

Balancing Audit Quality to Auditees Cash Reserves: A Phenomenon in Indonesia

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ABSTRACT

High audit quality is essential for capital providers seeking accurate financial reports for investments. External auditors play a crucial role in safeguarding capital providers' interests by detecting fraud and ensuring financial statement reliability. High-quality auditors scrutinize reports thoroughly, reducing legal disputes and financial constraints for entities. This research was conducted with a focus on several sectors on a company including, Finance, Manufacture and Mining Sector listed on IDX 2017-2021, with a total of 250 sample of a company. Research shows that firms with high audit quality rely less on cash reserves, enhancing cash liquidity and attracting investors. This research confirms that high audit quality significantly increases auditees' cash reserves, emphasizing the need for auditors to protect shareholder interests and avoid legal and reputational risks beyond verifying financial statements.

Keywords: Audit Quality, Auditees Cash Reserves, Big 4 Public Accounting Firms.

INTRODUCTION

A big public accounting firms are considered to provide higher audit quality services because they have a high reputation and a great trademark. A big public accounting firms have a good resource to settle the audit process. There are those who believe that the size of the public accounting firms having a significant correlation with the audit quality result. Usually, the size of the public accounting firms also determines number of training program in which have been provided to auditors with more robust and standardized audit methodologies, and more opportunities to review audit result. A number of studies have shown that larger and more developed accounting firms can provide higher audit quality because they have more expertise than smaller public accounting firm. This happens because they get used to deal with larger clients from different industries which increases the level of auditor expertise.

In the terms of firm scale, there are four big public accounting firms in the world that are often discussed separately in the literature compared to other public accounting firms which provide same services. This condition happened, because the big four public accounting firms have a more dominant position in the audit market, especially among public companies. The big four public accounting firms in the world are: PricewaterhouseCoopers (PWC), Deloitte and Touche, Ernst and Young (EY) and Klynveld Peat Marwick Goerdeler (KPMG). Although there are unavoidable exceptions or inaccuracies in the preparation of reports that may be made by the big four public accounting firms, most studies show that the big four public accounting firms provide better audits rather than other public accounting firms because their clients can demonstrate and assess, for example, less earnings management compared to non-Big 4 clients (Connie L. Becker, 2010).

Numerous research studies have been carried out to explore the correlation between audit quality and its impact on the investment decisions. Rena et al. (2016) conducted a study with the objective of examining how external auditor opinions influence investment decisions. Numerous research studies have been carried out to explore the correlation between audit quality and its impact on investment decisions. Rena et al. (2016) conducted research with the objective of examining how external auditor opinions influence investment choices in the Turkish banking sector. The research findings indicate that the auditor's opinion plays an important role in diminishing information risk and enhancing its reliability. Moreover, the study reveals a statistically significant relationship between external auditor opinions and investment decisions within the Turkish banking industry.

When investors making investment decisions, it is crucial to depend on the data that are reliable, trustworthy and having superior quality. Referring to insufficient audit fees that may hinder the effectiveness of the audit process and application of professional diligence, there are factors that influence the audit quality. However, accepting lower audit fees compared to others is not considered inherently unethical unless it adversely affects the quality of the audit itself (Thuneibat, 2021). As the cost-benefit principle influences the auditors, the presence of low fees may influence the choice of audit methods and the quantity of audit evidence gathered to assess audit quality.

Previous research findings indicate that entities with high audit quality tend to have lower financial constraints, enabling them to reduce their reliance on maintaining substantial cash reserves. These studies also consider the perspective of shareholders regarding the management of cash utilization in an organized manner. Consequently, one notable exploratory finding from previous research is the significant correlation of audit quality and the marginal value of cash reserves. If a high-quality auditing serves as a monitoring mechanism that reduces information asymmetry and agency conflicts, it should contribute to limit the misappropriation of cash reserves and the subsequent decline in their value. In line with this hypothesis, additional findings reveal that a high-quality auditing enhances the market value associated with each additional unit of nominal cash reserve.

STATEMENT OF PROBLEM

A High audit quality may affect the condition of auditees beyond the quality of their financial statements. The presence of high audit quality may affect the cash liquidity of a company by increasing investor interest in investing their money. However, sometimes the expectation of increasing the number of investors is not achieved. This has led to questions whether a high audit quality influence auditees cash reserve in which they are conducted. The difference between current and previous research is the population time interval used, which is 2017-2021, in addition to the renewal of the most recent data regarding the existence of the largest public accounting firm at the time of the study.

AUDITEES' CASH RESERVE

The firm's cash reserve decision is an important corporate policy that relates to different corporate activities and the firm's ability to take valuable investment opportunities and avoid high external borrowing costs when needed (Guney et al., 2007). According to the agency theory of cash reserves, managers often choose to retain cash rather than distribute it to equity holders (Jensen, 1986). By accumulating cash reserves, managers increase their control over a larger pool of assets, allowing them to pursue personal gains instead of maximizing shareholder wealth. In line with this perspective, (Harford J., 1999) demonstrates that firms with higher levels of cash reserves tend to engage in acquisitions that destroy value. Additionally, Harford et al. (2014) discover that firms with entrenched managers are inclined to allocate cash towards projects that diminish value.

The pecking order theory implies that firms choose debt as a substitute for internal financing. In particular,

when firms cannot use their internal financial resources for their projects, debt is the most important source of financing (Bae et al., 2016). There is no optimal level of cash, and cash has only a buffering role between retained earnings and investment needs (Garcia-Teruel et al., 2009). In line with this, firms tend to use internally generated cash before they seek external financing, with debt being the first alternative before equity. The idea of this hierarchy and order is that information asymmetry makes external financing more expensive compared to internal financing.

In summary, these theoretical perspectives share a common understanding that for firms characterized by informational opacity, particularly those with significant information asymmetry, obtaining low-cost external financing becomes exceptionally challenging (Habib and Hasan, 2017). Consequently, any factor, such as the external monitoring mechanism of audit quality, which can alleviate information asymmetry, can also mitigate firms' inclination to hoard cash reserves.

AUDIT QUALITY

The audit report serves as a means of conveying a message from an independent and professional individual, lending credibility to the financial statements. Its purpose is to inform users whether the financial statements have been prepared in accordance with accounting principles. In order to ensure audit quality, auditors must carry out the audit process and formulate their opinion in compliance with auditing and quality control standards.

The trustworthiness of an audit opinion is determined by the quality of the audit, as stated by Chin and Chi (2009). DeFond and Zhang (2014) expand the definition of audit quality beyond the detection of violations of generally accepted accounting principles (GAAP) to include the faithfulness of financial statements in representing a company's underlying economics. The literature emphasizes the importance of auditing processes in monitoring companies and signaling potential issues (DeFond and Zhang, 2014; Hammami and Zadeh, 2019).

Audit quality plays a crucial role in influencing the decisions of capital providers who seek accurate and reliable financial reports from potential investments. Independent external auditors serve to protect the interests of capital providers by detecting any insider fraud or misappropriation of funds, while also signaling the trustworthiness of financial statement information. Consequently, high-quality auditors are expected to scrutinize financial reports more thoroughly compared to low-quality auditors, thus reducing the likelihood of future legal disputes.

As a result, high-quality auditors offer both assurance value, by minimizing management reporting biases and enhancing trust and credibility in financial statements, and insurance value, by implicitly providing a financial claim that capital providers can make in the event of audit failure (Boubaker et al., 2018). A high-quality audit contributes to effective managerial oversight by enabling auditees to present reliable information to the market. Furthermore, high-quality audits enhance the efficiency of internal control systems, thereby promoting optimal managerial decision-making and minimizing the misappropriation of resources by management. Specifically, high-quality audits restrict managerial discretion in accounting policy choices and subjective accounting estimates, especially when there is pressure to improve short-term earnings performance (Ashbaugh-Skaife et al., 2008; Doyle et al., 2007).

RELATIONSHIP BETWEEN AUDIT QUALITY AND AUDITEE'S CASH RESERVES

Achieving a high level of audit quality, which involves conducting a comprehensive assessment of cash

reserves, can effectively minimize the likelihood of errors or fraudulent activities in financial statements. Consequently, auditors who execute audits with utmost quality can trust in stakeholders by ensuring the dependability of the cash reserves held by the entity being audited. The findings of analytical research indicate that the diligent monitoring functions performed during high-quality audits have beneficial effects in reducing information asymmetry. This reduction is reflected in auditees having easier access to affordable external financing sources (Harris and Raviv in 1996). Meanwhile, low quality-audits contribute to the level of information asymmetry and make scrutiny and oversight of managerial activities difficult and costly. As a result, capital providers would have less understanding of management effort and performance, making management supervision vulnerable (DeFond, Zhang, 2014; Gao et al., 2016; Harford et al., 2014).

In addition, the existence of information asymmetry and the insufficient supervision that results from performing substandard audits may motivate self-interested managers to retain larger amounts of cash. This, in turn, may lead to improper allocation of corporate resources for their personal benefit (Defond,Zhang, 2014). Associated with this, self-interested managers may reserve cash instead of pay it to shareholders (Hasan and Habib, 2020). One of the factors that can assist managers in achieving these objectives is the fact that they operate in an environment with less supervision and monitoring (e.g., a low-quality audit environment), enabling them to easily enhance their personal wealth by investing cash into projects they own (Hasan and Habib, 2020). By enforcing high corporate payouts (reflected with lower cash reserves), high quality audits (as a powerful tool) may restrict impulsive behavior and control-discipline the managers.

Cash is the most vulnerable asset of a company when it comes to information asymmetry between managers and capital providers. This is due to the significant discretion that managers possess in controlling cash expenditure with minimal supervision (Benlemlih et al., 2018); Habib and Hasan, 2017). According to the agency theory of cash reserves (Jensen, 1986), managers tend to prioritize the preservation of cash rather than distributing payouts to equity holders. Cash reserves contribute to the expansion of assets under the control of entrenched and self-interested managers, enabling them to pursue personal gains instead of maximizing the wealth of shareholders.

In essence, a significant number of companies encounter obstacles when attempting to secure external funding at a more affordable rate, primarily due to the existence of information asymmetry. This imbalance in information can be attributed to various factors, such as opportunistic behavior exhibited by managers and the lack of transparency in financial reporting. Consequently, these companies struggle to access external funds at a lower cost due to the inherent risks associated with the asymmetric information they possess (Hendijani, Z. M.,2022).

As a result of conducting high-quality audits, financial reports become more transparent, thereby reducing the information gap between external capital providers and internal managers (Boubaker et al., 2018). Consequently, capital providers gain a better ability to monitor managers' activities, leading to reduced information risk and monitoring costs (Fredriksson et al., 2020; Boubaker et al., 2018).

Previous studies also support this notion by revealing that companies with high-quality audits benefit from a more precise informational environment, which is reflected in more accurate financial analysts' earnings forecasts (Reichelt and Wang, 2010). In summary, high-quality audits reduce information risk for capital providers by indicating the reliability of financial statement information. This fosters a transparent environment that encourages trust and facilitates greater interaction and information sharing. Furthermore, it enables auditees (i.e., companies seeking capital) to access external financing at lower costs, thereby reducing the need for cash reserves.

In line with this argument, Aivazian et al. (2006) suggests that companies with easy access to affordable public debt markets tend to have higher payouts, as evidenced by lower cash reserves. In addition, we argue

that entities undergoing high-quality audits should reserve less cash in terms of cost-benefit. Reserving cash can help the auditee by allowing them to take advantage of investment opportunities and lessening the likelihood of financial difficulties. Considering the explanation above, the hypothesis development of this research is:

H1: High audit quality has a positive effect on cash reserve in a company.

METHODOLOGY

This study utilized the quantitative research approach involving the use of company's financial report listed on Indonesia Stocks Exchange with the sector classifications are finance, mining and manufacture industry sectors period from 2017 – 2021. With the classification is the companies audited by big 4 public accounting firm. The audit quality was determined as independent variable and auditee's cash reserve was determined as dependent variable.

$$\text{CashNai,t} = \beta_0 + \beta_1 \text{ Audit Quality}_{i,t-1} + \beta_2 \text{ Size}_{i,t-1} + \beta_3 \text{ SysRisk}_{i,t-1} + \beta_4 \text{ ROA}_{i,t-1} + \beta_5 \text{ Lev}_{i,t-1} + \beta_6 \text{ Intangibles}_{i,t-1} + \beta_7 \text{ EXP}_{i,t-1} + \beta_8 \text{ Capital Exp}_{i,t-1} + \beta_9 \text{ Cashflow}_{i,t-1} + \beta_{10} \text{ MTB}_{i,t-1} + \beta_{11} \text{ Dividendi}_{i,t-1} + \beta_{12} \text{ InfoAsy}_{i,t-1}$$

Description:

CashNa = The cash reserve of firm i at time t. scaled by company's net asset (Atif etl al., 2019; Cheung, 2016; Mansali etl al., 2019; Opler etl al., 1999).

To determining the audit quality itself, this research uses several proxies, such as AFR (Audit Fee Ratio), AFCR (Audit Fee City Ratio) and Industry Specialist. This research also uses the company control that consist several aspects such as, Size, SysRisk, ROA, Leverage, Intangibles, EXP, Capital EXP, Cash flow, MTB, Dividend and InfoAsy. For the company size, researcher use the total asset of companies to measure the company size variable. To measure the Systematic risk approximated by beta for a specific company in a specific year:

$$\text{Sys risk} = \text{ROA} / \text{Return Market}$$

Description:

$$\text{ROA} = \text{Return on Asset}$$

$$\text{Return Market} = \text{The Composite Stock Price Index (IHSG)}$$

To determine the ROA from this research by applying the formula:

$$\text{ROA} = \text{Net Profit} / \text{Total Asset}$$

Description:

$$\text{Net profit} = \text{Net profit earned by a company in a certain period}$$

$$\text{Total Asset} = \text{The total of all assets owned by the company in the same period.}$$

The leverage from this research can be determined by using:

IEV = Debt / Total Asset

Description:

Debt = Total liabilities, which include both short-term and long-term debt.

Total Asset = The total of all assets owned by the company in the same period.

Meanwhile the intangible assets also included as control variable in this research, because as a non-physical asset that lacks a physical substance and cannot be touched or seen, these assets are typically long-term in nature and contribute to a company's value and competitive advantage. The intangible assets describe as INT = Intangibles Asset

Description:

INT = The total amount of company's intangible asset.

Other control variables are the expenditures or expenses incurred by a company in order to carry out its operations and business activities, and capital expenditures, often abbreviated as Cap-Ex, refer to the funds a company invests in acquiring, maintaining, or improving its long-term assets, typically with a useful life extending beyond one fiscal year. The expenditure or exp from this research can be determined using:

EXP = Total Expense

Description:

EXP = The amount of company's total expenses.

Meanwhile the capital expenditures from this research, can be determined by using:

Cap Exp = Total Fixed Asset

Description:

CAP EXP = Total Fixed Asset

As a control variable, researcher also use the Cash flow is the inflow and outflow of cash from a business or investment during a specific period, typically measured quarterly, annually, or as required for reporting purposes. It reflects how well an entity generates money from its operations and how it manages cash to meet obligations and investments.

Cflow = Cash & cash Equivalent

Description:

Cash Flow = Ending of total cash and cash equivalent of companies in a certain period.

As a control variable, the market-to-book ratio (MTB) is calculated by taking the market value of equity and adjusting it in relation to the book value of equity. The market to book value from this research, can be determined using:

MTB = Total Equity

Description:

Market to Book Ratio = The total amount of company’s equity.

Researcher also considered the Dividends and the information asymmetry as control variables. Dividends are the distribution of a portion of a company’s profits to its shareholders. It is a recurring payment made to shareholders in exchange for their ownership of company stock. Dividends are typically paid in cash, but they can also be paid in additional shares or property. The researcher treats dividends as a dummy variable. For the Information Asymmetry, researcher considers to include it as a control variable because the standard deviation of financial analysts’ earnings per share forecasts, scaled by the stock price at the start of the period, is used to calculate information asymmetry. More amounts indicate more information asymmetry.

RESULT AND DISCUSSION

In the hypothesis of H1: High audit quality has a positive effect on cash reserve in a company.

The model shows a result that high audit quality has a positive effect on cash reserve in a company.

Table 1. Autocorrelation Analysis

Model Summary					
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin- Watson
1	.508	.258	.220	17.46	1.909

Based on table 1, the Durbin-Watson value is 1.909. This means that the $dU < dW < 4-dU$. dU value of total samples 250 with 12 independent variables is 1.88511 and $4-dU$ is 2.11489. $dU (1.88511) < dW (1.909) < 4-dU (2.11489)$ which means there is no autocorrelation.

Table 2. F-Test Analysis

ANOVA						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	25,084.33	12	2,090.36	6.852	.000
	Residual	72,299.75	237	305.06		
	Total	97,384.08	249			

Based on table 2, the significant value is 0.000 which is less than 0.05. This means the independent variables which are AFR, company size, ROA, leverage, intangibles, capital expenditure, cashflow, market to book value ratio, expenditure, systematic risk, dividend and infoasy which represents audit quality have simulant effect on auditee’s cash reserve which measured with cash reserve.

Table 3. T-Test Analysis

Coefficients					
Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		

1	(Constant)	11.711	2.263		5.176	0
	AFR	-3.32	12.84	-0.015	-0.26	0.03
	SIZE	-6.192	0	-1.007	-1.46	0.05
	ROA	8.586	291.821	0.135	-0.03	0.05
	LEV	-0.784	0.554	-0.089	-1.42	0.05
	INT	0.001	0	0.08	1.352	0.05
	CAPEXP	8.392	0	0.472	8.279	0.01
	CFLOW	4.794	0	0.1	0.429	0.05
	MTB	-3.344	0	-0.091	-0.57	0
	EXP	7.439	0	0.987	1.517	0.03
	Sysrisk	-6647.36	1.831	-0.166	-0.04	0
	DIV	-5.485	2.628	-0.128	-2.09	0.04
	InfoAsy	0	0	-0.068	-1.1	0.01

Based on table 3, AFR has B's value of -3.320 and significant value of 0.026 (less than 0.05) which means AFR has negative and significant effect on auditee's cash reserve.

Company size has B's value of -6.192 and significant value of 0.045 (less than 0.05) which means company size has negative and significant effect on auditee's cash reserve. ROA has B's value of 8.586 and significant value of 0.047 (less than 0.05) which means ROA has positive and significant effect on auditee's cash reserve. Leverage has B's value of -0.784 and significant value of 0.048 (less than 0.05) which means leverage has negative and significant effect on auditee's cash reserve. Intangibles has B's value of 0.001 and significant value of 0.048 (less than 0.05) which means intangibles has positive and significant effect on auditee's cash reserve.

Capital expenditure has B's value of 8.392 and significant value of 0.009 (less than 0.05) which means capital expenditures has positive and significant effect on auditee's cash reserve. Cashflow has B's value of 4.794 and significant value of 0.048 (less than 0.05) which means cashflow has positive and significant effect on auditee's cash reserve. Market to book value ratio has B's value of -3.344 and significant value of 0.001 (less than 0.05) which means market to book value ratio has negative and significant effect of auditee's cash reserve.

Expenditure has B's value of 7.439 and significant value of 0.031 (less than 0.05) which means expenditure has positive and significant effect on auditee's cash reserve. Systematic risk has B's value of -6,647.356 and significant value of 0.001 (less than 0.05) which means systematic risk has negative and significant effect on auditee's cash reserve. Dividend has B's value of -5.485 and significant value of 0.038 (less than 0.05) which means dividend has positive and significant effect on auditee's cash reserve. Infoasy has B's value of 0.00 and significant value of 0.013 (less than 0.05) which means infoasy has positive and significant effect on auditee's cash reserve.

Therefore, AFR, company size, leverage, market to book value ratio, systematic risk, and dividends have negative and significant effect on auditee's cash reserve. While, ROA, intangibles, capital expenditures, cashflow, and infoasy have positive and significant effect on auditee's cash reserve.

DISCUSSIONS

Based on T-test, independent variables which is audit quality measured with AFR, company size, ROA,

leverage, intangibles, capital expenditure, cashflow, market to book value ratio, expenditure, systematic risk, dividend and infoasy, all have significant effect on auditee's cash reserve and have simultaneously effects on auditee's cash reserve. Therefore, hypothesis is accepted. The model has measured audit quality by using 12 item measurement because researcher try to accommodate factors that having high possibility influence in audit quality variable according to the research by Hendijani (2022) under the title is Audit quality to Liquidity Policy.

In this research, the measurement of audit quality uses a proxy namely audit fee. The correlation between the dependent and independent variable that is, auditees cash reserves and audit fee is auditees cash reserves have a positive influence on audit fees, suggesting that auditors are responsive to the level of firm's cash reserve, which is a factor contributing to agency costs (Samuel, 2015).

A more accurate informational environment is advantageous to companies with high-quality audits, and this is reflected in financial experts' more accurate profit estimates. In conclusion, excellent audits will have impact lowering capital providers' information risk by demonstrating the accuracy of financial statement data. This promotes transparency which creates high trust and the easiness for people to communicate and share information. In addition, it is possible for auditees to obtain outside funding at a reduced cost. This condition will lessen the requirement for cash reserves, meanwhile high-quality audits required less money. By lowering the possibility of financial issues and enabling the auditee to take advantage of investment possibilities, cash reserves can benefit the auditee.

Academics and the financial community have become very interested in the policy of cash holdings, particularly in the wake of the last global financial crisis that led to a global increase in corporate cash holdings. The performance of the company is inversely U-shaped, or concave, in relation to cash holdings (Homaidi et al., 2019). This indicates that at cash holding levels below the optimal level (turning point), the marginal benefits from transactional and precautionary motives outweigh the marginal costs resulting from low pecuniary returns on liquid assets and agency problems related to growing cash holdings. Therefore, balancing the costs and benefits increases company performance.

The marginal cost of agency conflicts outweighs the marginal advantages, nevertheless, at levels higher than the ideal cash holdings. Firm performance is subsequently compromised when managers' irrational behavior persists in exchanging higher marginal costs for lower marginal rewards, so sacrificing firm performance for the managers' personal gain (Arora & Kumar, 2019). Firm performance and cash holdings are more closely correlated in higher audit quality firms than in lower audit quality organizations.

How much cash a company keeps is important for investors and the quality of audits. When a company earns money and has a skilled team checking its finances (called an audit committee), they tend to keep less cash. This means if a company's earnings information is accurate and experts oversee their finances, they don't need to hold onto a lot of extra money. Having trustworthy earnings information and expert oversight can help companies avoid keeping too much cash on hand. (Mukhlisin, 2020)

Due to their responsibility to shareholders, auditors are generally exposed to audit risks. They may also face legal action if they are careless or neglect to fulfil their duties when it comes to the auditing of financial holdings. It demonstrates how improving the quality of the audit can strengthen the auditor's accountability for keeping an eye on managers' excessive or insufficient investment.

When a company has good Investor Relations (IR), it means they are open and clear about their business. This openness makes sure that the company doesn't misuse or waste their readily available money. Instead, they use it wisely. Good communication with investors helps the company be transparent, and this stops them from making wrong or careless decisions about their cash and other easily accessible funds (Houdou,

Neglected disciplinary effects of investor relations: evidence from corporate cash holdings. *Journal of Business Economics*, 87(2):221-261, 2017).

This finding has theoretical implications for auditors, including the need to protect shareholder interests in agency conflicts and the simple verification on cash reported in financial statements, otherwise they face legal repercussions and reputational risks (Baghai et al., 2017). This result is supported by previous research from Boubaker et al., (2018), Fredriksson et al., (2020), and Hendijani (2022) which stated that high audit quality has a positive effect on cash reserve in a company.

CONCLUSION

This research examined the effect of high-quality audit on cash reserve in companies. This research shows that companies that have audit quality are easier to get investors and they tend to utilize their company's cash reserves. After analysing the data, this research resulted the conclusion that high audit quality has a positive effect on cash reserve in a company. It means a high audit quality can lower the auditees cash reserves and acts as a powerful tool to restricted impulsive behaviour by control and discipline the managers. Lower cash reserved may indicates that the company easy to get the external fundings since they have prepared a high quality of financial statement.

The limitation of this research is the samples used in the study were companies in the manufacturing, mining, and finance sectors from 2017 to 2021 listed in Indonesia Stock Exchange. Future research is recommended to use companies listed in Indonesia's LQ45 as samples with range of 5 years due to it will focusing on public listed companies in Indonesia. Other limitation of this research is the author only use the Audit Fee Ratio as a proxy to measure the independent variable, namely audit quality. Future research is very recommended to use the other proxies, such as Audit Fee City Ratio (AFCR), City Specialist and Industry Specialist.

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