



UNIVERSITY OF GOTHENBURG  
SCHOOL OF BUSINESS, ECONOMICS AND LAW

# The abolition of the mandatory audit:

Effects on Swedish small companies' credit-worthiness

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## **Abstract**

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*Title:* The abolition of the mandatory audit: Effects on Swedish small companies' credit-worthiness

*Background and problem:* In November 2010, a new legislation for small limited companies regarding the abolition of the mandatory audit was introduced in Sweden with the intention to reduce their administrative burdens and make them more competitive. An audit ensures that the information presented in a company's annual report is truthful and correct. This information is requested by a company's stakeholders, who therefore could be affected by the abolition of the mandatory audit. Banks are an important stakeholder since they are one of the most important sources of funding for small companies. Whether and how they and a company's credit-worthiness are affected has not fully been established so far.

*Purpose:* The purpose of this thesis is to investigate whether and also how the new Swedish legislation regarding the abolition of the mandatory audit affects small limited companies' credit-worthiness.

*Research question:* How does the abolition of the mandatory audit affect the credit-worthiness of Swedish small limited companies, for those chosen not to have their reports audited?

*Methodology:* This study is conducted with an inductive approach in order to, rather than verifying or rejecting a predetermined hypothesis, investigate the problem of possible effects on small companies' credit-worthiness caused by the abolition of the mandatory audit. A qualitative method was used and the empirical material was gathered through semi-structured interviews with seven respondents from three of the largest banks within Sweden.

*Findings and conclusions:* All respondents find the annual report important in their work with granting credit to companies. However, the value lies within the information provided, not whether it is audited or not. Reason to this is that several factors are important to consider when deciding a company's credit-worthiness. The annual report is one factor, but also future repayment ability, prognoses, budgets and the personal characteristics of the company leader are important. The use of different information sources and the personal relationship with the company leader reduces the value of audit, according to the respondents. Overall, the credit-worthiness seem to be unaffected by the new legislation. However, all respondents state that they find the new legislation to have had a small impact, which could be a reason to the unchanged level of credit-worthiness.

*Keywords:* Mandatory audit, audit, credit-worthiness, bank, small limited companies

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# 1 Introduction

*In this chapter of the thesis, a background for the chosen subject will first be presented as well as the concept of audit. Then a problem discussion will follow, which will lead to the purpose and the research question of this study. Essential definitions and limitations will thereafter be provided, followed by a presentation of the design of this thesis.*

## 1.1 Background

In March of 2007 the European Council demanded necessary changes regarding a decrease of the administrative burdens for small and medium-sized enterprises (SMEs), within the European Union and their membership states. The intention with these changes was for them to reflect well on the economy of Europe and also improve European companies' competitiveness. The goal was to reduce the administrative burdens by 25 percent by the year 2012, but the Swedish government had an ambition to realize this by the year 2010 through simplifications of the rules of accounting, audit and company law (SOU 2008:32).

One of the simplifications came to be abolition of the mandatory audit for Swedish small limited companies. The mandatory audit for limited companies had been a part of Swedish legislation for approximately three decades. It arose from the social interests to reduce the potential manipulation and defects in the companies' financial reports that could result in economic crimes (Lennartsson, 2010 (1), Thorell & Norberg 2005).

A submission for comment, produced by the Swedish government, regarding the abolition of the mandatory audit for small limited companies came out in 2008. The submission for comment was supported by the fourth council directive by the Council of Europe, which, among other things, states that smaller companies are allowed to be excluded from the mandatory audit. In the submission for comment, a proposal of the requirements for which companies should be embodied in the new legislation was stated, which corresponded to the maximum value in the fourth council directive: balance sheet total 41.5 million SEK, net sales 83 million SEK and number of employees 50.

Regarding the submission for comment, The Swedish Bankers Association made a statement of opinion, based on their belief that a majority group of the companies embodied in this proposal still would purchase an audit, even though it was not going to be demanded by law. Because of this belief, The Swedish Bankers Association supported the abolition of the mandatory audit. They did, however, emphasize that banks would still value audited information (The Swedish Bankers Association 2008).

The new Swedish legislation was introduced for small limited companies on November 1<sup>st</sup> 2010, after modifications of the submission for comment from the year of 2008, such as lowering the requirements for companies to embody in the new legislation (SFS 2010:834). It states that only those companies that exceed two of the three following requirements during each of the last two financial years need to have their annual reports audited (ABL 9:1):

- Balance sheet total: 1.5 million SEK

- Net sales: 3 million SEK
- Number of employees: 3

## **1.2 Audit**

*In this section the concept of audit and its purpose will be presented.*

### **1.2.1 Audit and its purpose**

Auditing is a method for reviewing and evaluating a company's annual reports, accounting and management in a critical and professional manner to ensure that the company is presented in a correct way towards the general public. An audit secures the quality of the information and also contributes to well functioning commercial and industrial life. The function of audit is also important for the stakeholders, which need trustworthy information about the company. From a bank's perspective, correct and trustworthy information is important when considering granting credit. Information about a company provides a feeling of increased security, and this feeling becomes stronger when the information is audited. An auditor is hired by the company and has professional secrecy, which implies that an auditor is not allowed to provide external stakeholders with information without the permission from the company (FAR 2006).

### **1.2.2 The mandatory audit before and after November 1<sup>st</sup> 2010**

The mandatory audit implies that a company is obligated to have its reports, such as cash flow, balance sheet and consolidated statement of income, audited by a professional. The legislation regarding the mandatory audit for limited companies was introduced in Sweden in January 1983 in order to decrease the amount of economic crimes, even though it would cause economic burdens for the companies. A positive aspect with the mandatory audit for companies was that possible economic problems could be discovered more easily when having the reports audited (Thorell & Norberg 2005).

With the submission for comment, SOU 2008:32, as base, the legislation of mandatory audit was reformed in the year of 2010 in order to decrease the administrative and economic burdens for small companies. The new legislation allows small companies to choose whether or not they want to have their reports audited, given that they do not fulfill more than one of the requirements listed in section 1.1 (SFS 2010:834). If a company chooses not to have their reports audited they risk losing the benefits of audit (see section 1.2.1).

## **1.3 Problem discussion and purpose**

Audit ensures that the information presented in a company's annual report is truthful and correct. This information is requested and used by a company's stakeholders (FAR 2006). How they are affected by the abolition of the mandatory audit in the long run has not fully been established so far since the new legislation, at the time of writing, has only been used for approximately two years.



A bank, in the role of a company's stakeholder, needs both accounting and non-accounting information about the company to be able to make decisions about granting credit (Andersson 2001). Accounting information that has been audited is thought of as more reliable than non-audited. For smaller companies, however, accounting information is less important since banks in those cases, also use other kinds of information in the credit assessment process (Svensson 2003). Because of the abolition of the mandatory audit there might be some changes within the contract between a bank and a company, such as stricter terms and a higher need for security, in order to reduce a bank's risk-taking (SOU 2008:32). Since a large amount of the information received by small companies' stakeholders is private, the audit plays an important role in providing them with correct and quality assured annual reports (Niemi & Sundgren 2012).

The banks can, if it is important for a company's credit-worthiness, demand that the company purchase an audit. Because of the possibility to always be able to purchase an audit, even though it will cause costs for the companies, the Swedish government do not see that the new legislation will affect the companies' possibility to get credit (SOU 2008:32).

However, some do believe that the new legislation can cause problems. It could result in a larger amount of defects; after all, the auditors are contributing in some respect to the quality in the annual reports (Lennartsson 2010 (2)). There are also concerns regarding the banks' willingness to lend money to companies who, after November 1<sup>st</sup> 2010, would no longer have their annual reports audited (CFO World 2010).

Studies have been made regarding the use of audited financial reports and the auditor's report when banks make their lending decision. In one of these studies, by Berry and Robertson (2006), they compared their results with a similar study by Berry et al. (1985), and showed that the use of some financial information, such as the balance sheet, and the auditor's report has decreased. However, the annual report is still important in the process. The two studies were conducted with a population drawn from the same source, namely overseas bankers who operate in the United Kingdom. Conversely, another study states that credit institutions base their credit decisions and the amount to be loaned on the information contained in the auditor's report and that this information is crucial in these situations (Duréndez Gómez-Guillamón 2003).

A Swedish study, also regarding banks in the United Kingdom, concludes that banks are pro mandatory audit particularly because of three advantages that audit provides: better orderliness in the current record of accounting, better and more trustworthy annual reports and the presence of an auditor to consult if needed (Thorell & Norberg 2005).

### **1.3.1 Purpose**

The purpose of this thesis is to investigate whether and also how the new Swedish legislation regarding the abolition of the mandatory audit affects small limited companies' credit-worthiness.

This subject has been discussed both before and after November 1<sup>st</sup> 2010 in articles, books and theses, which indicates that it is a subject of current interest. The majority of the Swedish

studies made within this subject were conducted before November 1<sup>st</sup> 2010, which implies that the actual outcome of the new legislation in Sweden is not significantly explored. However, there exist studies that have investigated the effects of abolition of the mandatory audit within other countries, such as England. This study will contribute to the field with information about banks' views regarding the new Swedish legislation's actual effects on small limited companies' credit-worthiness.

Banks are one of the most important sources of funding for small limited companies (Garmer & Kyllenius 2004), and without capital, a business in the long run will cease to exist. Therefore it could be valuable with this study for the companies affected by this legislation, since an investigation about banks' attitudes towards audited and non-audited information could determine whether or not a company will purchase an audit.

The results of this study could also be valuable knowledge for the Swedish government since a worsened credit-worthiness could affect a company's ability to get funding for its continued business, which then would counteract the intended advantages, such as improved competitiveness. This knowledge could be used in relation to making decisions about whether to increase the limits of the new legislation and thereby embody a larger amount of companies.

#### **1.4 Research question**

Due to the fact that audit is a part of the business world, it is interesting to investigate which meaning this function has, especially for small limited companies. If the abolition of the mandatory audit has a great effect on small limited companies' credit-worthiness, this could mean that companies of different size would operate on different terms. Thus, small limited companies' business opportunities and growth could decrease because of the new legislation. This justifies further investigation of effects of the abolition of the mandatory audit. Thus, the question that will be investigated more closely in this thesis is:

- How does the abolition of the mandatory audit affect the credit-worthiness of Swedish small limited companies, for those chosen not to have their reports audited?

#### **1.5 Definitions**

*Branch:* A banking office where service and counseling are offered to the bank's customers.

*Client:* A company that is a customer of a bank.

*Company leader:* A person involved in the small company, presumed that a small company only consists of one person.

*Credit-worthiness:* A company's ability to pay its debts, determined through a credit assessment process at a bank, where special requirements demanded by the bank have to be met.

*Small companies:* Swedish small unlisted limited companies that do not fulfill more than one of the requirements listed above in section 1.1, which needs to be fulfilled in order to be obligated to purchase an audit.

*The new legislation:* The new Swedish legislation regarding the abolition of the mandatory audit for small limited companies.

## **1.6 Limitations**

The thesis is written in the field of business administration, or to be more exact, accounting. It is focused on small companies in Sweden. The area of interest concerns the effects of the abolition of the mandatory audit after November 2010 in Sweden. Focus will be on whether the new legislation has affected the credit-worthiness of small companies, who have chosen not to have their reports audited. The companies' credit-worthiness will be investigated regarding credit granting from lenders. This study will only look into credit granting at banks, since they are the most important source of funding for small companies. This study will be carried out in the perspective of the banks and their experiences, not the companies'.

## **1.7 Thesis design**

This thesis will focus on how the abolition of the mandatory auditing has affected small companies' credit-worthiness. In the next chapter, theories, and how they are applicable on this problem, will be presented. Also the concept of credit granting and some previous research within this field will be described in order to enhance the understanding for the subject. Different suitable methods for this study and how they are used will thereafter be discussed in chapter 3. In the chapter after that, the empirical findings gathered through interviews with seven respondents from three of the largest banks within Sweden will be presented. An analysis, where the empirical findings will be compared with theories and previous research, will be provided in chapter 5, which will result in conclusions presented in the last chapter as well as suggestions for future research.

In the appendices of this thesis, the interview guide used to gather the empirical findings is found as well as abbreviations.

## 2 Frame of references

*In this chapter of the thesis an assortment of applicable theories will be provided, which will be used in order to understand and discuss the research question of this study. A description of the concept of credit granting and its process will then be provided. Finally, a sample of previous research conducted within this field will be presented.*

### 2.1 Theories

*The theories applicable for this study will be provided in this section.*

#### 2.1.1 Stakeholder theory

About 30 years ago the development of stakeholder theory began and the concept of the theory took shape. This theory provides an oversight of those who might have an interest in a company, i.e. stakeholders. Figure 1, below, gives an overview of a typical stakeholder-company-relationship

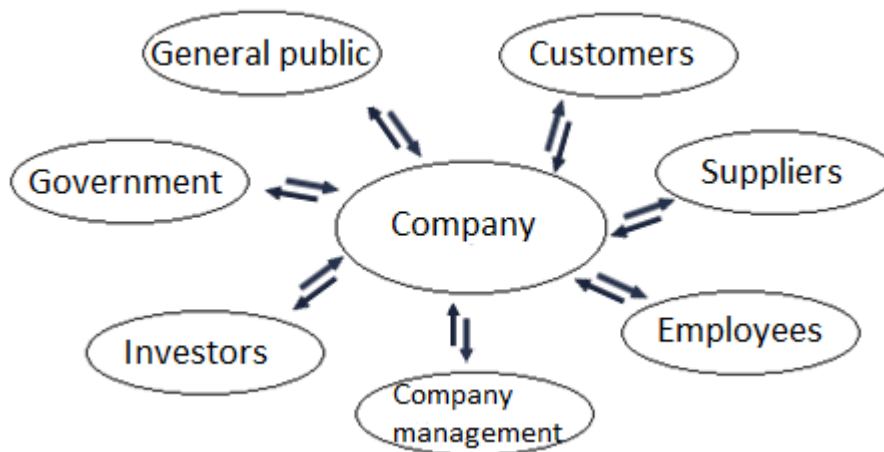


Figure 1 - Stakeholder theory

Simplification of Polonsky's model (1995)

A company has many different stakeholders, who are interested in its business. Who these are depends on the type of company and its size as well as how the concept of stakeholder is defined. Here the definition made by Freeman (1984) will be used: a stakeholder is someone who is affected by a company. However, the company is affected by the stakeholders as well. Therefore a company and its management have to take the stakeholders into consideration when planning, making decisions and taking actions (Mainardes et al. 2011).

In this study, the stakeholder theory is applicable in the relationship between a small company and a bank. Banks are one of the most important stakeholders for small companies since it is harder for small companies than large ones to get funding. This makes banks the most important source of funding which implies that a company, as the stakeholder theory states, needs to take the banks interests into consideration in order to fulfill the requirements for credit granting (Garner & Kyllenius 2004). The information about a business requested by the stakeholders varies. For example, banks are often interested in information connected to credit risk, something that a customer does not find as important (Smith 2006). Since, as mentioned, the banks are an important stakeholder for small companies, their interest should

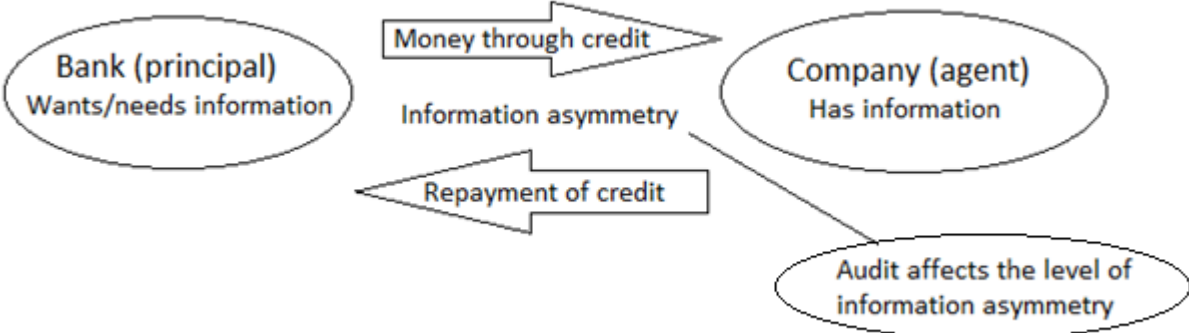
be fulfilled when information about a company is created, such as the annual report, as well as when important decision are made that could affect a company’s credit-worthiness.

The stakeholder named *Investors*, in Figure 1, includes both banks and shareholders in a company. Since this study focuses on small companies, the shareholders, employees and company management are often the same person(s), and because of the company’s size, the interest from the general public and the government is slightly decreased. If those groups are eliminated it becomes more obvious that banks are one of the most important stakeholders and that this relationship is valuable.

**2.1.2 Principal-agency theory**

The theory states that there are two parties involved in a situation, the principal and the agent. This relationship arises from the principal’s need to find another party, an agent, with specialized knowledge and abilities to perform a certain assignment that the principal itself is not able to handle. It is important for the principal to find the best agent for the assignment (Sappington 1991).

Figure 2, created by the author, shows an example of a principal-agent-relationship applicable for this study. The principal could be a bank wanting to find the best agent, for example a company with high credit-worthiness, to manage a certain amount of money, which will be given to the company through a credit. In order for the bank to find the best company, a credit assessment process will be initiated, which will be explained further in section 2.2.2.



**Figure 2 – Principal-agency theory**

**Back (2013)**

The theory is based on the existence of information asymmetry, which is further discussed in section 2.1.2.1. The information asymmetry, as shown in Figure 2, implies that the agent and the principal are presumed to have different kinds of information where the agent has an advantage through the possession of a larger amount of information than the principal (Adams 1994). The information asymmetry affects the actions taken by these parties and the level of information asymmetry could, in turn, be affected by the auditor since an audit ensures the correctitude in a company’s information as well as ensuring that nothing important is left out.

The agent, for example an owner of a company, has some information that the principal, for example a bank, needs, but cannot get, and this information could be used to the principal’s (bank’s) disadvantage. In this study an example of such information could be deeper

knowledge about the company and the business as a whole. Since this information lies within the company, it could imply problems for the bank when making credit granting decisions. Because of information asymmetry, banks find it difficult to evaluate small companies, which could lead to refused credit granting and inhibited growth for the company (Furusten 2009). The goal of the principal-agency theory is to find an optimal contract that will be acceptable for both parts (Eisenhardt 1989). An optimal contract, like a credit agreement, should imply that the bank have access to the information needed in order to make an accurate decision and to evaluate the company in the future. The contract would also entail terms, such as interest rate, acceptable for the company.

### ***2.1.2.1 Information asymmetry***

In contractual situations, terms have to be satisfactory for both parties in order for an agreement to occur. In this study, this contractual situation will be in the form of a company seeking credit in a bank. This kind of contract is often long term and comprises an amount of risks. To be able to reduce the risks, they have to be regulated somehow, for example through written agreements. All possible situations, however, will not be possible to regulate (Furusten 2009).

The risks connected to credit granting are often caused by the fact that there exists information asymmetry between a company and its bank, which affects the bank's ability to monitor the company's acts and intentions (Adams 1994). The requirements for how much information a company has to compile in its reports is lower for small companies, which implies that the company itself can influence what kind of and how much information that is provided in the process of credit granting at banks. Furthermore, the information in annual reports and other reports informs only what has already occurred in the company, while the information about the future lies within the company itself (Bruns 2003). The higher the level of information asymmetry is, the larger the risk of banks not wanting to grant credit (Svensson 2003).

Information about the company and its surroundings needs to be collected and evaluated in order to decrease the information asymmetry. However, collecting information is more difficult in owner-managed companies (Bruns 2003), since public information about the company does not exist, or at least is harder to find (Niemi & Sundgren 2012). This implies that the bank has to put their faith to the company and believe that the information needed will be provided and correct.

### ***2.1.2.2 Moral hazard***

Another problem that can arise within the principal-agency theory is called moral hazard, which often occurs after a contract is in place. This phenomenon implies that a company can keep important information from the banks or act in some way that does not coincide with the credit agreement (Furusten 2009, Bruns 2003). These acts do not have to be performed with the intention of hurting the bank in order to be called moral hazard. They could instead be caused by an opportunistic way of thinking within the company. Opportunistic here implies that a company, or its leader, acts in a way that is thought to be best for the company, without thinking of the consequences it can bring. The bank could act opportunistically as well, if it

for example wishes and encourages the company to generate short term cash flows, instead of thinking of long term growth (Bruns 2003).

Moral hazard will be present throughout the duration of the contract and has to be handled somehow. Since, as mentioned before, agreements and contracts cannot regulate everything, some kind of monitoring will often take place, which usually incurs some costs. This monitoring, performed by a bank, could be in the form of yearly follow-ups where the company and its numbers are evaluated (Furusten 2009). A contract between a company and a bank is, as mentioned, often long term and this gives the bank an opportunity to learn about the company, which could ease the bank's ability to foresee a company's future actions (Eisenhardt 1989).

Moral hazard is not a problem specific for small companies. No studies show that they are more likely to act in a disloyal manner. Instead it is the insecurity and lack of information that cause the problems (Bruns 2003).

## **2.2 Credit granting**

*In this section credit granting and its process will be described.*

### **2.2.1 Demand for capital**

In all types of companies a demand for capital will arise, whether it regards start-up of a new company, investments, expansion or other capital-intensive situations. This capital can be provided by, for instance, shareholders or other stakeholders, such as banks. A majority of the demand for capital in Swedish companies is provided by different kinds of credits with suppliers, The Swedish Tax Agency, banks and other financial institutes (Brommé et al. 1998).

### **2.2.2 The process of credit granting**

When granting credit, a credit assessment process will take place in order to determine a company's credit-worthiness. This process is divided into three different phases which, more or less, are integrated with each other. The phases are: acquirement of information, processing, analysis and interpretation of the information and finally, decision making. After these three phases and the possible occurrence of a contract, the bank will continue to do follow-up checks to make sure that the company's credit-worthiness remains the same (Svensson 2003).

The information included in the phases above concerns the company, securities, funding opportunities and other factors that can influence the creditor's decision. When conducting a credit assessment, these four components ought to be taken into account, although this is not always the case. The reasons why some credit risks are sometimes excluded are many. Perhaps the credit is insignificant to the bank or the company seeking the credit is well known at the bank (Brommé et al. 1998).

Banks collect different amounts of information about a company's accounting, which is an important basis for credit assessment. This information, which is found in annual reports,

analyses and different kinds of budgets, can reduce contingencies and ensure a company's ability to pay. One way to make sure that banks' contingencies are reduced is to get the company's information audited. This will also improve the credit-worthiness. The importance of accounting information compared to other grounds of judgment, such as judgments of person and market, varies with the size of a company, category of risk and degree of insecurity (Svensson 2003).

After the credit assessment, the bank will inform the company about the results and thereafter proceed with negotiations in order to reach an agreement in which the bank will have enough security to be able to grant the credit, and the company finds the terms reasonable (Brommé et al. 1998).

## **2.3 Previous research**

*An assortment of research conducted within this field, previous to this study, will here be presented.*

### **2.3.1 Overseas bankers in the UK and their use of information for making lending decisions: Changes from 1985**

This study made in the United Kingdom investigates which kind of information bankers use in their decision of granting credit. The results are compared with a similar study earlier conducted by Berry et al. (1985), and the outcome shows that accounting information in general remains very important since it provides a lot of information to bankers in their process of granting credit. However, the separate parts in the accounting information are valued differently. Some have increased in importance, such as cash flow statement, which could imply that this specific part has improved in quality, and some have decreased such as the audit report (Berry & Robertson 2006).

### **2.3.2 Are modified audit opinions related to the availability of credit? Evidence from Finnish SMEs**

This study, performed by using a sample of about 50 000 SMEs, investigates whether the use of credit from institutional creditors, such as banks, versus trading credit, provided by customers or suppliers, is affected by modified audit opinions or not. Small companies contributes significantly to the economy but they have more problems receiving funding than large companies. The results of the study show that there is no connection between a higher use of trading credit and modified audit opinions. The authors of the study consider that a reason could be that lenders base their credit granting decision on many sources of information, which implies that they not solely rely on the financial information. However, they do emphasize that their study does not imply that creditors find that audits lack value (Niemi & Sundgren 2012).

### **2.3.3 The mandatory audit in small companies (Revisionsplikten i små aktiebolag)**

Thorell and Norberg (2005) discuss that foremost banks are interested in small companies' accounting information. This statement is applicable on small companies where there are only



one or a few company leaders, which are active within the business as well. The authors also discuss their findings that banks are pro mandatory audit because of its advantages, mentioned in section 1.3, which is confirmed by material in their study regarding English banks. The apprehension of banks' positive attitude towards the mandatory audit is, according to the authors' beliefs, based on comfort and simplicity. If all the information is audited there will be no need for individual contracts between a bank and every single company, regulating the bank's demand of audit. The authors conclude that the mandatory audit is not of significant value when it comes to credit granting since a large number of countries within the European Union already do not have the mandatory audit for SMEs. This statement is also based on the fact that not even companies of all legal forms in Sweden need to have their information audited.

#### **2.3.4 The value of auditor assurance: Evidence from loan pricing**

Blackwell et al. (1998) investigate the value of auditor assurance. They analyze this in situations of revolving credit agreements. Private companies that are not required to have their reports audited will purchase an audit because of the expected advantages, such as decreased loan interest rates, according to the authors' findings. The results show that companies who purchase an audit pay a lower interest rate than those who do not purchase an audit. However, the authors mention that research conducted prior to their investigation shows varying results regarding audit and its affect on loan interest rates.

### **3 Methodology**

*This chapter will present the choice of subject and the research method for this study. Further a discussion about the procedure of collecting data and the selection of respondents will be provided. Thereafter, the method of analyzing the data will be presented and finally the reliability and validity of this thesis.*

#### **3.1 Choice of subject**

The subject of the abolition of the mandatory audit is of current interest and rather unexplored in Sweden. This is due to the new legislation having only been in use for approximately two years and the effects have not yet been fully established. The interest for the subject arose partly because of the public debate but also lecturers' statements when studying subjects related to the mandatory audit. Since audit could affect the correctness in a company's annual reports, first users of annual reports had to be established. Creditors, especially banks who are the primary source of funding for small companies, were found to be the most important user of the annual reports (Niemi & Sundgren 2012). Therefore, this subject will be studied closer, focusing on how small companies' credit-worthiness is affected by the abolition of the mandatory audit.

#### **3.2 Research method**

In this study, an inductive approach was used, which implies that no predetermined hypothesis was used when analyzing and drawing conclusions about the empirical findings (Patel & Davidson 1991). A study with an inductive approach was conducted in order to discover and investigate a situation or problem rather than to verify or reject a predetermined hypothesis (Merriam 1994). Since the new legislation only has been used for approximately two years and only a small amount of research has been conducted in this area, it would be hard to perform a deductive study. Instead the inductive approach proved more suitable.

A qualitative method was used in this study, which promotes the acquisition of deep knowledge about a specific field, where one should aspire to an attempt to understand and analyze the entirety of a situation (Patel & Davidson 1991). This method was used while executing the interviews since it made room for more complex and detailed answers in a way that a quantitative method would not (Trost 2010). Regarding this subject, the questions should not be limiting, instead they should open up for discussion, which makes the qualitative method more suitable.

In order to gather empirical material interviews were held with representatives from three of Sweden's largest banks which are working with granting credit to companies. These interviews were semi-structured, which is a method suitable for studying a subject that could benefit from the respondent's own thoughts and vocabulary (May 2001). This method implies that the interview guide consists of only a few base questions, in this case focused on small companies' credit-worthiness and the possible effects of the abolition of the mandatory audit. It was conducted this way so that not only the prepared questions were answered, but also gave the respondent an opportunity to elaborate his or hers answers and allowed follow-up

questions. This also enabled the possibility for open discussions. A drawback with allowing elaborations and open discussions could be that the interview could lose focus of the main subject (Kvale 1997). However, in those cases, the prepared questions enabled the interviewer to refocus the interview on the subject of study.

The base questions for the interview were the same for all bankers in order to enable a comparison of the answers in the analysis. In this manner the interviews were standardized, but since there were follow-up questions, the interviews also had features of low standardization (Trost 2010). The interview guide was sent out before the interview, with the intention of giving the respondents some time to prepare. Drawbacks with sending the questions out beforehand could be a loss of spontaneity in the respondents' answers and a feeling of them being rehearsed. However, since the respondent only had the possibility to prepare the base questions, and not the follow-up questions, an amount of spontaneity and the respondents' own power of thought were still required.

During the interviews notes were taken and, with the respondent's approval, also recorded to ensure that all the information could be transcribed and analyzed. One of the interviews was not recorded since it rather had the feature of a discussion than an interview. The reason for that is that the respondents did not have any experience from small companies, and therefore only could talk about credit granting within their bank in general.

Recording interviews enables shades and tones to be documented, which is difficult when taking notes. Another reason to why the decision to record the interviews was made was that, instead of focusing on taking notes of every answer, the focus was on the respondent and the interview itself (Kvale 1997). A drawback with recording the interviews is that it can affect the respondent's answers (Patel & Davidson 2011), but since the advantages with recording outweigh the disadvantages most of the interviews were recorded.

### **3.2.1 Interview guide**

The chosen semi-structured method requires a number of prepared questions to be asked in the interview, even though the specific order and wording were not predetermined (Merriam 1994). The prepared questions were gathered in an interview guide, which is supposed to cover the different fields of interest that will be discussed during an interview.

The interview guide, found in Appendix 1, consists of questions that enabled the purpose to be fulfilled as well as the research question of this thesis to be answered. When creating the interview guide the purpose and research question as well as the theories and other references presented in chapter 2, was used as a base in order to acquire the material needed. When the interview guide was finished, the questions were tested on a fellow student. Also, the tutor of this thesis and a business advisor at a bank were requested to read them and provide feedback. These tests of the interview guide were made in order to confirm the validity of the questions before conducting the actual interviews. Instead of requesting someone to read the interview guide, a test interview could have been an option since not only the questions but also the interviewer's abilities would be tested (Dalen 2008). However, if a test interview was to be conducted, the desired respondent should have been a person with knowledge about the subject in order to receive valid feedback about the interview guide. It was difficult to find

respondents for the actual interviews which eased the decision not to conduct a test interview as well.

### **3.3 Data collection**

*In this section the methods of data collection through a literature survey and interviews will be presented, as well as the concept of confidentiality.*

#### **3.3.1 Literature survey**

The study began with a literature survey where theoretical data from books, academic articles and newspaper articles were collected. This gave a deeper understanding for the problem, the underlying theories and which methods to use in this study. The literature survey also included reading previous research, such as dissertations, which provided an overall view of work that had already been conducted in this field. Most of the research found, were made before the new legislation was introduced in November 2010, which therefore resulted only in beliefs and expectations concerning the subject, not real facts.

Previous research and academic articles were found through different databases where *Web of Knowledge* mostly was used. Other databases that were used are *Scopus* and *Business Source Premier*. When finding articles and previous research the most frequently used search words, and combinations of these, were: *audit, credit, credit-worthiness, bank, stakeholder, annual report, principal* and *agency theory*. Different web sites has also been used in order to collect information concerning the process and work with the new legislation as well as statistics regarding banks' market share of credit granting.

#### **3.3.2 Interviews**

In order to collect the empirical material needed for this study, interviews were held. Interviews as a method provide an opportunity for one to get a deeper understanding and insight in someone's opinions, experiences and attitudes. Compared to questionnaire studies, interviews provide a larger amount of shades as well as deepened and diversified answers (May 2001). These features, instead of short answers of yes-and-no-character, were important in this study since explanations and insight about experiences in the field ought to be found. However, interviews are more time-consuming than questionnaire studies, which imply that fewer respondents were approached.

Interviews were held with respondents representing three of the four largest banks in Sweden. The respondents all had experience from credit granting which ensures the quality in their answers. Almost all of them also had experience from working with small companies. However, most of the small companies encountered by the respondents were audited. Because of the respondents' similar experience, a comparison of their answers was deemed appropriate. Further information about the process of selecting respondents is found in section 3.4.

The interviews were conducted through personal meetings in order to not only observe the respondents' answers but also aspects such as the body language and facial expressions. An interview is built on an interaction between the interviewer and the respondent. The reactions

and effects this interaction causes both parts are easier observed when meeting face-to-face (Kvale 1997). The interview started with questions of a more general nature, such as the respondent's background, before the main items were discussed. This method is supposed to make the respondent more relaxed (Dalen 2008). After the interviews were held and transcribed, complementary questions were needed in some cases. These were asked over telephone or by e-mail, which acquired feedback and answers in a less time-consuming way.

### **3.3.2.1 Confidentiality**

When using the method of interviews one should be aware of the consequences a respondent's unwillingness to answer could cause. The results of the study would not be the same if the respondents did not participate in a desirable manner. To prevent this, it is important to clarify how the respondent's answers will be handled and used after the interview (Patel & Davidson 2011).

The respondents were informed about the confidentiality of their identities, both through the information sent out before the interviews and at the beginning of each interview. The meaning of confidentiality is to not present data about a specific respondent that could make him or her identifiable (Kvale 1997). The decision to keep their identities confidential was based on the belief that it enables the respondents to talk more freely (Trost 2010). When keeping the identities of both the banks and the respondents confidential, the risks of preconceptions by the reader is also reduced. In chapter 4 to 6 the participating respondents of this study will be named *respondent A-F* in order to separate the different respondents and ease the reader's understanding of the material.

## **3.4 Selection of respondents**

The process of selecting suitable respondents for the study began with collecting information about different banks' market share of business lending in Sweden. Statistics about Swedish banks' market shares in this area were not easily found. In order to gather this statistics, The Swedish Financial Supervisory Authority was contacted. The requested data were unfortunately classified, which meant that the data were not available for this study. The Swedish Bank Association and The Central Bureau of Statistics were contacted as well, but they could not provide the data needed either. Finally, statistics from year 2011 were found, which stated that Handelsbanken occupied 23 percent, Swedbank 17 percent, Nordea 16 percent and SEB 13 percent of the total amount of credit granted to companies. There was also a category of banks named *Others* that occupied 20 percent altogether, but there were no information about which or how many banks this category entailed (Swedbank 2011). Because of these statistics and the lack of information about the category *Others*, it was intended that bankers from the other four largest actors in the business lending market, namely Handelsbanken, Swedbank, Nordea and SEB, would be interviewed. Unfortunately only three of these banks had the opportunity to participate in this study.

Since these banks are among the largest ones in Sweden it is credibly, not only that they widely contribute to small companies' funding, but also that they have a solid policy for credit granting (Svensson 2003), which could mean that they have specific rules to follow and a

special model that they use when making credit granting decisions. The selection of banks does not fully reflect the actual situation in the market of business lending, but since the banks who could participate have an aggregated market share that exceed 50 percent, the majority of the actual population will be represented.

It is important to ensure not to interview too many or too few. The number of interviews should depend on the timeframe of the study and the amount of material needed in order to ensure the quality of the data for the following work with analysis and drawing conclusions (Dalen 2008). Seven representatives were interviewed which is a suitable number based on the time frame. Perhaps seven representatives are not enough to fully ensure the quality of the data, but since three of the four largest banks in Sweden are represented, the majority of the market of business lending will be covered. The respondents had experience from granting credit to companies which implies that they possess the right knowledge and could give valid answers. However, not all of them had experience from working with small non-audited companies.

### **3.4.1 Contact and meeting with selected banks and respondents**

Contact was established with Sweden's four largest banks through e-mail and telephone calls. This first contact came to be with the banks' customer services or receptionists at their branches since contact information to the desired representatives was not published at the banks' web sites. When contacting the banks, a short presentation of the study as well as contact information to the author was provided. The response differed between the four banks. One of the banks directly forwarded the request to possible respondents, which led to booking of interviews. The other banks gave no immediate response, or simply turned the request down for different reasons, such as lack of time.

One reason behind the difficulties with finding respondents willing to participate could be the time-consuming method of interviews. Perhaps a larger amount of responses to the request of participation would have been received if the method was a questionnaire study instead. However, that method is not as exhaustive as interviews, and it does not allow the respondent to elaborate or form the answers in his or her own words, which made that method unsuitable for this study.

These efforts resulted in six interviews with seven respondents involved. When contact was established with the respondents, confirmations of the time of the interviews as well as the interview guide were sent by email.

The six interviews were conducted during a two week period of time and each interview lasted approximately 30-70 minutes. The time frame of two weeks partly depended on the respondents' schedules, but also on the fact that time between each interview was needed. This time was used to transcribe each interview before conducting the next one, which provided new answers and impressions. All six interviews took place at the respondents' branches in special rooms where no one other than the author and the respondent(s) were attending. After the interviews, further communication with the respondents was handled through e-mail and telephone.

### 3.5 Data analysis

The analysis of the empirical findings started during the interviews by interpreting the respondent's answers and receiving confirmation or correction of statements through follow-up questions, which is a valid method according to Kvale (1997). When the interviews were held, the data were transcribed the same day and the following, something that is important in order to ensure that nothing is forgotten and to avoid inaccurate interpretations (Dalen 2008). By transcribing the interviews as fast as possible, continuous analyses of each interview took place, instead of waiting until after all the interviews and making one joint analysis of all the data where important impressions could have gotten lost (Patel & Davidson 1991). The empirical findings, essential and significant to this study, gathered through interviews will be presented in chapter 4.

The interviews were held in Swedish, the respondents' and interviewer's mother tongue, and needed to be translated into English before using them in this study. This represents the challenge of translating whole expressions and avoiding word-for-word translation that could give a statement another meaning. This process could result in some inaccuracies because of interpretations made by the transcriber (Esposito 2001). With this in mind, the translations were made carefully and thoroughly in order to avoid any such mistake.

After the data were transcribed and before it was used in the thesis, the respondents received a copy of the transcript to make sure that their answers and opinions were presented correctly. This also gave the respondents a chance to give their approval of using the interview in the thesis (Kvale 1997). The respondents were also contacted in the case of follow-up questions or clarifications.

In order to structure the empirical findings, the data had to be read and processed again, which enabled a comparison of the respondents' answers, where similarities and differences were identified. The data were rearranged in different sub-sections covering different areas important for this study. In these sub-sections, the respondents' answers, both similarities and differences, were assembled. Thereafter, the data were continually processed and edited in order to ensure the relevance and understanding of the text.

Before the writing of the analysis and conclusions began, all data were reviewed anew many times in order to find connections between the material, provided in chapter 2 *Frame of references*, and the empirical findings. Thoughts and ideas that arose during this process were documented and then used for the writing of analysis and conclusions. The documentation of ideas is important in order to not lose anything in the process (Patel & Davidson 1991).

In order to enhance the reader's understanding, the same headings were predominantly used in chapter 4 *Empirical findings* and chapter 5 *Analysis*. After the analysis was made, the material was again reviewed and processed in order to find valid conclusions and to make sure the research question would be answered and the purpose fulfilled.

During the work with this thesis, ideas for other studies and future research arose. These ideas were documented during the process and are presented at the end of this thesis.

## **3.6 Reliability**

The level of reliability in a study is measured through how credible it is that the results will be repeated if a similar study were to be conducted (Merriam 1994), which implies that reliability aims to reduce defects and skewness in the study (Yin 2006). The reliability of this thesis regarding the references and study will be discussed in the following.

### **3.6.1 References**

When choosing types of references, the level of reliability was kept in mind. Because of that, information has only been used from reliable sources, such as books and well-known web sites. Academic articles used in this thesis are peer-reviewed, which enhances their credibility. Even though the sources are of a reliable nature, a critical attitude has been used when gathering the information and observing the results and theories presented.

A book published by FAR, which explains the process of audit, has been used in this thesis. The information in the book, such as the many advantages with audit, might not be entirely objective. However, the advantages of audit are important to note when discussing the subject of abolition of the mandatory audit in order to understand the possible issues it could cause.

### **3.6.2 Study**

The selection of banks asked to participate in the study was made consciously. However, the approached respondents were randomly chosen, in order not to control which respondents at which branches were going to be interviewed. Because of the random selection, there is a risk of the most suitable respondents not participating. The choice of selecting respondents depended on which branch and representative had the willingness and availability to participate.

When interviews are conducted in a study, the interviewer's skills are of importance. The judgments and interpretations made by the interviewer could lead to errors. There are different methods to reduce these errors, such as being more than one interviewer or recording the interview (Patel & Davidson 1991). In the interviews conducted for this study, only one interviewer was attending, but the interviews were recorded and, after transcription, also sent back to the respondents in order to avoid misinterpretations. These efforts should imply a high reliability in the empirical findings.

The interviews were conducted in a similar way, where the interviewer attempted to have an open mind before every interview in order to avoid preconceptions. An interview guide was sent out beforehand, and it was the same for all respondents, which enhances the reliability. However, since the interviews were conducted in a semi-structured manner, follow-up questions and desires for elaborations could differ between the interviews, which could have contributed to some of the differences in the respondents' answers.

All respondents were kept confidential in this study, which could affect the reliability since the reader does not get the opportunity to take part in specific information about the respondents that could affect the confidence in the truthfulness of the empirical findings. However, the choice of confidentiality was made because of the belief that the respondents would talk more freely and contribute to the study in a more extensive manner. Therefore, the



reliability in the material is still found to be high because of the reduction of the respondents' opportunity to withhold important information.

### **3.7 Validity**

Validity is regarding whether the subject that is intended to be studied, actually turns out to be studied (Kvale & Brinkmann 2009). At every step of the process of writing this thesis, the research question was held in mind. Reasons behind that were to avoid collecting material for *Frame of references* that were not applicable to the study and not to use valuable time in the interviews for questions and discussions that lacked relation to the studied subject. Before the interviews, the interview guide was tried out in order to assure the questions related to the subject of interest and the research question.

In order to ensure receiving the answers needed to fulfill the purpose and research question of this study, bankers working as business advisors were interviewed. However, all respondents did not have experience from small non-audited companies which could affect the received answers. On the other hand, the answers received from the business advisor with the right experience do, to a large extent, coincide with the other business advisors' answers, which could imply that even though they were lacking the right experience, they still possessed the knowledge.

## **4 Empirical findings**

*In this chapter the empirical material collected through interviews with three of the four largest banks in Sweden will be presented. A short presentation of each respondent will be provided in the first section. Ways of determining credit-worthiness through the different banks' credit assessment processes will then be provided. Thereafter, the respondents' views regarding when an audit is required or not will be presented. Finally the respondents' thoughts regarding effects of the new legislation will be provided. After section 4.2-4.4, summaries of the most important factors discussed in each section will be presented.*

### **4.1 Presentation of the respondents**

*The seven respondents from three of the largest banks within Sweden will here be presented.*

#### **4.1.1 Respondent A**

Respondent A has been working at the bank for about 30 years. He has been working as a business advisor for both smaller and larger companies for about 20 years, where granting credit is one of his work tasks. He does not have any direct experience from non-audited companies, since the new legislation has recently been introduced and many companies so far have not taken the opportunity of exercising this option, according to the respondent's view. Even though he lacks experience in the requested area, he does have great experience from credit granting and the process, which involves gathering information, both audited and non-audited, to determine a company's credit-worthiness. These experiences make it possible to have a discussion regarding the respondent's view of the auditor's value.

#### **4.1.2 Respondents B**

In this meeting, two respondents were present, one business advisor and one analyst, where the latter did not have any client responsibility. The meeting consisted more of a discussion than an interview with the respondents. The reason for this is that they did not themselves have any experience from companies of the size that is embodied in the new legislation, audited or not. However, they had experience from credit granting and could therefore provide valid answers to a certain extent.

#### **4.1.3 Respondent C**

Respondent C works as credit manager for one of the bank's business units. Her work tasks involves everything regarding credit within the bank, both companies' and private persons' engagements. She has worked at the bank for about 25 years, but only in direct connection with customers the first 10-15 years. She emphasizes the fact that the information provided by her will probably not contribute to this study in the same extent as an interview with a business advisor would, but since she is in charge of all matters regarding credit she still has knowledge about the credit process within the bank.

#### **4.1.4 Respondent D**

Respondent D works as manager for the business and capital segment at her branch. She has been working within the bank since year 1987 and has always had a certain amount of customer responsibility. Today she is, in some way, involved in almost every company and their engagement in the bank, but is responsible for only a few of them.

#### **4.1.5 Respondent E**

Respondent E has worked at the bank for approximately ten years, with tasks regarding both private persons' and companies' economical matters. Today she works as business advisor for small companies. She has experience from audited companies as well as non-audited, but she explains that the non-audited companies she has encountered are newly started. The current clients have not, according to her, decided to remove their auditor.

#### **4.1.6 Respondent F**

Respondent F has worked at the bank for six years where he started as an advisor for private persons but after three years transferred into working as a business advisor. He currently works with SMEs, but not with companies of the size affected by the new legislation. However, he has been working with those companies before and has the knowledge and the experience of credit granting.

### **4.2 Determining credit-worthiness through a credit assessment process**

*When determining a company's credit-worthiness, the respondents begin with conducting a credit assessment process. Different factors and their value in the process will be presented in this section.*

#### **4.2.1 Historic and future-oriented data**

In the different respondents' credit assessment processes, there are similarities as well as differences. All respondents find a company's annual report important, regardless of whether it is audited or not, since it provides both numbers and other information important for a company's future. Respondents A, C, E and F find the financial reports to be the most important and respondent F also mentions that small companies annual reports usually only consist of these financial reports. Respondent E also mentions the value of semi-annual reports, which provide information regarding activities during the business year.

Credit granting would be a lot more difficult without the information in the annual report. However, respondent C, D and F, emphasize that the information found in the annual report is not enough since it does not always tell the whole truth, and even if audited, is not guaranteed to be correct. The information found in the annual reports is used by all respondents when making an internal review. Also internal information, such as a client's engagement in the bank is important for this review.

All respondents agree that historical data from previous years, as well as prognoses and budgets for following years, are important to consider in the internal review and the credit assessment process. This data are taken into consideration when judging a company's future repayment ability, which is a crucial factor when deciding to grant credit. If the respondents do not find that a company has future repayment ability, credit will not be granted.

When a company is newly started, annual reports and other historic data do not exist, which makes it harder to perform a satisfactory credit assessment process. In that case, bankers solely have to rely on prognoses, which are uncertain. The more historic data the bankers have

access to, the easier and more correct view of a company is possible. This is due to the data providing information about a company's development and business during a long period of time. However, it does not imply that a current client is granted credit easier since the reliability and level of contingencies are affected positively or negatively depending on the respondents' experiences.

When making an external review of a company, all respondents gather information about companies from UC, before granting credit. UC places great importance on remarks and comments in a company's annual report in their analysis, which the banks take part in. The importance of the information provided by UC differs between the respondents. All respondents, except from B, find it important, but it is not a determining factor whether or not to grant credit. Respondent A and E state that, in cases of reliable current clients, they even sometimes overlook smaller remarks that UC reports. Respondents B value the information only in a limited manner since it mostly consists of information regarding problem areas, such as record of non-payment, and not other types of data. However, the information from UC is found to be especially important for all respondents when the credit is sought by a company that they do not have any prior relationship with.

Respondent D point out that the credit assessment process varies in almost every case. Something that applied to one company might not apply to another. That fact motivates the importance of performing an individual review of every company and its company leader. Respondent F in turn states that the credit assessment process for small companies is not as thorough as for larger companies since they usually seek smaller credits and the bank often has a personal connection to the company leader.

#### **4.2.2 The value of the company leader**

The company leader is an important factor that is taken into account by all respondents. Both the financial status and the individual characteristics of the leader are reviewed. All respondents gather information about the company leader and his or her intentions with the company before granting credit in order to acquire a combined picture of the risks and qualities with the company and its leader. Respondents B and D begin their credit assessment process with a meeting with the company leader, and the decision regarding whether or not to proceed with the credit assessment process could be determined already in that meeting. The fact that respondents B and D find the company leader reliable is a prerequisite in order to even consider granting credit. Respondent A also states that if a current client makes changes in the ownership, a new credit assessment process will be initiated and if the bank does not get to know the new company leader, the credit-worthiness will be worsened regardless of whether the company's annual report is audited or not.

The review of the company leader is also important in those cases a surety is established, which is usually the case in all banks, though respondents B have not made any statement regarding sureties. The surety covers a part or the whole credit in the bank. The surety reduces the demand for audit and the assurance of correctitude it provides. However, the respondents agree that securities are not enough to grant credit since the future repayment ability and reliability are factors that cannot be overlooked.

**4.2.3 Follow-ups**

When a credit agreement between a bank and a company is in place, yearly follow-ups will be performed by all respondents except from respondent F, whose branch only performs follow-ups for small companies when information about problems or changes within the company is received from UC. The respondents that perform continuous follow-ups could perform them other than yearly, depending on which company it is regarding, the size of the credit or other special terms of credit. The follow-ups include gathering new information from UC, as well as reviewing the client’s engagements in the bank and what has occurred in the client’s business during the elapsed time. The purpose of follow-ups, according to Respondent D, is not only to investigate risk taking, but also to determine if the cooperation between the bank and the company could expand.

**4.2.4 Remaining comments**

Another important factor, which is only mentioned by respondent A, is the volume of a company’s dividends, which is decided by the board of directors. On the one hand, dividends could imply that a company is showing a positive outcome, but on the other hand, large dividends could imply that money is disappearing from the company, which could be troublesome if a great loss or a profitless business year occur. Respondent A is more restrictive regarding granting credit if a company has had large dividends. In order to enhance the credit-worthiness, the company leader could reinvest some private capital in the company, which implies that the amount of credit from the bank could decrease.

**4.2.5 Summary of important factors in the credit assessment process**

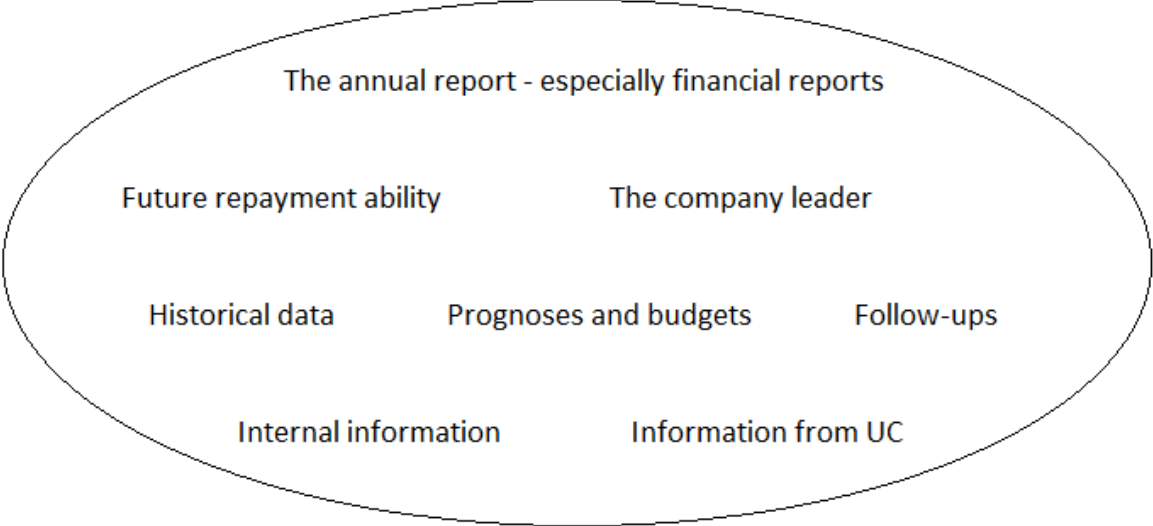


Figure 3 – Important factors in the credit assessment process

Back (2013)

### **4.3 When is an audit required?**

*In this section, Respondents B will not be included. This is because they did not work with small companies, and did not have the right experiences in order to provide valid answers regarding the audit's value for granting credit to small companies.*

#### **4.3.1 The value of audit**

A company's annual report, which is an important factor to banks in their process of credit granting, is reviewed by an auditor. The audit provides a quality assurance, which all respondents find important. However, they emphasize that even though an audit provides them with a decreased feeling of contingencies, it is not a guarantee that everything in the report is correct. Respondent A and C find the audit to be of greater importance for larger companies seeking larger credits, something that respondent D does not fully agree with. Respondent D finds it important to perform a thorough review before granting credit regardless of size of company and credit and emphasizes that many small credits sought by small companies add up to a large amount of money, which the bank does not want to lose. This makes the correctness of the company's numbers important.

Respondent D's priority is to work together with the companies and the people within, not their auditors. Respondent D finds it important to operate close to the client and because of the closeness to the companies, there is an opportunity to receive information in other ways than only through the annual report. Respondent D also has a more personal relationship with the client since they work closer together, which reduces the value of audit.

Respondents A, C, E and F find assets to be one post where an audit could be valuable since they themselves do not perform inventory, and a correct value of the assets is important in those cases a hypothec through a deposit in the assets is established. This does not, however, imply that correctness in the value of shareholder's equity, as well as debts, in order to determine a company's economical status, is less important.

The decision of granting credit is not dependent on whether a company is audited or not, although it is important that there exists reliable material to base the decision on. As respondent F states, a company that purchases an audit and one that does not, could have the same quality in their economy of the business, which implies that an audit is not the crucial factor in the credit granting process.

#### **4.3.2 Audit for current clients and established companies**

Respondents C, E and F find the audit less valuable when the credit granting is regarding a current client that they already have experience off. The reason for that is that the respondents in those cases already have a relationship with the client as well as access to internal information to use in their credit assessment process.

If the bank can follow the activities in the client's engagements, an audit is not as important, since the bank already has large parts of the information. For well established companies, it is also easier to find information such as annual reports and other data from UC, which implies that a newly established company could benefit more from purchasing audit.

The information from UC, regarding audited companies, shows whether there have been any remarks in the audit’s report. Respondent D, however, states that these possible remarks are usually not surprising for the bank, since problems within a company are often observed by the bank before utilizing of this information. This implies that the auditor’s report is not really required in that matter for respondent D.

**4.3.3 Remaining comments**

All respondents have some kind of contact with a company’s auditor when needed, which is valuable, but not a crucial factor in the credit granting process. This contact is established to, for example, coordinate and discuss the information provided by the company, to make sure that everything is correct.

Respondent A finds the auditor to play an important part since he or she reviews the decisions made by the board of directors and thereby approves, for example, if the dividends are of suitable size. Respondent A also finds a company’s contracts with customers and suppliers valuable and important since they show how the company earns money and whether its business partners are consistent or not. Since the auditor, according to respondent A, does not take part in that information and is not required in order to verify the correctness, the choice of purchasing audit or not does not affect this information. Respondent A further states that even though a company might not purchase an audit, the requirement of sending their annual reports to the Swedish Companies Registration Office still brings an amount of security. This is because it provides the bank with information, even though it does not imply anything about the level of the quality.

**4.3.4 Summary of statements regarding audit**

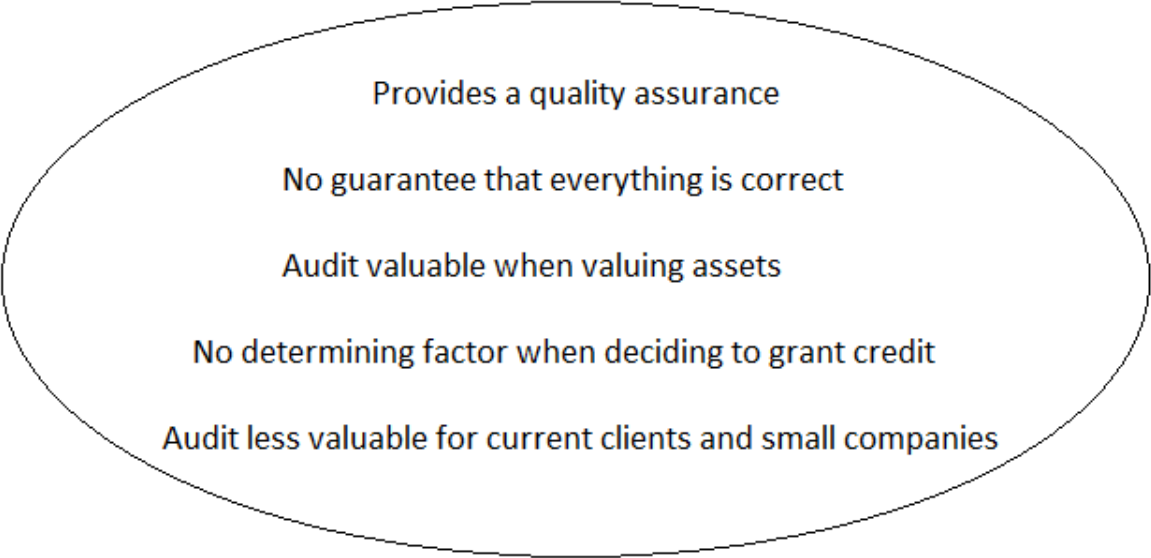


Figure 4 – Statements regarding audit

Back (2013)

#### **4.4 Effects of the new legislation**

All respondents only have little, or in some cases no, experience of non-audited companies and they emphasize that some of their answers are only speculations and expectations about the future effects of the new legislation, not facts.

The respondents agree that the new legislation, overall, has not had a large impact so far and one reason could be that an auditor provides both the company itself as well as external stakeholders with some form of assurance, which could result in companies choosing to keep their auditor. Respondent A believes that the option of not purchasing audit might increase in the future, which will then make it possible to evaluate the effects in a more extensive way than today. Respondent F mentions that only a few clients have chosen not to purchase an audit and he believes that one of the reasons could be that a company who have credit or want credit purchase an audit to get the quality assurance it provides.

The routines at the banks have not, overall, changed after the introduction of the new legislation, but the respondents agree that a change might occur if the limits for who does not need an auditor increase, as it would involve larger companies and also larger credits.

##### **4.4.1 Changes within the terms of credit**

In cases of non-audited companies, all respondents, except from respondents B, agree that the interest rate and terms of credit will probably not differ from audited companies'. This is because the terms of a credit agreement are not based on the choice of purchasing audit or not. Instead they are affected by other variables. An audit is of value when a bank experiences contingencies in the credit assessment process, not when deciding the interest rate. Respondent F states that the decision of credit granting will be made before deciding the price of the credit. Once the decision is made, the interest rate will be decided, regardless of audit or not. Respondents B believe that the contingency caused by the absence of audit could affect the interest rate, the frequency of follow-ups or other terms.

If a non-audited company seeks credit and respondent E experiences some contingencies regarding accepting a certain amount of assets as hypothec, these contingencies will not be compensated by changed terms of credit, instead an audit will probably be demanded in order to defeat the contingencies. Respondent E emphasizes that, in case of contingencies, a dialog with the company leader will probably be initiated in order to solve the problems, instead of turning the company down.

Respondent C, D and F do not believe that they will request securities in a larger extension in order to grant credit to non-audited companies. Respondent E, however, believes that if there are any contingencies regarding a company, the company itself usually compensates this with additional securities.

##### **4.4.2 Will an audit be required?**

All respondents, except from respondents B, are not convinced that they will require a non-audited company to purchase an audit. Factors that influence the decision are the size of the credit, how long the company has existed and how reliable the company is. It is also important to be observant of contingencies or indications of potential problems. Respondent C



believes that if there are contingencies, some kind of quality assurance will be required, such as a verification that states the quality and correctitude in the company's information, even though it will not be a full-scale audit.

Respondent E still advises companies to keep their auditor to ensure the correctitude in their reports, for guidance and also to have a party to discuss possible future plans such as expansion and economical matters with. Respondent E also believes it is positive for a company to have an auditor in those cases the bank is unable or, because of insecurity, unwilling to give recommendations about specific matters. These situations usually regard matters where the bank finds that it is not their area of knowledge, but the company still needs help.

Respondent F believes that companies who have chosen not to have an auditor should not somehow be punished because of that. He explains that he generally does not have any opinions regarding whether a company should have an auditor or not, even though he still finds it valuable when a company purchases audit.

Respondent C, E and F believes the review of a non-audited company might be more thoroughly performed today than before November 1<sup>st</sup> 2010 since the responsibility of judging the correctitude and reliability of information provided from a company has shifted from the auditors to the bankers.

#### **4.4.3 Non-audited companies of other legal forms**

Small companies of other legal forms are not obliged to purchase an audit, but are still able to get credit, which, according to respondents A and C, could imply that the credit assessment process and routines for these companies will also be applicable for small limited companies that are non-audited. Respondent E already sees an increase in the amount of limited companies she handles, which could be an effect of the new legislation. Her share of companies of other legal form has decreased and the share of limited companies has increased. She finds this positive since the bank does always have the possibility to request an audit or another kind of review from a limited company, which is not as easy when it comes to companies of other legal forms.

#### **4.4.4 Effects on the credit-worthiness**

Respondents A, D and E do not find that the credit-worthiness is affected in cases of non-audited companies since it is dependent on the company's future repayment ability, not whether the annual report is audited or not. Respondent E explains that if she finds it negative not to have the annual report audited, she will discuss the matter with the client. A company is not turned down because of its lack of audit, but if there are contingencies regarding some information, for example the value of a company's assets, the respondent will inform the company and have a discussion. This gives the company the opportunity to decide whether or not to proceed with the credit assessment process.

#### 4.4.5 Summary of the new legislation's effects

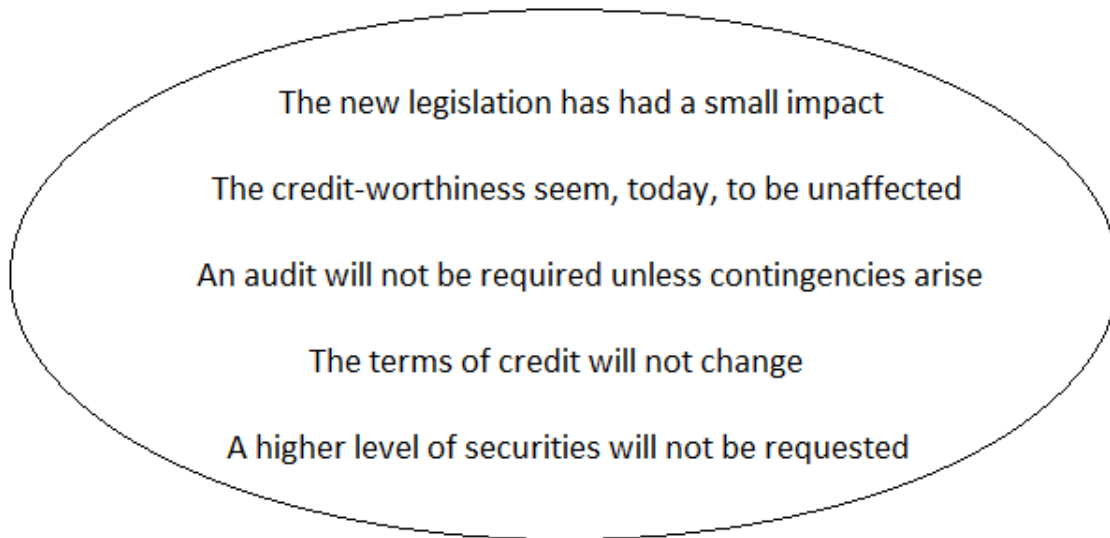


Figure 5 – The new legislation's effects

Back (2013)

## 5 Analysis

*In this chapter the empirical findings will be analyzed and connected to the material found in chapter 2, Frame of references. A further comparison between the different respondents' answers will be provided as well. This chapter will predominantly be divided in sections with the same headings as chapter 4, in order to ease the reading.*

### 5.1 Determining credit-worthiness through credit assessment process

In the principal-agency theory, the principal wants to find the best agent to allocate a special assignment to. When applying that theory to this study it results in a bank (principal) wanting to find the best company (agent) to provide credit to. The assignment necessary is to manage the bank's money, provided through a credit. This theory is reflected through the banks' process of credit assessment. If the credit assessment process for a company does not provide satisfactory results to the bank, credit will not be granted, hence the best company to manage the money has not been found.

#### 5.1.1 Historic and future-oriented data

In section 2.2.2, *The process of credit granting*, three phases in the credit assessment process are mentioned: acquirement of information, processing, analysis and interpretation of the information and decision making. These phases are found in the approached banks' credit assessment processes in different forms. Information is gathered from the annual report, UC and the company itself. This information is reviewed and processed before making a decision regarding a company's credit-worthiness and whether to grant credit or not.

According to Brommé et al. (1998), different information and factors that can influence a creditor's decision are included in the three phases mentioned above. When comparing the respondents' answers, some differences in the mentioned influencing factors are determined. Respondent B and D, for example, value the company leader higher than the annual report, while respondent A finds a company's dividends to be a valuable factor. Respondent D also emphasizes that the credit assessment process differs depending on who is seeking the credit, which could imply that the factors included in credit assessment processes could differ even within the same bank.

Brommé et al. (1998) also state that some factors might be excluded in a bank's credit assessment process for different reasons. This is confirmed by Respondents A and E's statements regarding overlooking smaller remarks received from UC, if everything else in the credit assessment process shows good results. However, all respondents state that one factor that is never overlooked is the company's future repayment ability, which is a factor that proves the company's ability to handle a credit. If the future repayment ability is bad, the bank will keep searching for another company more suitable to manage the money, which is in line with the principal-agency theory.

A study by Niemi and Sundgren (2012) investigates whether modified audit opinions affect a company's choice of credit, something that they reject in their conclusions. They reason that one cause could be that credit granting decisions do not solely rely on financial information, something that the approached respondents in this study confirm through their statements

regarding the variety in information sources. Also the statements that some information from UC, that is financial, in some cases could be overlooked in favor for other information, which support the conclusion by Niemi and Sundgren (2012).

In the principal-agent relationship between a bank and a company, the bank (principal) has to find ways in order to reduce the information asymmetry between itself and the company (agent). If the bank would not do so, the company could reveal the information favorable for itself, and conceal more unfavorable information, which would be to the bank's disadvantage. All respondents within their banks therefore take information from different sources into account in the credit assessment process, where the annual report is one of the most important factors. In the annual report itself are the financial reports, such as balance sheet and consolidated statement of income, considered, by the majority of the respondents, to be most important. This is in line with the study made by Berry and Robertson (2006), which showed that the annual report is important in a bank's process of granting credit and that different parts of the report are assigned different value.

The annual report only informs what has already occurred in a company and because of that, all respondents have also mentioned the use of other information in the credit assessment process, such as prognoses and budgets. The use of prognoses and budgets are associated with risk since that material, according to Bruns (2003), lies within the company itself, which implies that the company leader could decide which information to provide the bank with.

Information asymmetry could arise because of a company's unwillingness to disclose all information to the bank. In order to reduce the information asymmetry, information from different sources could be gathered, something that all respondents already do today. According to Bruns (2003) and Niemi and Sundgren (2012), information about owner-managed companies, which small companies usually are, is harder to find than information regarding larger companies. This is true to some extent. The public interest of small companies is low, and therefore the information is limited to information sources such as the annual report, prognoses, budgets, UC and possible current engagements in a bank. These sources provide different information, lower the information asymmetry and ease the possibilities of acquiring a total impression of a company. These sources are important in order not to exclusively base a credit granting decision on the information provided by the company, which would give the company leader an advantage and a possibility to act in his or her own interest since the information provided to the bank solely depends on him or her.

### **5.1.2 The value of the company leader**

The company leader is an essential factor in the process of determining a company's credit-worthiness. All respondents find the reliability of the company leader valuable in order to grant credit. Respondent F even states that the credit assessment process for small companies is not performed as thoroughly as for larger companies, partly because of the personal connection to the company leader.

Respondent A stated that a company's credit-worthiness is worsened if a company makes a change in the ownership of the company without him getting to know the new leader. Thus, the bank and the company are affected by each other, in line with the stakeholder theory, and

each party's interests are important. The company should therefore make sure that the bank's interest of getting to know the new company leader is met. The possible worsened credit-worthiness, because of a new unknown company leader, could be connected to the problems with moral hazard, which becomes easier to handle when a bank has had a long relationship with a client and the company leader. This, according to Eisenhardt (1989), is because the time passed has enabled the bank to learn about the company and its leader, which increases the bank's ability to predict intentions and actions taken by the leader.

The importance of accounting information compared to other grounds of judgment could, according to Svensson (2003), vary with company size. This statement is confirmed by the approached respondents' statements regarding the value of the company leader in small companies. To some of the respondents, the company leader is even more important than the accounting information in, at least, the beginning of the credit assessment process.

A surety is often established when a credit is granted, which makes the personal characteristics and economy of the company leader important. Therefore, as both the stakeholder theory and the article by Mainardes et al. (2010) states, the bank and a possible surety have to be taken into account before making important decisions, such as changes within the ownership of the company. The surety is a way to decrease contingencies, possibly caused by the presence of information asymmetry.

### **5.1.3 Follow-ups**

As Furusten (2009) states, some kind of monitoring of a company has to take place in order to assure the credit agreement is followed, and that moral hazard therefore will be limited. This monitoring is called 'follow-ups' by the approached respondents, which are made with differing frequency between the banks, as mentioned in section 4.2.3. These follow-ups are also made in order to assure a company's level of credit-worthiness has not changed, which is also mentioned by Svensson (2003).

Information asymmetry could arise when a bank and a company have access to different information. Follow-ups made by the banks' respondents compare the actual outcome with prognoses and budgets provided by the company, which do not reduce the information asymmetry per se, since follow-ups are made after a credit agreement is in place. However, the fact that follow-ups are made could prevent a company from creating purposefully inaccurate prognoses and budgets. If the company is truthful and open with the data in the budgets and prognoses, the information asymmetry will be reduced.

### **5.1.4 Remaining comments**

Respondent A mentioned that a company's dividends also are important to considerate in the credit assessment process. The board of directors should decide upon a reasonable amount of dividends. A risk could be that the decision regarding dividends could be taken in the interest of the owner(s), without taking other interests into consideration. Such actions does, at least, respondent A want to prevent, since actions taken with only the company's or the owner's interest in mind, also called moral hazard, could be in disadvantage to the bank if a credit agreement is in place. When reviewing a company's dividends, both before and after a credit agreement is established, the bank is able to decide if the company is reliable and takes the

bank into consideration. This is in line with the stakeholder theory and also could help to determine the risk of the company acting opportunistic, thus causing moral hazard. Since an auditor also reviews decision by the board of directors and their decisions, an audit could here be valuable, as respondent A mentions in section 4.3.3.

## **5.2 When is an audit required?**

*Respondents B will not be included in this part of the analysis because of their lack of experience in the area.*

### **5.2.1 The value of audit**

Audit is a method where a company's annual report is reviewed, and this function secures the quality in the information. Because of this review, a company is limited regarding only providing favorable information. An audit also reviews a company's management and its actions. This reduces the possibility to act opportunistically and not follow specific agreements, such as credit agreements, which reduces the issue of moral hazard.

The most prominent advantage with audit is the quality assurance it provides, something that all respondents emphasize is valuable. When a company's annual report is audited, the respondents know that the information is reviewed and more reliable, which reduces the level of contingencies. This is one of the intentions with audit and is also supported through statements by FAR (2006).

Thorell and Norberg (2005) conclude that banks are pro mandatory audit because of the advantages it brings. This conclusion does not coincide with the respondents approached in this study. Most of them talk about an audit being valuable, but none of them finds the new legislation to be inappropriate, at least not at today's level of the limits that regulate how large companies are embodied by the legislation. The respondents also state that audit is not the determining factor in the decision of granting credit or not. However, one of the advantages with audit, that Thorell and Norberg (2005) mentions, is better and more trustworthy annual reports. This is partly confirmed by the majority of the respondents' statement that they find the correctitude of the assets' valuation important because of the hypothec they sometimes establish. If the assets are valued incorrectly, the hypothec could be useless. Therefore, these respondents find assets to be an important post in the annual report to be reviewed by an auditor.

Respondent D states the importance of working close with the people within a company. Through the fact that respondent D's bank operates in areas close to the clients, they receive information in other ways than only through, for example, the annual report. This enables the bank to reduce the information asymmetry, even without an auditor involved. Their close relationships with their clients could also reduce the incentives of the company acting opportunistic, so called moral hazard. When a bank is operating close to its clients and gets to know companies in its surroundings, it also enhances the opportunity of finding the best company to lend its money to, in line with the principal-agency theory.

The value of audit differs depending on company size, according to respondent A and C, where audit is more important for larger companies who seek larger credits. This coincides with the statement by Brommé et al. (1998) that the information and factors that influence a credit granting decision could differ. Respondent D, however, do not agree that the size of the credit affects the credit assessment process.

### **5.2.2 Audit for current clients and established companies**

Respondents C, E and F find the audit less valuable when a credit is sought by a current client, which could be explained by reduced information asymmetry and moral hazard. With a current client, the bank has internal information about a company's economy and engagements in the bank, which could be used to compare the annual report and other information provided by the company. However, this does not eliminate the information asymmetry, but it could enable a reduction. Furthermore, moral hazard could be a smaller issue when dealing with a current client since a bank already knows the company and its leader, something that also Eisenhardt (1989) mentions. This implies that the bank could find the company reliable and is therefore assured that the company will act in the best interest of the credit agreement.

Respondent D states that when information from UC shows remarks in the audit report, it is of no use for the bank since possible problems within a company usually already is observed by the bank. This also is connected to the statement by Eisenhardt (1989) that a bank gets to know the company and its leader, and therefore can predict their actions and knows what is taking place within the company.

Information is also easier to find for established companies and therefore, newly started companies could benefit more from an audit. An audit would reduce the contingencies for the bank of possible information asymmetry, since the correctitude in the information provided by the new company would be reviewed.

### **5.2.3 Remaining comments**

A majority of the respondents have contact with companies' auditors in different situations and for different purposes, which is an advantage of audit according to Thorell and Norberg (2005). This contact works as another information source since an auditor can elaborate the information found in an annual report, even though in a limited way since an auditor is allowed to provide information to the bank only with the company's permission. The audit and possible contact with a company's auditor could decrease the information asymmetry through a limitation of a company's ability to withhold information important for the credit assessment process. The company's abilities are limited because of the audit where a review of the correctitude in information and numbers are made, and also the auditor's possibility to clarify and discuss the information provided by the annual report with the bank. However, that discussion is only possible if, as mentioned, the company approves it. If a company does not approve, there will be no contact between the auditor and the bank, but denying such an approval could seem suspicious and affect the reliability that all approached respondents find important when deciding to grant credit or not.

Respondent A also mentioned the value of a company's contracts. They show how a company earns its money and is therefore connected to the future repayment ability, which is a big part of a company's credit-worthiness. Since an auditor is not involved in a company's contracts, an audit is not required, which implies that an audit will not help to reduce information asymmetry in this case.

### **5.3 Effects of the new legislation**

Most of the respondents do not have any experience from non-audited companies and all agree that the new legislation has not had significant effects on their clients, even though an increase of non-audited companies might occur in the future. One reason to the small impact of the new legislation, that respondent D and F mentions, could be that those companies who have credit or wants credit purchase an audit to get the quality assurance it provides. Respondent C agrees, but adds that a company could find the quality assurance important, not only because of the credit issue, but for the company, itself, overall as well as for other external stakeholders. These statements are related to the statement of opinion made by The Swedish Bankers Association, which said that they believed most of the companies embodied in the legislation still would purchase an audit.

If the aforementioned statements turn out to be true, the amount of bankers with experience from non-audited companies could be low, and therefore, the amount of interviews could have been lower if only respondents with experience from non-audited companies had been requested to participate.

When making decisions within a company, the stakeholders' interests should be taken into account, according to the stakeholder theory, and since, as Garmer and Kyllenius (2004) states, banks are the most important source of funding for small companies, the company needs to take the banks' interests into consideration. According to Svensson (2003) and the respondents of this study, the banks find the annual report important in their process of credit granting, which could imply that a company's choice of purchasing audit can be connected to the stakeholder theory. An audit of a company's annual report ensures, according to FAR (2006), that a company is presented in a correct way through trustworthy information and correct numbers, which is important in a bank's credit assessment process.

#### **5.3.1 Changes within the terms of credit**

Blackwell et al. (1998) conclude in their article that companies who purchase an audit acquire a lower interest rate than non-audited companies. This, however, does not coincide with the majority of the statements by the approached respondents. All respondents, except from respondents B, believe that the interest rate will not be affected by a company's choice of purchasing audit or not. As respondent F states:

“The decision to grant credit will be made before deciding the price of the credit. Once the decision is made, the interest rate will be decided, regardless of audit or not.”



The belief that the interest rate will not be affected does instead coincide with research conducted prior to the investigation by Blackwell et al. (1998), which they mention in their article. Respondents B, who do not have any experience from small companies and especially not non-audited companies, do, however, believe that the interest rate could be affected. Respondents B also believe that a higher frequency of follow-ups could occur when dealing with non-audited companies, which could be one way for the bank to reduce the possible information asymmetry and moral hazard caused by the absence of audit.

Some of the banks also mention that the term of credit regarding level of securities will stay unaffected after the new legislation since securities do not compensate for contingencies. A higher level of securities does not affect information asymmetry or the occurrence of moral hazard. It does not make a company to become a more suitable agent to handle the principal's assignment of managing money. Respondent E, however, does not agree. She finds the securities to be a possible tool for companies to compensate contingencies. This is another example of how credit assessment processes could differ between banks, which Brommé et al. (1998) states.

### **5.3.2 Will an audit be required?**

The statement by Thorell and Norberg (2005), i.e. that banks are pro mandatory audit, does not coincide with the approached respondents' statements. The respondents do not believe that audit will be required from non-audited companies, unless their credit assessment process results in contingencies. This implies that auditing is not needed for all companies, and therefore the mandatory audit is not necessarily advocated by the banks. However, respondent E, for example, still advises companies to have an auditor, but not solely because of the audit issue.

In the principal-agency theory the principal (bank), wants to find the best agent (company) to manage a certain amount of money. The statements by the respondents, that audit not will be required from non-audited companies, shows that what decides which company is the best to manage the banks money, is not dependent on whether a company is audited or not, even though an audit could help with reducing information asymmetry.

One change, that respondents C, E and F mention, is that they believe that the credit assessment process and the review of a non-audited company might be more thoroughly performed and that the banker might be more critical to the information received. This is because the correctitude and the reliability of the information are no longer determined by an auditor; instead the banker has to make the decision. This, more critical review, could be an attempt to limit the information asymmetry between the bank and the company and through that also be certain that the best company to manage the bank's money is found, in line with the principal-agency theory.

If respondent E experiences contingencies because of the lack of audit, she will not turn the concerned company down. Instead she will have a dialog with the company and will, in line with stakeholder theory, together try to find a solution where both parties' interests are met.

### **5.3.3 Non-audited companies of other legal forms**

The routines regarding credit granting and the credit assessment process at the approached banks are not, overall, affected after the introduction of the new legislation. One reason to that, as some of the respondents has pointed out, could be that the banks are used to companies of other legal forms that are not obliged to purchase an audit, which implies that routines regarding a credit assessment process for companies lacking an audit already exist. These routines could contain information for how to reduce information asymmetry in situations where an external review is not available and also how to find the best company (agent) when the bank (principal) have no one else to rely on, but itself, when evaluating a company's provided information.

However, the majority of the respondents do not, as mentioned, have any experience from non-audited companies, which could imply that there has been no reason for any possible changes in the routines. Perhaps, possible changes will occur in the future when a larger impact by the legislation can be observed.

### **5.3.4 Effects on the credit-worthiness**

Three of the respondents state that small companies' credit-worthiness is not affected by the possible absence of audit since the audit is not the determining factor for deciding to grant credit or not. This coincides with the conclusion drawn by Niemi and Sundgren (2012), that banks do not solely base their decision on financial information. Instead they want a mixture of information before deciding to grant credit.

The remaining four respondents did not state anything directly about the companies' credit-worthiness, they were, however, agreed that the absence of an audit not automatically implies a worsened credit-worthiness.

## 6 Conclusions

*In this chapter, the conclusions of this study will be presented. These will ensure that the purpose has been fulfilled and the research question answered. Then, a discussion will follow and finally, suggestions of future research will be presented.*

### 6.1 Conclusions

**Purpose:** *The purpose of this thesis is to investigate whether and also how the new Swedish legislation regarding the abolition of the mandatory audit affects small limited companies' credit-worthiness.*

**Research question:** *How does the abolition of the mandatory audit affect the credit-worthiness of Swedish small limited companies, for those chosen not to have their reports audited?*

#### 6.1.1 The mandatory audit before the new legislation and the outcome after its introduction

Before the new legislation was introduced, concerns within the public debate were expressed regarding banks' future willingness to lend money to companies that chose not to purchase an audit. Richard Peters are one of them who were concerned regarding that Swedish banks would be more restrictive in their decision of granting credit to non-audited companies (CFO World, 2010). These concerns are, according to the results of this study, unjustified. Banks do not base their decision on whether a company is audited or not, instead they take other factors into consideration, which audit could be a part of but is not the determining factor. According to Brommé et al. (1998) are different mixtures of factors important in different credit assessment processes which strengthen the statements of the audit being less important than other factors.

The statement of opinion made by The Swedish Bankers Association expressed its support for the abolition of the mandatory audit. The Swedish Bankers Association's statement of opinion was based on their faith in the willingness to still purchase an audit among the majority of the companies embodied in the new legislation, and hence the credit assessment process would not be affected. One conclusion from this study could be that since the approached respondents have not encountered that many non-audited companies, The Swedish Bankers Associations belief is confirmed. One reason as to why this conclusion could be wrong is that the results could be influenced by the selection of respondents, where most of them had little experience from non-audited companies. Another reason is the fact that only about two years have elapsed since the introduction of the new legislation, which could imply that the possible effects have not yet been seen. Finally, the conclusion might be wrong since banks only reflect on whether a company is audited or not when a company seeks credit, i.e. becomes a possible agent; the ones who do not want credit, are not included. Thus, in line with principal-agency theory, the banks' (principals') effort to find the best company (agent) is concentrated to the ones interested in acquiring credit, which implies that the other companies is left out of the banks radar.

According to respondents C, D and F, companies who purchase an audit do it because of the quality assurance it provides in the situation of seeking credit, but also to meet the interests of other stakeholders than banks. The drawn conclusion, supported by the stakeholder theory, is that a company takes the banks and their interests into consideration in order to enable a continued business, where funding usually is needed sometime during a business life cycle according to Brommé et al. (1998).

None of the respondents expressed discontent regarding the new legislation or problems with non-audited companies' credit assessment process, something that do not coincide with the statements by Thorell and Norberg (2005) that say banks are pro mandatory audit. Nothing in the respondents' statements indicates that they find the mandatory audit important or that the credit granting to small companies has decreased because of the new legislation. These findings imply that the credit-worthiness is unaffected by the new legislation.

### **6.1.2 Requirements by the bank and effects on terms of credit**

The Swedish government stated in their submission for comment, regarding the new legislation, that non-audited companies' ability to get credit would not be affected, since banks can, if they experience contingencies, demand a company to purchase an audit. This is something the approached respondents verify through their statements that they, in some cases, might demand that a company purchase an audit. An audit is found to be valuable by the respondents but instead of demanding an audit directly, a credit assessment process will begin, and in case of contingencies, an audit or some kind of verification of the correctness in the information provided, will be demanded. The audit will reduce but not eliminate the information asymmetry between the bank and the company in their principal-agent-relationship, something that is shown in Figure 2 in chapter 2.

In the Swedish government's submission for comment, they stated that the terms of credit and the level of demanded securities probably would increase when a bank granted credit to non-audited companies because of contingencies. These statements turn out to not coincide with the results of this study. Blackwell et al., in line with the Swedish government, also state that non-audited companies would experience worsened terms of credit, such as higher interest rate. This study's results show that the majority of the banks will probably not change the terms of credit, such as the interest rate, and not increase the level of demanded securities. The reason for this is that a decision to grant credit, and determining a company's credit-worthiness, are dependent on several factors, such as the future repayment ability and the company leader's reliability. These factors determine which company that is most suited to handle the banks money, in line with the principal-agency theory. Bad repayment ability or an unreliable company leader, which implies a low credit-worthiness and hence an unsuitable company to handle a credit, cannot be outweighed by a higher level of securities.

### **6.1.3 The value of the audit and the company leader in small companies**

Banks can gather information from many sources in the credit assessment process, which could imply a minor decrease in the value of the annual report, even though all banks find it important, in line with the study by Berry and Robertson (2006). With a possible decreased value, the audit will also become slightly less vital when determining a company's credit-

worthiness. However, information regarding small companies are harder to find, which makes the annual report, but not necessary the audit, still important in the credit assessment process.

The approached respondents seldom state anything that is applicable in all possible situations. The processes and solutions differ to a certain extent depending on the concerned bank, company and situation, which Brommé et al. (1998) also states. This becomes obvious when reviewing the different respondent answers, especially respondent D's statement regarding the variation in the credit assessment process and that something that applies to one company might not apply to another. This, together with the lack of experience of non-audited companies among the respondents, obstructs drawing a distinct conclusion of how the small companies' credit-worthiness is affected by the new legislation. However, respondent A, D and E state in their interviews that a company's credit-worthiness is not affected by whether the annual report is audited or not, the factors determining credit-worthiness lies within other areas, such as future repayment ability. This does not coincide with the statement by Svensson (2003) that an audit improves the credit-worthiness.

Something that all respondents emphasize is that the information regarding current clients is easily gathered because of the internal material within the banks. However, this does not mean, as respondent D points out, that a current client is automatically granted credit more easily and have a higher credit-worthiness, since it depends on many factors. New clients, especially newly started companies, could benefit from purchasing audit in order to receive a quality assurance, since the information sources are fewer and there has been no prior relationship with the bank. Thus, the information asymmetry could be reduced through audit. The conclusions drawn are that current clients, regardless of audit or not, do not automatically have higher credit-worthiness but that new clients, especially newly started companies, could improve their credit-worthiness by purchasing audit.

The approached respondents also state that the credit sought by small companies is often of small amounts, which implies that the risk taking is reduced when granting these credits, compared to larger ones. Because of the reduced risks, the value of an audit also decreases, which implies that whether a company is audited or not does not affect the companies' credit-worthiness in a larger extension. However, worth mentioning is respondent D's view of many small credits summing up to a large amount of money, which in turn could imply that a bank's risk taking could increase with the amount of small companies seeking credit.

A good relationship with a company's leader is important for the credit-worthiness, especially regarding small companies, as all respondents have stated. Reliability and orderliness are important characteristics in order to create a trustful atmosphere between the bank and the company leader, which could reduce the issue of moral hazard. Some of the respondents even find the company leader to be a more important factor than the annual report, in the credit assessment process. Respondent D, for example, states that they have business with the people behind the company, not the company itself and its numbers. Because of the company leader's assigned value in the credit assessment process, a company should prioritize fulfilling the banks' requested requirements for the company leader, in line with the stakeholder theory, though without refraining from the quality of the annual report. The reliability of the company

leader, and the correctitude in the information he or she provides, will be more important when the annual report is not audited, because of the absence of an external review. A company should make sure to inform the bank when a change of company leader occur, in order not to worsen their credit-worthiness, which could otherwise be the case according to respondent A.

#### **6.1.4 Concluding remarks**

None of the approached respondents express that there has been any changes in the credit-worthiness of small companies. However, they do express that they find the new legislation to have had a small impact. Perhaps a connection could be found, which could imply that if or when a larger impact by the new legislation can be observed, the audit might be valued in a different way in the process of determining credit-worthiness.

As mentioned, banks are one of the most important sources of funding for small companies, and also one of few stakeholders. The purpose of audit is to contribute to well functioning commercial and industrial life, and ensure the quality and correctitude in the information companies provide their stakeholders with. Since the approached banks and respondents do not find the audit important for their credit assessment process, it could imply that the audit is not valuable for small companies and their stakeholders. This is in line with Thorell and Norberg (2005) that also found the mandatory audit not to be of significant value for SMEs, though based on other countries within the European Union.

If the Swedish government, however, decides to embody larger companies in this legislation it could bring effects other than those observed today since there are differences between small and large companies. Among other things do large companies have a larger amount and, to some extent, other stakeholders than small companies. Even though banks are a stakeholder of both small and large companies, banks find, as some of the respondents have stated, audit more valuable for large companies. This is one reason as to why this legislation might cause other effects than those observed today.

## **6.2 Final discussion**

All banks appear to, overall, have a quite similar method of working with small companies, even though some differences are observed. The similarities could be due to the fact that the three approached banks are among the largest ones in Sweden. Perhaps a different sample of banks would have shown more variability, but then the majority of the market share in the business lending market might not have been represented.

The number of approached banks and respondents could also have influenced the results of this study, which implies that no general conclusions can be drawn. Another reason to that is the selection of respondents. If only respondents that have experience from non-audited companies would have been interviewed, the results could have turned out differently. However, in this study, the answers from respondent E, who has experience from non-audited companies, do coincide with the other respondents' answers to a large extent, which indicates

that experience from non-audited companies might not be crucial in order to provide valid answers.

In the previous section, a conclusion is drawn that the credit-worthiness of small companies is not affected by the new legislation. However, a reason why it appears to be that way could be that the new legislation has not had any significant impact on the companies encountered by the approached banks. This would also mean that a sample of respondents with experience from non-audited companies would have been difficult to assemble.

### **6.3 Future research**

During the work with this thesis, thoughts regarding future research have emerged. Suggestions for subjects that could be interesting to investigate in the future will follow.

The new legislation has only been used for about two years, which could imply that the potential effects might not be possible to examine so far. This opens up for future research in this area. The period of time to have elapsed is too short to fully explore the possible effects on small companies' credit-worthiness, which respondent A agrees with. Because of that, a suggestion for further research is to perform a study similar to this one, again in the future.

In this study, the approached respondents stated that the terms of a credit, such as the interest rate, will not be affected by whether a company purchases audit or not. Whether that is true or not could be interesting to research. Another interesting subject to study could be whether the legislation has affected the amounts of defects or economical crimes, since these are two reasons why the mandatory audit first was introduced in 1983.

Some of the respondents in this study consider a connection between companies who seek credit and those who also purchase an audit. Which companies that have chosen to purchase an audit or not and also the reasons to that decision, could therefore also be interesting to study.

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## **8 Appendices**

### **8.1 Appendix 1 – Interview guide**

1. Could you tell a bit about yourself? What are your work tasks at the bank and what does your professional background look like?
2. When making a credit assessment you take different kind of information into consideration. How important is the company's annual report in the credit assessment process? Which parts do you find most important?
3. In November 2010 the new Swedish legislation regarding abolition of the mandatory audit for small limited companies were introduced. How reliable do you find audit?
4. What information do you base your credit granting decision on regarding small limited companies? Has the kind of information changed after November 2010 and how?
5. If small limited companies decide not to have their reports audited, how does that decision affect their credit-worthiness?
6. Do the terms of the credits change if a company's information is non-audited? In that case, why and how?
7. Does the value of audit differ depending on which company is seeking the loan? For example, a company that you have had a relationship with for years compared to a brand new company.
8. How can a company that does not have their reports audited accomplish the same level of security as those who do have them audited? Do you ask for complementary information from non-audited companies? Do you request that they have their reports audited?
9. How do you ensure that a company acts according to the contract, after credit is granted?

## **8.2 Appendix 2 – Abbreviations**

*FAR*: The professional institute for authorized public accountants, approved public accountants and other highly qualified professionals in the accountancy sector in Sweden.

*UC*: An information agency that provides banks with information about companies. This information is regarding, among other things, record of non-payment, class F-tax certificate, VAT registration and whether a company has handled their payments of taxes and other fees in a correct manner or not. Other examples of information provided by this information agency are a company's change of auditor and change in the quality of annual reports.