



The Interplay of Entrepreneurial Innovation, Government Regulation and Performance: any Lessons for The SMEs. A Theoretical Review

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Abstract

Entrepreneurial innovation is acknowledged as a key driver for improving the productivity of small and medium-sized enterprises. The effect of innovation on performance has been extensively researched, but many have overlooked small and medium-sized enterprises and government regulations. This paper provides a study of the current theoretical and empirical literature on entrepreneurial innovation constructs, government regulations and small and medium enterprise performance. The study's specific objectives have been to discuss the main concepts of entrepreneurial innovation, government regulation and performance related to small and medium-size firms. It also aims to establish theories that link entrepreneurial innovation and government regulations; to recommend a conceptual and methodological framework to guide future studies on the identified knowledge gaps. The study was anchored by a resource based view theory supported by dynamic capability theory, Schumpeter's innovation theory. The study was a review of previous research on entrepreneurial innovation and firm performance. These studies seem to have centered on a direct link between innovation and performance, according to the results. Thus, it is

recommended that further research incorporate the small and medium enterprise context to highlight how entrepreneurial innovation affects these enterprises and the moderating variable of government regulations.

Keywords: Entrepreneurial Innovation, Dynamic capability, Government Regulation, Small and Medium Enterprises, Performance, Resource Based View

1. Introduction

Small and medium enterprises are major actors in the economic performance and growth of economies (UNCTAD, 2002), such as in Bangladesh, Kenya, and Burundi, among others, and are therefore considered to be at the core of innovation activities. Despite their contribution, they have faced challenges such as rapid global competition (Mensah & Acquah, 2015). Unfavorable government regulations that prevail, limited access to sources of financing, rapid technological development, among others. Such challenges all limit their performance.

Various studies have revealed that one of the main ways to combat these challenges is through innovation, which is strongly linked to entrepreneurship and the performance of small and medium enterprises. Kiraka, Kobia and Katwalo (2013) and Maldonado-Guzman and Valdez-Gonzalez (2020) have agreed that entrepreneurial innovation enables the creation of new resources, products, processes, supply of raw materials, new markets, among others, and that these elements are essential to improve the performance of small and medium enterprises. Rosil and Sidek (2013) established that for a company to be successful, it must innovate products and processes. Kiveu, Namusonge and Muathe (2019) found that the ability of small and medium enterprises to innovate for change and meet the market demands of their customers is considered a good competitive advantage.

Worldwide, it is estimated that small and medium enterprises account for more than 95% and provide more than 60% of private sector employment opportunities. In developed economies, this sector contributes about 64% of GDP and 62% of employment (Muathe & Muraguri-Makau, 2020) but they are rarely innovative and yet they are better placed to innovate because of their structure compared to large firms (Kiss, 2011).

In Burundi, researchers show that small and medium enterprises face many challenges such as saturated and overcrowded markets and strict legal regulations: competition from large firms, limited access to finance, and technological backwardness, among others, have prevented them from realizing their full potential, thus hindering their contribution to Burundi's socio-economic development (Bizimungu, 2016).

As the reviewed literature shows the importance of innovation to businesses, most of the studies concentrated on innovation and performance and overlooked entrepreneurial innovation, government regulations and performance of SMEs. This study will discuss the main concepts of entrepreneurial innovation, government regulation and performance related to small and medium-size firms; to establish theories that link entrepreneurial innovation, government regulation and performance related to small and medium-size firms; to recommend a conceptual framework to guide future studies on the identified knowledge gaps; and to recommend a methodological framework for future studies.

1.1 Statement of the problem

Muathe (2010) and Muathe, Wawire and Ofafa (2013) posit that Small and Medium Enterprises play a very important role in the economy in terms of wealth creation and provision of employment opportunities. For example, in Burundi, SMEs are to contribute 70-80% of the GDP for the period of 2014-2020. Despite the expected contribution of SMEs to GDP, their performance has not realized its full potential, thus hindering contribution to socio-economic development of most African countries (Martine, 2020). These enterprises have been experiencing a lot of challenges, such as: the competition from established large companies and multinationals, restricted financial resources, lagging technology, saturated markets, and stringent legal regulations, among others (Bizimungu, 2016).

One of the key ways to combat these challenges is through innovation and it is highly linked to entrepreneurship and performance of SMEs. SMEs should implement innovative activities in their businesses. According to Nazlina, Nor, and Rushami (2016), in order to achieve performance within an organization, organizational innovation must be implemented. Kiveu, Namusonge and Muathe (2019) noted that for manufacturing firms in Kenya to be competitive, they have to come up with process, marketing and organizational innovation.

Another study by Rosil and Sidek (2013) established that for a firm to perform, it has to innovate products and processes. And Maldonado-Guzman and Valdez-Gonzalez (2020) found that key ways for firms to be competitive is to come up with marketing, process, and product and management innovation.

The reviewed literature shows the importance of innovation to businesses, but most of the studies concentrated on innovation and performance of SMEs and overlooked entrepreneurial innovation, government regulations and performance of SMEs. It is therefore important to do more research to illustrate the link between entrepreneurial innovation

and the performance of SMEs to bridge the gap by including government regulations as a moderator.

1.2 Objectives of the study

- i. To discuss the key constructs of entrepreneurial innovation, government regulations and performance of SMEs
- ii. To establish theories that link entrepreneurial innovation, government regulations and performance of SMEs.
- iii. To recommend a conceptual framework that guides future studies on the highlighted knowledge gaps.
- iv. To recommend a methodological framework for future study.

2. Literature review

2.1 Theoretical review

The study is anchored on three theories: Resource Based View (RBV), Dynamic capability theory, and Schumpeter's Theory of Innovation. The theories bring out the effect of entrepreneurial innovation and government regulations on the performance of small and medium enterprises.

2.1.1 Resource Based View

This theory came out by Edith Penrose (1959) and proposes that resources and capabilities are fundamental within a firm. Capabilities are skills used by a firm in organizing and placing resources into productive use. For example, the firm's structure, operations, which show how decisions are carried out. In the RBV theory, for the growth or the performance of any firm, resources have to be guided so that they can be altered into the strengths or weaknesses of a firm. The theory is mainly based on four assumptions and these include heterogeneous, immobile, inimitable and non-substitutable. Heterogeneous is concerned with how different organizations have different skills, capabilities and other resources.

According to Barney (1991), there are various types of resources, such as organizational capital, intellectual capital, financial capital, physical capital, technological capital, and human capital that enable firms to create unique values for their customers. Jones and Hill (2009) suggested that resources are either tangible or intangible and tangible resources can be touched, for example, land, raw materials among others and they are the source of origin of intangible resources.

If a firm has specific and valuable resources, but with no needed capabilities to utilize these resources effectively, then performance may not be realized by the firm (Jones & Hill, 2009). Rumelt (1987) noted that RBV

is an outstanding theory in innovation and competition because it improves performance. Entrepreneurial innovation is a capability that enables firms to create as well as combine resources to bring on board new heterogeneous resources. Product quality can evolve with innovation, which then leads to performance and competitive advantage for companies. Entrepreneurial innovation takes different forms. For example, process, product, organizational and market innovation among others, and these forms can enable a firm to outplay its rivals when properly used.

Innovation offers means to higher performance of the firm through producing outputs which have Valuable, Rare, Inimitable and Non-substitutable (VRIN) characteristics (OECD, 2009). Financial resources are critical to a firm because they support innovation activities such as research and development and human capital, which are major determinants of the firm's performance and competition. Knowledge based resources are also important in the firm because they aid in coming up with ideas and utilizing chances for innovation. Therefore, knowledge is important when it comes to manipulating, changing and developing other resources for competitiveness (Lee & Sukuco, 2007). In this study, the RBV will be used in anchoring product innovation, process innovation, organizational innovation and market innovation as there are firm resources and capabilities which affect the performance of enterprises.

2.1.2 Dynamic Capability Theory

Teece, Pisano and Shuen, (1997) initiated the theory and observed the way firms achieve sustained competitiveness or higher performance in the changing and volatile environment and this theory emerged due to the limitations of the resource based theory. This theory takes up entrepreneurship, innovation, organizational learning, knowledge and change management (Teece, 2010). Dynamic capabilities simply refer to capabilities of the firm which enable it to come up with innovative products and processes that meet changing market conditions (Teece & Pisano, 1997). There are various examples of dynamic capabilities that can be used to promote value within a firm. There are: skills, procedures, organizational structures.

These capabilities can come from the changing routines, product developments which aid the firm to position its resources and competences in the dynamic business environment (Teece, 2007). Within a rapid changing environment when a firm needs to perform and sustain, the dynamic capabilities help the firm to use its resources efficiently and innovation is among those critical capabilities (Teece, 2009; Albaladejo & Romjin, 2000; Teece, 2007; Teece, 2009, Muitya & Muathe, 2020).

Innovation capability enables firms to employ the available resources in order to bring new resources, products, processes and systems in the changing environment so as to secure a competitive advantage (Teece & Pisano, 1997). Innovative capacity can be fostered by training, mentoring, research and development, and processes, among others. Dynamic capabilities also show the capacity of the firm in solving market issues to obtain a new and innovative way to gain competitive advantage (Teece, 2007). The theory puts more emphasis on the capacity of a firm to merge as well as and rearrange resources to fit the market changes and also establish new markets through innovation (Teece & Pisano, 1997; Eisenhardt & Martin, 2000).

As innovation is critical for achieving performance or competitive advantage in a dynamic, volatile environment, the theory shows how firms that work in dynamic environments should increase the chances for survival as well as growth. They must enhance their dynamic capabilities (Teece & Pisano, 1997). The DCs theory is useful for this study because it supports the RBV theory and goes beyond the idea of sustainable competitive advantage, which is all about VRIN resources that businesses must acquire. It also gives a broad view of how SMEs can create value in the changing environment to enhance their survival and growth.

2.1.3 Schumpeter's Theory of Innovation

Schumpeter's theory of innovation was originated and promoted by Joseph Schumpeter (1911) and explains the importance of Entrepreneurship and Innovation in economic growth. This theory suggests variations in the markets as well as economies are continuous or ongoing processes. In a changing economy, there exists a force which is behind that change as well as growth and that's an entrepreneur. According to Joseph Schumpeter, an entrepreneur is both an agent of innovation and a pivot of change (Schumpeter, 1934). The role of entrepreneurs is to develop new combinations of production factors, thus enabling discontinuity and transformation and this is the basis of economic development. Entrepreneurship is about innovation.

Schumpeter established different innovation aspects which promote economic development and these include; "establishing new or changing existing products; the use of new production methods, the development of different market approaches and the setting up of a different industrial design" (Schumpeter, 1934). One of the approaches for businesses that can result in a change in the economy is innovation, as he called creative destruction. Schumpeter also suggested that innovation helps in the development of economies and the process of innovation is done by the entrepreneur

(innovator). The role of the entrepreneur is placing the available resources into new applications and creating new combinations.

Schumpeter suggested that entrepreneurship is a key factor in production since it supports and brings economic change and entrepreneurs change the techniques of production through utilizing new sources of raw material or reorganizing an industry (Schumpeter, 1939). Creative destruction establishes wealth by destructing existing firms through bringing new products or services and shifting resources from existing to new companies, thus allowing new companies to grow (Schumpeter, 1942, Muathe, 2010). Therefore, innovation is a unique instrument entrepreneurs utilize in order to bring up opportunities for different products or services. The theory explains the importance of innovation and the main importance is of establishing new products which gives entrepreneurs a good competitive edge compared to their rivals.

Schumpeter (1942) demonstrated that the reason for improved performance in terms of profits and investments is innovation, and the theory backs this up by demonstrating that business profits can be obtained through entrepreneurial innovation. That's why innovation is a vital factor for growing the economy and the gain of a competitive advantage for businesses.

In this study, the theory indicates the effect of entrepreneurial innovation on improving firm performance and economic development. In order to achieve economic development, more innovation by entrepreneurs should take place so as to enable creative destruction that creates value. This theory anchors the independent variable of entrepreneurial innovation and the dependent variable of performance and supports the two main theories. Entrepreneurial innovation leads to the performance and sustainability of economic growth. The theory also establishes the various types of innovation which can be utilized to create value (Schumpeter, 1934).

2.2 Conceptual Review

This study is anchored on different constructs like performance, entrepreneurial innovation, government regulations and small and medium enterprises. Therefore, this section is detailed with a review of the conceptual literature which provides an accurate explanation of each the construct.

2.2.1 Performance

Entrepreneurs within the SME sector open up businesses when they have goals or objectives that they want to achieve at a given time interval (Waheed, Abbas, & Malik, 2018). And so, performance is vital since it shows them their positions in a given time frame (Yusuf, Gunasegaram & Dan 2007). There are two different measures of performance, for example,

financial or non-financial measures that entrepreneurs can use to measure and find out the position of entrepreneurial ventures (Tudose, 2012). For instance, the financial measures are profits, return on capital employed, return on investment and return on sales among others (Smith, Bracker, & Miner 1987; Duchesneau & Gartner 1990) and non-financial measures are number of employees, market share, employee satisfaction, customer satisfaction among others.

SMEs usually measure their performance using financial measures, yet this has some short comings. To solve the problems related to the use of measures Chong (2008) argues that SMEs should adjust to the application of both measures, financial and non-financial. Furthermore, in their adaptation to this hybrid approach, entrepreneurs should also use a time-axis approach in measuring performance. This is because time-axis brings out the time period, whether short or long term period.

Birley and Westhead (1990) noted that short-term and long term measures indicate different aspects. For example, short-term measures are majorly financial and they are good at examining or evaluating enterprises that last for twelve months. Long term measures are mainly non-financial and are good at measuring or evaluating enterprises that will last for more than twelve months. Even though long term non-financial measures like number of employees, market share clearly predict the long term while bringing the existence and survival of the firm, short-term financial measures like profitability, on the other hand, show the current firm performance (Barney 1997; Haber & Reichel 2005).

According to Brush and Vanderwerf (1992), financial measures have a number of advantages, including the fact that they are objective, easy to understand, and simple to compute. However, they have some drawbacks, including the fact that they are historical, inaccessible, inaccurate, and profits can be easily manipulated as well as misinterpreted. On that financial measures should be employed by SMEs to supplement the financial measures because combining the two enables entrepreneurs to have a good view of their business performance both in short and long term aspects (Covin & Slevin 1989; Kunkel & Hofer 1993).

2.2.2 Entrepreneurial Innovation

Sheu (2007) and Kiraka, Kobia and Katwalo (2013) agreed that entrepreneurial innovation enables creation of new resources, products, processes, supply of raw materials, new markets among others and these enhance the performance of the firm. Entrepreneurial innovation is widely recognized as a critical driver of improving the productivity, the performance and the survival of businesses in a globalized and changing climate. Porter (1996) remarked that for an enterprise to be competitive with other

enterprises, it has to produce specific and sustainable factors that are different and innovation is a pathway by which enterprises can create these different factors. Entrepreneurial innovation takes different forms, for example, product, process, organization, market, market innovation among others.

Schumpeter (1934) explained that product innovation involves bringing new goods that are unfamiliar with consumers and have better quality. Forker et al. (1996), Camison and Lopez (2010) and Garvin (1987) observed entrepreneurial innovation is key when improving the performance of firms. And according to Hult, Hurley and Knight (2004), product innovation protects the firm from competition and market threats and it also has a good positive relationship with organizational performance.

Generally, process innovation involves a process of improving the internal functioning of the firm and it takes various forms, such as the development or creation of techniques and systems. Like technology innovation, expertise, methods, equipment and techniques that are used in the transformation process or in the process of producing a product (Gopalakrishnan & Damanpour, 1997; Wan, Ong, & Lee 2005; Oke, Burke & Myers, 2007).

OECD (2005) found that organizational innovation implies employing new organizational methods in the daily business operations of a firm that can enhance their performance. Such methods are the introduction of methods of organizing work and practices, new ways of assigning tasks, new management design, and the development of new methods of building relationships with other firms.

Johne (1999) observed that market innovation is the improvement or creation of a marketing approach. A firm needs to carry out market innovation on a daily basis because it is through this direction that a firm can reach its potential customers. For example, the use of the internet enables firms to reach customers globally at a low cost and greater speed. Rodriguez-Cano (2004) and Appiah-Adu and Satyendra (1998) noted that for firms to fulfil the needs of the market, they have to come up with market innovation.

2.2.3 Government Regulation

The government develops different regulations by which it controls the activities of firms (King & Levine, 1993). According to Quartey (2001), regulations pertaining to SMEs take various forms, such as regulations on the formation of firms, labor regulations practices, taxation, and foreign trade. James and Diana (2017) have found that harsh regulations in many countries deter entrepreneurship and innovation of firms. Government policies and regulations are viable, particularly with regard to the fostering of

entrepreneurship, and also determine the success of businesses on a national scale (Obaji & Olugu, 2014).

Towards this, many governments, as arbiters on the margins of the market, have proposed legislative initiatives and policies to facilitate the SME sector, but within the limits of tight national budgets and other considerations (Okeke & Eme, 2014). France and Russia established a political structure that has led them to entrepreneurial growth (Ricketts, 2006). In the Doing Business Report (2020), they ranked the countries out of the 190 economies surveyed in terms of favorable regulations for starting a business, obtaining credit, trading across borders, ease of doing business, paying taxes, and so on. They showed how New Zealand is the best regulated country and that there is still work to be done in improving the business environment.

As countries with lower levels of regulation for accessing licenses develop at a higher rate and thus benefit from increased production compared to those with higher levels of regulation (Djankov 2002). Most studies have shown that the business climate strongly impacts SME performance like Lumpkin and Dess (1996) and Dethier and Effenberg (2012) have identified regulations as the major hindrance to the performance of firms but that SMEs are the most affected. Bouazza *et al.* (2015) assert that SMEs in Algeria don't perform due to different external factors such as inaccessibility to finance, inequality of the tax system, harsh laws, policies, and regulations among others.

Due to different government regulatory requirements, such as the expense and the time for getting a license and permit, Algerian SMEs have been facing various challenges when establishing administrative and operational procedures. Those challenges limit SMEs in Algeria from performing and expanding their business. Most SMEs don't register due to the fear of being visible. Being visible to the government means that the cost of operation increases. Most of the government restrictions and regulations affect more SMEs than large enterprises due to financial weakness that most of them experience (Bouazza *et al.*, 2015).

2.2.4 Small and Medium Enterprises

The significance of SMEs towards the economy has been noted by different studies like the study of Shahjahan (2017). He asserts that enterprises that have less than 20 employees have increased job creation in the USA within the period of 1969 and Muathe, Wawire and Ofafa (2013) noted that the critical drivers for most of the economies are SMEs and entrepreneurial enterprises. SMEs are major players in the competition and growth of economies (UNCTAD, 2002), therefore they are considered as the core of innovation activities.

Worldwide, SMEs are estimated to be more than 95% and offer over 60% of employment opportunities in the private sector. In developed economies, this sector accounts for approximately 64% of GDP and 62% of employment (Muathe & Muraguri-Makau, 2020), whereas in Bangladesh, it provided 1.5 million jobs from 2009 to June 2014 (Rahman, 2015). In Eastern countries like Kenya, 80% of companies are SMEs and contribute approximately 40% of GDP (KNBS, 2016).

Despite the expected contribution of SMEs to GDP, their performance has not realized full potential, thus, hindering contribution to socio-economic development (Martine, 2020). These enterprises have been experiencing a lot of challenges, such as: the competition from established large companies and multinationals, restricted financial resources, lagging technology, saturated markets, and stringent legal regulations, among others (Bizimungu, 2016). Those challenges come with a changing environment in terms of consumer needs, technological change, and high standards requirements, among others (Kiraka, 2009; KAM, 2012).

2.2.5 Entrepreneurial Innovation and Performance

Entrepreneurial Innovation is widely accepted as one of the key ways to combat challenges and as a major factor in promoting firm performance as well as survival and growth (Kasevu, 2017). It is highly linked to entrepreneurship and the performance of SMEs. SMEs should implement innovative activities in their businesses. The capability of SMEs to innovate for change and satisfy the demands of their customers' markets is considered as a good competitive advantage (Kiveu, Namusonge and Muathe, 2019).

Due to that, entrepreneurial innovation is perceived as a source of strategic change where firms can achieve greater performance. It is therefore recommended that for SMEs to improve, they need to carry out innovation by adopting an appropriate process and that results in a competitive advantage (Gunday, *et al.*, 2008). Mensah and Acquah (2015) point out that the performance of enterprises gets higher as innovation increases. The importance of innovation SME is shown by the way it offers opportunities to alleviate external threats (Murphy & Ledwith, 2007) and it is easy to carry out because SMEs have a horizontal management structure with few levels of management and bureaucracy compared to larger enterprises (Kiraka, Kobia & Katwalo, 2013).

According to Nazlina, Nor, and Rushami (2016), in order to achieve performance within an organization, organizational innovation must be implemented. Kiveu, Namusonge, and Muathe (2019) discovered that in order for manufacturing firms in Kenya to be competitive, they must implement process, marketing, and organizational innovation; however, the study discovered that product innovation was not significant. Rosil and Sidek

(2013) established that for a firm to perform, it has to innovate product and process and Maldonado-Guzman and Valdez-Gonzalez (2020) found that key ways for firms to be competitive is to come up with marketing, process, product and management innovation.

2.2.6 Entrepreneurial Innovation, Government Regulation and Performance

Government regulations are reshaping the business climate by affecting profits, production costs and risks of various value chains in different countries (Dethier & Effenberg, 2012). In the Doing Business Report (2020), they ranked the countries out of the 190 economies surveyed in terms of favorable regulations for starting a business, obtaining credit, trading across borders, ease of doing business, paying taxes, and so on. They showed how New Zealand is the best regulated country and that there is still work to be done in improving the business environment.

Lumpkin and Dess (1996) demonstrated that the business climate is heavily influenced by government regulations and policies. Countries with lower levels of regulation for accessing licenses develop at a higher rate and thus benefit from increased production compared to those with higher levels of regulation (Djankov 2002). Harsh regulations deter entrepreneurship and innovation of firms (James & Diana, 2017). SMEs in Algeria are limited from performing and expanding their business due to different government regulatory requirements, such as the expense and the time for getting a license and permit.

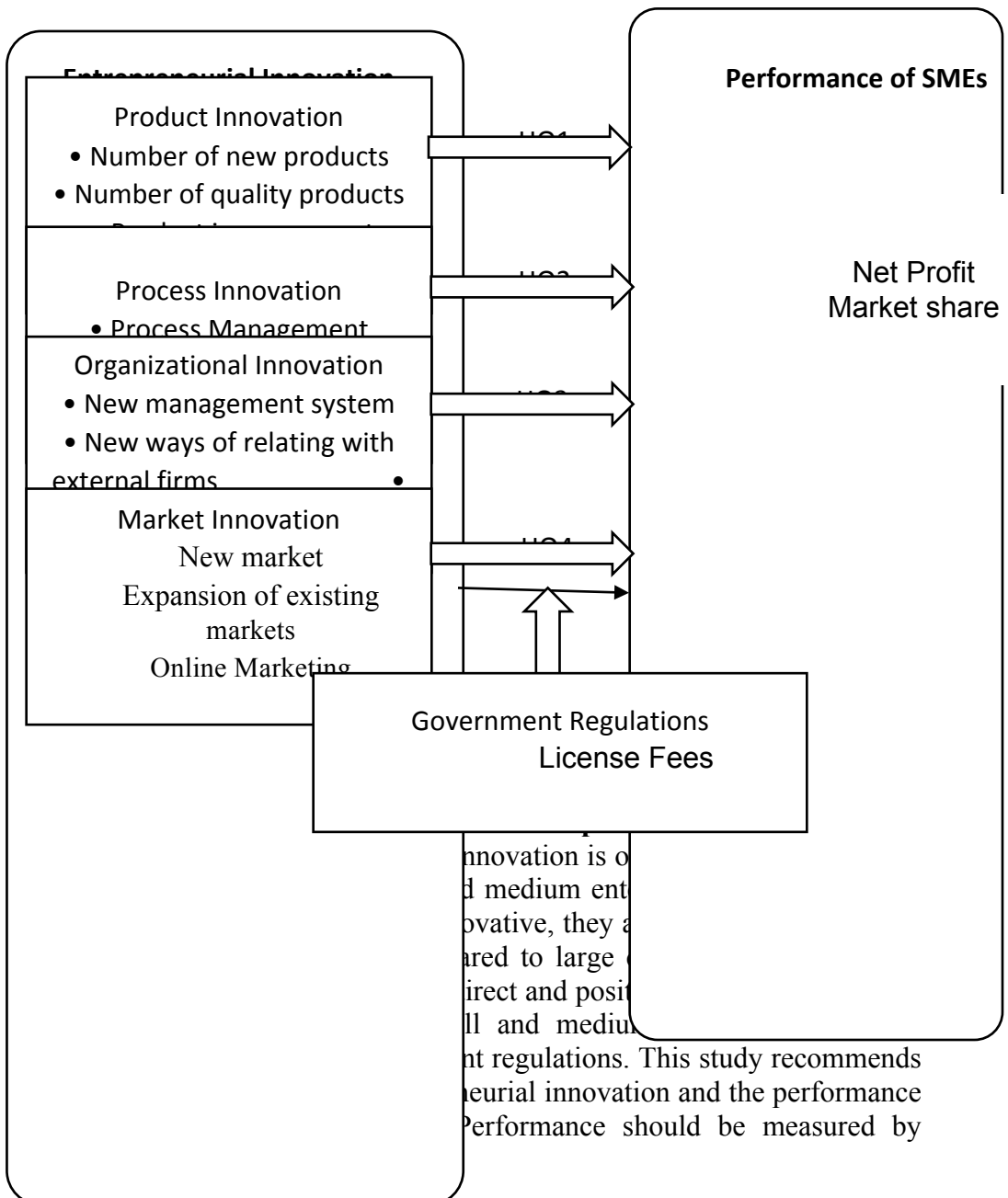
Government regulations and entrepreneurial innovation have an effect on the performance of firms. In the study of Jiang, Wang and Li (2018) conducted in China, they found that regional regulations that rely on the government have a positive impact on innovation as harsh local regulations restrict the production and R & D efficiency of enterprises. And Eniola and Entebang (2015) in the study done in Nigeria found that regulations limit SMEs from performing and that they impact their competitiveness. In addition, Mwasiaji (2019) carried out in Kenya and found that manufacturing enterprises face challenges brought about by harsh regulations and concluded that governmental policies are important in providing an environment that is conducive to business development. In this study, government regulations are introduced as a moderating variable between entrepreneurial innovation and performance. Future studies should be carried out to bring out this relationship more, especially in the context of small and medium enterprises.

The study further proposes a schematic structure that illustrates a correlation between entrepreneurial innovation, government regulations and

the performance of small and medium enterprises that are the constructs of the study.

Independent Variables
Variables

Dependent



employing both financial and non-financial measures and this is called a hybrid approach which overcomes the shortcomings of using one measure. The study should include government regulation as a moderating variable and the purpose of this moderating variable is to establish the strength of the correlation or association between entrepreneurial innovation and performance of small and medium enterprises. Most of the studies in the reviewed literature relied on one research design, either descriptive or explanatory, and these have limitations, for example, descriptive does not reveal the relationship between variables, while explanatory does not explain the behavior of variables in the study.

3.1 Propositions

The proposed conceptual framework represents the investigation of the relationship between the constructs of entrepreneurial innovation and the performance of small and medium-sized businesses, with government regulations acting as a moderating variable. Entrepreneurial innovation is an independent variable while performance is a dependent variable. The following hypotheses can be drawn from the conceptual framework:

H₀₁: Entrepreneurial innovation has no significant effect on the performance of Small and Medium Enterprises.

H₀₂: Government regulations have no significant moderating effect on the relationship between entrepreneurial innovation and the performance of Small and Medium Enterprises.

4. Conclusions and direction for future research

Secondary Data Review (SDR) was used in this study to review entrepreneurial innovation constructs, government regulations, and performance related to small and medium enterprises because it involves comparing different types of data, synthesis, and analysis based on different desk studies containing all important, valid, and accurate information found from various sources such as the government, non-government organizations, and academia.

Based on the results of earlier studies, the study noted that these studies have focused on a direct relationship between entrepreneurial innovation and performance and that there is an effect of entrepreneurial innovation on the performance of small and medium enterprises, which means that small and medium enterprises need to focus more on innovation in order to improve their performance and be competitive.

Consequently, future research should establish how entrepreneurial innovation can help small and medium enterprises strengthen their competitive advantage and thus their performance and additional research

can be carried out taking into account the primary data in order to build additional documentation on the secondary data already available.

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