LUNDS UNIVERSITET

School of Economics and Management

Department of Business

Spring 2013

Master thesis

Are K2 guidelines sufficient and credible for credit assessments?

Course: BUSN69 Degree Project – Master of Accounting and Auditing
Lund University - Sweden

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Date Of Submission: 2013-05-24

Abstract

Title: Are K2 guidelines sufficient and credible for credit assessments?

Seminar date: 2013-05-31

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Five key words: Credit assessment, Financial statements, K2 guidelines, Banks, Auditing

Purpose: To what degree do K2 guidelines affect the usefulness of the financial reports for banks making credit assessments for companies reporting according to K2.

Methodology: Throughout the completion of the thesis, a qualitative method has been used with interviews as a primary source. Additionally, a triangulation in the form of audit firms as expert interviews has been corroborated. The secondary sources used are articles, literature and information located on the Internet.

Theoretical perspectives: The use of theory in this study has not been to develop but to understand the phenomena of the usefulness of the reports to the banks. Therefore we have drawn from several theories and described the regulatory environment and literature review to try to explain and understand this phenomena.

Empirical foundation: The empirical foundation of this thesis is based on interviews with seven banks and four audit firms as expert interviews.

Conclusion: K2 guidelines do not affect the usefulness of the financial reports to any large extent, as there is much more information found outside of the regulation that is of importance to banks making credit assessments.

Acknowledgements

We would like to thank our supervisor Dr. Amanda Tan-Sonnerfeldt for all her support, guidance and encouragements throughout the process, and as well as our opponents in our seminars for the valuable comments.

Lund, Sweden, 2013

Ali Mansour Firouz

Sina Attaran

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Abbreviations

AA	Accounting Act	(Bokföringslagen)
AAA	The Annual Account Act	(Årsredovisningslagen)
ABL	Companies Act	(Aktiebolagslagen)
BFN	The Swedish Accounting Standards Board	(Bokföringsnämnden)
BFNAR	Accounting Board Guidelines	(Bokföringsnämndens Allmänna råd)
CRO	Companies Registration Office	(Bolagsverket)
GAAP	Generally Accepted Accounting Principles	(God redovisningssed)
IASB	International Accounting Standard Board	
IASC	International Accounting Standards Committee	
IFRS	International Financial Reporting Standards	
RFR	Council For Financial Reporting	(Rådet för Finansiell Rapportering)
RL	Auditor Act	(RevisorsLag)
RR	Swedish Financial Accounting Standards Council	(Redovisnings Rådet)
ÅR	Annual Report	(Årsredovisning)
ÅB	Annual Accounts	(Årsbokslut)

Chapter I Introduction

The introductory chapter presents a background to the thesis topic. Followed by a rationale of study leading up to the thesis problem. Finally a description of the purpose, research questions, scope of study and further disposition of the thesis will be presented.

1.1 Background

"*The publication of IFRS for SMEs is a major breakthrough for companies throughout the world. For the first time, SMEs will have a common high quality and internationally respected set of accounting requirements. We believe the benefits will be felt in both developed and emerging economies*" Sir David Tweedie, IASB Chairman (IFRS a, 2013)

In 2009 International Accounting Standards Board (IASB) published IFRS for SMEs, which was designed to be used by small and medium-sized entities (SMEs). This includes all entities that are not publicly traded and entities that are not banks or similar financial institutions (IAS, 2013). The *IFRS for SMEs* is standard, designed to meet the needs and capabilities of small and medium-sized entities (SMEs), which are estimated to account for over 95 per cent of all companies around the world (IFRS c, 2013). IASB, in order to establish a simplified and scaled down version of full-IFRS, primarily removed complementary information and events that are not particularly common in non-listed companies, and reduced its choices, basically employing much less complex principles than full-IFRS. Users of the financial statements of SMEs do not have the same requirements or those needs of full IFRS; rather, they are more focused on assessing shorter-term cash flows, liquidity and solvency. In addition, many SMEs say that full IFRSs impose a burden on them that has been growing as IFRSs have become more detailed and more countries have begun to use them (IFRS b, 2013). Practically speaking, IFRS for SMEs is viewed as an accounting framework for entities that are not of the size or have the resources to use full IFRS (AICPA, 2009).

IFRS for SMEs is a modified, simplified and cost beneficial version of Full IFRS created with the intent to aid private company financial reporting users and private companies in easing their burden of financial reporting. Although based on Full IFRS, IFRS for SMEs is self sufficient and self contained. It is published by the IASB, as is Full IFRS, and is applicable to the financial reporting of entities considered to be small and medium sized entities (IFRS b, 2013).

Considering the above, in 2004 almost every recommendation in the Swedish accounting standard board (BFN), Sweden's state's expert body in the accounting field, was working towards adopting international accounting standards for non-listed companies (BFN a, 2004). This work was also prepared by BFN due to the unnecessary complications found within Swedish accounting regulations such as the fact that Swedish accounting rules are divided into different categories; statements, recommendations and advice. Moreover, these different categories are further issued by different agencies, which complicates matters even further; therefore one important job for the BFN is to establish one single document, which includes all the principles and regulations (Månsson, 2008).

In 2004 BFN replied to the discussion paper entitled Preliminary Views on Accounting Standards for Small and Medium-sized Entities, which was released by the IASB. In its reply, BFN reaffirms the need for "common global accounting standards for unlisted entities" and voices its support for the IASB´s work on creating such standards, adding that these said standards should be independent with their own framework. Furthermore, BFN believes that the standards should be further simplified. However it must be noted that BFN does not believe that there is any requirement for harmonized accounting standards at a global level in the case of smaller entities. It advises that such harmonized standards should be applied only to relatively larger unlisted but active entities and not for relatively smaller entities. It should also be noted that even with harmonized accounting standards for such unlisted entities, BFN is of the opinion that each individual country should be allowed to decide which entities are to apply the standards (BFN b, 2004).

BFN started the simplification project for annual report and annual accounts for non-listed companies, the so-called K-project in 2004 (BFN, 2008). The K-project is divided into four categories and the companies are divided into categories based on size and legal forms. These are individual regulatory frameworks which consist of four separate categories, whereas the preliminary points are the rules of the Accounting Act under which the company is either guilty or in some cases may decide what project it wants to apply:

K1: Mainly private firms (turnover less than < 3M SEK)
K2: Small private companies (<50-40-80)[1]
K3: Larger companies (> 50-40-80)
K4: Listed companies implementing (BFN a, 2013)

Only K1 and K2 have been published, by the BFN, and it is voluntary for a company to apply if it does not want to abide by the existing regulatory framework, Accounting Board Guidelines, BFNAR or the Swedish Financial Accounting Standards Council, RR, recommendations 1-29. Listed companies must apply to the regulation IFRS, which is voluntary for unlisted companies (SOU 2008:67), Attachment 1. The K3- framework has also been published and may be applied if the company wishes to do so but for every fiscal year that begins after December 31, 2013, companies must apply the framework (BFN a, 2013).

A similar trend can be observed in mandatory audits and, as much as the Swedish state is trying to scale down the financial reporting for SMEs, Sweden is also trying to scale down the statutory audit as well. The statutory audit in Sweden comprise the profession to serve the public interest and according to IAASB the objective of the audit is to express opinion on financial statements, i.e. whether they are prepared in accordance with applicable standards (IFRS, for instance) and free from misstatements (IFAC, 2011). Auditing is used as a mean of evaluating the effectiveness of a company's internal controls. Maintaining an effective system of internal controls is vital for achieving a

[1] Described in Chapter 3; 3.4.2

company's business objectives to obtain reliable financial reporting on its operations, prevent fraud and misappropriation of its assets, and to minimize its cost of capital. The role of the auditor is to give reasonable assurance that the financial statements give a true and fair view so that investors can reasonably rely on the financial information to make healthy economic investment decisions (Soltani, 2007). Not all K2 companies undergo an audit since the statutory audit was exempted on November 1, 2010 in Sweden. 72 % of the companies are exempted from the statutory audit (Broberg, 2010). Private companies that meet at least two of the following criteria must continue to have a qualified accountant:

- More than 3 employees (in average)
- More than 1.5 million in total assets
- More than 3 million in sales (AAA, Chapter 9, § 1)

The same criteria must be fulfilled for two years in a row, which basically means that new companies would not be subject to the audit requirement for the first two years (Broberg, 2010).

1.2 Rationale of Study

Stakeholders represent "any group or individuals who can affect or is affected by the achievement of the organization's objectives" (Freeman, 1984). The financial information is used for assessing different situations and types of decisions, which varies the preferences, demand and usage for the financial information. Different stakeholders have different information needs depending on numerous factors such as type of company, branch, size and individuals within the same group (Smith, 2006). A stakeholder will require financial information to get an understanding of the performance of the organization and the financial reports are one of the key documents stakeholders needs. Financial records reveal the assets owned, amounts owed, amounts invested in the organization and profitability and are used to better manage the operations in the organization (Andersson, 2001). Creditors often require both historical information and future prognoses from the company (Graham, 2000).

Banks are the key stakeholders for small companies (Nair & Rittenberg, 1983) and the importance of the banks cannot be emphasized; nearly three-quarters of SMEs firms have bank loans (IASB, 2013). For this reason, and due to the importance of the banks as a leading financial institute and because of their powerful position as the key stakeholder for small companies, this study has been done from the perspective of the banks. In Europe there are 23 million SME-firms representing 98 percent of the total number of companies in Europe (European Commission, 2011). Financial statements can provide significant information about a company but they sometimes fail to give appropriate information to answer all the diverse questions that each stakeholder is concerned with (Ito & Kiyoki, 2013).

The financial system has played a large role in the design of the accounting principles and stakeholders such as financiers, and in particular banks, have influenced its design significantly (Swedish Banking Association a, 2013). It has long been globally recognized that SMEs require different reporting standards to meet the external needs of the users of the financial information. Regulators agree that IAS / IFRS is too complicated and restrictive; business events are difficult to apply in practice and they are therefore not appropriate for financial reporting for SMEs (IFRS d, 2013). Furthermore, current accounting rules have been perceived by many to be difficult to read, difficult to foresee, requiring a great deal of knowledge and in many cases rules have become unnecessarily complicated (Broberg, 2010).

BFN decided in February 2004 to change the focus of its efforts to develop rules for non-listed companies to create unvarying accounting policies in the country. This is a part of the process of harmonization (BFN a, 2004). BFN was commissioned by the government to create simplifications of the existing regulations and also to gather all regulatory frameworks into one place (SOU 2008:67). This became the starting point of the K-projects. The objective of the project was to draw up rules which would be simple, clear and comprehensive for the users to use. In addition, for the purpose of extra clarification, the rules and regulations were arranged rule-based and not principle based (BFN, 2012).

With regards to statutory audits of SMEs, Thorell and Norberg were commissioned by Swedish Industry in 2005 to determine if the usefulness of the audit for SMEs was sufficiently large enough to be justified (Swedish Industry, 2005). The report provoked debate in the media and discussions followed. This led to the elimination of the mandatory audit-duty for SMEs, on November 1, 2010, effectively excluding 70 % of stock companies in Sweden (SOU 2008:32).

1.3 Problem Statement

Financial statement analysis provides important information about a company's financial health. Creditors and investors demand that companies provide financial accounting information for two important economic reasons. The foremost purpose is to find where to allocate their funds. The second purpose is to be able to distinguish financial statements numbers to control and enforce the debt and at the same time establishes compensation contracts with the clients (Pratt, 2010). Two types of basic information's must be foregathered within credit assessments, namely, accounting and non-accounting factors (Andersson, 2001). The financial accounting reports are crucial in credit assessment (Coogan-Pushner & Bouteille, 2013), since accounting is "the process of identifying, measuring and communicating economic information to permit informed judgments and decisions by users of the information"[2]. Creditors have great concerns for the company's economic situations such as profits, costs, assets and liabilities (Coogan-Pushner & Bouteille, 2013). Consequently, the financial report becomes extremely important for making judgments about the creditworthiness of entities (Glantz and Mun, 2011).

According to the IFRS framework, accounting statements should be useful to users and should have four qualitative characteristics: understandability, relevance, reliability and comparability (IASB, 2009). Financial Reporting Council (FRC), states ''*The whole essence of standards is to provide for recognition, measurement, presentation and disclosure for specific aspects of financial reporting in a way that reflects economic*

[2] American Accounting Association, A statement of Basic Accounting Theory: American Accounting Association 1966 p1

reality and hence that provides a true and fair view''. In addition they add, ''*Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due*'' (FRC, 2011).

The new K2 framework contains a couple of differences when compared to the old rules. For instance, the company is not allowed to capitalize the costs of generated internally research and development (Engström, 2009) and the company is not allowed to use fair value to reevaluate financial assets and it is not a requirement for the company to defer revenues and costs that are less that 5000 SEK (Engström, 2010).

One of the banks most important documents for lending decisions is the corporate financial report (Coogan-Pushner & Bouteille, 2013). The simplified financial statements in the K2-framework means that the information in the financial statements in K2 has been reduced and the reflection of the company's accounts are limited. By this, the rules become easier to grasp and apply. This involves some shortcomings since the company may not apply alternative accounting standards, such as, function-based income statement and internally generated intangible assets, which may not be recognized as an asset (Månsson & Ohlson, 2008). Furthermore BFN has also decided to remove what was prescribed in EC's Fourth Company Law Directive, that the annual report should give "a true and fair view ' in the K2-framework (Engström, 2010). Based on the differences arising from the report under the simplified rules, the banks may meet difficulties in credit assessment since the information banks receive from the company's financial reports is, to some extent, limited by the establishment of K2.

Auditors identify risks that can have a significant impact on the financial accounting and they pay attention to the market condition, company's transactions, accounting system and the company's internal control system and managers' behaviors. Auditors provide a reasonable assurance that financial statements are free from material misstatements (Skalak et al, 2011). As a result, auditors play a significant role in presenting the financial reports in a true and fair view so that users can be confident about the financial reports (Plessis et al, 2005). The negative effects of eliminating the statutory audit in Sweden are

difficult to measure (SOU 2008:32) and all books suggest a new perspective of looking at this subject. Instead of looking at it in terms of the audit being eliminated, the debate in Sweden has been how to implement the new rules in a proper way (Ahlberg & Collin & Lazarewska,2011).

There have been many articles written regarding this subject. However, most of the research conducted so far has dealt with the question of what information the banks require in order to make credit assessments and determine credit worthiness. This particular study looks to approach the subject from a different point of view. Here, the focus is on the information provided in credit assessments and the study will attempt to determine if the given information in the financial reports is truly sufficient for the banks. BFN is still working on the K-projects, which will be finalized and released in 2014. During this work, significant changes are being made (BFN a, 2013). This uncertainty in the K-project gives companies differing guidelines to follow in making their financial reports, thereby affecting the banks credit decisions. This information-change is a constant condition that banks have to deal with and try to cope with.

Research regarding the exempted statutory audit in credit assessment has been carried out prior to and after November 1, 2010 (date of exemption). In the case of the research done the year before the date of the exemption, the future was unknown at the time of research. In the case of the research done after the exemption of the statutory audit, the exemption will only have been in effect for lesser than three years after the research. Therefore considering the time lag the circumstances around the change need to be updated and researched again.

1.4 Purpose Of Study

With reference to the above discussion the purpose of this study is to analyze to what degree the K2 guidelines will affect the usefulness of the financial reports for banks making credit assessments for companies reporting according to K2.

1.5 Research Questions

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

1) To what extent do banks perceive the financial statements of companies reporting according to the K2 guidelines to be sufficient for credit assessments?

2) How do banks perceive the credibility of unaudited reports for K2 companies that are exempted from the audit?

1.6 Scope of Study

This study deals with an evolving and comprehensive area and so boundaries are motivated to fit into the study's scope and timeframe. Since the interest of the study lies in the reporting requirements treating K2 - framework, we have excluded the other frameworks K1, K3 and K4. The companies chosen in this study are only those classified as minors in the AAA because they are the only ones able to choose K2 or K3 (optional for K2). The K2 regulatory framework for small economic associations has not been examined in this thesis, only K2 applicable for small private companies have been the main focus. The K2 framework is also very extensive. Therefore, it is important to focus on the most important parts relating to banks and credit assessment and the most significant differences between current and the K2-framework. Only theories will be drawed that will contribute to understand the usefulness of the reports to the banks, so restrictions have also been made in the theories, where only relevant material has been used.

1.7 Further Disposition of the Thesis

Method: In the chapter, the study is further described and the approach, design and research strategy of the study is justified. The selection process of interview respondents and interview questions are also described in detail. At the end of the chapter a discussion will be presented on the thesis; Validity, reliability and source criticism.

Regulatory Environment: This chapter describes the regulatory environment, which has been used for the report. Swedish accounting regulations have been particularly presented.

Theory & Literature Review: This chapter describes relevant theory and literature review used for the report, which we have linked to our problem area.

Presentation of Findings: Presentation of Findings: This chapter describes the information that the interview respondents gave. Seven banks and four accountants were interviewed. We have divided the answers in this chapter between two research questions, related to the purpose of the thesis, to help the reader get a better view of the interviewee's responses.

Research results and discussion: This chapter provides an analysis of the empirical data collection where the starting point is the theoretical framework that forms the basis for the next chapter.

Conclusions: This chapter describes the basis of the analysis chapter where the purpose of the study is answered and suggestions for further research are made.

Chapter II Method

This chapter will begin by presenting the choice of method, the research approach and design. Finally, the chapter presents the approach of the study, which intends to respond to the reliability and validity of the survey.

2.1 Introduction

This chapter will describe how this research has been conducted and the chosen method for our thesis. The chapter contains research approach, research design, choice of respondents, interview questions, analyses of data and selection of literature. Finally, the quality of the study will be presented.

2.2 Qualitative Method

In order to reach new levels knowledge and to be able to solve various problems different methods, which are considered to be the researchers tool when trying to achieve his objective in his research, must be employed. There are two social science theories; the quantitative and the qualitative method (Holme & Solvang, 1997). These theories are distinguished apart by the fact that one method uses data in the form of numerical values. In the quantitative method, researchers focus on statistical processing methods and analytical methods, where data collection is done by the use of questionnaires and by arranging the analysis with graphs and statistics (Bryman & Bell, 2005).

The choice of the approach that will be used in this research is affected by the research questions and the purpose of study. To recapitulate what was said earlier, the purpose of our study is to: *analyze to what degree the K2 guidelines will affect the usefulness of the financial reports for banks making credit assessments for companies reporting according to K2.* Therefore the method used is based on which of them is best suited to provide relevant answers to our research questions. The quantitative research provides results in the form of numbers, concretely specified amounts, as well as, occasions (when and how

often), responses such as gender, age, education and other things that are possible to count on, i.e. factors we can easily quantify. Quantitative studies can be done via surveys, questionnaires, experiments and strict interviews designed by the researcher to acquire his answers (where the answers should be brief and as concise as “yes”, “no”, “never”, “sometimes”, “often”, “at home”, “at work” etc.). The researcher therefore has a clear picture of what he wants to explore and has already pre-structured his research method based on the current theories (Bryman & Bell, 2005).

The qualitative method investigates things that are not measurable; it is about finding peculiar and unique characteristics and it delves more in depth compared to quantitative research. The Qualitative method aims to address the “how” and “why” rather than the “how many” which makes this research method appropriate for the purpose of this study. This method is an observational study requiring interpretation of texts or interviews with individuals and focus groups. In these interviews, the discussion is open and focused on the participant's opinions, experiences, feelings, attitudes, memories, etc., during the work process new theories are developed. (ibid).

Both the study of the regulatory framework and the in-depth interviews were conducted with a qualitative approach. The purpose is to study *to what degree the K2 guidelines will affect the usefulness of the financial reports for banks making credit assessments for companies reporting according to K2.* It impossible to get a measurable answer to this question, verifying that this is a qualitative study. The study aims to explore and find the Patterns in the current and the K2 regulatory framework as well as common patterns in the banks. The theories are used to help to better understand the phenomena and get a deeper understanding of the subject. The collection of data, interpretations, analysis should generate a clearer picture of how a particular type of examined people experience their situation from a given context.

2.3 Research Approach

The method includes the inductive approach to the relationship between theory and practice, which basically means the method will tend to use unstructured methods of data collection to fully explore the topic. Theories are generated on the basis of the collected data (Bryman & Bell, 2005). There are three approaches scientists use to generate knowledge about reality and relate it to the theories. These are deduction, induction and abduction. Deduction, also called the top-down approach, requires the researcher to draw conclusions of the knowledge substance about individual events based on principles and theories. Induction, the bottom-up approach, moves from specific observations to broader generalizations and theories, meaning that the collected information expresses the theory. Abduction is a mixture of deduction and induction (ibid). Since both theories are used along with the interviews to fulfill the purpose of our study the abduction method became the most relevant approach. From theory to empirical theory and vice versa has been an experienced journey during the writing of this thesis. The researchers began the essay from a deductive methodology in terms of the Swedish Accounting Board K-regulations and statutory text to present difficulties in current reporting in the chosen field of study, banks credit assessment. After conducted interviews chapter four was scrutinized in-depth to expand the understanding and explored new means of tackling difficulties.

2.4 The Research Design

The study design is a framework aimed to collect and analyze data. This framework is based on a structure that governs, guides and analyses the data and information originated from the study. The most common forms of research design are experimental design, longitudinal design, comparative design, cross-sectional or survey design and case study design (Bryman & Bell, 2005). We have used the case-study design, which means a thorough or detailed examination of a specific case. This specific case refers to an individual, community group organization or group. This type of study design deals with the complexity of research study and reveals the specific nature of the case (ibid).

The subject of our paper is a case study of how the standards will contribute to the usefulness of the reports when banks make credit assessments for K2 companies. For a

complementary picture of the essay choice the authors set the questions of, "how" and " why" to further reflect the gathered information.

2.4.1 Data Collection

2.4.1.1 Primary Data

Primary data is the data that is collected in order to meet the thesis aim and purpose. The primary data consists of semi-structured interviews with both banks and accounting firms. This data is to be considered as new data where the information can also be used as secondary data and later be used in other studies. Later, however, the data can be used as secondary data for subsequent studies. In this study personal interviews are used to collect empirical data to further form the basis of the analysis.

Interviews were chosen as the method to use in order to find out the different opinions of the banks on the financial information sufficiency when making credit assessments for K2 companies. Therefore the first research question is, *To what extent do banks perceive the financial reports of companies reporting according to the K2 guidelines to be sufficient for credit assessments?* The same question was then asked without the input of an auditor. We considered the auditor's opinion to be of great importance due to their experience and insight into the regulatory framework and the K projects since banks do not have the same knowledge and expertise of these regulations. In addition, the banks have interaction with both the corporate' auditors and public accountants. Discussions are being made with the corporate auditors about questions relating to the company's finances of which the banks find unclear or incomprehensible because the business owner usually lacks that knowledge. The public accountants are engaged when financial counseling is needed, as when financial information is difficult to interpret or incomprehensible, and to keep up-to-date changes that occurs in the regulations. Victor, SEB, says that meetings with auditors usually are made for educational purposes since they are considered experts in the accounting field. Victor also informed us that "a while ago" a meeting was adjourned with public accountants, who informed about the K-projects and in particular the K2 project. Furthermore, to get a loan granted, when the banks find any information to be inadequate or insufficient, the customer is requested to

bring additional financial or non-financial information. Regarding financial information, the client will most likely contact his accountant to obtain the additional information that the banks demand. This obtained additional information is of great importance to get a deeper understanding and insight into what the banks are looking for within the financial information when companies are being credit assessed. Therefore our second research question is, *how do banks perceive the credibility of unaudited reports for K2 companies that are exempted from the audit?*

2.4.1.2 Secondary Data

In this study, official and electronic documents formed the core of the collected data. Secondary data is data that has been collected by other studies and other researches. Our secondary data is gleaned mainly from books, academic articles, university's database and previous studies that are relevant to our study. During the writing of the thesis, the search for literature was a constant procedure. We began by studying the K – regulations and in particular K2: s framework because of the fact that most SMEs companies in Sweden are under its influence. The EU and the Swedish accounting regulations as well as BFN were then studied for further understanding and in-depth knowledge of the purpose of the K-projects. Further information was pursued within the literature and the BFN, which is responsible for the publication of the K – regulations. Additional essential information was located on the Internet, annual reports, and business related magazines such as Balans, previous thesis papers and articles from Lund and Malmo University databases.

To obtain current information about the K-projects, the Internet was used diligently because the K-projects are still under construction. BFNAR and the BFN latest guidance and annual reports were also retrieved electronically to obtain the latest versions. When using electronic sources, one always faces a risk in the credibility factor of the information and the uncertainty of the references on the Internet pages. However, one feels that the sources used can be trusted because the information provided came from respected and knowledgeable bodies in the accounting field. Misguided or wrong information on these pages would most likely have been eliminated instantly.

2.5 Choice of Respondents

Table 2.1

	Interviewee	Position	Experience	How	Location	When	Duration
Banks							
Färs & Frosta	Emanuel Eriksson	Office manager	10 years	Personal Interview	Lund	18-04-2013	55 min
Swedbank	Håkan Lehmark	Credit manager	26 years	Personal Interview	Malmö	22-04-2013	60 min
Handelsbanken	Ulf Larsson	Office manager	25 years	Personal Interview	Malmö	02-05-2013	50 min
Nordea	Magnus Liljenberg	Credit manager	28 years	Personal Interview	Malmö	06-05-2013	55 min
SEB	Vitor Afonso	Office Credit manager	27 years	Personal Interview	Lund	07-05-2013	60 min
Sparbanken Öresund	Stefan Ögell	Office manager	28 years	Personal Interview	Malmö	08-05-2013	75 min
Länsförsäkringar	Filip Åkesson	Credit manager	17 years	Personal Interview	Malmö	10-05-2013	65 min
Auditors							
Mazars	Sonny Malmquist	Authorized Auditor	19 year	Personal Interview	Malmö	10-04-2013	55 min
Grant Thornton	Christoffer Hultén	Authorized Auditor	24 year	Personal Interview	Malmö	15-04-2013	50 min
KPMG	Eva M. Henriksson	Authorized Auditor	28 year	Personal Interview	Malmö	22-04-2013	45 min
Ernst & Young	Anders Mårdell	Authorized Auditor	28 year	Personal Interview	Lund	25-04-2013	60 min

The focus of our study is on the creditors. Therefore interviews were conducted with the four largest banks in Sweden (Swedish Banking Association (b), 2013) and regional banks: Färs & Frosta, Swedbank, Handelsbanken, Nordea, SEB, SparbankenÖresund and Länsförsäkringar.

The largest banks were chosen since they are the largest creditors on the Swedish market providing credit to small companies. Four of the largest banks were chosen and three smaller regional banks were also chosen, mainly by their location. The geographical delimitation was the reason we conducting personal interviews. The advantage of respondents being locally based is that it creates a closer and better contact with the respondents and one is able to add questions and also ask again any interview question for further clarification. Different sizes, small and big, of banks were chosen specifically

to get an interesting and varying spread amongst the interviewees and to increase reliability. A loan decision involves information gathering and analysis, which requires a skilled staff involved in credit-decisions. It is this staff of people that we had intended to come into contact with.

We have interviewed seven banks and four audit firms. Seven banks and four auditors were interviewed personally. A couple of days before the appointments, the questions were sent in advance so that preparation could be done. In order to gain high quality information, the respondents at the banks were experienced office managers who work with credit assessments and credit granting for numerous years.

2.6 Interview Questions

As mentioned above, personal interviews was conducted with banks and audit firms in the Öresund region: Malmö and Lund. The questions asked in the interview were semi-structured, which means the framework is conducted quite openly; conversational and two-way communication, which gives the respondent the opportunity to respond from different perspectives. Open questions also let the person decide what is important to address and so they can articulate their message based on their own experience. The authors also asked follow-up questions openly during the interviews and the respondents were helpful in this aspect, encouraging follow up questioning during the interview.

The interview respondents were contacted by e-mail and phone and the time/date for the interview was decided upon. For practical reasons the interview took place at the respondents' office and the duration of the personal interviews was between 45 to 75 minutes. All interviews were recorded in order to increase the reliability of the empirical data and to be able to review and process the information at a later time.

Table 2.2

Research Questions

1) To what extent do banks perceive the financial reports of companies reporting according to the K2 guidelines to be sufficient for credit assessments?

Credit Assessment Information **Q1 - Q3**

- From the reports: Balance sheet, Loss and profit statement, Cash Flow, Other Information

Sufficient Accounting Information **Q4 - Q9**

- From the reports: Balance sheet, loss and profit statement, Cash Flow, Other Information

The Quality and The Design of The Reports **Q10 - Q14**

- Comparability, Relevance, Fair and True-view

Information banks wish to add to the financial statements **Q15 - Q16**

- Added information: Important factors

2) How do banks perceive the credibility of unaudited reports for K2 companies that are exempted from the audit?

Credit Assessment Process: Information required, Reliability & Quality of the reports **Q17 - Q21**

The first question was divided into four parts (table 2.2). The first part, Credit assessment information, involved questions such as, how the bank works when a company applies for a credit with them, their workflow, specific methods or analysis that are standardized routines in credit assessment, and finally, which items in the financial statements are important / unimportant to the bank and how these items are used in the form of ratios and cash flow analysis. With these questions, we wanted to find out if they use certain parts of the annual report more than other parts. In this way, one is able to reflect towards K2 and see if the regulatory simplifications can provide implications for lending decision. In the second part (Sufficient accounting information), we ask whether the financial information is sufficient for credit assessment decision or not. Even the non-financial information that is required for a credit was questioned. The purpose of these questions

was to try to determine what type of financial and non-financial information the Bank requires the company provides to the bank when seeking credit.

The questions in the third part (The Quality and the Design of the reports) asked how banks perceive the format of the financial data, its quality, comparability and true and fair-view. These questions were asked to get a better picture of how the bank experienced the financial information in general and to get a deeper understanding on how they view and experience the reports.

In the fourth part (Information banks wish to add to the financial statements), questions were asked about the information that the banks would like to add in the reports and the simplifications in the report that have been of importance for the banks. These questions were asked in order to hear the bank's opinion regarding smaller company financial statements relevance and usefulness in decision making, and to find out what banks demand from a smaller company's annual report.

In the second research question, banks were asked how they implement a credit assessment now that the statutory audit has been exempted. These questions were asked to better understand the role of the auditor for both the banks and the company's financial information. In particular, we wanted to research the banks opinions and insight regarding this very interesting issue of exempted statutory audit**.**

2.7 Analyses of Data

Data was collected in Chapter five, which was initiated immediately after every interview to create an assembly. Notes and recordings were carried out during the interview to establish this assembly. The questions that were asked to implement this assembly were written according to our research questions and purpose of the essay. This assembly was also carried out in order to structure and to ensure that the necessary information had been collected. If ambiguities were discovered or if insufficient information had been collected, we were able to re-contact our responders for clarification. In the assembly, differences and similarities in the banks' responses were compared. This was then

compiled into Chapter five. These responses were then linked to Chapter 3 to achieve greater consistency in the thesis. Chapter 4 has been very important for this study where the theories and literature reviews have been linked to both empirical data and analysis for a deeper analysis and understanding.

2.8 The Study's Quality

2.8.1 Validity

Validity is an assessment of whether the conclusions of the study are related or not (Bryman & Bell, 2005). Validity is divided into concept-, internal-, external- and ecological validity. Concept validity, also called theoretical validity, applies to quantitative researchers and concerns correlation between the theoretical concept and how it has been put into operation. Internal validity concerns issues of causality; whether its conclusion is sustainable or not, in a relationship of causality between two or more variables (ibid). Variables are "a characteristic or attribute that varies in terms of different 'cases'" (ibid. p.49). External validity indicates the extent to which one can generalize the results obtained in a study to other groups or situations. How individuals and organizations have been selected to participate in the survey is a critical element in the external validity. Ecological validity is about how results, that are social science, really can be applied in our daily lives and social environment.

Interview respondents were well versed in the subject as could be emphasized by their title and knowledge in the field. The interview respondents were credit managers and local bank office managers with at least 20 years of experience in banking. The respondents were also very helpful during and after the interview providing us with extra information. To increase the validity of the study we tried to modify the interview questions in the clearest possible manner and also reword and add one question. This question did not have any impact on the result, as this question was not used in our study. For accurate information, sources such as BFN´s and IASB´s, were searched on the Internet for higher validity. This approach was preferred to other sources and explanations where their subjectivity could have influenced their answers. To increase

validity further, a clear understanding of the subject matter was investigated so that information would not be taken out of context leading to misleading results.

2.8.2 Reliability

Reliability means that if the study had been carried out again, the result would be the same and reliability becomes relevant when making quantitative studies. Three main dimensions are involved in reliability: Stability, Internal reliability and inter-rater reliability. Stability asks us to question if the measure over time is stable; if a group of respondents are interviewed twice successively, the results should not differ remarkably. The Internal reliability questions if the indicators that make up a scale are reliable and can be followed in a proper manner. Inter-rater reliability refers to subjective judgments; the result should be the same regardless of who performs the test (Bryman & Bell, 2005).

Our research is based on qualitative research. Since qualitative study is based on interpretations, our respondents spoke freely during the interview. Therefore, we cannot expect the same exact answers when repeating the study. Nevertheless, we believe the empirical content should be the same if the same issues were raised. Another factor that may affect reliability could be the respondents themselves because if another respondent was to answer our questions, his own experiences and values may give rise to different answers. Another very important factor to reliability is the constant changes in the regulations within and outside Sweden's borders, which could contradict or give different results if the study was repeated again. Even the banks' criteria for credit assessment or certain government regulations that are sometimes imposed on the banking-industry might change the way banks, act or treat certain issues, and these might be reflected in a study if the same study was repeated again.

Triangulation means that the researchers take different perspectives on issues that they are studying or different perspectives in answering their research questions. Triangulation should also produce new knowledge on different levels and contribute to the quality in the research (Flick, 2011). "The use of expert interviews is an qualitative method for the reconstruction of complex experiences and is used when the research interest has a focus on decision maxims, experiential knowledge, rules for action routines and knowledge

relying on systematic problems, which can be mentioned explicitly or implicitly" (Flandorfer & Wegner, 2011). Triangulation allows us to access new data through qualitative methods. We have attempted to find corroborated evidence to improve the reliability of the study through expert interviews and to raise issues banks don't talk about. In an effort to make the study more reliable, talks were held with four experts from different accounting firms who were interviewed in Lund and Malmö. The majority of them showed work experience of 20 years and more, and the experts were authorized auditors.

2.8.3 Limitations of research design

Primary Data

The reliability of the respondents in the empirical chapter is to be considered highly because the respondents were very well versed in the subject. The respondents had managerial positions or were responsible in the area of dealing with credit assessment. Additionally, all the respondents had a master's degree in business and had worked for many years with credit assessment on the corporate side. We were also aware that the respondents would produce some kind of distortion in favor of their companies as well as they don't want to exceed the banking-secrecy.

Secondary Data

The secondary data used primarily in our study is the K2 framework, which is based on law and therefore examined by several instances before published and so, the study creates good grounds for reliability. Sources like BFN or Balans are written by skilled and experienced authors active in the accounting field. These papers have been published and therefore examined on numerous instances, thus increasing the trustworthiness of the publications. The second chapter of Bryham and Bells' 2005 book, "Corporate financial research methods" has been used frequently. For the theory section we used scientific articles published by universities and faculties of other researchers worldwide. These published scientific articles were located on the Internet and on the Lund & Malmö University Databases. The Scientific articles chosen were carefully selected and different

authors were used, instead of putting all emphasis on what only one author had written, to prove our arguments.

Chapter III Regulatory Environment

This chapter will present the regulatory environment with a focus on the Swedish accounting regulation environment. We will present the Swedish Accounting Regulation, Regulation Framework, BFN, The K-projects, Supplementary Information, Credit Assessment, Financial Accounting Information, Non- Financial Information and Auditing In Sweden is described in detail.

3.1 Swedish Accounting Regulation

The continental accounting tradition has influenced the Swedish accounting regulation by the assets being carefully evaluated. The accounting regulation has through this been subjected to two important basic principles:

- Realization Principle: Profits only get recognized when realized
- Precautionary Principle: Accounts must be taken for expected losses

The Swedish regulation aims to protect the creditor and the carefully measured balance report will contain a "buffer", meaning that the company's financial position is at least as good as reported, but in many cases better (Engström, 2009). The Swedish statutory regulations are contained in the Accounting Act, AAA, and the Companies Act, ABL. BFN is the state's expert body in the accounting field and is responsible for developing and promoting GAAP, which is expressed by giving out general guidelines for the application on accounting (BFN b, 2011).

Additionally, Chapter 8:1 in the law of 'Banking and Financing states:

"*Before a credit institution decides to grant a loan they must assess the risk that the obligations under the credit agreement cannot be fulfilled. The institution may grant credit only if the obligations may be reasonably expected to be completed* "(Law 2004:297, Chapter 8. § 1). Laws and regulations regulate the financial operations and in addition the Swedish Financial Supervisory Authority (Finansinspektionen) gives out additional rules in form of regulations and guidelines.

3.2 Regulation Framework

In accordance with the Swedish AAA and ABL, companies shall establish and provide its stakeholders with financial information (FAR SRS, 2012). Therefore, Swedish companies are obliged to prepare an annual report, which shall provide information about the company's activities and operations (Marton et al, 2008). Currently, non-listed companies required to maintain accounts can either choose to comply with the entirety of the Swedish Financial Accounting Standards Council (RR) recommendations, or BFNs standards, and acquire guidance in the RRs standards unless they have been adapted by BFN (BFN b, 2013). The RR recommendations, which is known as the Council For Financial Reporting (RFR), ceased in 2005, which is why their recommendations are no longer updated. This was followed by a decision by EU, that listed companies no longer will apply RR in its consolidated financial statements but instead need to use IFRS (BFN c, 2013).

3.3 The Swedish Accounting Standard Board, BFN

BFN is a government agency under the Ministry of Finance (BFN, 2012). BFN was established in connection with the introduction of the 1976 Accounting Act (BFL) (SOU 2008:80). The Board consists of eleven members appointed by the government who represent various areas of interest such as Entrepreneurial Association (Företagar Förbundet), Tax Department, FAR SRS, the Swedish Ministry of Finance and the Confederation of Swedish Enterprise (BFN b, 2011).

Important tasks the board are responsible for are assisting the Government offices in accounting matters, participating in investigations committee systems, communicating norms, and giving guidance in courts on what is generally accepted accounting principles (GAAP) (BFN, 2012). BFN are also responsible for the development of GAAP in corporate accounting and public accounting. This is used as a supplement to the law in difficult areas where detailed rules are needed, both in AAA and the BFL. Additionally, BFN work also consists of ensuring that the regulations are simple and adapted to users need (BFN a, 2013). BFN does not have regulatory power, which makes their standards not legally binding, but GAAP shall be written and followed according to the AAA and the BFL. This is expressed through the BFNAR, but in rare cases the law allows for interpretations deviating from the law, if information and reasons of these deviations are provided and explained (FAR SRS, 2012).

3.4 K-projects

3.4.1 History of the project

IASB started deliberations on the project in 2003 after it was forwarded from the former International Accounting Standards Committee agenda, IASC (IFRS e, 2013). It developed because the IFRS was developed for listed companies whose financial reports focus foremost on investors; while small companies are more focused on short-term goals in terms of cash flows, liquidity and solvency. Furthermore, small companies have different user needs and considerations regarding costs (IFRS b, 2013). Most countries in Europe have developed their own set of rules for SME firms and therefore the IASB wants to establish a unified regulatory framework based on principles of full IFRS so future transitions will be performed smoothly (Evans et al.2005). Arguments for a separate regulatory framework for SMEs vs. large companies are many but foremost to reduce the burden on companies and maintain more balanced costs. A more important argument for establishing separate framework is the need for universal regulation, like the IASBs harmonization work in EU, comparability and reliability. Other concerns might appear such as threats from large companies wanting to use the same framework,

the fear of making small companies to “second class citizen” or the risk of a divided accounting profession (Evans et al. 2005).

In Sweden, the government decided in 2007 that a special investigator should be appointed to consider the simplification of accounting rules. The aim of the project was to simplify the rules in order to reduce administrative burdens for the small companies and to create good conditions for the enterprises. This simplification was set up to put special emphasis on SMEs enterprises and follows the EU directives, which states that certain questions must be raised such as EU Directives on accounting, financial statements disclosures, rules regarding the annual accounts and financial analysis (SOU 2008:67).

3.4.2 Delimitation between small and large companies

PE stands for the English concept of Private Entities and is according to Swedish translation private companies. PE firms are according to IASB's definition:

a) Do not have public exposure
b) Do not intend to publish financial statements for external users at first hand (IASB a, 2007)

Each country decides themselves which of the unlisted companies that must adopt IFRS for PEs (IASB b, 2007). The introduction of the new limits introduced in Sweden was defined as, 50-25-50 rule, but since 2010 has changed to 50-40-80 rule:
A company that meets more than one of the following three conditions are considered major and must be registered in the trade register:

a) The average number of employees in the company during each of the last two fiscal years amounted to more than 50;
b) The Company reported total assets for each of the two financial years amounted to more than 40 million, or

c) The company has reported net sales for each of the two financial years amounted to more than 80 million.
d) A small business is a business that is not defined as large (AAA Chapter 1:3).

3.4.3 K1-K4

BFN started the simplification project for annual report and annual accounts for non-listed companies, the so-called K-project, in 2004 (BFN, 2008). This was decided after BFN decided not to continue its adaptation of the recommendations of the council to the corresponding rules for unlisted companies. K-project involves four categories of collected frameworks, K1-K4, which shall be developed for businesses of all types and sizes. The new regulatory framework follows the rules under AA (1999:1070), which explains how the fiscal year shall be terminated. The different categories of regulations are as follows:

- **K1** - Individual traders, establishing simplified accounts. Applicable for individual traders making simplified accounts. K1 became effective 2007 - BFNAR 2006:1.
- **K1** – Non profit-making associations: regulatory framework for non-profit-making associations and religious groups, which establish simplified accounts - BFNAR 2010:1.
- **K2** - Small companies: Applicable for smaller private companies who prepare financial statements, annual report for smaller companies. K2- became effective December 31, 2008 - BFNAR 2008:1
- **K2** – Small economic associations: regulatory framework for annual reports in small economic associations - BFNAR 2009:1
- **K3** - The main framework for compiling the annual report: The starting point of the K3 is IFRS for SME: s. The rules are the main alternative when annual accounts are prepared in non-listed companies and the framework shall apply to fiscal years beginning after December 31, 2013 but may be applied earlier if the company decides so - BFNAR 2012:1
- **K4** –Large Companies: prepare consolidated accounts in accordance with IAS / IFRS. BFN has not yet taken a position on how a possible framework for this category of companies will look (BFN a, 2013).

The state have appointed two investigations, after BFN simplification project:
The relationship between accounting and taxation, and simpler accounting. The changes in the tax and accounting rules will eventually leads to results, which K2 and K3 will have to adapt accordingly. Current standards will not be lifted until the essential elements of the new legislation have entered into force, and K2 and K3 are aligned (BFN, 2008). The close relationship between accounting and tax has been the preliminary point for the states investigation on the relationship between accounting and taxation. The states' proposal mean, particularly that the tangible link between accounting and taxation shall be eliminated. They impose rules on the taxation time, using the statement, which according to the investigation instead should be determined by the rules of the Income Tax Act (Regeringskansliet, 2008).

Only K1 and K2 have been published and is free to apply if a company doesn't want to apply the existing regulatory framework, BFNAR or RR 1-29. The K3 project is still not finalized but once entered, the project will also be a voluntary choice. After all the states investigations are completed and accounting legislation adopted by the parliament, K2 and K3 will be based on these changes (BFN, 2008). Accounting Board Guidelines is called BFNAR 2012:1 and it's the main framework for all companies preparing annual accounts and consolidated financial statements in the AAA. BFNAR does not include the companies preparing their consolidated accounts in accordance with IFRS or have voluntarily chosen to do so. BFNAR may be applied now but K3 will be applied to the financial statements and consolidated financial statements issued for fiscal years beginning after December 31, 2013 and may be applied to financial years beginning before (BFNAR 2012:1).

3.4.4 K2

BFN decided 2008 to issue a general council for compiling the annual report in smaller companies, BFN's General Advice (BFNAR 2012:1), and general guidance, Annual Report in small companies. K2 is linked to the provisions of the AAA and the AA and must therefore be read together with the linked provisions in these for complete

comprehensibility. The purpose of the K2 and its rules are that it should be easy to use and apply, so therefore the K2 rules are standardized and requirements for professional judgment and estimation are lower than large companies (Broberg, 2010).

Creating simplification is an important aim for K2 and an important basis for the BFN has been that the rules should be based on the user needs and perspectives. Consequently, it is not the same as the starting point for IFRS. In practice simplifications made should be implemented first and foremost for the companies that prepare the report. Simplifications implemented to assist the reader are:

1 The rules are presented in a single document
2 Limit the number of allowable options
3 Simplifying and clarifying the individual rules
4 Less supplementary information
5 Clear materiality rules
6 Linguistic and pedagogical simplifications (Månsson & Ohlson, 2008)

When applying the K2 framework for the first time, regulations should be used prospectively; business events that occur after the date on which the company will apply these rules. Therefore there is no need to recalculate previous year's comparative figures (BFN b, 2011). The framework of K2 is divided into K2 Annual Report (ÅR) and K2 Annual accounts (ÅB). K2 ÅR is a voluntary framework for small businesses and one can choose to apply K2 instead of applying the broader K3 regulations. Norms for the ÅB is available in K2 ÅB, which shall conclude its financial year with an ÅB (Olsson & Wedin, 2008). The rules regarding the K2 framework are based on:

- The Precautionary Principle.
- Valued at acquisition value.
- Clear materiality rules
- Simplifications: All the rules are in one framework & fewer opportunities.
- Simplifications: Linguistic and Pedagogical (Broberg, 2010 p.53-54).

Companies authorized to apply K2- framework are companies which meets the AAAs requirements for small businesses, therefore they may not be registered as a public company, or be a parent of a larger group. If K2 is chosen, rules shall be considered as a whole and may not extend the framework. Because the K2 only regulates financial statements, a company that chooses K2 also follows BFNs norms on bookkeeping and filing (Olsson & Wedin, 2008).

When K2 regulatory framework is chosen one must apply all the rules of the council and rules should be seen in its entirety (BFNAR 2012:1 *1,4*) and applied together with the RR recommendations. If a question is not regulated in the council, one should first seek guidance in the BFNAR that governs related transactions, events and conditions (BFNAR 2012:1 *1.5a*). Secondly, one should seek guidance in the fundamental principles of AAA (BFN b, 2013). If the guidance is still not helpful, one may go to the international accounting standards referred to in the European Parliament and Council Regulation (EC) No 1606/2002 of 19 July 2002 on the application of international accounting standards. In that case one must use RFRs recommendations (BFNAR 2012:1 *1.5*).

Only a cost-based income statement is allowed in K2 because a function-based income statement would have set higher requirement on the financial reports and become more extensive. Most K2 businesses today are already using cost based income statements which is the reason the BFN chose to impose this restriction (Broberg, 2010).
An annual report for the K2 company shall contain:
- Management Report
- Income Statement
- Balance Sheet
- Footnotes (Additional Information).

According to the AAA, additional information should be provided in the footnote. The requirements of demand for additional information in the footnotes in the K2 regulatory framework are low compared to RR recommendations, BFNAR and suggestions for K3-rules (Broberg, 2010)

3.5 Supplementary information

Supplementary information will help to clarify and complement the information in an annual report and the information to be provided is: accounting principles, income statement and the balance sheet. Any additional information shall be provided in the notes, except those directly provided in the balance sheet or in the income statement. Requirements for additional information in K2 is low compared to RR recommendations, K3 rules or BFN previous standards and only additional disclosures in the AAA must be provided. These disclosures must show a true and fair view and information that directly relates to the income statement and the balance sheet shall not be inconsistent with the requirement of rationality (Broberg, 2010).

3.5.1 Accounting Principles

The notes shall specify the accounting principles used, for example K2 framework, and that the financial statements are prepared in accordance with the AAA. It is important to highlight that the accounting policies have been used for the valuation of assets, liabilities and provisions. After rules have been selected it must be applied in its entirety, and deviations from the Council may not be made. In specific valuation situations, the principle of its valuation must be presented:

- Method of accounting for service and construction contracts
- Basics of depreciation on fixed assets
- A longer amortization period than 5 years of an intangible asset
- How assets, liabilities and provisions in other currencies have been translated (Broberg, 2010).

3.5.2 The Income Statement

If an entity prepares an annual report in abbreviated form reasons must be specified in detail. In specific cases it is allowed to omit a post on the company's net sales if the company explains why the reasons of competition to the detriment.

Staff costs: A number of staff costs must be illustrated in the income statement e.g. average number of employees and the distribution of gender in the company's board and management (Broberg, 2010). Disclosure of sick leave was abolished January 1st 2011.

Average number of employees is calculated by the employees working volume in the financial year in terms of FTEs (Full Time Equivalent) under collective agreements or similar agreements.

Average number of employees = Number of hours worked /1920 (or under contract)

If fiscal year is not 12 months it should be adjusted:

Fiscal Year length in months / 12 months x hours worked per year (Broberg, 2010 p.46)

With regard to the gender distribution, companies must disclose this information if they have more than 10 employees. Gender distribution should be accounted for only the members of the management board and the other executives at the balance sheet date. Other supplementary disclosures are:

- Salaries and other remuneration
- Social security costs, special information: pension costs

Salaries and other remunerations:

- Taxable employee benefits recognized as expenses in the financial year
- The change in vacation pay during the year and other payroll related accruals

Social benefits:

- Current year's employer social security contributions (Arbetsgivaravgifter) in accordance with the law on social security contributions
- This year's social security contributions arising out of contracts
- This year's taxes on pension contributions and pension funds pension costs (Broberg, 2010)

3.5.3 The Balance Sheet

3.5.3.1 Fixed assets

All entries raised in this category must be described in detail:

- Cost of assets
- Additional and leaving asset

- Transfers
- This years depreciation
- This years impairment losses
- This year's write-ups (only allowed for building and land)
- Accumulated depreciation
- Accumulated impairment
- Accumulated revaluation
- Corrections of previous years depreciation, impairment losses and write-ups

(Broberg, 2010 p. 149)

This information must be provided in "amount form" and incoming and outgoing amounts must be described. According to the AAA, companies shall disclose the depreciation made and state the method of depreciation and amortization that was carried out on the fixed assets.

Revaluation: It's only allowed to revaluate land and buildings according to the K2-framework. And if that has occurred, explanation must be provided in accordance with the AAA, if the revaluation amount is treated for tax purposes. Since the revaluation is made against a revaluation reserve and this does not affect the taxable profit its not needed to disclose this information in K2.

The fair value is below book value: Fair value is not allowed in K2. In the AAA, the information on financial assets must be revealed, which may be valued at fair value, when the option is not used. If the book value exceeds the fair value the information that must be provided is:

- The assets book value and fair value
- Why the book value is not written down, and how it will be recovered (Broberg, 2010)

3.5.3.2 Current assets

Account Receivables: Each account receivable under current assets shall according to AAA be described, specifically the part that falls due more than one year after the

balance sheet date. The K2 framework does not require this because all receivables maturing later than 12 months shall be accounted for as financial assets (Broberg, 2010).

3.5.3.3 Equity

Number of shares: Information on the number of shares and type of shares shall be reported in the AAA. In the K2-framework, the number of shares should only be recognized directly in the balance sheet and if different types of shares exists, they should be divided into its types of shares.

Changes in equity: Statements should only be given about the changes in the shareholders' equity compared with the former preceding year and not last year's changes in equity. According to the K2-framework reported changes in restricted and unrestricted equity is reported in its own private table schema and only rows that are relevant to the company are needed to be included (Broberg, 2010).

3.5.3.4 Liabilities

Liabilities that, according to the AAA, should be enlightened are those that fall due more than one year and five years on the closing date and the portion of the long-term liabilities falling due more than five years after the closing date.

According to the K2-framework, the only information that should be revealed is if the debt is short-term or long-term. Short-term liabilities are liabilities whose maturity is less than 12 months from the balance sheet date and long-term liabilities are greater than 12 months from the closing date (Broberg, 2010).

3.6 Some differences between K2 and current regulation

After reviewing these standards, the K2 standards in comparison to the current standards, we found four important differences namely Internally generated intangible assets, Financial instruments, Revaluation of intangible and tangible fixed assets and Accrual. These four factors have been confirmed in our interviews with auditors.

Internally generated intangible asset

According to K2, BFNAR (2008:1), 10.3: "An internally generated intangible asset may not be recognized as an asset even though Chapter 4. § 2, AAA (1995:1554) provides some opportunity. Expenses attributable to such asset shall be recognized as an expense'' (BFN b, 2011).

Financial instrument

According to K2 regulation a company is not allowed to value its financial instruments at fair value. BFNAR (2008:1), 11.6 says: "A company that applies this general advice can not measure financial assets at fair value even though Chapter 4. 14 a § AAA (1995:1554) provides some opportunity'' (BFN b, 2011).

Revaluation of intangible and tangible fixed assets

According to K2, BFNAR (2008:1), 10.37: ''Companies that adopt this general advice may not re-evaluate (write up) fixed assets other than land and buildings, although Chapter 4. § 6 AAA (1995:1554) provides some opportunity''. Furthermore, according to BFNAR (2008:1), 10.38: ''Building and land may be re-evaluated (Write up) up to a maximum assessed value'' (BFN b, 2011).

Accrual

According to IFRS (2012) accrual means that the record of income and expenses relating to the financial year, regardless whether cash is exchanged or not (IFRS, 2012). But according to the K2 regulation, the company does not need to defer revenues and expenditures separately below 5 000 SEK. ''An entity need not defer revenues and expenditures separately below 5 000 SEK, although it referred to in Chapter 2. 4 § 4 first paragraph of the AAA (1995:1554)'' (BFNAR 2008:1) (BFN b, 2011).

3.7 Statutory auditor in Sweden

In Sweden, the audit regulation goes back to 1895 when the new Swedish Companies Act was introduced. The new law meant that all limited companies should appoint at least one auditor. At that time, there were not any specific requirements for auditors skills. The

work of professional auditors increased in 1975 when a new Companies Act (1975:1385) was passed. This Act states that all companies with a higher restricted equity than one million SEK, or companies where the owner of a tenth of the shares at the annual general meeting requests an auditor, are obliged to appoint a qualified auditor. These companies should have at least one certified or approved auditor (Öhman & Wallerstedt, 2010) and (SOU 2008:32). In 1983, a new law was passed (SOU 1983:36) requiring, all limited companies have at least one certified auditor. According to the Swedish government, the motivation for passing the new law reads as follows:

"It is clear that an efficient and expert audit is important to combat financial crime and other irregularity which may occur in connection with business activities" (SOU 2008:32, P. 73). Considering the above, during the past decades the role of the audit has changed. The whole concept of the audit today is different and much wider than what it used to be. Over the years the rules and principles of the audit have become more legal-based and regulated in terms of both the design and the aspect of the profession for the individual auditor.

When Sweden entered the European Union (EU) in 1995, discussion regarding the exemption of statutory audit arose. Consequences of entering the EU led to not only the Companies Act directing the audit, but EU company law directives as well. The EU corporate directives controlling the audit are many but it is primarily the EUs Fourth Company Law directive, which governs small companies (Damberg, 2002). The EUs Fourth Company Law is also called the annual report directive because it contains rules that concern the presentation of the balance sheet, income statement, disclosures, publishing, auditing duty and so on (Thorell, 1993). ''The harmonization of Swedish accounting and auditing regulations with EU directives provided the impetus for new laws. An Annual Accounts Act was introduced, incorporating the terms of the 4th EU Directive, and separate laws for auditors and auditing were introduced in 1995 and 1999, respectively''(Öhman & Wallerstedt, 2010, p 18).

According to the 4th EU directive (2009), all companies with limited liabilities must have their annual accounting audited, but less strict rules are regulated for SMEs. EU members are allowed to eliminate statutory auditing if they do not exceed the limits of two of the following three criteria:

Balance sheet total: EUR 4 400 000;
Net turnover: EUR 8 800 000;
Number of employees: 50.

Accordingly, in 2010, the Swedish government decided to eliminate statutory auditing for SEMs that meet specific conditions (SOU 2008:32).

In Sweden the main audit laws are in the ABL (2005:551) (Moberg, 2006).
ABL, Chapter 9, § 1 describes which companies are exempt of statutory auditing:
‘’A limited liability company shall have at least one auditor.
The Articles of Association of a private limited company may specify that the company should not have any auditor.

The second paragraph does not apply if the company satisfies more than one of the following conditions:
1. Average number of employees in the company during each of the last two fiscal years amounted to more than 3,
2. Company's reported total assets for each of the two financial years amounted to more than 1.5 million SEK,
3. The company reported net sales for the each of the last two fiscal years amounted to more than 3 million SEK’’.

The Swedish legislation covers plenty requirements on auditors and their activities. Rules and regulations concerning these are mainly found in Auditors Act, RL and company law regulations such as ABL. According to Moberg (2006), the center of audit duties is in the ABL, Chapter 9, § 3 ‘’The auditor should review the company's annual report and

accounts of the board and the companies director's report. The examination shall be as detailed and comprehensive as accepted auditing standards require''. The auditor should also examine parent companies that have established consolidated financial statements and the relationship within the groups companies. Additionally, each financial year the auditor shall submit an audit report to the Annual General Meeting and in the context of the audit prepare the remarks and observations that exists of GAAP to the Board and the CEO (ABL Chapter 9; § 5-6). The ABL, Chapter 9, § 31-32 says that the report shall contain statements about whether the ''financial statements are prepared in accordance with the AAA or other applicable laws''. ''If the auditor has found that a board member or the management has engaged in any act or been guilty of any negligence which may give rise to liability, it should be noted in the report. The same applies if the auditor has found that a board member or the company's director in any other way, acted in contravention of this Act, the law on annual reports or articles of association'' (FAR SRS, 2012). When auditing the business performance of a company it is of great importance that the auditor acts with an independent, objective and impartial manner (RL § 20).

Chapter IV Theory & Literature Review

This chapter will first present the chosen theories and the literature review. In the literature part the users of financial information, credit assessment, financial accounting information, non-financial accounting information and and differences towards the K2 regulatory framework will be presented.

4.1 Theory

4.1.1 Introduction

Theory is a coherent set of hypothetical, conceptual, conceptual and pragmatic principles forming the general framework of reference for a field of inquiry (Deegan & Unerman 2011, p.2).

Since accounting is a human activity, there is a need for theories to describe people's behaviour as a regard of financial accounting information. There is a need for theories to explain why managers within companies might choose to provide particular accounting information to particular stakeholders group. Some financial accounting theories are prescriptive and tell what should occur (normative theories) and some theories are predictive and describe people' behaviors (positive theories) (Deegan & Unerman 2011). In this study, theories are needed to understand standard setting and development of K2 (normative theories) and auditing theory to explain the auditor's role in the market economy (Soltani, 2007).

The role of the theory is not to develop but to understand this phenomenon. Several theories will be drawn upon to understand the usefulness of the reports to the banks. K2 is based on normative assumptions by BFN. Normative theories, which are based on how the reporting *should* look like, will be employed to understand the sets of propositions and hypothesis as to why the K2 regulation emerged. The decision usefulness theory is divided into two branches. In order to find out what the banks want the focus here will be on the decision-usefulness market branch. Subsequently, based on what the banks want,

the criteria for building the analysis will be developed. In addition, since the report is for the banks and since the banks are the largest stakeholders, stakeholder theory will be examined. In this manner, the focus will be on how the stakeholder perceives the report by the company instead of the conventional way of looking at the matter from the point of view of the company. Furthermore, theories are needed to explain how stakeholders' expectation are considered and managed by companies and what are the managers' behaviors toward the stakeholders (positive theory) (Deegan & Unerman 2011).

4.1.2 Normative Theory

In some ways, economics is both a science and an art. An investor can look at financial data to determine the most financially stable or attractive stocks to purchase. At the same time, the money invested in a company is a statement of what products or services an investor finds worthwhile. This contrast in economics is expressed through the ideals of positive and normative accounting (Deegan, 2010). Positive economic theory and accounting practices are objective and based on fact. Positive accounting focuses on analyzing the economic statistics and data at hand, and deriving conclusions based on those figures (Deegan & Unerman, 2011). The aim of positive theories is to explain and predict particular phenomena. While positive theories tend to be based on empirical observation, there are other theories that are rather based on what researchers and experts believe *should* occur in special situations. These theories are called normative theories and they are based on the researches' values, norms or beliefs that researches prescribe (propose) how financial accounting should be carried out (Deegan & Unerman, 2011).

Moreover, Deegan & Unerman (2011) says: '*'the accounting's normative theories are not necessarily based on observation, therefore, cannot be evaluated on the basis of whether the theories reflect actual accounting practice. In fact they may suggest radical changes to current practice''* (Deegan & Unerman 2011, p 11). For example, the use of historical costs for measurements of assets has switched to using the market value to measure assets (Deegan & Unerman 2011). Standard-setters set standards based on normative assumptions of what people should do. The conceptual framework is an example of normative accounting that prescribes various assumptions about useful

information for decision-making. The conceptual framework provides guidance on how factors, such as liabilities, equity, assets, income and expenses should be recognized, measured and defined (Riahi-Behlkaoui, 2004) & (Deegan & Unerman 2011). K2 framework is an example of normative theory that prescribes how financial accounting should be undertaken. Furthermore, auditing is another example of a normative theory law that says which companies should have an audit and which companies are exempted from having an auditor. In addition Deegan & Unerman (2011), describe that normative theories are not are not necessarily based on observation. Therefore, it is difficult to say the advantages and disadvantages of theses laws.

4.1.3 Decision usefulness theory

According to Deegan & Unerman (2011) normative theories can be subdivided and some can be classified as decision usefulness theories. ‘’The decision usefulness theories ascribe a particular type of information for particular classes of users on the basis of assumed decision-making needs’’ (Deegan & Unerman 2011, p. 11). Furthermore, ‘’decision usefulness theories are based on the study of the information needs of stakeholders where the theory attempts to describe accounting as a process of providing the relevant information to the relevant decision’’ (Deegan, 2010 p12). The empirical theory was created based on how stakeholders used the financial information (Sundelid, 2010). For certain decision situations, the decision usefulness theories try to ascribe the “best situation”. The approach of the decisions usefulness theory is based on the view that the main purpose of the financial accounting information is to satisfy the information needs or wants (Laughlin & Grey, 1988).

Decision usefulness theories are divided into two branches, the decision-makers emphasis and the decision-model emphasis (Bebbington & Gray & Laughlin, 2001). The decision-makers emphasis relies on undertaking research that seeks to ask decision makers what information they want. Once this is determined, it can be implemented by choosing the best accounting alternative and prescribe what information should be supplied to the users of financial statements (Deegan, 2010). The theory also maintains, “that the decision-makers knows best what information they want and that the financial accounting

function should satisfy these desires" (Laughlin & Grey 1988 p333). This type of research is mostly questionnaire-based (Deegan, 2010).

The decision-model emphasis develops models based on the researches perception of what s necessary for efficient decision-making and this emphasis assume that whatever class of stakeholder you may be, you will have identical information needs (Deegan, 2010, p 13). The theory maintains, "that the accountants (or the preparers) know what the decision-makers really need (related to the objectives they wish to achieve through the focal organization), and it is this need which should guide the contents of financial accounting flows" (Laughlin & Grey 1988 p334).

4.1.4 Stakeholder Theory

In general, stakeholders are groups and individuals who affect the company or become affected by the company (Andriof et al, 2003) and includes customers, creditors, employees, stockholders, unions, government and the community that the company run its operation (Hill & Jones, 2008). Those stakeholders that have more influence on the company are more important for company managers (Deegan & Unerman 2011). Hill & Jones (2008) divided stakeholders into internal and external. Internal stakeholders are managers, executive officers, employees and stakeholders. External stakeholders are those groups, organizations or individuals that have claims on the company. External stakeholders can be creditors, suppliers, customers, local communities and government. Each stakeholder supplies companies with important resources and each stakeholder expects its interest to be satisfied. Furthermore, each stakeholder will demand different information from companies and managers within the companies should provide the information that stakeholders demand. (Idowu & Filho, 2009) and (Hill & Jones, 2008).

Some stakeholders are primary and companies cannot survive without them while other stakeholders are secondary and are not essential, and moreover, companies can survive without them. All stakeholders should be treated fairly by the companies, but according to the Stakeholders Theory, managers in the companies act in a way that meets the needs of the most powerful stakeholders. ''The more important the stakeholder's resources are to continued viability and success of the company, the greater the expectation that the

stakeholder's demands will be addressed'' (Deegan & Unerman 2011, p. 353). Creditors provide capital for companies in the form of debt (Hill & Jones, 2008) and are one of the important and powerful stakeholders, without which, companies cannot survive. Thus, managers attempt to act in a way that meets their creditor expectations. (Idowu & Filho, 2009) and (Deegan & Unerman 2011).

4.1.4 Auditing theory

Auditing theory describes why auditing is needed and what the purpose and role of auditing is. Moreover, auditing theory explains the relationship between different parties in companies (Ittonen, 2010).

4.1.4.1 Definition

''*Auditing is the process of providing assurance about credibility of the information contained in a financial statement prepared in accordance with generally accepted accounting principles or other rules''* (Soltani 2007, p 4). Auditing is the control mechanism of the capital market economy. The Auditor reviews assertions that are made by companies or individuals about economic activities that they have operated. After assessing, the auditor gives his or her opinion on how closely these assertions conform to the existing rules. The auditor communicates the result of his or her assessments through a written report (Porter & Simon & Hatherly, 2008). Auditors are members of independent companies and have the responsibility to ensure that financial statements are prepared fairly in accordance with generally accepted framework and to ensure that companies provide adequate disclosure (Glantz and Mun, 2011).

4.1.4.2 Agency theory

The demand for auditing increased when business owners separated from the business and these business owners (principals) delegated managers (agents) to act on their behalf. Hence, conflict between different interests increased. Managers are assumed to be self interested, trying to maximize their own wealth (Gul, 2008). A company is seen as the result of several formal contracts and each group make some kinds of contribution to the company, given a certain price. Managers at companies try to get these contributions under the best situations for their own interest. For example, paying low interest rate to

the creditors, high share prices for stockholders and low wage for employees. Nevertheless, managers need principles, trust and faith, because ultimately, managers depend on principles for the financial structuring of the business that they supervise. As a result, in order to for principals to trust in managers, there is a need for an independent body to control and monitor managers and provide assurance to principles. In fact, there is an incentive for both managers and principals to engage reputable auditors (Gul, 2008) & (Hayes et al 2005).

4.1.4.3 The lending credibility theory

Itton et al (2010) say: "The lending credibility theory suggests that the primary function of the audit is to add credibility to the financial statements. In this view the service that the auditors are selling to the clients is credibility'' (Ittonen 2010, p 4). Reviewing financial statements by auditors enhances the stakeholder's faith in managers. When stakeholders, such as creditors, have to make their decisions and judgments on the financial information, they must have faith that this is a fair report of the company's value. As a result, auditing improves that quality of investment decisions (Hayes et al 2005).

4.1.4.4 The policeman theory

According to Itton (2010), "The policeman theory suggests that the auditor is responsible for searching, discovering and preventing fraud'' (Ittonen 2010, p.4). However, the main focus of auditing has been to provide reasonable assurance and verify the fairness and truth of financial statements. Recently, the auditors' responsibility to discover fraud have been relevant (Hayes et al 2005) & (Ittonen 2010, p.4).

4.1.4.5 The role of the auditor in credit assessment

In general, financial accounting plays a major role in credit assessment and creditors need a lot of information about the financial situations of borrowers (Glantz and Mun, 2011). Managers have access to information that creditors do not have and this situation generates *information asymmetry* (Soltani 2007). Managers know more about company's ability to repay loans than bank do (Hayes et al, 2005). Today, the business is very complicated and the information asymmetry has increased, thus increasing the need for

auditing since the aim of auditing is to reduce the information asymmetry and increase usefulness of financial statements (Glantz and Mun, 2011) and (Soltani 2007). Moreover, Glantz and Mun (2011) explain that auditors review financial statements to ensure that information is correct, reliable and true. Financial accounting that have been audited and certified are called *certified financial statements* and financial accounting that are not audited are called *compiled financial statements*. In fact, statements about the accuracy of compiled financial accounting are below the level of financial statements (Glantz and Mun, 2011).

4.2 Literature Review

4.2.1 Users Of Financial Information

The external reporting and its regulation are intended to satisfy the users financial information needs. For users to be able to assess a company's development and get a prognosis of what's going on in the company, the information in the reports are required to be reliable and relevant (Marton et al, 2008). Stakeholders are people or organizations that are in someway involved or financially interested in a business, usually divided into current and potential investors such as creditors, customers, employees, suppliers and government agencies (IFRS, 2012). Small companies financial statements users do not have the same needs as the major listed companies. The number of stakeholders is considerably lesser and their financial reports are less complicated (Smith 2006 p.17-23). For small companies, applying regulatory framework, one of the most important stakeholder is banks, which importance cannot be emphasized as three- quarters of Europe's SMEs have bank loans. Other important users of financial information are the owners of the entity themselves (IASB, 2011). The owners in small companies have access to information in a rather different way compared to the large companies shareholders so the financial information is rather irrelevant for the owners of small companies, as they seek and gather information through other various channels. The focus of the owners is in the investment he/she put in the business and the risk and returns attached to that investment (Edenhammar & Thorell 2005 p.16-17). The annual reports works as a function of control for the owners as the financial information will describe the effectiveness of the management in the company (Smith, 2006)

4.2.2 Credit Assessment

The purpose of credit assessment is to judge about the company's ability to pay the loan back and the judge about company's security value (Svensson, 2003). In general, creditors gather information from different sources, and then analyze the information and make a decision about credit granting (Andersson, 2001). There are several models for credit assessment and banks usually use five Cs model that including five concepts (Svensson, 2003). The five concepts stand for ''*Character o f management's determination o f paying debts, Capability o f management to run a business, Capital to fund the business, Conditions of the business cycle, and Collateral,* which is an additional source of payment'' (Andersson 2001, p 11). In fact, each case (company) has its own characteristic and its own solution (Feschijan, 2008). According to Andersson (2001), the information that creditors require is divided into *accounting information* and *non-accounting information*.

4.2.3 Financial Accounting Information

One of the most important documents that companies submit to the bank is their financial statements (Andersson, 2001). Creditors often require both historical information and future projects (Graham, 2000). In order to understand the company's business and its future, creditor blend historical reports, such as balance sheet and income statement, to financial forecast, such as future project and budget. (Glantz and Mun, 2011). Financial statements are normally including balance sheet, profit and loss statement, cash flows, notes on account and supplementary details, financial ratios, and audit report. Future projects are business plan budget. Each pieces of data in financial statements play its own important role, therefore, it is impossible to say which information is more important than other information (Graham, 2000) and (Glantz and Mun, 2011).

4.2.3.1 Balance Sheet

In the balance sheet there are several factors that are crucial for credit judgment. The company's liability is one of the most important items in the balance sheet, because, liabilities show that what the company already owes to other companies and creditors (Graham, 2000). Banks set current assets and short-term debts together. If the company's short-term debts exceed its current assets, it means that the company is financing long-

term investments and fixed assets by short-term debts. The consequences are that some of creditors with short-term loans won't get paid on time (Sigbladh & Wilow, 2008). Assets are also significant, because in the case of company's failure to pay the debt, the bank could hope to get repayment from selling the assets (Graham, 2000). In fact, the assets that owned by the borrower secure the debt and lower the credit risk. (Feschijan, 2008)

4.2.3.2 Profit and loss statement

In the profit and loss statement, the costs and revenues are significant for banks. It is important to know how big the costs are and to what extent the company's revenue covers costs (Sigbladh & Wilow, 2008). In fact, it is important to know company's profitability and efficiency (Feschijan, 2008). The bank predict the company's future profit and efficiency through analyzing company's costs and revenues and usually banks compare the company's profit and loss in several periods. (Sigbladh & Wilow, 2008).

4.2.3.3 Ratios

Ratios filter absolute numbers down to a common scale and are used for three main analyses: to structural analysis; to clarify the relationship between items in the financial statements. To time-series analysis; to match the company's performance against historical levels. To cross-sectional analysis; to compare performance with benchmarks or industry averages (Glantz and Mun, 2011). In general, ratios have credit power and play an important role in creditworthiness (Andersson, 2001). There are many rations and depends on the company's characteristic different ratios are used by the banks (Svensson, 2003). Solvency ratio, current ratio and quick ratio are example of ratios that banks usually measure (Sigbladh & Wilow, 2008).

4.2.3.4 Cash flows

The company's cash flow is another valuable information for the credit assessment, because banks want to be sure that the company is able to generate enough cash in order to pay its costs and debts (Graham, 2000). Banks usually set cash flows with ratios and the company's previous profits in order to forecast the company's future developments (Svensson, 2003).

4.2.3.5 Footnotes

According to Glantz and Mun, (2011) the information and disclosures in footnotes are very important and credit analysts see footnote disclosure as a step above core financial information. Footnotes contain valuable information, such as, long-term purchase contract, changes in accounting principle, accounting policies and the healthiness of business operation. Glantz and Mun (2011) say: *"The back of the report, the footnotes, is where the managers hide the bad stuff they didn't want to disclose but had to. They bury the bodies where the fewest folks find them—in the fine print"* (Glantz and Mun 2011, p 29).

4.2.4 Non-financial Information

According to Andersson (2001), financial information are not the only important factors, but non-financial information are also crucial in credit assessment. It is important for the bank to know about the borrowers characteristics; managers and business owners. The managers' experiences and their ability to handle the business plan, remarks of payment and references from former employers are important factors that banks consider (Andersson, 2001). Moreover, the impact of macro and micro economic factors, such as, business cycle, economic growth and market demand are also important factors that banks consider in credit assessments (Feschijan, 2008).

Andersson (2001) describes that non-financial information can be more important than financial information because of several reasons; It is possible that managers of a failure company attempt to hide the bad news by manipulating accounting and financial rations. Furthermore, in many cases the financial accounting does not accurately demonstrate the financial situation of a the company because there are some time lags associated with reporting accounting information. The information in accounting statements is prepared upon data that were measured some months and in some cases even a year before that information reached the banks. Another shortage of financial accounting information is that in financial distress, companies usually make their financial statements publicly available several months after the end of the financial year. As a result, in many cases,

banks' officers have more attention on non-financial factors in credit judgment (Andersson, 2001).

4.2.5 K2

There has been a lot of criticism towards the K2-projects. The regulatory framework has been perceived as quite square because the user are not permitted to choose other accounting solutions than what the K2 recommends and K2 limits some options available in AAA because they are not allowed in K2. But current K2 framework is voluntary so if a company wants to apply an option that is not allowed in K2 they may choose K3 freely (Drefeldt & Törning 2012).

Engström (2009) argues that there are some shortages in the K2 regulations. Under certain items in K2, different methods of accounting are applied, such as construction contracts where two different methods can be used. This can cause a complication when the very purpose at the same time is to be an abbreviated form of the rules. When different methods of calculation can be selected it will open up the possibility of a more subjective accounting, which can cause serious effects on the balance sheets and income statements, in the Management Report, ratios and other evaluation factors (Engström, 2009).

K2 can be fraught with uncertainty for its stakeholders as K2 provides for simplification of the Annual Report. It is mainly simplifications on depreciation, impairment and amortization. Depreciation and amortization of tangible and intangible fixed assets are recognized at the same item in the income statement. Clarification on this item can be of great importance as users of financial information want to know the costs that are attributable to the impairments as they can provide the reader with information about the history made failed investments. This can affect credit decisions where the credit provider may be misled by the financial statements, which can be seen for example if the value of a financial asset is zero it must be impaired to the same value. If it is greater than zero impairment won't be required if the asset's value is less than the carrying value by less than the minimum of SEK 25 000 and 10 % of its equity at the beginning of year (Engström, 2009).

In its entirety the K2 framework must be used, which means no other rules or recommendations may be used. This can cause problematic situations wheareas other accounting rules could have given a more accurate picture, true and fair view, of the company. It costs the company money and time preparing the annual reports, since resources must be spent on the preparation. So its important the benefit of preparing the financial statements for the company to be more important in relation to the cost spent for preparation the annual reports (Smith, D 2006). A simplification of the rules therefore leads to reduced administrative costs for the companies, which is one of K2s objective. K2 framework consists of less information in the report than the previous framework and is also more standardized. This might make it easier for the smaller company as the new standards has made it simpler to prepare financial statements. Furthermore, the K2 framework can also lead to accounting firms will find it easier to process and review the financial statements because of the simplifications (Månsson, J. 2008). K2-framework lacks the true and fair view principle; according to EU's Fourth Company Law Directive, the annual accounts of the companies must give a true and fair view, but BFN has eliminated its K2 regulation and the only principle under the standard is the use of precautionary principle for preparing financial accounting reports. As a result of BFN opted out "the true and fair view" it will bring desirable simplifications, given that such valuation is often based on estimates, which in turn are based on subjective assumptions. Despite of this fact, there are still traces of "true and fair view 'in standard that it is possible to report the working in progress as a general rule and fair view as an alternative rule. The comparison between them can lead to major differences in the results and financial position. Which can result, in some situations the regulation cannot give correct information to the financial accounting's users (Engström, 2009). For BFN to simplify the K2 framework options would mean that an informed assessment of the different approaches must be made, which takes time, knowledge and extra expense for the company (Drefeldt & Törning 2012).

4.2.6 Companies Registration Office

In Sweden Limited companies must submit an annual report to the Companies Registration Office, CRO, whether they have an auditor or not. The submission of the report must be within seven months of the fiscal year, or else the company will suffer late fees. Statistics from 2012 shows that the CRO received numerous annual reports that the quality was inadequate and late fees increased with ten percent, than the same year before the exemption of the statutory audit. Most new registered companies choose not to have a qualified accountant, 65 percent, and since the statutory audit was exempted 64000 companies in mid-august 2012 decided to deregister their auditor. In 2012 there were 417 000 companies registered in CFOs register and approximately 27 percent have removed the requirement for audit, 114 000 companies. CFO describes their concern regarding these numbers and in particular the inadequate quality in the reports when not approved by an auditor (Companies Registration Office, 2012).

Chapter V Presentation of Findings

This chapter presents interviews with our correspondents. Seven banks and four audit firms have been interviewed. The interviewed banks are: Färs & Frosta, Swedbank, Handelsbanken, Nordea, SEB, Sparbankenöresund and Länsförsäkringar. Audit firms are Mazars, Grant Thornton, KPMG and Ernst & Young.

5.1 Interview with banks

Research Questions:

1) To what extent do banks perceive the financial statements of companies reporting according to the K2 guidelines to be sufficient for credit assessments?

2) How do banks perceive the credibility of unaudited reports for K2 companies that are exempted from the audit?

5.1.1 Färs & Frosta

Emanuel Eriksson at Färs & Frosta has been interviewed. Emanuel Eriksson is the office manager and has 10 years of experience in the banking industry. Emanuel Eriksson answered our questions as follows:

1) The most important factor for the credit judgment is the person who borrows the money. The borrower's background, level of education, business experience, personality and his or her profession, including business concept, financial forecast and budget are the crucial factors in credit assessment. Emanuel adds: ''in other words, we analyze the borrower's characteristic and borrower's business concept''. In credit granting policy, two factors are important for the bank. First, whether the borrower has the ability to repay the loan, and second, whether there is a reliable security that the bank can sell the security in case of bankruptcy. In addition, the process of credit assessment is similar for all kinds

of companies, regardless of the company's size and type (Emanuel Eriksson).

There are several items in financial statements that are important for the bank. First and most important, cash flow is extremely crucial for credit analysis, because banks want to know whether the company can generate enough cash and whether the company has been profitable so far. According to Emanuel, there are several items in the balance sheet that are crucial for the bank and normally the bank cannot get enough information through the balance report. Such important factors are:

Assets: It is important to know the real value of assets; because, in the case of bankruptcy the bank wants to know what percentage of its claim can be repaid.

Inventory: Bank should be informed whether it is difficult or easy to liquidate goods.

Account receivable: Bank needs to know who the companies' customers are (consumers or other companies) and when the company can get its claim.

Liabilities: Banks are interested to know the company's current debt and they also require information about other debt holders, and existing contracts between the company and a third party. (Emanuel Eriksson).

It makes no difference whether the company applies K2 or other accounting regulations. A financial statement is not sufficient and bank needs more information and disclosure. Emanuel says: *''As a matter of fact, in many cases, there is a big difference between theory and the practice''*. Bank managers need to visit the companies personally and measure company's cash flow, profit and loss and ratios, regardless of the company's financial accounting regulation (Emanuel Eriksson).

Furthermore, Emanuel says, "financial statements are historic and usually are out of date, therefore, they are less important". As a result, factors such as, business concept, financial forecast and budget are much more important than annual reports. Emanuel adds environmental reports, company competitions are other important factors that they

are not in the report. Emanuel mentions that companies do not disclose all information, because it is expensive for the companies to provide all information.

2) According to Emanuel, it is very important that an independent auditor review financial accounting and he adds that in most cases where the financial statements are audited, "serious companies always cooperate with auditors". But there are some situations where the auditor's role is not important. For example, when a newly established company applies for credit, financial statements are less important, whether they are audited or not. In fact, the bank wants to know about the company's earnings forecast, budget, and business concept. Moreover, according to Emanuel, the bank always builds a strong relationship with companies and bank personnel always visit the companies personally. Banks control and measure important items such as assets, products, inventory and the company's customer information. As a result, even if a company does not have an auditor, the managers at the bank can get reliable information. Therefore, if the managers of a company have an acceptable business concept and if the firm puts a high value asset as collateral, then the credit granting is possible for a firm without an auditor (Emanuel Eriksson).

5.1.2 Swedbank

Håkan Lehmark at Swedbank was interviewed. Håkan Lehmark is credit manager and has 26 years experience.

1) According to Håkan, documents that banks require for credit analysis vary on many factors and it is different from case to case. Factors such as the company's size, company's type, industry, branch, market and macroeconomic condition are major factors. The bigger the company is, the more information and documents are required for credit analysis. But in general bigger companies are more credit grantable because they have a better plan and have more securities and capitals. Macroeconomic factors, such as, currency exchange rate, oil prices, and boom and bust cycle are also influential for credit analysis (HåkanLehmark).

Håkan explains that financial statements are a very important requirement for credit assessment. In the balance sheet all items are crucial and each item gives its own meaningful information. There is however much more information that bank managers cannot find in financial statements. According to Håkan, the most important points that bank usually need to get more information on from the borrowers are:
Assets: For banks it is very important to know the real value of assets and all information about assets' depreciation, revaluation and write off.

Inventory: Håkan says ''it is important to know what kinds of goods there are in inventory. Are goods in high demand? Are goods in the working process? If yes, when and how goods are going to be ready for the market? What kind of technology is used to produce products?''

Accounts receivable: In credit analysis the bank needs to know what kinds of contracts there are between the company and its customers. Who are the company's customers? And when and how the company will receive its claims?

Cash flow: It is extremely important for credit analysis because of two reasons. First, cash flow reveals whether the company is efficient and whether the company has the ability to generate cash. Second, in many cases income statements do not give correct information. The profit and loss in the income statement depends on many factors, such as, the method of depreciation and accounts receivable. In fact, in most cases income statements are misleading because banks do not know what is behind costs and because bank managers measure company's cash flow, profit and loss and break-even. According to Håkan, further important information that banks need is the company's business mission, new plan, financial forecast and budget. These are not in the financial statements normally. There are also other important factors that are not included in financial statements such as environmental issues and company competitors. (Håkan Lehmark).

According to Håkan, in more than 90% of cases the bank needs additional information for credit assessment. Bank managers visit the companies in order to measure assets and get important information not included in the financial statement, such as, the company's

products and the company's customer information. Håkan mentions that, sometimes, financial statements do not reveal correct information because in many situations the numbers on the balance sheet depend on many factors, such as boom and bust cycle, depreciation method and the level of the company's disclosure, (because companies do not reveal what they consider to be bad information) (Håkan Lehmark).

2) Håkan says: ''the borrower, the bank and the auditor are three partners who work together and if one of them is absent, credit granting will be impossible''. Auditors review financial accounting and find risk and errors in the report, thus playing a very important role in credit assessment. Håkan explained that in most cases, the companies get their financial statements audited, and if financial statements are not audited, the bank normally asks the company to hire an auditor. In cases where the company does not accept audit of their financial report, then, the bank will either reject the application or it will consider the application as private credit. This means that regulations for private credit will be applied (Håkan Lehmark).

5.1.3 Handelsbanken

Ulf Larsson at Handelsbanken was interviewed. Ulf Larsson is the office manager and has 25 years of experience. He answered the interview questions as follows:

1) According to Ulf, the bank is first interested to know the borrower's characteristic, his experience about business and business idea. To this end, bank managers interview the customers and get basic information regarding business concept and plan, the company's earnings forecast and also the company's competitors and borrower's previous experiences. In general, the banks have one framework and the credit assessment process is similar for all kinds of companies, regardless of the companies' size and type.

Ulf explained that one of the most important documents that customers must provide is the financial statement. All items in the financial statements are important for the bank, but depending on the company's industry and its operation, some items are more important than others. In many cases, the information in financial statements is not sufficient and bank would contact the company managers or company auditor for more

information and disclosures. According to Ulf, key items that banks normally need to get more information on are:

Dividend: bank wants to know how much the company has paid out as dividend in recent years.
Account receivable: It is very important for the bank to know who the company's customers are, whether they are reliable, and whether the company can receive its claim on time.

Assets: Ulf said: ''in many cases the deprecation and revaluation of assets are not clear. Moreover, bank wants to know the real value of the company's assets''.

Inventory: The bank always wants to know how old the inventory is and whether the inventory has high or low demand.

Cash flows: According to Ulf, cash flow is one of the most important items in financial statements because cash flow shows to what extent the company is efficient and whether the company is able to generate enough money for its costs. In many cases banks have to measure the company's cash flow, because either the cash flow has not been measured by the company or because the company's cash flow needs some adjustments (Ulf Larsson).
According to Ulf, the most important factors that bank would like to be included in the financial statements are financial forecast, budget, company's plan, business concept, company's competitors and company's contract to the third parties including information about environment. Financial statements are historic and were relevant several months ago and the bank is more interested to know the company's future earnings. Therefore to some extent, the financial forecast can be more important than financial statements (Ulf Larsson).

Ulf explained that it makes no difference whether the companies apply K2 or other accounting standards. Financial statements are not sufficient for credit assessment and banks need more information and disclosures. Banks need to adjust numbers and pre-measure important factors. Furthermore, bank managers should visit the company to get

more information. In many cases company managers do not like to reveal bad news, therefore decreasing the level of disclosure. (Ulf Larsson).

2) According to Ulf, the auditor is an important part of the company and without an audited report, the quality of the financial accounting is below the accepted level. If the company is not complicated and the credit amount is not high, it is still possible for the bank to grant credit with greater scrutiny and oversight and control and other means. But if the company is complicated, the bank will demand that an auditor should review the financial statements. If the company fails to hire an audit, then, the bank will reject credit granting (Ulf Larsson).

5.1.4 Nordea

Magnus Liljenberg at Nordea was interviewed. He is a credit manager and has 28 years experience.

1) According to Magnus, the bank has a standard framework and depending on the company's risk, the bank demands different information and documents. Those companies that have higher risk should demonstrate more information and documents. This process is different from case to case. Depending on the level of risk and the company’s operation, the bank will control and analyze different items in the financial accounting. Nevertheless, all items in the financial statements are important and banks look at all the information contained. There are some items that bank normally cannot find through financial statements. As a result, the banks demand that the customers and sometimes the customers’ auditor provide more information and disclosure. Important items are:

Account receivable: Risk depends on how many customers the company has and how high or low is the possibility that the company can receive its claim. Moreover, bank wants to know whether the relationship between the company and its customers is long term or short term.

Asset: Banks normally measure the company's assets because, in many cases, the real value of assets is not revealed in the balance sheet.

Inventory: The demand in the company's goods, and also the age of the goods, are important for the bank. Therefore, the banks normally demand companies to reveal more information about inventory.

Cash flow: This is another important item and in many cases cash flow is not included in financial statements. As a result, the bank managers should measure cash flow. Cash flow is important because it shows as to what extent the company has been efficient. Moreover, it is a means of predicting the company's future income.

Expenditures, cost and contracts to the third parities: the bank wants to know more about the company's contracts to the third parties and the company's future costs and expenditures. Magnus adds, normally during measuring and analyzing ratios, more questions about financial statements will come up and managers should contact customers or their auditor to get extra information (Magnus Liljenberg).

Furthermore, according to Magnus, the bank is normally interested to know the company's plan and the companies' future earnings, therefore, bank's managers like to get item such as, financial forecast, budget, liquidity report, company's contract to other parties and information about the company's competitors. Magnus adds that recently environmental issues have become important and therefore the bank wishes to get a report about the relationship between a company's activities and its environment. Audit report has become more complicated and longer and is sometimes difficult to interpret. Magnus says, "financial statement is not sufficient and banks need more information and disclosure for credit assessment'' (Magnus Liljenberg).

2) Magnus says, the auditor plays a big role in the credibility of financial statements and in fact, auditors are a part of the company. Many SMEs do not have an economist in the company; therefore, bank prefers to contact their auditors to get information such as company budget and company future earnings. Without an audit report, the financial

statements are not reliable. Therefore, the bank usually needs more analysis and require further information from a company which does not have an auditor. Accepting or rejecting a company without an auditor depends on many factors. The most important factors can be the characteristics of the company's manager's, previous experiences and educations. A good manager can turn a low profit company into a high profit one and vise versa. Another important factor to remember is collateral. In some cases, it is possible to grant credit to companies without an auditor if the company puts up a high value asset as collateral (Magnus Liljenberg).

5.1.5 SEB

Vitor Afonso at SEB was interviewed. He is an office credit manager and has 27 years experience.

1) According to Vitor, the information and documents that the bank requires depends on the credit amount, company's size, and business idea and market conditions. For example, when the business cycle is booming and a company wants to launch a product that is in high demand, the bank demands less information and documents. Therefore, credit assessment and credit analysis depends on the business concept, business cycle and macro and micro economic conditions. If the bank is not sure about the market demand, then, the bank will get more information about the company's managers; their experience, level of education, and their competence (Vitor Afonso).

Vitor explains that one of the most important documents that borrowers submit to the bank is the financial statement. In general, the bank managers want to know what is exactly behind the numbers and how those numbers have been measured. Therefore, banks always need to get more information on how numbers have developed. In many cases information about numbers is not in the financial statements and banks should contact the company's managers for such information. Many SMEs managers do not have knowledge about accounting; therefore, the bank should turn to the company's auditors (Vitor Afonso).

According to Vitor, items that banks often need more information on are:

Cash flow: Cash flow is essential for the bank because it shows the company's ability to generate cash to cover its liabilities. Cash flow is also useful for predicting the company's future efficiency. The bank's managers set cash flows with ratios to find out to what extent the company will be efficient in the future. In many SMEs cash flow is not included within financial statements and the bank should measure it or ask the company to measure the cash flow.

Inventory: For credit assessment, it is important to get all information regarding inventory. What type of goods is in the inventory? How old is the inventory and whether there is high demand in the market. In many cases the company's inventory increases sharply, but there is no information to describe the reason behind it.

Accounts receivable: It is important for the bank to know the company's customers because the company's revenue depends on its customers and their reliability. If the company's customers are not reliable, it means that the company is a high credit risk.
Assets: In credit assessment, assets play an important role because, if the company fails to pay back its debt, the banks can liquidate a company's assets. Therefore, it is important for the bank to know the real value of the company's assets. Furthermore, bank needs to know the history of assets' depreciation, written-off and revaluation. Normally, disclosures about these kinds of information are very poor and the bank should ask for more details (Vitor Afonso).

According to Vitor, the most important information that is not normally found in financial statement is the financial forecast. It is very important for the bank to know how company managers have made plans for new business concepts. Therefore, the bank normally asks about the new plan, budget, and liquidity report, results of the company's market research and about the company's competitors. In many cases the information is very poor and bank needs more researches and measurements. Other information that is crucial for the bank is whether there is a contract between the company and a third party, and normally this information not included in the financial statements. In fact, the bank wants to know how different contracts can impact a company's future efficiency.

Sometimes, liabilities to the third parties are so high that the company loses its competency and efficiency. Other important issues that banks always want to know is whether the company's operation and products are dangerous to the environment and to what extent. Most SMEs do not have an environmental report. Vitor adds, that the financial accounting is still not sufficient and bank needs more information and disclosure for credit assessment (Vitor Afonso).

2) According to Vitor, the bank has never granted credit to a company without an auditor. The auditor is an integral part of a company and if a company wants to finance its capital through the bank, the company should hire an auditor. Financial statements reviewed by an auditor are very important for the bank, because the bank can be sure that numbers in the financial statements are correct and credible. Many SMEs do not have an economist in the company and therefore, the bank wants to be sure that important factors be measured scientifically and mathematically (Vitor Afonso).

Vitor explained that reviewing financial statements is not the only role that auditors have. In fact, auditors help companies to make an acceptable plan and budget for the company's new business idea. Vitor mentions that the only situation that he can imagine where the bank accepts granting credit to a company without an auditor, is when a company has a long relationship with the bank and the bank is sure that the company's managers are honest, experienced and have the competence to handle the business and the credit amount is very small (Vitor Afonso).

5.1.6 Sparbankenöresund

Stefan Ögell at Sparbankenöresund was interviewed. He is an office manager and has 28 years experience.

1) According to Stefan, the information and documents that the bank demands for credit assessment depends on the company's industry, business concept and credit amount. The most important factors for credit assessment are the characteristics of the borrowers, business concept, and market situation. Therefore, bank managers meet borrowers personally to understand the business concept and get information about the borrower's

previous experience, education and their competence to handle the business. After analyzing borrowers' personality, business concept, company's branch, industry and business cycle, the bank demands documents and information. For example, if a company product has low demand in the market, the company needs to bring more information and documents to convince the bank that the product and the company will be successful (Stefan Ögell).

According to Stefan, all items in the financial statements are important and each item gives value information. One of the most important items for the bank is the cash flow. By analyzing cash flow the bank will find out whether the company is efficient and whether the company can generate enough cash in the future. In many cases the cash flow is not included in the companies' financial statements and the bank's managers should measure it. In some cases, the bank needs to adjust some items in the cash flow. The bank normally looks at all items in the balance sheet and always needs further information about several items. Some important items in the balance sheet that bank cannot find through financial accounting are:

Account receivable: the bank needs to know who the customers are and when the company can get its claims. In fact, the company's revenue depends on its customers, therefore, the bank always asks more questions in this area.
Assets: The bank needs to know the history of asset depreciation, written-off and revaluation. It is important to know the real value of assets for collateral judgment.

Audit report: the audit report has become very long and complicated and it needs interpretation.
Inventory: It is important to know the inventory's age, the type of goods, demand in the market and whether the inventory is out fashion. In some cases, the company's inventory increases but there is no indication in the financial statement (Stefan Ögell).

According to Stefan the most important information that bank would like to be included in financial statements are financial forecast, budget, company's future earnings, and

liquidity report and also, a company's contract with third parties. The bank wants to know whether the company can generate enough cash to cover its costs in the future and whether the business idea, budget and plans are reasonable. Another important report that Stefan emphasizes on is the environmental report since many business activities are dangerous for the environment, but the bank cannot get a reach and valuable information from companies (Stefan Ögell).
According to Stefan, the financial statement is not sufficient and the bank always needs more information and disclosures. The bank managers should measure important factors, such as cash flow, ratios and assets. As a result, bank's managers always visit companies in order to get the information that they need. The bank also needs to talk to the company's auditor to get more information and opinion about the company's operation (Stefan Ögell).

2) According to Stefan, an auditor is an important part of a company. In many cases, owners and managers of SMEs are not educated in the economic field and therefore do not have knowledge about economy and accounting. Furthermore, some business owners have good business ideas, but because they are not educated in economic courses, they cannot present their business concepts scientifically. Since banks will contact the company to get information about the company's economic and accounting issues, it is very important that a company hire an auditor. When there is an auditor, both the bank and the company reap benefits (Stefan Ögell).

According to Stefan, it is impossible to grant credit to a company without an auditor. If a company that does not have an auditor applies for a high credit and its operation is complicated, the bank will definitely demand that an auditor should review the company's financial statements. But if the bank (without an auditor) has a long relationship with a company and the bank is sure that the company's managers are experienced and are competent enough to handle the business, it may be possible that the bank will grant a small credit (Stefan Ögell).

5.2 Interviews with Auditors

To increase the reliability of the study we interviewed auditors as expert. The audit firms that were chosen were MAZARS, Grant Thornton, KPMG and Ernst & Young.

5.2.1 MAZARS

Sonny Malmquist was interviewed. He is an authorized auditor at Mazars and has 19 years experience.

5.2.1.1 Accounting information

According to Sonny, whether or not financial statements are sufficient, depends on the industry and company's situation. For credit assessment, banks measure cash flow and ratios in order to find out the company's efficiency and they need the company's future earnings forecast and company's budget, and in fact, the process proceeds regardless of the financial accounting regulation. Sonny states that in 2014, K2 will be adopted officially by companies and it is difficult to say how K2's impact on credit assessment. Nevertheless, in some cases, K2 is not sufficient for larger companies, and therefore auditors recommend that their clients transfer from K2 to K3. The most important short comings of K2 are the measurement of assets (fixed and financial assets are not allowed to be valued at fair value) and, component depreciation and the fact that internally generated intangible assets are not allowed (Sonny Malmquist).

Sonny said, sometimes there is a big difference between theories and the reality. Financial statements are just half of all the factors that are important for banks. In fact, the borrowers' personality is more important than financial statements. Banks grant credits to managers who are experienced and have a high competence to manage the business. "In some cases, the numbers in the financial statements were very good, but the bank declined to grant the credit because the bank could not trust the company managers competence and characteristics'' (Sonny Malmquist).

5.2.1.2 Auditing information

According to Sonny, because of the elimination of the statutory audit, the quality of the financial statements is reduced and becomes a big hindrance for banks to be able to judge

the quality and credibility of financial statements. Many SMEs do not have an economist in the company and they do not have knowledge about accounting regulations. For example, they do not know how to depreciate assets, how to accrue revenues and costs or how to make a budget for future projects. One of the most important factors for banks is the company's financial forecast but in many cases, companies fail to measure future earnings forecast and budget scientifically and mathematically due to lack of auditors. Therefore, eliminating auditors creates problems for both companies and banks (Sonny Malmquist).

5.2.2 Grant Thornton

Christoffer Hulten was interviewed. He is an authorized auditor at Grant Thornton and has 24 years experience.

5.2.2.1 Accounting information

According to Christoffer, it makes no difference which accounting regulation is adopted. K2 gives enough information and banks are generally satisfied with the regulation. In fact, K2 is clearer and its simplifications make it easier for users of accounting information. Moreover, it is less expensive for companies. Banks, however always need extra information and it actually depends on loan amounts, the company's situation, the company's industry and its branch. The most important factors for the banks are that a company should have a reasonable business concept and that it puts up a high value asset as collateral. These factors are not dependent on accounting standard regulations (Christoffer Hulten).

5.2.2.2 Auditing information

Christoffer relates that it is important to audit financial statements and research shows that financial accountings that are not audited are considered to be of a lower quality. Two factors are important for banks; financial statements and the company's plan. Financial statements are historic and give information about a company's situation. If a company's financial statements are not audited, it becomes more difficult for banks to make credit judgments because auditors give confidence to creditors to trust that a company's financial statements are correct and true. The other factor that creditors need

to know is the company's plan and the company's financial forecast. Creditors want to be sure that the borrowers have a good plan and that there will be high-level cash flows in the future. Auditors review a company's assets value, ratios, plans, budget, future earnings forecast and cash flows, allowing creditors to be more certain that all measurements are mathematically correct and accepted. This means that without an auditor's report, it is difficult for creditors to judge a company's financial accounting as a whole. Christoffer adds, ''many small companies do not have an economist and therefore, it is more difficult for banks to judge the credibility of financial statements''. Christoffer mentions that, auditors are not responsible for a company's liabilities, but they are responsible for correct measurements of accounting items (Christoffer Hulten).

5.2.3 KPMG

Eva Melzig Henriksson was interviewed. She is an authorized auditor at KPMG and has 28 year experience.

5.2.2.1 Accounting information

According to Eva, it makes no big difference if a company applies K2 or another accounting regulation. In general, K2 and other accounting regulations are sufficient for credit assessment. However, there are some issues regarding K2. In K2, the company is not allowed to use component depreciation. As a result, this creates difficulties for real estate companies. Moreover, the company is not allowed to measure financial instruments in real value. In general, each bank has its own requirements and information and documents that the banks need is immaterial to the accounting regulation. The most important factors for banks are cash flow, financial forecast, and business concept. In many cases, banks do not have issues with financial statements because financial statements are historic and may be less important at present. Future cash flow is what banks are more interested about (Eva Melzig Henriksson).

5.2.2.2 Auditing information

According to Eva, it is important to get financial statements audited. Most companies that are borrowing money from banks and financial institutes have auditors. Auditors review financial statements and give confidence to the creditors that items in the financial

statements, such as, assets, cash flow, ratios are calculated and measured correctly. Banks are mostly interested in the financial forecast. Auditors cannot predict the future, but they can review financial forecasts and budgets that companies have calculated. Eva says that in many situations, banks contact her not because of financial statements but mostly because they want to know about the financial forecast. This means, first, financial statements are sufficient, second, banks are more interested in the future, and third, auditors are a form of security for the banks. When the financial statements are not audited, banks in some cases demand higher interest rates and higher security (Eva Melzig Henriksson).

Eva believes that the elimination of statutory auditors is a satisfactory rule since many small companies do not really need to have an auditor. In many cases banks have granted credit, even when the financial report had not been audited. The reality is that, financial statements (historic and future forecasts) are not the only factor for credit granting. In fact, the person/s who borrow the money is important. If a bank is sure that the borrower is professional and is well experienced and has a good business concept, the bank will definitely grant credit to the person, regardless of the financial statements (Eva Melzig Henriksson).

5.2.4 Ernst & Young

Anders Mårdell was interviewed. He is authorized auditor at Ernst & Young and has 28 years experience.

5.2.2.1 Accounting information

According to Anders, the information and documents that banks need depends on the company and its industry and in most cases K2 is sufficient. Banks can analyze factors, such as, cash flows, ratios and a company's security (collateral) using the K2 financial accounting regulation. The only factors that can create difficulties for banks could be the measurements of financial instruments and component depreciation. In K2, companies are not allowed to measure financial instruments in real/fair value and this is one of the most serious problems with K2, because in general banks need assets to be valued at real

value. K2 it is not allowed to use component depreciation and in many cases component depreciation provides better information to the banks (Anders Mårdell).

Anders added, banks sometimes contact auditors in order to get more information about a company's budget and future earnings forecast. In fact, banks are more interested in getting information about a company's future earnings than its financial statements (that are historic) (Anders Mårdell).

5.2.2.2 Auditing information

According to Anders, in general, the credibility and reliability of financial statements is dependent on whether financial statements are audited or not. Many small companies do not have an economist and therefore, in many cases, the financial statements are not correct. For example, assets are not measured correctly, costs and revenues are not accrued and depreciations are not done correctly. As a result, it is important that financial statements be reviewed by an auditor. It does not mean that companies without an auditor cannot get credit from a bank. Banks have their own system and, in many cases, companies without an auditor have been granted credit because the bank either trusted a company's managers or the bank probably demanded a high value asset as collateral. But in general, it is very important for all users, especially the banks, that a financial statement be audited. In addition, Anders said, in some cases the company is very small and its operation is very limited and clear and therefore, there is no need to have an auditor (Anders Mårdell).

Chapter VI Research results and discussion

In this chapter we will answer to our research questions by analyzing the empirical material and combine it to our regulatory environment, theories and literature review.

6.1 To what extent do banks perceive that their information needs for credit assessment to be satisfied for companies reporting according to K2 regulation?

In our study we have used a qualitative research approach to try to answer the purpose of the study and to understand the phenomena of the usefulness of the reports to the banks. According to decision usefulness theories, standard-setters set regulations that are useful for users of financial statements in order to make economic decisions (Deegan, 2010). K2 is the conceptual framework that was produced by BFN. The purpose of the K2 and its rules are that K2 should be easier to use and apply. Moreover, K2 was established in accordance with users need and perspectives. Standards-setter, BFN, assumed that by restricting the information in the financial statement the stakeholders would find it easier to find the information that they need (Månsson & Ohlson, 2008). In this study we have used decision-makers theory and asked banks what they require for credit assessment and also to what extent they can get their information needs from the K2 conceptual framework. Our findings show that in credit assessment, banks need much more information and disclosures that are not included in the financial statements.

Our finding shows that each bank has its own standard and its own particular method for credit judgment but in general, the information and documents required are very similar amongst banks. Basically, the information that the banks need depends on the business concept, the company's industry and market situation. In general, managers at the banks do not have much information about K2 and they are not very concerned whether K2 reveals more or less information. The banks' credit managers often visit customers personally and measure, control and check factors that they need for credit assessment and then, ask for more disclosures if it is needed. If the disclosures are not satisfactory, the banks will simply reject the customer.

According to stakeholders theory, the more important the stakeholder's resources are, the greater the expectation that the stakeholder's demands will be addressed. Furthermore, the companies will provide information to strong and primary stakeholders (Deegan & Unerman 2001, p. 353). On the other hand, Nair & Rittenberg (1983) argue that creditors are one of the most important SMEs stakeholders. Our findings support both the stakeholder theory and Nair & Rittenberg (1983) statements. Our finding shows that banks are one of the most important stakeholders and companies provide all information and disclosures that banks demand regardless of the accounting regulation in place. Banks are such strong stakeholders that they are allowed to go to the companies and control the companies operation. They are allowed control of the company's inventory and they check confidential documents and information that other stakeholders do not have access to. For example, Emanuel in Färs & Frosta and Håkan in Swedbank said that they visit the companies and measure their assets, such as the inventory and buildings. They also check the company's operations and products and are even able to get other information important to them such as customer's information.

Engström (2009) argues that one of the important shortages of K2 regards the measurement of assets. Our findings support the Engström (2009) statement. In K2, assets such as financial instruments are not allowed to be measured at fair value. In contrast, all interviewed banks said that, in credit judgment, banks need assets to be measured at market value because they need to know the company's real value. Moreover, according to interviewed banks, cash flow is very important for credit judgments because cash flow shows to what extent the company is efficient and whether the company can generate enough cash to cover its costs. All the interviewed banks related that they need to get more information about costs items from the companies and adjust the numbers in profit and loss statements in order to measure the company's cash flows because in many cases it is difficult to see what is really behind costs. In fact, banks want each type of cost to be written as a separate item in the profit and loss statements. This finding supports Engström (2009) in that depreciation and amortization of tangible and intangible fixed assets are recognized as the same item in the income statement and this creates difficulties for creditors.

We used the auditors as our expert witnesses due to the credence banks give to the opinions of auditors. Auditors provide confidence to the banks because they give assurance that the financial reports are reliable, the numbers are correct and credible and the quality is above the accepted level, which is confirmed by the banks. Our interviews with auditors shows that they believe that the K2 does not have much impact on credit assessment and, in general, the financial statements are sufficient for credit assessment and banks are able to get most of their information needs from the report. According to auditors, financial forecast and budget are very important factors that banks cannot get from the report. They know this because banks regularly contact them to inquire about a company's future earnings forecasts.

Our researches show that banks demand more information and many documents from the companies before granting a credit. The foremost important factors for the banks are non-financial, such as the borrowers' characteristics, their business experience, the borrowers' competence to handle the business, and also the business concept and market situation. The next important factors are the financial statements and the financial forecast. Banks blend financial statements and financial forecasts together in order to analyze a company's efficiency and its future earnings.

The results of our study show that from a credit assessment perspective, there are many important factors that are either not included in financial statements or the information is quite poor, which forces banks to demand more details from the companies before granting a credit. As we mentioned above, the banks' credit managers do not have much information about K2, but according to what the banks want and how K2 is regulated, we can conclude the key factors in credit assessment, which are not in the K2 regulation or are not satisfactory to banks in credit assessment. These are:

Cash flow; According to all interviewed banks, one of the most important items for credit judgment is cash flow and in many SMEs cash flow is not included in financial statements.

Information about account receivable: All interviewed banks needed more information about companies' accounts receivable: Who are the company's customers? Does the

company have a long or short-term relationship with its customers? To what extent are the company's customers reliable?

Details about inventory: All interviewed banks need more details about a company's inventory; What is the quality of the goods inventory? How high is goods' demand in the market? How old are goods?

Assets measurements and details information about assets depreciation, revaluation and written-off: All interviewed banks said that all assets should be measured at fair value. Moreover, historic asset information such as depreciation, revaluation, and written-off are not satisfactory for credit assessment. According to Swedbank, Handelsbanken, SEB, and Sparbankenöresund, security judgment will be much easier when a company uses component depreciation for its properties.

Accrual costs and revenues under 5000 SEK**:** Swedbank, Handelsbanken, SEB, Sparbankenöresund and Länsförsäkringar believe that in order to paint a good picture of a company's costs and revenues it is important for the bank that companies accrue their costs and revenues, even small amounts.

Financial forecasts: All interviewed banks say that one of the most important factors for credit judgment and credit worthiness is financial forecast; budget, new business plan, liquidity report, competitors and a company's critical contracts to third parties. The interviewed banks stated that before launching a new product, the companies normally undertake research about market situations, competitors and the level of the product's demand in the market. Moreover, companies make a plan and budget about new projects. As a result, banks want to get information about the results of those researches and plans.

Environmental report**:** All interviewed banks believe that environment is a very important issue and they want to know to what extent a given company's operation affects the environment. But in many cases it is difficult for banks to judge the environmental effects. Banks wish for high quality environmental reports from companies.

The table 6.1 shows the banks answers to the question: To what extent are the below five factors important in credit assessment?

a) Intern generated intangible assets?

b) Component depreciation?

c) Revaluation of fixed assets at fair value?

d) Revaluation financial instruments at fair value?

e) Accrual revenues and costs under 5000 SEK?

Table 6.1

Banks	Intern generated intangible assets	Component depreciation	Revaluation of fixed assets at fair value	Revaluation financial instruments at fair value	Accrued revenues and costs under 5000 SEK
Färs & Frosta	Not important	Not important	Very important	Very important	Not important
Swedbank	Not important	Very important	Very important	Very important	Important
Handelsbanken	Not important	Important	Very important	Very important	Important
Nordea	Not important	Not important	Very important	Very important	Not important
SEB	Not important	Important	Very important	Very important	Important
Sparbanken öresund	Not important	Important	Very important	Very important	Important
Länsförsäkringar	Not important	Important	Very important	Very important	Important

Table 6.1 illustrates five factors that are important for credit assessment and are not required in K2 regulation and the figure shows which (according to our interviewed banks). The figure shows that factors, such as measure financial instruments and fixed assets in real value play a very important role in credit assessment. Moreover, component

depreciation is important for all banks except Färs & Frosta and Nordea. To accrue costs and revenues under 5000 SEK were also important for all interviewed banks except Färs & Frosta and Nordea. Intern generated intangible asset is not important to the interviewed banks.

Table 6.2 shows the key information required for credit assessment and shows to what extent banks can get their information needs from the current regulation and the K2 regulation.

Table 6.2

Is the information provided sufficient for credit assessment?	According to current regulation	According to K2 regulation.
Cash flow	NO (Cash flow is not mandatory)	NO (Cash flow is not mandatory)
Details information about account receivable	NO	NO
Details information about inventory	NO	NO
Revaluation of fixed assets at fair value	YES	NO (Building and land can be written up as assessed value)
Revaluation financial instruments at fair value.	YES	NO
Historic information about assets' depreciation, revaluation and written-off	To some extent	To some extent
Component depreciation	YES (Optional)	NO (Not allowed)
Accrual costs and revenues	YES	YES (Costs and revenues under 5000 SEK need NOT be accrued)
Financial forecasts; budget, earnings forecast and liquidity report	NO	NO

Environmental report	NO	NO
Companies' contracts with third parties	NO	NO
Information about companies' competitors	NO	NO

According to our findings (Table 6.2), K2 regulation has less information and less useful items for credit assessment and this means that the simplified K2 regulation makes it more difficult for banks to use financial statements for credit assessment. In fact, in credit assessment, the most important shortage of K2 is that, in K2, the company is not allowed to revalue assets such as financial statements and fixed assets at fair value.

Different stakeholders are affected differently by the simplifications in the K2 guidelines. However, as was confirmed by the banks and our expert interviews, it does not make much of a difference whether the company applies the current or the K2 regulation. Since the selection of regulation is inconsequential to the banks as stakeholders, it saves them time and in particular, costs. The reason why it does not matter much which regulation is applied is due to the fact that the information revealed by the financial statement is insufficient for the banks and the banks seek further financial and non-financial information by their own means. So the debate now becomes whether the companies that have the audit should scale down the audit as well.

6.2 To what extent do banks perceive the reports to be credible without an input of an auditor for K2 companies that are exempted from the audit?

Our findings show that the reviewing of financial statements by an independent auditor is very important for Swedish banks. Although banks are very powerful stakeholders and companies will provide any information and disclosure that banks demand, the fact is that banks cannot control and monitor all factors and all companies. Therefore, they need an auditor to review financial statement. If a company needs to finance its capital through creditors, the banks normally demand that the company's financial statements be audited. In Sweden, auditors play an important role in credit assessment and all interviewed banks

see auditors as their partners. In fact, from the banks perspective, an unaudited reported is not credible.

This finding supports the lending credibility theory that financial statements that are reviewed by an independent auditor would give assurance to the banks that accounting statements are correct, free from material errors and true. Our results show that auditing will add credibility to financial statements and will enhance the banks faith in any financial statement. Moreover, auditors detect fraud in financial statements (policeman theory). As a result, audited financial statements become reliable for banks. Furthermore, our findings support the agency theory that both banks and companies get the benefits of an auditor because many interviewed banks, such as Håkan in Swedbank and Stefan in Sparbankenöresund believe, the bank, the company and the auditor are three partners that cooperate together and if one of them is absent, credit granting becomes impossible.

Our findings show that the banks perceive that companies do not have incentive to reveal information because either providing information is expensive for the companies (Färs & Frosta and SEB) or companies don't want to reveal bad news (Swedbank and Handelsbanken). As a result, our studies support the theory that managers in companies have access to information that banks do not have, hence, information asymmetry will have occurred. We show with our findings that auditing reduces the information asymmetry and auditors make financial statements more useful.

In general auditors have three important roles in SMEs companies. Auditors review financial statements and give assurance to the banks that financial statements are reliable and free from material errors. Second, auditors review the financial forecast (which is measured by company managers) and give assurances that the financial forecast, such as budget, are measured mathematically and scientifically correct. Furthermore, auditors give their opinion on how credible the financial forecast is. Our research shows that this role of reviewing financial forecast can be the most important role of auditors, because banks are mostly interested to know about a company's future cash flow and the efficiency. But annual reports are historic and do not tell so much about the future. The third role of an auditor is to present the SMEs business concept scientifically since most of managers (and owners) of SMEs are not educated in economic fields. Our findings, as

confirmed by the banks, show that in many cases the managers at SMEs have a good business concept, but they can not present their business concept, plan and budget academically and scientifically to a creditor. As a result, the company needs an economist who can answer the creditors' questions scientifically. Indeed, it is the auditor who can answer and verify the company's business concept. The banks prefer to contact the company's auditor when they want to get extra enquires. As a result, both creditors and companies get the benefits of having auditors. The answers we collected from the banks show that companies that are serious and want to cooperate with creditors will hire an auditor whether or not they are exempt from the statutory audit.

If a company decides not to hire an auditor banks will either reject the company or they will demand higher security, but it mostly depends on the company manager's characteristics, its industry and its business concept. Swedbank, Handelsbanken, SEB, Sparbankenöresund and Länsförsäkringar will normally reject a company without an auditor and Nordea and Färs & Frosta will demand a higher security and a reasonable business concept. If a bank has a long relationship with a company and the bank believes that managers in the company are experienced, educated, have a good business concept and are able to handle the business, it is more likely that bank will grant the credit even if the company has not an auditor.
The table 6.3 shows how different banks grant credit to a company without an auditor.

Table 6.3

Banks	How do banks grant a credit to a company without an auditor?
Färs & Frosta	1- The company should have a reasonable business concept 2- The company should put a high value asset as collateral
Swedbank	The bank does NOT grant credit to a company without an auditor. In some cases, the company's application will be recognized as a private person who applies for credit.
Handelsbanken	If the company is small and is not complicated it is possible to grant credit, but for complicated companies or companies with a higher amount of credit, having an auditor is a requirement.
Nordea	If the company managers are experienced and the company put a high value asset as collateral, credit granting is possible.

SEB	The SEB in Lund has NEVER granted credit to a company without an auditor according to Vitor.
Sparbankenöresund	If there is a long relationship with a company and the credit amount is low, it is more likely to grant credit. In other cases bank definitely requires an auditor.
Länsförsäkringar	Having an auditor is a requirement for credit of a large amount. If the credit amount is small, under some conditions, granting credit is possible.

Chapter VII Conclusions

In this chapter we will present our conclusion of our research, answering to what degree the K2 guidelines will affect the usefulness of the financial reports for banks making credit assessments for companies reporting according to K2. Finally our suggestions on future research will be presented.

Creating simplification is an important aim for K2 and an important basis for the BFN has been that the rules should be based on needs and perspectives of the user. Our findings show that the financial statement is not sufficient for credit assessment and banks need much more information and documentation. There are various financial and non-financial factors that banks cannot determine using the regulation. The most important items that banks require is information about accounts receivable and inventory, including information about assets' historic depreciation and revaluation. Moreover, banks need to know the real value of assets (fair value) and financial forecast. When companies want to launch a new product, they research the market situation, their competitors and make a plan and budget. In fact, the result of company's research is missing in financial statements. It should also be noted that there are other very important factors that banks will take into account, these being, the character of the borrowers, their expertise, experience and competence. The duration of the relationship between bank and borrower can also play a role.

The studies finding show that K2 provides less information and disclosure than current accounting regulations and this means that it will be more difficult for credit assessment. In general, banks managers do not have much information about K2 and they do not consider whether K2 discloses more or less information. Since banks are one of the most important stakeholders, companies will provide any information that banks demand. Banks are even allowed to visit the companies and control company operations.

In spite of the banks power over companies, it is not possible for banks to control and monitor all companies. As a result, credible financial statements and credible financial forecasts play a big role in credit assessment. Financial statements must be credible and free from material errors. In order to make financial statements credible, there is a need for an independent auditor to review the financial statements. Most banks believe that auditors are their partners and that without auditing the financial statements are not reliable. Auditors also help to reduce the likelihood of information asymmetry occurring. Another way that auditors inspire confidence is by detecting fraud. Moreover, due to the fact that banks are not likely to give out "bad" information, there is more confidence in the auditor's findings. Finally, auditors are the ones who are best able to present business concepts and budgets and forecasts scientifically and mathematically. Our findings show that most of banks reject companies without an auditor and only in rare cases do banks grant credit.

7.1 Suggestions for further research

The K project is a work in progress and still evolving. Although this is a framework developed for the banks, banks have very little idea about the K2 framework and we suggest that further research should be done to find how best banks can be better acquainted with the framework.

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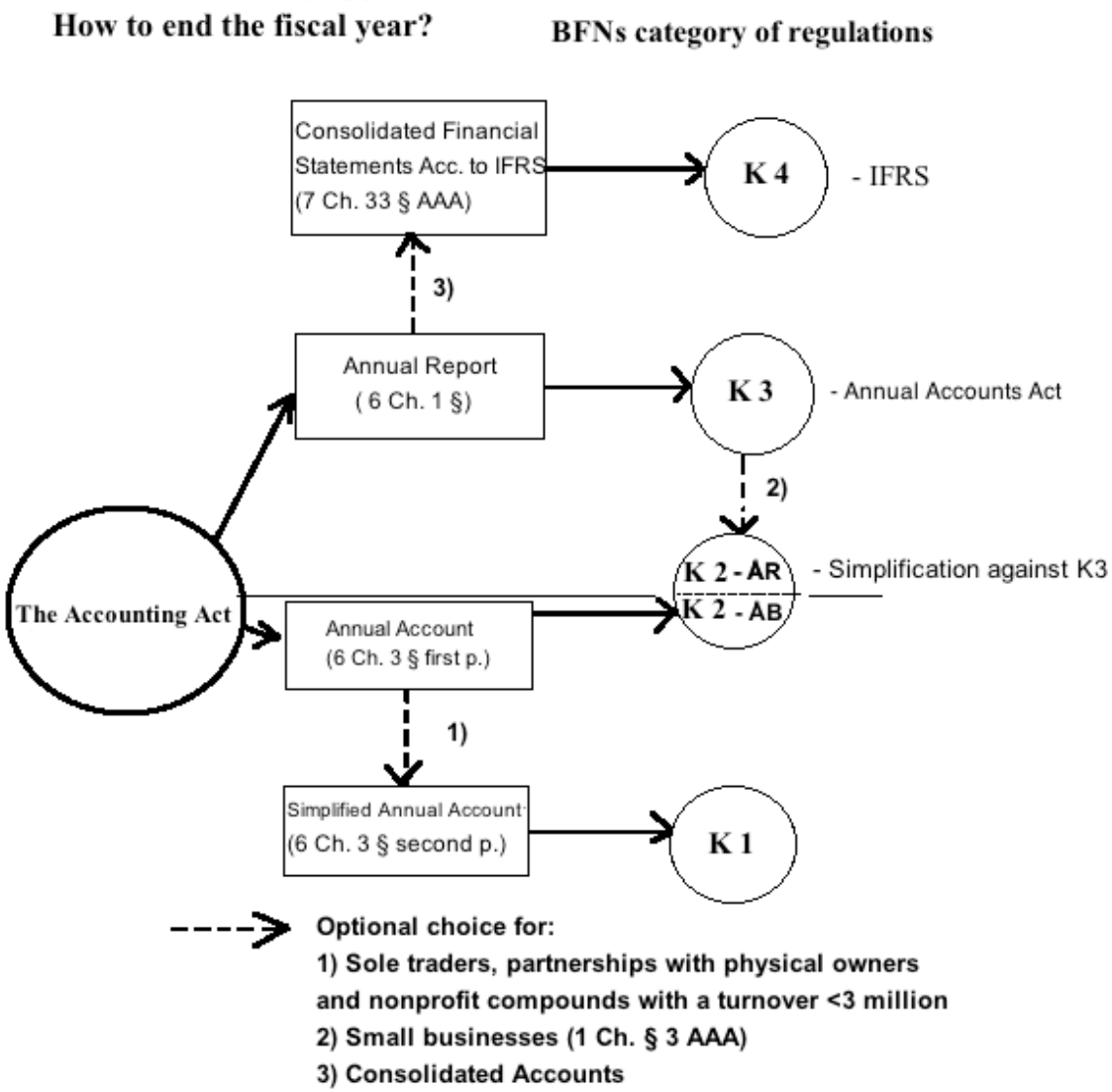
NORDEA	Malmö	Magnus Liljenberg	06-05-2013
SEB	Lund	Vitor Afonso	07-05-2013
Sparbankenöresund	Malmö	Stefan Ögell	08-05-2013
Länsförsäkringar	Malmö	Filip Åkesson	10-05-2013

Audit firms

MAZARS	Malmö	Sonny Malmquist	10-04-2013
Grant Thornton	Malmö	Christoffer Hulten	15-04-2013
KPMG	Malmö	Eva M Henriksson	22-04-2013
Ernst & Young	Lund	Anders Mårdell	25-04-2013

Chapter VIII Attachments

Attachment 1 K1-K4



Attachment 2 Interview Questions

Bank interview questions

1) To what extent do banks perceive the financial statements of companies reporting according to the K2 guidelines to be sufficient for credit assessments?

Credit assessment information

1. Do the bank follow any specific policies/guidelines /models in credit assessment?

2. Does A) The legal status play any role in credit assessment?
   B) The size of the company plays any role in credit assessment?
   C) The industry plays any role in credit assessment?
   D) Any other factor plays any role in credit assessment?

3. What type of information is collected from the financial statements in credit assessment? Key factors?

From the Annual Report A) The Balance sheet?
B) The Income Statement?
C) In the notes?
D) The audit report?
E) Other important information?

Sufficient accounting information

4. Is the financial information in K2 companies sufficient in credit assessment? If the answer is no, which specific items are not sufficient?

From the Annual Report A) The Balance sheet?
B) The Income Statement?
C) In the notes?
D) The audit report?
E) Other important information?

5. Does it make any difference if the company applies to the K2 framework or any other framework in credit assessment?

6. What types of financial information (documents) is collected that is not in the K2 financial statements?

7. What type of information is collected in credit assessment, which is not in the financial information?

A) Information on credit check?

B) Information about safety assessment?

C) Information about the customer relationship?

D) Information on future forecasts?

E) Information about the market and the economy?

F) Any other relevant information

8. How is the credit monitoring perceived?

9. What type of relevant information is collected when credit monitoring?

The Quality and the Design of the reports

10. Do the bank find any misleading information in the financial statements? If the answer is yes, what information?

11. Does the financial information need interpretation before using?

12. What do the bank perceive of

A) The quality of the financial statements?

B) The design of the financial statements?

D) The comparability of financial statements?

E) True and fair view picture of the financial statements?

13. To what extent is the information and disclosures sufficient in the financial statements for credit assessment? (Current accounting regulation)

Not good at All Partially Strongly Completely

14. To what extent is the information and disclosures sufficient in the financial statements for credit assessment? (K2 accounting regulation)

Not good at All Partially Strongly Completely

Information banks wish to add to the financial statements

15. What kinds of information / items would the bank like to add in the financial statements?

16. To what extent are the below factors important in credit assessment?

a) Intern generated intangible assets?

b) Component depreciation?

c) Revaluation of fixed assets at fair value?

d) Revaluation financial instruments at fair value?

e) Not accrued revenues and costs less than 5000 SEK?

2) How do banks perceive the credibility of unaudited reports for K2 companies that are exempted from the audit?

17. What is the credit assessment process for a company without an auditor?

18. How do the bank grant a credit to a company without an auditor?

19. How does the bank collect information from a company that does not have an auditor?

20. How do the bank perceive:

a) The reliability of the financial statements without the input of an auditor?

b) The quality of the reports without the input of an auditor?

21. What information and documents are required from a company without an auditor in credit assessment?

Auditor interview questions

1- Accounting information

1. What are the most important items in the financial statements in credit assessment? In:

From the Annual Report A) The Balance sheet?

B) The Income Statement?

C) In the notes?

D) The audit report?

E) Other important information?

2. What information do the banks need in the financial information that is not in the K2

From the Annual Report? A) The Balance sheet?

B) The Income Statement?

C) In the notes?

D) The audit report?

E) Other important information?

3. How often does banks contact you to get more information and inquiries about financial statements regarding credit assessment for companies? What do they want to know?

4. Does it makes any difference if the company applies the K2 regulation or other regulations (for credit assessment)?

5. What is the K2's impact on credit assessment?

2- Auditing information

6. What is your perception of the exempted statutory audit –duty?

7. To what extent has the exempted statutory audit –duty impacted on the quality and the reliability of the financial statements?

8. How do banks grant a credit to a company without an auditor?