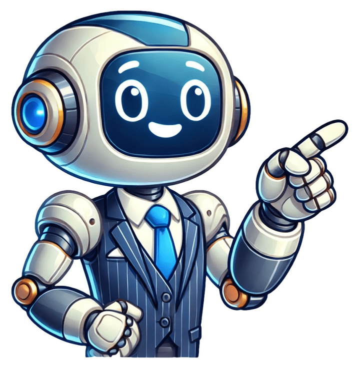

Purchasing inventory on account:

Inventory is usually a big asset for the company, especially the merchandising company, as buying and selling the inventory is usually its main activity in the operation. Hence, it is important to properly account for inventory purchases in making journal entries into the accounting record. A mistake of recognition of inventory purchase may lead to a big misstatement on both the balance sheet and income statement.There are two methods or systems to account for inventory including the perpetual system and periodic system. Likewise, the company uses one of the two systems to make journal entry for inventory purchase.In the journal entry of inventory purchase, the difference between the perpetual system and periodic system is on the debit side. Under the perpetual system, the amount of inventory purchase is posted to the inventory account while, under the periodic system, it is posted to the purchase account instead.Inventory purchase journal entryPerpetual inventory systemUnder the perpetual system, the company can make the inventory purchase journal entry by debiting inventory account and crediting accounts payable or cash account.AccountDebitCreditInventory000Accounts payable/cash000In this journal entry, there is no purchase account and the amount of purchase directly goes to the inventory account by adding to the inventory balances. This way the company can view the inventory balances after posting the purchase journal entry (or at any time). This is one of the big advantages of the perpetual inventory system.Also, the purchase transaction does not involve income statement items. Although there is an increase in accounts payable or cash out here, the cost has not occurred yet. The cost usually only occurs when the company makes the sales of inventory.Periodic inventory systemUnder the periodic system, the company can make the journal entry of inventory purchase by debiting the purchase account and crediting accounts payable or cash account.AccountDebitCreditPurchase000Accounts payable/cash000The purchase account is a temporary account, in which its normal balance is on the debit side. It will be used for the calculation of cost of goods at the end of the period. And after closing entries, the purchase account will have zero balance.Likewise, there is no inventory account involved when the company purchases the inventory in. The inventory account only appears when the company closes the entries, (e.g. the beginning inventory is credited to close old balances and the new inventory after the physical count is debited to record the ending inventory).ExampleFor example, on October 12, 2020, the company ABC Ltd. receives the inventory it purchases on credit from one of its suppliers. The inventory purchases amount to $5,000 and the company ABC Ltd. uses the perpetual inventory system. What is the journal entry for the purchase transaction?If the company ABC Ltd. uses the periodic inventory system instead, what is the journal entry for the inventory purchase?Solution:Perpetual inventory systemUnder the perpetual system, ABC Ltd. can make the journal entry for inventory purchase on October 12, 2020, as below:AccountDebitCreditInventory5,000Accounts payable5,000In this case, the $5,000 will directly add to the balances in the inventory account. Likewise, on October 12, 2020, the company can check how much balances the inventory has after adding $5,000 of purchase.The company can also review and verify the inventory on October 12, 2020, by comparing the inventory in the account record with the physical inventory count. This is a big advantage of the perpetual inventory system as the company can investigate immediately if there is any variance between the physical count and the account record.Periodic inventory systemIf ABC Ltd. uses the periodic inventory system instead, it could make the journal entry for inventory purchase on October 12, 2020, as below:AccountDebitCreditPurchase5,000Accounts payable5,000In this journal entry, the purchase of $5,000 does not add to the inventory balance but it will be used in the cost of goods sold calculation. The inventory balances will be based only on the physical count of inventory at the end of the period. Hence, unlike in the perpetual system, the company cannot check how much balances the inventory has immediately after adding the $5,000 of purchase on October 12, 2020.It is useful to note that the purchase account is for inventory only. So, any purchase of equipment or office supplies should never be posted into the purchase account. Otherwise, there will be a misstatement in the calculation of the cost of goods sold at the end of the period. An inventory purchase journal entry records the acquisition of goods that a business intends to sell. This entry typically involves debiting the Inventory account to increase the company's assets, showing that inventory has been added to the stock. Concurrently, the Cash account is credited if the purchase is made in cash, decreasing the company's cash on hand, or the Accounts Payable account is credited if the purchase is on credit, increasing the company's liabilities. This journal entry is crucial for maintaining accurate financial records, helping in the management of inventory levels, and ensuring that financial statements accurately reflect the company's current assets and liabilities. Components of a Inventory Purchase Journal Entry When a business acquires inventory, whether through cash or on credit, it must record this transaction in its accounting records. The journal entry typically involves the following accounts: Inventory Account (Debit): This account is debited to reflect the increase in the company's inventory. It is classified under current assets on the balance sheet. Cash or Accounts Payable Account (Credit): Depending on the method of payment, this component can vary: Cash Account: For cash purchases, the cash account is credited, indicating a decrease in the company's cash holdings. Accounts Payable Account: For purchases made on credit, the accounts payable account is credited, signifying an increase in the company's liabilities. Example Assuming a company, XYZ Inc., purchases $5,000 worth of inventory on credit, the journal entry would be: Debit Inventory Account: $5,000 (to increase inventory) Credit Accounts Payable Account: $5,000 (to increase liabilities) This entry reflects the acquisition of inventory without the immediate outlay of cash, increasing both the company's assets (inventory) and liabilities (accounts payable). Key Takeaways Directly Affects Financial Statements: Inventory purchase journal entries impact both the balance sheet, by increasing inventory assets and either decreasing cash or increasing accounts payable, and the cash flow statement, by reflecting outflows or obligations. Essential for Accurate Cost Tracking: Recording inventory purchases accurately is crucial for determining the cost of goods sold (COGS), which in turn affects gross profit calculations and overall financial analysis. Reflects Financial Health and Operational Efficiency: These entries provide insights into a company's purchasing activities, inventory management, and financial health, influencing strategic decisions regarding stock levels and supplier relationships.How to Record Journal Entry for Inventory Purchases To record an inventory purchase journal entry, follow these steps: Step #1: Debit the Inventory Account: This increases the inventory asset on the balance sheet, reflecting the addition of new stock that the company intends to sell. Step#2: Credit the Cash Account or Accounts Payable Account: If the purchase is made in cash, credit the Cash account to decrease the company's cash on hand, showing that cash has been spent to acquire inventory. If the purchase is on credit, credit the Accounts Payable account to increase the company's liabilities, indicating that the company has an obligation to pay the supplier in the future. This journal entry ensures that the acquisition of inventory is accurately reflected in the company's financial records, affecting both its assets and, depending on the method of purchase, either its cash holdings or its liabilities. Steps to Record an Inventory Purchases Journal Entry Identification of Purchase: Initially, the details of the inventory purchase, including the quantity, price, and terms of sale, are determined. Determination of Payment Method: The method of payment (cash or credit) influences which accounts are involved in the transaction. Example of Inventory Purchase Journal Entry Let's illustrate with examples for a company named "Garden Supplies Co." that purchases inventory both in cash and on credit. Scenario 1: Cash Purchase Transaction: Garden Supplies Co. purchases $15,000 worth of gardening tools in cash. Journal Entry Debit Inventory Account: $15,000 This increases the inventory, reflecting the addition of gardening tools. Credit Cash Account: $15,000 This decreases the cash balance, indicating money paid out for the purchase. Explanation for Cash Purchase The debit to the Inventory account shows an increase in assets, as the company now has more inventory. The credit to the Cash account decreases the company's cash on hand, reflecting the payment for the inventory. Scenario 2: Credit Purchase Transaction: Garden Supplies Co. purchases $20,000 worth of landscaping materials on credit. Journal Entry Debit Inventory Account: $20,000 This increases the inventory, reflecting the addition of landscaping materials. Credit Accounts Payable Account: $20,000 This increases liabilities, indicating an obligation to pay the supplier in the future. Explanation for Credit Purchase Debiting the Inventory account increases Garden Supplies Co.'s assets, as it adds value to the company's stock. Crediting the Accounts Payable account increases the company's liabilities, showing that the purchase will be paid for at a later date, not immediately impacting the company's cash flow. These examples highlight how inventory purchases impact a company's accounting records, affecting both the balance sheet and cash flow, depending on whether the purchase was made in cash or on credit. Considerations for Freight and Discounts Additional factors, such as freight charges and purchase discounts, can also affect the journal entry for inventory purchases. Freight costs are typically added to the inventory's cost if they are directly associated with the acquisition, whereas purchase discounts reduce the total cost of the inventory if payment is made within a specified discount period. Importance of the Purchase of Inventory Journal Entry Inventory purchases represent the acquisition of goods that a business intends to sell. These transactions not only affect the company's current assets but also have implications for its cost of goods sold (COGS) and, ultimately, its gross profit. The inventory purchase journal entry is crucial for several reasons: Accuracy in Financial Reporting: It ensures that the balance sheet accurately reflects the company's current assets by recording the value of inventory on hand. Cost of Goods Sold Calculation: It provides the necessary information to calculate the cost of goods sold (COGS), a key figure in determining gross profit. Inventory Management: It helps in tracking inventory levels, facilitating better inventory management and planning. By meticulously recording inventory purchases, a business can maintain accurate financial records, essential for analyzing its financial health, making informed decisions, and reporting to stakeholders. Bottom Line The accurate recording of inventory purchases is fundamental to effective inventory management and financial reporting. By meticulously documenting these transactions, businesses ensure that their financial statements accurately reflect the value of their assets and liabilities, thereby providing stakeholders with a clear picture of the company's operational health and financial status. This guide serves as a foundational resource for understanding the principles and processes involved in recording inventory purchase journal entries, an indispensable aspect of accounting for inventory-holding entities. Frequently Asked Questions How do you record an inventory purchase in accounting? To record an inventory purchase, debit the Inventory account to increase your stock assets, and credit either Cash or Accounts Payable, depending on whether the purchase was made in cash or on credit. What happens to the balance sheet when inventory is purchased on credit? When inventory is purchased on credit, the Inventory account on the balance sheet increases, reflecting more assets, and the Accounts Payable account also increases, indicating a rise in liabilities. Is the purchase of inventory always recorded as an increase in assets? Yes, purchasing inventory is recorded as an increase in assets (Inventory account) because it adds physical stock that the company intends to sell for a profit. How does a cash purchase of inventory affect a company's cash flow statement? A cash purchase of inventory results in a decrease in the Cash account, impacting the cash flow statement by reducing the cash available for operations and other activities. Inventory accounting involves tracking and recording the costs associated with inventory, from purchase to sale. Below are examples of common inventory-related journal entries, including purchasing inventory, recording cost of goods sold, and adjusting for inventory shrinkage. When inventory is purchased, the cost of the inventory is recorded. Example 1: A company purchases $15,000 worth of inventory on credit. Journal Entry: DateAccount TitleDebit ($)Credit ($)08-01-2024Inventory/Purchase15,00008-01-2024To Accounts Payable15,000 Explanation: Inventory/Purchase will debited to reflect the increase in assets. Accounts Payable will credited to record the obligation to pay the supplier. When payment is made for the inventory purchased on credit, the accounts payable is reduced. Example 2: The company pays $15,000 to settle the accounts payable. Journal Entry: DateAccount TitleDebit ($)Credit ($)09-01-2024Accounts Payable15,00009-01-2024To Bank15,000 Explanation: Accounts Payable will debited to reduce the liability. Bank will credited to reflect the outflow of bank. When inventory is sold, the cost of the inventory sold is recognized as an expense. Example 3: A company sells inventory that cost $10,000 for $20,000. Journal Entry for COGS: DateAccount TitleDebit ($)Credit ($)10-01-2024Cost of Goods Sold (COGS)10,00010-01-2024To Inventory/Purchase10,000 Journal Entry for Sales: DateAccount TitleDebit ($)Credit ($)10-01-2024Accounts Receivable20,00010-01-2024To Sales Revenue20,000 Explanation: Cost of Goods Sold (COGS) will debited to reflect the expense associated with the sale of inventory. Inventory/Purchase will credited to reduce the asset. Accounts Receivable will debited to reflect the amount due from the customer. Sales Revenue will credited to recognize the revenue from the sale. When the value of inventory decreases, such as due to obsolescence, an inventory write-down is recorded. Example 4: The company writes down $2,000 worth of obsolete inventory. Journal Entry: DateAccount TitleDebit ($)Credit ($)11-01-2024Inventory Write-Down2,00011-01-2024To Inventory2,000 Explanation: Inventory Write-Down will debited to reflect the expense of reducing the inventory value. Inventory will credited to reduce the carrying value of the inventory. Inventory shrinkage refers to the loss of inventory due to theft, damage, or errors. It is recorded as an expense. Example 5: The company identifies $500 worth of inventory shrinkage during a physical count. Journal Entry: DateAccount TitleDebit ($)Credit ($)12-01-2024Inventory Shrinkage50012-01-2024To Inventory500 Explanation: Inventory Shrinkage will debited to recognize the loss. Inventory will credited to reduce the inventory balance. If inventory purchased is returned to the supplier, the inventory account and corresponding accounts payable (or cash if it was paid) are adjusted. Example 6: The company returns $1,000 worth of inventory to the supplier. Journal Entry: DateAccount TitleDebit ($)Credit ($)12-15-2024Accounts Payable1,00012-15-2024To Inventory/Purchase Return1,000 Explanation: Accounts Payable will debited to reduce the liability owed to the supplier. Inventory/Purchase Return will credited to reflect the reduction in inventory. These entries are essential for accurate financial reporting and ensuring that the cost of inventory and related transactions is properly accounted for in the financial statements. The general ledger account Purchases is used to record the purchases of inventory items under the periodic inventory system. Under the periodic system the account Inventory will have no entries until it is adjusted at the end of the accounting year so that it reports the cost of the ending inventory. Under the periodic system, the cost in the account Purchases will be added to the cost of the beginning inventory to arrive at the cost of goods available. The cost of the ending inventory is computed through a physical count (or an estimate) and is subtracted from the cost of goods available to arrive at the cost of goods sold. Inventory Account Under the Perpetual Inventory System The account Purchases is nonexistent with the perpetual inventory system. Under the perpetual inventory system, the cost of inventory items purchased are recorded directly into the account Inventory. Under the perpetual system, the costs of the goods sold are removed from the account Inventory when the goods are sold and are recorded in the account Cost of Goods Sold. As a result, the balance in the account Inventory should be the cost of the ending inventory. 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Hence, unlike in the perpetual system, the company cannot check how much balances the inventory has immediately after adding the $5,000 of purchase on October 12, 2020.It is useful to note that the purchase account is for inventory only. So, any purchase of equipment or office supplies should never be posted into the purchase account. Otherwise, there will be a misstatement in the calculation of the cost of goods sold at the end of the period. Inventory management is one of the important areas to run and manage your business effectively. Knowing how much inventory you have at your business premises and what level should be maintained mitigates the risk of an out-of-stock situation. So, there is a need to account for inventories properly via recording journal entries of purchasing, processing, and selling.Learning about different accounting entries is necessary to balance the financial figures to keep track of business inventories. To record journal entries for inventories, you must have a basic understanding of the double-entry methods. In this article, we shall explain how to record journal entries for inventories under different scenarios.Inventory transactions are journalized to keep track of inventory movements. Various kinds of journal entries are made to record the inventory transactions based on the type of circumstance. For example, entries are made to record purchases, sales, and spoilage/obsolescence, etc.Further, two inventory accounting systems record the journal entries for inventories, i.e., periodic and perpetual. The periodic inventory system is better for those businesses that maintain less inventory. On the other hand, a perpetual inventory system is a much-detailed way of recording the transaction and is suitable for higher inventory levels businesses.The inventory cycle is comprised of three following stages.Ordering stage of inventoryThe production stage of inventoryTransfer to finished goodsIn the first stage, inventory is ordered to meet the demand of business operations. The inventory purchased is then processed (known as Work in progress) to produce finished goods. The last stage involves the packaging and delivery of finished goods to customers. The inventory cycle is usually calculated by estimating the number of days.For instance, it may take a week to order the goods, 3 days may be used to process raw material, and two days may be required to pack finished goods and deliver to customers. The combined figure of these days constitutes an inventory cycle.See also Discount Allowed Journal Entry with ExampleWe shall debit the raw material and credit either cash or accounts payable to record the inventory purchases. If we have paid our suppliers in cash, the cash account is credited to show that cash has been used to finance raw material inventory.ParticularsDebitCreditRaw Material InventoryXXX Cash XXXNow, if you haven't paid your suppliers immediately and agreed to terms that payment will be made after a few days, we shall credit Accounts payable instead of cash.Further, the following entry will be passed if your business deals in merchandise to buy finished goods and resell them to the customer by adding profit margin.ParticularsDebitCreditInventory Account (Finished goods)XXX Cash/Accounts Payable XXXIt depends on the nature of the business whether to record inventory as raw material or merchandise inventory. However, if the business model is processing and sale, the material purchase is recorded. On the other hand, finished goods are purchased and recorded if the business model is based on trading (buy and sales).The conversion of raw inventory into finished goods may result in incurring production-related expenses. For example, rent, utility, and supplies are necessary for the manufacturing process, and these expenses are charged as production overheads that are ultimately allocated to inventory. The entry for the recording of indirect production costs is as follows:Particulars DebitCredit Production overheadsXXX Cash\Accounts payable XXXThere are some other expenses such as salaries of staff managing the materials. These costs are also allocated to overheads and become part of inventory ultimately by charging those overheads to work in the process. The journal entry to record these costs is as follows:ParticularsDebitCreditProduction OverheadsXXX Wages XXXThe raw materials purchased are used in the production process. This phenomenon is shown in journal entries by debiting Work in process and crediting raw material. The following journal entry is passed.ParticularsDebitCreditWork in progressXXX Raw materials XXXThe production process may sometimes result in spoilage or obsolete inventory. So, it's important to know how to record such obsolescence. To record this spoilage, the overhead account is debited by crediting it against Work in progress. The entry is:ParticularsDebitCreditOverhead AccountXXX Work in progress XXXOnce the production is completed, the completed units are transferred out to finished goods. The entry is passed by debiting finished goods inventory and crediting the Work in the process account.ParticularsDebitCreditFinished Goods Inventory AccountXXX Work in process Account XXXThe finished goods can be sold to the market after packaging. A cost of goods sold account is created upon its sale that tells us what the cost of goods sold was. The entry to record this cost of goods sold is as:ParticularsDebitCreditCosts of goods soldXXX Finished goods inventory XXXA separate entry for sale is also made by crediting sales and debiting accounts receivables.ParticularsDebitCreditAccounts receivableXXX Sale XXXNow you know how to record a journal entry for inventory purchased and how the inventory processing is recorded. At every stage to keep an up-to-date record for your business.Different accounting entries are made to show the inventory figures for different types of business (merchandise business journal entries for inventory are different from other business types).Suppose a company HLK .ltd has purchased merchandise inventory costing $50,000 on credit on 1st January 2021. HLK. ltd has agreed to pay the suppliers after three weeks, i.e., on 21st January 2021.Here are the journal entries for this transaction:1st January 2021(Purchase of inventory on credit)ParticularsDebitCreditMerchandise inventory50,000 Accounts Payable 50,000(Payment to the supplier)21st January 2021ParticularsDebitCreditAccounts Payables50,000 Cash 50,000Inventory management is one of the essential aspects of business management. It's the fact that a large amount of the working capital is allocated for the inventory. So, it means that holding inventory for the business costs money. Hence, business needs to minimize the cost of holding inventory without going out of stock.Further, the inventory cycle of the business contains three stages that include ordering, production, and finalization of the finished goods. In general, a lower period of inventory is more desirable from a profitability perspective. However, the operational perspective supports the availability of stock in significant quantity. Hence, the business needs to balance between operational and profitability perspectives.In addition to this, there can be different journal entries for recording inventory. For instance, if inventory is purchased, there can be different entries depending on the business model. Like if inventory is purchased for further processing, it's debited in the raw mater account and transferred to the working in process account. And once production is completed, it's transferred to the finished goods account.On the other hand, the purchase of trading goods is directly posted in the chart of account for finished goods.What is double entry for the purchase of finished goods and impact the accounting record?Following double entry is posted for the purchase of finished goods.ParticularsDebitCreditFinished goodsXXX Accounts payable/cash XXXThe debit impact of the transaction is a recording of the finished goods in the accounting record, and it remains in the books until sold to the customers. On the other hand, the credit impact of the transaction is a recording of liability or outflow of the cash from the business.Cost of inventory includes the following,Ordering cost – the cost of placing an order to purchase inventory.Holding cost – the cost of holding inventory like the cost of warehousing.Stock out cost – the cost of not being able to meet the customer's order.What is the audit risk associated with inventory?Overstatement of inventory is the prime audit risk associated with the inventory. It means the inventory balance may be overstated in the business leading to overstated assets and overstated profitability. The purchases account is a general ledger account in which is recorded the inventory purchases of a business. This account is used to calculate the amount of inventory available for sale in a periodic inventory system. Under the periodic system, the amount of purchased inventory is compiled throughout a period and added to the beginning inventory to arrive at the amount of inventory available for sale. A physical count at the end of the period establishes the ending inventory valuation, which is subtracted from the amount of inventory available for sale to arrive at the cost of goods sold for the period. Thus, the calculation in which the contents of the purchases account is used is:(Beginning inventory + Purchases - Ending inventory) = Cost of goods soldWhen to Use the Purchases AccountThe purchases account is not used in a perpetual inventory system, where inventory purchase and usage transactions immediately update the inventory records, with the intent of maintaining accurate record balances at all times (not just at the end of the reporting period). Thus, if you were using a periodic inventory system in the preceding reporting period, you would stop using it when the business switches over to the perpetual system.Example of the Purchases AccountAs an example of how the purchases account is used in the periodic inventory system, ABC International has a beginning inventory balance of $800,000 and purchases $2,200,000 of inventory during the month. It conducts a physical inventory count at month-end to arrive at an ending inventory balance of $1,100,000. Therefore, the cost of goods sold of ABC for the month is $1,900,000, which is calculated as:($800,000 Beginning inventory + $2,200,000 Purchases - $1,100,000 Ending inventory)The amounts recorded in the purchases account may be for raw materials that will require subsequent conversion to be made ready for sale, or they may be for completed merchandise.Related AccountingTools CoursesAccounting for InventoryHow to Audit Inventory Inventory is usually a big asset for the company, especially the merchandising company, as buying and selling the inventory is usually its main activity in the operation. Hence, it is important to properly account for inventory purchases in making journal entries into the accounting record. A mistake of recognition of inventory purchase may lead to a big misstatement on both the balance sheet and income statement.There are two methods or systems to account for inventory including the perpetual system and periodic system. 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This is one of the big advantages of the perpetual inventory system.Also, the purchase transaction does not involve income statement items. Although there is an increase in accounts payable or cash out here, the cost has not occurred yet. The cost usually only occurs when the company makes the sales of inventory.Periodic inventory systemUnder the periodic system, the company can make the journal entry of inventory purchase by debiting the purchase account and crediting accounts payable or cash account.AccountDebitCreditPurchase000Accounts payable/cash000The purchase account is a temporary account, in which its normal balance is on the debit side. It will be used for the calculation of cost of goods at the end of the period. And after closing entries, the purchase account will have zero balance.Likewise, there is no inventory account involved when the company purchases the inventory in. The inventory account only appears when the company closes the entries, (e.g. the beginning inventory is credited to close old balances and the new inventory after the physical count is debited to record the ending inventory).ExampleFor example, on October 12, 2020, the company ABC Ltd. receives the inventory it purchases on credit from one of its suppliers. The inventory purchases amount to $5,000 and the company ABC Ltd. uses the perpetual inventory system. What is the journal entry for the purchase transaction?If the company ABC Ltd. uses the periodic inventory system instead, what is the journal entry for the inventory purchase?Solution:Perpetual inventory systemUnder the perpetual system, ABC Ltd. can make the journal entry for inventory purchase on October 12, 2020, as below:AccountDebitCreditInventory5,000Accounts payable5,000In this case, the $5,000 will directly add to the balances in the inventory account. Likewise, on October 12, 2020, the company can check how much balances the inventory has after adding $5,000 of purchase.The company can also review and verify the inventory on October 12, 2020, by comparing the inventory in the account record with the physical inventory count. This is a big advantage of the perpetual inventory system as the company can investigate immediately if there is any variance between the physical count and the account record.Periodic inventory systemIf ABC Ltd. uses the periodic inventory system instead, it could make the journal entry for inventory purchase on October 12, 2020, as below:AccountDebitCreditPurchase5,000Accounts payable5,000In this journal entry, the purchase of $5,000 does not add to the inventory balance but it will be used in the cost of goods sold calculation. The inventory balances will be based only on the physical count of inventory at the end of the period. Hence, unlike in the perpetual system, the company cannot check how much balances the inventory has immediately after adding the $5,000 of purchase on October 12, 2020.It is useful to note that the purchase account is for inventory only. So, any purchase of equipment or office supplies should never be posted into the purchase account. Otherwise, there will be a misstatement in the calculation of the cost of goods sold at the end of the period.

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