Advanced International Journal of Banking, Accounting, and Finance
EISSN: 2682-8537
AIJBAF
Volume 3 Issue 7 (June 2021) PP. 47-58
DOI 10.35631/AIJBAF.37004

ADVANCED INTERNATIONAL JOURNAL OF BANKING, ACCOUNTING AND FINANCE (AIJBAF)
www.aijbaf.com

THE IMPACT OF COVID-19 ON THE FINANCIAL PERFORMANCE OF PN17 AND GN3 STATUS FIRMS: DOES IT ADD SALT INTO THE WOUND?

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Article Info:

Article history:
Received date: 21.03.2021
Revised date: 19.04.2021
Accepted date: 01.05.2021
Published date: 15.06.2021

To cite this document:

Shahimi, W. R. M. A., Hanafi, A. H. A., & Yusof, N. A. M. (2021). The Impact of Covid-19 on The Financial Performance of PN17 and GN3 Status Firms: Does It Add Salt Into The Wound? Advanced International Journal of Banking, Accounting, and Finance, 3 (7), 47-58.

DOI: 10.35631/AIJBAF.37004

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Abstract:

The Covid-19 pandemic has brought about major changes to the Malaysian economic landscape in terms of productivity level, investment, and household spending. Nonetheless, the unprecedented presence of Covid-19 has caused an unexpected level of disruption to firms from a liquidity and leverage perspective that impacts financial performance. This study focused on financially distressed firms classified under PN17 and GN3 by Bursa Malaysia. Hence, the aim of this study is to examine the impact of liquidity, leverage, and the Covid-19 pandemic period on the financial performance of financially distressed firms in Malaysia which are classified as PN17 and GN3 firms. By using liquidity ratios, financial leverage ratios, and a dummy variable of Covid-19, the result showed that the current ratio, net working capital, and debt ratio were found significant to affect the financial performance. Meanwhile, there is no significant evidence to support that the Covid-19 pandemic has an impact on the performance of financially distressed firms. The finding indicates that the financially distressed firm's financial performance was purely due to bad management practices, and not contributed by the Covid-19 pandemic.

Keywords:

Financial Performance, Liquidity, Financial Leverage, PN17 and GN3, Covid-19 Pandemic

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Advanced International Journal of Banking, Accounting, and Finance
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Introduction

Since independence, Malaysia has successfully diversified its economy which was initially based on agriculture and commodities into an economy focusing on the manufacturing and services sectors (World Bank, 2020). Malaysia's economy is ranked the 6th largest in Southeast Asia and the 39th largest economy in the world (Amin, 2020). However, there is no denying that Malaysia has gone through several episodes of financial crises (Asian and Global), political crisis, the fall in global oil prices and China's economic slowdown which have put pressure on its economy.

Most recent, the Covid-19 pandemic has brought about major changes to the Malaysia's economic landscape in terms of productivity levels, investment and household spending. Malaysia's gross domestic product (hereafter GDP) recorded a sharp decline of -17.1% with unemployment rate rose to 5.1% in the second quarter of 2020, the worst since 1998. On 13 November 2020, Bank Negara Malaysia (BNM) and the Department of Statistics Malaysia (DOSM) stated that in the third quarter, GDP showed a smaller decline of -2.7% indicating a recovery point from the previous quarter. The recovery of the Malaysia's economic performance can be seen through the regulatory measures announced by government such as the implementation of various phases of the Movement Control Order (MCO) in dealing with the spread of the Covid-19, the reopening economic activities in stages and the permission for interstate travel for Malaysians (DOSM, 2020).

Ozili (2020) explained that the Covid-19 pandemic has led to the closure of financial markets and corporate activities. In addition, the uncertainty over the Covid-19 cases influenced investment decisions by investors which led to higher volatility in the stock market. There are recent literatures examining the effect of Covid-19 on stock price and economy (e.g. Hadiwardoyo, 2020; Lee *et al.*, 2020; Ozili, 2020). Yet, literatures examining the effect of Covid-19 on firm performance are still limited. Undoubtedly, the profound circumstances developed by Covid-19 have caused unexpected levels of disruption to the firms such as decline of profits and financial performance in various types of businesses (Devi *et al.*, 2020).

According to Bardia (2004), firms can be liquidated due to financial problems. Therefore, efficient liquidity management is very important for the sustainability of a firm (Ali *et al.*, 2018; Mohammed *et al.*, 2020). Evidence from previous studies suggested that firm liquidity affected the financial performance (Ali *et al.*, 2018; Bardia, 2004; Ramlan & Nodin, 2018; Rehman *et al.*, 2015; Ehiedu, 2014; Zaid *et al.*, 2014). There are however mixed results on the empirical evidence of liquidity relationship with firm's financial performance. From another perspective, Ivo and Anyanwaokoro (2019) claimed that leverage is the most important factor that can affect financial performance. During the economic boom, financial leverage benefits the financial performance but in the event of an economic downturn, financial leverage will adversely affect the firm's financial performance (Ahmad *et al.*, 2015). The existing literatures offer mixed perspectives on how leverage might influence financial performance (Ramlan & Nodin, 2018; Nadeem *et al.*, 2015; Enekwe *et al.*, 2014; Khatab *et al.*, 2011; Yoon & Jang, 2005). It remains inconclusive on how liquidity and leverage will affect financial performance at the time of Covid-19 as the literatures covering this scope are very limited (e.g. Aifuwa *et al.*, 2020; Devi *et al.*, 2020; Kroeger *et al.*, 2020; Shen *et al.*, 2020).

Endri *et al.* (2020) cited that financial analysis is useful for determining the financial performance and financial condition of a firm in avoiding the risk of bankruptcy. Financial

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EISSN: 2682-8537
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DOI 10.35631/AIJBAF.37004

ratios are useful to differentiate the distressed and non-distressed firms. This financial ratio analysis is able to provide information on the financial status of firms to benefit investors in making their investment decisions. Financially distressed firms in Malaysia are classified as PN17 (Practice Note 17) and GN3 (General Note 3), which involves firms that are listed on the Bursa Malaysia's Main Market and ACE Market, respectively. PN17 firms must submit proposals to the Agreement Board to restructure and restore their firms in order to maintain their listing in Bursa Malaysia. In the wake of Covid-19, Bursa Malaysia on 17 April 2020 had temporarily relaxed the classification of PN17 and GN3 (General Note 3) on firms under these criteria effective from 17 April 2020 to 30 June 2021 by giving more time for them to regulate their financial position (Tan, 2020).

According to Kok (2010), there are investors holding stocks in PN17 firms who are not aware that those firms had been listed as PN17. The PN17 status firms are known as the firms that are not well managed and have poor management practices (Kim-Soon *et al.*, 2013). However, with the new Covid-19 pandemic disruption, it raises the question as to whether this pandemic also has a hand in the distressed firms' financial position. Previous studies have not explored this scope. Therefore, this study intends to fill this gap in the literature. Hence, the main objective of this study is to examine the impact of liquidity, leverage, and Covid-19 pandemic period on financial performance of the financially distressed firms in Malaysia which are classified as PN17 and GN3 firms. Therefore, this study is critical to provide relevant information to the body of knowledge on the financial performance of these firms during the Covid-19 pandemic as the information is hard to find specifically related to the topic.

Literature Review

Liquidity and Financial Performance

Liquidity reflects a firm's ability to meet short-term fund needs. Firms are said to be more profitable if short-term fund needs are derived from the high value of current assets rather than external debt (Ahmad, 2016). According to Bardia (2004), the financial performance of any firm is assessed by the efficiency of liquidity management. Several studies have examined on liquidity (current ratio and quick ratio) and financial performance in various industries or countries. A significant positive effect between liquidity and profit (return on assets, hereafter ROA) was reported in the study of Ali and Bilal (2018) and Ali *et al.* (2018) in Jordan, and Ehiedu (2014) in Nigeria. Madushanka and Jathurika (2018) and Kanga and Achoki (2017) and also concluded the similar results in their study covering Kenya and Sri Lanka respectively by using both ROA and return on equity (hereafter ROE) as a measure of profitability. On the other hand, Jepkemoi (2017) found that firm's liquidity was insignificantly positive towards ROA and ROE.

In the Malaysian context, Ramlan and Nodin (2018) and Zaid *et al.* (2014) asserted that liquidity has a significant positive relationship with the financial performance measured by ROA. However, in a recent study, Mohammed *et al.* (2020) stated the opposite whereby liquidity is not a significant variable to indicate a firm's profitability. On the contrary, Noor and Lodhi (2015) found negative impact of liquidity on firm's profitability (ROA and ROE) in selected sample on Karachi stock exchange which indicated that the lesser liquidity, the more the profitability. A study by Rehman *et al.* (2015) revealed a negative but insignificant relationship between the ROA and liquidity, while ROE had insignificant relationship with liquidity in the context of Saudi Arabia. The findings from Priya and Nimalathasan (2013)

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suggested that there was a significant negative relationship between liquidity and profitability in Sri Lanka.

From another point of view, some authors asserted that liquidity does not affect financial distress (e.g. Oktasari, 2020; Rohmadini *et al.*, 2018; Cinantya & Merkusiwati, 2015). According to Oktasari (2020), current assets are used to finance the liabilities so any amount of liquidity will not affect the possibility of the firm experiencing financial distress. Meanwhile, Curry and Banjarnahor (2018) and Wahono *et al.* (2017) indicated that liquidity has a negative effect on financial distress. Other researchers such as Almansour (2015) and Bunn and Redwood (2003) concluded that liquidity has insignificant negative association to the financial distress. The argument is that the higher the liquidity, the lower the probability of a firm's bankruptcy. Some studies are consistent with each other in their findings and some found contradiction in the relationship between liquidity and financial distress firm.

Leverage and Financial Performance

Leverage refers to the extent to which firms use their borrowings to increase profitability (Alkhatib, 2012). High leverage can motivate financial managers to improve the performance of their firms but can also increase agency costs. Thus, leverage can affect a firm's value positively or negatively, since it magnifies returns and risk (Ivo & Anyanwaokoro, 2019). Earlier study by Barclay, Smith and Watts (1995) showed significant positive correlation between the leverage measured debt ratio and profitability (ROA and ROE). In Pakistan, Khatab *et al.* (2011) also documented the same result when using ROA as the representation of a firm's performance. It is consistent with Nadeem *et al.* (2015) who found positive and significant association between profitability (ROA & ROE) and financial leverage (debt to equity). Under the same proximity, Rehman (2013) showed that the leverage (debt ratio) positively correlates with ROA but negatively associated to ROE. Nonetheless the result in Nguyen *et al.* (2019) study was the opposite of Rehman (2013) whereby financial leverage (debt to equity) negatively impacts ROA, but displays a positive impact on ROE for real estate firms in Vietnam.

Some researchers reported negative relationship between leverage and profitability of the firms. Earlier, Yoon and Jang (2005) found negative relationship between ROE and leverage measured by debt ratio leading to the conclusion that firms with higher debt rates are less profitable. Another negative result was found by Kaumbuthu (2011) for the industrial sector in the Nairobi Securities Exchange. In Iran, Pouraghajan *et al.* (2012) found a significant negative relationship between the debt ratio and the ROA and ROE. In addition to that, Enekwe *et al.* (2014) also indicated the negative impact of financial leverage (debt ratio and debt-equity ratio) on financial performance (ROA) in Nigeria. Most recent, Ivo and Anyanwaokoro (2019) in their study revealed that leverage (debt ratio and debt to equity) had negative insignificant effect on ROA of manufacturing firms in Nigeria, where he explained that an increase in leverage could lower the ROA. A study in Malaysia by Ramlan and Nodin (2018) confirmed that the leverage represented by the debt ratio had a significant relationship with firm's performance (ROA). Most recent, Mohammed *et al.* (2020) found leverage (debt to equity) had a significant negative relationship with the firm's profitability (ROA and ROE) of the listed oil and gas firms.

From the financial distress context, some researchers pointed out that leverage has significant effect on the firm's financial distress (e.g. Rohmadini *et al.*, 2018; Muhtar & Aswan, 2017;

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EISSN: 2682-8537
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DOI 10.35631/AIJBAF.37004

Simanjuntak *et al.*, 2017). The positive relationship between leverage and financial distress was reported in a research conducted by Andre (2013). On the contrary, Ginting (2017) indicated a significant negative influence of leverage on the financial distressed firms implying that the firms with high leverage are not necessarily categorized as the firms with financial distress, and vice versa because high firm liabilities are covered with high assets owned as well. Recently, Oktasari (2020) also proclaimed that leverage does not have a significant effect on the likelihood of financial distress. According to him, the higher the funds provided by creditors with firm owners, the lower the likelihood of financial distress.

Outbreak and Financial Performance

Past literatures have shown that public catastrophe and global concern can affect a firm's performance. However, researches on the disastrous effects of these outbreaks are not comprehensive. A previous study conducted by Chen *et al.* (2007) showed that the SARS epidemic had significantly damaged the performance of hotels in Taiwan which saw a sharp decline in stock prices during the outbreak period. Chen (2010) expanded the study by looking at corporate performance (ROA and ROE) of the same industry in Taiwan. The growth rate of total foreign tourist arrivals and GDP had a positive impact on profitability, but the size was found to be negatively related to ROA and ROE.

With regard to the Covid-19 outbreak, Shen *et al.* (2020) investigated the impact of Covid-19 on firm's performance in various provinces and industries in China. With ROA as a dependent variable and various elements of size, leverage, growth rate, and cash flow as the independent variables, the results showed that the pandemic indeed has led to the reduction of income consequently resulting in lower performance. Meanwhile, Aifuwa *et al.* (2020) who studied the effect of the Covid-19 on the performance of private businesses in Nigeria revealed that the pandemic has harmed the financial performance, as measured by ROA. They recommended that the government should include private businesses in its stimulus packages in helping them to sustain their businesses and operation during this tough time. Devi *et al.* (2020) who examined the impact of the Covid-19 pandemic on financial performance listed on the Indonesia stock exchange drew two conclusions from the study; firstly, there was an increase in leverage (debt to equity) and but a decrease in liquidity (current ratio) and profitability (ROA) during the Covid-19 pandemic. Secondly, no significant difference was found in the liquidity and leverage, however there was a significant difference in the profitability before and during the pandemic.

Nonetheless, Hafidzi and Qomariah (2020) revealed a positive relationship between corporate social responsibilities (hereafter CSR), ROA and share prices in Indonesian manufacturing firms during Covid-19. They explained that investors are confident with firms that show consistent profits, higher stock prices and better ability to allocate CSR exposure costs from operating income. Through the sensitivity analysis on the Vietnamese non-financial firms, Kroeger *et al.* (2020) highlighted that smaller domestic firms are predominantly vulnerable than to regional firms to have Covid-19 impact on profitability (EBIT), liquidity (cash, current ratio) and leverage (interest coverage ratio). Although larger firms were more profitable but also highly leveraged and lower liquidity in the wake of the pandemic.

Although, there are mixed findings from previous literature, three hypotheses are proposed in order to investigate the impact of liquidity and leverage on financial performance as follows:

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H1 - There is a significant impact of liquidity on the financial performance of the financially distressed firms.

H2 - There is a significant impact of financial leverage on financial performance of the financially distressed firms.

H3 - There is a significant impact of Covid-19 pandemic period on the financially distressed firms.

Empirical Design

Sample Data

This study used the financial information of the financial distressed firms listed under Practice Note 17 (PN17) and (GN3) by Bursa Malaysia as at 31 October 2020 as the study sample. There is a total of 24 firms listed under both lists. This study used quarterly panel data starting from 2019Q2 to 2020Q3. The financial information of all firms were collected from the Bloomberg Terminal, and were used to calculate the financial ratios.

Empirical Model

In order to examine the impact of liquidity, leverage, and Covid-19 pandemic period on financial performance of financially distressed firms in Malaysia, this study used panel regression analysis based on the following regression model:

$$ROA = \alpha + \beta_1 \text{ Liquidity Ratio} + \beta_2 \text{ Leverage Ratio} + \beta_3 \text{ Covid19} + \varepsilon$$

Where α represents intercept while β represents the coefficient for each selected variable. The dependent variable in this study is firm performance, which is represented by return on assets (ROA). It is an accounting measure which indicates how well a firm is using its assets to generate profits (Oktasari, 2020; Curry & Banjarnahor, 2018; Rehman *et al.*, 2015; Ehiedu, 2014). Meanwhile, the independent variables in this study are liquidity, financial leverage, and Covid19 period. Similar to previous studies by Mohammed *et al.* (2020) and Bardia (2004), two ratios were used to represent the firm's liquidity position i.e., current ratio (CR) and net working capital ratio (WC). Meanwhile, debt ratio (DR) and debt to equity ratio (DTE) were used to represent firm's financial leverage elements of the firms (Mohammed *et al.*, 2020; Ivo & Anyanwaokoro, 2019). A binary dummy variable was used to account for the Covid-19 period, which equals 1 for post-WHO pandemic announcement (11 March 2020); and 0 otherwise. Table 1 presents the operationalisation of the variables used in this study.

Table 1: Operationalisation of the Variables

Variable	Operationalisation
ROA	Net profit / Total Assets
CR	Current Assets / Current Liabilities
WC	Current Assets – Current Liabilities
DR	Total Liabilities / Total Assets
DTE	Total Liabilities / Total Assets
Covid19	1 = Post-WHO pandemic announcement; 0 = otherwise

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AIJBAF
EISSN: 2682-8537
Volume 3 Issue 7 (June 2021) PP. 47-58
DOI 10.35631/AIJBAF.37004

Results

This section starts by analysing the data collected based on descriptive analysis which includes the reporting of mean, standard deviation, minimum and maximum value of the variables. Table 2 shows the results of descriptive analysis**.**

Table 2: Descriptive Analysis

Variable	Mean	Std. Dev	Min.	Max.
ROA	-1.518	13.180	-155.400	4.655
CR	1.250	2.359	0.003	10.480
WC	-23.220	170.300	-318.700	593.400
DR	11.46	41.480	0.158	391.600
DTE	-0.168	4.995	-18.940	29.410
Covid19	0.500	0.501	0.000	1.000

Note: ROA represents return on assets, CR represents current ratio, WC represents net working capital, DR represents debt ratio, DTE represents debt to equity ratio, and Covid19 represents Covid-19 pandemic period.

Based on Table 2, ROA that represents dependent variable showed a mean value of -1.518 with standard deviation of 13.180. The variable had values between -155.400 and 4.655. CR had mean value of 1.250 and standard deviation of 2.359 with maximum value of 10.480. WC recorded the mean value of -23.220 with standard deviation of 170.300 and ranged between -318.700 and 593.400. As for DR, the mean value was 11.460 while the standard deviation value was 41.480 with the maximum value of 391.600. DTE ratio representing the leverage ratio showed the mean value of -0.168 and standard deviation of 4.995 which fluctuated between -18.940 and 29.410. Lastly for dummy variable Covid-19, the mean value was 0.500 with standard deviation of 0.501.

Next, the results from the panel regression analysis are presented in Table 3.

Table 3: Regression Analysis

	Coefficient	Std. Error	t-ratio	p-value
Constant	2.786	0.921	3.024	0.003***
CR	-0.926	0.412	-2.249	0.026**
WC	0.011	0.006	1.886	0.061*
DR	-0.276	0.013	-20.87	0.000***
DTE	-0.026	0.107	-0.242	0.810
Covid19	-0.538	0.964	-0.558	0.578

Note: ROA represents return on assets, CR represents current ratio, WC represents net working capital, DR represent debt ratio, DTE represents debt to equity ratio, and Covid19 represents Covid-19 pandemic period. The asterisk symbol (*) on p-value represents statistically significant at a certain level; *** statistically significant at 1% level, ** statistically significant at 5% level, and * statistically significant at 10% level

The result in Table 3 indicates that CR was negatively affecting the firm's performance and the result is statistically significant at 5% level. The finding suggests that as the financially distressed firm's liquidity increases, the firm's financial performance will decrease. As firm liquidity increases, it also indicates lower financing from current liability due to lower credit purchase of raw materials that lead to lower sales which will reduce the firm's profit and performance. It may also indicate that current assets are not utilised efficiently in order to generate more profits for the firm. This result is similar to the study by Noor and Lodhi (2015). However, the result showed that WC has a positive and significant effect on the financial

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Advanced International Journal of Banking, Accounting, and Finance
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EISSN: 2682-8537
Volume 3 Issue 7 (June 2021) PP. 47-58
DOI 10.35631/AIJBAF.37004

performance of the financially distressed firm. This indicates that higher liquidity will help to increase the firm's performance. This is similar to previous study such as Ramlan and Nodin (2018) and Zaid *et al.* (2014) that also found significant positive relationship between liquidity and financial performance. The result obtained revealed that as firm's ability in meeting short-term obligation is higher, the firm could obtain more short-term financing to finance their operation which will help to increase the firm's revenue as well as profit and improve firm's financial performance.

The result also showed that the DR which represents the leverage ratio recorded negative coefficient value with the significant level of 10%. This indicates as financially distressed firm's leverage level increases, the firm's financial performance will drop due to higher financial cost that the firm need to bear, consequently reducing the firm's profit. This result is in line with the results found in the studies by Ivo and Anyanwaokoro (2019), Ramlan and Nodin (2018), Kaumbuthu (2011) and Yoon and Jang (2005). However, DTE which also represents the leverage ratio was found to be insignificant. The result is totally contradicted to the findings in the studies by Nadeem *et al.* (2015), Rehman (2013) and Khatab *et al.* (2011). This might indicate that the proportion of debt to equity has insignificant effect on the financial performance of the financially distressed firm.

Lastly, this study also included a dummy variable for Covid-19 period order to find the effect of pandemic period on the financial performance of financially distressed firm. The results indicates that the financial performance of financially distressed firms is not significantly affected by the pandemic period. Given the fact that these companies were already in a financially distressed position, it is plausible that there was little impact caused by all the social and economic restrictions imposed during the Covid-19 pandemic period. Hence, this result is found to contradict some other studies, e.g., Aifuwa *et al.* (2020) and Shen *et al.* (2020), which had examined the firm performance generally, without focusing on financially distressed firms.

Conclusion

This study examines the effect of liquidity, financial leverage, and Covid-19 pandemic period on financial performance of financially distressed firms in Malaysia. This study involved the financially distressed firms classified under PN17 and GN3 by Bursa Malaysia within the period of 2019Q2 to 2020Q3. Financial ratios such as liquidity ratio and leverage ratio were used as the independent variables in this study. As for Covid-19 pandemic period, this study used binary dummy variable which equals 1 for post-WHO pandemic announcement (11 March 2020); and 0 otherwise.

The result suggests that both the liquidity (CR and WC) and financial leverage position (DR) have a significant effect on the performance of the financially distressed firms. Meanwhile, there is no significant evidence to support that Covid-19 pandemic has an impact on the performance of the financially distressed firms. The finding in this study is consistent with Kim-Soon *et al.* (2013), whereby it can be concluded that the financially distressed firm's financial performance was purely due to bad management practices, and not contributed by the Covid-19 pandemic.

There are some limitations in this study. Firstly, the duration of this study was relatively short. Future research could lengthen the duration of the study to comprehensively assess the impact of liquidity and financial leverage on financial performance as Covid-19 is still a global

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EISSN: 2682-8537
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DOI 10.35631/AIJBAF.37004

concern. Secondly, only two ratios were tested for each liquidity ratio and leverage ratio. It is therefore recommended for further research to carry out more in-depth research by including other ratios and other elements such as firm size and growth rate for better comparison.

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Advanced International Journal of Banking, Accounting, and Finance
EISSN: 2682-8537
AIJBAF
Volume 3 Issue 7 (June 2021) PP. 47-58
DOI 10.35631/AIJBAF.37004

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Advanced International Journal of Banking, Accounting, and Finance
AIJBAF
EISSN: 2682-8537
Volume 3 Issue 7 (June 2021) PP. 47-58
DOI 10.35631/AIJBAF.37004

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Advanced International Journal of Banking, Accounting, and Finance
AIJBAF
EISSN: 2682-8537
Volume 3 Issue 7 (June 2021) PP. 47-58
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