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# The abolishment of the statutory audit requirement

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- Does it change credit assessment processes?

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*Thank you,*

Gothenburg, May 25<sup>th</sup> 2011

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## Abstract

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**Title:** The abolishment of the statutory audit requirement – Does it change credit assessment processes?

**Background:** In November 2010, the statutory audit requirement in Sweden was abolished for Swedish SMEs. The abolishment was the result of the objective of a 25% reduction of administrative costs, for companies within the European Union. Further on, Sweden is considered to have a bank-oriented system, which means that banks play an important role when it comes to financing SMEs. When assessing the creditworthiness of an SME, financial accounting information is an important source of information for the banks. This means that banks are concerned by the abolishment of the statutory audit requirement since one of their most important source of information no longer has to be reviewed by a third party.

**Aim:** The aim of this thesis is to investigate how the new legislation regarding the abolishment of the statutory audit requirement affects the credit assessment process of a Swedish bank located in a metropolitan area and a Swedish bank with a distinct local profile.

**Method:** Due to the complexity of the subject of this thesis, interviews have been performed in order to receive more deeply understanding for the subject and to find out the arguments behind the banks' opinions regarding the abolishment of the statutory audit requirement. Three personal interviews have been performed with a total number of four respondents. The empirical data was then analyzed based on the frame of reference to be able to answer the research questions.

**Conclusion:** The conclusion of this thesis is that the credit assessment process of the investigated banks is not greatly affected by the abolishment of the statutory audit requirement and that no major differences exist between the different bank types. Contrary to previous research, this thesis also concludes that no major differences can be found in the credit process of the two types of banks compared.

**Further research:** It would be interesting to further investigate how the abolishment of the statutory audit requirement has affected the credit assessments after a period of time. Will there be a different result after a couple of years when the banks have had the opportunity to fully adapt to the new legislation?

**Key words:** Abolishment, audit, bank, credit assessment process, credit granting, creditworthiness financial accounting information, the statutory audit requirement.



## Abbreviations & Definitions

Administrative costs	Relates to those costs that companies inflict due to legal liabilities to provide information according to their business, either to public authorities or to individual parties.
Adverse audit report	Refers to an audit report where the auditor have left comments.
Credit evaluator	Relates to the advisor who handles a credit application in the bank.
FAR	Relates to the professional institute for authorized public accountants, approved public accountants and other highly qualified professionals in the accountancy sector in Sweden.
Going concern	Refers to the condition which presumes that the company has the ability to continue its business on schedule.
Limited Company	Throughout the thesis <i>Limited Company</i> refers to the Swedish type of company, called "Aktiebolag".
Local bank	Refers to a bank which is located in the countryside, or in a small community of Sweden.
Metropolitan located bank	This is a bank located in a metropolitan area of Sweden.
SME	SME is an abbreviation of <i>small-and-medium-sized enterprises</i> and throughout this study SMEs are defined as those companies which do not exceed the limits in the new Swedish legislation regarding to the statutory audit requirement.
UC	Is the leading business and credit information agency in Sweden.



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## Chapter One - Introduction

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*In this chapter the authors present the background to why they have chosen the subject of this thesis. The reader is introduced to the subject and it is explained what has caused the research questions. Further, the authors also provide the reader with a better understanding of the scope of this thesis.*

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### 1.1 Background

#### 1.1.1 The statutory audit requirement

The Fourth Council Directive of the European Communities requires that companies must have their annual accounts audited by an authorized auditor. However, the same directive admits the Member States of the European Union (EU) to relieve the small and medium-sized enterprises (SMEs)<sup>1</sup> from this requirement according to certain conditions. These conditions are set as a maximum level, which means that the Member States themselves can choose their own level, as long as they do not exceed the maximum level. Most of the countries within the European Union have taken advantages from this exception.<sup>2</sup> Conversely to this, Swedish legislation<sup>2</sup> has since 1983 required auditing for all Swedish Limited Companies.<sup>3</sup> Hence, Sweden has been one of the very few countries within the EU which has not used the opportunity mentioned above. The Swedish legislation was however on November 1<sup>st</sup> 2010, subject of a reform that was prompted by several factors:

In January 2007 the European Commission presented a platform for a 25% reduction of the administrative costs<sup>4</sup> for companies within the European Union. This objective was set to be achieved by 2012. The Commission found that companies need to spend a lot of time and money providing information that is required by different legislations, instead of focusing on their main business activities.<sup>5</sup> According to this, the Swedish government decided to incorporate this objective in their budget for 2008. However, the government changed the time schedule and cut the time limit to 2010.<sup>6</sup>

The same year as the Swedish government included the objective of the Commission in their budget, a governmental investigation regarding the abolishment of the Swedish statutory audit requirement

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<sup>1</sup> See "Abbreviation & Definitions"

<sup>2</sup> Government Offices of Sweden, 2008

<sup>3</sup> See "Abbreviation & Definitions"

<sup>4</sup> See "Abbreviation & Definitions"

<sup>5</sup> Commission of the European Communities, 2007

<sup>6</sup> Government Offices of Sweden, 2007

for SMEs, was completed. The conclusion of this investigation was that the abolishment was a step in the right direction hence to the target of the European Commission. An abolishment of the statutory audit for SMEs would, according to the investigation save up to 5.8 billion SEK for the companies involved.<sup>7</sup> The investigation proposed three conditions, of which the companies had to meet at least two of them, to be able to reject auditing. These were the same conditions as in the Fourth Council Directive of the European Communities:<sup>8</sup>

- The total assets were not allowed to exceed 41.5 million SEK.
- The net sales were not allowed to exceed 83 million SEK.
- The company was not allowed to have more than 50 employees (on average).

At this point of time it meant that 96% of the Swedish companies had the opportunity to abolish the auditing process.<sup>9</sup>

This rather radical proposal created a discussion of large-scale among the Swedish organizations concerned. The main part of the consultive authorities agreed in that a modification to the existing legislation should be implemented. Hence, the *primary* discussion was about the range of the three different conditions mentioned above, rather than whether to abolish the statutory audit requirement or not.

The Confederation of Swedish Enterprises embraced the proposal and meant that it corresponded to their own investigation, made in 2005.<sup>10</sup> Further, the Swedish Federation of Business Owners and The Association of Swedish Accounting Consultants were two of the consultive authorities that also clearly sympathized with the proposal.<sup>11</sup>

The Swedish Tax Agency and FAR<sup>12</sup> were two of the consultive authorities that had reservations towards the limit ranges of the investigation. They stated that the limitations should be decreased, resulting in a less dramatic modification. In a debate article<sup>13</sup> Dan Brännström, secretary general of FAR, meant that an abolishment according to the proposal would create a chaos and that it is *“preferable to lead a change in comparison to unravel a chaos”*. Instead, the Swedish Tax Agency

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<sup>7</sup> Government Offices of Sweden, 2008

<sup>8</sup> Commission of the European Communities, *The Fourth Council Directive of the European Communities*, Art.51

<sup>9</sup> Government Offices of Sweden, 2009

<sup>10</sup> The Confederation of Swedish Enterprises, 2008

<sup>11</sup> Government Offices of Sweden, 2009

<sup>12</sup> See *“Abbreviation & Definitions”*

<sup>13</sup> Brännström, D., 2008



and FAR favored to implement the changes gradually since the consequences of the modifications were not fully determined.<sup>14</sup>

The Swedish Government had these opinions in mind when elaborating the final legislative proposal in which the limits were extensively decreased:

- The total assets were not allowed to exceed 1.5 million SEK.
- The net sales were not allowed to exceed 3 million SEK.
- The company was not allowed to have more than 3 employees (on average).

This means that 72% of the Swedish companies, instead of 96% which the investigation suggested, now would be able to abolish the auditing process.<sup>15</sup> This was later on the legislative proposal which was accepted by the Swedish parliament.

### 1.1.2 Briefly about the capital need of SMEs and the credit assessment process

A common feature for all companies is that they need capital in one way or another, either from in-house or an external part. The in-house approach relates to the companies' accumulated profits. However the external part, mainly banks and other credit agencies, stands for a major amount of the companies' funding<sup>16</sup>. According to Bruns & Fletcher (2008) Sweden has a bank-orientated financial system, which means that banks play an important role when it comes to the financing of companies. Since SMEs are recognized as a crucial factor for economic growth and job creation, the funding of these companies is essential for the development of the society.<sup>17</sup> Previous research has showed that SMEs especially prefer bank loans when they need capital. A reason to this is that bank loans do not affect the ownership and thus not the management of the company. Hence banks serve as a vital source of capital for SMEs and therefore also as a source of economic growth.<sup>18</sup>

According to Svensson (2003), credit assessment involves making judgements of a company's future income, cash flows and the value of its assets for the purpose of estimating the future repayment ability. The valuation of the assets is performed to secure repayment in the case of bankruptcy. To be able to make this judgment the creditors need different information sources such as business plans, the knowledge- and ability of the individuals involved and financial accounting information. The two sources mentioned first represent sources of a more subjective nature, whereas the last source is

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<sup>14</sup> Government Offices of Sweden, 2009

<sup>15</sup> Government Offices of Sweden, 2009

<sup>16</sup> Bruns, V., 2001

<sup>17</sup> Winborg, J., Landström, H., 2001

<sup>18</sup> Bruns, V., Fletcher, M., 2008

more objective, especially when it is reviewed by a third party. Hence, financial accounting information is a substantial part of the credit assessment process.<sup>19</sup>

## 1.2 Problem discussion

The new Swedish legislation concerning the statutory audit requirement, as mentioned above, makes it interesting to investigate the consequences of the reform. There are some previous student essays within the subject, but most of them were written when the reform was only at a level of investigation. Hereto comes that the proposal in that time had a different content, hence the results of the previous essays are obtained from different premises, compared to the final reform. Therefore it is necessary to examine the consequences of the final reform.

The authors would especially like to find out how the abolishment of the statutory audit requirement affects the credit assessment process of the banks. This aspect is particularly interesting since banks are an important source of capital for SMEs and, as mentioned above, one important assessment tool when evaluating creditworthiness is financial accounting information provided by the company. This means that the banks are crucial users of this kind of information and consequently the banks could be highly affected by the new reform. When the financial accounting information no longer has to be reviewed by a third party the information cannot be considered to be as reliable as when the information has been reviewed.<sup>20</sup> Accordingly, the risk of credit assessments may increase as a consequence of non-reviewed information, which is especially interesting in the perspective of the recent financial crisis, which caused great credit losses for Swedish banks.<sup>21</sup>

To further distinguish this study from previous research the authors have decided to investigate the consequences of the new reform for on the one hand a Swedish metropolitan bank<sup>22</sup> and on the other hand for a Swedish bank with a distinct local profile. It would be interesting to see if the two different kinds of banks handle the situation with non-reviewed financial accounting information differently.

## 1.3 The aim of the thesis

The aim of this thesis is to investigate how the new legislation regarding the abolishment of the statutory audit requirement affects the credit assessment process of a Swedish bank located in a metropolitan area and a Swedish bank with a distinct local profile. The authors want to consider if

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<sup>19</sup> Svensson, B., 2003

<sup>20</sup> Government Offices of Sweden, 2009

<sup>21</sup> Swedish Bankers' Association

<sup>22</sup> See "*Abbreviation & Definitions*"

there are any differences in how the different bank types approach the new legislation and how they handle the new conditions for credit assessment.

This study may be of interest to many parties. For instance, the SMEs themselves can use this thesis as a guideline to understand how an abolishment of the audit process can affect their opportunity to receive a bank loan. Further, banks can benefit from this thesis since it clarifies how other banks argue towards the new legislation. Auditing firms are also possible readers of this thesis.

## 1.4 Research questions

According to the discussion above the following *main research question* have been derived:

- *How is the credit assessment process of a bank located in a metropolitan area, compared to a bank with a distinct local profile, affected by the abolishing of the statutory audit requirement for Swedish SMEs?*

To be able to investigate this question the following conditions and *sub questions* have been added:

- *Does the credit assessment process of an SME differ among the two kinds of banks?*
- *Is there a difference in the information sources used by the different banks, when assessing the creditworthiness of an SME?*
- *Does the opinion regarding the importance of auditing for the credit assessment differ among the different banks?*

## 1.5 The scope of the thesis

The abolishment of the statutory audit requirement for Swedish SMEs affects several stakeholders such as shareholders, public authorities, creditors et al. This study is defined to examine the effects of the new legislation for the creditors and in particular banks, since they are one of the largest creditors for SMEs. Further, the focus is put on two different kinds of banks in the Swedish banking sector, on the one hand a metropolitan located bank and on the other hand a bank with a distinct local profile, this in purpose to illustrate if there are any differences between the two different types of banks, in their way to assess the creditworthiness of an SME.

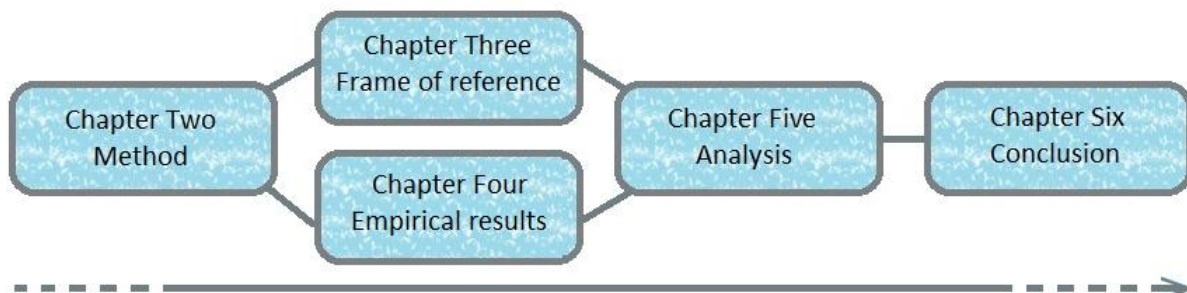
## 1.6 Disposition

### Chapter Two

**Method:** This chapter presents the research method of this thesis. Further, the reader is given insight into the selection of method, data collection, information around the interviews and the credibility of the thesis.

- Chapter Three** **Frame of reference:** This chapter presents previous research concerning auditing and credit granting. It is also presented how these two areas are connected to each other.
- Chapter Four** **Empirical results:** In this chapter the result from the interviews is presented. The chapter is divided into four main themes in order to highlight the essential issues.
- Chapter Five** **Analysis:** In this chapter the empirical results are analyzed based on the Frame of reference. This is performed in order to relate the results of this study to previous research on the problem area of this thesis.
- Chapter Six** **Conclusion:** In this chapter the research questions are answered and conclusions are drawn. In addition, contribution of the thesis, reflections of the authors and suggestions for further research are presented.

The figure below illustrates how this thesis is composed.



Backestål & Carlsson, 2011

## Chapter Two – Method

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*In this chapter the authors present their research method. Further, this chapter gives the reader insight into the data collection, information around the interviews and the credibility of the thesis.*

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### 2.1 Selection of method

This study aims to investigate how the credit assessment process of a bank is affected by the abolishment of the statutory audit requirement. In order to decide the structure and the execution of the study, previous theses regarding the subject were reviewed. It turned out that the subject was complex and that the previous theses contained many different approaches to the subject. After this, a solid discussion concerning what kind of approach that would be applicable to achieve the aim of this thesis, took place. It was concluded that due to the complexity of the subject, a more profound approach was required. Large sample sizes and questionnaires containing pre-determined answers were rejected, since complex and important reasoning might not be possible to get through this kind of approach. Instead the focus of the research was put on a narrowed sample of respondents which induces the possibility to investigate each responding bank on a deeper basis. To reach this, personal interviews were performed.

### 2.2 Data Collection

In order to answer the research question and also achieve the aim of this thesis, data have been collected. As mentioned above this data have been collected through personal interviews. These interviews were performed solely by the authors, which means that the data have been collected in a direct manner and that nobody else has been involved in the gathering and interpreting of data. Since this thesis aims to investigate the subject on a more profound basis and find out how the banks argue regarding the abolishment of the statutory audit requirement, interviews were found to be an appropriate tool. During interviews, the respondents have the opportunity to give their perspective of the subject, in their own words. Hence, the respondents are able to argue freely and develop their thoughts, without being restrained. The authors found that it would be hard to reach the same quality if using for example questionnaires, or similar research tools.

### 2.3 Interviews

For this thesis three different interviews have been performed, with totally four respondents. Two of the interviews were performed at banks with local profiles, while one was completed at a metropolitan bank.

### 2.3.1 The selection of respondents

When selecting the respondent banks it was important to investigate two banks of *either* metropolitan or local location, to be able to perform a comparison. Further, when selecting the individual respondents, the emphasis was put on that these persons had a large experience regarding business credit granting. It was also important that the respondents possessed experience from both working as a credit evaluator<sup>23</sup> as well as an executive post, concerning business credit granting. The reason for this was that a wide perspective of the subject was preferred. In the two local banks<sup>24</sup>, one person possessed both these qualities, while in the metropolitan bank two persons had to be interviewed to achieve the objective of receiving a wide perspective.

Two different approaches were used in order to book interviews with relevant respondents. Since it was easy to get contact information concerning adequate respondents from the homepages of the local banks, these were contacted by telephone. The objective was to book interviews with two local banks in the western region of Sweden. This was succeeded after contacting the two first banks on the list of possible respondent banks. On the other hand, when contacting the metropolitan located banks it was considerably harder to find contact information to an appropriate respondent. Hence, in this case e-mails were sent to several bank offices located in Gothenburg. Also in this case the objective was to find two responding banks. However, it turned out to be hard to find respondents that had time, the adequate competence or were willing to contribute to this study. This finally resulted in that just one bank was interviewed.

### 2.3.2 Structure and execution of the interviews

The interviews were performed through personal meetings, which took place in a separated room at the different banks, hence no one else than the respondents and the authors were present. The duration of the interviews was from 45 to 90 minutes. The interviews were made according to an interview-guide which consisted of different subject areas with related questions. The research questions of this thesis were the basis of the interview-guide, which consequently was designed to answer these questions. The questions of the interview-guide were not designed to result in specific answers, but to give the respondents the possibility to express their thoughts in a flexible manner. The interview-guide was not revealed until the time of the interview, this in purpose to avoid that the respondents would prepare their answers in advance. During the interviews, notes were taken and each interview was also recorded. The reason for that was to assure that all information would be available afterwards.

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<sup>23</sup> See "*Abbreviation & Definitions*"

<sup>24</sup> See "*Abbreviation & Definitions*"

## 2.4 Collection of information for the Frame of reference

The frame of reference contains information from laws, a legislative proposal, a governmental investigation, scientific articles, doctoral theses, books and articles from journals relevant for the subject of this thesis. To collect this information, different search engines and data bases available through the library of the University of Gothenburg were used, such as Google, Google Scholar, Business Source Premier, Science Direct, EconLit (EBSCO) and FAR Komplet. The words that were frequently used within these search engines and data bases were: *audit*, *audit requirement*, *the abolishing of the audit requirement*, *financial accounting information*, *credit assessment*, *creditworthiness*, *bank loans* and *credit granting*. The list of references in earlier written student essays, doctoral theses and scientific articles were also used to find adequate information. When selecting the information it was important to collect data from different authors to get different angles of approach, which can increase the credibility of this thesis. Regarding the scientific articles, emphasis was put on how frequently the articles have been cited, and also by whom.

## 2.5 Analysis of the data

The arrangement of the data was initiated by a compilation of the collected data, performed immediately after every interview. Both notes taken during the interviews and the recordings of the interviews were used to perform this compilation. Further, the data was compiled and structured according to the interview-guide. The compilation was completed in purpose to structure and also to guarantee that all the data needed was collected. If not enough data was collected, or if there were any obscurities concerning the interview content, there was a possibility to contact the respondents for a clarification afterwards. The compilations of the interviews were further compared to each other in order to find out if there were any differences between the investigated banks. Later on, the compilations were transformed into the fourth chapter of this thesis, the *“Empirical results”*. The structure of this chapter was based on interesting themes from the interviews. Hence, the data was not presented according to the order of each interview. This was in purpose to illuminate the important issues which came up during the interviews and also to illustrate similarities and differences between the banks concerning these issues. In addition to this, the third chapter *“The frame of reference”* and the fourth chapter was during the whole process of analyzing the data, adapted to each other to reach a greater coherence throughout the thesis and also to be able to illuminate the data from previous research concerning the problem of this thesis.

## 2.6 The credibility of the thesis

When designing the study, it was necessary to investigate at least two different banks, of *either* metropolitan or local location to be able to make a comparison between the two types of banks. If only one bank of both categories was investigated, the risk of randomness concerning the result was



increasing. When investigating two different banks with a local profile, the authors believe that this risk decreased. Further, the respondents in advance got the same information regarding the subject of the thesis. The respondents possessed similar experience concerning business credit granting and also the same interview-guide was used during every interview. Hence the conditions for all the interviews were comparable, in purpose to increase the accuracy of the research.

The selection of respondents has also contributed to the credibility of this thesis. The respondents were chosen carefully to assure that the respondents possessed the appropriate knowledge and experience, to be able to give useful answers related to the research question of this thesis. This was also a prerequisite for the opportunity to investigate what intended to. For the same purpose, the research questions were used as a guideline throughout the entire research process. When constructing the interview-guide, as well as the "*Frame of reference*" the research questions were held in mind, this in purpose to have all the parts within the thesis to match the main research question. This is expected to increase the concurrence of this thesis.

Throughout this thesis the intention has been to use sources of credible nature, but anyhow it is important to review the sources of information and approach of the research in a critical manner. It is understood that additional respondent banks, as well as respondents within the banks would have increased the credibility of the research results and contributed to more reliable conclusions. This can however be compensated by other factors, such as the design of the study as well as the careful selection of respondents like mentioned above.

The fact that every interview was recorded might have restrained the answers of the respondents. When recording an interview, the respondent may not give their full opinion in fear of that what they say can be shared to others, for example competitors. This risk is assessed to be out weighted by the opportunities that a recording gives, such as an assurance that all the information is available afterwards. To reduce the risk of restrictive answers due to the recording, the different banks have been offered to be anonymous. At the same time, keeping the respondents anonymous might bring other advantages. Especially the different brands of the banks might influence the reader of the thesis, even before the final results of the research are presented. When anonymizing the respondent banks, the risk of preconceptions is reduced.



## Chapter Three – The frame of reference

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*In this chapter the authors present previous research concerning auditing and credit granting. The reader also finds out how these two areas are connected to each other. The chapter is concluded by a section which explains how auditing affects the credit granting.*

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### 3.1 Credit granting

This section contains information regarding the credit assessment process, how the creditor gathers information and finally how financial accounting information is used during the credit assessment. This in purpose to explain how creditors act and how they assess creditworthiness.

#### 3.1.1 The credit assessment process

According to the Swedish legislation, the banks are forced to assess the company's future ability to repay the loan and claim collaterals that ensures a possible degradation of the company's creditworthiness. Further on, the bank is only allowed to grant a credit when there are good reasons to believe that the borrower will be able to fulfill its commitments.<sup>25</sup> In excess of the legislation, The Swedish Financial Supervisory Authority also releases additional guidelines for financial business. According to FFFS 2004:6 15§, all creditors should have a written document containing rules regarding the credit assessment process. This document is often referred to as a credit policy. The credit policy includes inter alia a report of which internal authorities that may take credit decisions and which mandate the different authorities have. However, the banks have the possibility to decide the content of the policies themselves.<sup>26</sup>

The process of assessing a company's creditworthiness is possible, just like other decision making processes, to divide into three different phases: First the information-gathering phase, then the phase of interpreting the gathered information and then finally the decision making itself. After the decision is taken, the creditor however continues to follow up the borrower in an iterative process.<sup>27</sup> The assessment of a company's creditworthiness can also be divided into two different judgements. The first judgement the creditor has to do is to estimate the borrowers earning capacity and its future ability to repay the loan. The company is assessed based on the condition of *going concern*.<sup>28</sup> The future ability to repay the loan can also depend on the business sector in which the applying firm operates and its business concept. It is even noted that companies within business sectors

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<sup>25</sup> Lag (2004:297) om bank- och finansieringsrörelse, 8 kap 1 §.

<sup>26</sup> FFFS 2004:6 15§

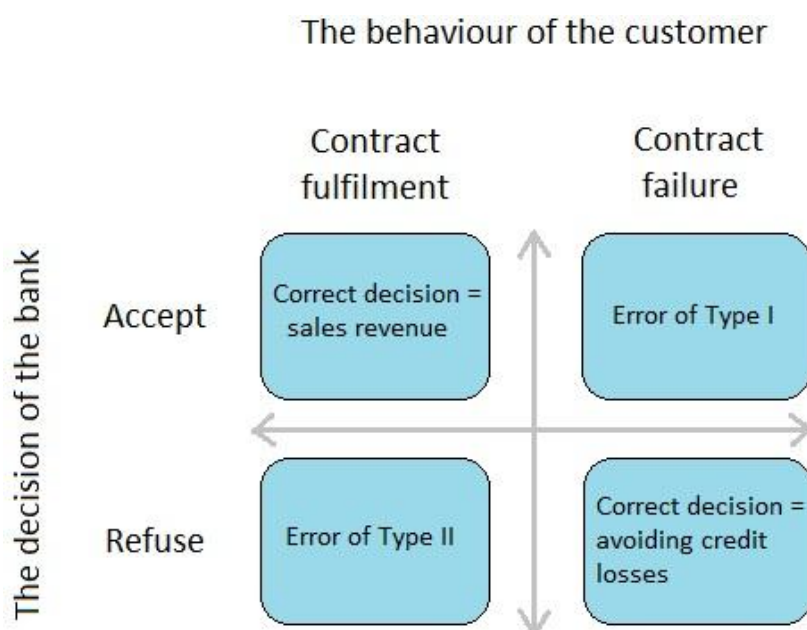
<sup>27</sup> Murray, R.F., 1959.

<sup>28</sup> See "Abbreviations & Definitions"

recognized by a return on investment below standards, face more difficulties in receiving a bank loan.<sup>29</sup> Further on, the creditor has to estimate the value of the collaterals that the borrower may contribute.<sup>30</sup>

The assessment of the future loan repayment can be related to two different types of errors, according to Newbold et al. (2009) called Type I - and Type II-error<sup>31</sup>.

- *The error of Type I* is characterized by that the creditor underestimates the risk associated with the contract and hence accepts the contract. In the long run this leads to credit losses.
- *The error of Type II* is characterized by a creditor that refuses a credit application from a company which is creditworthy, resulting in no return or sales revenue from this possible contract.



Different types of errors in credit granting. Backestål & Carlsson, 2011.

The assessment of the value of a borrower's possible collaterals is for certain an objective basis for the credit assessment process, but it can notwithstanding cause some contingency. The contingency derives from the future sales value of the assets, which can be completely different at a time of bankruptcy compared to the value in a condition of going concern, when the estimation of the value often is done.<sup>32</sup>

<sup>29</sup> Rad, A., et al., 2011

<sup>30</sup> S-E Johansson, 1973

<sup>31</sup> Newbold, P., et al., 2009

<sup>32</sup> Gandemo, B., 1990



According to Svensson (2003), the most subjective basis for an assessment of a company's creditworthiness consists of the personal ability, the competence of the corporate management and its willingness to fulfill contractual commitments. A company's annual report is on the other hand the only relatively objective source of information that verifies the verbal information according to the company and its future plans, enunciated by the corporate management.<sup>33</sup> Further on, Hagberg (2006) means that the credit assessment process can be divided into two different analyses: one quantitative and one qualitative. The quantitative analysis is based on different kinds of financial accounting information, such as budgets and annual accounts. This kind of information is often analyzed by advanced computer technologies, for example scoring systems.<sup>34</sup> The qualitative analysis is based upon non-financial (qualitative) information and the single credit evaluator's opinions about the company, such as experience from previous business relations or the confidence in the company and/or the corporate management. Within this type of analysis it is important that the credit evaluator understands how the firm is running its business and what kinds of risk that is involved in the contract. The final decision is hence a result of the two kinds of analyses just mentioned, and will later on be categorized as either a correct, or an incorrect decision.<sup>35</sup>

Research concerning credit assessments does also contain different models to describe the assessment process of a firm's creditworthiness. Here follows a selection of some well-known models. Murray (1959) define the assessment of a company's creditworthiness in a model called "*The 3C-model*", which is built upon the main assessment grounds: *Capital*, which takes the borrower's assets in consideration, *Capability*, which takes the borrower's ability to repay the loan in consideration, and finally *Character*, which considers the personal character of the borrower. The 3C-model has later been extended to "*The 5C-model*", which also includes *Collaterals* and *Conditions*. Collaterals describe what kind of collaterals the borrower wants to put into the lending contract, while Conditions describes the borrowers business environment.<sup>36</sup>

Another model that describes the assessment of a company's creditworthiness is called "*CAMPARI*". This model considers *Character*, *Ability*, *Margin*, *Purpose*, *Amount*, *Repayment* and *Insurance*. This model is, compared to "*The 5C-model*", more focused on the credit terms, the credit need of the company and the purpose of the credit.

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<sup>33</sup> Svensson, B., 2003

<sup>34</sup> Berger, A.N., Udell, G.F., 2006 & Svensson Kling, K., 1999

<sup>35</sup> Hagberg, A. 2006

<sup>36</sup> Svensson Kling, K. 1999

In addition to the models mentioned above there is one more model that needs to be declared. This is a model that focuses upon the relationship, the interaction and the bargaining between the borrower and the lender. Among other factors, the ability to bargain, the bargaining power and the both parts' personal capacity are aspects that determine the outcome of the assessment.<sup>37</sup>

Finally, the credit assessment depends on the single credit evaluator. The evaluators gradually receive increased experience in assessing creditworthiness, but in addition to this there are several other factors, like personal chemistry, feeling and intuition that also have a major impact on the assessment. Although the credit assessment process deals with similar and relatively well-structured issues, and hence the credit evaluator over time can be expected to do more accurate assessments, it has however been shown that the standardized rules and routines of the creditors can lead to systematic bias and errors of both Type I and II. According to McNamara & Bromiley (1997), an increased level of standardization in the assessment process does not result in more careful assessments but rather more errors of Type I.<sup>38</sup>

### 3.1.2 Information gathering

As mentioned above, one of the phases within the assessment regarding creditworthiness, is the phase of information gathering. How often, and what type of information the creditor gathers, depends on the relationship between the creditor and the borrower. Is there a good relationship between the parts, the creditor prefer accessible before inaccessible information, inexpensive before expensive information and information from the creditor's own databases before public information, like the borrowers annual reports et cetera. A good relationship between the creditor and the borrower can also lead to that the creditor does not collect as much internal information from the company, as compared to a regular situation. Contrary, if there is a problematic relationship between the creditor and the borrower, the creditor usually collects information on a more regular basis, normally every quarter or month. There is also more emphasis put on external sources of information, expensive and for the creditor specific designed information, such as accounting reports and future-oriented plans. If possible, the creditor also collects information from an external part, such as the borrower's auditor.<sup>39</sup> When contacting the auditor, the reputation of the single auditor and even of the entire audit bureau, is also considered to influence the assessment of the applying firm.<sup>40</sup> Pittman & Fortin (2004) even mean that the choice of auditor and audit bureau can affect the level of interest rate, especially for newly started firms. Since a newly started firm does not possess

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<sup>37</sup> Broomé, P. et al, 1995

<sup>38</sup> McNamara, G., Bromiley, P., 1997

<sup>39</sup> Burghof, H-P., 2000

<sup>40</sup> Svensson, B., 2003



as much reputation as an established firm, a newly started firm could benefit from hiring an auditor of a well-known audit bureau, in terms of lower interest rates.<sup>41</sup>

Further, when assessing a new customer, the creditors often follow the same assessment criteria as when assessing an already known customer, however the creditors usually do a provisional assessment to find out if a further assessment of the new customer is eligible. This since the creditor has no previous experience or information about the behavior of the new customer and therefore an extended information gathering process is necessary.<sup>42</sup> The confidence in existing and loyal customers is often larger, than in a new customer, which means that the creditor might collect less information when assessing an existing customer. Annual reports and other quantitative information are still collected, but the importance of this kind of information tends to be reduced as the relationship between the creditor and the borrower develops.<sup>43</sup>

Other factors that might affect the information gathering, is the geographical market and the local social context of the creditor. According to Svensson Kling (1999) and Silver (2001) the knowledge about the participants of the local market and the local social networks are more important in smaller districts than in metropolitan areas. Creditors in smaller districts are considered to rely on qualitative information and informal contacts in their local surroundings. In metropolitan districts, the gathered information mainly consists of data gathered directly from the applying firm and data that is publicly available.<sup>44</sup>

### 3.1.3 The influence of the financial accounting information

As mentioned above, several different sources of information are used during the credit assessment process. The borrower's financial accounting information is considered to be widely used by the creditors. Berry & Robertson (2006) even mean that this kind of information is the single most important source of information when assessing a customer.<sup>45</sup> The main reason for this is that the creditor is interested in the future repayment ability of the borrower. In short term, the repayment ability depends on the current liquidity and the debt ratio of the borrower, while in long term the profitability, which can be assessed based on historical figures, is more central. However all of this information can be found in the annual report, which makes the annual report a highly useable source of information in the credit assessment process. Furthermore, financial accounting information is also used *ex post* to be able to reduce the contingency of the company's plans and

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<sup>41</sup> Pittman J., Fortin S., 2004

<sup>42</sup> Bouckaert, J., Degreyse, H., 2006

<sup>43</sup> Svensson, B., 2003

<sup>44</sup> Silver, L., 2001 & Svensson Kling, K., 1999

<sup>45</sup> Berry, A., Robertson, J., 2006

forecasts as well as *ex ante* for preparation of forecasts.<sup>46</sup> A problem concerning financial accounting information and especially annual reports as a source of information in the credit assessment process, is the recency of this kind of information. The annual report consists of historical information. Conversely, the creditors desire as current information as possible, which means that the creditor often has to complement the figures in the annual report with more updated information.<sup>47</sup>

According to DeWayne et al. (2008), one additional factor that may affect the credit decision is how frequently the customer hands in financial accounting information to the creditor. This effect occurs when dealing with high-risk companies (according to the criteria of the creditors). High-risk companies that provide financial accounting information on a strict regular basis have a greater chance to receive a bank loan, than those companies that do not. However, the interest rate is not affected by the frequency of information providing. Finally, these results are valid for both new and existing customers.<sup>48</sup>

## 3.2 Auditing

This section contains a shorter insight into what auditing is about and who benefits from it. Further on, research is presented concerning the effect that an abolishment of the statutory audit requirement have had in other countries, as well as possible effects in Sweden. This in order to give the reader knowledge about why auditing exists and how an abolishment of an audit requirement can affect its existence. Finally, the relation between auditing and credit granting is examined, in purpose to increase the understanding for the importance of auditing in the credit assessment.

### 3.2.1 Audit

The audit process includes a critical review of a company's financial accounting information and its management.<sup>49</sup> This means that the auditor has to evaluate whether the financial accounting information is produced in line with what the law requires and also evaluate how the board and the Chief Executive Officer (CEO) operate the management of the company. This evaluation results in an audit report in which the auditor make a statement about the issues mentioned above.<sup>50</sup> In this way the audit process serves as a quality assurance of the financial accounting information. Hence, the

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<sup>46</sup> Svensson, B., 2003

<sup>47</sup> Berry, A., Faulkner, S., Hughes, M., Jarvis, R., 1993

<sup>48</sup> DeWayne, L.S., Ward, T.J., Woodroof, J.B., 2009

<sup>49</sup> Government Offices of Sweden, 2009

<sup>50</sup> ABL, 9:31-32

process of auditing is often demanded in a situation where *asymmetric information* exists.<sup>51</sup> This situation occurs when one part has more information than another part. This means that the part that has access to less information might not be able to make an adequate assessment concerning its counterpart. As a consequence of this, an independent review is often required by the part that has less information. In this way the auditor acts as a third party who independently reviews information, in order to reduce the asymmetric information between the two parts.<sup>52</sup>

The auditor is chosen by the shareholders<sup>53</sup>, who also are the primary job requester. Since the shareholders invest capital in the company it also is in their interest to get reliable information on how the company performs, so that they can decide whether to keep their capital in the company or invest elsewhere. However the shareholders are not the only group who benefits from the work of the auditor. Also other stakeholders such as suppliers, the state, creditors et cetera request reliable information. For example suppliers can use the information to decide if they like to do business with the company or not and furthermore the Tax Agency need accurate information to make a correct tax assessment for the company.<sup>54</sup> Concerning the creditors, financial accounting information is used as a basis for decision in the credit assessment process. Naturally it is in the creditors' interest that the information is correct and therefore the audit process is considered to be valuable for the creditors.<sup>55</sup>

### 3.2.2 The influence of the audit for the credit assessment

As mentioned above, the audit works as a quality assurance of a company's financial accounting information in order to reduce problems, such as asymmetric information. In a situation concerning the credit assessment, the problem of asymmetric information can occur. This is especially common in SME lending.<sup>56</sup> The applying firm is considered to possess more information regarding its business environment and financial position than the creditor. For example the applying firm can adjust the financial accounting information in purpose to misdirect the creditor and hence increase the opportunity to receive a bank loan.<sup>57</sup> According to Moore and Ronen (1990) the problem of asymmetric information can be reduced by the process of auditing. When the financial accounting information is reviewed by an auditor, the creditor receives more credible information which they

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<sup>51</sup> Collis, J., 2003

<sup>52</sup> Adams M.B., 1994

<sup>53</sup> ABL

<sup>54</sup> FAR Förlag. *Revision – En praktisk beskrivning*.

<sup>55</sup> Svensson, B., 2003

<sup>56</sup> Liao, H.H, Tsung-Kang, C, Chia-Wu, L, 2009.

<sup>57</sup> Andersson, P., 2001

can use for a more accurate decision making.<sup>58</sup> Also Svanström (2008) and Rad et al. (2011) claim that if an auditor has reviewed the information produced by the applying firm, the problem regarding asymmetric information is perceived to decrease.<sup>59</sup>

Further on, studies regarding the use of audited information and how it affects the credit assessment of a creditor have come to different conclusions. Some argue that the audit report has no effect on a creditor's decision, while others claim the opposite.<sup>60</sup>

According to Gómez-Guillamó (2003 & 2008) the opinion of the auditor on a company's financial accounting information affects a bank's lending decision. It is found that the lenders thought that the information provided in the audit report is valuable and useful, when making a judgement concerning a loan application. It is also concluded that the opinion of the auditor to a certain extent influences the amount of the loan, though not as much as the loan decisions itself.<sup>61</sup> Furthermore a study performed by Bamber & Stratton (1997) argues in a similar manner and states that an adverse audit report<sup>62</sup> influences a creditor to give a loan application a higher risk assessment and also results in a greater probability of a rejection of the loan application.<sup>63</sup> Guiral-Contreras et al. (2007) reach similar conclusions and mean that an adverse audit report can alter a previous positive attitude of a creditor towards a customer, to the opposite. Consequently, an adverse audit report is considered to function as a significant warning signal which results in a more critical assessment of the customer.<sup>64</sup>

On the other hand, Libby (1979) means that adverse audit reports do not influence a loan officer's credit risk assessment. Instead Libby draws the conclusion that the information provided by an adverse audit report is either redundant, relative to other information regarding uncertainty, or does not indicate a change in a company's repayment ability.<sup>65</sup> Further Abdel-Khalik et al. (1986) replicated and extended the study performed by Libby. Also this study confirms the results found by Libby that an adverse audit report does not significantly affect a credit evaluator's credit risk assessment.<sup>66</sup> Finally, more recent research finds similar results. According to Bessel et al. (2003) and

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<sup>58</sup> Moore, G., Ronen, J., 1990

<sup>59</sup> Svanström, T., 2008 & Rad, A. et al. 2011

<sup>60</sup> Schneider, A., Church, B.K., 2008

<sup>61</sup> Gómez-Guillamón, A. D., 2003 & 2008

<sup>62</sup> See "Abbreviation & Definitions"

<sup>63</sup> Bamber, E.M., Stratton, R.A. 1997

<sup>64</sup> Guiral-Contreras, A., Gonzalo-Angulo, J.A., Rodgers, W., 2007

<sup>65</sup> Libby, R., 1979

<sup>66</sup> Abdel-Khalik, A.R., Graul, P.R., Newton, J.D., 1986



Lin et al. (2003) the adverse audit report has a fairly limited influence on the credit assessment and the final decision of the creditor.<sup>67</sup>

Schneider & Church (2008) also claims that the opinion of the auditor on the effectiveness of a company's internal control is relevant in the credit assessment process. In their study they have investigated 111 bank loan officers and their attitude towards an adverse internal control opinion from the auditor. The conclusion is that an adverse internal control opinion affects the bank loan officer's judgement negatively regarding the probability to extend the credit contract. It is also concluded that an adverse internal control opinion reduces the importance of the balance sheet and income statement as well as the confidence in that the financial statement is produced in line with the generally accepted accounting principles, in the credit assessment process.<sup>68</sup> These results are further verified by Lopez et al. (2009) who mean that the opinion of the auditor regarding internal controls is valuable information for users of financial statements.<sup>69</sup>

There has also been research performed on the subject of the influence of the auditor assurance on interest rates. According to Blackwell et al. (1998) audited companies pay lower interest rates than un-audited companies. Blackwell et al. claim that interest rate on average is 25 basis points lower for companies who hire an auditor, compared to those companies who do not. This means that a company can reduce its interest charges by having their accounts audited.<sup>70</sup> However there is also research that does not support the statement concerning the relation between auditing and interest rates. In a study performed by Johnson et al. (1983) one of the conclusions is that a relation between interest rate and a company's use of audit cannot be found. However it is also mentioned that this result does not mean that the use of audit has no influence on the interest rates at all, just that it cannot be proofed in a statistically significant manner.<sup>71</sup>

### 3.2.3 The statutory audit requirement

In the year of 1983 the statutory audit for all Limited Companies was implemented in Sweden as a step towards fighting economic crimes<sup>72</sup>. Over the years, this requirement has been a subject of discussion which finally has resulted in a relief of the audit requirement for SMEs, as mentioned in *Chapter 1.1.1*. According to the new legislation, approximately 250,000 Swedish companies have the opportunity to abolish the audit process. However, around 73,000 of those companies do not

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<sup>67</sup> Bessell, M., Anandarajan, A., Umar, A., 2003 & Lin, Z., Tang, Q., Xiao, J., 2003

<sup>68</sup> Schneider, A., Church, Bryan, K., 2008

<sup>69</sup> Lopez, T.J., et al., 2009

<sup>70</sup> Blackwell, D.W., Noland, T.R., Winters, D.B., 1998

<sup>71</sup> Johnson, D., Pany, K., White. R., 1983

<sup>72</sup> Government Offices of Sweden, 2008



practice business.<sup>73</sup> How many of the Swedish SMEs that will use this opportunity is yet hard to tell since the new legislation just recently was accepted.

In Sweden a study regarding the demand of audit and other services provided by the audit bureaus was published in 2008. According to Svanström (2008) 68% of the companies that were investigated state that they would like to undergo the audit process even if the Swedish statutory audit requirement was abolished. Further on, 16% state that they would skip the audit process, while the remaining part has no specific opinion on the matter. However the opinion among the smallest companies, which also are the companies that are concerned by the new legislation, differs from the total results. In this group 54% would keep the audit process, whereas 30% would skip it. This result implies that there is a relation between the size of a company and the tendency to voluntary undergo the audit process.<sup>74</sup>

In Denmark the statutory audit requirement for SMEs was abolished in 2006. The boundaries concerning which companies that would be permitted to reject the audit process was set at a similar level as the boundaries set in Sweden.<sup>75</sup>

Before the statutory audit requirement was abolished, the Danish banks in an investigation declared that those companies who voluntary chose to undergo the audit process could benefit from this, in terms of lower interest rates and better credit terms. This was motivated by the opinion that audited financial accounting information is more confidence-inspiring than non-audited.<sup>76</sup> In 2009 an evaluation by the Danish Commerce and Companies Agency regarding the abolished statutory audit requirement was completed. This evaluation states that 22.8% of the Danish companies that had the possibility to get rid of the auditing process also used this possibility. Of those companies, 30.6% on the other hand hired an auditor for other services than a proper audit, such as reviews and accounting assistance. The evaluation also declares that annual reports from companies that do not undergo the full audit process contains more errors compared to annual reports from companies that have to, or voluntary go through the auditing process. The most common errors found were formal faults and inadequate notes.<sup>77</sup>

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<sup>73</sup> Governmental proposal 2009/10:204

<sup>74</sup> Svanström, T., 2008

<sup>75</sup> Government Offices of Sweden, 2008

<sup>76</sup> Danish Commerce and Companies Agency, 2005

<sup>77</sup> Danish Commerce and Companies Agency, 2009.



In the UK, the statutory audit requirement was abolished already in 1994. Since then, the conditions regarding which companies that would have the opportunity to abolish the audit process, have been raised twice and are today at the same level as the conditions in the Fourth Council Directive of the European Communities. This means that about 900,000 British companies have the possibility to reject the audit process. Of these approximately 60–70% has used this possibility.<sup>78</sup> During the years of deregulation of the statutory audit requirement in the UK, research on the area has been performed; among others Collis (2003) investigated the opinion among British company directors on the matter of the exemption of the statutory audit. According to the study, two main reasons for voluntary undergo the process of auditing are:<sup>79</sup>

- The opinion that the audit process contributes to better internal controls and to a higher quality of the financial accounting information, which can give positive effects on the creditworthiness
- The company on a regular basis hands in a copy of the annual report to the bank or other funders.

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<sup>78</sup> Government Offices of Sweden, 2008

<sup>79</sup> Collis, J., 2003



## Chapter Four – Empirical results

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*In this chapter the results from the interviews is presented. The chapter is divided into four main sections; A short presentation of the respondents, Credit granting, The importance of the audit for the credit assessment and The statutory audit requirement.*

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### 4.1 A short presentation of the respondents

In this section the banks which have been investigated in this study will be presented. The section also contains a shorter presentation of the respondents representing the different banks.

#### 4.1.1 Bank A – Respondent A

Bank A is a small bank with a local profile, located in the western region of Sweden. The bank has four full-service offices and has about 50 employees. According to the annual report of 2009, the total assets for the same year amount to well over 5 billion SEK. Respondent A has been employed in Bank A since 1974, when the respondent started as a bank cashier. Since then, respondent A has had different positions within the bank. In 1983, Respondent A became office manager for one of the local offices where Respondent A was responsible for all the credit granting at this office. In 2003 the Respondent A changed position and became vice president of the whole bank. This position implied responsibility for all business credit granting and issues concerning the human resources of the bank.

#### 4.1.2 Bank B – Respondent B

Bank B is a small bank with a local profile, located in the western region of Sweden. The bank has three full-service offices and has approximately 0.6 times as many employees as Bank A. According to the annual report of 2009, the total assets for the same year amount to about a third of the total assets of Bank A. Respondent B has been employed in Bank B since 2008, but has been working within the banking sector since 1980 with experience from both metropolitan and local banks. Respondent B has since 1985 been working with credit granting and within the last 20 years with business credit granting. Today, Respondent B is the manager of the business department of Bank B and is also the head of issues concerning credit granting within the bank.

#### 4.1.3 Bank C – Respondent C & D

Bank C is, unlike the two previous banks, a large Swedish international bank with around 350 times as many employees as Bank A. Sweden is the largest single market and counts for around 50% of the revenues 2010. According to the annual report of 2009, the total assets for the same year amount to about 440 times larger than the total assets of Bank A. Respondent C has been employed in the bank for 35 years and has been working with business credit granting since 1981 in different positions. Respondent C is today vice division manager with responsibility for business credit granting.

Respondent C has a bachelor degree in accounting and financing from the University of Gothenburg. Respondent D has been employed in the bank for 26 years and has since then been working in the business department of the bank in several different positions. Today, respondent D work as a credit evaluator. The respondent D has a bachelor degree in business economics from Lund University.

## 4.2 Credit granting

In the following section, the credit assessment processes of the responding banks are presented, as well as which sources of information that the investigated banks use for their assessments and finally the importance of financial accounting information is declared.

### 4.2.1 The credit assessment process

All of the respondents state that their banks have a specific written credit policy which is followed throughout the credit process. Respondent C and D especially point out that the credit process is rather regimented by this policy. Since Bank A and B are environmental certificated banks, environmental factors are also included in their credit policy, which means that Bank A and B have to consider what kind of impact their customers' business activities have on the environment. Further on, at least two credit evaluators are according to all of the respondents always involved in the final credit decision. A bank officer can consequently never approve or deny a credit application on his own, no matter what position within the bank he holds. However some cases demand more than two officers' opinions. For example, Respondent A and B mention that a special decision making delegation containing different decision levels are included in their credit policies. The size of the credit and the quality of the deal in terms of the creditworthiness of the customer and the value of the collaterals determine how many officers and what position they are in, that will be involved in the process. The lowest level contains of two credit evaluators while the highest level even includes a statement from the board of the bank. At the same time, Respondent A and B strictly claim that the rapidity of the decision making is not affected by the different delegations. Further, Respondent A and B both mean that the rapidity of the decision making of their banks is a competitive advantage, since all decisions are taken in-house.

The credit processes of the examined banks focus according to the respondents in general on two issues; on one hand the borrower's ability to repay the loan and on the other hand also what kind of collaterals the borrower possesses. For example, Respondent B points out two different risk-parameters that are used in the credit assessment. The first parameter considers the ability to repay the loan while the second parameter refers to the risk which the bank is exposed to, if the customer should become bankrupt. Respondent B means that the collaterals are especially important when assessing a new customer, either in the bank or if the business is in an initial phase. This because the bank has less information about a new customer compared to an existing customer. Respondent C

claims that collaterals play the most important role concerning financing real estates, while Respondent A states that collaterals influence the credit assessment and that it is one among other factors that affects the final credit decision. Respondent A also claims that the role played by the collaterals is different in every new credit assessment, this because every credit assessment is unique and requires different kinds of terms. The importance of the repayment ability appears to be indisputable among the respondents, while the question concerning the significance of collaterals is more unambiguous.

Another item concerning these two issues that all the respondents highlight is that the business sector which the customer operates in can have an effect on the result of the assessment regarding the repayment ability. Respondent A claims that companies within a business sector that is more frequently represented in the statistics of bankruptcy can be subject to a slightly more critical credit assessment. Contrary, Respondent B states that Bank B does not use statistics of bankruptcy in the assessment process. Instead Bank B purchases analyses regarding the current conjuncture status of different business sectors from a third party for the purpose of analyzing the company's future ability to succeed. According to Respondent C and D, Bank C has its own data base containing business sectors where the risk level is considered to be higher than the normal case. Generally these sectors are in the phase of maturity where overcapacity often is the case. All the respondents do anyhow clearly express that a credit can be granted even if the customer operates within a risky sector, just that extra caution is taken in these cases.

All of the respondents also points out that a very important step within the credit process is to select adequate customers in order to avoid credit losses. Therefore a profound review of the customer needs to be performed. Respondent C and D mean that the customer has to run its business in a way that Bank C finds appropriate, otherwise Bank C will not grant a credit to the customer. Both Respondent A and B state that the banks that they represent act under the philosophy that if the bank enters a business relationship with a customer, the bank has the intention to follow the customer throughout their entire business cycle. This leads to that the process of selecting adequate customers is even more important. When a customer has been selected and received a bank loan, the process of reviewing the customer is however not over. All of the respondents state that a continuous monitoring of the customer after the final credit decision always is performed.

Further on, an analysis regarding the customer's financial position is performed by all of the responding banks. To facilitate this analysis all the respondents state that scoring models is used as an assessment tool. The result of the scoring is one factor that determines the credit conditions, such as the interest rate and amount of credit for the customer. Especially Respondent C emphasizes the

importance of the scoring model when assessing SMEs since less time and fewer resources are available when analyzing these kinds of customers.

That the business idea and the person in charge of the business also have a large impact on the credit assessment is something that all of the respondents agree in. The respondents find it important to understand what kind of business the customer runs and also how it is managed. Respondent A has experienced that companies with the same initial conditions has ended up completely different just because of the person in charge and its ability to run the business. The respondents of Bank C mean that all business credit granting is built upon personal confidence in the person who runs the business, especially when it comes to SMEs since their business concepts rarely are highly unique. SME business is, according to Respondent C, often represented by restaurants, coffee shops and other basic businesses. One of the respondents from one of the investigated banks illustrates the importance of personal trust like this:

*“A skilled businessman can often succeeds with a mediocre business idea, while an unskilled business man might not succeeds even with a great business idea.”*

Finally, an interesting item that only Respondent A mentions is that the experience of the single credit evaluator can affect the credit assessment. The respondent means that an increased experience of a credit evaluator enables less standardization within the credit assessment process, since the credit evaluator observes more factors that can affect the customer’s ability to fulfill contractual commitments. Hence, a more experienced credit evaluator has a wider perspective of what can go wrong.

#### **4.2.2 The information gathering**

The phase of information gathering is quite similar for all the banks included in this study. Sources of information that according to the respondents are important are among others annual accounts, budgets, information from the *UC*<sup>80</sup>, business plans, different kinds of calculations regarding future plans and personal meetings with the customer. However, the investigated banks distinguish themselves in some issues. Respondent A and B highlight that emphasis is put on future cash flow analyses. Respondent A also claims that the question whether the customer is an optimist or a pessimist is considered, this in order to determine the accuracy of the calculations. An optimist has a tendency to beautify the accounts, while a pessimist does the opposite. Further, Bank C separates itself from the other investigated banks since Respondent C and D find the internal scoring models, which is partly based upon how the customer runs its business, to be the most important source of information.

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<sup>80</sup> See “Abbreviations & Definitions”

What also is in common for all the banks is that they, according to the respondents, have contact with the customer's auditor in purpose to gather information, albeit in different situations. Respondent A states that Bank A contacts the auditor both on their own initiative and after suggestions from the customer itself, usually for an update. If a customer is applying for a large credit or faces a large investment, Bank A wants to have the auditor present at the credit meeting with the customer. According to respondent B, Bank B does often contact a customer's auditor and does also prefer that the auditor is involved, in what Respondent B calls a "triangular partnership", since the business owner, the bank and the auditor hold different competences and experiences. Respondent C and D express that the contact with the auditor depends on the business owner and his knowledge concerning economic issues. The confidence in the customer is the decisive factor. However the respondents of Bank C also state that who the signing auditor is, may affect the credibility of the accounts, since there is a difference among the auditors regarding proficiency and stringency.

Finally all of the respondents agreed in that how much and what kind of information that is gathered is influenced by if the credit assessment concerns a new customer or an already existing one. The respondents mean that an existing customer has had the opportunity to create a relationship to the bank and some of its employees. This means that the bank already has an idea about the business of the customer and also whether the customer is a conscientious customer or not. According to the respondents, the bank has also gathered information about the customer during the relationship, which leads to that the bank has an internal source of information concerning the history of the customer. As a result of this, the bank already knows the historical and current position of the existing customer. Consequently the bank does not have to gather as much of information concerning an existing customer, as evaluating a new customer. Respondent A means that a customer's past within the bank, can facilitate the credit assessment assuming that the customer has fulfilled its commitments to the bank in the past. Respondent B indicates that in the assessment of a new customer it is important to collect information about its current financial position, while regarding an existing customer more future oriented information is in focus. The respondents of Bank C mean that a new customer can be inflicted a higher interest rate, compared to an existing customer. The reason for this is that a new customer implies a higher level of risk in their scoring models, since the bank does not possess as much historical information about a new customer as in the case of an already existing one.

#### **4.2.3 The influence of the financial accounting information**

As mentioned above one source of information that according to the respondents is used by all the investigated banks, is financial accounting information, such as annual reports, budgets and calculations. All of the respondents agree in that this is a very important source of information and



that the credit decision for a significant part is built upon this type of information. Respondent C titles the financial accounting information as a “linchpin” within the credit assessment process. The respondent of Bank B means that financial accounting information is used in every assessment process, hence the financial accounting information is a very important source of information. However, the respondent of Bank B express a small alarm regarding the use of annual reports in a credit assessment, this because that this source of information is partly historical. However, Respondent B still claims that this kind of information is useful in the credit assessment since it is important to calculate the current financial position of the customer. Further on, Bank B and C claims that a customer, who hands in financial accounting information to the bank on a regular and voluntary basis, gives the impression of not having anything to hide. In this way, handing in financial accounting information can increase the credibility of the customer.

### **4.3 The importance of the audit for the credit assessment**

During the interviews, all of the respondents stated that it is very important for the credit assessment, that the annual report is audited. The respondents regard the audit as a quality sign, which confirm the accuracy of the figures in the annual report and enhance the credibility of the customer. Respondent B claims that, even though the information from the annual report is historical, it is still important that the accounts are audited. Even if changes may have happened since the annual accounts were completed, it is still an assurance of the economic situation of that time. What now is incumbent on the bank is to analyze what has happened since then. The respondents of Bank C state that a customer applying for a credit, has to be able to prove its financial situation. The same respondents also claim that to have the accounts audited is one way to achieve this. All of the respondents also mention that regarding the smallest companies, which are the companies concerned by the new legislation, accounting consultants *can* be an alternative to auditors. Since the accounting consultants work continuously within the company, the respondents mean that this profession is more updated regarding the situation of the company compared to the auditors who just audit the company once a year.

When it comes to factors that may influence the value of the audit of the accounts, the respondents have different opinions and as an example Respondent A state that what kind of firm the customer runs matters in this question. The respondent means that a manufacturing company contains more issues to assess compared to for example a service enterprise. A manufacturing company may have a lot of mechanical equipment and a large stock, while a service enterprise has less material equipment to value and the audit may therefore be of more value when assessing a manufacturing company. Respondent B claims that the relationship to the customer influences the importance of the audit. If the customer is unknown, the bank wants to outweigh this factor with something else.

Respondent B means further that audited accounts can weigh out this uncertainty. Something that all the respondents however agree in that the audit can infer more for a new customer than for an existing. This is explained by the bank having a greater knowledge of an existing customer's historical behavior.

Further on, all of the respondents state that an adverse audit report is something that much emphasis is put on. Respondent A and B claim that they always try to find the reasons behind the adverse audit report. There are a lot of reasons to why a company receives adverse opinions from the auditor and these reasons are of different levels of importance for the bank. Further, Respondent B implies that a customer that has had an adverse audit report will be assessed on a different basis, not only during the current loan application but also the customer's entire engagement within the bank. Respondent C and D interpret an adverse audit report as a major warning indicator. This affects the scoring of the customer in a strongly negatively manner, which also can lead to restraints concerning receiving future credits.

The auditing of the internal controls appears to have an inferior position, compared to the audit of the accounts. Respondent B states clearly that this type of auditing is not as important as the regular audit, while the respondents of Bank A and C claim that this kind of information is more useable than that. Further, the respondents of Bank A and C imply that they would like to use this information more often and in a better way. Respondent C claims that this kind of information is used at a time when a customer already has faced a crisis, which the respondent believes is too late. Respondent C further implies that in, for the bank, loss-making deals, warning indicators in the auditor's report regarding internal controls are often discovered afterwards.

On the question if an audited firm will pay a lower interest rate than an un-audited firm, all of the respondents are unanimous. They mean that this particular condition does not affect the level of interest rate in a direct manner. The interest rate is instead derived from many different factors and auditing is just one of them. However, this does not mean that there is no relation between interest rates and the process of auditing at all. Audited accounts according to the respondents still bring extra credibility for the customer, in a situation of credit assessment. Hence, it is one factor among others that contributes to better credit terms.

#### **4.4 The statutory audit requirement**

The opinions of the respondents regarding the abolishment of the statutory audit requirement for SMEs diverge. Respondent A implies that the statutory audit requirement was something positive for Bank A's business. However the respondent is not against the reform of the legislation and does also understand its purpose. The respondent of Bank B claims that the auditing is valuable for the bank,

but neither this respondent takes a stand against the reform. Contrary, both respondents of Bank C believe that the abolishment of the statutory audit requirement is something positive. The respondents do not consider every company to need an auditor, instead they state that it depends on the specific conditions of every company. All of the respondents do however believe that the most of their existing customers still will continue undergo the audit process. Respondent B indicates that newly established firms might not hire an auditor for the audit process since they do not have to do an active choice of abolishing, which is the case for already running companies. Respondent C believes that the customers who want to receive a credit still are going to undergo the audit process, but for those customers that do not have a credit need, it can be invitingly to hire an accounting consultant or not hire anyone at all.

All the respondents have the same main opinion concerning how the abolishment of the audit requirement will affect the credit assessment. The opinion is that it probably will not affect the credit assessment substantially. The respondent of Bank A claims that the assessment was, and will still be, a combination of many different factors, which leads to a final decision. Hence it can be hard to see the consequences of an adjustment of just one factor. Respondent B implies that the Bank B may introduce a future audit requirement for those companies that want to receive a bank loan. At least, Bank B will require some kind of review from an objective inspector, which will resemble the situation during the statutory audit requirement. Respondent C and D state that for those companies who like to receive bank loan, audited accounts will be required. For the smallest companies concerned by the new legislation, an accounting consultant *can* be approved, but this depends on the specific conditions for the loan application. This means that the companies that choose to abolish the auditor and instead hire an accounting consultant will face approximately the same assessment as those who choose to keep their auditor. Neither of the investigated banks will according to the respondents raise the interest rates, nor deteriorate the credit terms as consequences of the choice to abolish the auditor.

Finally, on the question if the responding banks in the future can grant a credit to a company that has unaudited accounts, all of the respondents state that their banks are willing to do this. However, this is to interpret as an exceptional case. Respondent A claims that the audit of the accounts is not the most important issue within the assessment of a company's creditworthiness. At the same time, the respondent states that the bank will continue to assess the customer from a general impression, which also is the base for the final decision. Respondent B highlights that in the case of unaudited accounts Bank B will put more emphasis on the business owner as well as the customer's collaterals, if the bank is insecure about the accuracy of the accounts. The respondents of Bank C state that the



bank under normal circumstances will require audited accounts, but in some exceptional cases a credit can be granted based on unaudited accounts.

## Chapter Five – Analysis

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*In this chapter the empirical results are analyzed with the Frame of reference as a guideline. This is performed in order to relate the results of this study to previous research on the problem area of this thesis. This analysis is also the basis for the conclusions of this study, which follows in the next chapter.*

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### 5.1 Credit granting

In the following section, the credit assessment processes of the responding banks are analyzed, as well as which sources of information the responding banks use for their assessment and finally the importance of financial accounting information is declared.

#### 5.1.1 The credit assessment process

Like the recommendation FFS 2004:6 advocates, all of the responding banks have a written credit policy which acts as a guideline throughout the entire credit assessment process. Further on, these policies include rules regarding how many credit evaluators and which positions they must possess, to have mandate to make decisions concerning credit granting, just like the FFS 2004:6 promotes. As mentioned in *“The frame of reference”*, banks have the opportunity to design their credit policies themselves. Factors that affect the design of each bank’s credit policy and especially the decision-making rules are according to the respondents the size of the credit and the quality of the deal.

Similarly to Murray (1959), three different phases can be distinguished in the answers of the respondents, concerning the banks’ credit processes. From the statements of the respondents, it is obvious that all the investigated banks in an initial phase gather information concerning the customer, which then in the next step is interpreted through different tools, like for example scoring models. When the interpretation of the information has been performed it is time for the final decision whether to grant the credit or not, which also is the third phase of the credit process according to Murray. In addition to this, Murray claims that the creditor after the final decision continuously performs follow-ups and monitoring of the customer. This is also according to the respondents the case of the banks, which monitor and gather information of every customer even after the customer has received a bank loan.

Further, it was apparent from the respondents’ answers that the credit assessment of all the banks is focused on the issues of repayment ability and the collaterals of the customer, just the two issues that Johansson (1973) finds to be central for the judgement of the creditworthiness of a borrower. However, the respondents have different opinions regarding how important the collaterals are and in which situation they matter the most. These differences were not found concerning the importance



of the repayment ability, which indicate that the respondents value the matter of the repayment ability higher than the matter of collaterals.

Even if there were no doubt among the respondents about the importance of the repayment ability, there was still one subject that all the respondents mentioned could affect the assessment of the repayment ability. Similar to what Rad et al. (2011) claims, the respondents mean that the business sector which the customer operates in is an important factor when assessing the repayment ability. According to Rad et al. (2011) firms within a certain business sector, characterized by a low return on investment, can even face difficulties in receiving a bank loan. The results of this study indicates that the responding banks perform more critical reviews when assessing customers within risky business sectors, which for these customers can result in more difficulties when applying for a credit.

One item that was especially highlighted by the respondents was the importance of selecting adequate customers, in purpose to reduce the credit losses as much as possible. This concern of the respondents can be connected to at least one of the two types of errors, which according to Newbold (2009) can appear during the credit process. When selecting a customer, it is according to the respondents essential for the banks to assure that the customer runs his or her business in a proper way, so the customer will be able to repay the loan during the whole credit period. In this way the responding banks want to avoid accepting a customer who in the future will fail to fulfill its commitments to the bank. In other words, the banks want to avoid making an error of Type I.

Hagberg (2006) divides the credit assessment into two analyses, one quantitative and one qualitative. This division can also be applied on the credit assessment of the investigated banks. On the one hand the banks, according to the respondents, perform profoundly analyses regarding the customer's financial position, which can be referred to the quantitative type of analysis. All of the respondents state that they use some kind of scoring models for this type of analyses, which is consentient to what Berger & Udell (2006) claim. However, it was obvious that the respondents of the metropolitan located Bank C value the scoring models higher than the respondents from banks with local profile. On the other hand, the respondents claim that analyses concerning the type of the business and the business management's ability to run the business properly are accomplished. These analyses can be considered to be of a qualitative nature. Similar to what Hagberg (2006) states, the respondents of Bank C mean that the personal confidence is a crucial factor in this type of analysis.

Concerning the different models of credit assessment, none of the respondents directly states that they use one model or another. However, the content of two of the models is especially relevant for the credit assessment of the investigated banks. The basic 3C-model, designed by Murray already in

1959, can be used to describe the core factors of the credit assessment processes, presented by the respondents. *Capability*, *Capital* and *Character* can be referred to the analyses regarding the repayment ability, the financial position and the ability of the business owner. These three factors are, according to the answers of the respondents, central in the credit assessments of the investigated banks. Hence, the 3C-model is highly relevant for illustrating the assessment process. Further on, the extended 5C-model is also considered to be relevant for the responding banks. Collaterals and Conditions are referred to the analyses of the collaterals and the customer's business environment, such as the business sector. These are factors that the respondents find to have an impact on the credit assessment. Concerning the other models, CAMPARI and the model based on bargaining power are not as applicable as the 3/5C-models. CAMPARI contains partly the same features as the 3/5C-models and is in that aspect relevant, but the features that distinguish CAMPARI from the 3/5C-models, for example the Insurance factor could not be found in the answers from the respondents. When it comes to the model based on bargaining power, none of the respondents mentioned this to be of crucial matter for the credit process.

Finally, McNamara & Bromiley's observation from 1997 concerning the effect of standardization within the credit process is according to the reasoning regarding experienced credit evaluators of Respondent A. Just like McNamara & Bromiley (1997), Respondent A means that an experienced credit evaluator, who uses less standardization, can be considered to make less incorrect decisions but also to discover more problematic factors in the long run.

### 5.1.2 Information gathering

The sources of information used by the different banks are according to the respondents of both quantitative and qualitative nature. Annual accounts, budgets and future calculations are examples of quantitative information sources, while business plans and personal meetings are examples of qualitative sources of information. It is also interesting that all of the respondents put extra emphasis on the importance of quantitative sources of information, even if they throughout the interviews stated the importance of the personal relationship and confidence for the customer. The respondents mention cash-flow analysis and the rating from scoring models as the most important source of information, which indicates that the quantitative information sources still is the most significant.

Further on, in agreement with Burghof's (2000) research, all of the banks according to the respondents have contact with the customer's auditor. This contact is most common in situations where the uncertainty is larger than usual, such as when a customer is applying for a large credit or when the purpose for the credit is a large investment. Similar to what Burghof (2000) means, the

respondents of Bank C state that the confidence in, and the relationship to the customer decides whether to contact the auditor or not. In addition and also in contrast to the other respondents, the same respondents also state that the reputation of the single auditor might affect the assessment of the customer's accounts. This is in line with what Svensson (2003) claims. However, the respondents of Bank C does not go as far as Pittman & Fortin (2004) do, who mean that the reputation of the single auditor even may affect the credit terms, such as the interest rate.

All the investigated banks agree in that the information gathering differs in the matter of a new, or an already existing customer. This is also according to what Svensson (2003) states, who mean that extra information needs to be collected when assessing a new customer. The reason for this, according to Bouckaert & Degreyse (2006), is that the bank has no previous experience or information concerning the new customers and their behavior. To outweigh the absence of a previous relationship, more information has to be collected.

Finally, in the matter of the geographical market and local social context, that according to Svensson Kling (1999) and Silver (2001) is more important in smaller districts than in metropolitan areas, it was noticed that the opinion among the respondents differ slightly. The respondents of Bank C, which is located in a metropolitan area, emphasis more on the scoring models, while the respondents of the local Banks A and B, focus more on the personal relationship to the customer and the knowledge of the local and social business environment. However, the respondents of Bank C as mentioned above, still finds the confidence for the customer as a significant factor and both types of banks still mentioned quantitative sources as being the most important. Hence, the differences cannot be considered to be very large.

### **5.1.3 The influence of the financial accounting information**

According to Svensson (2003), the financial accounting information is a very significant source of information that is widely used in the credit assessment process, which also is a statement that all of the respondents agreed in. Similar to Berry & Robertson (2006) the respondents also suggest that financial accounting information is the most important source of information. The respondents stated that they put extra emphasis on cash-flow analyses and scoring models and that these two sources are the most important. Both these information sources are derived from financial accounting information. Further on, the respondent of Bank B agrees with Berry et al. (1993) regarding the problem of the annual reports containing historical information. This is not an issue that the other respondents even mentioned. This objection can therefore not be considered to diminish the level of relevance for the financial accounting information. Finally, the situation according to the respondent of Bank B and C, when a customer hands in financial accounting



information on a regular and voluntary basis, can partly be referred to the study of DeWayne et al. (2008). The respondent agrees in the fact that continuously reporting has a positive effect on the credit assessment, but the bank does not mention any differences between high- and low risk companies, which is the case in the study performed by DeWayne et al.

## 5.2 Auditing

In this section the influence of the audit for the credit assessment is analyzed, as well as issues regarding the statutory audit requirement.

### 5.2.1 The influence of the audit for the credit assessment

That all of the respondents find auditing important for their kind of business was very clear, since they need accurate and credible information for their credit assessments. This is in line with the research by Svensson (2003), who claims that the audit process is valuable for the creditors. This also means that the audit process works as a quality assurance for the respondents, which is similar to what Collis (2003) means. Further on, it is implied by the respondents that situations of asymmetric information do exist between the investigated banks and their customers. As an example, the respondents of Bank C state that their customers have to prove their financial situation to receive a bank loan, which indicates that the bank has less information than the customer about this, pursuant to what Andersson (2001) claims. One way for the customer to prove their financial position, and hence reduce the situation of asymmetric information, is according to the respondent of Bank C to have their accounts audited. This follows the statements regarding asymmetric information by Moore & Ronen (1990), Svanström (2008) and Rad et al. (2011). This is further verified since all of the respondents believe that the audit process is extra important when evaluating a new customer, whom the bank has less information about, compared to an existing customer. It is apparent that the auditor acts as a third party who reviews information in order to reduce the situation of asymmetric information between the bank and its customer. This statement is similar to what Adams (1994) claims.

On the question whether an adverse audit report matter in the credit assessment process or not, all of the respondents undoubtedly stated that an adverse audit report is information that matters greatly for the outcome of the credit assessment. This is just in line with the findings of Gómez-Guillamó (2003 & 2008), who means that the opinion of the auditor has an effect on the lending decision of a bank. Further, the respondents of Bank B and C verify the statements of Bamber & Stratton (1997) and Guiral-Contreras et al. (2007) concerning the effect of an adverse audit report on the credit assessment. Just like these authors, the respondents interviewed in this study state that an adverse audit report serves as a warning indicator, which results in a more careful assessment that can lead to a higher probability of a rejection of a loan application. Thus, there is no support among

the respondents for the opinions of Libby (1979), Abdel-Khalik et al. (1986), Bessel et al. (2003) and Lin et al. (2003), who all mean that the information provided by an adverse audit report is either redundant or just has a fairly limited effect on the assessment and final decision of a creditor. Instead the respondents seem to believe the opposite in this matter.

Further it seems like the opinion of the auditor regarding internal controls is not as important as the opinion concerning the regular accounts. For example the respondent of Bank B stated that the review of the accounts is much more important than the review of the internal controls. Consequently, the audit of the internal controls may not significantly affect the judgement of a credit evaluator, at least not as much as the audit of the regular accounts. Accordingly, the results of the study performed by Schneider & Church (2008), who concluded the opposite, is not confirmed by the respondents in this study. However, the respondents of Bank A and C meant that they would like to use the information regarding the internal controls more often and in a better way, which indicates that these banks find the review of the internal controls to be valuable information. This can be related to the conclusions of Lopez et al. (2009). It is also possible that this statement is an indication that the responding banks in the future will increase the use of the report concerning internal controls in their credit assessment. Therefore the influence of this kind of information in the credit assessment might also increase.

Finally, the respondents do contrary to Blackwell (1998), state that there is no direct relationship between auditing and interest rates. Instead the banks mean that auditing is just one factor among others that can affect the level of interest rate. This is similar to what Johnson (1983) state, who means that no direct relation could be proved between the use of auditing and the level of interest rates. However, just like Johnson (1983) claims, the respondents believe that audited accounts still are one, but not the only factor that influence the credit terms.

### **5.2.2 The statutory audit requirement**

Regarding the abolishment of the statutory audit requirement, all of the respondents express that they do not believe that a majority among the companies concerned by the new legislation will use the opportunity to skip the process of auditing. Thus, this prediction of the respondents are cohesive with the results of the study performed by Svanström (2008), who means that a majority of Swedish companies voluntary will keep the process of auditing, even among the smallest companies. Further this prediction is also coherent with the evaluation of the outcome of the abolishment of the statutory audit requirement in Denmark. Since the conditions regarding which companies that were concerned by the abolishment in Denmark are very similar to the Swedish conditions, the outcome of the Danish abolishment is highly relevant. In Denmark 22.8% of the companies concerned by the



abolishment, decided to skip the process of auditing and of these a substantial part still hired a third party for other accounting services than a proper audit. That the companies in Sweden who choose to skip the audit process instead will use other accounting services than a full audit might be something that the respondents believe to be a possibility. This since all the respondents mean that accounting consultants *can* be an alternative to auditors for those companies, who chose to skip the audit process, but still want to prove their financial position.

However the respondents did not, like the banks in Denmark, state that the companies who voluntary chose to undergo the audit process, will face lower interest rates and better credit terms than those companies who do not. Instead two of the respondents stated that audited accounts, or at least an assurance of an accounting consultant in most cases will be required. Hence, it is likely that one of the reasons to voluntary undergo the audit process, is that audited accounts are required by the banks. This is similar to the statement of Collis (2003), who mean that one of two main reasons for companies to voluntary hire an auditor for a proper audit is that they hand in a copy of the audited annual report to their banks, which they also want to continue to do. The other reason is that the companies like to raise the quality of the accounts in purpose to increase their creditworthiness.

## Chapter Six – Conclusion

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*In this chapter the research questions are answered and conclusions are drawn. In addition, contribution of the thesis, reflections of the authors and suggestions for further research are presented.*

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### 6.1 Conclusion

First in this section, the sub-questions formulated in *Chapter One* are answered in order to be able to answer the main research question of this thesis.

#### The first sub-question:

- *Does the credit assessment process of an SME differ among the two kinds of banks?*

Unexpectedly small differences between the two kinds of banks investigated in this study were found concerning this question. Both kinds of banks have a written credit policy containing rules regarding the decision-making authorities within the banks. The credit assessment processes of both types of banks also follow the three phases according to Murray (1959) and furthermore contain a phase of follow-ups and monitoring. Further, the central issues for the credit assessment of the responding banks are the repayment ability and the collaterals of the customer. In addition, the credit assessment process of both kinds of banks contains two types of analyses; one quantitative and one qualitative. Consequently, the credit assessment processes of the both types of banks are generally similar. However, one minor factor that differs among the both types of banks in this study is that the local banks are also considering environmental factors in their credit assessment.

#### The second sub-question:

- *Is there a difference in the information sources used by the different banks, when assessing the creditworthiness of an SME?*

Similar to the case above, small differences were found between the both types of banks even in this matter. Both kinds of banks in this study use similar sources of information of both quantitative and qualitative nature. Both bank types do also mention quantitative sources as the most important. The metropolitan bank puts extra emphasis on the results of scoring models while the local bank puts more weight on the cash-flow analysis. However, both of these information sources are partly built on financial accounting information which means that this kind of information can be considered to be prominent. Both bank types considered in this study

do also mention the personal relation to, and confidence in the customer as a very important source of information. Especially the local bank values the personal relationship to the customer and the knowledge of the local and social business environment more than the metropolitan bank, which instead have the scoring models in focus. This represents the most significant difference between the banks. The range of this difference is however not extensive, since both bank types still mention quantitative information sources as the most important, like mentioned above.

**The third sub-question:**

- *Does the opinion regarding the importance of auditing for the credit assessment process differ among the different banks?*

Both bank types considered in this study find auditing to be very valuable for their business. The banks do also have similar reasons for their standpoint. The investigated banks believe that the auditing composes a quality assurance of the financial accounting information and that the auditing in the same time works as a tool to decrease the asymmetric information which exists between the banks and their customers. Further, both bank types put emphasis on an adverse audit report and it is stated that this kind of information affects the credit assessment in a negative manner. However, it is noteworthy that both kinds of banks, even if they clearly expressed how important the auditing is for the credit assessment process, may accept accounting consultants as an alternative to the auditors. This might mean that the focus of the responding banks lies on that an independent review by a third party is performed, but however it is not that important that this review is a proper audit. Hence, the statutory audit might not be that important for the credit assessment of the banks in this study. Instead, the investigated banks indicate that an independent review is what they value, and there are nowadays other ways than a proper audit to achieve this review.

After answering the sub-questions, it is now possible to answer the main research question of this thesis:

- *How is the credit assessment process of a bank located in a metropolitan area, compared to a bank with a distinct local profile, affected by the abolishing of the statutory audit requirement for Swedish SMEs?*

The main conclusion is that the abolishment of the statutory audit requirement will have minor effects on the credit assessment of the both investigated bank types in this study. Since SMEs want to receive capital from the bank, the SMEs are in a position of dependence to the bank.

Thus, the bank is able to set the conditions. Both types of banks stated that they, in most cases will require some kind of independent review of the customer's accounts. As a result, the investigated banks face a similar situation as when the statutory audit requirement was in use and consequently the credit assessment process will not be particularly affected. In addition, the prediction of the responding banks regarding that the most customers will continue to have their accounts audited is likely to be true, since this in most cases will be a requirement for receiving a bank loan. Further on, it is after evaluating the answers to the sub-questions not surprising that no significant difference between the metropolitan and the local bank was found regarding the effect of the abolishment of the statutory audit requirement. Since there were just minor differences between the credit assessment processes, the information sources used for the credit assessment and the opinions regarding the importance of auditing among the different kinds of banks, it is quite logical that the abolishment has a similar effect for the different kinds of contributory banks of this study.

## 6.2 Contribution of the thesis

The aim of this thesis was to find out if there are any differences in how the credit assessment process of a metropolitan- and a local located bank is affected by the abolishment of the statutory audit requirement. The conclusion is that the credit assessment process is not greatly affected by the abolishment and that no major differences exist between the different bank types. Contrary to previous research, this thesis also concludes that no major differences can be found in the credit process of the two types of banks compared. These conclusions are the main contribution of this thesis.

## 6.3 Reflections of the authors

Since the number of respondents in this thesis is slightly limited, the authors are aware of the restricted possibility to draw general conclusions from the result of this thesis. Hence, the authors do not claim that the result can be applied on other banks than the ones investigated. However, this does not mean that the result is of minor importance or not useable. Instead, the authors believe that this result, along with previous research, can contribute to an increased comprehension and insight to the subject concerned.

Further on, the authors understand that due to the recency of the abolishment of the statutory audit requirement, the complete effects may not yet be totally observable, this since it may take some time until the total effects from a major reform can be seen. During the performance of this study it has been noted that all of the investigated banks are well prepared for the new legislation. All of the investigated banks have according to the respondents a plan for how to



approach the abolishment of the statutory audit requirement. Hence, it is still interesting to consider the possible effects on the credit assessment process.

Finally, the authors have reflections regarding the similar answers from the two different kinds of banks. There might be several reasons behind the similar answers. One reason that may explain the similar answers is that the type of customers concerned by the new legislation, and hence this thesis, are all SMEs. This means that the credit assessment processes investigated in this thesis concern customers of similar nature. Consequently, the credit assessment process may be performed in a similar manner regardless what type of bank performing it. Another reason to the similar answers may be that the banking sector has to adapt the credit assessment process to the strict legislation concerning this type of business. Hence, due to the legislation there may not be many possibilities for differences between the designs of the credit assessment processes between banks.

#### **6.4 Suggestions for further research**

After performing this study, the authors believe that it would be interesting to further investigate how the abolishment of the statutory audit requirement has affected the credit assessments after a period of time. As mentioned above, it may take some time until the total effects from a major reform can be observed. Will there be a different result after a couple of years when the banks have had the opportunity to fully adapt to the new legislation? Further, it would also be interesting to investigate how different cultures within the banks (due to their country of origin) may affect their approach to the abolishment of the statutory audit requirement. This since this study only considers Swedish banks. Do foreign banks handle the abolishment in a way similar to Swedish banks or not?



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*In this chapter the sources of information are presented.*

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# Appendix 1

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*This chapter contains appendix 1.*

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## The interview-guide

### Introduction

1. What do you currently work with and what does your background in the bank look like?
2. For how long have you been working with credit granting towards companies?

### Credit granting

1. Can you describe the credit process of your bank? Does your bank have a credit policy?
2. What type of information is gathered as the basis for decision in the credit assessment?
3. What type of information is the most important to consider in the credit assessment process?
4. Are there any differences in the information gathered when assessing a new customer, compared to an existing?
5. Does the business sector, which the customer operates within, matter for the credit assessment?
6. How important are the collaterals of the customer for the credit assessment?
7. How important is the confidence in, and the personal relationship to the customer for the credit assessment?

### The importance of auditing

1. How is financial accounting information used in the credit assessment process? How important is this kind of information?
2. How important is it that the financial accounting information is audited?
3. What is your opinion regarding the audit of internal controls? Is it useful in the credit assessment process?
4. What qualities do you believe that auditing of the financial accounting information adds to the basis for decision of the credit assessment?
5. Are there any factors that may affect the importance of the auditing for the credit assessment? (Factors that may increase, or decrease, the importance of the audit.)
6. Is auditing of the same importance when assessing a new customer, compared to an existing?



7. Do you contact the customer's auditor during the credit assessment process? In which situations and on what premises do you contact the auditor?
8. What is the opinion of the bank regarding an adverse audit report in a situation of credit assessing?

### **The statutory audit requirement**

1. What is your opinion concerning the abolishment of the statutory audit requirement for SMEs?
  - Do you believe that your customers will avoid the auditing process?
2. Have the abolishment of the statutory audit requirement affected the credit assessment process of SMEs? If that is the case, how?
3. How will you treat the companies, which have chosen to skip the audit process?
4. Is it possible for you to grant a credit to companies, which do not have audited accounts?

Is there anything else that you would like to add or comment on?