performing loans in listed banks in Nigeria. Although insignificant, the relationship between the audit committee meetings and non-performing loans also revealed a negative influence. While the influence of audit committee independence on non-performing loans revealed a positive relationship. Therefore, the study recommends that financial experts on the audit committee should take in cognizance of the negative effect of increased non-performing on the performance of the listed banks and the committee meetings should discussed the ways in which non-performing loans are reduced.

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1. INTRODUCTION

The existence of the Deposit Money Banks has contributed marginally to the growth of and decline in any economy. In Nigeria, there is a need to address the prevailing weaknesses in financial institutions because of their capacity to define and determine the economic climate of the country. Deposit Money Banks and Other Financial Institutions act as a liaison between the demand and supply side of the funds through the provision of loans, which requires the need for efficiency and effectiveness in the banking system (Mondal, 2016). A major tool in which efficiency and effectiveness in the banking industry can be achieved is through corporate governance as it is about monitoring and controlling decisions in organizations as well stipulating processes, procedures, guidelines and codes to be followed by managers and board of directors (Institute of chartered accountants of Nigeria, 2014).

Abioye (2017) established that the current economic recession in Nigeria has proved that deposit banks still harbors flaws in governance, which is characterized by poorly appraised credits, flouting of credit limits, weakening of shareholders' funds, insider non-performing loans and over-domineering executive. This has further established the fact that there is a strong relationship between weak governance in the Banks and the existence of substantial amount of non-performing loans, which has been one of the main challenges in the banking industry and in the economy of most developed countries as there is a decline in value of loan collections of banks. In addition, Terzungwe & Simon (2011) established that credits are issued by banks to customers in their day-to-day transactions having the hope of reimbursement right after the completion of the agreed

period. It was further explained that sometimes this credit remains uncollectable, and therefore make up of what is called non-performing loans. The risk associated with non-performing have a serious impact on the banks therefore there is a need for good corporate governance.

Good corporate governance cannot be exhibited without the active participation of the audit committee. Hamdan, Mushtaha & Al-Sartawi (2013) established that the audit committee serves as a vital tool for corporate governance. Due to the several volumes of transactions, large quantity of cash and cash substitutes held increased use of technologies in banking processes and the numerous complex financial product that is traded in banks, the tendency for risk is likely to be higher. There are possibility of fraud and the internal control function is likely to be more difficult. All of these makes the role of audit committee become extremely important (Prabhu, 2012). The audit committee is saddled with the responsibility to check, examine, scrutinize and evaluate the processes and procedures for carrying out operations stipulated by the law, regulatory bodies, the code of corporate governance and the organization in issuing out loans on behalf of the board of directors. The audit committee also carry out the function of overseeing the auditing procedure and financial reporting, which has gained renewed interest in controlling frauds perpetuated by accountants and managers (Adhikary & Mitra, 2016).

A plethora of studies (Messai & Jouini, 2013; Nyor & Mejabi, 2013) have addressed non-performing loans in banks by examining various variables that are likely to affect it. Messai and Jouini (2013) stated that micro and macro economic variables affects non-performing loans. In addition, Nyor & Mejabi (2013) has examined non-performing loans using corporate governance as a variable. Most of these studies have focused on variables that are broad in scope such as corporate governance, macro and micro economic determinants, auditors and regulatory examiners. There have been very limited empirical studies on the influence of audit committee on non-performing loans.

To the best of the researchers knowledge, little is known about audit committee and non-performing loans in deposit banks in Nigeria but most reserchers have looked at how corporate governance and other factors affect non-performance. The study examined the influence of audit committee characteristics decomposed into audit committee financial expertise, audit committee meeting and audit committee independence on non-performing loans in the listed banks in Nigeria using fixed effect panel analysis. The study affirmed that affiliation among audit committee financial expertise and non-performing loans in Nigerian Banks was significantly positive, which suggested the increased non-performing loans due to risk appetite of financial expertise in audit committee. Although insignificance, the relationship between the audit committee meeting and non-performing loans was positive while the influence of audit committee independence on non-performing loans in listed banks in Nigeria. The remainder of this study was further organized into sections. Section 2 discussed the prior literature and hypotheses development followed by a section on research methods. The subsequent sections focus on empirical findings and discussion of results and the study is concluded in the last section.

1.1 Trends of Non-performing Loans in Nigeria

Nigeria like other economies has a long-standing problematic condition with non-performing loans identified as a major obstacle to banking stability. Prior studies like Barr, Seiford & Siems (1994) trace prior high non-performing loans to banks failure. Similarly, the global financial crisis of 2008 shows the fragility of the financial system globally, as the financial crisis initiated by the United States banking sector has a split over effect on other economies banking sector and incidentally disrupt the global real economy. Taking cognizance of the roles of the banking sector, various economies have heavily regulated the banks' activities to mitigate any uncertain risks in turns promote financial stability. The Nigerian banking sector has experienced diverse reforms. Before 2004 reforms, which require a minimum capital base of 25 billion naira for banks, a total of forty-eight banks liquidated between 1995 and 1998 whose licenses were revoked by regulators. The reforms were targeted at achieving diversified, reliable and strongly capitalized institution, which led to the mergers and acquisition of banks from 89 banks to 25 banks as of 2005 (Soludo, 2008).

Nevertheless, deteriorated loan quality has plagued the Nigerian banking sector. In 2009, the non-performing loans are approximately 37% of all loan, which eventually dropped to 2.97% in 2014, which is now approaching 20% as at December 2017 against 5% regulatory threshold coupled with the recession or financial crisis in-between the period while the net value of non-performing loans taken over by the Assets Management Company of Nigeria (AMCON) is 4.5 trillion naira as of 2016 (Central Bank of Nigeria, 2017). Central Bank of Nigeria set up AMCON in 2010 with the motive to acquire the delinquent loans from troubled banks, which could boost their liquidity level and their recapitalization strategy. With the progressive level of non-performing loans, the regulator that is CBN has introduced a new policy that bank with above 10% non-performing loan ratio is restricted from paying dividends to its shareholders (Udom, Eze, & Inim, 2018).

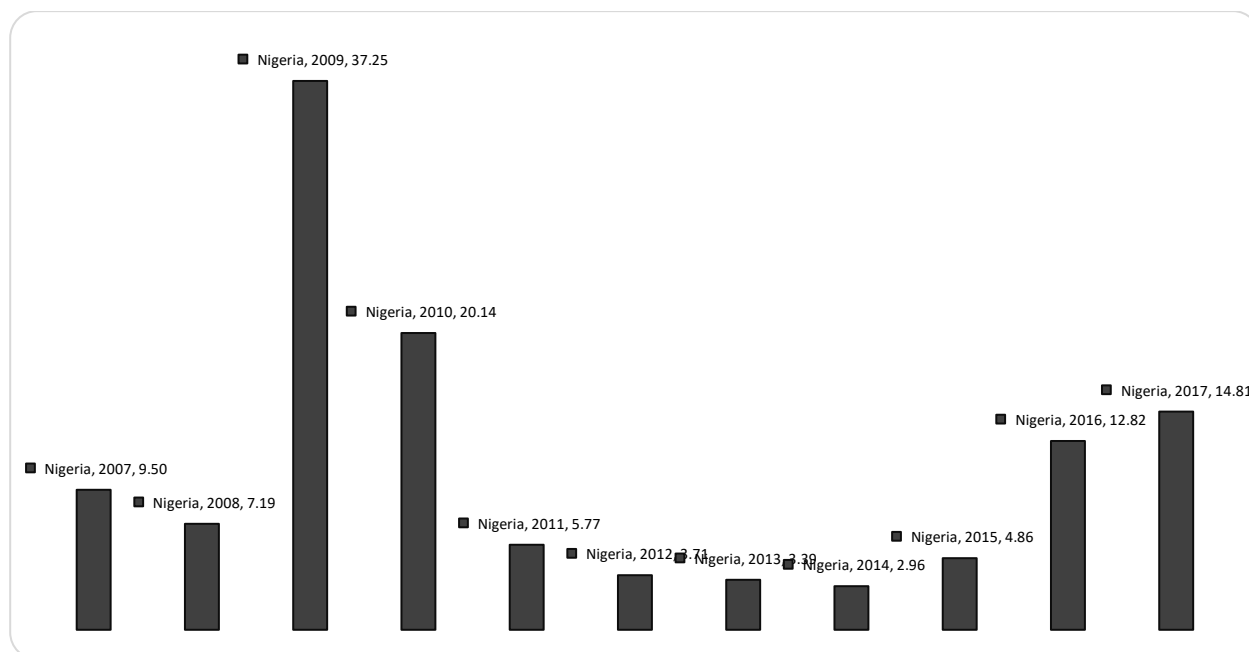


Figure 1: Trends of Non-performing Loans in Nigeria
Source: World Bank Dataset

2. LITERATURE AND HYPOTHESES DEVELOPMENT

2.1 Audit Committee Independence and Non-Performing Loans

The Sarbanes-Oxley Act states that for audit Committee members to be independent, they should avoid accepting any consulting, advisory, or compensatory fees from the company in which they work for. Cohen & Hanno (2000) further highlight that the presence of an independent audit committee influences the quality of the assessment of risk by the manager significantly. In the light of this, there is a need to focus on the evaluation of the risks related to the banks' assets management in the search to reduce the level of non-performing loans (Houbenova-Delisivkova, 2015). It was further postulated by Houbenova-Delisivkova (2015) that the European Banking Authority emphasized the need of risk assessment of banks' assets in its references for the banking industry in EU in 2013. According to Owolabi & Dada (2011), the Audit committee should not be subject to the control of any dominant personality on the board, Audit Committees should be made up of tough and independent persons. DeFond & Francis (2005) as cited in Owolabi & Dada (2011) established that independent directors are better monitors of management than are inside directors. This was confirmed by Houbenova-Delisivkova (2015) as he noted that the banking crisis in Bulgaria demonstrates the weaknesses in the bank management with regard to asset quality and prudential supervision of bank's management of assets and liabilities. In addition, it was found out that full independent audit committees brings about lower debt financing costs which indicates that all the members must be independent before there could be any significant impact. (Anderson, Mansi and Reeb, 2004) as cited in (Aanu, Odianonsen, & Foyeke., 2014). Adhikary & Mitra (2016) postulated that firms that have large boards and more independent non-executive directors are likely to provide more freedom to the audit committee. Freedom of the audit committee declines as the firm size increases. Firms having potential growth opportunities are less likely to provide freedom to their audit committee.

The presence of an independent committee is an hint of the organizations commitment to a good corporate governance (Sommer, 1991) as cited in (Adhikary & Mitra, 2016). Collier (1996) in Adhikary & Mitra (2016) established that audit committee that has non-executive directors in its composition of the firms in UK are more willing to make known information against other firms that do not. This is because the necessity for accounting standards and better disclosures has enlarged due to the nature of lending that has become longer term, which in turn enhances the growth of longer-term lending, where banks take up more credit risk. As a result of this, the significance of having correct and timely data to monitor asset quality through a loan's long life has increased. Bholat, Lastra, Markose, Miglionico, & Sen, (2016) emphasized on the need for independent members in the audit committee. However, the reason for establishing the audit committee would be displaced if executive directors are included in the audit committee. According to Dechow et al. (1996) and Klein (2002) in Angahar & Mejabi (2014), fraudulent financial actions are significantly brought low when autonomous directors are included in the audit through the audit committee. One of the fraudulent activities that increases the rate of non-performing loans is information asymmetry. Kwambai & Wandera (2013) explained that banks in Kenya have been loaning funds to a number of defaulters, because of the banks having dissimilar credit information concerning the borrowers. These debtors are exploiting the information asymmetry to collect numerous loans from the Kenyan banks and defaulting in the long run thus growing the level of nonperforming assets (NPAs) in the banking sector in Kenya. Maria (2012) in Abernathy et al. (2015) established that

establishments with more external directors favour independent audit committees to ease information asymmetry between outsiders and insiders allowing control to be effective in management decision. Klein (2002), Carcello and Neal (2000) further argued that audit committee may underperform if sufficient freedom is not given to them which would ultimately lead to their ability to raise questions on the quality of financial reports and where information asymmetry is suspected. Menon & Williams (1994) explained that outside directors improve the effectiveness of audit committee.

H₀: The audit committee financial expertise does not affect non-performing loans in Nigerian deposit banks.

2.2 Audit Committee Meetings and Non-Performing Loans

The Code of best practice (2003) in Nigeria indorses that the audit committee meets together nothing less than three times in a year. The code also states that the quorum for the audit committee meetings would be subject to on the amount of members in the committee and should be denoted in the terms of reference of the committee. It is also recommended that the audit committee should have a meeting together with the external auditors not less than once in a year, without the presence of the executive board members. To carry out its responsibilities, the Committee Chairman shall every year create a calendar of meetings to be ratified by the Board. Additional meetings, as they arise, may be arranged by the Committee Chairman or the Chairman of the Board of directors. According to the Financial Reporting Council (2016), an adequate interval should be permitted between the meetings of the audit committee and central board meetings so as allow any work coming out from the audit committee meeting to be carried out and to give an account to the board as appropriate. It was established that no individual as side from the audit committee's chairman and its members is permitted to be in attendance at the meeting of the audit committee. It is for the members of the audit committee to agree if non members should appear for a specific meeting or a certain agenda item. It is predictable that the finance director, head of internal audit and the lead partner of the external audit will be invited on a regular basis to show up at meetings. Zhou (2004) in Aanu, Odianonsen, & Foyeke (2014) noted that audit committee meetings function as an imperative mechanism for improving and stimulating corporate governance in organizations. Owolabi & Dada, (2011) recommends that the audit committees should meet recurrently so as to have sufficient time to attend to serious issues that may need their attention. One of such issues is the occurrence fraudulent activities. There is possibility that financial scam would be condensed if the audit committee meets often and carry out its responsibilities as required (Stewart & Munro, 2007). Best practice requires that every board should consider in detail what audit committee arrangements are best suited for its particular circumstances. While all directors have a duty to act in the interests of the company, the audit committee has a particular role, acting independently from the executive, to ensure that the interests of shareholders are properly protected in relation to internal control (Financial Reporting Council., 2016).

H₀: The audit committee m does not meetings influence non-performing loans in Nigerian deposit banks.

2.3 Audit Committee Financial Expertise and Non-Performing Loans

One of the primary characters of the Audit Committee is objective oversight of accounting of the organization (Lindberg, 2004). The concern of financial expertise for at-least one audit committee member was recognized at first under Section 359 (3) and (4) of the CAMA. This was further provided in the SEC code of 2011. According to Lindberg (2004), the financial expert must be able to evaluate the over-all application of GAAP in relation with any accounting reserves estimates or accruals. It was further opined that the know-how in preparing, auditing, analyzing, or evaluating financial statements should be possessed by financial professionals and should also have an understanding not only of inside controls and processes for financial reporting, but as well of sound comprehension of the functions and responsibilities of the Audit Committee. Abernathy et al. (2015) additionally discovered that the source of audit committee members' accounting expertise ought to be carefully considered when seeking to add a director to an audit committee or to engage a director as a chair of the committee. It was further explained that it may be unfeasible to implement a narrow description of financial expertise for the entire audit committee, but evidence has shown that audit committee effectiveness can be heightened by having memberships and chairs who have public accounting experience. Carcello, Hollingsworth, Klein & Neal (2006) opined that allowing a member of an audit committee that has a financial expertise would most likely ease earnings management for firms where the mechanisms of corporate governances are weak. Empirically, Sinkey & Greenwalt (1991) as cited in Messai & Jouini (2013) affirmed that there is a significant positive relationship between the rate of loan losses and internal factors such as excessive lending, high interest rates. Audit committee members with accounting expertise may help to efficiently resolve this internal factors by monitoring excessive lending and moderating the interest rate. Abbott et al. (2004) cited in Adhikary & Mitra (2016) verified that a substantial relationship that is negative exist between the presence of member an audit committee with financial expertise and the occurrence of statement restatements, which means that the enclosure of a financial expert in the audit committee advances excellent monitoring and firm value. Rationally, more specialists in finance and auditing as the members of audit committee may aid improvement in the whole internal control process of a firm and audit committee 's independence as well. Furthermore, Balasubramaniam (2001) as cited in Sahu & Maharana (2017) propose that, effective internal control systems, good credit appraisal procedures, along with the enhancement in asset quality in the balance sheets have the prospective to bring down NPA in banking sector. In addition, Carcello, Hollingsworth, Klein, & Neal (2012), finds a proof that anomalous accruals reduce after an accounting financial professional enrolls into the audit committee. Sahu & Maharana (2017) pronounces that audit committee financial expertise may be effective in compelling the management of accounting accruals.

H₀: The audit committee independence does not influence non-performing loans in Nigerian deposit banks.

3. RESEARCH METHODS

This study adopted an ex-post research design. Data were employed from annual financial reports of 12 quoted banks, which involve the Non-performing loans and audit committee characteristics in terms of audit committee financial expertise, audit committee meetings and audit committee independence. The study estimates model (1) using the pooled Ordinary Least Square with the adjusted standard errors for heteroskedasticity and clustering by firms. In panel data analyze, there is a need to select between the Fixed Effect and Random Effect via the Hausman test. We then perform the Hausman specification test with the null hypothesis that Random Effect would be consistent and efficient while the alternative hypothesis state that Fixed Effect would be consistent and efficient. The estimated Chi-square (Pro>chi2) guide our decision to either accept or reject the null hypothesis. Therefore, our Hausman test result accepts the null hypothesis summarized in Table 4 making the Random Effect model consistent and efficient for our analysis.

3.1 Model Specification

The mathematical forms of the relationship between the non-performing loans and audit committee characteristics of the listed banks in Nigeria are expressed as follows:

$$NPL_{it} = \beta_0 + \beta_1 ACFE_{it} + \beta_2 ACM_{it} + \beta_3 ACI_{it} + \beta_4 SIZE_{it} + \beta_5 ROA_{it} + \beta_6 LDR_{it} + \beta_7 CAR_{it} + \varepsilon_{it} \dots (1)$$

Table 1. Description of Variables

VARIABLES	ACRONYM	MEASUREMENT
Dependent Variable		
Non-performing loans	<i>NPL</i>	The ratio of non-performing loans to total loans and advances expressed in percentage
Independent Variable		
Audit committee Financial Expertise	<i>ACFE</i>	The number of members in the audit committee having financial knowledge and experience in the audit committee.
Audit committee independence	<i>ACM</i>	Number of meetings held.
Audit committee meetings	<i>ACI</i>	The number of independent non-executive director in the audit committee.
Control Variables		
Firm Size	<i>SIZE</i>	The natural logarithms of total asset of the banks
Return on Asset	<i>ROA</i>	Ratio of Profit before tax to Total Assets
Loan to Deposit Ratio	<i>LDR</i>	Ratio of Loans to customers to Deposit of Customers
Capital Adequacy Ratio	<i>CAR</i>	Ratio of Total Tier 1 and Tier 2 capital to Risk-weighted Assets

Source: Authors Feld Work.

4. ANALYSIS AND PRESENTATION OF RESULT

This section revealed the various analyses of results and presentations. The hypotheses stated were rectified and analyzed via descriptive statistics, correlation coefficient and static panel data estimators.

4.1 Descriptive Analysis

The values applied in the analysis as presented in Table 2 is the descriptive statistics that give details on the mid values, maximum, minimum, range, spread and normality of the variables. The value of mean of non-performing loans (NPL) is 0.0473, which had a maximum number of 0.2 with standard deviation of 0.0356 showing a small disparity in that way presenting a low level of flexibility in the non-performing loans of companies. This means that averagely the non-performing loans of the selected banks is 4.7% with the maximum value of 20%, which is above the 5% threshold profound by the Central Bank of Nigeria.

Table 2. Descriptive Statistics for the Population

Variables	N	Mean	Standard Deviation	Minimum	Maximum
NPL	60	0.0473	0.0356	0.00872	0.200
ACFE	60	2	1.249	1	5
ACM	60	4.250	1.284	1	8
ACI	60	1.283	0.958	0	3
ROA	60	0.0212	0.0147	-0.0201	0.0594
LDR	60	0.635	0.163	0.0147	1.004
CAR	60	0.181	0.0607	-0.160	0.310
SIZE	60	14.19	0.714	12.41	15.37

Source: Authors' Survey (2018)

Audit Committee Financial Expertise shows an average of 2 with minimum and maximum values of 1 and 5 respectively with a standard deviation of 1.249. This connotes that the selected banks ensure the presence of experts in the formulated audit committee. Audit Committee Meeting exhibits a mean value of 4.250. It has a standard deviation of 1.284, with minimum and maximum value of 1 and 8 respectively. Audit Committee Independence reveals a mean of 1.282. While it has a standard deviation of 0.958, with minimum value of 0 and maximum value.

4.2 Correlation Analysis

Table 3. Correlation Matrix Table

	ACFE	ACM	ACI	SIZE	INF	LEND
<i>ACFE</i>	1					
<i>ACM</i>	-0.210	1				
<i>ACI</i>	-0.501***	0.315**	1			
<i>SIZE</i>	0.247*	0.0402	0.0634	1		
<i>INF</i>	0.0383	-0.0347	0.0124	0.0567	1	
<i>LEND</i>	0.215	-0.348**	-0.249*	-0.250*	0.0413	1

Source: Authors' Survey (2018)

* $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 3 reveals the Pearson correlation matrix for the independent variables adopted in the analysis. The Table indicates low correlation among the variables, which indicate no evidence of multicollinearity in the models.

5. MULTIPLE LINEAR REGRESSION ANALYSIS

The study analyzed the influence of the audit committee characteristics, which was decamped into Audit Committee Financial Expertise, Audit Committee Meeting and Audit Committee Independence on Non-Performing Loans in listed banks in Nigeria using Ordinary Least Square, Fixed Effect and Random Effect. Table 4 reported the relationship between the non-performing and audit committee characteristics while the appropriate model selection was done using Hausman Test. However, Hausman Test validated the Random Effect Model as the more appropriate model at $\text{Prob} > \chi^2 = 0.6622$. By means of the random effect panel analysis, it was deduced that the model is appropriate to draw conclusion based on the $\text{Prob} > \chi^2$ of 0.00285. From table 4, the coefficient of the financial expertise of audit committee revealed a negative relationship although at insignificance level of 5%. This suggested that the inclusion of financial expertise in audit committee leads to lower level of non-performing loans in listed banks in Nigeria. Although insignificant, the relationship between the audit committee meetings and non-performing loans also revealed a negative influence. This connotes the effectiveness of the board audit committee meeting to reduce the level of non-performing loans in the listed banks in Nigeria.

Table 4. Panel Data Analysis of Non-Performing Loan and Audit Committees' Characteristics

VARIABLES	OLS	Fixed Effect	LSDV	Random Effect
ACFE	-0.00558 (0.00361)	0.0135** (0.00551)	0.0135** (0.00551)	-0.0000911 (0.00410)
ACM	-0.000506 (0.00330)	0.0000953 (0.00362)	0.0000953 (0.00362)	-0.000336 (0.00341)
ACI	0.00644 (0.00465)	0.000655 (0.00660)	0.000655 (0.00660)	0.00486 (0.00499)
SIZE	0.0109 (0.00717)	0.0203 (0.0331)	0.0203 (0.0331)	0.0127 (0.00907)
ROA	-0.736* (0.367)	-0.557 (0.672)	-0.557 (0.672)	-0.603 (0.433)
LDR	-0.0224 (0.0272)	-0.0600 (0.0420)	-0.0600 (0.0420)	-0.0302 (0.0283)
CAR	-0.264*** (0.0846)	-0.380*** (0.110)	-0.380*** (0.110)	-0.277*** (0.0903)
Constant	-0.0243 (0.0980)	-0.150 (0.450)	-0.163 (0.462)	-0.0553 (0.123)
Observations	60	60	60	60
R-squared	0.324	0.395	0.619	

rmse	0.0311	0.0264	0.0264	0.0280
F-test	3.567	3.820	3.694	
Prob > F	0.00331	0.00279	0.000264	
chi-squared				21.71
Prob > chi2				0.00285
Hausman Test				4.98
Prob>chi2				0.6622

Source: Authors' Survey (2018)

Standard errors in parentheses*** p<0.01, ** p<0.05, * p<0.1

In same vein, the coefficient of audit committee independence showed a positive influence on non-performing loans. This suggested that the involvement of independence member in audit committee increases the level of non-performing loans, although the influence might not be significant.

6. CONCLUSION AND RECOMMENDATION

This study examined the effect of audit committee characteristics on the non-performing loans in listed banks in Nigeria. The study extracted data from the financial reports of the banks to describe the dependent variable and the explanatory variables. Although the study examined the relationship using Ordinary Least Square, Fixed Effect and Random Effect, Hausman Test validated the Random Effect Model as the more appropriate model. The coefficient of the financial expertise of audit committee revealed a negative relationship although at insignificance level of 5%. This suggested that the inclusion of financial expertise in audit committee leads to lower level of non-performing loans in listed banks in Nigeria. This result is consistent with the Carcello, Hollingsworth, Klein, & Neal (2012); Angahar & Mejabi (2014); Sahu & Maharana (2017); Nyor & Mejabi (2013); Adhikary & Mitra (2016). Although insignificant, the relationship between the audit committee meetings and non-performing loans also revealed a negative influence. In same vein, the coefficient of audit committee independence showed a positive influence on non-performing loans. This suggested that the involvement of independence member in audit committee reduced the level of non-performing loans. This study is therefore consistent with the findings of Sahu & Maharana (2017); Angahar & Mejabi (2014); Nyor & Mejabi (2013); Hamdan, Mushtaha & Al-Sartawi (2013). This study, therefore, recommends that the Board of directors should ensure that more board members with financial expertise with relevance in risk management should be part of the audit committee to investigate the loan portfolio whenever there is a report of a susceptible increase in non-performing loan. The audit committee should work with other committees like the risk committee to ensure more effectiveness in reducing non-performing loans. Banks should ensure more independent non-executive directors are included as members of the audit committee.

Public Interest Statement

This research work has policy implications and policymakers will find it useful for matters relating to corporate governance, non-performing loans in banking sector and it contributes to existing knowledge.

About the Author

OJEKA Stephen bagged his B.Sc., M.Sc. (distinction) as well as PhD in Accounting from Covenant University Ota. He is a dynamic, result driven and self-motivated professional. Ojeka Stephen has substantial industrial and teaching experiences. His research areas include; Corporate Governance, Audit Committee, Financial Reporting, Taxation and Accounting Information System. Ojeka Stephen is married and blessed with children.

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