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The influence of banks on companies' accounting choices

A study of K2 and K3

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School of Business, Economics and Law

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Abstract

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Objective: The objective of this paper is to develop a shared understanding of what affects different banks' lending process, how banks set to similar companies' choice of different accounting rules and their incentives to affect companies.

Method: In order to answer the research question data has been collected through interviews and literature consisting mainly of articles. The respondents were credit analysts and business advisors and thus possessed the competence to answer the questions. The research question is of descriptive character and aims to describe banks' behavior and how they want to steer companies' accounting choices.

Conclusion: Our results show that banks are not working to steer companies' accounting choices, the most crucial is that they understand and trust the figures the companies provide through their financial statements. In the credit assessment of small and medium-sized companies the banks investigate the cash flow, the management and they collect much qualitative information, not provided only from the financial statements but also from meetings and the relation with the customers. The banks have not taken a position regarding the K-regulations and how they want small and medium-sized companies to report. As long as the information is enough to make an assessment according to their risk approach, they are indifferent and will not steer companies in any direction.

Further research: Since K2 and K3 have not become mandatory yet; the knowledge about the K-regulations is not great. Therefore it would be interesting to study if the same conclusion is reached after the K-regulations are implemented in the companies. Do banks want to control companies to a specific accounting choice after the regulations have been implemented and the banks have seen how the new regulatory has affected them and what approach they then will have.

Key words: Rules-based, principle-based, credit rating, small and medium-sized business, K2, K3, accounting

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1 Introduction

1.1 Background

International Accounting Standard Board (IASB) is an organization that issues accounting standards known as International Financial Reporting Standards (IFRS). The purpose of these standards is to harmonize the accounting in such a way that the reports should have a high quality with strong comparability between countries. As capital markets have evolved to the global stage they are at today, it requires that financial statements provide more and more information. The complexity has increased significantly and to provide stakeholders with the amount of information that a listed company is obliged to, costs huge amounts of energy and resources. For small and medium-sized companies this is a heavy burden, they usually do not have a large group of stakeholders as listed companies do. In reality they therefore do not have to produce any complex reports as IFRS demands.

For this reason, the IASB started a simplification project for small and medium enterprises; the project was called "IFRS for SMEs". The purpose was to develop standards for small and medium enterprises, which constitute 95% of the world's business. The project started in 2003 and the exposure draft was published in 2004. The IFRS for SMEs was published in 2009 (IFRS).

Regulation in Sweden is principles-based which means that there is a lot of room for interpretation. The Swedish Accounting Standards Board is a governmental body and operates under the Finance Ministry and one of their main tasks is to provide small business owners with standards and guidance on accounting (BFN).

In conjunction with the IASB's simplification for small and medium enterprises the Swedish Accounting Standards Board chose to start a simplification as well, which went under the name "The K-project". The project started in 2004 and was finished in 2012. The K-project divides companies into four different categories. The categories are named K1, K2, K3 and K4. K1 includes non-profit organizations and individual companies and K4 are listed companies and corporations that must use IFRS. The K3 regulation is the regulation inspired by the IFRS for SMEs and is principle-based. K2 is regulatory, optional for companies that fall within the limits of what is considered as small businesses. Businesses found in K3 and K2 represent almost all Swedish companies. The major differences between K2 and K3 are that K3 is principle-based and K2 is rule-based, but also that K2 is a major simplification where the demand for information is not nearly as large as the K3. For companies it is only mandatory to report according to the K-regulations for financial years starting January 2014. However, companies will have to account for fiscal

years starting January 2013 since the annual report will require comparative figures from the previous year.

An annual report is supposed to give the stakeholders an insight in the company and is a significant source of information. Stakeholders read annual reports to examine how the financial year has been but also to analyse how it will be in the future.

The banks' role in society is extremely important and the society is dependent on banks on many levels. A very important function banks and other credit institutions have is that they give credit, and thus open up the possibility of carrying out transactions that would never have been possible otherwise. In order to obtain credit from banks, whether for businesses or individuals, the bank requires information. When it comes to companies, the annual report serves as a part of the foundation on which the bank makes their decision. An annual report full of information gives the bank a better basis than an annual report with little information. In the transition to K-regulations 97 percent of all Swedish companies will have the opportunity to choose to report according to K2. For banks, this means that 97 percent of their corporate customers will in the future be able to choose to report according to K2 and thus deliver more compressed statements regarding disclosures and other information (Lennartsson, 2012).

1.2 Problem discussion

When regulation becomes mandatory, the opportunity for smaller companies to choose which regulation they want to follow will cause a situation where companies at the same financial level may look differ from one another in a study of their annual reports depending on what regulation they choose to follow. In reality they may have identical economic structure but since they have chosen to use different regulations, different amount of information will be given through the annual reports. Since the K2-regulation is supposed to be a simplification of K3, much of the information that K3 demands is removed from K2.

The K2-regulation has been criticized since its publication in 2008. Critics say that K2 is too narrow and it does not give companies the opportunity to give a true and fair view of the business. There are some who believe the contrary, that K2 based on caution gives a true and fair view of the company and fulfils its role as a simplification of K3 (Drefeldt and Törning, 2012). One of the benefits with K2 is that it saves a lot of time. Accounting consultants think that it gives them time over to really play their role as consultants. Approximately 97 percent of all Swedish companies have the opportunity to choose K2. Among these companies there are many who have stakeholders who demand a more informative annual report, such as investors and analysts. For the larger part of Swedish companies, the annual report is just created for Bolagsverket and sometimes the bank when the company has to

borrow money. In most cases, the companies only have two stakeholders. Bolagsverket demands an annual report every year and the bank demands an annual report when a company enters the credit process (Lennartsson, 2012). In a credit process the bank wants to receive as much information as possible to reduce the risk of the company not paying back the loan and the loan rate. As mentioned above, 97 percent of all Swedish companies have the right to choose between K3 and K2. The question is, do banks want to steer these companies into K3 or K2 or are they indifferent and acquire additional information in other ways to reduce the risk in a lending process?

1.3 Research question

How would the banks like to steer companies when it comes to accounting regulations?

1.4 Objective

The objective of this paper is to develop a shared understanding of what affects the different banks' lending process, how banks look at similar companies' choice of different accounting rules and what their incentives are to affect companies. This study will provide information about critical points when it comes to the lending process. A bank is a large stakeholder of most companies and this study will try to investigate whether banks want to steer corporate accounting, which is important so that the setters can share our findings and therefore may consider the outcome in future norms to better align the accounting rules of businesses.

1.5 Limitations

Since large companies will not be able to choose between K2 and K3, we will not focus on these. Under certain circumstances, choices of K2 and K3 will affect the large companies indirectly through their subsidiaries. Since we want to investigate how banks want to steer companies' accounting choices the study is limited to small and medium-sized companies. We will also not focus on all banks, but the five largest banks in Sweden, which are Nordea, SEB, Handelsbanken, Swedbank, and Danske Bank.

2 Research method

2.1 Research methodology

In research, there are mainly two different methods of gathering information: through quantitative or qualitative studies. When conducting quantitative studies, the researcher gathers information and facts and then studies the relation between the facts. If qualitative studies are conducted, the researcher finds out how humans perceive their environment, where the goal is insight rather than statistics (Bell, 1999).

Because of the complexity of the research question, it is hard to conduct a quantitative study by studying figures and calculating them to reach an. The research question is of a more descriptive character and therefore to answer it, it is more suitable to do a qualitative study because of the need for more understanding and deep analysis. The focus was on how banks use corporate accounting information and on what their attitudes are towards companies' different accounting choices. Since the study is about behaviour and people's perception of a situation a quantitative method would not be sufficient because a survey could not ask the follow-up questions needed to make a conclusion about the subject nor could it get the depth needed to answer the research question. With the information from the interviews we were able to interpret how much banks can effectively control the companies to choose accounting regulations in the banks' favour.

There are two ways to design qualitative studies, through analytical induction or through grounded theory (Lundahl and Skärvad, 1999). Since the basis of this study is to explain the behaviour of banks, it is designed through analytical induction, which means that the results were interpreted so we could analyse them later.

2.2 Research approach

According to Collis and Hussey (2009) there are two approaches to how researchers can draw scientific conclusions, namely inductive and deductive research. Deductive research is a study where the theoretical framework is developed and is then tested by empirical observation. This means that we can draw special cases from general conclusions in the theories. Inductive research is a study where you develop theories from observations and where general conclusions are drawn from special cases (Collis and Hussey, 2009). Qualitative studies usually consist of inductive research, but at the same time interpretations are made and this can be seen as some kind of deductive research (Strauss and Corbin, 1998). According to this it is hard to perform only inductive research because scientists are engaged in deductive research from the collection of information to life experience.

Due to the fact that there is a lack of literature about the research question the frame of reference have been structured in a way that frames the question. The frame of reference consists of articles published by specialists and was used to interpret and explain the results. With the theories it has been possible to associate special cases from general conclusions and gain a wide comprehension about the question. Further it is important to stay open-minded and thus find an appropriate way that fits the research question. By using theories to frame the question facilitates the open-minded approach and is therefore the most appropriate way to answer the research question.

2.3 Data collection

Qualitative and quantitative studies can consist of different methods of data collection. Monitoring is a form of data collection where the researcher observes a subject's activity without producing responses from the subject. Another form of data collection is interrogation, where the researcher asks the subject questions and collects their responses. Quantitative and qualitative studies can rely on both of these methods of data collection (Blumberg, Cooper and Schindler, 2011). The best way to get a deep understanding of the chosen subject and to answer the research question was to collect data through interrogation of people that are competent in the subject. When interviewing the respondents, discussions facilitated our understanding.

2.3.1 Primary data

Primary data is data that the researcher collects on his own, for example from field studies and interviews, while secondary data is data that already exists and that someone else has collected (Blumberg, Cooper and Schindler, 2011). Because the study uses a qualitative perspective through interviews the primary data consists of the answers from the interviews conducted. The primary data collected was satisfactory and by using the theories in the frame of reference, the empirical findings could be explained and understood. A collection of secondary data would not help to further our understanding.

2.4 Interviews

There are different types of interviews and the choice between them depends on the kind of information that needs to be retrieved. One form of interviewing is a standardized interview, where both the questions and the order of the questions are determined. The interview of different people is conducted in the same way in the whole survey. The second form of interviewing is an unstandardized interview, where the questions and the order of the question are more free and where the most important thing is that the questions asked actually give the answers that to the question (Lundahl and Skärvad, 1999). In this case, the interview can be more

flexible and be based on the situation. A third category of interviewing, that neither falls under standardized or unstandardized, goes under the name semi standardized. When conducting this type of interview, a sample of questions is determined and given to the respondents, but follow-up questions are asked and some questions can be asked only to some respondents (Lundahl and Skärvad, 1999).

Since this study is based on how different people perceive a situation, we engaged in semi-standardized interviews. This decision was based on the fact that we wanted the respondent to know some of the questions we were going to ask, but also because to have the opportunity to ask follow-up questions to gather the information needed. In this study it was chosen to focus on the use of accounting information when conducting the interviews due to the fact that banks are not accounting firms and we did not expect them to have a deeper understanding about the K-regulations. Therefore, we wanted to focus on the use of accounting information and from there formed an opinion on how much accounting information matters in a credit assessment process.

The respondents wanted their answers to be anonymous and therefore we will not refer to the banks' names in "*5. Empirical findings and analysis"* but use letters as aliases. We will refer to the banks as A, B, C, D and E.

2.4.1 Sample selection

Respondents were selected through examining their size and the number of clients they have. Therefore, five banks were selected that companies use and that are able to provide loans to companies. The reason for the choice of these five banks was that we believe that these banks use accounting information in a great extent when granting loans. Local banks in the countryside are usually smaller and more familiar with the companies operating in a specific town and therefore we did not believe that the accounting information is used in the same way. It was important that the accounting information was significant for the banks since it otherwise would not have matter if the company choose to report according to K2 or K3. Also, we believe that these banks are the ones who have a potential to influence companies' choice when it comes to accounting rules, because if a large bank does not want to offer a company a loan, chances are that a smaller bank, with less resources, will not be able to provide the company with a loan either.

The four largest banks in Sweden are Nordea, SEB, Handelsbanken and Swedbank. Other financial groups are Danske Bank, Länsförsäkringar and Skandia (Swedish Bankers' Association). The choice of research object was based on this information and the four largest banks were chosen with Danske Bank, which is the largest financial group in the Nordic countries, after Nordea. The reason for choosing five banks is that we believe that interviewing more would not be necessary because if these apply a specific method, it is likely that you can make general conclusions.

Also, five banks are enough to obtain a good impression of the subject and the reason for choosing exactly five banks is that we wanted to be sure that a majority applied the same method.

The respondents within a bank were chosen based on their role in the company. To receive as much information as possible about the credit process and to be able to ask questions related to accounting it was important to interview a credit analyst because of their knowledge and the fact that they work with these questions on a daily basis. In some banks the interview was held with both a credit analyst and a chief of credits and in some only with a credit analyst or the chief of credits.

When contacting the banks, we had personal contacts in some banks, but in others we had to go through the student representative who we thought would give us contact information to a credit analyst or a chief of credits, but it took too long and therefore we decided to find the contact information on our own. We did this by calling the front desk and asking to talk to a credit analyst. An initial contact was therefore made via telephone, but it took some time to schedule an appointment. All of the interviews were conducted at the head office of each bank in Gothenburg except for Handelsbanken, where the interview was conducted at a local office at Brunnsgatan 1, Gothenburg. The reason why we had an interview at one of Handelsbanken's local offices is because their credit decision process is decentralized and the local offices thus have competent personnel.

2.5 Empirical structure and method of analysis

As an introduction to the empirical findings the banks and employees interviewed are presented so the reader can comprehend which position each person has in the bank, which helps to understand what kind of knowledge they possess about the subject. Then the answers given in the interviews with the banks are presented, these have been anonymised because of the banks confidentiality so there is no possibility to distinguish one bank from another. The presentation of the answers from the interviews was built up so the reader can obtain a complete picture of the bank's procedures and therefore the difference between them is described in the empirical findings to make it easier to compare.

After the empirical findings the compiled answers are analysed so the reader can more easily understand the reasoning. With the help of the frame of reference the answers from the interviews with the banks are analysed and linked to our study about K2 and K3. The analysis provides the basis for the conclusion and thus answers the research question on how banks want to affect banks accounting choices.

2.6 Criticism of the method

At the end of the interview with one of the banks, the recording device stopped recording, which resulted in us using only our notes from the last 15 minutes of the interview. This may cause some kind of misunderstanding, but since we sent all material to the bank for their approval, we believe that everything was interpreted in an accurate way.

In the interviews the focus was on people who are familiar with accounting and the credit assessment process. It was important that the people we interviewed were knowledgeable in accounting so that they could answer our questions. During the interview process we realized that there was a lack of knowledge, among the banks when it came to the new K-regulations, and therefore not all questions were answered. Interpretations had to be made based on the responses we received, which in turn may have led to us drawing conclusions based on our individual interpretation instead of facts.

Furthermore, we believe that if we would have interviewed small and medium enterprises as well, to investigate the research question from their point of view we might have understood the outcome better. We believe it is difficult to generalize from only interviewing one or two people in the banks, as we have done. It can be hard to determine whether the respondents' answers can summarize and represent how banks look at the assessment of companies in the credit process and which factors are more or less important to take in consideration.

2.7 Literature search

The literature used in this study came from different websites, databases and nonfiction literature. The choice between K2 and K3 and the factors that affect this choice is a relatively new subject and is not discussed in the nonfiction literature. For this reason the database FARkomplett.se was used, where articles from the paper Balans was found, where the subject is discussed. The keywords used during the literature search in the study were rules-based, principle-based, credit rating, small and medium-sized business, K2, K3 and accounting.

2.8 Literature review

The frame of reference is supposed to give an overview of the K-project because it is the most essential subject in this study. Furthermore, to understand how accounting information is used by banks it is crucial to understand the credit assessment process, where banks rate and evaluate companies based on their ability to be able to repay a loan in the future. Based on the information found about the credit assessment process, the frame of reference developed. Considering that the study is based on the banks' perception of the K-project it is important to understand what role banks play as stakeholders in companies.

2.9 Credibility

2.9.1 Validity

Validity can be very complicated to measure. The term refers to a measurement of whether a particular question measures what it is intended to measure or describe. A question might lack reliability and it can also lack validity, but it can also have high reliability without validity (Bell, 1999, p 90). This means that a question can give the same answer at different times, but still does not measure or describe what it is supposed to measure or describe.

To be able to ask the right questions, we had to have a lot of knowledge about the subject and understand both how the credit assessment processes function but also understand how much knowledge credit analysts have about the K-framework. To have a high validity in the study the focus was on getting in contact with the people who actually work with credit assessment and annual reports on a daily basis and not just someone who has some knowledge of it. The respondents have been employees well versed in the company and the answers received when conducting the interviews were relevant and therefore we believe that the validity is high in our study.

Small samples are used and based on these have formed a general opinion about the population with some degree of certainty. If the validity is high, the general conclusion should apply to the entire population and not only a small part of it Jacobsen, 2002). In the study five banks are examined and based on these it is difficult to draw a general conclusion but since the study is about the five largest banks in Sweden, some general conclusions can be made about the understanding of how banks want to and can affect companies when it comes to accounting choices.

2.9.2 Reliability

Reliability provides a measure of how well the same approach would produce the same results on different occasions if all other circumstances are similar (Bell, 1999, p 89). When conducting interviews it is difficult to say whether someone would produce the same results even if the same questions were asked. The interviewer or a variety of factors in one's surroundings may affect the respondent. However, we believe that when it comes to specialists in a bank the reliability is high because they work with this on a daily basis and should not be affected by external factors. Although, it is hard to say that others would still obtain the same results even if the respondent were not influenced by anyone or anything, because there is still a high risk of affecting the results with our own view and our understanding of the subject and of personal characteristics. The study may have been affected by misinterpretation, but due to the fact that both authors obtained a simi-

lar view of the subject after each interview, the risk of misinterpretation is very low and therefore we believe that this study has a relatively high reliability.

2.10 Criticism of sources

Data that has been collected by someone else should always be viewed critically due to the fact that the source can be partial or deliberately angled (Lundahl and Skärvad, 1999). This has been taken into consideration every time information has been searched for. The scientific articles and literature used in this study are considered to have high reliability because they are published by people researching the subject and their work has often been used as sources. In this study, the use of ordinary articles, such as articles from Balans, is of great extent since there is not much literature or scientific articles about K2 and K3 since it is a relatively new subject. But in order to obtain a deeper understanding of the subject it has been important to use these articles. The non-scientific articles can be partial or deliberately angled, which has been taken into consideration when gathering this information. Although there is a risk of the using unreliable sources, we believe that these articles are written by specialists, who work with these issues on a daily basis and should not be affected in any way to deliberately angle an article. Although these articles are not scientific, we believe that the reliability is high anyway.

3 Frame of reference

3.1 Annual report

There are two different views of what the primary purpose of an annual report is. On one hand there are people of the opinion that the annual report is of dynamic balance and that the main purpose is to investigate the performance of a company that continues to operate. On the other hand there are people of the opinion that the annual report is of static balance and that the main purpose is to determine the asset value of a company and this is done on special occasions (Gandemo, 1990).

Bolagsverket demand that a company establishes and submits an annual report, sometimes also an audit report if necessary, for each financial year, regardless of whether the company is active or not (Bolagsverket, 2013).

3.1.1 Annual report content

A company's annual report should consist of (ÅRL 2:1)

- A balance sheet
- An income statement
- Notes to financial statement
- A management report

The annual report should be made as a whole and give a fair picture of the company's position and results (ÅRL 2:3).

3.2 K-regulations

The K-regulations are based on Bokföringslagen (BFL), which specifies how the currents accounts should be closed. A company can either be guilty of or, in some cases, choose to establish a simplified annual report, an annual financial statement, an annual report or a consolidation (IAS/IFRS).

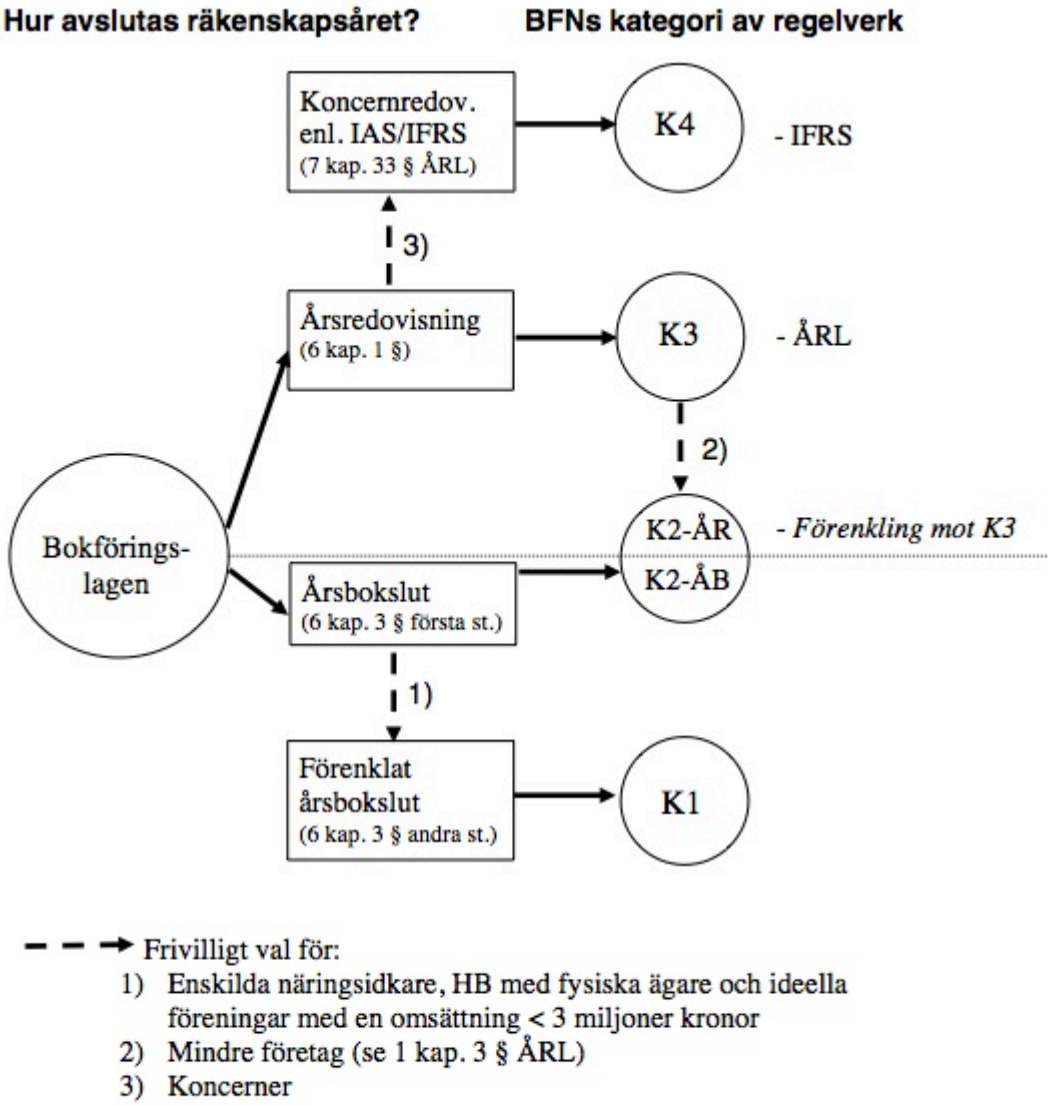

Image from Swedish Accounting Standards Board, illustrates what regulations a company should apply depending on how they finish their current accounts for the financial year.
Figure: 3.1-1

BFL is always used as a starting point and the demands or choices that the law states determine which K-regulation a company may or must apply.

3.2.1 K3

K3 is the main regulation when a company must prepare an annual report or a consolidated financial statement and K3 is consistent with Årsredovisningslagen (ÅRL). It follows International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs), which is the starting point, but K3 is an independent regulation. Accounting and taxation are closely related in Sweden which is

something that has been taken into consideration in the design of K3. Existing norms and applied accounting standards have also been taken into consideration (BFN). K3 is a principles-based regulation, which is standard in Sweden because the regulations used today are principles-based (Drefeldt and Törning, 2012). The regulation is applied as a whole but if K3 does not provide enough guidance for recognition of a certain transaction, guidance should primarily be sought in K3 for rules that treat similar and related issues (BFN).

3.2.2 K2

K2 is a voluntary regulation that smaller companies may choose to apply instead of K3. K2 is very simplified compared to K3. The simplifications found in K2 are standard rules with clear boundaries, fewer disclosures, fewer choices and rules that are close to the tax law (BFN). Other simplifications include the extent of disclosure of accounting policies. The disclosures a company must mention are that the annual report has been prepared in accordance to ÅRL and BFNAR 2008:1 (K2), how the amortization of tangible and intangible assets have been made, how recalculations of accounts receivable and accounts payable in foreign currency has been made and which method has been used for accounting on-going projects. As for the other account entries there is no need to disclose them because K2 clearly states how these are reported and there is no alternative accounting method (Drefeldt and Törning, 2012).

K2 is written as a general advice and contains the entire regulation that smaller companies can apply therefore companies do not need to use other regulations or norms if K2 is applied (Drefeldt and Törning, 2012). Before K2, companies had to use RR and URA to search for complementary norms but with the introduction of K2 all is now gathered in one place (Drefeldt and Törning, 2012). K2 can not be used if a company wishes to report self-developed intangible assets or if a company wants to use fair value-valuation, for example if a company wants to value financial instruments to a fair value, K3 has to be chosen regardless of the company size (Lennartsson, 2012).

Because K2 has been perceived as very inflexible it has been criticized a lot, but K2 is a simplified regulation that describes exactly how a company should account instead of leaving room for interpretation. Much of the criticism is probably also because the point of reasoning is principles-based in Sweden (Drefeldt and Törning, 2012). K2 is rules-based and this is something the companies have to get used to. Although companies may apply K2 perhaps they should not. The company must take various factors into consideration, such as how many owners it has, type of business, low profitability, and large temporary differences and if it has a large number of accrual items on its balance sheet data (Drefeldt and Törning, 2012).

3.2.3 Differences between K2 and K3

All of the rules in K2 are based on the precautionary principle, which means that all assets are normally valued to the acquisition cost, thereby forbidding valuation to a fair value unlike in K3 where fair value is possible to some extent (BFN, 2007).

One significant difference between K2 and K3 is that K3 states that all essential entries should be periodized and all insignificant entries should not be periodized. K2 also states that one should periodize, but it is the fixed amount of 5000 SEK per entry that determines the periodization (Drefeldt and Törning, 2012). K2 does not distinguish if an entry should be periodized depending on its significance, however the fixed amount is what decides if an entry should be periodized or not. Also, the useful life for machines and inventory should always be five years, where K3 lacks these simplification rules. No discounting should be done in K2 except for provisions for pension obligations and in K3 this discount calculation should be done for provisions. In K2 it is also not permitted to report self-generated intangible assets, expenditures must be reported as costs for the period they have been taken (BFN, 2007). For those companies that apply K2 it is only necessary to have statutory disclosures whereas K3 contains many more disclosures.

It is possible to change between applying K2 and K3 and the general advice BFNAR 2012:4 states how the change should be made, although it is not possible to change from K2 to K3 too often (Lennartsson, 2013).

3.3 Principle-based and rules-based accounting

In accounting, we find two different types of regulations, a principles-based and rules-based. FASB publishes the American regulations with U.S. GAAP, which is rule-based and IASB publishes IFRS, which is principles-based. In rules-based accounting, we find little room for interpretation and opinion, most of it is closely controlled and the underlying purpose of detail-driven standards is that they improve comparability and reduce variations in accounting (Collins *et al*, 2012). Some also believe that the detail-driven rules-based accounting protects the company against litigation so that it can get away with having followed rules to the letter (Donelson and McInnis, 2012). The principles-based accounting provides the opportunity for each unique situation to make an assessment, and as far as possible, work towards an accurate picture (Collins *et al*, 2012).

Critics of rules-based accounting mean that the detail-driven accounting does not provide the opportunity to make choices that would otherwise have led to a more accurate picture. They also say that the focus is more on form than substance in the rules-based accounting, which degrades the quality. Just as there are critics of the rules-based accounting, there are those who are against the principle-based. In the criticism of the principles-based accounting, we find that the volatility of the prin-

ciples-based accounting is a large risk, since much depends on the opinion that the practitioner of accounting holds (Collins *et al*, 2012).

A major problem at the global level is that companies that use these different frameworks can be difficult to compare with each other. In attempts to overcome this problem, the U.S. FASB and the IASB have since 2002 worked with a convergence project, which aims to integrate IFRS into the U.S. financial statements and thus move towards a global accounting standard that can be found in IFRS.

3.4 Accounting choices

”An accounting choice is any decision whose primary purpose is to influence (either in form or substance) the output of the accounting system in a particular way, including not only financial statements published in accordance with GAAP, but also tax returns regulatory filings.” (Fields *et al, 2001).*

Accounting choices are something management faces in their daily work. There is much research and work on accounting choices and there is a range of theories that try to explain the topic, but none is comprehensive. The complexity of accounting makes it difficult to find a theory that explains the accounting choices at all levels. Much of the research has resulted in theories that can be used in isolated parts of the basis by which we want to understand the accounting choices, but when you merge the factors underlying the decisions taken no comprehensive theory exists (Fields *et al*, 2001).

One can say that the research can be divided into two parts in terms of attempts to explain accounting choices. One part consists of theories related to management wanting to maximize their wealth and theories that are widely used are Principal-Agent and Positive Accounting. Principle - Agent is largely about how there is an information asymmetry between management and shareholders and how management tries to take advantage of it. Also, it is about how the goals of the management (the agents) do not go hand in hand with those of the owners and a balance needs to be maintained. Positive Accounting is broadly about how management of an enterprise is self-interested and works to maximize their own compensation that is based on accounting figures. There is therefore often a tendency among managers to produce better figures through the accounting, since the reward or compensation is based on the accounting figures.

3.5 Cost and benefit of accounting

Financial statements are made partly for the company itself but also for the company's stakeholders, such as banks, government, shareholders, suppliers and customers. It costs money to produce information but it also provides some sort of benefit. An analysis of the net effect of accounting results looks at whether the benefits exceed the cost of preparing the information and the companies are some-

times making a trade-off in how much information they want to reveal. The accounting regulation is designed to meet the shareholders' need for information and many companies criticize the regulations for being too complicated and expensive to set up in proportion to the benefit they bring (Marton *et al, 2008)*. High disclosure often results in a lower information risk premium and thereby may lower the cost of capital. Capital suppliers need information to price their capital and with little or no information they have to charge more in order to compensate the risk they take. Disclosing more will lower the risk for capital suppliers and therefore it may also reduce the price they charge for capital. Information disclosure contributes to a better allocation of capital (Elliot and Jacobson, 1994) and thereby it is not necessary that the disclosure will benefit the company but the economy as a whole (Marton et al, 2008).

3.6 Legitimacy theory

3.6.1 The foundation of Legitimacy Theory and how to work with it

Legitimacy theory is based on the view that companies and organizations do not have an inherent right to exist. They exist because society has chosen to recognize them and their business as legitimate. The right to exist based on the rewards of the company or organization must be greater than the costs they cause society. If the costs are greater than the benefits, society would punish the company to show their dissatisfaction (Deegan, 2002). Legitimacy is therefore something extremely important for a company or an organization, but it is easily lost if it is not taken care of. Legitimacy can be described as a resource that the organization has an opportunity to influence and manipulate. The organization is dependent on the resource for its survival and as soon as the management in an organization knows of legitimacy and its importance, the organization forms strategies to ensure the supply of the resource (Tilling and Tilt, 2010).

"Legitimacy is a condition or status which exists when an entity's value system is congruent with the value system of the larger social system of which the entity is a party. When a disparity, actual or potential, exists between the two value systems, there is a threat to the entity's legitimacy. "(Deegan, 2002).

Much of the research that has been done in the area surrounding the legitimacy has often concluded that the disclosures that companies do, largely depend on the existence of a financial incentive behind the disclosure. The disclosure did not happen because the management genuinely believes in doing the right thing or that the community deserves to know everything the company does, but because the company or the organization wins something from revealing information.

It is important to work with legitimacy and there are many reasons for doing it such as the economic benefits of disclosure, which means that companies choose to

disclose information because they believe it will assure economic benefits for them; it is also perhaps the most likely reason for any type of disclosure. Stakeholders as lending institutions and communities are very important to satisfy and that is also a good reason for disclosure, as these stakeholders in turn have large demands from society to comply with certain standards and values. Sometimes there may also be a reaction to negative publicity and the company wants to rebuild the legitimacy that has been lost with publicity from the media or other type of event that damaged the status it previously had. One scenario that is not very common is that management chooses to make disclosures because they believe in doing the right thing, and that society deserves to know. It happens, but all too rarely (Deegan, 2002).

3.6.2 Different layers of Legitimacy Theory

A restructuring of the legitimacy theory has resulted in splitting the theory into different layers, starting with the upper layer called Macro-layer and Institutional legitimacy theory. The Macro-layer is about the community as a whole and how it receives and perceives the company. The second level of legitimacy theory is called organizational legitimacy theory, which attempts to explain how the company tries to gain legitimacy towards smaller groups and is thus the result of using a magnifying glass in order to understand things more closely than is done in institutional legitimacy theory. One last and final layer of the theory is a refinement of the previous level. If the previous level wanted to explain how the company works toward groups within society, then the purpose in this final step explains it in even greater detail.

3.6.3 Phases of establishing and maintain legitimacy

Tilling and Tilt (2010) have divided legitimacy theory into phases in order to explain how things differ between them. The first phase is the establishment of legitimacy, where the company or organization works essentially to gain legitimacy and there is a lot of focus from the society to control that the organization has the expertise and the efficiency to meet market needs and, in addition, the organization has to meet its commitments. A second phase is to maintain the existing legitimacy. Through activities that assure society that the organization is doing the right thing, the organization maintains existing status. A third phase involves increased legitimacy and it appears often in changing environments in which the company or organization must adapt, and thereby need to gain new legitimacy. A final phase, where also much of the research has taken place, is the defence of legitimacy. The negative publicity from the media or some other event that has damaged the legitimacy of the company is causing a reaction where the company has to rebuild its reputation and its legitimacy (Tilling and Tilt, 2010).

3.7 Stakeholder theory

3.7.1 Managing stakeholder

The stakeholder model sees the company from a management perspective and how management will deal with the outside world and its problems (Lundahl and Skärvad, 1982). The stakeholder theory assumes that businesses and organizations have stakeholders. The stakeholders consist of individuals or groups that may be linked to the organization or company in the sense that they have an interest in the company's actions. The stakeholders can be divided in two types; one is that they can influence the company's actions to some extent and the other one is that they are in a position where they will be affected by the company/organization (Freeman, 2010).

A company does not have a goal in itself, but uses its stakeholder's goals as business objectives. The stakeholders who have the greatest influence on the company are the ones that can carry out sanctions and have other means to threaten the company's survival. To satisfy these stakeholders is the primary goal for the company. Sometimes the stakeholders' objectives are conflicting and then it is important to mediate, so that all parties feel satisfied (Lundahl and Skärvad, 1982).

There are many definitions, but most flow into the same one that is that stakeholders are dependent on the company and the company is dependent on stakeholders. Lundahl and Skärvad (1982) state that "Stakeholders in an organization are the Individuals and groups who are depending on the firm in order to achieve their personal goals on whom the firm is depending for its existence."

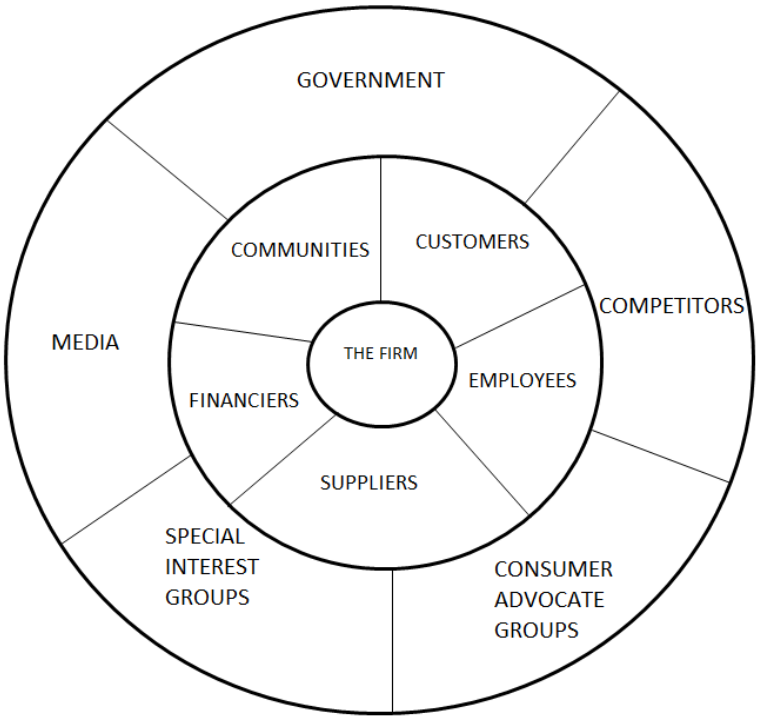

Image from Managing for stakeholders: survival, reputation, and success. Illustrating primary and secondary stakeholders. Figure: 3.2-1

The picture is a standard one of stakeholder theory and explains the mapping of stakeholders from a corporate perspective. The map is designed in such a way that it consists of two layers of stakeholders, where the first layer is seen as the primary stakeholders, which are important to satisfy and the second layer is the secondary stakeholders, which are also important to look after, but not as important as those of the first layer. Of course, the company is not the centre of the universe. Designing the map of stakeholders from the company's perspective facilitates the understanding of the theory. A company should, in its actions, ensure that it not only meets the wishes of the owners but also those of all the other groups and individuals who are affected by the company.

Criticism of this kind of default mapping of stakeholders has been great and many believe that it is far too coarse in its expression and does not capture the stakeholders' different power and influence over the company. Other distinctions have been made and one claimed that the primary stakeholders were those who worked on the company and its management, the rest was secondary stakeholders (Lundahl and Skärvad, 1982). Many have tried to distinguish between the more or less important stakeholders but the overall opinion can be summarized by the illustration above.

3.7.2 Stakeholder relations and their relative power

Another illustration that describes the relationship between the company and the stakeholder is:

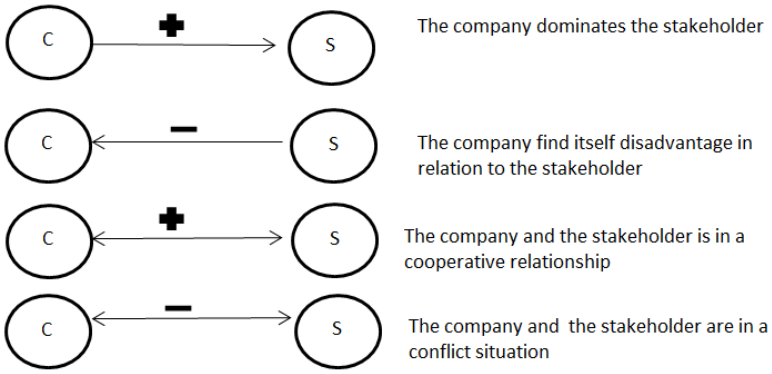

Figure: 3.2-2

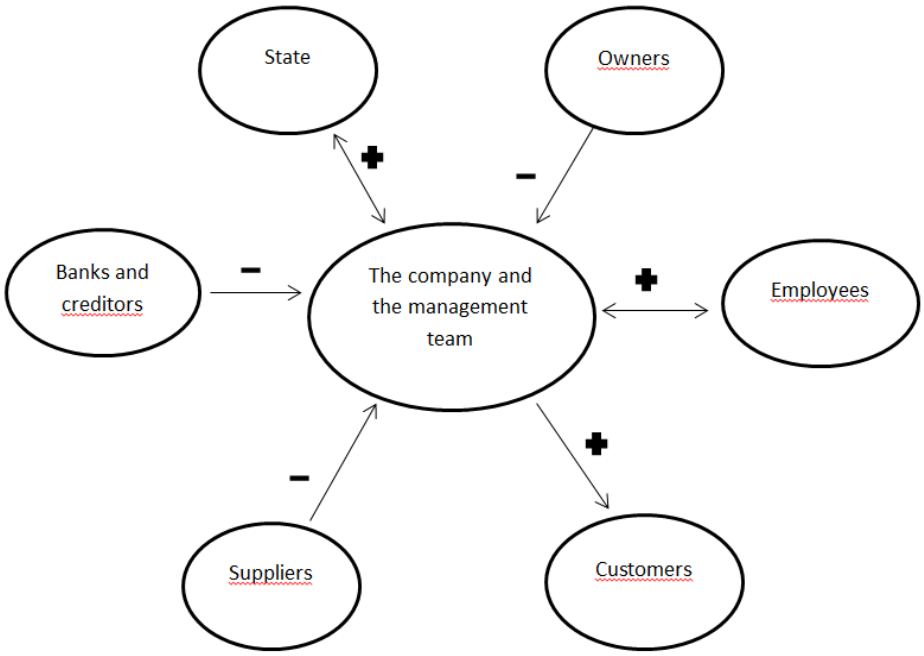

Figure: 3.2-3

The relationship that we see here has either been emphasized with a + or a -. This has been done to emphasize who is the underdog and who is the dominant one. As we can see there is a mutual relationship between the company and the state and between the company and the employees, there is also a cooperative relationship. If we look at stakeholders such as shareholders, creditors and suppliers, they have

an advantage over the company, the opposite of what we find in the relationship between the company and the customers where the company dominates the customer. However, this is just an example of how the relationship could look, in many cases the relationship between the company and the suppliers is the opposite. As we can see there are different types of relations between the company and its stakeholders. Sometimes the company is the underdog and sometimes it is dominant, it is however important to realize that the company is obliged to satisfy its stakeholders whether they are dominant or the underdog.

It is important for a company to maintain a kind of balance between the stakeholders, regarding the power of impact it has on the company. For the company it is necessary to keep the balance between the stakeholders to maintain and increase the flow of resources and thereby survive. To manage the stakeholders, the company has to identify the stakeholders' relative power and influence (Lundahl and Skärvad, 1982). The table below explains the power of the stakeholder, from the point of view of stakeholder's mobility and how hard or easy it is to reimburse the resource it provides.

	High mobility	Low mobility
Resource hard to reimburse	Great power	Locked positions of power
Resource easy to reimburse	"Market power"	Little power

(Lundahl and Skärvad, 1982) Figure: 3.2-4

3.7.3 Creditors as stakeholders

Apart from the owners in a company there are also other stakeholders that are interested in knowing how a company is doing and these stakeholders tend to be employees, customers, suppliers, creditors and the government. The question is how accounting should be designed to satisfy the needs of all the stakeholders' need of information in the best possible way. This is hard to answer due to the fact that different stakeholders have different needs for information. Also, the need for information can be different depending on the company (Smith, 2006).

Some of the most essential stakeholders are creditors, namely banks and other credit institutions. Accounting is of great interest to the creditors due to the credit risk that is the risk that a company will not meet their payment obligations. The creditors need to assess a company's future development is therefore very different from the owner's because the owners want to assess all possible scenarios while the creditors see it more as "either-or", where the future scenario is that the company either can meet its payment obligations or it can not (Smith, 2006).

3.7.4 Influence of stakeholders

Previous research on the stakeholders' influence on companies indicates that the size of a company plays an important role when it comes to the stakeholders who have the power to influence a business (Rudžionienė, 2004). A study that was conducted examines stakeholders' influence on Lithuanian companies' accounting choices. The result of the study shows that the shareholders, the media and the state have the most influence on a company's accounting choices in large Lithuanian companies and that most stakeholders have a strong impact on small and medium-sized enterprises, however the impact is smaller than in large companies. The key stakeholders in Lithuanian SMEs are investors, regulators and employees, which means that they have a certain impact on the companies' accounting choices (Rudžionienė, 2004).

3.7.5 Stakeholder approach

Stakeholders have different views on how they want the accounting control to be established. One can divide these into two categories: hard data and soft data. Stakeholders in the first category, hard data, see the reconciliation process as very structured and seem to believe that the process from individual transactions to closing is very clear. For users of the financial statements, the ideal situation is when all companies follow the same accounting policies as this increases the comparability between companies (Marton, 1998). The opposite of hard data, so called soft data, involves ensuring the accounting process is realistic rather than systematic. Stakeholders in this category perceive the accounting process as incomplete and it is not possible to define how to produce financial statements. Although there are detailed accounting policies to be followed according to the regulations, companies still have to make accounting choices, which make them differ from one another (Marton, 1998).

3.8 Credit assessment

3.8.1 Credit assessment approach

The process of credit rating can be divided into three parts - information retrieval, processing, analysis and interpretation of information and decision-making. A company's creditworthiness is always followed up continuously even when the creditor has made a decision (Svensson, 2003). When creditors do a credit rating, they are doing two assessments; one that relates to a company's future earnings and ability to pay and another that relates to collateral's future realizable value. A company's going concern policy is assessed by historical, contemporary and future information collected from different sources and is processed in order to reduce uncertainty and the risk of failed future payments. The future realizable value is valued based on the market value of the assets in case of a financial crisis the as-

sets are supposed to guarantee the creditor payment (Svensson, 2003). When banks construct their policies and procedures for credit ratings they base their advice and recommendations on what the Swedish Financial Supervisory Authority considers good banking and lending practices. This means that one should base the assessment on factual and objective rather than subjective information (Svensson, 2003). By law, banks are required to conduct an assessment of companies' future ability to repay and also require collateral to protect themselves against various incidents that can impair a company's creditworthiness. The Banking Business Act states that "credit may be granted only if the borrower may reasonably be expected to fulfil the loan agreement. It also requires collateral in movable or immovable property as bail. The bank may refrain from such security if it can be considered unnecessary or if there are special reasons to forgo safety" (SFS 1987:617, BrL 2:13).

When banks and credit institutes conduct a credit assessment, there are a few questions that need to be answered. These questions are if they should give a certain company credit and how large a credit they can give a company. Also, they need to decide which conditions should apply to the credit, which collateral to demand and the enforcement of the amortization. Due to the fact that a credit from a bank extends over several years, it is crucial that the decision, if credit is granted, is based on a long-term assessment of a company's finances. Therefore it is not enough only to analyse the recent liquidity situation, but instead to conduct a long-term assessment of a company's future ability to pay interest and amortization (Hansson, Arvidson and Lindquist, 2006).

3.8.2 Credit risk

When the lender predicts a company's ability to pay, they can make two types of errors either an error of type I or type II. The first error is if the creditor underestimates the risk and thereby extends credit to a company that is not creditworthy and as a consequence the bank will get a loan loss. An error of type II happens when the creditor does not grant credit to a company that is creditworthy and thus gets lost revenue (interest) as a consequence (Svensson, 2003). A study shows that many experienced credit analysts can get more out of the analysis of the balance sheet, income statement and financial ratios than novices, but these tend to make errors of type II anyway (Svensson, 2003).

3.8.3 Models for credit assessment

There are different models used for credit ratings. One model described in the literature is the 3C model, which is based on the assessment of assets (capital), affordability (capacity/capability) and personal nature (character). Capital is the valuation of a company's valuable assets which can be used as collateral, capacity refers to the ability to repay debt and character refers to credit history and reliabil-

ity to repay a debt (Practical Money Skills). Another model described is the CAMPARI model, which stands for "Character, Ability, Margin, Purpose, Amount, Repayment and Insurance" and is more focused on the purpose of the credit and the company's need for credit as opposed to the 3C model. One can also see the credit assessment with focus on the relationship and negotiations between lenders and borrowers. The decision is then influenced by the bargaining power, personal characteristics and past experiences. These criteria tend to complement each other and are considered in each specific situation (Chapman, 2009).

3.8.4 Collection of information

When banks do credit ratings both quantitative and qualitative information is included in their decision-making. The quantitative information shows behaviour and performance and tries to give an objective view and the qualitative is on a more personal level and is more subjective (Silver, 2001). A decision is made on commercial terms only if the conditions are characterized by a purely economic exchange, which supports the use of quantitative information. However, it has long been known that there are other controlling factors. The information is not perfect and banks have to use qualitative information as well. Social networking is of high importance when it comes to decision-making. Qualitative information based on network is highly dependent on trust and this means that past relationships and continued exchange is taken into account during the process of credit rating. It has already been observed that in some local contexts credit rating is highly based on trust (Silver, 2003). The information used in credit ratings can either be quantitative or qualitative. In most cases, quantitative information is to be preferred, because quantitative information can easily be transmitted to others within an organization. Unlike quantitative information, qualitative information can be much more extensive, but can also depend on the individual interpretation. There are many different theories of quantitative sources of information, but what they all have in common is that the information can be used to easily compare companies (Silver, 2001). In smaller communities, creditors usually have a closer relationship with the companies and rely much more on qualitative information when credit rating is performed. In larger communities on the other hand, credit rating is mainly based on information retrieved directly from the company and information that is publicly available. Thus, the annual report becomes the objective source of information (Svensson, 2003).

Banks have certain rules and procedures that control what kind of information will be requested by the borrower when credit rating is performed and how this information is handled. "In addition to affect the 'quality' of the operation, the type of information also controls the use. Officials may be made to place more or less emphasis on historical data such as financial statements and ratios, forward data such as mission and market position or character data regarding people responsible for

it or the company's reputation. An Assessment's ultimate purpose is to obviously clarify the borrower's ability to repay." (Lönnborg-Andersson et al, 1997).

In the U.S there are two banks both of which only attempt to use quantitative data to assess the small and medium-sized enterprises and by only using this data, they developed systems that are fully automated. This has resulted in higher losses but on the other hand it has reduced personnel costs. There are also banks that have gone the opposite way and still want the local bank managers to play a large part in the loan process even if it is moving towards standardization. In the latter case, the banks choose to have a more decentralized role in the lending process to be as safe as possible from loan losses (Silver, 2001).

3.8.5 Usefulness of accounting information

The key concepts in the analysis of accounting information for credit rating are profitability, liquidity, cash flow and solvency all of which are identified by the financial statements (balance sheet and income statement). Therefore, the financial statements play an important role in assessing creditworthiness. The design of the annual report will therefore be crucial for the assessment, because the information in the annual report must meet the demand of the creditors. "The creditors give companies an incentive to hand over accounting information to a certain extent and the specific requirements for the form and content." (Svensson, 2003).

4 Empirical findings and analysis

4.1 Presentation of respondents

4.1.1 Danske Bank

Danske Bank is headquartered in Copenhagen and is one of the leading banks in northern Europe. At Danske Bank we interviewed Björn Hansson who is a credit analyst and Björn Svensson who was chief of credits in western Sweden.

4.1.2 Handelsbanken

Handelsbanken has operations in 24 countries and is known for its decentralized organisation. We interviewed Anna Gren who works as a personal and business adviser.

4.1.3 Nordea

Nordea is the largest bank in Northern Europe and has a leading position within all their services. They also have approximately 0.6 million corporate customers and 10.4 million household customers which is the largest customer base among the banks in the Nordic region. We interviewed two people at Nordea, Robert Olofsson who works as vice region manager and Björn Karnefors who works as a credit analyst.

4.1.4 SEB

SEB is one of the largest banks in the Nordic region and has operations around the world but mainly in the Baltic countries and Germany. The interview was conducted with Reinert Siweborn who works as a business adviser. He also holds learning programs at SEB within finance.

4.1.5 Swedbank

Swedbank is one of the largest banks in Sweden with home markets in Baltic countries as well. At Swedbank we interviewed Peder Wiland who works as a credit risk manager.

4.2 Structure of empirical findings and analysis

In the empirical results and analysis, banks will remain anonymous and are designated A, B, C, D and E, unrelated to the order in which they are presented above.

In order to understand how the banks use the accounting information the empirical findings and analysis are structured to first give an idea of the credit assessment process. It is crucial to understand the credit assessment process in order to understand the importance and usefulness of the accounting information. The K-

regulations are not mandatory yet and have thus not affected the accounting information. For that reason, this part is reported last.

4.3 Credit assessment process

The banks work relatively similarly in their credit processes but differ in some areas and approaches. What is strikingly similar among all banks is their focus on cash flow. The financial assessment of the business is dominated by key figures linked to the cash flow. It is crucial for a company if they want to receive a credit that their cash flow covers the repayment with interest. This was something all banks considered important when granting a credit.

Small businesses with small amount of credit are managed centrally and in a more automated way by the different banks through special entities made for handling small credit decisions, with the exception of bank E where each office handles even the small credit decisions on their own. Bank A did not mention any direct intervals of credit volumes that are centrally managed and automated but pointed out that small amounts of credit is managed in a standardized process. Bank B, bank C and bank D stated clearer intervals and depending on the size of the credit the assessment process differ. Bank C and bank B let official records and rating agencies provide the basis for evaluating companies. They do not make any deeper analysis but let the information from a third party serve as a foundation for the assessment.

When making an assessment of a new client, all banks said that the person or the people behind the company are extremely interesting to watch. Bank A thought that you have to really want to do business with this person or these people. At bank A impression they got of the company was extremely important to be able to proceed in a case. If, after an initial meeting, the bank wants to continue and review the opportunities for a loan, they make a quick analysis of the company's financial figures to make sure it is worth making a detailed analysis of the company. If you after the analysis decide to give the case a chance, the process is quiet tough. They look to a great extent at the company's cash flow and its solvency, ownership structure, the industry in which they are active and the business idea.

Bank D has a similar process in which they first start from a customer contact and then make a seismic analysis of the company, where they look at similar factors as bank A. It is important to understand the business idea, how the company will make money. In a situation where bank D does not understand how the company will make money, they are unwilling to leave a credit. The answer has been similar among the banks, and they must believe in the idea by which the company is going to earn money and have a positive cash flow and thereby be able to cover repayments of the loan and interest. The approaches for determining whether an entity qualifies to receive a credit are described in some part differently between the banks but it all focuses on the risk that the customer will not be able to repay.

Overall, there is an emphasis on the soft values such as management, competitive advantages and business idea, but most emphasis is put on the quantitative analysis where one can forecast the cash flows, analysing the company's history and compare to standard financial ratios in the industry in which the company is active. Bank C says that when it comes to small and medium-sized companies they prefer to understand the management and the ownership in the company. They think that the larger the company becomes, the more the focus moves to the financial statements but at small and medium-sized companies, it is more important to understand the management and the owners than the financial statements.

With existing customers the banks specifically said that they work proactively with preventing a failed credit deal by continuously following up with customers including period reports, a change in ratios and industry analyses. Bank B has an industry barometer that indicates which sectors are on the rise and fall and it can thus be aware of the potential risks. At bank D they visit their customers a few times a year to obtain information about the company's status. If they find evidence that a company seems to be going poorly, they do more visits, so this way they can better ensure that the credit deal does not fail. At bank A they have almost the same process and every year they also do annual reviews in order to identify "early warnings" to then focus more attention on these companies to secure the repayments.

All banks argued that the process does not differ very much when dealing with small and medium-sized enterprises. What the banks could think was that they have to be more thorough in the assessment of the owners of small and medium-sized companies. Bank A focuses more on how the company is structured as with management and owners when it comes to small companies and they do not put the focus on turnover and size measurements. Similarly, bank B thinks that the process is different depending on the structure of the ownership since small companies with one or two owners often stand and fall with these owners. Therefore it is crucial to focus on the owners as well as the financial statements.

When the company is larger more time for analysis is necessary and it may be in that way the process is different, but technically the same things that are performed, only that it takes more time to perform the assessment of larger companies. Bank C considered that there was no difference in how to deal with companies that have a turnover of twenty million or a turnover of three hundred million, the process is of course more complicated for the company that has three hundred million in turnover than twenty million since it requires more knowledge in order to draw conclusions. However, when companies are slightly smaller and you might only have one or two owners they put more focus on the principles of the business. This is a common sentiment among all of the banks. Bank E also felt that the process was different among different-sized companies but meant that the process will be slightly heavier and decisions must go through additional instances the

larger the company and the credit volume is. Bank B and bank C said that the amount of credit to some extent controlled the process, but still maintained that they worked relative little by measures of size of the turnover and balance sheets to categorize the companies. Bank A and bank D talked about how the complexity of the company and the credit deal sometimes increased the larger the company was and therefore may spend more time on these deals. The process gets more difficult as the size and the complexity of the company increase.

The industry is important to keep in mind since ratios are quite different and it is very difficult to make cross-industry comparisons as companies to a large extent are structured differently. It is also important to keep track of how the industry is like, what the prospects are and if there is an industry the bank is exposed against. At bank A and bank D this was very important to look at. It is also important to be able to quickly find indications of how the industry itself is going and how the business idea is working. Bank E did not say much more than that you must be aware of the different ratios between industries. Bank B has an industry barometer that indicates whether it is a lucrative business for the bank to finance or if there is an industry that involves risks and something that the bank shouldn't finance. There are also low-priority industries where history says that the probability of bankruptcy is relatively high. This is the case of the hospitality industry, where the bank avoids to do credit deals. When it comes to ratios it differs from industry to industry and especially in the real estate industry, where companies are extremely capital-intensive and profitability measures in relation to capital are very low. Bank C has two models in their analysis process where one model is only used in assessments of companies in the real estate business and the other model is for all other industries. In the assessment of the smallest companies all banks are talking about the need to analyse the owner since the company in many cases largely depends on the owner. Companies' sizes range widely within the medium category and the banks do not analyse differently depending on turnover and the volume of the balance sheet, they focus on credit amount and the structure of the company.

4.4 Analysis of credit assessment process

In the theory about credit assessment, we can see that they divide the process into three different parts, namely, retrieving information, processing, analysing and interpreting the information and making a decision and we can see that all banks follow this pattern since they receive information from companies (Svensson, 2003), analyse it in their internal systems and rate companies based on that information together with external information and then interpret the results and make a decision. To explain what banks search for in a loan process, there are some theoretical models that are useful. As we can see from the interview responses all of the banks work according to the 3C model, which means that they value the capital, capability to repay a loan and the credit history (Practical Money Skills). Further, we can

see that bank A and bank D also work to understand the purpose behind the loan, thus, it is also possible to use the CAMPARI model to describe their approach to a credit deal. CAMPARI is more focused on the reasons for the loan and the need of borrowed capital unlike the 3C model (Chapman, 2009). Meanwhile, all the banks are very interested in the personal contact and thus it can be said that they, to a certain extent, apply the CAMPARI model as well.

According to the Banking Law, banks are required to assimilate the information to calculate the firms' ability to repay. They also have to demand collaterals from the companies to protect themselves (SFS 1987:617). In the interviews, we can see that all the banks focus on cash flow and ratios related to it. The focus the banks have on cash flow can be explained on one hand because of the law but also because the banks' business idea is not working if the companies cannot repay their debts. Even when it comes to security, they do it because the law requires it but also to protect themselves against potential credit losses. The banks would rather not use their collaterals, and to protect themselves from getting into such a situation, where they are forced to use their collaterals, they work really hard at analysing the company. The regulations and guidelines from the Financial Supervisory describe what is good banking and lending practices, which means that banks should make their decisions on objective rather than subjective grounds (Smith, 2003). What has been highlighted in the interviews is that much emphasis is placed on the qualitative assessment of the company and the people behind the business. The qualitative assessment largely depends on which view the person performing the credit assessment has and that means that there are subjective grounds when a credit decision is made, which goes against the regulations and general advice. There are times when the banks make decisions on almost only objective basis and exclude the qualitative analysis and it is in the case of a smaller credit volume; that kind of process is more or less automated. It has been found that two U.S banks have used this type of credit process in all small and medium-sized companies regardless of credit amount with the result that they made larger credit losses but also reduced personnel costs. Studies have shown that banks in smaller communities have more personal relationships with the companies and therefore rely more on qualitative data rather quantitative, whereas in larger communities they rely more on quantitative information supplied by the companies themselves, and the information which can be found in official records (Smith, 2003). However, we can see that the banks in larger communities also base their credit assessment largely on qualitative data and the qualitative information is not subordinate to the quantitative, as studies have shown. They are thus very careful to also assess the qualitative information when dealing with small and medium-sized companies. All of the banks claim that the understanding of the business is very important in a credit assessment and this can only be inferred from the qualitative information.

4.5 Accounting information

When conducting an analysis of larger companies all of our correspondents believe that the annual report is of great significance because these companies are obliged by their listings agreements to have as much information as possible in their annual reports. Non-listed companies, such as small and medium-sized, are not obliged to have as much information as possible, which means that annual reports cannot be expected to contain all of the information. Therefore banks use annual accounts to examine a company. Despite this, banks think that the accounting in small and medium-sized companies is essential, but they do not bury yourself into the figures according to bank C and instead only examine annual accounts and period reports thoroughly, where you actually might find interesting things since you receive the entries in a different way than in an annual report. Bank E states that accounting is not significant if it is an old customer, because you know that you can trust the customer. However, they still want them to create accounting that the bank can receive. Bank A, on the other hand believes that accounting is the most central part and it is also a lot of complementary information, but the accounting is the main part. Bank C believes that the problem with small companies is to receive figures that they can trust and can use.

All respondents believe that one must have a basic knowledge of how accounting works and understand how all parts fit together. It is not essential to know how to prepare financial statements, but it is crucial to understand how different entries can affect each other and how that can affect cash flow, balance sheet and income statement. At the same time, according to bank A, one should be able to consolidate a group with a parent company and several subsidiaries, which may demand more accounting experience and that is the reason that you do not start as a credit analyst because it is important to be good at summarizing a lot of data to make it as simple as possible. All of the banks said that knowledge in accounting is more important the larger the company is because it is crucial to be able to interpret accounting information. According to bank E, it is more important to learn the bank's point of view than to be proficient in accounting since one considers everything from the bank's rules, while bank D uses a lot of auditors and accounting firms and therefore there is no need to be that informed about accounting since they receive professional help, but of course one is required to have financial education and plenty of common sense.

All of the respondents are of the opinion that there is no consideration taken into account on how companies have chosen to report. The explanation for this is, according to bank B, are that they are more interested in viewing period reports that have not resulted in an annual report or any accounting choices yet and therefore there is no need to take into consideration how the companies have chosen to report.

However, bank C says that they have a perception of how the companies have chosen to report, but it is not as relevant as one would believe, but it is not insignificant, but they assume that the choices a company has made are correct in some way. Bank D, on the other hand, thinks that they do not put much emphasis on how companies report, but if a company changes something, they are very alert. All of the banks demand complementary information but it is always easier to demand more information from larger companies due to the fact that they have a financial function, which most small companies do not have. But the banks differ in terms of what information they want from the companies apart from the annual report. For bank E, forecasted cash flows are very important, but they view very differently the forecasted cash flows depending on the customer involved. Old customers, whose financial predictions have come true year after year, have the banks' trust while others, new customers, often have a brighter view of the future and therefore need to be examined some more. That is the reason why complementary information is demanded when dealing with a new company. For bank A, it is about having a good relationship and to maintain that relationship it is good for companies to offer as much complementary information as possible because it makes the bank feel safer than with a company that is discreet with the information. They think that since they work in an industry where trust in each other is important, disclosure of information facilitates the relationship between the bank and the company. Bank D requests additional information on various occasions depending on if it is a company that has a professional accounting function, then the bank wants more reports continuously and visits are common a few times a year. To them, complementary information is very important and it is mostly forecasts of the current fiscal year, budgets for the future and long-terms strategic discussions. Bank C differentiates between the real estate industry and other industries, where the assessment of the real estate industry requires much more additional information while assessments of other industries consider the annual report as superior complementary information, but considers that they should try to improve on examining certain entries in the financial statement. Since banks usually demand complementary information, the majority of the respondents believe that they have no need for an annual report with more information. Bank C do not consider the annual report as sufficient when conducting a credit assessment regardless of how much information there is in it. Bank D also believes that there is no need for more information in an annual report since they think that the annual accounts reveal a part of it and they want to study the complementary material rather than the annual report. According to bank E it does not matter if they receive all the information served in an annual report or if they on their own have to ask complementary questions and gather more information, because if there is something that is not clear the questions are bound to be asked anyway. Bank E would also rather have a dialogue with the company rather than finding everything in the

annual report because they get a better picture of how involved the company is in their own figures. Bank A considers the information in an annual report to be rather poor in general, but one thing they would like to see is that consolidated statements should be mandatory.

Overall, all banks examine cash flow but they also use the balance sheet and the financial statement to calculate ratios and put them in relation to different entries in the balance sheet. For bank B, the cash flows are essential and put these in relation to debt, total assets and equity. Bank A almost exclusively examines cash flow since they believe that equity does not pay bills, instead it is what the liquidity does. In bank D examination of the change in numbers and margins is a way of finding risks. In the financial statement they try to find what generates cash flow, what binds and frees capital and in the balance sheet they try to see if it is growing or shrinking and what that might depend on. Overall, the banks think that the financial statement is often insufficient and they do not trust the figures without having them investigated it. Poor routines and lack of competence in accounting are often the main reasons to why the figures are not correct.

4.6 Analysis of accounting information

According to legitimacy theory, legitimacy is described as a resource which the company has an impact on, both positive and negative (Tilling and Tilt, 2010). When a company has banks as stakeholders and wants to create legitimacy there are certain demands from the banks' side due to the fact that they demand information from the company (Smith, 2006). As shown in the answers we have received from the banks, the banks demand a wide variety of information where the annual report is a consistently significant part of the banks' credit assessment and monitoring. It is part of the banks perceiving their customers as serious and the fact that the companies submit an annual report creates a reputable company image, which in turn helps the company to gain legitimacy. With a stronger legitimacy comes even greater trust for the company from the banks and as bank A said the banks work in a "trust industry" where one must be able to trust the people behind the company but also the figures that the companies provide as economic information. All of the banks have great faith in their existing customers and it is expected that the economic information they give the banks is accurate, which makes the annual report a large part of the credit assessment. One can say that the banks consider the purpose of the annual report to investigate the performance of a company that continues to operate (Gandemo, 1990). The annual report is crucial when it comes to the credit assessment because it says where the company is heading, but it does not reveal the whole story. That is the reason why banks collect complementary information. The accounting is of great interest for the bank and with a great extent the complementary information; they examine a company's opportunities for a repayment of the loan (Smith, 2006).

A company does not have a goal in itself but uses its stakeholders' goals as business targets (Lundahl and Skärvad, 1982) and when it comes to small and medium-sized companies they often have very few stakeholders where banks are one of the most important, usually together with the state and employees (Rudžionienė, 2004). According to stakeholder theory, the most important stakeholders are those who can bring sanctions or have other means to threaten the company and its survival (Lundahl and Skärvad, 1982). The banks' relative power can be illustrated with the figure 3:2-4 where their resource, the credit is relatively hard to reimburse since the company in case of denied credit has difficulty obtaining credit from another bank. The mobility of the bank as a stakeholder is relatively high as well. Lundahl and Skärvad (1982) illustrate the different structures of relations the company has to its stakeholders by assigning the relations with a plus or a minus, to emphasize who dominates and who is dominated.

In the relation with the company the bank is the dominant one, and, because of their size they can put up strict requirements for granting credit and widely choose to which companies they would like to be in business with. Therefore it can be said that the mobility of the bank as a stakeholder is relatively high, and thereby the relative power of the bank as a stakeholder can be considered as high.

The importance of a reporting that is full of information about the company does not create as much benefit in relation to how much it costs (Marton et al, 2008). In the relationship with the bank the balance between cost and benefit becomes easier because the company can see how more disclosure can benefit them in terms of a credit and increased legitimacy.

Companies should, in their annual report, take their different stakeholders into account where banks are considered to be a very important stakeholder. For different stakeholders to receive a good image of the company it is important that the company satisfies all of the stakeholders' need for information, which can be done with various details in the annual report (Smith, 2006). All of the banks consider that the annual report of smaller companies is not superior a personal contact and complementary information such as annual accounts, period reports and forecasts when conducting a credit assessment. The reason why the focus is on complementary information and personal contact is due to the fact that the figures in an annual report are rarely accurate for smaller companies because they usually lack financial functions.

Despite the fact that the banks do not consider the annual reports for small companies to be reliable they believe that if the companies do not reveal information in their annual report it can hurt the relationship between the bank and the company because it may seem as though the company is trying to hide information. As cited

earlier, the bank is one of the most important stakeholders to satisfy and in order to do so; the company has to reveal as much information as possible. This can also be associated with the banks in the United States that focused on automating the entire credit assessment and leave the qualitative assessment aside. The result of this was that credit losses increased while personnel costs decreased (Silver, 2001). The fact that all of the banks choose to collect more information to do a better assessment can be explained by the fact that the banks are scared of doing greater losses if they do not consider other factors than quantitative data.

The bank as a stakeholder wants to obtain information from the company to calculate the future cash flows as accurately as possible to ensure the company's ability to repay the credit (Smith, 2006). Banks and other stakeholders can view accounting in different ways, either as hard data of as soft data. If one is of the opinion that accounting is hard data they believe that the process from individual transactions to the financial statement is very clear and the ideal would be if all companies would apply the same process to make it easier to compare them with each other. Soft data, however, takes into account that the process is not so clear and that the companies make plenty of interpretations when they report (Marton, 1998). Since the banks do not take companies' accounting choices into consideration, one could say they view accounting as hard data and that almost everything should be clear from each individual transaction to the annual accounts, but at the same time the banks are aware of the fact that companies make interpretations of their own in their accounting, even though they do not take that into consideration when conduction credit assessment. According to the answers we have received the banks believe that the interpretations made by the companies are correct according to the law and therefore they do not take the accounting choices into consideration.

4.7 K-regulations

In the current situation none of the banks operate to ensure that companies report in a special way and they have not taken a position on how they think it will be like when K-regulation is mandatory for the companies. Bank A says, however, that they will prefer K3 since accounting according to K3 is richer in information, which they value highly. They believe that the complexity of the credit deal controls how much information they require and therefore also what type of accounting regulation they will wish that companies apply. Something that they also were concerned about at bank A is that you may not do any consolidation, which is a vital part of the information they require from companies. Bank B placed great emphasis on existing customer and how they have approved or certified public accountants, which is a hallmark of quality and as long as they understand the figures and the auditor has given his approval they will feel safe. They also have a major focus on period reports, which help to explain the background to the figures that they later find in

the annual report. At bank E where they also emphasized the importance of understanding the figures, they clarified that the verbal dialogue is also an important part of the assessment of the company and to get confidence in the figures.

None of the respondents have actually begun to prepare for K2 and K3 and most were not familiar with the regulations. Bank E has started preparing some little things but does not think they will start preparing until next year when it becomes mandatory because they do not see it as a major change and there are other things that are more important at the moment. Bank B and bank C have not started preparing yet, but they understand that they soon should start to do so. At bank A they thought that the central entity for credit assessment may have already begun to prepare for the changes, but for those who work with the credit assessment on a daily basis it is not on the agenda. They were not concerned that too many companies will choose to report according to K2 since they said that most of the companies that can apply K2 do not have the need for credit volume that is dealt in detail. Bank D has not really even begun to prepare, but they will be having an educate their staff after the summer about how K2 and K3 affect them as a bank, but from the bank's point of view there are no guidelines or recommendations, so even though they soon will start to begin their preparation they do not know how it will affect them. Bank C uses an internal rating system that will not work in the beginning since it counts on statistics, and that is something they have to deal with and start to prepare for.

4.8 Analysis of K-regulations

In a rule-based framework, there is not much room for interpretation, since everything is regulated, which makes accounting easier for the practitioner. Policy-based is based on very own interpretations and values (Accounting Horizons, 2012). Bank A said that they will prefer reports according to K3 since it reveals more information, and the simplification in K2 such as periodization of entries and self-generated intangible assets (BFN, 2007) may explain why bank A will prefer K3-reporting in the future since it will let the practitioner use his or her judgement to best describe the economic transaction. K2 is rule-based and K3 is structured as the accounting is in Sweden today, principle-based, which means that it can differ greatly between companies reporting under the two different frameworks and figures in an annual report may look completely different. Today, the banks are not taking any position on how they want companies to produce their financial statements.

Since K3 will allow a higher degree of complexity than K2 (Drefeldt and Törning, 2012), bank A believes that they would rather see a presentation according to K3 than K2, especially at the more credit-intensive companies. The other banks have not taken a stand yet, but think that as long as they understand the figures, it does not matter how companies report.

It is important that the company receives some form of legitimacy from the society for their survival (Deegan, 2002) and one of the most important stakeholders to consider is the bank (Smith, 2006). Bank B placed great emphasis on the fact that they want financial statements to be approved by a certified or approved accountant, and again the trust is important between the bank, the company and its figures, because it is important that the company is perceived as legitimate. Statements that have been approved by an auditor, bank B said is a mark of quality and suggested that they do not need to focus on how the financial statements are reported since an auditor approved the figures and they will represent a true picture of the company. Likewise, bank A means that the accounting material should have been approved by an accountant and thus legitimized, regardless of what valuations or which accounting choices that have been made.

5 Discussion

5.1 Credit assessment process

When banks conduct credit assessments they use both quantitative and qualitative information, the latter to support the first. When considering small companies, the bank is more interested in personal contact and ownership because the company usually stands and falls with the owner and in that case, figures do not matter as much. Due to the fact that earlier studies have shown that banks that only use quantitative information tend to have higher credit losses this can be an indicator that there is more to take into consideration than quantitative information when conducting a credit assessment of smaller companies. Based on the fact mentioned above, one can understand why banks differ from the recommendation from the Swedish Financial Supervisory Authority to only make assessments on objective grounds. We believe that great consideration is taken of the qualitative information in the assessment of small and medium-sized companies because they usually do not have a financial function that takes care of the accounting, which means that there can be many errors that can occur when preparing the report, unlike larger companies that have large financial functions and greater demands from stakeholders. The risk of error in the figures does not make the annual reports fully reliable. We believe that the annual report is not that crucial when conducting an assessment of small and medium-sized companies because all of the banks still have to use complementary information and do an qualitative analysis of a company to get a picture of the organization and the owners, because that is what matters.

5.2 Accounting information

For many of the smaller companies, the accounting is mainly done for the bank and the government. Unlike the large listed companies there is no need to take into account the same amount of stakeholders and their need for information. Usually it is just enough for the smaller companies to report what they, by law, are obliged to report and nothing else and instead have a dialogue with the bank along with complementary information. We do not believe that the banks need to work to affect the accounting for these companies because they are usually the only stakeholder apart from owner and government and therefore can ask for customized complementary information.

5.3 K-regulations

In the interviews we noticed that the banks are still not familiar with the K-regulations, except for one bank and we believe that this is because of the credit analysts' background as an auditor and believe that this person could have a better understanding of what is going to happen when the K-regulations are implemented

since bank A was very clear about how they want the companies to report and that is according to K3. The other banks showed a lack of knowledge about the K-regulations and therefore did not have an opinion about future stance on the subject due to the fact that they have not yet started preparing for the transition. Since bank A was more familiar with the subject and very clear where they stand, while the others were more uncertain, one can interpret banks as more willing to steer the companies into K3 in the future if they want to receive a loan from the bank. Meanwhile the banks state that the analysis of the information they use when conducting an assessment of small and medium-sized companies, the annual report is not always the most important and crucial. This could mean that the accounting choice might not matter as much in many cases when the most important issue for the banks is to actually understand the figures and that they can have a dialogue with the company. It is also the situation for bank A that they understand and trust the figures, despite having a clear picture of how they want the companies to report.

6 Conclusion

6.1 Conclusion

- *How would banks like to steer companies when it comes to accounting regulations?*

This study shows the need for information banks have in the credit process and thus answers the question of how the banks want to steer companies when it comes to accounting choices. The information banks want to assimilate in the assessment of small and medium enterprises consist of the annual reports and complementary material but also a personal contact. The study focuses on companies that can report according to K2 or K3 and in the assessment of companies of this size; we have found that banks place great emphasis on the complementary material and the personal contact. The complementary material consists of information about the ownership structure, management, forecasted cash flows and budgets. As for the annual report, it is important that banks understand the figures but also can rely on them, which means that how the figures have been produced is less important as long as they can show a true and fair view of the company. The continuous dialogue between banks and companies reduce misunderstanding and thereby reduce the risk for the banks. It is in the annual report that the choice between K2 and K3 will have an impact and we have found that the banks have not taken any position in the question of what rules companies should choose - again, it is important that the figures are accurate and show a true and fair view.

The study shows that banks neither want nor need to steer companies in the choice of accounting choices. Our opinon is that banks are indifferent when it comes to choosing between K2 and K3 as long as companies can provide banks with information of the right quantity and quality, so that they in turn can make a full proper credit assessment. It is not important from the banks' perspective how the companies have chosen to report or which accounting choices they have made as long as the figures they provide through its annual report show a true and fair view of the company.

6.2 Further research

When conducting this study on banks' thoughts of the choice between K2 and K3, we noticed that the knowledge of the K-regulations is not as good as one might have hoped. Due to the fact that the regulations have not yet been implemented and the choice has not been made yet it would be interesting to examine if the banks want to control companies to a specific accounting choice after the regulations have been implemented. The knowledge about K-regulations will probably be greater and it would be easier for banks to answer the questions and see how the new regulatory has affected them and what approach they will have.

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8 Appendix

8.1 Questionnaire

General

- Tell us about yourself and your role in the bank

Credit assessment

- How does your process look?
- Is there a difference between the assessment of small and medium-sized companies compared with large companies?
- Is there a difference of the assessment of companies in different industries?

Accounting

- How much knowledge must one have in accounting to be able to do a credit assessment of small and medium-sized companies?
- How important is the accounting when conducting a credit assessment of these companies?
- Is complementary information important and which type of information would you like to receive?
- To you take into account, today, which accounting choices companies have made?
- If you got to choose, would you rather have an annual report with all the information you need or a more compact annual report and instead receive complementary information?
- Which parts of the balance sheet and the income statement do you study the most?

K2/K3

- Do you work in some way to effect companies accounting choices in a certain way?
- Are the demands you require enough to make a company choose in your favour?
- Have you started to prepare for the transition?