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The Informativeness of Reported Earnings and Characteristics of the Audit Committee

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ABSTRACT

An information usefulness approach to decision making points out that only the information is regarded as useful that will bring valuable messages to investors and lead to stock price adjustments. This study examines the effectiveness of audit committees in improving earnings quality and informativeness, particularly among family-owned firms. Earnings informativeness was measured through the relationship between accounting earnings and cumulative abnormal stock returns (CAR). In addition, the characteristics of the audit committee include independence, size, and financial expertise. The sample under study included 138 firms listed in the Tehran Stock Exchange over the period from 2011 to 2017. The research hypotheses were tested using statistical analysis techniques including the panel data method and linear regression model in Eviews software. Besides, the Chow test was used to determine if the mixed data would be more efficient for estimating the desired function, and Fisher's statistic was used to examine the significance of the regression model. Also, Student's t-test was employed to examine the significance of the coefficients of the explanatory variables in the regression model and Durbin-Watson's test we run to check the non-autocorrelation assumption of the model residuals. The results showed that the characteristics of the audit committee increase earnings informativeness. Also, the characteristics of the audit committee do not affect the relationship between family ownership and earnings informativeness.

Keywords:

Audit committees; Accounting earnings; Earnings informativeness.

1. Introduction

One of the main goals of financial reporting is to provide useful information to help investors make more effective decisions. Based on empirical research, accounting information seems to be useful for investors to estimate the expected value and return risk of securities. Among the huge bulk of information provided by firms, the firm's reported earnings have a significant weight in the assessment and decision-making processes. In other words, the firm's earnings are considered as a summary of the firm's performance (Pouraghajan et al., 2011).

Based on the leading studies conducted by Ball Brown and Beaver (1986) and Kothari and Zimmerman's (1995) study on the stock market, earnings informativeness refers to the usefulness of net profit accounting for decision making from shareholders' perspective. Earnings informativeness is a feature of the quality of earnings that expresses the reported earnings capability in helping shareholders in the firm's valuation process (Ball Brown & Beaver, 1986). In other words, if earnings yield useful information for investors to take decisions on the sale and purchase of their own shares, it can be suggested that the earnings are informative, and this is reflected in stock changes.

Several factors affect the informativeness of reported earnings. For instance the factor that can significantly affect the firm's information space and the informativeness of reported earnings is the existence of an effective audit committee. The existence of an independent audit committee substantially increases the quality of financial reports and drastically reduces the likelihood of financial statements being manipulated by the firm (Agrawal & Chadha, 2005). In addition, the informativeness of reported earnings is increased due to the presence of financial experts in the audit committee because firms with an effective audit committee use profit management activities less frequently and corporate executives are subject to more regulatory constraints (Dhaliwal et al., 2010). The presence of an effective audit committee in firms with a centralized and family ownership can reduce the negative impact of ownership concentration and control of major shareholders on the firm by overseeing the firm's financial and accounting processes, leading to the reduced information asymmetry and the increased informativeness of the firm's reported earnings.

Based on what was mentioned, the present study uses the empirical data from the firms listed in Tehran Stock Exchange to determine the effect of the audit committee's characteristics, including the independence and financial expertise of the members of the audit committee on the informativeness of reported earnings among family-owned firms.

2. Literature Review

Information is useful if it changes investors' ideas and behaviors. Besides, the degree of information usefulness can be measured by the extent of changes in turnover and prices following the release of information. Among the vast amounts of information provided by financial reports, Iranian investors give special weight to profit figures in their assessment of information and decision-making process and consider profits as a summary indicator of corporate performance. Based on the leading studies conducted by Ball Brown and Beaver (1986) and Kothari and Zimmerman's (1995) study on the stock market, earnings informativeness refers to the usefulness of net profit accounting for decision making from shareholders' perspective (Karami et al., 2016).

Karami et al. (2016) evaluated the impact of tax avoidance activities on the informational content (informativeness) of earnings as one of the most implicit tax consequences resulting from complex tax planning. To this end, they studied a sample of stock exchange firms with positive pre-tax profits in a five-year period from 2008 to 2012, and concluded that tax avoidance would distort earnings informativeness of the firms, since tax evasion, by increasing complexity and ambiguity and reducing the transparency of financial reporting, makes it difficult for shareholders to understand earnings reported by firms and they pay less attention to such earnings in their investment decisions such as buying and selling stocks.

Talaneh and Kazemi (2016) studied the relationship between conservatism and information content of accounting profit using the data of 167 firms in the Tehran Stock Exchange during the period from 2003 to 2012. To do this, they measured conservatism following Khan and Watts's (2009) study. To evaluate the information content of accounting earnings at different levels of conservatism, the price model (Feltam & Olson, 1995) and the return model (Aston & Harris, 1991) were used. The results of the fitting of the price and return

models for conservatism two and three leveling showed a negative relationship between conservatism and the informational content of accounting profit, indicating that the explanatory power of price and return models at high conservatism is lower compared to the low conservatism scenario. Also, there was a negative relationship between shareholder returns and conservative levels applied by firms. The results were stable against sensitivity analyses.

Krishna et al. (2018) studied the effect of the audit committee's characteristics on the informativeness of reported earnings in family-owned firms. Using data from 368 Indian firms over a six-year period from 2007-2012 using the reported earnings informativeness model (Woidtke and Yeh, 2013). They found that the informativeness of reported earnings in firms with family ownership was significantly lower compared to other firms. It was also found that the size of the audit committee had a positive and significant effect on earnings informativeness only non-family firms. Also, the independence of the audit committee only had a positive and significant effect on non-family firms and the financial expertise of the audit committee did not have a significant effect on the informativeness of reported earnings.

Joseph et al. (2014) studied firms that were involved in a network of bureaucratic relationships known as firms involved in scandals and corruption between 1996 and 2007 and assessed their accounting profit informativeness before and after such relationships and networks. They then concluded that the existence of such relations reduced the ability of accounting profit to show the company's economic performance, and the discontinuance of such relationships due to the existence of anti-corruption forces promoted earnings informativeness.

Tucker and Zarowin (2006) explored whether income smoothing promotes the past and current earnings informativeness in relation to future profits and future cash flows. Their results indicated that changes in the current stock prices of firms that are classified at high levels of income smoothing provide more information than future profits, while changes in the current stock prices of firms placed at lower levels of income smoothing do not contain this amount of information.

3. Methodology

The present study is a correlational research in terms of the method used, an applied research in terms of its objectives, and is classified as a descriptive accounting research. In addition, considering the historical data used to test the research hypotheses, this study is classified as a pseudo-experimental study. Also, the present study is an empiricist research from an epistemological view that uses a deductive approach. It is also considered as a field-library study and since it uses historical data it can also be classified as a retrospective study.

The firms included in the research sample were selected based on the following requirements:

1) For comparability purposes, the firms whose fiscal year ended on March 20.
2) The firms that did not stop their operations and had no changes in their fiscal period during the period under study.
3) The firms whose all data were available during the period under study.
4) The firms that were not part of the banks and financial institutions (investment companies, financial intermediaries, and holding and leasing companies).

Accordingly, 138 firms that met the above constraints during the period from 2011 to 2017 were included in the research sample.

The following hypotheses were developed and tested in this study:

Hypothesis 1: The characteristics of the audit committee have a significant effect on the informativeness of the firm's reported earnings.

Hypothesis 2: The characteristics of the audit committee have a significant effect on the relationship between the informativeness of the firm's reported earnings and family ownership.

Research Models and Variables

In order to test the research hypotheses, the following multivariate regression models adopted from Krishna et al.'s (2018) study were used:

The model used to test the first hypothesis:

$$CAR_{i,t} = \alpha_0 + \alpha_1 Earnings_{i,t} + \alpha_2 \text{Audit_size}_{i,t} + \alpha_3 \text{ Audit_expertise}_{i,t} + \alpha_4 \text{Audit_indep}_{i,t}$$
$$+\alpha_5 Earnings_{it} * \text{Audit_size}_{i,t} + \alpha_6 Earnings_{it} * \text{Audit_expertise}_{i,t} + \alpha_7 Earnings_{it} * \text{Audit_indep}_{i,t}$$
$$+\alpha_8 LEV_{i,t} + \alpha_9 SIZE_{i,t} + \alpha_{10} GROWTH_{i,t} + \varepsilon_{i,t}$$

The model used to test the second hypothesis:

$$CAR_{it} = \alpha_0 + \alpha_1 Earnings_{it} + \alpha_2 Family\ Holdings_{i,t} + \alpha_3 \text{Audit_size}_{i,t} + \alpha_4 \text{ Audit_expertise}_{i,t} +$$
$$\alpha_5 \text{Audit_indep}_{i,t} + \alpha_6 Earnings_{it} * Family\ Holdings_{it} + \alpha_7 Earnings_{it} * \text{Audit_size}_{i,t} + \alpha_8 Earnings_{it}$$
$$* \text{Audit_expertise}_{i,t} + \alpha_9 Earnings_{it} * \text{Audit_indep}_{i,t} + \alpha_{10} Earnings_{it} * Family\ holdings_{it} * \text{Audit_size}_{i,t} +$$
$$\alpha_{11} Earnings_{it} * Family\ holdings_{it} * \text{Audit_expertise}_{i,t} + \alpha_{12} Earnings_{it} * Family\ holdings_{it} * \text{Audit_indep}_{i,t}$$
$$+ \alpha_{13} LEV_{i,t} + \alpha_{14} SIZE_{i,t} + \alpha_{15} GROWTH_{i,t} + \varepsilon_{i,t}$$

The Dependent Variable

Following on the leading studies conducted by Ball Brown and Beaver (1986) and Kothari and Zimmerman (1995), earnings informativeness refers to the usefulness of net profit accounting for decision making from shareholders' perspective. Generally speaking, information is useful when it brings about valuable outcomes for investors. Hence, in order to measure the earnings informativeness, one can measure investors' reaction to a monetary unit of the newly reported earnings in the stock price adjustment, which in the above model is the same as the coefficient of the net profit, and is referred to as the earnings response coefficient. Therefore, to measure earnings informativeness through the earnings response coefficient, the standard price-earnings model with the following variables is used:

Cumulative additional returns (CAR) are calculated using the Woidtke and Yeh (2013) method as follows:

First, each firm's daily additional return (stock returns minus market returns) is calculated. Then, the firm's monthly cumulative return is calculated using the daily stock returns. Finally, the firm's annual cumulative return is calculated using the monthly cumulative return on the basis of the firm's fiscal year for the period 3 months after the end of the fiscal year and 9 months before the end of the fiscal year (For example, for firms whose fiscal year ends in March 20, the cumulative annual return is calculated from June 22 of the previous year to June 21 of the current year).

Independent Variables

The following variables were manipulated as independent variables in this study:

- Net earnings that are calculated as net profit after taxes at the end of the period divided by the firm's stock market value at the beginning of the period
- Family holdings which are equal to the percentage of family ownership.
- The size of the audit committee (Audit_size), which is the natural logarithm of the number of members of the audit committee.
- The independence of the audit committee (audit_indep), which is equal to the ratio of the independent members of the audit committee to all the members of the audit committee.
- The financial expertise of the audit committee (Audit_expertise) which is equal to the ratio of the number of members with a degree in accounting or finance to all the members of the audit committee.

Control Variables

The following variables were used as control variables in this study:

- Financial leverage (LEV), which is the ratio of the firm's total liabilities to its total assets.
- The firm size (SIZE) is the natural logarithm of the firm's total assets.

- Growth opportunities (GROWTH) which are equal to the ratio of the book value of the firm's assets to the market value of its assets (the market value of equities plus the book value of liabilities).

4. Results

Table 1 shows the descriptive statistics for the research variables:

The financial expertise of the audit committee is another independent variable that was measured as the ratio of the number of members with a degree in accounting or finance to the total number of members of the audit committee. The results showed that the members with a degree in accounting or finance in the firms under analysis constitute about 31.33% of the total number of members of the audit committee. The average ratio in the firms is about 33.33%.

The independence of the audit committee as one of the independent variables was measured as the ratio of the number of independent members to the total number of the members of the audit committee. The results showed that independent members on average accounted for 41.66% of the total number of members of the audit committee. The median of the independence of the audit committee in the firms under study is about 33.33.

The financial leverage was measured as the ratio of the book value the firm's total liabilities to the book value of its total assets. The results suggested that the firms' liabilities during the period under study were on average about 62.90% of the firms' assets. This shows that a larger share of the firm's finance was provided through debts and a smaller portion of the firms' finance was provided through equities. Growth opportunities (GROWTH) were measured as the ratio of the book value of the firm's assets to the market value of its assets. The results showed that the growth of the firms in the sample under study was 69.74% on average. The firm size was calculated as the natural logarithm of the firm's total assets. It was shown that the mean of this variable in the firms under analysis is 14.10 logarithmic units.

Evidence has shown that net profit and size of the audit committee have a negative skewness and are, in fact, left-skewed, while other research variables have a positive skewness and are, in fact, right-skewed. Also, all research variables have positive elongation. The skewness and elongation values of the variables indicate a deviation from the corresponding values in the normal distribution, so no variable has a normal distribution. Furthermore, the Jarque-Bera statistic and its probability (less than the error level of 5%) also indicate that the distribution of the variables is not normal.

Table 1: Descriptive statistics for the research variables

Statistics	CAR	EARNINGS	FAMILY	A_SIZE	A_EXP	A_INDEP	LEV	SIZE	GROWTH
Mean	0.194210	0.066492	0.043447	2.225673	0.313320	0.416632	0.629025	14.10324	0.697410
Median	0.034213	0.102239	0.000000	3.000000	0.333333	0.333330	0.622170	13.91089	0.696930
Max	10.5670 1	1.329306	0.900000	0.000000	1.000000	1.000000	4.002700	19th.37431	1.705350
Min	- 0.710836	- 2.988073	0.000000	0.000000	0.000000	0.000000	0.090160	10.16654	0.153200
Std. Deviation	0.788385	0.241823	0.136453	1.340792	0.350533	0.381646	0.269798	1.490523	0.228 869
Skewness	8.618604	- 4.476032	3.999127	-0.999480	0.699801	0.256175	3.399330	0.868448	0.330797
Elongation	153.3559	43.55382	19th.72893	2.215038	2.148906	1.605803	34.75402	4.430855	3.496320
Jarque-Bera statistic	921886.7	69421.27	13839.13	180.6331	108.0006	88.80303	424 40.22	203.8323	27.53256
Probability	0.000000	0.000000	0.000000	0.000000	0.000000	0.000000	0.000000	0.000000	0.000001
Number of observations	966	966	966	966	966	966	966	966	966

Model Estimation

Table 2 presents the results of the regression analysis used to estimate the first research model. As the results of the Chow test show, F-Limer value (0.794) is smaller than the critical value and the probability (0.9541) is greater than the error level of 5%. Therefore, the null hypothesis pointing to the homogeneity of the cross-sections and intercepts is

confirmed, and thus the group effects are rejected and the same intercepts are used in the estimation. Accordingly, the mixed data method is preferred and there is no need to run the Hausman's test.

The results of testing the first research model using the mixed data model are presented in Table 3. Given that the Fisher statistic (14.907) is greater than the critical value and probability (0.0000) is smaller than error level of 5%, the model under study is generally significant in terms of linear relations. This shows that a significant relationship is expected between the dependent variable and at least one of the explanatory variables in the model. The Durbin-Watson value (2.067) is about 2. This means that there is no autocorrelation problem in the model residuals, and the residual independence assumption is met. The values of the coefficient of determination (0.135) and the adjusted coefficient of determination (0.125) indicate that independent and control explanatory variables have an effective role in explaining the variations in the dependent variable. After assuring that the appropriate conditions for the tested model are established, the first hypothesis can be tested. The first null and alternative hypotheses are stated as follows:

H0: The characteristics of the audit committee have a significant effect on the informativeness of the firm's reported earnings.

H1: The characteristics of the audit committee have a significant effect on the informativeness of the firm's reported earnings.

The results of testing the first model showed that the size of the audit committee and the firm's net income have a significant relationship with cumulative additional returns (CAR) (t= 3.298, prob. = 0.0010, p < 0.05). Accordingly, the first hypothesis is confirmed, indicating that the size of the audit committee has a significant effect on the informativeness of the firm's reported earnings.

It was also shown that the financial expertise of the audit committee and the firm's net income have a significant relationship with cumulative additional returns (CAR) (t= 2.302, prob. = 0.0215, p < 0.05). Accordingly, the second hypothesis is confirmed, indicating that the financial expertise of the audit committee has a significant effect on the informativeness of the firm's reported earnings.

Finally, it was also shown that the independence of the audit committee and the firm's net income do not have a significant relationship with cumulative additional returns (CAR) (t= -1.679, prob. = 0.0934, p = 0.05). Accordingly, the second hypothesis is not confirmed, indicating that the financial expertise of the audit committee has no significant effect on the informativeness of the firm's reported earnings.

Of the control variables in the research model, only the firm's growth has a significant effect on the cumulative additional returns, and given that it has a negative sign it can be suggested that there is a negative significant relationship between the two variables.

Table 4 displays the results of the regression analysis used to estimate the second research model. As the results of the Chow test show, F-Limer value (0.874) is smaller than the critical value and the probability (0.8361) is greater than the error level of 5%. Therefore, the null hypothesis pointing to the homogeneity of the cross-sections and intercepts is confirmed, and thus the group effects are rejected and the same intercepts are used in the estimation. Accordingly, the mixed data method is preferred and there is no need to run the Hausman's test.

The results of testing the second research model using the mixed data model are presented in Table 5. Given that the Fisher statistic (9.272) is greater than the critical value and probability (0.0000) is smaller than error level of 5%, the model under study is generally significant in terms of linear relations. This shows that a significant relationship is expected between the dependent variable and at least one of the explanatory variables in the model. The Durbin-Watson value (2.092) is about 2. This means that there is no autocorrelation problem in the model residuals, and the residual independence assumption is met. The values of the coefficient of determination (0.127) and the adjusted coefficient of determination (0.113) indicate that independent and control explanatory variables have an effective role in explaining the variations in the dependent variable. After assuring that the appropriate conditions for the tested model are established, the second hypothesis can be tested. The second null and alternative hypotheses are stated as follows:

H0: The characteristics of the audit committee have a significant effect on the relationship

between the informativeness of the firm's reported earnings and family ownership.

H1: The characteristics of the audit committee have a significant effect on the relationship between the informativeness of the firm's reported earnings and family ownership.

The results of testing the second research model showed that the family ownership, the size of the audit committee, and the firm's net income do not have any significant relationship with cumulative additional returns (CAR) (t= -0.165, prob. = 0.8684, p = 0.05). Accordingly, the second hypothesis is not confirmed, indicating that the size of the audit committee has no significant effect on the relationship between the informativeness of the firm's reported earnings and family ownership.

The results of testing the second research model indicated that the family ownership, the financial expertise of the audit committee, and the firm's net income have a significant relationship with cumulative additional returns (CAR) (t= 1.362, prob. = 0.1734, p = 0.05). Accordingly, the second hypothesis is not confirmed, indicating that the financial expertise of the audit committee has no significant effect on the relationship between the informativeness of the firm's reported earnings and family ownership.

The results also showed that the family ownership, the independence of the audit committee, and the firm's net income have no significant relationship with cumulative additional returns (CAR) (t= -1.887, prob. = 0.0594, p = 0.05). Accordingly, the second hypothesis is not confirmed, indicating that the independence of the audit committee has no significant effect on the relationship between the informativeness of the firm's reported earnings and family ownership.

Of the control variables in the research model, only the firm's growth has a significant effect on the cumulative additional returns, and given that it has a negative sign it can be suggested that there is a negative significant relationship between the two variables.

Table 2: The test for choosing the regression analysis for the second model

Test	Statistic	Value	Degree of freedom	Probability	Result
Chow compatibility	F-Limer	0.794060	137.818	0.9541	Mixed data

Table 3: Testing the first research hypothesis

The mixed regression model and generalized least squares (GLS) method Number of observations: 966 firm/year (The number of cross-sections is 138 firms and the number of periods is 7 years)				
Dependent variable: $CAR_{i,t}$				
Explanatory variables	**Coefficients**	**Standard error**	**t**	**Probability**
C	0.560639	0.204067	2.747334	0.0061
EARNINGS	0.195540	0.134855	1.449997	0.1474
A_SIZ E	-0.021494	0.007100	-3.027304	0.0025
A_EXP	0.197522	0.172922	1.142258	0.2536
A_INDEP	-0.138909	0.051839	-2.679612	0.0075
A_SIZE * EARNINGS	0.095556	0.028973	3.298112	0.0010
A_EXP * EARNINGS	0.493658	0.214364	2.302893	0.0215
A_INDEP * Earnings	-0.350262	0.208551	- 1.679499	0.0934
LEV	0.011648	0.097807	0.119094	0.9052
SIZE	-0.004427	0.018937	- 0.233780	0.8152
GROWTH	-0.517408	0.063108	- 8.198797	0.0000
Coefficient of determination	0.135025	Fisher statistic		14.90778
Adjusted coefficient of determination	0.125967	Fisher's Probability		0.000000
Durbin-Watson	2.067773			

Table 4: The test for choosing the regression analysis for the second model

Test	Statistic	Value	Degree of freedom	Probability	Result
Chow compatibility	F-Limer	0.874506	137.813	0.8361	Mixed data

Table 5: Testing the third research hypothesis

The mixed regression model and generalized least squares (GLS) method Number of observations: 966 firm/year (The number of cross-sections is 138 firms and the number of periods is 7 years)				
Dependent variable: $CAR_{i,t}$				
Explanatory variables	**Coefficients**	**Standard error**	**t**	**Probability**
C	0.575572	0.152667	3.770 123	0.0002
EARNINGS	0.170405	0.073756	2.310389	0.0211
FAMILY	- 0.080011	0.160472	- 0.498598	0.6182
A_SIZE	- 0.017392	0.015051	- 1.155526	0.2482
A_EXP	0.168935	0.048778	3.463340	0.0006
A_INDEP	- 0.127496	0.049029	- 2.600414	0.0095
FAMILY * EARNINGS	-3 .143087	1.547480	2 -.031101	0.0425
A_SIZE * EARNINGS	0.064493	0.061213	1.053590	0.2923
A_EXP * EARNINGS	0.324344	0.242673	1.336546	0.1817
A_INDEP * Earnings	- 0.187224	0.191339	- 0.978493	0.3281
A_SIZE * EARNINGS * FAMILY	- 0.134053	0.809011	- 0.165700	0.8684
A_EXP * EARNINGS * FAMILY	5.094412	3.739079	1.362478	0.1734
A_INDEP * EARNINGS * FAMILY	- 5.063904	2.683117	- 1.887322	0.0594
LEV	0.004782	0.063651	0.075121	0.9401
SIZE	- 0.003875	0.010516	- 0.368487	0.7126
GROWTH	- 0.546371	0.063866	- 8.554960	0.0000
Coefficient of determination	0.127706	Fisher statistic		9.272147
Adjusted coefficient of determination	0.113933	Fisher's Probability		0.000000
Durbin-Watson	2.092394			

5. Discussion and Conclusions

Quality disclosures of accounting earnings are essential for well-functioning capital markets. These disclosures provide relevant information to investors, enabling them to make informed investment decisions. Earnings informativeness requires both high-quality reported earnings and their absorption in stock prices and returns. Earnings informativeness is measured by the relationship between stock returns and operating earnings. Compounded cumulative abnormal returns have been considered as a proxy for market returns (Fan and Wong, 2000). The ratio of earnings to the market value of equity capital has been considered as a proxy for earnings of the firm (Woidtke and Yeh, 2013).

The results of the present study suggested that the characteristics of the audit committee have a significant effect on the informativeness of reported earnings. In addition, it was found that the characteristics of the audit committee will increase the informativeness of reported earnings. The characteristics of the audit committee can considerably affect the firm's information space and the informativeness of reported earnings. The existence of an independent audit committee substantially increases the quality of financial statements and drastically reduces the likelihood of the firm's manipulation in financial statements. Besides,, the informativeness of reported earnings is increased due to the presence of financial experts in the audit committee, as companies with an effective audit committee are less likely to use earnings management practices and corporate executives are subject to more regulatory constraints. Krishna et al. (2018) also found that the characteristics of the audit committee increased earnings informativeness, which is consistent with the results of the present study.

The evidence from the present study indicated that the characteristics of the audit committee do not have a significant effect on the relationship between the informativeness of reported earnings and family ownership. Krishna et al. (2018) found that the size of the audit committee only had a positive and significant effect on the earnings informativeness in non-family-owned firms. Also, the independence of the audit committee only had a positive and significant effect on the earnings informativeness in non-family-owned firms and the financial expertise of the audit committee did not have a significant effect on the informativeness of reported earnings, which did not match the results of the third research hypothesis.

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