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Impact of Financial Transparency on SMEs' Value

Andrea Quintiliani[1]

Abstract

This study aims at investigating the effects of financial transparency on SMEs' value. The main purpose of research work is to test hypothesis that there is no significant relationship between financial transparency and SME value improvement as indicated by interest coverage ratio and Tobin Q. Agency theory is a useful framework for designing financial transparency tools. Further the study applied census survey for one hundred twenty-eight SMEs listed in AIM Italia. The time under study was from 2014 to 2018. Out of the 128 listed SMEs targeted, 115 were analyzed forming 90% of the population. Financial transparency index (FTI) was developed as proxy measures of variables. Regression analysis and correlation analysis have been applied to test the hypotheses. Key study variables of SMEs are subject to descriptive statistics. The results suggest a positive and significant relationship between the variables. Greater financial transparency allows SMEs to reduce information asymmetries and optimize their capital structure. This research work has applied important mechanism in FTI to examine the effect of financial transparency on SME value which has provided new insight on the relationship thereby enriching the finding.

JEL classification numbers: C30, G20, G30, G39
Keywords: Financial transparency, SME value, Agency theory, Information asymmetries, Tobin Q, Capital structure.

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[1] Extraordinary Professor in the Academic field of "Economics of Financial Intermediaries and Corporate Finance", Department of Law and Economic Sciences, Pegaso Telematic University, Naples, Italy.

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1. Introduction

Financial transparency can be defined as an information disclosure system that solves information asymmetry problems among firm's stakeholders.

The academic debate on the topic of transparency has emerged in the corporate finance studies of the last decade. This is partly due to the works to Healy and Palepu (2001), Bushman et al. (2004), and Lang and Maffet (2011).

On the other hand, a well-structured financial transparency system allows owner-manager of a small or medium-sized entity govern the structure of lending contracts and to keep degree of financial leverage under control (Thorsten and Demirgüç-Kunt, 2006). Similarly, Mazani and Fatoki (2012) show empirically that the firms with higher financial transparency are more likely to be able to obtain bank loans on favourable terms.

Put more simply, transparency affects credit market as banks are different in terms of information-gathering and processing data abilities (Blackburn et al., 2013).

As described by Ricardo Julio Rodil (2015), the owner-manager of an SME pursues a policy of financial transparency as this allows to attract private equity funds.

Studies attempting to relate financial performance to financial transparency are still indecisive. Bushman and Smith (2001) and Ojeka et al. (2015) found a significant association between financial transparency and a firm's financial performance despite the limited evidence of a long-term relationship. Conversely, researchers such as Prat (2005), and Sahore and Verma (2017) did not find a significant relationship between profitability and financial transparency.

Chau and Gray (2002) define financial transparency as a set of rules and policies established by the management to regulate its affair and have efficient management of financial resources to improve the value of the company and achieve maximum shareholders returns. Likewise, an adequate financial transparency system allows the owner-manager to optimize financial structure and increase the bargaining power towards the lenders and investors. Emphasize transparency, publish reliable financial information for any potential interested party, are useful practices for achieving the value objectives of the firm.

For Degryse et al. (2010), firms with good financial transparency practices are investor friendly, which enable them to optimize their capital structure by attracting cheaper funding thereby maximizing returns to shareholders.

Damodaran (1996) states that SMEs suffer agency conflicts between shareholders and outside lenders. In SMEs the main agency costs do not derive from the relationship between shareholders and management but from the relationship between inside and outside lenders. In particular, shareholders have an interest in carrying out high-risk, high-return transactions, while loan-holders can protect their interests (reduce agency costs) through a series of loan instruments and techniques based on the presence of adequate guarantees.

According to Samuels et al. (1995) information opacity is the primary factor affecting the relationship financing as it generates the agency costs attributable to situations of hidden action and hidden information.

Murphy (1985) argues that financial transparency practices improve the efficiency and effectiveness of the company through adequate supervision and governance, thus minimizing conflicts between agencies and putting the interest of outside lender with that of shareholders in optimizing the corporate value.

This study aims to determine the influence of financial transparency system for the growth of SME value. Analyzing SMEs listed in AIM Italia, the results confirm the positive relationship between financial transparency and variables that generate value creation.

An adequate financial transparency system allows SMEs owners to improve financial policy with positive impacts on interest coverage ratio (ICR), one of the best-known metrics to capture a company's ability to create value. In fact, ICR emphasizes the company's ability to pay off the interest with the profits earned.

This article is structured as follows. Section 2 examines the related literature, while Section 3 illustrates the research hypotheses, data sources and empirical model. Section 4 presents the main results of which their implications are discussed in Section 5. The final section contains the concluding remarks.

2. Theoretical analysis

A clear definition of transparency is present in the studies of Bushman et al. (2004) and Lang and Maffet (2011). The authors associate transparency with the provision of information in favor of a large number of stakeholders. These studies converge in affirming that transparency can be a remedy to overcome the problems of information asymmetry between two or more related parties.

Put more simply, transparency can be a remedy to overcome information asymmetry problems between two or more related parties. In general, Stiglitz and Weiss (1981) argue that agency conflicts such as asymmetry of information and moral hazard may impact on the ability to obtain the external sources of funds.

Financial transparency reduces informational asymmetries and the phenomena of moral hazard and adverse selection in the credit market. Therefore, a high financial transparency mitigates the danger of moral hazard (Diamond, 1991) and reduces agency costs (Jensen and Meckling, 1976).

In line with previous studies, Shinozaki (2012) argues that information asymmetry between borrowers and lenders increases the adverse selection and moral hazard risks for financial institutions.

The research conduct by Zulfikar et al. (2017) has shown that financial transparency is related with better financial outcomes, leading indirectly to higher credit ratings.

The information environment plays a crucial role in determining conflicts and designing solutions to mitigate them. In particular, the fact that some contracting parties have superior specific information about the firm at various times before and/or during the contracting relationship creates a wide range of agency conflicts (Armstrong et al., 2010).

In the search conducted by Mazani and Fatoki (2012), asymmetry of information has become a major issue for lenders in credit rationing. Hong and Gu (2014) studies add that asymmetry of information has made severe impacts on accessing external financial resources from formal financial industry.
Some authors associate the phenomenon of financial transparency with the disclosure of accounting information. Healy and Palepu (2001) argues that organizations disclose accounting information that is useful for investment decisions. Buskirk (2012) and Quintiliani (2018) points to the fact that financial disclosure is useful to minimize agency costs.
Other studies highlight that financial transparency systems are designed to help an organization adapt to the environment in which it is set and to deliver the key results desired by stakeholders (Petersen and Rajan, 2002).
As can be seen from the study by Cucculelli and Bettinelli (2015), SMEs should adopt tools to enhance transparency and provide proactively to banks all relevant information necessary to assess their risk profile. The tools to improve financial transparency are: planning system, quality standard, management control system, auditor, and the presence of a CFO. These tools improve the dialogue between and SMEs and banks and prove to be a good way to reduce information asymmetry and create stronger relationships.
This study uses the tools above mentioned for the construction of the financial transparency index.
As can be seen by Hirdinis (2019), SME value creation is the result of an adequate combination between net cash flow generated by investment and cost of capital. Furthermore, lenders closely observe the value of the company. For the bank, the value of the SME is related to the liquidity of the firm and its ability to repay the loan.
Value creation can also be defined as the attainment of predetermined targets, objectives, and goals within a given timeframe (Casey and O'Toole, 2014; Rahman, 2014).
Management control effects company's value because of minimized expropriation by management, increased effectiveness in investments and improvement in available cash flows for owners (Jensen, 1991).
A good performance indicator should be measurable, applicable and important to the company (Carpenter and Petersen, 2002).
Performance measures used in empirical research can be classified as accounting-based means or market-oriented means. Firm performance was measured by market price of resources acquired and market price growth by Tobin's Q calculation which measure share value growth.
This study uses ICR as the measurement of financial performance for the selected companies. Tobin's Q measures the wealth generated by a firm for its shareholders. It compares how much more a company is worth when compared to the book value of its assets. Any excess of market value of assets over their book value results from intangible assets, goodwill, future growth potential, and competitive position. Tobin's Q can be affected by both the internal and external factors. Tobin's Q is a

company's performances indicator, so it is important for an organization to manage its effectively.

3. Hypothesis, data and empirical model

The main purpose of this research work is to is to verify the link between financial transparency constructs and financial performance of SMEs.

The population of the study comprised of all the 128 companies listed at the AIM Italia (the market of Borsa Italiana devoted to the Italian small and medium enterprises, which wish to invest in their growth) as at 31st December 2018.

Listed SMEs are preferred as they have a defined structure, a legal mandate to operate, are likely to exhibit elaborate linkages between research variables and provide a basis for determining the market value and performance in an objective manner. The SMEs were obtained from AIM listings. Statistical sampling is conducted with systematic elimination method. The sampled SMEs must meet the following criteria: i) presence of homogeneous data over the past five years; ii) availability of useful data to test research hypotheses. As a result of these conditions, a sample of 115 firms was obtained.

The research adopted a census method due to the small number of qualifying companies at the AIM Italia. Secondary data were acquired through questionnaires, financial statements and financial reports of the AIM listed companies. An index was formed for financial transparency.

For SME value, financial statements and financial reports was analyzed to find ICR and Tobin Q. We used Rahavard Novin software for data collection and SPSS 20.0 for data analysis.

Where necessary data were not obtained, the same were requested directly from the company's management. The period of research covered 2014 to 2018.

Financial transparency is measured by assessing the level of implementation of related 5 transparency variables (i.e., planning system, high quality standard, management control system, auditor, and whether the borrower has a CFO in the organizational structure or not) used as questions in the questionnaire.

Transparency variables are described below:

1. *Auditor*. According to Lang et al. (2012) the choices of accounting auditors and accounting standard affect the transparency through their effect on overall accounting quality and on the additional disclosures provided with the financial statements. The relationship between auditor and financial transparency is still inconclusive. Krishnan (2003) reported a feeble relationship; conversely, Han et al. (2011) noted a significant association. Therefore, this research includes an indicator variable if a SME adopts international standards on balance sheet and auditing.
2. *High quality standard*. The studies of Barth et al. (2008) show that global accounting standards facilitate more transparent reporting. However, Daske et al. (2008) argue that when the adoption of accounting standards is taken on a voluntary basis, the commitment to financial transparency

disappears. These also argue that high quality accounting standards are critical and important in environments where regulatory oversight is strong. Similarly, the research of Francis (2004) and, Hope and Langly (2010), claim that the use of international accounting standards and the use of high-quality auditors are binding in contexts where exposure to disputes is strong.

3. *Management Control System*. Merchant (2007), maintains that management control systems aim to support decision-making processes and to monitor resources in order to achieve effectiveness and efficiency objectives. According to Shleifer and Vishny (1997), management control entails a governance mechanism that assures investors that they will get return at the end. The prime problem stemming from ownership and lenders is difference in interests that leads to huge agency cost. The chief objective of management control is determined that appropriate check systems, controls, management structure and governance have been established to optimize returns and minimize losses the best interest of the shareholders with the aim of enhancing accountability, governance and transparency in such a way as to reduce agency costs through increased productivity and efficiency.
4. *Chief Financial Officer (CFO)*. This research assumes that SMEs with a CFO are more transparent (Quintiliani, 2017). In the context of SMEs, CFO takes strategic and critical role to dissolving information asymmetries between SME and its lenders. Information asymmetries and the resulting credit constraints are consequence of business opacity (Ackert et al, 2007). An unsatisfactory and incomplete piece of information has negative effects (so-called, adverse-selection problems): rationing of financial resources for the firms having valid business fundamentals, wrong pricing of loans, increase in nonperforming loans, suboptimal allocation of risk-based resources (Stiglitz and Weiss, 1981; Farmer, 1985; Bester, 1985; Williamson, 1987; Cressy and Toivanen, 2001). The CFO more than ever has become a reference point in the interlocutory processes with the managers and corporate managers of the banks with whom the company works. On this way, the relationship of mutual knowledge has gone into deepening also thanks to the need of the banking system to increase information transparency by the side of the firms. Good bank-firm relationship is often influenced significantly by CFO's capacity. Jiang et al. (2010) group the segment of CFO's ability into relationship ability with banks and technical ability to analyze invisible business assets.
5. *Planning system*. The presence of a planning system facilitates and makes communication between company and financial markets more transparent. Long-term financial planning and forward-looking rating are necessary to sit at the table of lenders in a transparent way, with real and certain data, and with the possibility of creating alternative scenarios. It is essential that SME is able to produce data quickly (financial simulation scenarios,

forecast rating, budget), also with a view to improving the relationship between bank and firm. The study by Ali et al. (2007) indicate that SMEs equipped with financial planning systems have larger analyst following, lower dispersion in analysts' earnings forecasts, smaller forecast errors, less volatile forecast revisions, and smaller bid-ask spreads. The presence of a planning system is closely related to the presence of CFO.

Financial Transparency Index (FTI) were formulated as a standard proxy and based on forty-three binary objective study queries obtained from secondary data.

FTI has a value of 0 to 100, the assumption is that it is expected that companies with poorer financial transparency (opaque borrower) may perform sub-standard. Our quantitative research approach is descriptive and correlational. A multivariate regression model was applied to establish the relationship between financial transparency and company's value. The model to test hypothesis is shown in formula:

$$Y_{it} = \alpha + \beta_1 FT_{it} + \varepsilon_{it} \quad (1)$$

where "Y" represents corporate value parameter (ICR and Tobin Q), "α" is the intercept or constant, "β_1" is regression coefficient, "FT" is the composition of financial transparency (measured by financial transparency index - FTI), "ε" is a random error term, "i" is a number of SMEs used in the sample and "t" is the duration of the research. The research purpose is to see if there is a significant relationship between the creation of value as captured by ICR and Tobin Q and financial transparency attributes (planning system, high quality standard, management control system, auditor, and CFO).

The objective is twofold: first, to assess the impact of the level of financial transparency on the ability of the SME to create value; second, to understand if the relationship is linear.

The null hypotheses of the study are proposed as follows:

RH_1 - There is no significant relationship between financial transparency and interest coverage ratio for AIM Italia listed SMEs.

RH_2 - There is no significant relationship between financial transparency and Tobin Q for AIM Italia listed SMEs.

4. Empirical results

The aim of this study is to test the relationships between research variables concerning financial transparency system and financial performance. Variables of interest are planning system, quality standard, management control system, auditor, and CFO. Table 1 provides descriptive statistics of the sample. The average mean of variables is 0.6848 and planning is practiced by an average of 0.8012 of the 115 listed SMEs at the AIM Italia - which is a reasonable number. Analysis of quality standard gives an overall mean score of 0.5642 which is comparatively very low given the high observed scores of the other financial transparency measures.

Results disclosed in Table 1 indicate that the overall mean score for Auditor is 0.7133. The results on Management control constructs give an overall mean average of 0.8001. Kurtosis analysis shows that peakedness of the distribution of the variables is 2.3701 which is less than k factor of 3 which indicates a platy-kurtic distribution (flatter than normal distribution with shorter tails). All the constructs are platy-kurtic distribution and are normally distributed. The reading from the study indicates that presence of CFO has average of 0.8450. The study score confirms a compliance rate of over 68% with all variables for financial transparency.

Table 1: Financial transparency - Average scores of planning system, high quality standard, management control system, auditor, and CFO

Variable	N.	Mean	Max.	Min.	S.D.	Kurt.	Prob.
Planning system	115	0.8012	0.8212	0.4010	0.4511	3.1276	0.3821
Quality standard	115	0.5642	0.6532	0.4283	0.4121	3.1312	0.0100
Mgmt control system	115	0.8001	0.8112	0.4618	0.3145	2.1459	0.0098
Auditor	115	0.7133	0.8028	0.3345	0.3213	1.7893	0.0134
CFO	115	0.8450	0.8823	0.4212	0.1980	2.1191	0.0178
Average Score	115	0.6848	0.8001	0.4304	0.3101	2.6233	0.0156

In order to tests if corporate value and financial transparency are related (RH_1), we use the equation below:

$$Y = \beta_0 + \beta_1 X \tag{2}$$

where X = Financial transparency and Y = ICR.
Table 2 highlights the main results of testing data for the first hypothesis. It is evident that effect of financial transparency on ICR is significant with a regression (R) of 0.632. Therefore, financial transparency explained up to 62.1%, ($R^2 = 0.621$) of the total variation in ICR is attributed to changes in financial transparency. The remaining 37.9% is explained by the other variable. In addition, the number of Durbin-Watson Test is 1.289, which shows that there is not auto correlation problem. These findings indicate that there is a significant relationship between financial transparency and ICR which is in line with the results of the study done by Carpenter and Petersen (2002).

Table 2: Regression model of financial transparency against interest coverage ratio

R	R^2	Adj R^2	Std. Error	Durbin Watson test
0.632	0.621	0.632	0.117654	1.289

Variance analysis was used to examine how effective statistically the model is to establish the significant impact of financial transparency on ICR. Based on the results of the ANOVA test or F-test in Table 3 obtained F count is 422.680 with a significance level of 0.001. Because the significance level of 0.001 < 0.050, it can be stated that financial transparency has a significant influence on company value. This assertion therefore does not confirm the null hypothesis that financial transparency has no significant effect on firm value (as measured by ICR).

Table 3: The result of F-Test - ANOVA (financial transparency and interest coverage ratio)

Model	Sum of Squares	Df	Mean square	F	Sig.
Regression	4.121	1	4.298	422.680	0.001
Residual	2.842	299	0.027	-	-
Total	6.963	300	-	-	-

Table 4 shows a significant relationship between financial transparency and ICR; this is indicated by beta coefficients (ß = +0.633). With respect to significance level and the number of T statistic, null hypothesis is rejected. Thus, the study fully not supports first research hypothesis (RH_1).

Table 4: Coefficient of financial transparency and interest coverage ratio

Model	Std. Error	Beta	T	Sig.
(Constant)	0.41	-	-14.987	0.001
Financial transparency	0.51	0.633	19.301	0.001

Second hypothesis sought to establish the relationship between the variables declared for SMEs listed on AIM Italia. A regression of financial transparency on firm value was done using the equation below:

$$Y = \beta_0 + \beta_1 X \qquad (3)$$

where X = Financial transparency and Y = Tobin Q.
The results highlighted in Table 5 indicate a weak association exists concerning the variables with regression R of 0.512. This means that only 31.8% ($R^2 = 0.318$) can be explained by financial transparency index (FTI) of the Tobin's Q while the balance 68.2% is accounted for by other variables. At p-value greater than 5, F value is 111.018 indicating that FTI has a significant effect on firm value as measured by Tobin's Q. Second research hypothesis (RH_2) is thus rejected.

Table 5: Effect of financial transparency index (FTI) on Tobin's Q

	R	**R^2**	**Adj R^2**	**Std. Error**	**Durbin Watson test**
	0.512	0.318	0.296	0.6671901	1.433
Model	**Std. Error**	**Beta**	**T**	**Sig.**	
(Constant)	0.279	-	-5.541	0.001	
FTI	0.301	0.498	12.309	0.001	
Model	**Sum of Squares**	**Df**	**Mean square**	**F**	**Sig.**
Regression	35.698	1	36.194	111.018	0.001
Residual	216.298	299	0.423	-	-
Total	251.996	300	-	-	-

5. Discussion

Some studies (Lambert et al., 2007; Lardon and Deloof, 2014; Myers, 2014; Kim et al., 2013; Buskirk, 2012) show that financial transparency increases the credibility of the borrower with positive effects on the cost of debt. Furthermore, the most transparent SMEs are immune from the credit crunch effect. This impacts directly on ICR and indirectly on business value. In line with previous studies this work highlights the close positive link between transparency and value creation.
The study findings established that financial transparency attributes contribute significantly to the performance of SMEs. As presented in Tables, FTI are related to value parameters. The findings confirmed the significant and positive impact of financial transparency attributes (planning system, high quality standard, management control system, auditor, and CFO) on SMEs' performance.
Correlation output indicated that relationship between financial transparency and

SME value of listed firms is statistically significant. Therefore, H_1 and H_2 hypotheses were not confirmed by the study results.
The study result on significance of relationship between the independent variables and corporate value as measured by ICR and Tobin Q is also supported by agency theory.
Using Tobin's q as a measure of value SME, this work seeks to estimate the relative importance of financial transparency in determining firm performance. Research method are analogous to those of Rodil (2015), like him, we find that financial transparency effects account for the majority of the explained variance.
Transparency in modern financial disclosure is considered as being crucial (Barth and Schipper, 2008) in helping lenders to reach their own conclusions about businesses (Billings and Capie, 2009).
Hutton (2007) argue that financial transparency can be a good tool for limiting the increase of opportunistic behavior of managers.
The agency theory referred to in this study concerned with aligning interest between outside lenders and shareholders. In this field of studies some authors have examined the problems faced by SMEs when attempting to raise finance. In particular, Lean and Tucker (2001) suggest that information asymmetry hinders the ability of the firm to demonstrate the quality of its investment projects to the provider of finance (usually the bank). These asymmetries are even more accentuated in SMEs which are notorious for having poorly financial culture. Therefore, the problem of information asymmetry falls within the sphere of communication. A closer relationship between the bank and the firm should reduce information asymmetry as it facilitates bank managers in understanding the firm.
Relationship between bank and SME which must be based on transparency that is an open exchange of information with banks and other providers of finance (Watson, 1986). To fulfil the expectations for transparency, SMEs they must have useful tools such as: planning system, quality standard, management control system, auditor, and the presence of a CFO. These tools improve the dialogue between and SMEs and banks and prove to be a good way to reduce information asymmetry and create stronger relationships.
Auditor and accounting standard skills have a positive influence on the performance of SMEs.
The study revealed the presence of a strong positive linkage between SME value and presence of a management control system. This indicates that management control practices improved financial transparency. This is in line with the evidence of the studies of Merchant (2007), and Cucculelli and Bettinelli (2015).

6. Conclusion

This study analyzes the effects of financial transparency on SMEs. In this perspective, questionnaires, financial statements and other relevant reports of 115 firms listed at the AIM Italia was used to gather information. The period of research covered 2014 to 2018.

The independent variable was examined under different sub constructs affecting the main financial transparency: planning system, high quality standard, management control system, auditor, and CFO.
Analysis of variance provide valuable insight into the performance of SME under financial transparency condition. In fact, F statistic is equal to 422.680 while p value is less than 5%. Furthermore, chi-square statistic is always positive.
The study drawn the conclusion that the higher the financial transparency of the entrepreneur, the greater his ability to create value as measured by ICR and Tobin Q.
Therefore, the empirical results reject the research hypotheses (RH_1 and RH_2) and they claim that financial transparency has a positive impact on the ability of small and medium enterprises to create value, as measured by ICR and Tobin Q.
The results of this work lead to some implications of potential interest.
First, it reinforces the body of research and empirical studies concerning the quality and quantity of financial transparency system in developed markets and highlights the importance of financial transparency in the business world within the framework of agency theories.
In addition, would provide a basis for future research and allow academics to further investigate this concept in the context of other markets (so called emerging markets). Further research can examine all the effects of desirable financial transparency related or not to firm value.
Significantly, a number of managerial implications come from this research but two major areas are financial transparency of entrepreneurs and problem management.
The financial transparency that entrepreneurs should pursue since financial transparency has a direct impact on creditworthiness (Quintiliani, 2016). Furthermore, banks should try to make the entrepreneur aware of financial transparency. Such transparency would lead to a more accurate judgment.
The second is problem management that owner should resolve to enhance financial transparency. The increase in financial transparency positively affects financial performance as well as capital structure. This finding suggests that SMEs need to use valid tools to improve financial transparency. A tool is valid when it is consistent with the management complexity of the firm.
It is good to specify that this study has some limitations. The main limitation of the study relates to the number of the firms involved. Only SMEs listed in Italy are considered. Furthermore, the data may be subjected to more statistical analysis in order to establish a more robust validity and reliability. To avoid erroneous conclusions about the impact of financial transparency on SMEs' value, it is necessary to acquire further strengthened data and assume a variety of conditional situations. Future studies will analyze the phenomenon using comparison samples of SMEs listed in EU and non-EU markets.
In the end, is indeed desirable to increase financial transparency? Today, trust can be built only on excessive financial transparency? Studies like the ones conducted by Tadesse (2006) discuss about the transparence fragility, when disclosures created negative externalities with negative economic consequences.

Canibano et al. (2002) also documented that extensive transparency and disclosures can have sometimes exact the opposite effect. Until what point financial transparency can increase in order to improve SMEs performance but not to comprise negative effects? These questions will guide future studies that will deal with the link between financial transparency and SMEs' performance.

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