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**SCHOOL OF BUSINESS, ECONOMICS AND LAW**

Master Degree Project in Accounting

# **Abolition of Mandatory Audit and its Effect on Swedish Small Limited Companies from Banks Perspective**

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Sincerely

## **Abstract**

In November 2010 the Swedish government approved the abolishment legislative proposal of mandatory audit for small limited companies. The changes of regulations led to voluntary audit according to the Swedish Audit Act (Revisionslag SFS 1999:1079). The Swedish Bankers Association supported the reform. However, it was underlined that banks still would value audited information. The aim of this study is to examine how this reform of mandatory audit had impact on the bank's decision-making regarding the credit granting. In addition, it is also interesting to comprehend whether or not the audited financial reports increase the assurance and legitimacy of the company to bank and ease the process of lending credit or loan. However, both theoretical analysis and empirical findings of this study reveal that the absence of auditing have in somehow impact on the banks decision-making of credit granting, which banks sense difficulty and insecurity to evaluate the non-audited clients' application for credit granting. Further, it might be claimed that the audited financial reports increase the assurance and legitimacy of the company; thereby banks can make the decision to grant credit or loan easier. Banks may rely more on the audited financial reports because of the higher legitimate and safety of the financial information.

**Keywords: mandatory audit; audited financial reports; legitimacy; Banks; credit/loan; small companies**

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# 1. Introduction

The first chapter starts with a background and problem discussion narrowing down the subject of interest to the thesis research question. Also the main purpose of the thesis is presented along with the delimitations of the study. The chapter is concluded with a thesis disposition.

## 1.1 Background

Fundamentally, an audit is essential to several parties to acquire some management and financial information of a company. Definitely the issue of whether or not small and medium-size companies (SMEs) should be audited has been addressed in several studies in the UK, Australia and some Asian countries such as Hong Kong and Singapore. Malaysia is a country that still legally obligates all its companies legally to report their annual accounts audited which is prepared by an independent auditor regardless to firm size, private or public companies (Salleh, et al., 2008).

In the year 2008 there was a prospect that the mandatory audit would be abolished for small limited companies in Sweden within a few years. The Swedish government conducted a preliminary investigation for a new regulation. Finally, the Swedish parliament accepted the legislative proposals by November 2010 (SOU 2008:32), and the mandatory auditing for small limited companies was abolished. The changes of regulations according to the Swedish Audit Act (Revisionslag SFS 1999:1079) led to voluntary audit only for companies, which meet two of the three following criteria:

- The average numbers of employees within a company during each of the last two financial years have been amounted to more than three.
- Companies, which have reported total assets of each of the two financial years, amounted to more than 1.5 million SEK.
- Companies, which have reported net sales, for each one of the last two financial years, amounted to more than 3 million SEK.

The official report of (SOU 2008:32) sustained that the audits for companies, which were below this criteria, would be considered both too costly and time-consuming for the owners. The benefits regarding the removal of mandatory audit for these companies exceed the drawbacks according to the preliminary investigation. The Swedish government expected the total estimation of cost reduction to be 5,8 billion SEK when the mandatory audit requirement is abolished (SOU 2008:32).

Furthermore, the new legislation was accepted by the Swedish Bankers Association however, banks stressed that the audited information are still valuable for them. The reason behind this endorsement by Swedish Bankers Association might be that a majority group of the companies, which embodied in this proposal, still choose to have audit even it is not be demanded by law (Swedish Bankers Association, 2008).

Recently, statistics from the Swedish Companies Registration Office shows that 76 percent of the new established limited companies choose not to have an audit, which is a relatively high percentage. While, the figure for all registered incorporated companies in Sweden means existing and start-up companies have declined by only 15 percent in auditing in the year of 2012. This means that 85 percent of all limited companies in Sweden keep their audit. In both Norway and Denmark, where the mandatory audit also have been removed, the impact has been greater. For instance, in Denmark approximately 25 percent of all limited companies chose not to have an auditor (Danielsson, 2012).

Furthermore, some previous studies from different countries, for instance Malaysia illustrate that companies will benefit from audit and therefore they will continue to have their accounts audited. Thus, it is time to auditors appraisal their role in order to ensure that audit remains relevant and as a vital link in the financial reporting value chain (Pertanika, et al., 2012).

## **1.2 Problem discussion**

The new legislation and the position of banks regarding this new law to grant credit or loan to small companies make the interest of the investigation in this study. It is interesting to find how audited financial information of a company is important for banks. However, clearly banks are one of the most important capital providers for small companies. Therefore, the financial information is one of the curial elements for banks evaluation and decision related the credit grating. Thus, this new reform might have huge effect on banks' decision. Since, there is no auditor to audit the financial reports of the companies who is going to provide a true and fair interpretation of the financial statements? The owner, who has a personal profit in the company, the bookkeeper, who is not willing to accept his/her mistakes and perhaps his lack of experience, the board of directors, who are principally interested in the company's well-being and a high profit? It will be very difficult to find an independent person who can offer the society what it demands. The expectation gap might in this case increase when the abolition of the mandatory audit for small companies takes

place. Further, the issues regarding the reliability, legitimacy and assurance of the companies' financial reports may rise up.

Even though the deregulation of mandatory audit mostly has received positive responses from the Swedish Bankers Association and society, in accordance with current research and studies, the issues of not having an audit could result in devastating outcomes for companies. For instance, it increases the possibility of doubt and untrustworthy of accounting records in the annual report for external stakeholder the banks as an extensive lender.

In addition, Pertanika, et al., (2012) mentioned that there are three top benefits behind audit which might makes bank as a pro-mandatory audit; first, it provides a check on accounting records and systems by an auditor who has ability to interpret the financial information, second, it contributes to defend against fraud and third, it superior the validity and credibility of the financial reports.

According to the Andersson (2001) there are some specific issues that should be considered regarding the lending to small firms. In order to a bank as an external stakeholder be able to lend cash/credit to small firms, requires of both audited and non-audited financial information. However, according to the Banks in Sweden (2003), banks practice other type of information as well. For instance they ask for deposit, property and other non-financial information in the process of credit assessment.

Moreover, according to the professional business magazine in auditing and accounting published by FAR SRS, the major banks mentioned that they had some concerns – before the abolishment of mandatory audit were established – that small companies would find it harder to borrow money if they choose not to have an auditor who can review the company's financial information. But when the deregulation was settled and the criteria were even lower than the investigator's proposal, the major significant people at banks still considered positive attitudes towards the value of mandatory audit for small companies.

Furthermore, audited financial reports are possibly more important for small companies because stakeholder (banks) receive less public information about these companies and thereby the quality of financial statements is likely to be lower (Ball and Shivakumar, 2005; Carcello, et al., 2009).

However, this study is conducted during the establishment of the deregulation therefore, the attitude may have changed within the banks as three years have passed and they have



experienced the reform. Probably the banks have increased their level of assessment regarding annual reports as of the recent recession. Further, this issue will be evaluated through an empirical study.

### **1.3 Purpose**

The aim of this study is to examine how this reform of mandatory audit had impact on the bank's decision-making regarding the credit granting. This study is evaluated from the banks perspective because banks are the most credible systems for financing, saving and controlling the risks. Further, they have a great authority of lending to companies (Banks in Sweden, 2003). It is also interesting to comprehend whether or not the audited financial reports increasing the assurance and legitimacy of the company to bank in order to receive credit or loan.

However, the results of this study may be interesting for different parties, for instance, for small companies to understand how audit can affect the opportunities to receive credit or loan. Further, banks and the Swedish government can also benefit from this study for their future plan and decision-making concerning the new legislation.

### **1.4 Research question**

However, the new legislation and the importance role of auditing brought up the motivation to fulfill the main issue of this study that can be summarized in the questions below:

- How has this reform of mandatory audit impact on the banks decision-making of credit granting?

Further, it is also interesting to understand:

- Do audited financial reports increase the assurance and legitimacy of the company to bank and ease the process of lending loan or credit?

### **1.5 Limitations**

According to the stakeholder model that developed by Freeman (2010) companies required to have a good relationship with their environment, which consists of different groups of stakeholders. Freeman (2010) mentioned that there are especially some stakeholders, which should be influenced largely by neglecting the auditor in a business. These stakeholders consist of suppliers, customers, shareholders, and employees with interest in company, government agencies and banks as the most important source for funding lenders.

Further, because this specific study concerns of the audited financial report for small limited companies, so the shareholders are often the same as the owners and the executive. The research therefore only has a focus on banks as one of the external stakeholders that use the annual report in order to grant credit/loan. This means that all government agencies like the Swedish Tax Agency that use the tax return assessment and other stakeholders such as suppliers and customers are excluded.

Due to time restrictions and funding, this study has been limited to bank offices within the Sweden. The focus lays thereby on the research question in this specific area. Even it can be argued that for instance the bank offices should have the same principles and core values. However it would be valuable to understand that the collected empirical data surely could differ between different regions and offices. Nevertheless, In order to investigate the research question of this study interviews have been conducted. The largest market shares occupied by the four largest Swedish banks and one foreign bank within Sweden. Accordingly, they were asked to participate in this study. However, three of the Swedish banks accepted the invitation, which resulted in five interviews.

## **2. Method**

### **2.1 Research subject**

The subject addressed in this thesis is one that previously has been studied on various academic levels with different angles. Öhman, et al., (2006) wrote about the mandatory audit and how audit was perceived from auditors themselves. They examined audit firms and found correlations between the occurrence of economic crime and lack of mandatory audit. Svanström and Sundgren (2012) were studying the demand for non-audit services with evidences from Swedish small and medium size companies (SMEs) and related the findings to auditor-client relationships. Öhman and Häckner (2012, p.477) also reviewed “the client satisfaction and usefulness to external stakeholders from an audit client perspective” to enable a broader explanation of the voluntary audit. However, from the comprehensive previous research within the subject, the topic has a broad foundation and a well-stipulated theoretical framework.

However, the raised research problem and the intended subject of this thesis have an uncommonly argued issue; that is the importance of the audit. Also, as time goes by and the environment experience the deregulation, the conditions and beliefs change regarding the removal of the mandatory audit for small companies and so do the attitudes. This emphasizes the importance of yet another input to the current debate and this thesis will therefore give a vital contribution to the scientific discussion regarding mandatory or voluntary audit.

### **2.2 Research paradigm**

In order to achieve the thesis purpose it is vital to gain understanding of the background and the current situation of the deregulation of mandatory audit. The aim of the empirical gathering is to gain knowledge of how the respondents perceive the importance of the audit and audited financial reports and what they believe can be said about the current situation of the removal of the mandatory audit.

Collis and Hussey (2009) identify two main research paradigms; interpretivism and positivism. These paradigms could be described as philosophical frameworks of how scientific studies should be conducted. The paradigm that is most fitted for this research is the interpretivism. This paradigm assumes that the social reality is subjective. The reality is affected by proper investigation, and the research involves interpretive understanding of a social phenomenon within a certain context.

The research approach of the thesis is qualitative, as this approach best justifies the purpose of the thesis. The characterization of qualitative research is better described as the focus on words using an interpretive nature. On the contrary a quantitative research is more objective and focused on numbers (Bryman and Bell, 2003). This study will thereby collect qualitative data and analyze them by using the interpretivism methods. The aim will be to focus on the interviewees' interpretations and perceptions of the removal of mandatory audit regarding the credit assessment process.

### **2.2.1 Classifying the research**

Regarding the purpose, this research would be classified as a descriptive research. Collis and Hussey (2009) explain a descriptive research as a research that describes phenomena as they exist. Descriptive research is used to obtain data regarding the characteristics of a certain problem or issue. A descriptive research is always trying to describe the characteristics of the relevant issues. Looking at the research questions and the purpose of this thesis, there is no doubt that the study is regarded as a descriptive research.

## **2.3 Interview techniques**

The underlying premises of this research consist of conducted interviews from professionals that have a greater understanding of the characteristics regarding the deregulation of the mandatory audit and the relating issues. As the purpose of the thesis is to estimate the value of the audited financial reports, it is necessary to acquire insight regarding different views from working professionals. By comprehending the topic and its issues from different perspectives the selection of interviewees performed by three of Swedish largest banks which are working with credit granting to companies.

There are basically three types of interviewing methods for conducting a qualitative research. There are unstructured interviews and structured interviews, which are each other's extremes, where the unstructured interview method consists of open questions and the structured interview consists of beforehand prepared and formulated questions for quantitative research. The third interview method is called semi-structured interview, which is a mix of the structured and the unstructured interview method (Collis and Hussey, 2009). It is vital to consider the purpose of the interview when choosing a certain interview method. If conducting a qualitative interview the greatest interest lies in the respondents' insight and opinions. This should be reflected in both the formulation of questions and in the selection of the specific interview method. (Collis and Hussey, 2009)

This study is more suited conducting semi-structured and unstructured interviews, which offers the possibility to interviewees to answer the questions more comfortably. The interviews are always conducted in person and by preparing semi-structured interview questions the respondents could be aware of the purpose of the session. An interview guide was thereby used and questions were expressed to ease the flow in the session.

### **2.3.1 Semi-structured interviewing**

The reason for conducting semi-structured interviews with the most central questions prepared in advance is to reduce the differences between the interviews conducted (Bryman and Bell, 2003). In order to formulate the main questions beforehand the interviewees are able to answer to the same type of questions, even though the interviews develop into unstructured sessions. The interviewees could also be able to answer the best possible questions relating to the research problem, thus reduce any risk of confusion. Another benefit derived from a semi-structured interview regards the fact that the same essential questions are asked regardless of respondent. (Bryman and Bell, 2011).

As different individuals of respondents are to be interviewed, the same type of questions is prepared for these individuals. Though the underlying context of the questions always regards the research subject, the focus still lies with the specific group. The questions for banks are formulated in a clear way to enable them a better understanding of the topic.

### **2.3.2 Preparing and conducting the interview**

The rationale of the interview guide is to provide guidance throughout the interview. When preparing the interview guide the first question to ask is which respondents that are interesting and vital in order to reply to the subject of the interview. Once this is determined the continued work lies in considering what in fact are interesting to find out at the interviews, depending on the respondents' different special competences.

The process of preparing questions for the respondents will have to take into consideration the situation and position of the interviewee in order to best adjust specific questions for specific respondents. An outline of the thesis purpose and also a draft of the subject and type of questions will be sent to each interviewee in advance, the aim is that the respondents comprehend the goal of the study and be prepared for the interview.

The interviews are to be conducted in person in order to enable an unstructured interview session with follow-up questions, while letting the respondent develop thoughts and ideas concerning the subject. As complementary questions and additional feedbacks are unavoidable, the respondent can contact at a later stage for further explanation.

### **2.3.3 Choice of respondents**

In order to achieve different opinions on the research subject, it is started to collect data and information about these four large Swedish enterprise banks, namely FöreningsSparbanken (Swedbank), Svenska Handelsbanken, Nordea and SEB. Obviously, they have powerful position with large assets potential in the financial market. (Banks in Sweden, 2003)

However, it was not easy to find the statistics about Swedish banks' market shares. However, after exploring in this area some statistics demonstrate that the large Swedish banks namely Swedbank, Nordea, SEB and Handelsbanken cover the relatively high percent of credit requirement of companies. Because of this statistics and lack of information, it was planed to arrange the interview with four largest Swedish commercial banks plus the Danske Bank as a large foreign bank in Sweden. However, Unluckily merely Swedbank, Nordea and SEB had opportunity to collaborate and response the questions of this study. Since, these banks embedded in the category of large banks, it is easier to trust them. However, according to Diamond (1989) relationship banking can increase credit facilities for small companies. Furthermore, developing in credit granting via banks has impact directly on the existence and performance of small companies in transition economics (Zambaldi F, et al., 2009).

According to Rubin and Rubin (1995) the number of interviews should be time consuming in link with the study and the extent of material that are essential for confirming the quality, completeness and accuracy of the results. However, this study considers five agents that were interviewed. It is the appropriate number in an intensive period. Five agents may not be sufficient to certify completely the value of the data. However, this study considers three of the largest banks in Sweden. Thus, it can probably cover the mainstream of the lenders and creditors in the market. However, they have more experience of lending to large audited companies. Therefore, there is some lack of experience to work with small non-audited companies among the respondents. On the other hand, the respondents are specialist and competent. Further, they have practical and convenient knowledge that can result in the rational and effective answers.

## **2.4 Criteria of evaluation**

According to both Collis and Hussey (2009) and Bryman and Bell (2003) the basic measures for evaluation of business research consist of reliability and validity. Bryman and Bell (2003) also add the criteria of replication when regarding a qualitative research.

Basically, the reliability concerns the duplication of a study. A study is said to be reliable if other examiners obtain equivalent research results if the study were to be performed another time.

The notion of reliability is closely correlated to the idea of replication. The point is that in order to assess the concept of reliability, the procedures leading to the research outcome must be replicable and therefore it is presented in great detail. The most important criteria however may well be obtaining validity in the conclusions generated by the research. In principle this term refers to the integrity of the study, to what extent the study actually addresses the key issues as intended.

### **2.4.1 Reliability**

In a qualitative research the term reliability can be understood through an internal and external perspective. The degree of internal reliability in qualitative research deals with the members of the research team. Bryman and Bell (2003) conclude that internal reliability reflects the degree to which members of a research team agree about what they see and hear. This notion, when applied to the techniques of interviewing in this thesis sets a demand on the persons handling the interviews. This means raising awareness and understanding of factors that are influencing both interviewer and interviewee in order to establish credibility of the research findings.

In order to raise credibility to the findings of this thesis the personal interviewees were recorded and later transcribed. Ultimately, the findings were analyzed.

This effort raised the internal reliability in one sense, however to increase the credibility from the interviewee's perspective other measures were taken. The interviewee for instance was able to see the interview questions beforehand also received information on the purpose and underlying thesis questions dealt with in the thesis. However, this approach allowed the interviewees to prepare themselves better for the interview. Another issue, which deals with the reliability of this thesis, is related to the translation of interviews from Swedish to English. To minimize the errors in this process much time was dedicated to translating the information gathered from the various interviewees.

The issue of external reliability and the degree of replicability, in qualitative research is a difficult criterion to meet according to Bryman and Bell (2003). However, the reason is that the variables of human behavior cannot be controlled; rather the society and people are unpredictable. Further, a qualitative research based on interviews is contingent rather than based on fixed assumptions or information as is the case in quantitative research. Since,

this study conducted through an interpretivism approach, it might be difficult to consider the reliability. However, to raise the reliability of this study, an accurate theoretical description and interpretation of the data collected will be performed.

### **2.4.2 Validity**

The third concept addressed by Bryman and Bell (2003) relevant for qualitative research relates to congruency between the researcher's observations and theoretical ideas generated by the study. Further, validity indicates that the investigation is valid regarding the data used in the study. In addition, the concept of validity relates also to the extent of internal validity, the degree of generalization of the research findings and external validity.

To ensure a high level of internal validity the empirical evidence was carefully examined in order to ensure a high level transparency, strengthening the findings of this thesis. Moreover, several interviews performed by different specialists at three Swedish largest banks. The semi-structured questions used to ensure that all of the respondents achieve the same information. Also, the external validity in this study can be reached through a detailed clarification of the research process and outcomes that are achieved. However, the difficulties in generalizing the findings of this study, as suggested by LeCompte and Goetz in Bryman and Bell (2003), are common for many qualitative studies and especially those employing case studies and small samples.



### **3. Frame of reference**

In this section of the study a selection of applicable theories and the concept of audit and its purpose are provided to analyze and discuss the aim of this study.

#### **3.1 Audit purpose**

To have an appropriate perception of audit purpose the study starts by describing about what is the audit and why audit is essential to be performed. Further, the importance of audited financial reports will be considered as well.

According to the FAR publisher (2006), audit is a professional skepticism plan, view, judgment and statement about annual report, accounting records and management. In addition, audit assists the integrity, effectiveness and internal control of the financial statements/reports of the companies. It also serves the company's acquiescence with lawful and regulatory requirements. However, this paper considers the most important aspects of external audit in order to fulfill the overall issue of the research study.

##### **3.1.1 Who are interested of audit and audited financial reports?**

As it was mentioned previously audit is significance for different categories of stakeholders. The stakeholders have to be able to rely in companies' economic and administration information. Obviously, audit provides diverse information about different economic situation and thereby it leads to high level of reliability and credibility of companies' financial information. Since, banks as an important stakeholder for small firms consider accurate and truthful information, audited financial information may be essential regarding the credit granting. However, the stakeholders gain either direct or indirect benefits of audit and what the auditors perform. If there were not auditor then the stakeholders themselves would be required to prepare and control the financial reports of the companies. Therefore, audit leads to the public interest. (FAR publisher, 2006)

However, the most focus of this study is laid on the relevant stakeholder bank that will be more discussed in the next section.

##### **3.1.1.1 Banks**

All types of company need to take credit or loan for any reason regardless the factors like size, location, etc. Therefore, banks require accounting information because it is "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information" (Dury, 1988, p.3). Consequently, it is not an unexpected fact that accounting information plays a significant

role in the credit assessment process (Andersson, 2001).

In addition, banks and other lender institutes must be certain about the managers' capability of paying debt. Further, banks need to catch correct information of the companies in order to make fund availability, like Character of management's strength of paying debts, Management's Capability to run a business, Capital to fund the business, Situations of the business cycle, and perhaps an additional source of payment like Collateral. (Andersson, 2001)

Banks demand for high security. Consequently, in such situation, there is solely an independent audit that can examine performance of financial information of the companies. (FAR publisher, 2006)

Furthermore, according to the results of the investigation performed by Berry and Robertson (2006), there are two important sources for lending decision by a bank that are namely, financial information and private information. Further, he mentioned that audited reports continue to be the most important single source of information for the lending decision by bank.

### **3.1.1.2 Credit or loan granting**

In this section the credit granting and its process as the most relevant link between companies and bank will be described.

### **3.1.1.3 Demand for capital**

As it was mentioned previously all sorts of companies regardless the size of them may be required to demand for capital in order to start a new business, financing, development or other capital requirement circumstances. However, lender institutes or stakeholder such as banks can provide the process of applying capital. Beside banks as a popular lender or creditor, there are other type of credit providers in Sweden such as The Swedish Tax Agency, other financial organizations and suppliers. However, regarding the study of Lucus (1988) capital is very crucial for the performance of small companies.

Furthermore, Cressy and Olofsson (1997) argues that the special focus is putting on credit granting to small firms to contribute them capitalizing. However, some researchers thought that lends to small firms is associated with risk regarding the capability of paying debt.

#### **3.1.1.4 The process of credit granting**

It is clear that the credit granting or lending have a vital role for economic development. However, the negative effects can also be associated with this process. For instance, in the beginning of the 1990s the financial crises in Sweden caused great credit losses in the Swedish banks and other creditor organizations. In addition, the impact of this experience in the Swedish banks was more than three percent credit loss annually of total assets during the years 1992-1993. (Andersson, 2001)

However, the sensitivity of the credit granting process requires the credit managers to examine the applicant's financial condition, this process started by realizing of both financial and non-financial information, analysis and interpretation and ultimately decision-making. Following, the bank shall assess and be sure of the applicant's ability to fulfill the repayment obligations. (GNWT, 2012)

According Danos, Holt and Imhoff, Jr. (1989), banks relay more on applications that include of detailed accounting information like business activities, economic background and future plan in order to decision-making of credit granting. However, the detailed information like ability of financing, safety, capital possibility, credit history, increase of obligations and other elements about the firms can influence on the banks' decision-making.

Furthermore, according to the Guideline On Credit Risk Management (2004) to evaluate the credit granting process the debtors' economic and legal condition should be considered. Moreover, the approval of this process consists of a great comprehension of credit risk and the level of credit efficiency for banks. However, this process has to be assessed by banks or other creditors before they decide to lend to companies.

Thus, when the credit assessment process held, then bank will apprise the company about the result and have a discussion regarding a contract. Further, bank will make sure adequate security through the contract with the aim of grant the credit or loan to appropriate company. (Brommé, Elmér and Nylén, 1998)

#### **3.1.1.5 Previous research**

Some previous research in United Kingdom and Australia analyzed the different sorts of information used by banks regarding the credit decision. The investigations demonstrate that the financial statements placed more importance than the other sorts of information.

It was showed previously that both formal and informal financial information used in decision-making process by bankers to credit granting. However, some accounting information such as cash flow statements is more valuable because it improves the quality while some becomes less valued such as audited reports (Berry and Robertson, 2006).

In addition, the results of analysis in some developing countries illustrated that there are clear differences between various users such as banks and lender institutes. Thus, their rating of importance and use of information regarding the credit decision vary as well. (Berry and Robertson, 2006)

An empirical study about credit granting to small businesses in Brazil discussed that operation costs limit the allocation of credit to small and medium-sized companies (SMEs). However, a variety of 65,535 SME credit application presented to a big Brazilian bank during January 2004 and September 2006, to evaluate credit-granting decision. Results proposed that small firms face credit and risk assessment controlling. Additionally, banks are able to catch private information about their borrowers via credit assessment process. Then, this information may affects on bank decisions. The researches illustrate that the mentioned bank faces some issues to provide credit to small companies. The issues were because of the cost, security and information asymmetric that will be discussed in the theory section of this study. (Zambaldi F, et al., 2009)

Another study, which performed in Finland, investigated the effects of modified audit opinions on the availability of credit or loan. The study used a sample of more than 50 thousand SME firm-years, including more than three thousand observations with modified reports. The result of this investigation revealed the factors that can affect the credit granting decision by banks. However, these factors are control for profitability, creditworthiness and unobservable factors such as the availability of individual property like collateral, managerial talents and the overall quality of the firm. Researchers claimed that they did not discover association between an audited reports and an increased usage of credit granting. (Niemi and Sundgren, 2012)

### **3.1.1.6 The auditing advantages related to grant credit or loan**

However, regarding to the study of Lennox and Pittman (2011) failures augment caused that firms should be required to have their financial statements audited to certify outsiders and banks access to reliable accounting information. It means that the mandatory audit has benefits for all outsiders and banks.

The empirical research of Lennox and Pittman (2011) reveals that companies have their financial statements audited to achieve loan. Further, the most interesting and important part of this research is that the results are coming from a comparative study between voluntary audited and non-audited financial reports of companies.

In addition, Melumad and Thoman (1990) claims in his theory that companies which pursuing credit or loan choose to submit an audit. Rather, it mentioned that companies sometimes decide to hire an audit. In addition, lenders and banks require of an audit because of the high-risk types of borrowers. It is mentioned that the audit signal is important for lenders and banks whether positive or negative because audit can keep the assurance benefits of financial information. (Lennox and Pittman, 2011)

## **4. Theoretical framework**

According to the study by Pertanika, et al., (2012) there are three top benefits derived from audit; firstly, it provides a check on accounting records and systems, secondly audit assists to defend against fraud and thirdly it makes superior the reliability and credibility of the financial reports. However, one of the most important issues for the reform of mandatory audit might be the cost of audit for small firms. In contrast, the research reveals that the benefits derived from mandatory audit outweighed its costs thus mandatory audit should be retained. The other problem may relate to the legitimacy of small firms' financial reports. For instance, if companies decide to neglect the auditing it may have effects on their legitimacy of the financial report and thereby the judgment from stakeholder (banks).

Furthermore, regarding to the subjects described above and from the theoretical perspective, the demand for auditing can be defined by the legitimacy and Agency Theories. Thus, according to Deegan (2002, p.292) the legitimacy theory offers a good description. "Organizations are not considered to have any inherent right to resources or in fact to exist." Nevertheless, the companies will get more access to resources and recognition to exist if they gain legitimacy from society. Further, the agency theory proposed by Jensen and Meckling (1976) described company as where is a separation of ownership and control. The owner should be willing to acquire a financial cost to monitor the activities of their managers (Salleh, et al., 2008).

### **4.1 Audit dependence explained by legitimacy theory**

In order to comprehend the essentials of accounting and voluntary disclosures, previous research has tried to explain these fundamentals by deriving a legitimacy theory. This theory would also clarify the essential intentions of auditing. The legitimacy theory assumes that society, politics and economics are consistent and correlated. The theory tells us that the financial accounting and thereby the auditing will not be valid without reflecting the society and politics and all other environmental fields that regards an organization. According to the legitimacy theory these fields and stakeholder (banks) have a major impact on the economics and the figures of the accounting (Deegan, 2002). The basic model of the legitimacy theory consists of pressure from bank as the most important source of funding to achieve legitimacy within the firm by increasing of the content and substance of voluntary disclosures. However, by reaching the legitimacy, the company will be able to attract resources and thereby apply for funding. Further, to engage legitimacy at the first place companies of course need to establish legitimacy and then maintain it. The

challenge of maintaining legitimacy is to forecast changes in the banks' expectations.

In addition, the intention of all audits is thereby to ensure correct and truthful financial reporting, meaning to confirm business and accounting transparency by control and review the assessment of the companies' assets, liability, income and expense. Thus, by auditing the credibility of the complete financial statement will be maintained. This includes an examination of both the disclosure and the accounting records of the financial statement. (Arens and Loebbecke, 1997)

Power (2003) debates about the important series of influential contributions within auditing research. Power tries to apprehend the creation of legitimacy around auditing topics. He develops this thought and attempts to clarify the relation between institutional theory and legitimacy theory. Companies namely need to endeavor institutional rules regarding auditing processes to achieve legitimacy toward both shareholders and stakeholders. As the institutional rules and rituals most certainly suggests for Swedish companies as well as any other companies, an approved audit has to be conducted for a financial report to be legitimated.

However, from the legitimacy theory and its relationship with banks can be realized that how audited financial information is important to achieve the legitimacy. Additionally, audited financial reports ensuring transparency, evaluating liability and preserving credibility that are the essential factors for bank as a creditor/lender. The stakeholder (bank) demands different things and as the society changes, so the demands lead on higher security and regulatory. Thus, it is important that the financial reports reflect what the banks consider to be necessary and trustworthy information. Nowadays, banks may consider the audited information as a tool for providing a confirmation of truth and legitimacy to companies. Therefore, the key expectations from banks might relate to the assurance and fairness of the financial statements. However, according to the theory banks may achieve this assurance and legitimacy through an audited financial report. Further, audited reports can assist banks to have an overview on the company's ability, internal control system and the occurrence of fraud and illegal acts.

## **4.2 Audit dependence explain by Agency theory**

The agency theory is an element that can affect on the balance between the costs and benefits of the audit (Jensen and Meckling, 1976). The agency theory assumes that the company composed of an interest of contracts between the owners of company and the agents who are authorized to manage and control the assets. Consequently, the

performance of this contract affects the decision-making by agents (ICAEW, 2005).

However, a simple model of agency proposes to resolve concerns arise from information asymmetries and self-interest. Further, generally owners (clients) and agents (banks) having difficult to trust each other. Thus, the absence of trust creates concerns and anxiety. However, it may decrease the concerns through methods such as bring up the agents' interests and decrease the possibility for information asymmetric and opportunistic behavior. (ICAEW, 2005)

However, by providing the audited financial information, it is possible to bring up the agents' (banks) interests and decrease the uncertainty and other possibly problem that arise from the desires of owners and agents conflict.

In addition, according to the study of Jensen and Meckling (1976), the base of agency theory claims that sometimes the agents have more information than the owners. Thus, it leads to the information asymmetry that can negatively affects the owners' ability to control effectively their interests whether they are being correctly served by agents. Due to the information asymmetry, the requirement for audited financial statement arise on the presumption that human nature is weak, greed, unreliable and in need of some kind of examination. (Ismail and Boon, 2012)

From agency perceptions Jensen and Meckling (1976), both owners and agents will act rationally and use contracting process to maximize their wealth. Further, the agency basis is more appropriate to apply in large firms where there are external shareholders and the audited accounts play an agency role in the link between shareholders (owners/principals) and managing administrator (the agents).

However, if the agency reasoning applies on small companies an owner who is distant from the activities of management is unable to prove the activities such as an external shareholder, lender or other creditors. Consequently, excluding the external users the information that will be present amongst internal shareholders also may be asymmetry because of the lack of necessary skills to interpret the financial information. (Ismail and Boon, 2012) Therefore, requirement of the audit may not be dependent on size because "even in the very smallest company disputes can arise amongst shareholders and the audited accounts can be an essential protection" (Freedman and Goodwin, 1993, p.128).

According to the Bolton, (1971); Carsberg, et al., (1985) and Collis & Jarvis, (2000) small



companies are usually family-owned and owner-managed so there is little delegation of control also risk of internal and external moral hazard is significantly lower than large companies.

Furthermore, an economic-theoretical perspective explains that the credit granting process can be like a reaction between the applicants (owners) and the banks (agents). However, this reaction is related with information asymmetry.

Such asymmetry assumes that a credit applicant is privately informed of the actual reasons behind his/her application for credit and therefore tries to make the firm more viable for banks or lender regarding to achieve credit.

Thus, regarding to the case, the credit applicants have resourceful motivations to report financially powerful creditworthiness to loan officer or the credit manager. However, this information asymmetry creates unequal information for banks as a lender or creditor. (Andersson, 2001) Therefore, the existence of an auditor who has skill and competence to interpret the financial information might be a great solution in such situation (Cressy, 1994).

## **5. Empirical findings**

In this chapter the empirical findings from the conducted interviews will be presented. The results presented here include interviews of this main stakeholder means banks/creditors, which have been translated from original language and then collected. Together with the frame of reference and theoretical evaluation presented in earlier chapters the empirical findings will later be analyzed and discussed.

### **5.1 Presentation of the banks' representatives**

Five representatives from three Swedish largest banks have been interviewed. This section follows the presentation of each respondent from considered banks.

#### **5.1.1 Interview with Mikael Alkmark regional credit manager at Västra Götaland province**

Mikael Alkmark stands as regional credit manager for Swedbank, which is one of the large banks in Sweden. He started with this point that historically, they always had audited and auditors as a routine or standard, he said that bank would like to consider audit as a requirement for the clients. He is added that regarding to this reform, if we recognize the requirement for auditing then we will ask the clients for it. Further, he mentioned that if bank has long-term relationship with clients who involve in an efficient and stable business then it is not essential to either ask them for auditing or auditors. In addition, these rules also apply in the case of new clients who engage in a profitable and stable business.

He also said; the limits were much higher in the law proposal earlier. However, after the changes of regulations according to the Swedish Audit Act (Revisionslag SFS 1999:1079), the restrictions became less. Therefore, in such situation banks will look at the owner's condition. He added that the risk will be transferred to individuals because bank performs an analyze risk control. Morley, bank is going to perform an evaluation and judgment for each individual case.

Alkmark mentioned that in small limited companies, this is the owners' responsibility not banks' responsibility to have contact with auditors for more safety in business and in case of fallback in business process. In addition, it was mentioned that they have not a clear position for small limited firms and neither decided whether they require auditing.

However, the respondent mentioned that they did not experience at all small firms, which

applies for credit or loan. In addition, another inquiry was about owners who are working in construction industry branch and entrepreneurs those who have a great need for financing and generally have no auditors and they do not use auditing reports. However, these types of clients may be forced to apply for loan or credit in order to be able to continue their business activities. The answer to this question was that it is depended on which type of loan/credit they ask for. It was added that both leasing financing and operating loan/credits are more relevant for this group because in such situation the risk will impose on the operations or business.

Alkmark mentioned that in case of small firms, they consider most the owners' condition and histories about their economic situation. Anyhow, he mentioned that bank seems audit as a quality sign for its clients.

Alkmark mentioned later on the word of "trust" as a significant element in relation with clients. He said if they do not trust the customers who ask for loan/credit, then they will demand for auditing and an auditor to check and control the financial reports.

However, He mentioned that there are financial reports, which include incorrect financial numbers. Despite they have auditors simultaneously there are also clients that use only of accounting firms or accounting consultants for arranging their reports however the financial numbers are correct and credible.

Therefore, Alkmark said that the trust is not depended on auditors; he said that they care more about who the managers are and how the historical and business background of firms appears. Also, it depends on companies' future business plan that follows the present idea and strategy. Further, the economic functions of firms have a vital role as well. Additionally, the experience of auditors is also an important aspect for bank.

## **5.1.2 Interviews with Johan Särneö and Mikael Angerlöv Business Advisors**

### **5.1.2.1 Preface**

The next interview held with these two respondents at SEB. The initial reaction of them about the prepared questions was of course being without audited financial report is a sign of disadvantages and weaknesses for business activities. The reason is that it will be quite difficult for bank to evaluate whether the financial numbers are accurate or not. The bank was extremely doubtful about the non-audited clients who ask for credit/loan.

Representatives from SEB thought that the small companies with total assets 1.5 million SEK and maximum net sales 3 million SEK, do not have huge need for credit/loan. However, it might be relevant for those new started businesses that need more capital for financing. Further, about entrepreneurs and their requirement of more money for financing in business activities, both of respondents mentioned that the entrepreneurs do not need huge financing for machines and instruments. Rather, there are other alternatives to finance in such businesses. For instance, hire or secondhand purchasing that is more cost-efficiently for capitalizing.

### **5.1.2.2 Interview with Mikael Angerlöv**

Mr. Angerlöv regarding to the questions and decision-making of credit granting pointed that it is quite different from case to case. Also, it depends on customers' long-term interesting, business idea and safety about the activities they involve in. Further, the individuals or owners' responsibility mentioned as a very important factor in the relationship process with bank. He mentioned that bank might reject the new started businesses because of insufficient information about business activities regarding credit granting.

During the interview Angerlöv came to an interested point, he said about some owners who have very small businesses but they have auditors and audited reports. The reason was the difficulty of responding to the questions, which stand by Swedish Tax Agency.

The respondent described a client who applied credit for purchasing machines and instruments for couple weeks ago, however the client had non-audited financial reports that were also messy and full of incorrect numbers. Unfortunately, this client had no auditor to support and arrange the financial statements. Therefore, bank rejects the application for loan immediately. At the end, about the cost as the only reason for abolishing of mandatory audit, Angerlöv mentioned that it is not cost-efficient for firms in contrast to a valuable job of auditing, and he said people only deceive themselves.

### **5.1.2.3 Interview with Johan Särneö**

Regarding the questions was sending to the respondents, Särneö mentioned that he did not experience small and medium size companies that apply for credit/loan during the recent years. However, he said that there is no direct rejection for the small businesses like

individual/private owners who involve in building industry and may have large need for capitalizing in the business processes. It was mentioned that an auditor is a quality assurance for a business. In addition, it is important to trust the auditors and be aware of their legal behavior and judgment as well. Särneö thought that the audited financial reports could be more important for suppliers than banks.

#### **5.1.2.4 Common ideas of Johan Särneö and Mikael Angerlöv**

Johan Särneö and Mikael Angerlöv said directly that bank consider audit and audited financial reports as a quality for their clients. Both of the respondents mentioned that quality for them is a pure audited financial report that does not exist of late paid tax or big differences of assets on balance sheet. In addition, it is important that annual reports be hand-in on time or even earlier to the Swedish Companies Registration Office. Further, as the previous respondents mentioned profitability of business result is another important factor that bank considers and then it does not play an extreme role if customers have not an auditor. However, the respondents mentioned that it plays no role the having of an approval auditor or an accounting firm or accounting consults especially for SEB when clients apply for loan/credit. However, it is also depending on customers demand as well. Whether demands increase more safety and quality will be considered. On the other hand, a legal audit mentioned as a quality for who are applying for loan/credit

Additionally, there were agreements on more cautious about new started businesses but not those one that have great business idea or adequate money for capitalizing on business activities.

The final outcome of interview was that the abolishment of mandatory audit was not so huge help for small companies regarding credit granting. Because, respondents think that it is difficult to see who or which agency actually benefit of this new legislation. They thought that this reform is not an advantage for the small and even private businesses because if they need to apply for loan/credit then bank requires to know detail information about the business activities, also it can be easier for bank to judge and make the decision through an auditor and audited financial report.

## **5.2 Interviews with Jerker Jonsson Group Manager and Christer Fögelström**

### **5.2.1 Interview with Jerker Jonsson**

The third interview was held with Jerker Jonsson at Nordea bank. Mr. Jansson said that

basically they need a revised audit in order to make the decision whether customers can receive loans/credits or no.

As other respondents in other banks he also mentioned that it is an advantage to have an auditor that has extra control on financial statements. However, in respondent opinion a revised audit is not even enough information rather; bank need more current information about the customers who apply for loan/credit. He mentioned the term of economic period and said think about that a client who applies for loan and his/her financial statements are for half years ago or even more than half year. Therefore, bank cannot take into account this old information for one current decision. Both audited data/information and non-audited data are require for bank according to the interviewee, because some data cannot be audited in exact that time or period firms apply for loan.

Again was mentioned about the firms' economic background because most of the time is easier to investigate the financial statements of small firms and make the decision for credit/loan granting. Another reason is that the small businesses do not need large amount of loan/credit.

Furthermore, the ability of clients to explain their business activities and idea reveal how their business expectations appeared after five years. However, bank will control the previous financial results of each case.

In addition, quality for respondent as a bank representative was a correct audited reports and an approval auditor. Further, both trust and reliability are essential factors for lenders' decision-making. According to the Mr. Jonsson there are a lot of experts and masters auditors who can modify the results or amounts of financial statements. Therefore, reliability and credibility of auditors are very important for credit granting.

Jonsson talked about one of his recently customer who works with several ongoing projects of fire protection systems brand for buildings and apartments. Since the project is an ongoing project, so perhaps the process starts at January 2013 but the profits of the project will be appeared at January 2014. Therefore, the financial statements reveal an extent amount of expenditures in November and December of the current year (2013) when final reports will be hand in. Further, when bank look at these results from November and December then the decision for offering of loan or credits is negative. Therefore, Jonsson mentioned the essential of auditor who can create assurance and safety

for bank in such condition. Because auditors have an extra control and explanation of business future plans.

Further, he mentioned that the auditing seem as a quality for clients in this situation. Moreover, bank needs to evaluate the clients' condition. However, the bank will definitely confirm the audited reports that have been approved by auditors. Respondents said that they did not experience non-audited clients whether from small or large firms.

However, bank position about new-started businesses was not quite positive. The respondents said because of the lack of business economic background, new started clients could apply for credit together with their auditor. The reason is the auditor's professional knowledge and skills about financial process. On the other hand, he mentioned that bank use other alternatives as well in order to be ensure about credit granting, for instance analytical persons who are expert in the financial analysis also Swedish Credit Information Agency (UC) which provides day-to-day information about customers economic background.

### **5.2.2 Interview with Christer Fögelström**

Furthermore, it has been held another interview with Christer Fögelström at Nordea Bank. Regard to the questions he said that we do not ask direct of our clients about either they have audited financial reports or no. The reason was that it is the business owners' responsibility to know about business processes. However, bank considers the clients' economic background.

Additionally, once more about the new-started businesses, he said that it might be a little subjective, and bank is going to look at earlier experience, competence and education of clients who drives of business activities. Further, the credibility and reality of financial amounts and financial statements are also important elements for bank according to Fögelström. He stated that the existence of an auditor who strength the financial statements and financial amounts is also as an extra assurance for bank.

However, it cannot seem as a quality for approving clients' business plan. Rather, he said an auditor examines the accounting reports and he/she has nothing to do with budget planning of business activities. He added that it is definite work even without an auditor if the budget has been held in a credible and reliable set.

As the other respondents said trust was an important factor for him as well. On the other

hand, it was mentioned that even bank is going to trust the clients but the business notion is not rational and profitable, then it cannot be accepted to confirm the application for loan/credit. Rather, security and safety for bank is changeable from case to case and it depends on different business.

However, according to the respondent, customers' daily activities will be checked by Swedish Credit Information Agency (UC) and Swedish Tax Agency.

Further, Fögelström claimed that both audited and non-audited firms have an equal value for bank. It is sufficient for bank that clients have well-worked business.

Finally, he mentioned that there is not an extreme reaction from bank about the new legislation. Fögelström claimed that auditing is not guaranty for a business; also it is still early to observe a direct effect of this new legislation.



## **6. Analysis and discussion**

The following chapter covers an analysis of the previously presented information. In this section the theoretical framework, frame of reference and the empirical findings will be interpreted and discussed.

### **6.1 The process of credit granting**

The sensitivity of the credit granting process requires the credit managers to examine the applicant's financial condition, this process started by realizing of both financial and non-financial information, analysis and interpretation and ultimately decision-making. In the next step, bank shall assess and be sure of the applicant's ability to fulfill the repayment obligations. (GNWT, 2012)

In addition, as Brommé, Elmér and Nylén (1998) mentioned, when the credit assessment process held, then bank will apprise the company about the result and have a discussion regarding a contract. Further, bank will make sure adequate security through the contract with the aim of grant the credit or loan to appropriate company.

Therefore, the important resource regarding this process will be discussed in following sections.

### **6.2 The economic background, current and future condition**

As it was mentioned previously, according to the Danos, Holt and Imhoff, Jr. (1989), banks relay more on applications that include of detailed accounting information like business activities, economic background and future plan in order to decision-making of credit granting. However, the detailed information like ability of financing, safety, capital possibility, credit history, increase of obligations and other elements about the firms can influence on the banks' decision-making.

The empirical findings through banks and the respondents revealed also the same statements. For instance, Mikael Alkmark who stands as regional credit manager for Swedbank mentioned, in case of small firms, bank considers most the owners' condition, histories and background about their economic situation. Anyhow, he mentioned that bank seems audit as a quality sign for its clients. Further, he pointed out that bank care more about who the managers are and how the historical and business background of firms appears. Also, it depends on companies' future business plan that follows the present idea and strategy.

In addition, Jerker Jonsson considered firms' economic background as well as current information about the clients who apply for credit/loan. Also, Christer Fögelström considered the clients' economic background as the important information regarding credit granting.

However, regard to the both empirical findings and theoretical research, it can be realized that the economic background and future plan of companies are important factors for banks decision-making regarding credit granting. It should be considered that before this new legislation the limits were much higher in the law proposal. While after the revision of regulation the restrictions became less. Therefore, in such situation banks will look at the owner's condition. Consequently, the impact of this reform on banks' decision is visible in order to grant credit or loan. Because having no audited financial report may be a sign of disadvantages and weaknesses for business condition. Further, it makes difficult for bank to evaluate, whether the financial numbers are accurate or not. Therefore, from the author's view this reform might make difficult the process of credit assessment for banks.

Refer to the respondents again, Johan Särneö and Mikael Angerlöv thought that this reform is not an advantage for the small and even private businesses because if companies need to apply for loan/credit then bank requires to know detail information about the business activities, also it can be easier for bank to judge and make decision through an auditor and audited report.

Further, Mikael Alkmark started with this point that historically, bank always had audited and auditors as a routine or standard, he said that bank would like to consider audit as a requirement for the clients. He is added that regarding to this reform, if we recognize the requirement for auditing then we will ask the clients for it.

However, the interpretation of both empery and theory would be that banks require both financial and non-financial information about clients. Following banks consider several factors in the process of credit assessment. The clients' economic background is also one of those elements that can be important for bank. The reason might be securitized of clients' ability for repaying of credit/loan. Therefore, to evaluate this process the audited financial report and an auditor who has knowledge and skill would be great assistance to banks. Thus, from the respondents' view and theories could be understood that this new legislation made the assessment for banks to some extent difficult to grant credit or loan. Further as it was pointed previously decision making through an audited financial report

would be much easier for banks.

On the other hand, most of the respondents mentioned that bank use other alternatives as well in order to be sure about credit granting process, for instance analytical persons who are expert in the financial analysis also Swedish Tax Agency and Swedish Credit Information Agency (UC) which provides day-to-day information about customers economic background. However, the sensitivity of the credit granting process and the negative effects that may occur behind it such as great credit losses in the Swedish financial crises at the beginning of 1990s, which was pointed, previously by Andersson (2001) illustrates the importance of this process for banks. Therefor the absence of audit might make the process complicated and time consuming for banks' decision-making regarding the credit granting.

However, it should be considered that one of the respondents had not the same idea as the other respondents. From this respondent' view audited and non-audited firms have an equal value for banks regarding the credit granting. Respondent thought that it is adequate for banks that clients have well-worked business. The earlier experience, competence and education of clients were pointed as well regarding the credit granting. Further, the other alternatives to check the client's business condition would assist bank in the process of decision-making. Thus, this respondent pointed that the new legislation has not extreme effect on the banks decision-making regarding the credit granting.

However, from the author's view, the idea of one representative compares to the rest of respondents and theoretical perspectives may not completely be considered. Therefore, in author's point of view the reform had to some extent impact on the bank decision-making regarding credit assessment process. However, it is difficult to claim the precise extent of this impact but it might be a large impact when banks' representatives claim that audit is an important factor for them. The importance of it may be seen more in banks' decision regarding the new-started businesses that need the credit to capitalize. Further, when respondents mentioned that non-audited businesses reject immediately or the bank is extremely doubtful about non-audited clients. However, these issues can be more discuss in the following sections.

### **6.3 The auditing, legitimacy and credit granting by bank**

The basic model of the legitimacy theory consists of pressure from bank as the most

important source of funding to achieve legitimacy within the firm by increasing of the content and substance of voluntary disclosures. However, by reaching the legitimacy, the company will be able to attract resources and thereby apply for funding. Further, to engage legitimacy at the first place companies of course need to establish legitimacy and then maintain it. The challenge of maintaining legitimacy is to forecast changes in the banks' expectations.

To achieve the banks' expectations, all audits lead to ensure correct and truthful financial reporting, meaning to confirm business and accounting transparency by control and review the assessment of the companies' assets, liabilities, incomes and expenses. Thus, by auditing the credibility of the complete financial reports will be maintained. This includes an examination of both the disclosure and the accounting records of the financial statements/reports. (Arens and Loebbecke, 1997)

However, from the theory mentioned above can be realized that auditing and audited financial reports can increase the legitimacy of firms. Thus, it may create easier for banks to make the decision to grant credit or loan to companies. As it was mentioned frequently in theory and empery, the credibility and assurance of financial information are essential factors for banks in order to grant credit. However, from the author's perspective the abolition of mandatory audit might affect on the legitimacy of companies' financial reports, and thus made it difficult for banks to grant to non-audited clients.

By referring to the empirical findings, almost all of the respondents preferred audited financial report in order to grant credit or loan to the clients. Frequently, audited financial reports were mentioned as a certified document for owners and firms. However, for endorsing the respondents' claim, the legitimacy theory clarifies the essential intentions of auditing and support the empirical finding.

According to the legitimacy theory, as the institutional rules and rituals most certainly suggest for Swedish companies as well as any other, that an approved audit has to be conducted for a financial report in order to be legitimated. Therefore, the absence of auditing in small firms will lead to a lesser legitimacy. Probably, this reform of mandatory audit made hard the process of credit assessment by banks.

However, to link the empirical finding with legitimacy theory and reveals the accuracy of this research, it refers directly to some of the respondents. For instance, Mikael Angerlöv mentioned that, "*We are extremely doubtful about the clients when they ask for credit/ loan if they have not auditors and audited financial reports.*"

It means that auditors and audited financial reports are as legitimated documents for bank in order to decision making.

Moreover, Jerker Jonsson mentioned that the extra external control by auditor on financial reports creates assurance and safety for bank as a user of financial reports in case of credit/loan granting. Thus, it can be realized that bank consider audit as legitimacy and validity for clients.

On the other word, some other respondents mentioned again that it could be easier for bank to judge and make the decision through an auditor who has knowledge, competence, education and skill to interpret financial reports.

Therefore, it may achieve the answers to questions of this study. Considering the first question, the absence of audit and this reform of mandatory audit probably have to some large extent impact on the banks decision-making of credit granting, which banks sense difficulty to evaluate the client condition. Further, regarding to the second question might be claimed that the audited financial reports increase the assurance and legitimacy of the company; thereby banks can make the decision to grant credit or loan easier. Banks may rely more on the audited financial reports because of the higher legitimate and safety of financial information.

However, in contrast to the other representatives, there is one respondent who almost has not the same opinion about auditing.

Christer Fögelström states also in the position that it definitely works even without an audit if the budget were held in a credible and reliable set. It was added that an auditor examines the accounting reports and has nothing to do with budget plan of business process.

However, the respondent may not consider that an auditor can be as an expert and professional advisor behind managers for their future budget plan. Further, as it was mentioned previously the idea of one respondent cannot be so effective on the results of the study.

## **6.4 The auditing, Agency and credit granting by bank**

However, a simple model of agency proposes to resolve concerns that arise from information asymmetries and self-interest. Further, generally owners (clients) do not trust their agents (banks) thus it leads to concerns. However, it may be possible to decrease the concerns by applying the methods such as bringing in the agents' interest with owners and

decrease the possibility for information asymmetries and opportunistic behavior (ICAEW, 2005). Therefore, in this situation both parts should serve and cover each other's interests, owners (clients) should serve agents (banks) interests through an approved auditor and audited financial reports. In this way, the owners (clients) create trust for agents by legal and pure audited financial reports; on the other hand agents perform owners demand by offering them credit/loan. However, auditors are as intermediate agent between these two parties that covers both parties' demand/interest. An approved and loyal auditor is as an assurance and certified document for both groups.

However, there is always possibility of information asymmetry that can negatively affects the owners' ability to control effectively their interests whether they are being correctly served by agents. Due to the information asymmetry, the requirement for audited financial statement arise on the presumption that human nature is weak, greed, unreliable and in need of some kind of examination (Ismail and Boon, 2012). However, an audit provides an independent check on the financial information that is provided by clients. Thus, it creates confidence and trust (ICAEW, 2005).

Since the asymmetry of information and other issues are inevitable in the relationship between agents and owners. Thus, the absence of audit may lead to higher asymmetry of information and untrustworthy regarding the credit granting by bank. On the other hand, from the agency theory can be understood that the audit traditionally consider as an assurance and certainty. Therefore, the lack of auditing and this reform might have to some extent impact on the banks decision-making regarding the credit granting.

In order to be a connection between theory, empery and the research questions following come some coupling to respondents:

Mikael Alkmark, mentioned the word "trust" and said, if they do not trust the customers who ask for loan/credit, then they will ask them for requiring of auditing and an auditor to check and control their financial reports. From this description the critical role of auditors and audited financial report regarding the credit assessment process can be realized.

Furthermore, Johan Särneö and Mikael Angerlöv said that another important aspect for us is interrelationship trust in terms of credit granting. Thus, interrelationship trust might be created through existence of an audit in the firms, which may ease the process of lending credit or loan.

## 6.5 Quality and assurance

The extent between a clean audit and a compilation report is very extensive. However, a clean audit that is created by an auditor includes a careful consideration and acquired reasonable assurance about the financial statements and internal control systems.

According to the study of Lennox and Pittman (2011), lenders and banks require of an audit because of the high-risk types of borrowers. It is mentioned that the audit signal is important for lenders and banks whether positive or negative, because audit can keep the assurance benefits. Further, the authors mentioned that failures augment caused the requirement of audited financial statements to certify that banks access to reliable accounting information.

However, the perception of the theory might be that banks benefits of mandatory audit because the audit creates more quality and assurance of financial reports. Thereby, the process of credit assessment will be much more easier for bank. So, it might be interpreted that this reform of mandatory audit has in somehow impact on banks decision-making regarding the credit granting. As most of the respondents mentioned it is difficult to trust to non-audited reports. Therefore, the process of credit assessment may take longer time for banks.

According to most of the respondents in three Swedish largest banks, the banks have doubts about non-audited financial reports and information. The respondents were agreed on that the audited financial report and auditor seems as a quality and assurance for firms business. For instance Mikael Alkmark state that:

*“Audit is as a quality sign for the businesses. In addition, if we do not trust the clients who ask for loan/ credit, then we will ask them for requiring of auditing and an auditor to check and control their financial reports.”*

The initial reaction from Johan Särneö and Mikael Angerlöv was:

That an audit is a quality assurance for business activities and of course being without audited financial report is a sign of disadvantages and weaknesses for business activities, because it will be quite difficult for us to evaluate that the financial numbers accurate. We are extremely doubtful about the non-audited financial reports or financial statements.

Further, it was mentioned that quality and assurance are a pure audited financial report that does not exist of late paid tax to Swedish Tax Agency or big differences of assets on balance sheet.

To confirm this claim that auditor and audited financial reports seem as quality and assurance for banks; Jerker Jonsson state that as well:

*“Basically, bank needs a revised audit in order to make the decision whether clients can receive loan or no. Also this is an advantage to have an auditor that has extra control on financial statements.”*

However, the author’s perception from the factual findings is that this reform creates more doubt and difficulty for creditors to make a decision regarding credit granting. Further, as it was mentioned frequently, audited financial reports are as a sign of more assurance, reliability, quality and certainty for banks that can ease the process of credit granting.



## 7. Conclusions

This chapter returns to the underlying aims of research questions, which presented in the introductory chapter and answer them accordingly. This chapter includes the reflections and interpretation of author to answer the research questions, also some suggestions for future research and study.

### 7.1 Conclusion

To make it easier for readers to understand the conclusions of this study, the research questions will be answered respectively. The first question state:

- **How has this reform of mandatory audit impact on the banks decision-making of credit granting?**

From the theoretical framework and empirical findings, there is substantial evidence that an independent audit has a perceived value and benefits that exceed the quality and assurance of financial reports regarding the credit granting.

Furthermore, as state by Andersson (2001) it is not an unexpected fact that accounting information plays a significant role in the credit assessment process. FAR publisher (2006) also pointed that Banks demand for high security. So, there is solely an independent audit that can examine performance of financial information of the companies to bank. As another theoretical evidence, Berry and Robertson (2006) state that audited reports continue to be the most important single source of information for the lending decision by bank.

Regards to the study conducted by five representatives in diverse positions at three largest Swedish banks, it can be realized that majority of respondents ultimately have a positive attitude toward audited financial reports and auditors. They expressed the audited financial reports and auditors as a quality and confirmation for businesses regarding the credit granting.

Therefore, the author perception from both empirical and theoretical results show that the absence of audit might make the process of credit granting by banks difficult and complicated. As some respondents mentioned previously it is difficult for banks to evaluate non-audited financial reports applications. Further, non-audited financial applications rejected by banks. Audited financial reports create safety and certainty for banks.

In addition as Pertanika, et al., (2012) mentioned there are three top benefits derived from audit; firstly, it provides a check on accounting records and systems, secondly, audit assists to defend against fraud and thirdly, it makes superior the reliability and credibility of the financial statements.

However, from the author's perspective since the process of credit granting is quite sensitive for banks, the lack of audit can have critical impact on decision making regarding credit granting. Thus, without audit there is no an external check on accounting records whether the numbers are accurate or not. However, the additional reason behind it was mentioned frequently in both empery and theory of this study.

However, as also clarified by the legitimacy theory banks demand different things and as the society changes. So, when demands lead to higher security and regulatory, then banks consider more quality and assurance of financial reports. Nowadays, banks may consider the audited financial reports as a tool for providing a confirmation of truth and legitimacy of the companies' financial information. Therefore, the lack of audit may lead to lower legitimate of financial reports. Thereby, it will be difficult for bank to take the decision whether grant credit or not.

Moreover, the agency theory describes this effect as well. However, by providing the audited financial information may bring up the agents' (banks) interests and decrease the uncertainty and other possibly problem that arise from the desires of owners and agents conflict. As Jensen and Meckling (1976) mentioned both owners and agents will act rationally and use contracting process to maximize their wealth. Therefore, the existence of an auditor who has skill and competence to interpret the financial information might be a great solution in such situation (Cressy, 1994). Further it avoids of creating the information asymmetry as well.

Considering the second research question of this study; it is also interesting to understand:

- **Do audited financial reports increase the assurance and legitimacy of the company to bank and ease the process of lending loan or credit?**

Both empirical findings and theoretical study have a great agreement about that audit seems as a legitimacy and assurance for financial reports. As it was mentioned previously, Arens and Loebbecke (1997) state that the intention of all audits is to ensure correct and truthful financial reporting, meaning to confirm business and accounting transparency by

control and review the assessment of the companies' assets, liability, income and expense. Thus, by auditing the credibility of the complete financial statement will be maintained. This includes an examination of both the disclosure and the accounting records of the financial statement.

In addition, a simple model of agency proposes to resolve concerns that arise from information asymmetries and self-interest. Further, generally owners (clients) and agents (banks) having difficult to trust each other. Thus, the absence of trust creates concerns and anxiety. However, it may decrease the concerns by applying the methods like bringing in the agents' interest with owners and decrease the possibility for information asymmetries and opportunistic behavior (ICAEW, 2005)

Therefore, from the theories mentioned above can be understood that an independent audit certainly increases the legitimacy, assurance and credibility of the financial reports. Moreover, it is realized that audit still have a secure role for credit institutes and banks. Further, banks demand a certain level of assurance regarding the credit assessment process. The reason is that higher legitimacy and assurance create more security for banks and make the process of decision-making easier.

Refer to the respondents, almost all of them mentioned that it could be easier for bank to judge and make the decision through an audited financial report and an auditor who has knowledge, competence, education and skill to interpret financial reports. Respondents mentioned that audit create assurance and safety for bank as a user of financial reports in case of credit/loan granting. Another important aspect for respondents was interrelationship trust in terms of credit granting. Thus, interrelationship trust might be created through existence of an audited financial report, which may ease the process of lending credit or loan.

To summarize this section, the author thinks that if companies decide to neglect the auditing it possibly have effects on their legitimacy of the financial report, therefore the absence of auditing leads to lower assurance and legitimacy of financial reports. Rather, it can influence the judgment from banks as an extensive lender regarding the credit granting. From both theory and empery can be understood that audited financial reports considered as a legitimacy and assurance for banks decision- making and thereby it possibly make the process of credit assessment easier for banks.

The author's interpretation can be that banks relay more on audited financial reports

because it may sense more safe and secure through an audited financial reports than non-audited financial reports in order to grant credit/loan. However, obviously an independent audit minimizes the level of information uncertainty for bank and creates higher legitimacy and assurance. Thus, it simplifies the process of credit granting.

## **7.2 The reflections of author**

However, there are some additional reflections regarding the empirical findings of this study. Following, the additional observations will be considered respectively.

Accordingly, other factors are crucial for banks credit assessment process such as firms' business background, interrelationship trust between banks and clients. Further, banks consider the long-term relationship with clients who involve in an efficient and stable business, reliability, budget arrangement, future plan and benefit of the businesses. These factors are also important for banks regarding the credit assessment.

Furthermore, the position of bank regarding the new-started businesses was briefly discussed in almost all of the interviews. Some of the respondents mentioned that banks reject the new-started businesses immediately because of the lack of financial detailed and background information about the business activities. The position of banks was fairly unclear and unstable to either accept or reject these clients' applications for credit granting.

However, some respondents mentioned that it depends on the type of credit or loan these clients ask for. Rather, it might be a little subjective, and bank is going to look at earlier experience, competence and education of clients who drives of business activities.

Further, about entrepreneurs and their requirement of more money for financing in business activities, it was mentioned that the entrepreneurs do not need huge financing for machines and instruments they use. Rather, there are other alternatives to finance in such businesses. For instance, hire or secondhand purchasing that is more cost-efficient for capitalizing.

However, the respondents experience about small companies whether audited or non-audited was limited. Further, some of the respondents did not practice non-audited reports and they believed that reform has no benefit to small firms. The reason was that it is not cost-efficient for firms in contrast to a valuable job of auditing in case of needing credit or loan. Therefore, as it was mentioned frequently banks have great consideration to audited

financial reports regarding the credit granting.

Consequently, the result of this study might be limited to the numbers of considered banks and lack of the respondents' information and experience of small companies and non-audited financial reports regarding the credit assessment process. In addition, the early effect of new legislation is another obstacle that might be considered in this research.

Additionally, it should be considered that banks enable to catch daily information of business activities through Swedish Credit Information Agency (UC) and Swedish Tax Agency.

## **8. Recommendation for future work**

Due to the time restriction, the author could not investigate all of the interesting contexts in this study. Therefore, this study can suggest some of these themes for future research. At beginning of starting to research in this field, it has been planed to investigate the effects of abolition of mandatory audit from wider perspectives. It was planed to assess the abolition of mandatory audit from stakeholders such as suppliers, customers and owners as well. However, it would be interesting to investigate the impact of mandatory audit from these stakeholders' perspective. It would be quite motivating to see how these categories of stakeholders deal with this new legislation.

The next interesting theme that can be suggested is to explore this new legislation after some couple years again. As some of the respondents also mentioned, it may be still early to see the direct effect of the abolition of mandatory audit. Thus, it would be even interesting to see how banks experience this reform again after some years. It is motivating to understand if banks have the same position regarding the credit granting after couple of years or they consider other important factors to make the decision of credit granting.

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# Appendices

## Appendix 1

### Interview guide

The interview guide was designed to fit all the professionals interviewed; more time was however spent on certain topics depending on the interviewee's special competence. The aim was however to discuss all the issues presented in the guide, along with questions prepared beforehand. The themes however permitted for more open forms of interviewing, more semi-structured interviews, giving both us and the interviewee to focus on certain questions that seemed more interesting and also made way for further follow-up questions.

We will now examine the banks' point of view and perspective on how you are going around to lend money or provide credit to companies that do not have auditor and therefore no audited financial report.

1. The new legislation regarding abolition of mandatory audit for small limited companies were approved in November 2010. What was the bank reaction about it?
2. Do the existence of an auditor and the audited report mean as a quality for bank regarding the credit granting?
3. Do you have customers/clients who do not have the auditor nor audited report?
  - a) Is there any difference between the clients who have auditor and audited report with those who have not?
4. How is the difference if you will give them credit or loan? Is it important to you that clients come with the audited reports?
5. What has audit means for you, do you think that audited financial report create more reliability and credibility for you?
6. Has this law affected your business? What do you think of the new law?
7. Is it important to you that the borrowing companies have auditors and the audited financial report in order to obtain credit or loans?
8. Does it matter anything to you at all?
9. How is the banks reaction to the new started companies and entrepreneurs regarding the credit granting? Would the value of audit be important in such situation?
10. Would the long relationship between banks and clients affect the banks decision?

