The Role of Financial Reporting
Perspectives of Different Actors within the Reporting Environment of Entrepreneurial SMEs

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Preface

The study presented in this thesis was conducted in two parts. The empirical material and results of the first part were published as a licentiate thesis, Financial reporting in entrepreneurial SMEs: In search of significant areas of financial reporting information (Yström, 2010). When using empirical material and text that was initially published in the licentiate thesis, this thesis follows the guidelines presented in Good Research Practice by the Swedish Research Council (Swedish Research Council, 2017).

Chapter 1 of this doctoral thesis contains parts which are corresponding to the opening discussion of the licentiate thesis, but the discussion is developed, in particular by taking the current debate regarding the objectives of financial reporting into consideration.

In Chapter 2, Section 2.2 on financial reporting and SMEs constitutes a development of corresponding sections in the licentiate thesis. Section 2.3 on entrepreneurship corresponds to section 2.3 of the licentiate thesis but includes language editing and minor improvements. The text in section 2.4 on studies of accounting in entrepreneurial entities corresponds to 3.2 and 3.4 in the licentiate thesis. As Section 2.3 in this doctoral thesis serves another purpose compared to the purpose of the licentiate study, the text is edited and developed.

Chapter 3 on methodology, Section 3.5, presents the details of the process followed for the different steps taken in collecting data for the study’s first part, which besides minor modifications is in accordance with Sections 4.1, 5.1, and 6.1 in the licentiate thesis.

In Chapter 4, presenting the empirical results of the licentiate study, Sections 4.1, 4.2, and 4.3, of this thesis include the empirical results previously presented in Sections 4.2, 5.2, and 6.2 in the licentiate thesis. The content of these sections complies with the original text, with minor language improvements, changes in the mode of expression, and a few corrections.

Chapter 5, 6 and 7 report the second part of the study and have no correspondence in the licentiate thesis. Chapter 8 and 9 contains the analysis and conclusions of both parts of the study. Although in line with parts of the discussion in the licentiate thesis the text in these chapters is new.

In the relevant sections, references are made to the corresponding sections in the licentiate thesis in footnotes.
Abstract

In this study the role of entrepreneurial SMEs’ financial reporting is inquired into by posing questions about purposes of use, information needs of users and the extent to which users’ information needs are fulfilled by financial reports. By finding answers to these questions, the study aims to increase our understanding of what overall objective/s financial reporting can fulfill with respect to entrepreneurial SMEs. The study departs from the discussion on the development of differential reporting standards for privately held companies and previous research on accounting in entrepreneurial entities. The contemporary debate on financial reporting objectives forms the base for the discussion. The study is performed with an interpretivist view of financial reporting as a social activity and follows a qualitative research strategy. The empirical work of the study has been carried out in two parts. In the first part, the main source of empirical data was interviews with accounting experts engaged in the debate on the development of accounting standards for SMEs, representing the groups of standard setters, auditors and academics. Document studies of comment letters to the two drafts of the Swedish standard Financial reporting in small companies (K2) and IASB’s Exposure draft of an IFRS for SMEs were also conducted. In the second part of the study, the empirical focus was on reporting entities and other users of entrepreneurial SMEs’ financial reports. For this empirical part of the study, managers of entrepreneurial SMEs as well as venture capitalists and bankers were interviewed, and official documents about each organization reviewed.

With respect to entrepreneurial and growth-oriented SMEs, the significance of future-oriented information is a matter of course. However, the results of this study provide limited support for the usefulness of financial reports to users’ predicting of future performance and, hence, for the theoretical assumption of the decision-usefulness objective of a probabilistic relationship between the past and the future. While the accounting experts interviewed for the first part of the study suggested additional disclosures on future-related aspects to be particularly important to this group of entities, evidence from the second part of the study shows the limitations of financial reporting in predicting future performance. To the interviewed venture capitalists and bankers financial reporting provided a yearly control of the performance and financial position of the reporting entity. However, due to the time delay and the historical perspective of financial reports, additional information on financial as well as non-financial aspects of a business was essential for making judgments about future performance. Additional information was partly provided by reporting entities to users and partly produced by the users themselves. Reporting entities, on their part, used their discretion not to disclose sensitive information and to describe information related to prospects for the future in general terms in the publicly available financial reports. Besides financial reports, additional information was provided
to the closest related stakeholders. When additional information was disclosed within financial reports, the interviewed managers expressed their concern for making a good impression to related parties and to communicate the responsibility and honesty of management. Respondents further emphasized the role of reliable financial reports in building trust and mutual confidence between reporting entities and users. In this respect the results of the study show that financial reporting can be useful both to the user and the reporting entity, even if the reports only confirm past or current performance. Accordingly, the results of this study illustrate the complexity of the interactive relationships between reporting entities and users that is more in line with the stewardship/accountability perspective than with decision-usefulness.

When evaluating the stewardship/accountability of management, reliability of measurement becomes crucial. Representatives of the different groups of actors included in this study emphasized the confirmatory value of financial reporting, reinforced by the audit, not only to external users but to management as well. Respondents also emphasized the importance of keeping track of the balance sheet in order to avoid equity capital deficits. Repeated references were also made by respondents to the importance of the “hard” measure of cash flows, not least considering the uncertainty involved in the valuation of intangible investments. With respect to intangibles in specific respondents suggested information on cash flows to provide straightforward and reliable complementary information which was considered important when assessing a business’ prospect.

In the academic literature, arguments in favour of the reliability of performance measures are generally based on agency theory and the conflicting interests between management and owners and the risk of funds flowing in the direction of individual managers. However, the empirical results of this study indicate that it is the inherent uncertainties and risks of the entrepreneurial process that call for reliable measures. Indications are also provided that the evaluation of accountability/stewardship is not restricted to management’s performance, but that capital providers are concerned about their accountability as stewards as well, which is in line with the pro-organizational and collectivistic behaviours that are central to the theoretical concept of stewardship within the disciplines of management and organization.
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I Introduction

1.1 Financial reporting by SMEs – regulation and research

Traditionally the literature on financial reporting has focused on large and/or publicly listed companies. However, a few decades ago practitioners and researchers as well as standard-setting institutions began showing interest in smaller and privately held entities to an increasing extent. At the core of the discussion was whether these companies should be held accountable according to the same financial reporting standards as their larger and/or publicly listed counterparts (Di Pietra, Evans, Chevy, Cisi, Eierle & Jarvis, 2008; Evans et al., 2005; Jarvis, 1996). The main arguments commonly put forward for differential reporting were the undue administrative burdens and the cost of reporting being out of proportion for smaller entities (e.g. Collis, Dugdale & Jarvis, 2001; Harvey & Walton, 1996). Following this discussion, several jurisdictions developed differential reporting systems for privately held small and medium-sized enterprises (SMEs).¹

In Sweden, a differential reporting system was applied in the sense that non-public enterprises were able to choose either to apply the IAS/IFRS-based standards issued by Redovisningsrådet², or the simplifications offered by Bokföringsnämnden’s³ general advice. Since this reporting system, which had been in use since 1998, turned out to be not only to be complicated in application but also resulted in financial statements that were difficult for users to interpret (BFN, 2004a), Bokföringsnämnden initiated a project in 2004 with the aim of developing a completely new set of reporting standards. For financial years beginning after December 31, 2013, all Swedish companies, depending on their size, had to apply one of four new sets of standards⁴.

In 2002, the International Accounting Standards Board (IASB) initiated a research project with the intention of reducing the financial reporting burden on

¹ In the United States, for instance, the Financial Accounting Standards Board (FASB) issued Statement No. 126, Exemption from Certain Required Disclosures about Financial Instruments for Certain Non-public Entities, in 1996 and subsequently, in 1997 the UK standard setter Accounting Standards Board (ASB) published the Financial Reporting Standard for Smaller Entities, which includes a less complicated measurement for some assets and liabilities and a number of exemptions from the otherwise required disclosures.
² The Swedish Accounting Council.
³ The Swedish Accounting Standards Board.
⁴ The Bokföringsnämnden project is further described in Chapter two (Section 2.2.3) of the thesis.
SMEs wishing to apply global standards (IASB, 2006a). The first International Financial Reporting Standard for SMEs (IFRS for SMEs) (IASB, 2009) was published in 2009. However, a glance at the early project descriptions published by the IASB shows that there were different views put forward during the initial meetings of the project group on the issues of who the primary users of SMEs’ financial reports were, and what information they needed. A topic summary published by the IASB in 2002 stated:

*It is clear that the users of a small entity’s financial statements may be different, but are their information needs different? If so, do they need less information (the usual presumption) or different and perhaps additional information about the entity? (IASB, 2002, Paragraph 12)*

In a further updated project summary in June 2003 (IASB, 2003), which included a report on a meeting of the SME Advisory Panel held at the IASB’s offices in April 2003, there were several statements which were not in line with the initial project description. Among other things, there was ‘broad agreement’ among the attendees that the users of SMEs’ financial statements were the same as those identified in the IASB Framework, but with extra weight given to providers of capital and debt (IASB, 2003, Paragraph 3). The summary further stated that, contrary to what is often advanced among the SME community, management was not put forward as a primary user (IASB, 2003, Paragraph 3). It also appears from the summary that there was a broad range of views on the issue of possible alternatives for IASB standards for SMEs. Still, the greatest support was for the “simplified” accounting approach, with no further reference in the summary to the formerly raised issue of whether there was a need for different and/or additional information about SMEs. It was also noted in the summary that there may be a need for additional work to find out what kind of information users need (IASB, 2003).

When turning to the academic literature, studies suggest that the main user groups of SMEs’ financial reports include owner-managers, providers of loan finance, suppliers, employees and the tax authority (Collis & Jarvis, 2000; Evans et al., 2005; Jarvis, 1996). Concerning the information needs of users, studies tend to investigate the usefulness of financial reports published by entities categorized as smaller or as SMEs, focusing on specific groups of users. While these studies tend to focus on smaller entities or SMEs in general (Collis & Jarvis, 2002; Sian & Roberts, 2009; Svensson, 2003), these groups are not homogenous – not only with respect to size but to other qualities as well. For one thing, the information needs of users of financial reports of entrepreneurial SMEs where high growth puts higher demands on the financial flow from both internal and external resources (Berggren, Lindström & Olofsson, 2001) – may very well be different when compared to established SMEs without ambitions for growth. In the study presented in this thesis, the focus is on entrepreneurial and growth-oriented entities within the SME group.
1.2 Accounting and entrepreneurial SMEs

Entrepreneurship is today a multidisciplinary field of research engaging academics from a wide variety of disciplines such as economics, sociology and geography. In Sweden, entrepreneurship has since long been studied within the discipline of business administration, and especially in the field of organization theory and strategy (Landström, 2005). The literature offers no single definition of entrepreneurship, but the concept is frequently referred to as having to do with the discovery and exploitation of new business opportunities. The successful exploitation of such opportunities is not only considered to lead to the development and growth of the entrepreneurial entity carrying out the exploitation nities, but to contribute to development at the societal level as well (Ireland & Webb, 2009).

In the process of discovery and exploitation, information becomes significant (Venkataraman, 1997). The importance of accounting information in this respect is illustrated in a study by Sexton, Upton, Wacholtz and McDougall (1997) who investigated the learning needs of growth-oriented entrepreneurs. Their study found that among the ten topics where the entrepreneurs experienced the greatest learning needs, the highest rated one was how to use cash flow in operational and financial decisions.

The use of accounting information by growth-oriented and entrepreneurial managers is further supported by Dergård (2006), Lundell (2005) and Hansen (2005). What the studies show in common is that entrepreneurs use accounting information in the management of on-going operations as well as in entrepreneurial processes. Further, in the two studies in Blomkvist (2008) statutory financial reporting is in focus when inquiring into the extent to which entrepreneurs participate in the production of annual accounts. Blomkvist’s qualitative pilot study shows that entrepreneurs are not merely participants in the process of creating annual accounts, but instead have a highly active role in both discussions on how to give accounts in a manner that provide users with ‘correct’ information, and the very procedure of doing so. Among the reasons for their engagement, the studied entrepreneurs express the significance of keeping themselves up to date with the financial aspects of their businesses, implicating that the entrepreneurs consider themselves as users of their entities’ financial reports. Blomkvist’s quantitative main study compares the participation in the year-end procedures by entrepreneurs managing fast growing firms to the participation of managers of non-growing firms. According to the study’s results, entrepreneurs in fast-growing firms use and produce formal financial accounting information, and they participate in the year-end procedures, to a greater extent than managers of non-growing firms of similar size, leverage and profitability.

The studies reported on here focus on the use of and engagement in accounting by entrepreneurs. However, when statutory financial reports are discussed, it is not explicitly investigated whether users’ information needs are
met by the reports. Over the years, research has increasingly focused on the importance of accounting information for entrepreneurship and innovation, but with a greater relative focus on management accounting as compared to financial reporting (Davila, Foster & Oyon, 2009).

1.3 The objectives of financial reporting

Till now, this chapter has discussed users of financial reports and their information needs both with reference to SMEs in general and to entrepreneurial entities within the SME group in particular. While knowledge about users’ information needs is important, it should also be kept in mind that these information needs are contingent on the purposes for which the financial reports are used. As Beaver, Kennelly and Voss (1968) say, “one of the earliest thoughts in accounting” is the notion that accounting information should be evaluated with respect to its purposes of use. As Paton concluded in 1922:

Accounting is a highly purposive field and any assumption, principle, or procedure is accordingly justified if it adequately serves the end in view. (Paton, 1922, p. 472, in Beaver, Kennelly and Voss, 1968)

However, the concept of purpose may be given different meanings depending on perspective or level on analysis. On the one hand, it may refer to uses in different situations, such as shareholders’ assessment of the performance of management, or bankers making credit decisions. On the other, purposes may be discussed on a more general level, aiming at the question of what overall objective financial reporting can and should fulfil. In the accounting literature, the objective of financial reporting is mainly discussed with reference to the two tasks of stewardship/accountability and provision of decision-useful information. According to the stewardship approach, financial reporting aims at providing information on the management of resource-use (Mellemvik et al., 1988), thus facilitating capital providers’ evaluation of the stewardship of management (Beaver, 1998). In the decision-usefulness view, the objective of financial reporting is to provide users with information that is helpful in making economic decisions for the future (Riahi-Belkaoui, 2004; Scott, 2015).

Recently, and with reference mainly to large and/or public companies, arguments have been put forward that there is a need for regulators to reconsider what overall objective/s financial reporting can fulfil. At the core of this discussion is regulators increased emphasis on the decision-usefulness objective while paying less attention to the often-conflicting stewardship function of financial reporting (e.g. Artsberg, 1995; Jönsson, 1988; Zeff, 2013; O’Connell 2007). Critics claim that this direction by standard setters is not sufficiently grounded in accounting practice (Kuhner & Pelger, 2015; Zeff, 2013; O’Connell, 2007; Young, 2006; Ijiri, 1983). Even though the two objectives are often referred
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to as overlapping, the differences in emphasis and perspective are considered to bring about subsequent consequences in terms of the significance denoted to the different qualitative criteria, measurement methods and, also, for individual financial reporting standards (Whittington, 2008a).

With regard to smaller and privately held entities, the accounting literature tends to focus more on the issues of users and users’ information needs than on what overall objective/s financial reporting can fulfil. When an objective is articulated, the general assumption is that financial reporting mainly aims at providing information that is useful to users in their economic decision-making (e.g. Svensson, 2003; Collis & Jarvis, 2000). In the final IFRS for SMEs the objective of financial statements is expressed as the provision of information that is useful to users in their economic decision-making, with stewardship as a secondary purpose (IASB, 2009). Still, it has been argued that there is a need for financial reporting on stewardship irrespective of whether an entity is privately held or publicly listed (Botosan et al., 2006).

Further, Zimmerman (2015) suggests that the demands of 21st century private equity firms are such that the role of accounting will be gradually shifted back to its stewardship roots. In this respect Zimmerman highlights the increasing rate of technological innovations by both new and existing firms, greater reliance on human capital and intangible assets, increased competition and the greater risk of failure, which bring about diverse conflicts of interest and accordingly different challenges accessing capital. The value of companies today is largely created by key stakeholders including the entrepreneur. In this setting, Zimmerman continues, stewardship accounting has an important role in aligning the incentives of these stakeholders.

1.4 Problem statement, research questions and purpose

In the light of the discussion so far, it is not only important to pose questions about users and their information needs, but there are also clear indications that there is a need for further inquiry into the issue of what objective/s financial reporting can fulfil, not only with respect to large and public companies but to private entities as well. The focus of this thesis is on privately held entrepreneurial and growth-oriented entities within the SME group. To acquire knowledge of what overall objective/s financial reporting can fulfil, with respect to this group of entities, we need to study how financial reporting functions in practice. While the concept ‘objective’ refers to the intended function of financial reporting, as put forward by standard setters and in the accounting literature, the concept ‘role’

5 In a commentary of the IASB/FASB decision not to designate ‘stewardship’ a separate financial reporting objective in their joint conceptual framework project, O’Connell (2007, p. 224) calls for a “renewed emphasis on stewardship-related research in financial reporting”.
is used with reference to the function of financial reporting in practice. The problem statement for the study is expressed as follows:

*What is the role of entrepreneurial SMEs’ financial reporting?*

As the role of accounting is not directly observable in organizations or in society, we need to interpret how actors talk about, make decisions and act on accounting to acquire knowledge about this role (Mellemvik, Monsen & Olson, 1988). One important aspect in this respect is in what situations and for what purposes users rely on financial reports. Accordingly, a first research question has been formulated as follows:

1. **For what purposes do users rely on entrepreneurial SMEs’ financial reports?**

The role of financial reporting is further contingent on the extent to which users’ information needs are fulfilled by the financial reports. Hence, a second research question has been formulated as:

2. **What are the information needs of users of entrepreneurial SMEs’ financial reports in relation to the purposes of use?**

By inquiring into the situations and purposes of use and information needs of users, conclusions can be drawn about the extent to which entrepreneurial SMEs’ financial reporting can be expected to fulfil the overall objectives outlined by standard setters and in the accounting literature. This leads to the third research question formulated for the study:

3. **What overall objective can entrepreneurial SMEs’ financial reporting fulfil?**

The main purpose of this study is to inquire into the purposes of use and information needs of users of entrepreneurial SMEs’ financial reports, in order to increase our understanding of what overall objective financial reporting can fulfil, with respect to this group of entities.

In this thesis, the concept *entrepreneurial SME* refers to an entity within the SME group that is managed by growth-oriented individuals who are eager to engage in new development projects and to exploit new product areas or markets, in order to take advantage of new business opportunities faster than competitors. To make the results of the study as comparable to other studies as

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6 The reference to organizations’ financial reporting is not intended as a claim of organizations being capable of acting as individuals, but rather follows the discursive practice in the research area of business administration.

7 As suggested in Section 1.3, examples of purposes may be a banker’s credit decision or a shareholder’s assessment of his or her investment.

8 The definition is derived from the contemporary entrepreneurship literature (see Chapter 2, Section 2.3).
possible, the EU definition of SMEs is used in this study. The focus of the study is on privately held, limited liability companies.

The concepts financial reports and financial reporting are used with reference to the statutory reporting that companies are required to apply according to accounting regulation. Even though financial reporting and financial accounting are often used synonymously in the academic literature, the former not only addresses accounting measurement and recognition, which requires only one party, but it also recognizes that there are two parties involved – the preparers and the users of the reports (Rosenfield, 2006). The use of the concepts of financial reporting and financial reports is also in line with the expression used in current frameworks. Further, the focus of this study on statutory reporting does not imply that voluntary reporting is not up for discussion, since the latter is assumed to be important in understanding the role of the first. Considering the different views put forward by standard setters and in the academic literature, this study addresses the relationship between financial reporting and management accounting.

1.5 Overall design and structure of the thesis

In the accounting literature, the concept of financial reporting environment is used with reference to the different groups of actors that are affected by and have a stake in the requirements of the accounting regulation (Beaver, 1998; see also Scott, 2015). In this way, the concept includes not only the preparers and users of companies’ financial reports - who are directly affected by accounting regulation – but also the standard setters themselves, as well as other actors such as auditors and information intermediaries. To exemplify with reference to the setting of this study, the auditing profession in particular has by tradition had a strong influence on the Swedish accounting regulation because of its engagement in the development of generally accepted accounting practice (GAAP), God Redovisningssed (Artsberg, 2005; Jönsson, 1985).

As roles and interests differ between actors in the financial reporting environment, their views of financial reporting and related concepts may differ as well - not only between groups but also within groups (Beaver, 1998). For one thing, what is desirable information to potential investors or competitors may not be in the interest of management to report on because of the risk of revealing business secrets or for reasons of cost-efficiency. For another, and with reference

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9 According to this definition an SME is an enterprise with a maximum number of 249 employees, a maximum turnover of 50 million Euros, and/or a maximum value of total asset of 43 million Euros. In accordance with the EU definition, micro-entities with less than 10 employees are excluded from this study.

10 See Chapter 2, Section 2.2.2.1, for a further description of the concept.
to within-group differences, this study departs from the assumption that the information needs of users of SMEs’ financial reports may differ not only depending on size but on other qualities as well, such as ambitions for development and growth.

In the accounting literature there have been calls for enhanced communication between standard setters and users in particular (Harding & McKinnon, 1997; Jonas & Young, 1998; Young, 2006). While standard setters have been criticized for not anchoring their work with developing accounting regulation in practice (Young, 2006; Ram & Newberry, 2013; Zeff, 2013), empirical studies show that users tend to take the opportunity to engage in the standard setting process to a limited extent (Geourgiou, 2010; Jorissen, Lybaert, Orens & Van Der Tas, 2012; Larson, 2007). It has also been suggested that the differences in training and experience between users and professional accountants who tend to engage to a larger extent than users make the latter group less representative of the former (Jonas & Young, 1998).

Scott (2015, p. 21) refers to the environment of financial reporting as both complex and challenging, mainly due to lack of “perfect and true accounting concepts and standards”, leading to conflicting preferences of the different groups that have an interest in financial reporting. The importance of financial information for the functioning of markets and, hence, the economy at large, further adds to this complexity. In this setting, Scott argues that an important role of research is improving our understanding of an accounting environment that is constantly changing and evolving.

When inquiring into the role of financial reporting by entrepreneurial SMEs, this study incorporates not only the perspectives of managers of reporting entities and users, but also other actors engaged in the development of accounting regulation. In this way, the study sheds light on the views held by different actors of the financial reporting environment of entrepreneurial SMEs. The study departs from an interpretivist view of financial reporting as a social activity and follows a qualitative research strategy. Empirical data was collected in different steps, conducted within two main parts of the study. In the first part, the focus is on actors within the financial reporting environment outside the immediate user groups. The main source of empirical data is interviews with accounting experts engaged in the debate on the development of accounting standards for SMEs. The first part of the study also includes two document studies of comment letters to drafts of national as well as international accounting standards for SMEs. The empirical results of the first part of the study have been published in the form of a licentiate thesis (Yström, 2010).

In the second part of the study, the empirical focus is on reporting entities and other users of entrepreneurial SMEs’ financial reports. For this part, managers of entrepreneurial SMEs as well as other users of entrepreneurial SMEs’ financial reports, in this study represented by venture capitalists and bankers, were interviewed. The structure of the thesis is outlined in the following.
Chapter 2 presents the frame of reference of the study. The chapter starts with a discussion of financial reporting in terms of objectives, users and information needs, from the perspective of standard setters and as put forward in the academic literature, in general and with reference to SMEs. The concept of entrepreneurship - its prerequisites and its consequences – is then discussed, followed by a review of previous empirical studies on accounting in entrepreneurial entities. Since information on cash flows information and intangible resources recurrently were identified by the respondents as being of specific importance in relation to entrepreneurial SMEs, this chapter also includes discussions on regulation and research with respect to these two areas.

Chapter 3 presents methodological issues at a comprehensive level, departing from the philosophical assumptions of the study and with focus on research strategy and overall design of the study. The discussion further attends to the dynamics of the research process, specifically with reference to the relationship between theoretical and empirical knowledge. Thereafter, the more concrete modes of procedure for carrying out the different steps of data collection are described, including the process of interpreting and presenting the data collected. The chapter further attends to the process of interpreting and analysing the results of the different parts of data collection on a comprehensive level, i.e. the process that resulted in the final analysis as presented in chapter eight of this thesis.

Chapter 4 presents the empirical results of the first part of the study, the licentiate study. Firstly, the results of the interviews with accounting experts are presented. The respondents have been chosen for their extensive and documented knowledge and expertise in accounting and regulation issues, and represent the groups of auditors, standard setters and academics. The chapter also presents the results of the two document studies conducted in the first part of the study. Firstly, the comment letters to the two drafts of Financial reporting in small companies (K2) issued by the Swedish standard setter BFN (BFN, 2006a, 2007) were analysed; and, thereafter, the comment letters to the Exposure draft of the IFRS for SMEs that was published for comment in 2007 (IASB, 2007a).

In the second part of the study, the issues of users, purposes and information needs have been further inquired into from the perspective of managers of entrepreneurial SMEs and other users of entrepreneurial SMEs’ financial reports. Firstly, Chapter 5 reports on the interviews conducted with managers, including presentations of their respective entity’s financial report. Thereafter, in Chapter 6 and 7 respectively, the results of the interviews with venture capitalists and bankers are presented.

Chapter 8 provides an analysis of the data collected in the different steps of the two parts of the study, and in relation to the frame of reference. The discussion is structured in accordance with the research questions formulated in Section 1.4 above. Chapter 9 presents the conclusions of the study with reference to the research questions and the overall purpose. The chapter also presents the
intended contributions of the study and gives some suggestions for further research.
2 Frame of reference

This chapter presents the study’s frame of reference, which in different parts has provided the starting point for the different steps of data collection, and the framework in relation to which the results of the different steps have been interpreted and analysed. The chapter opens with a discussion of the objectives of financial reporting, together with the related concepts of qualitative criteria and users. The presentation includes both the historical background and the contemporary debate on financial reporting objectives. Since the debate on objectives has taken place both within the academic literature and by standard setters when developing conceptual frameworks, the discussion in this chapter attends to both research and regulation. Following on this discussion, research and regulation of financial reporting by SME is attended to. The concept of entrepreneurship – its prerequisites and consequences – is then discussed and followed by a review of empirical studies of the use of accounting information in entrepreneurial entities. The chapter is concluded with an outline of regulation and research regarding cash flow and intangibles - two areas that throughout the different steps of the study have been recurrently addressed.

2.1 Financial reporting: Objectives, users and qualitative characteristics

When the overall objective of financial reporting is discussed in the accounting literature, it is mainly with reference to the two tasks of stewardship/accountability and provision of information for economic decision-making. Stewardship accounting has been practiced since ancient times and was mostly important during the manorial accounting period when stewards had to prove their trustworthiness to an often-absent landlord (Mathews & Perera, 1996). With the growth of companies, resulting in an increasing separation between ownership and control, the emphasis evolved to the way in which financial statements demonstrated to shareholders that the resources entrusted to management had been used properly (Mathews & Perera, 1996). Successively a wider group of stakeholders came to hold companies accountable for their activities in marketplaces for capital, products, services and labour, and for actions with environmental consequences. Consequently, financial reports came to serve as an instrument for accountability control not only for shareholders, but also for customers, suppliers, employees, creditors, government agencies and

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11 Chapter 3 on methodology (Sections 3.3 and 3.4) further describes how the frame of reference successively has been developed during the research process.
Even though there are traces of stewardship accounting far back in history, the accounting literature offers no “agreed or stable meaning” of the concept of stewardship (Zeff, 2013, p 264). Still, some general tendencies in connotation can be discerned over time. Traditionally, stewardship referred to management’s honesty in husbanding (Zeff, 2013), or safe keeping of (Gjesdal, 1981; Birnberg, 1980; Pelger, 2016), the resources entrusted to them. With time, the concept evolved to include the efficiency of management in utilizing the resources and, in due course, the provision of “a suitable return on management’s employment of the resources” (Zeff, 2013, pp. 264). Whereas the terms of stewardship and accountability have come to be used interchangeably by accounting scholars, there are also differences in expression with respect to the relationship between the two. Notably, Ijiri (1975, pp. ix-x) included in the concept accountability “not only the traditional stewardship issues centered on the compliance with established rules but also the modern performance issues oriented toward the efficiency and effectiveness notions”.

While there are various groups of stakeholders who may be interested in companies’ financial reports (Whittington, 2008a), shareholders have been in focus as financial reporting users (Flower, 2004; Mathews & Perera, 1996). As noted by Flower (2004), it is only the shareholders of an entity that have the authority to dismiss the directors. Further, discussions in relation to the stewardship objective often departs from agency theory, focusing on the conflicting economic interests between a principal and an agent (Lambert, 2001; Jensen & Meckling, 1976; Eisenhardt, 1989). Following on an argumentation departing from the agency theoretic school, the primacy of financial reporting becomes the protection of property rights and by that the need to hold stewards as agents to account (Miller & Oldroyd, 2018). The evaluation of how well stewards have fulfilled their accountability requires reliable and verifiable information on past events and transactions.

While historical cost traditionally has been emphasized as the proper measurement basis from a stewardship/accountability perspective (Ijiri, 1975; Gjesdal, 1981), the discussion has evolved to include current cost as a conceivable alternative (Whittington, 2008b). As suggested by Flower (2004), if the overall aim of the accounts is restricted to the demonstration of the honesty of management to shareholders, i.e. that they have not lost or stolen the funds entrusted to them – referring to the historical meaning of stewardship - a balance sheet carrying assets at historical cost becomes logical. When “adding the aim of monitoring efficiency to that of checking honesty” […], however, “a profit and loss account becomes essential and valuation much more problematical since historical cost is no longer the uncontested valuation basis” (Flower, 2004, p. 34). For instance, the reporting of inventory at historical cost would effectively demonstrate the honesty of a merchant to his agent; but to demonstrate the
merchant’s efficiency as a buyer, it would be relevant to know the current price of the inventory (Flower, 2004).

The economic decision-making objective, also referred to as decision-usefulness, is a more recent view that gained ground in the accounting literature in the 1950s, initially in the USA (Zeff, 2013, p. 262). According to this view, that rose as a consequence of changing capital markets and investors becoming more interested in capital gains than dividends (Young, 2006), financial reports should provide information that is helpful to users in making good decisions (Scott, 2015). This approach to financial reporting is grounded in capital market theory, information economics and decision theory (Scott, 2015; Gjesdal, 1981), and it follows the assumption of financial reporting information as a means for the efficient allocation of resources within the economy (Artsberg, 2005, 1992).

Among the different groups making use of financial reporting, the decision-usefulness approach generally assumes investors as a major constituency of users (Scott, 2015). It is a future-oriented view in the sense that financial reporting information should be helpful to the decision-maker, i.e. the investor, in making judgements about future performance (e.g. Flower, 2004; Beaver, 1998). Decision-useful information is in this respect information that helps the user to predict future cash flows (e.g. Whittington, 2008a). The relevance of financial reporting information on past or current performance in making predictions about the future is established with reference to decision theory and the probabilistic relationship between the past and the future (Scott, 2015). Value in use or fair value may increase the relevance of financial reporting to economic decisions. Conservative accounting, on the other hand, such as the recognition of unrealized losses but not gains, may have a detrimental effect on relevance and, hence, decision-usefulness (Scott, 2015). To increase the relevance of financial reporting information, without sacrificing reliability, supplementary information may be provided (Scott, 2015). In this respect, empirical capital market research reports on the decision-usefulness of disclosed management information (Li, 2010; Brown & Tucker, 2011)\(^\text{12}\). However, as noted by Flower (2004), because of the uncertainty involved in making forecasts, it is only information related to the past that can provide an investor with any solid facts. Hence, in the absence of anything better, the investor or shareholder may be compelled to rely on financial statements reporting on past position. In all that, from a decision-usefulness perspective, these statements will only be helpful to investment decisions if they provide a basis for making forecasts for the future (Flower, 2004).

The decision-usefulness perspective has been manifested through the development of conceptual frameworks to a large extent (Young, 2006; Pelger, 2016), and today, the major standard-setting bodies give prominence to decision-

\(^{12}\) The studies by Li (2010) and Brown and Tucker (2011) focus on the Canadian “Objectives of Management Discussion and Analysis” (Canadian Securities Administrators, 2008) which is mandatory for all public companies in Canada. In 2010, the IASB issued the non-binding IFRS Practice Statement 1: Management Commentary.
usefulness as the overall objective of financial reporting (Scott, 2015). The following section presents an overview of how the FASB and the IASB have dealt with the objectives over the years, in their concept statements and frameworks respectively.

2.1.1 Objectives according to conceptual frameworks

The first FASB Concept Statement No. 1, *Objectives of Financial reporting by Business Enterprises* (SFAC No.1), issued in 1978, stated that “financial reporting is not an end in itself but is intended to provide information that is useful in making business and economic decisions” (FASB, 1978, p. i). Even though the objectives were “directed toward the common interests of many users” (p. iv), present and potential investors and creditors were specifically in focus as reference users. While the statement emphasized that financial reports should be useful to users in assessing prospective net cash inflows, reference was also made to the task of financial reports in informing how an enterprise’s management had “discharged its stewardship responsibility to owners” (p. x). In SFAC No. 2, *Qualitative Characteristics of Accounting Information*, relevance and reliability were referred to as most critical to the decision-usefulness of financial reporting information, and as such listed as primary qualities (FASB, 1980).

There were close points of similarity between the IASC’s *Framework for the Preparation and Presentation of Financial Statements* of 1989 - later adopted by the IASB in 2001 – and FASB’s concept statements (Zeff, 2013). In the IASC Framework the objective of financial statements was defined as “to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions” (IASC, 1989, Paragraph 12). While suggesting that the information needs may differ among users, it was also assumed that financial statements that meet the needs of investors, as providers of risk capital to an entity, would also meet most of the needs of other users (Paragraph 10). The framework asserted that financial statements “also show the results of the stewardship of management, or the accountability of management for the resources entrusted to it”. However, it was also clarified that “those users who wish to assess the stewardship or accountability of management do so in order that they may make economic decisions” (IASC, 1989, Paragraph 14).

The IASC Framework put forward four principal qualitative characteristics that the financial statements should fulfil to be useful to users: understandability, relevance, reliability and comparability. Even though the characteristics were not expressively ranked, as in the FASB Framework, the importance denoted to relevance was made clear in the text. Recurrent references were made to the usefulness to economic decisions, and most clearly with respect to the relevance criterion, per which “information must be relevant to the decision-making needs of users” (IASC, 1989, Paragraph 26). While the reliability criterion called for information that is not unreliable in nature of representation to such an extent
that its recognition is potentially misleading, the overriding consideration in balancing between relevance and reliability was stated as how to best satisfy the economic decision-making needs of users (Paragraph 44).

Following the agreement in 2002 to work together on future standards and to align existing ones, the IASB and the FASB initiated a project of developing a joint conceptual framework (Whittington, 2008a). In a discussion paper issued by the IASB and the FASB respectively in 2006, presenting the first two chapters of the proposed conceptual framework, the objective of financial reporting was defined as to provide decision-useful information to current and prospective providers of finance. While both the SFAC No. 1 and the IASC/IASB Framework referred to stewardship/accountability as an additional objective, the discussion paper claimed that the reporting requirements for stewardship could be subsumed within the decision-usefulness objective. The discussion paper further proposed to exclude reliability from the principal qualitative characteristics in favor of faithful presentation, to eliminate the possibility of a trade-off between relevance and reliability (IASB, 2006; Whittington, 2008b). Moreover, because of the inconsistency of prudence “with the desirable quality of neutrality”, the discussion paper rejected the usage of the terms (IASB, 2006, in Whittington, 2008b).

The proposals of the 2006 discussion paper were highly criticized by two Board members who argued for the Alternative View that stewardship should be identified as a separate objective (EFRAG, 2007). Furthermore, of the comment letters that the IASB and FASB obtained on the discussion paper, of the respondents who considered stewardship/accountability as an issue, 78 per cent were of the opinion that stewardship should be stated as a separate objective of financial reporting in the joint framework (EFRAG, 2007, p. 3.) Yet still, in the first two chapters of the conceptual framework issued by both standard setters in 2010, the suggested changes came into force. In late 2010 the IASB and the FASB postponed their joint work on the conceptual framework until other more urgent convergent projects were finalized.

In December 2012, the IASB reactivated the conceptual framework project as an IASB-only comprehensive project. Following due process with the publication of a discussion paper in 2013 and an exposure draft in 2015, considering the responses received (IASB, 2015), a revised conceptual framework was issued in March 2018 (IASB, 2018). The revised framework specifies the objective of general purpose financial reporting as to “provide financial information that is useful to existing and potential investors, lenders and other creditors in making decisions relating to providing resources to the entity” (Paragraph 1.2). In conformity with the joint framework of 2010, user’s decisions are stated to involve “buying, selling or holding equity and debt instruments” and “providing or settling loans and other forms of credit” (Paragraph 1.2). In the

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13 Accordingly, the IASB substituted the previously used term “financial statements” by “financial reports”.
14 European Financial Reporting Advisory Group
revised IASB *Framework*, however, “exercising rights to vote on, or otherwise influence, management’s actions that affect the use of the entity’s economic resources” is added as a user decision (IASB, 2018, Paragraph 1.2). Furthermore, to make these decisions it is stated that users not only assess “the amount, timing and uncertainty of (the prospects for) future net cash inflows to the entity”, but also “management’s stewardship of the entity’s economic resources” (Paragraph 1.3). With respect to the linkage between past and future performance, it is specified further down the document that “information about a reporting entity’s past financial performance and how its management discharged its stewardship responsibilities is usually helpful in predicting the entity’s future returns on its economic resources” (Paragraph 1.16).

With reference to users, the revised framework acknowledges that “the management of a reporting entity is also interested in financial information about the entity. However, management need not rely on general purpose financial reports because it is able to obtain the financial information it needs internally” (IASB, 2018, Paragraph 1.9).

### 2.1.1.1 A note on users’ engagement in the standard setting process

At the same time as the debate on financial reporting objectives has caught the wind in the accounting literature, there has also been a discussion focusing on the defining of the related concepts of users and users’ decisions. Young (2006) argues that the priority given to users’ needs and users’ decisions by accounting standard setters and in contemporary textbooks has arisen despite limited knowledge about the information needs and decision-making processes of actual users of financial statements. In a social construction study, Young (2006) questions the primacy of financial statement users that has become to be taken for granted among standard setters and in the accounting literature. The study illustrates how the conception of financial statement users have been constructed in various documents and reports - including conceptual frameworks and accounting standards – despite relatively little participation by physical readers of financial statements.

While the study by Young (2006) is conducted in the US context, it is notable that the IASB has followed the same argument as the FASB in stating the primary purposes of financial statements as to provide information useful to users in their economic decision-making. Further, several studies clearly indicate that financial reporting users tend to engage to a little extent in the IASB standard setting process. In a study by Botzem (2012) it is shown that the users of financial statements are poorly represented among members of the Board and the various bodies assisting and supervising the Board in its tasks.

In all that, the Botzem study (2012) does not consider the other channels through which different interest parties can influence the standard setting process. Political pressures are continuously put on standard setters by different groups that consider prescribed accounting treatments, the elimination of alternative treatments, or additional disclosure requirements, to be detrimental to
2. Frame of reference

the interests of investors and other users (Zeff, 2002). While a considerable number of studies have inquired into the lobbying activities by different interest groups in national standard-setting processes, there are also studies that have investigated the lobbying pressures by users towards the IASBs (Georgiou, 2010). Common for these studies is that they show little engagement by users in the IASB standard setting process (e.g. Jorissen, Lybaert & Van de Poel, 2006; Larson, 2007; Jorissen, Lybaert, Orens & Van Der Tas, 2012). For instance, in a study by Jorissen, Lybaert, Orens & Van Der Tas (2012), a number of 3,234 comment letters in response to five discussion papers (482 comment letters submitted) and 28 exposure drafts (2,752 comment letters) during the time period of 2002-2006 were analysed. According to the study results, most comment letters to the IASB were sent by preparers (43 percent), followed by the accounting profession (25.2 percent) and standard setters (14.6 percent). The total number of comment letters from users amounted to 47, representing only 3.7 percent of all comment letters sent to the IASB during the five-year period of study. 15

In a study by Georgiou (2010) the cost of lobbying and the expectation that interests would be represented by other users, were put forward as major reasons for investment management firms to not participate in the development of accounting standards. Also, the respondents of the Georgiou study did not believe users to be particularly influential in the IASB standard setting process. Further discussion of the reasons for the underrepresentation by users in the standard setting process is presented in a commentary by Jonas & Young (1998)16. They suggest that the complexity of decision processes, decision usefulness and usefulness of information makes understanding hard to achieve. Also, users might seek competitive advantage from information that other users cannot get, and therefore have little motivation to engage in the development of accounting standards (Jonas & Young, 1998). Moreover, benefits from engaging in the standard setting process are long-term, while many users are preoccupied with getting and using information, now.

Accordingly, even though standard setters, including the FASB and the IASB, consistently have sought to involve users in the standard-setting process (Botzem, 2012; Jonas & Young, 1998; Young, 2006), the result of such efforts seems to leave much to desire. To come to terms with the underrepresentation in the standard setting process Jonas & Young (1998) urge standard setters and constituents to encourage further empirical research on the information needs of users and the decision usefulness of financial reporting. Realistically, they argue, users should not be expected to participate in the standard-setting process at nearly the level proportionate with their importance. In this setting, “quality

15 Among the remaining comment letters sent to the IASB during the years 2002-2006 were stock exchanges (2.3 percent), governments (1.8 percent), individuals (3.3 percent), academics (1.8 percent) and other interested parties (4.2 percent).
16 Gregory J. Jonas and Stephen J. Young were both with Arthur Andersen LLP in Chicago.
research would go a long way to helping standard setters ground their decisions in facts” (Jonas & Young, 1998).

2.1.2 Early views on stewardship/accountability

Even though the discussion on financial reporting objectives intensified as a result of the publication of the IASB and FASB joint discussion paper in 2006, the issue has been debated for a long time. Before attending to the arguments raised in the contemporary discussion on objectives, some classical works on stewardship/accountability will firstly be provided.

In the middle of the last century, Paton and Littleton (1940) questioned the, at the time, more recent view of accounting and its emphasis on the provision of information for future-oriented economic decisions, which they believed was to overstate its function. While recognizing that accounting is about information of events and factors which not only have an impact on the present but on the future as well, Paton and Littleton argued that accounting could not be expected to “go much beyond the supplying of information to make possible various controls” (Paton & Littleton, 1940, p. 11). In their view, the need for verifiable and objective data would be even greater with business activities becoming more complex, and an increasing distance between business management and financial investment.

Another author who has made a significant imprint on the theorizing of accountability is Yuji Ijiri. Ijiri (1983, 1975) proposed that the role of the accounting system was to enable the smooth functioning of accountability relationships among interested parties. As “accountability has been the social and organizational backbone of accounting for centuries” (Ijiri, 1975, p. 32), Ijiri argued, accounting practice could be better understood if viewing accountability as the underlying objective. Ijiri drew attention to the substantial shift in emphasis from the internal processes of accounting, incorporating the recording, classifying and summarizing of accounting data, to the external processes of economic decision-making; and questioned whether accounting in reality had “changed as much as the shift in definitions indicated […]” (p. 32). It was “our interpretation of accounting methods and not the fundamental substance of accounting” that had changed, according to Ijiri (Ijiri, 1975, p. 32).

In developing conceptual frameworks, the choice between a decision-based approach and an accountability approach had according to Ijiri (1983) critical effects on the resulting framework (see also Whittington, 2008b; Lennard, 2007). When adopting the idea that the role of accounting is to provide information useful for economic decisions, he argued, the focus is solely on the decision maker, i.e. the user of accounting information, while the important relationship between the decision maker and the supplier of the accounting information, the reporting entity, is ignored (Ijiri, 1983). When taking a user-oriented and decision-based approach, “more information is always preferred to less as long as it is cost effective” (Ijiri, 1983, p. 75). “Subjective information is welcome as
long as it is useful to the decision maker” (Ijiri, 1983, p.). In contrast, a framework departing from the accountability objective focuses on the relationship between the reporting entity and the user of accounting information, and the provision of “a fair system of information flow” them between (Ijiri, 1983, p. 75). While the user, or *accountee* in Ijiri’s terminology, “has a certain right to know”, the reporting entity, the *accountor*, “has a right to protect privacy” (Ijiri 1983, p.75). More information about the reporting entity may be better from the user’s standpoint, “but not necessarily from the overall accountability relations”. “Subjective information can seriously damage the interest of the accountor, even if it is highly useful to the accountee” (Ijiri, 1983, p. 75). In Ijiri’s view, accounting protects both the reporting entity/preparer and the user; while the user is assured “that the required information will flow to the user with the required accuracy and timeliness”, the preparer is protected “from indiscriminate disclosure requirements by fixing the limits of disclosure”. “Financial statements define simultaneously what should be disclosed and what need not be disclosed.” (Ijiri, 1983, p. 76).

Ijiri did not discard the decision-usefulness approach but rather claimed that it may not be the sole objective that the accounting profession should aim at (Ijiri, 1975). If the use of accounting is restricted to providing information that is useful to decision makers, Ijiri questioned, “why [then] is practice not more selective in choosing the items to be recorded and reported?” (Ijiri, 1975, p. 32). Ijiri’s answer was that “records are kept for every transaction because [the accountor] is accountable for every transaction”. Accordingly, the process of accounting is as important as its product:

> Like insurance, what is ultimately of use here is the assurance provided by an accounting system of records and reports that things can be accounted for whenever necessary. (Ijiri, 1983, p 78)

In this way, the accounting system can in itself be highly useful both to the preparer (the accountor) and the user (the accountee):

> If the accountor behaves more accountably and the accountee increases the trust on the accountor because of the existence of records and reports, that benefit of the accounting system is of fundamental importance even if neither party reads the records or reports. (Ijiri, 1983, p 78)

One key element of accounting reports is, according to Ijiri, the performance measure (Ijiri, 1975). When the performance of the accountor is evaluated based on financial reports, it is in human nature that he or she tries to present the best performance picture possible (Ijiri, 1983). In this context the concepts of objectivity, verifiability and stability become highly important. Historical cost is considered “more objective and verifiable than current cost or other valuation methods based on current market price”. The argument is that “historical cost is
based on the actions actually taken by the firm while other methods are based on hypothetical actions that the firm could have taken or is likely to take in the future” (Ijiri, 1983, p. 79). In his earlier work, Ijiri (1975) argued for the importance of an accounting measurement that was standardized and verifiable to such an extent that it provided little room for dispute between an accountor and an accountee. He used the concept of ‘hardness’ with reference to a measure that gave limited room for dispute in this sense (Ijiri, 1975, p. 36). For a measurement to fulfil the criteria of hardness, three elements were considered necessary; there should be verifiable facts, the measurement process should be well-specified, and there should be a restricted number of justifiable rules (Ijiri, 1975). “A “hard” measure is one constructed in such a way that it is difficult for people to disagree. A “soft” measure is one that can easily be pushed in one direction or the other. For example, cash balance is a hard measure, while goodwill is a soft measure.”

Ijiri clearly attended to the agency-problems related to an accountor’s performance being evaluated based on accounting reports. However, his focus on both parties and a measurement system that gave little room for dispute between them, distinguishes his work from the general one-directional modelling of the agency relationship. Ijiri rather emphasized the interactive relationship between the reporting entity and users, with the accountor’s “right to protect privacy” as important as the accountee’s “right to know”. Ijiri brought forward the importance of integrity and trust that follows on the separation of ownership and management and the role of accountability in enabling this integrity and trust (c.f. Glover, 2018).

2.1.3 The contemporary discussion on objectives

Following on the publication of the IASBs and FASBs joint discussion paper in 2006, the discussion on financial reporting objectives caught the wind. Former IASB Board member Geoffrey Whittington, who was one of the board members arguing for the Alternative View referred to above (section 2.1.1), has contributed to the discussion in several articles providing arguments against the inclusion of stewardship within the decision-usefulness objective (2010, 2008a & 2008b). With reference to the Alternative View, his objection is that accountability involves more than predicting future cash flows. Its stewardship dimension sometimes bears upon the integrity of management as economic performance, and as such it is more concerned with the past than decision-usefulness (Whittington, 2008b). Yet still, Whittington contends, the information needs following on the two objectives generally overlaps. While the past conduct of management may provide relevant information to the prediction of future cash flows, an appropriate assessment of stewardship would involve an estimate of prospects for the future to evaluate the consequences of past policies adopted by management (Whittington, 2008b).
The idea of stewardship presented by Whittington (2008a), and as advanced in the Alternative View, “is one of accountability by the management board of an entity to its proprietors” (p. 499). As existing proprietors of the entity, present shareholders have a specific status among users (Whittington, 2008a, 2008b). From this view, the stewardship relationship between shareholders and management is interactive in the sense that the information contained in the financial reports may prompt shareholders to influence the actions by management (Whittington, 2008b). Accordingly, future cash flows may be endogenous to the process, rather than exogenous variables that can be predicted (Whittington, 2008a).

Whittington argues that the increased emphasis by standard setters on the decision-usefulness of financial reporting, and by that the initiation of fair value as the overall measurement objective, builds on an idealized view of complete markets that are in perfectly competitive equilibrium (Whittington, 2008b, 2010). In Whittington’s view:

*The alleviation of information asymmetry through the exercise of accountability17 is the principal reason why accounts are needed. (Whittington, 2010, p. 104)*

For financial reporting to relieve information asymmetry in an uncertain world, Whittington argues, reliability becomes an essential characteristic (2008b). As advanced in the Alternative View, Whittington (2008a) further brings forward the agency relationship between the management board of an entity and its proprietors, which gives the former an incentive to misrepresent performance. This circumstance, Whittington contends, is the justification for prudence, which can enhance reliability (Whittington, 2008a).

Andrew Lennard, who at the time for the publication of FASB’s and IASB’s joint discussion paper was a member of the UK standard setter Accounting Standards Board (ASB), contends that the exclusive focus on decision-usefulness has brought about “an excessive emphasis on the forecasting of future cash flows, and insufficient emphasis on reliability […]” (2007, p. 52). Lennard argues in line with the Alternative View that “stewardship contributes an important dimension to financial reporting, which should be reflected by specific acknowledgement in the objectives of financial reporting” (2007, p. 51-52). However, he argues, stewardship accounting should not be considered merely as information for assessing the integrity, efficiency or competence of management, but as “the provision of information that provides a foundation for a constructive dialogue between management and shareholders” (Lennard, 2007, p. 52). However carefully business activities have been planned by management, various challenges and opportunities will occur. While management may take certain courses of action in response, it is the shareholders’ right to have their say on these actions (Lennard, 2007). A dialogue them between is therefore essential,

17 Italicized in the original.
and this dialogue may take place in numerous ways and in various media, in narrative or oral form, in print or electronic (ibid.). Even though the annual financial statements only confirm or provide further detail to previously released information, Lennard (2007) argues, they make up a key part of the communication package.

Based on his argumentation, Lennard (2007) contends that financial reporting should not be viewed as a burden that is imposed on management for the sole benefit of the entity’s shareholders. Without financial reporting, management would have no means to explain their actions in response to new challenges or their success. Accordingly, Lennard argues, the provision of credible financial reporting that is helpful in the assessment of stewardship is a fundamental building block of corporate governance that benefits both management and shareholders.

Notably, the critical positions put forward in the course of the due process of the IASB and FASB and in the academic literature do not suggest an either/or relationship between decision-usefulness and stewardship/accountability. As expressed by Whittington (2008b), the objectives differ in emphasis rather than being mutually exclusive, and to achieve a proper balance them between, both should be recognized. Williams and Ravenscroft (2015, 2009) argue that the mixing by standard-setters of “the two metaphors” of decision-usefulness and accountability over the years “has led to incoherent concept statements and incoherence in the standard setting process” (2015, p. 784). They suggest a rethinking of decision-usefulness in order to make it a useful concept rather than “an empty slogan for regulating financial reporting” (p. 784). Further, they argue, instead of subsuming stewardship/accountability under decision usefulness, the opposite may be “more intellectually defensible”. To provide economic “facts” bearing reference on the relationships between companies and the users who have to make decisions about them, rather than information that is decision-useful, Williams & Ravenscroft (2015, p. 784) suggest, may prove to be a more useful way forward for the regulator.

The reintroduction of stewardship into the revised IASB conceptual framework (IASB, 2018) may signify the step towards a rethinking of stewardship that Williams and Ravenscroft (2015) calls for. Yet still, Pelger (2019) argues, based on his analysis of the content of the revised framework, this action by the IASB has not had any substantial effects in the later chapters of the conceptual framework. Even though the IASB may not engage in a new revision of the framework within the near future, Pelger (2019) encourages further research on objectives and qualitative characteristics as it will provide important empirical insights to the standard setter in the future.

In relation to the overlap between decision-usefulness and stewardship/accountability, Watts and Zuo (2016) provides interesting input when tracing the development of practices of accounting and auditing from before the 1930s. Their historical analysis shows that “the approach to accounting and financial reporting was more consistent with stewardship (care
2. Frame of reference

of net assets) and prudence than an attempt to value the firm” (p. 414). In all that, it is emphasized in the study how conservative and audited financial statements could inform analysts and investors about the quality of the future-oriented and less verifiable information achieved in the past from management or other external stakeholders. A parallel may also be drawn to Sabac and Tian (2015) who use Ijiri’s (1975) conceptualization of ‘hard’ versus ‘soft’ measures when they analytically illustrate how hard and verifiable accounting information may increase the trustworthiness and hence the stewardship value of private, forward-looking and unverifiable managerial disclosures. However, as their analysis shows, when the information is used both as an incentive to exert effort and to report truthfully, its confirmatory ability must be high enough to overcome the agency problems of using reporting as an incentive to exercise effort. Yet still, the analyses by Watts and Zuo (2016) and Sabac and Tian (2015) shed light on the argumentation by Lennard (2007) of financial reporting making up an important part of the communication between management and shareholders, and as such useful to both parties.

2.1.4 Summarizing the main features of decision-usefulness and stewardship/accountability

Even though the decision-usefulness and stewardship/accountability objectives are interrelated and overlap, there are also differences in emphases them between. The presentation hitherto on the main differences between the two objectives is summarized in the following and illustrated in Table 2.1 below.

Firstly, from the decision-usefulness perspective, the aim of financial reporting is to provide users with information that is helpful in making economic decisions. Current and prospective investors and creditors are commonly seen as reference users, and relevant information is information that helps them assess the future cash flows of a reporting entity. Proponents of the stewardship/accountability perspective, on the other hand, withhold that financial reports first and foremost should provide information on the accountability of management for the resources entrusted to them. From this view follows that present shareholders hold a specific status among users in their role of proprietors of the business (Ijiri, 1975; Whittington, 2008a & 2008b; Flower, 2004).

Secondly, when the decision-usefulness of financial reporting is prioritized, users and users’ information needs tend to be in focus. In contrast, when financial reporting is viewed from a stewardship/accountability perspective, the interactive relationship between the reporting entity and the users is attended to. Not only are users’ information needs considered important, but the rights and needs of reporting entities as well (Ijiri, 1975). The relationship between users and reporting entities has also been suggested to be interactive in the sense that the financial reporting information may inspire shareholders to influence the
actions by management (Whittington, 2008a, 2008b). In this setting, financial reporting provides a tool for communication between an entity and its shareholders, which benefits both shareholders and reporting entities (Lennard, 2007).

Thirdly, while the decision-usefulness approach emphasizes relevance of financial reporting to users’ predictions of future cash flows, information on past transactions and events becomes significant when the focus is on evaluating the stewardship/accountability of management. With a stewardship/accountability approach, reliability of measurement has been emphasized as essential to alleviate information asymmetry of complex business environments (Whittington, 2008b), as well as to come to terms with the agency-related risks management having an incentive to misrepresent performance.
### 2. Frame of reference

#### Table 2.1 Features of decision-usefulness and stewardship/accountability

<table>
<thead>
<tr>
<th>Fundamentals</th>
<th>Decision-usefulness</th>
<th>Stewardship/accountability</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Main focus</strong></td>
<td>Economic decision-making: Predict future performance/cash flows</td>
<td>Accountability by management of entrusted resources:</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- safe-keeping (traditional)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- efficiency (contemporary)</td>
</tr>
<tr>
<td><strong>Orientation</strong></td>
<td>Users in focus (Scott, 2015)</td>
<td>Users and preparers in focus</td>
</tr>
<tr>
<td>(actors in focus)</td>
<td></td>
<td>- fair system of information flow (Ijiri, 1975, 1983)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- shareholders may affect management actions (Whittington, 2008b)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- the financial report as a tool for communication (Lennard, 2007)</td>
</tr>
<tr>
<td></td>
<td>Reference users:</td>
<td>Reference users:</td>
</tr>
<tr>
<td></td>
<td>Investors (Scott, 2015)</td>
<td>Current shareholders</td>
</tr>
<tr>
<td></td>
<td>Current and prospective investors and capital providers</td>
<td>(Whittington, 2008a)</td>
</tr>
<tr>
<td></td>
<td>Management is not a primary user (IASB, 2018)</td>
<td>Financial reporting is useful to management (Ijiri, 1975, 1983; Lennard, 2007)</td>
</tr>
<tr>
<td><strong>Qualitative</strong></td>
<td>Relevance to economic decisions, i.e. predicting</td>
<td>Reliability of measurement</td>
</tr>
<tr>
<td>characteristics</td>
<td>future performance/cash flow (FASB; IASB; Flower, 2004;</td>
<td>- objectivity, verifiability and stability; hardness of data (Ijiri, 1983, 1975)</td>
</tr>
<tr>
<td></td>
<td>Scott, 2015)</td>
<td>- reliability and prudence (Whittington, 2008a)</td>
</tr>
<tr>
<td></td>
<td>Faithful representation (IASB, 2018)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Measurement</td>
<td><strong>Measurement:</strong></td>
</tr>
<tr>
<td></td>
<td>Current value (value in use or fair value) increases</td>
<td>Historical cost (Ijiri, 1975)</td>
</tr>
<tr>
<td></td>
<td>relevance (Flower, 2004; Scott, 2015)</td>
<td>Historical or current cost (Flower, 2005; Whittington, 2008a, 2008b)</td>
</tr>
</tbody>
</table>

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18 It should be noted that the authors refereed in the table are represented as such, and not necessarily as proponents of one specific view.
2.1.4.1 A note on the concept of stewardship within management and organization

Considering that proponents of the importance of the stewardship/accountability objective often base their arguments in agency theory, it should be noted that the approach by accounting scholars in this respect generally differs from how the concept of stewardship is used within the disciplines of management and organization. Within the latter fields, stewardship theory has developed as an alternative to agency theory, based on the presumption that managers will act as responsible stewards of the assets they control (Donaldson, 1990, Franco-Santos, Nalick, Rivera-Torres & Gomez-Mejia, 2017; Hernandez, 2012; Le-Breton-Miller & Miller, 2018; Neckebrouck, Schultze & Zellweger, 2018). While the premise of agency theory is that both agents and principals seek to maximize their individual utility (Jensen & Meckling, 1976), stewardship theory “defines situations in which managers are not motivated by individual goals, but rather are stewards whose motives are aligned with the objectives of their principals” (Davis, Shoorman & Donaldson, 1997, p. 21). In this theory, the model of man is such that pro-organizational and collectivistic behaviours are of greater benefits to the steward than individualistic and self-serving behaviours (Davis et al., 1997). As the steward pursues to achieve the organization’s objectives, the principal will be benefited as well (ibid.). In contrast to agency theory, stewardship theory is centered on intrinsic, intangible rewards such as opportunities for growth, achievement, affiliation, and self-actualization, which will motivate to harder work in the organization’s interest (ibid.). Since the principal is part of the collective, he or she would expect to be as accountable as the steward in terms of contributions to the collective (ibid.).

2.2 Financial reporting and SMEs

In their development of conceptual frameworks and accounting standards, the major standard setting bodies have focused on users’ information needs in relation to large and public companies. Likewise, accounting researchers have traditionally directed their inquiries towards this group of companies. A few decades ago, however, both standard setters and researchers began to show interest in smaller and privately held entities to an increasing extent. In the following, a short review of trends within academic studies of SME financial reporting is firstly provided, followed by a discussion of international and national regulation with respect to this group of entities.

2.2.1 Financial reporting and SMEs in the academic literature

As introduced in the first chapter of this thesis, when the aim of financial reporting of SMEs is discussed in the academic literature, it is often in relation
to different groups of users rather than an overall objective. In this regard, previous studies suggest that the main users of smaller companies’ financial reports include owner-managers, providers of loan finance, suppliers, employees and the tax authority (Evans et al., 2005; Collis & Jarvis, 2000; Jarvis, 1996). Further, the usefulness of financial reporting to management tend to be related to the development and use of management accounting systems. In this respect it has been suggested that the sophistication of management accounting systems is contingent on the size of companies. As proposed by Thomas (1986), as size increases so does the sophistication and formalization of accounting systems (see also Collis & Jarvis, 2002; Perren, Berry & Partridge, 1998). Research has also shown that statutory financial reporting is attached a greater relative weight in the accounting system as a whole in smaller entities within the SME spectrum, than in larger ones (Collis & Jarvis, 2002). Concerning the information needs of users of SMEs’ financial reports, there are studies investigating the use of various parts of the financial reports, and in relation to specific groups of users (e.g. Svensson, 2003; Collis & Jarvis, 2000; see further section 2.5 below).

When an objective is articulated in studies related to SMEs, it is often assumed that financial reporting should aid users in their making of economic decisions (Svensson, 2003). In all that, it has been suggested that financial reporting is needed for stewardship purposes irrespective of size and whether a company is privately held or publicly listed (Botosan, 2006; AICPA, 2005). In section 2.1.3 above, the stewardship relationship between the management of an entity and its shareholders was described as interactive. However, with respect to this relationship, Flower (2004) attends to the difference between companies of different sizes. For shareholders of large companies there is no effective way to influence management and, hence, the only option for an individual shareholder who is discontent with the directors’ performance is to sell his or her shares (Flower, 2004). Since ownership of smaller entities in general is concentrated to fewer actors, who often have a greater insight into management (Collis & Jarvis, 2000), the stewardship relationship can be expected to be different in smaller entities as compared to larger ones.

2.2.2 The IASB project on financial reporting standards for non-public entities: IFRS for SMEs

For almost a decade, the IASB worked on a project with the aim of providing high quality, understandable and enforceable accounting standards that are suitable for entities that (1) do not have public accountability and (2) publish general purpose financial statements for external users (IASB, 2006a). The intention was to reduce the financial reporting burden on SMEs that want to use global standards, while at the same time ensure that the information needs of the users of their financial statements are met.
The point of departure for the IASB research project was that the accounting standards for SMEs should be built on the same conceptual framework as IFRS’s (IASB, 2004). In the draft of an IFRS for SMEs that was published on the IASB website in early August 2006, it was stated that the objective of financial statements provided by SMEs was to provide information on the financial position, performance and cash flows that is useful to a broad range of users in their economic decision-making (IASB, 2006b). The main users, whose information needs the IASB intended to look after by the IFRS for SMEs, were external users such as owners not involved in the management of the business, existing and potential creditors, and credit rating agencies. Users who are in a position to request reports designed to meet their specific needs such as owner-managers and the tax authority are thereby excluded from the target audience (IASB, 2006b).

In the basis for conclusions accompanying the final standard issued in 2009, the Board argued for full IFRSs as the logical starting point in the development of the IFRS for SMEs on the grounds that “the needs of users of financial statements of SMEs are similar in many ways to the needs of users of financial statements of publicly accountable entities” (IASB, 2009b, BC96). The document further stated that the alternative “fresh start” was rejected as such an approach “could have resulted in different objectives of financial reports, different qualitative characteristics of financial information, different definitions of the elements of financial statements, and different concepts of recognition and measurement”. It was concluded that such an approach would be “costly and time-consuming and ultimately futile”, and also that users’ information needs as regards general purpose financial statement was sufficiently convergent between privately-held and publicly-held entities (IASB, 2009b, BC96).

In the final standard IFRS for SMEs issued in 2009 and updated in 2015, it is stated that the objective of financial statements provided by SMEs is to provide information on the financial position, performance and cash flows that is “useful for economic decision-making by a broad range of users of the financial statements who are not in a position to demand reports tailored to meet their particular information needs” IASB, 2015, Paragraph 2.2). Thereafter follows a separate paragraph stating that financial statements also “show the results of the stewardship of management—the accountability of management for the resources entrusted to it” (IASB, 2015, Paragraph 2.3). Even though the qualitative characteristics as described in the IFRS for SMEs do not include all dimensions of the concepts mentioned in the IASB general framework, the content is largely the same. Unlike the general framework of 2010, however, the IFRS for SMEs holds prudence as a separate qualitative characteristic (IASB, 2015).
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2.2.3 The Swedish accounting regulation for non-public entities

The Swedish accounting system has its origins within the continental tradition and, hence, corporate financial reporting has been regulated by law to a great extent, with a strong focus on creditor protection and a close connection between accounting and tax. While the accounting regulation has developed towards the Anglo-Saxon tradition during the past few decades, not least because of the implementation of IAS/IFRS on group accounts in 2005, there is still a strong connection between accounting regulation and tax law as concerns individual legal entities.

In Sweden, statutory financial reporting is transparent to the public to a large extent as limited liability companies are required by law to make their financial reports public by way of registration with the Swedish Companies Registration Office, Bolagsverket (Annual Accounts Act, chapter 8, section 3 and 3 a). An audit report should also be attached to the financial report, except for smaller entities that have chosen to apply the exemption from the audit requirement.

Swedish limited liability companies are required to include a director’s report in their financial reports. While the requirements differ depending on company size and ownership structure, the Swedish Annual Accounts Act (Årsredovisningslagen) requires that the director’s report in any case includes a fair presentation of the development of an entity’s business activities, financial position and performance (chapter 6, section 1). Information should also be provided about significant events during the financial year (p. 2). For privately held companies that are not categorized as smaller (i.e. of K2 size, see below), there are additional requirements of information such as expectations for future development including material risks and factors of uncertainty, activities related to research and development and share buybacks (chapter 6, section 2). When need for the understanding of an entity’s development, financial position and performance; the report shall also include information on factors related to sustainability, such as environment and personnel (chapter 6, section 4).

2.2.3.1 Swedish accounting standards

According to the previous national accounting regulation system, which was in use between 1998 and 2013, Swedish non-public entities could either choose to apply the IFRS/IAS-based accounting standards that were issued by Redovisningsrådet, and which were statutory for public companies, or the recommendations called “general advice” that were issued by Bokföringsnämnden. The general advice was mainly simplifications of the standards issued by

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19 The smallest limited liability companies in Sweden are since 2011 exempted from the audit requirement and may choose whether they want to engage an authorized auditor or not, provided that at least two of the following criteria are fulfilled and so has been during the last two financial years: a maximum number of three employees, a maximum value of total assets of 1,5 million SEK, and a net turnover of less than 3 million SEK.
where the extent of the simplifications was dependent upon company size. The simplifications that were free of choice for non-public companies were dealt with in each recommendation separately, providing reporting entities the possibility to apply a simplification in one area, and a more advanced principle in another. This system turned out not only to be complicated and incomprehensible for preparers - the possibility to choose rules and principles on level of recommendation also resulted in financial statements less comparable and difficult for users to interpret (BFN, 2004a & 2004b). As a consequence, Bokföringsnämnden initiated a project with the aim of developing a completely new set of reporting standards. As from 2014 all Swedish companies shall apply one of four new sets of standards, depending on legal form, size and degree of public interest:

K1: Sole proprietorships or partnerships with a turnover of less than 3 million SEK.

K2: Limited companies and co-operatives with less than 50 employees, less than 40 million SEK in assets and a net turnover of less than 50 million SEK.

K3: Larger non-public companies and co-operatives.

K4: Public entities or entities with a high degree of outside interest obliged to prepare their consolidated accounts according to IFRS.

Reporting entities can choose a higher category than the one they belong to according to size and legal form, but are then obliged, with a few exceptions, to apply the standard in full. In order to make the standards for the different categories comprehensive, they also include references to statutory regulations. One example in this respect is the requirement of the Swedish Annual Accounts Act of a director’s report to be included in the financial reports of limited companies (1995:1554; chapter six).

The K3 standard is the main alternative for setting up a financial report (or a closing of the books). The framework for the standard is Årsredovisningslagen. One of the points of departure in the formulation of the K3 standard has been the IFRS for SMEs (BFN, 2009), but also the close connection between accounting and tax in Sweden, existing standards and applied accounting practises. In the final standard, the objective of a financial report is stated as to provide information on the financial position, performance and cash flows of a company. The information should be useful as a basis for users’ decisions on economic issues. (BFNAR 2012:1). The standard includes no further specification of what economic issues the standard setters has had in mind in this respect, neither does it specify who the main users are intended to be. There is no reference to stewardship in the standard.
Concerning the K2 category, drafts of a general advice was published on two occasions, in 2006 and 2007. According to the official report that preceded the 2006 draft, and which was developed by Bokföringsnämnden and the Swedish tax authority together, the working presumption was that the accounting rules for entities belonging to the K2 category should be designed in order to meet the information needs of mainly creditors and the tax authority (BNF, 2006b). I was also emphasized that there should be no major differences in information needs between these two user groups, and also that it was desirable to minimize the differences between accounting rules and tax rules. The information needs of other users such as owners and employees were assumed to be met by other means than the official financial reports. The report also urged the development of accounting rules that meet the criteria of understandability and comparability, and that the information needs of both creditors and the tax authority would be met by a simple regulation based on historical cost measurement and prudence. In the final standard published in 2008 there was no reference to an objective of the financial reports (statements) prepared according to the standard, neither to the main user groups (BNF, 2008).

2.2.4 Summary

When reference is made to the objective of financial reporting, both research and regulation on financial reporting by SMEs tend to put forward the usefulness to economic decisions. While the IFRS for SMEs adds stewardship as a secondary purpose, the Swedish standard K3 includes no such reference. In the K2 standard the aim of financial reporting is rather related to users. With respect to the main users, it is notable that research has shown that financial reporting tends to be useful to management in smaller entities, and to a greater extent in the smaller entities of the SME group, while the IFRS for SMEs as well as K2 and K3 excludes management from targeted user groups.

2.3 Entrepreneurship

Despite the large number of studies that have investigated various aspects of the entrepreneurship phenomenon during the past decades, researchers have not been able to unite on a single definition of the concept. Some researchers stress that entrepreneurship has to do with the creation of new organizations (Gartner, 2001), while others claim that entrepreneurship certainly occurs in already existing organizations as well (Davidsson, Delmar & Wiklund., 2002). The concept of entrepreneurship is also frequently used with reference to the management of small and/or family firms in general. The issue of the “correct” organizational setting is, however, not a problem according to the widely cited

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20 Section 2.3 is extracted from the licentiate thesis (Yström, 2010), but with minor changes.
Shane & Venkataraman (2000) since entrepreneurship is viewed as the discovery and exploitation of profitable opportunities. The focus on opportunities implicates that entrepreneurship according to this contemporary definition can be practiced within an existing organisation as well as by the formation of a completely new organization.

Accordingly, opportunity is a concept that is central when discussing entrepreneurship and that can take many forms. According to Davidsson et al. (2002), who restrict the entrepreneurship phenomenon to the market context, a business opportunity should not only be new to the firm but also change the product or service offers that are available on the market. Entrepreneurial opportunities may for instance involve the innovation or discovery of completely new products or services, but also the exploitation of existing products on new markets. Furthermore, activities such as the development of new production technology or the internal reorganization would also count as entrepreneurial as long as they bring about changes in what is offered on the market (Davidsson et al., 2002).

Traditionally, entrepreneurship researchers have primarily been concerned with the innovative abilities of individual entrepreneurs. In a small and newly founded firm, the entrepreneur has a major influence on the entrepreneurial activities carried out in his or her firm. When an enterprise develops and grows, however, more people are likely to get involved in its management and accordingly the influence of the individual entrepreneur diminishes. In these situations, it is significant to recognise entrepreneurial dimensions of strategy in addition to individual level entrepreneurship (Wiklund, 1998). The concept of entrepreneurial orientation (EO) initially developed by Miller (1983), refers to a firm’s strategy and comprises specific entrepreneurial aspects of decision-making styles, methods and practices (Davidsson, Delmar & Wiklund, 2006). In an entrepreneurial oriented firm, there is a willingness to engage in innovation, take risks to try out new and uncertain products, services, and markets, and be more proactive than competitors toward new marketplace opportunities (Wiklund & Shepherd, 2005).

### 2.3.1 Entrepreneurship and growth

From the entrepreneurship literature, it appears that there is a consensus among academics that the concept of entrepreneurship is closely connected to growth (e.g. Gartner, 1990). Such a connection does however not imply that we will find entrepreneurship wherever we find growth, or that we will find growth wherever we find entrepreneurship. Growth can take many forms and some forms rather than others can be considered as manifestations of entrepreneurship. While the organic growth that occurs because of the successful exploitation of new business opportunities can be considered as a reflection of entrepreneurship (Wiklund & Davidsson, 1999), the growth that follows from an acquisition, where a new business is merely added to the original entity without the creation
2. Frame of reference

of any surplus value, will not count as such. In all that, Davidsson, Delmar & Wiklund (2002) suggest that the assumption that “growth is entrepreneurship” is a realistic generalization for young and small firms, but not for large and old ones. The reasoning for this is that younger and smaller firms to a greater extent than older and larger ones tend to grow organically rather than through acquisitions (Davidsson & Delmar, 1998). Consequently, even if entrepreneurship certainly happens in various types and sizes of organizations, acting in the most varying lines of business, it can be concluded that if we study newer and smaller growing enterprises we will probably find out that the growth is organic as a result of successful entrepreneurship.

When studying entrepreneurship, there are many different ways in which the growth of an enterprise can be measured. With reference to previous studies showing that sales is the most common indicator among entrepreneurs themselves (Hoy, McDougall and D’ souza, 1992; Barkham et al., 1996), Davidsson & Wilklund (2000) emphasize the importance of sales when measuring growth. Other important aspects of growth that can be used as measurements are total assets and number of employees. The use of multiple measures may, however, be preferable to individual measurements since they provide richer information (Davidsson & Wiklund, 2000).

The concept Gazelle, which refers to small and organically fast-growing enterprises, was originally developed by Birch (1979) who showed that this group of entities created most new jobs in comparison to larger and established enterprises. The concept Gazelle has also been used in entrepreneurship research when discussing the complex and diverse issue of business growth and development (Achtenhagen, Naldi & Melin, 2010; Achtenhagen, Melander, Strandgren & Strandoff, 2014). To inspire growth and entrepreneurship, the Swedish business paper Dagens Industri yearly rewards the fastest growing enterprises in the country with a Gazelle diploma, which has made the concept well known in the Swedish business world. To achieve the label Gazelle, there are a number of criteria that should be fulfilled, including a 100 percent increase in sales turnover throughout a period of three financial years; the growth of the entity should in all essentials have been organic and not achieved through mergers or acquisitions, and the entity should be in a healthy financial position (Dagens Industri, 2009)

2.3.2 Growth and the demand for financial resources

When a firm grows, its management faces a number of unique problems. One such problem is how to handle the increased demands for financial resources that the growth brings about (e.g. Sexton et al, 1997; Storey, 1994). Berggren, Lindström & Olofsson’s (2001) two studies investigating the financial position of Swedish SMEs show that managers of growth-oriented enterprises, to a greater extent than their counterparts in non-growth enterprises, consider the limited resources of capital – internally generated as well as externally acquired -
as a serious obstacle to development (see also the one-case study performed by Collier, 2005, which is presented in chapter 2). Even if internally generated financial resources are seen as the most important source of capital in growth-oriented enterprises as well as in non-growth enterprises, it is also shown that managers of growth-oriented enterprises are more positive in general towards various types of external finance. In conformity with Storey (1994) the studies by Berggren et al. (2001) also show that the owner structures of growth-oriented enterprises incorporate more categories of owners, and also that external owners, i.e. owners that are not managers or family of managers, in general hold a greater lot of shares than is the case in non-growth enterprises. Furthermore, growth enterprises tend to be financed by investment companies, venture capitalists and other companies to a larger extent than is the case in non-growth enterprises (Berggren et al., 2001). The studies by Berggren et al (2001) also show that bank financing tends to be considered as slightly less important in the growth-oriented enterprises than in the non-growth enterprises.

2.3.3 Implications for this study

This study inquires into the role of financial reporting in relation to entrepreneurial SMEs. The focus on entrepreneurial SMEs rather than entrepreneurs within SMEs implies that the concept entrepreneurship is connected to the entity as a whole rather than to an individual entrepreneur, or a few individual entrepreneurs, within an entity. The reasoning for this focus is based on the idea behind the concept entrepreneurial orientation (EO), i.e. that the influence of an individual entrepreneur on the entrepreneurial activities carried out in an enterprise usually diminishes when it develops and grows and more people are involved in its management. In addition, the focus of this study on statutory accounting information, which is prepared for the entity as a whole, provides with further argument for the focus on entrepreneurial SMEs rather than individual entrepreneurs, since individuals may be accountable only for a part of the business carried out by the enterprise.

Consequently, in this study the definition of an entrepreneurial SME, as presented in section 1.3, has been developed with the concept of entrepreneurial orientation as a point of departure, together with the assumption that organic growth is closely connected to successful entrepreneurship. More specifically, the term entrepreneurial SME is in this study used with reference to an entity within the SME group managed by growth-oriented individuals who are eager to engage in new development projects and exploit new product areas or markets, in order to take advantage of new business opportunities faster than competitors (see section 1.3).

The focus on opportunities of this study’s definition of entrepreneurial SMEs is in line with the fundamental idea behind the Shane & Venkataraman (2000) view of entrepreneurship, which is also applied in several studies about
2. Frame of reference

accounting in entrepreneurial contexts (Blomkvist, 2008; Dergård, 2006; Hansen, 2005; Lundell, 2005; see section ).

The academic literature suggests that the main users of SMEs financial reports include managers, providers of loan finance, suppliers, employees and the tax authority. With reference to the entrepreneurial context, however, there is a tendency among entrepreneurial entities – as growth increases the demands for financial capital - to rely on external financial capital to a larger extent than what is the case in established SMEs. For the present study this would implicate that we can expect external financiers – including venture capitalists – to belong to the main user groups of entrepreneurial SMEs financial reports to a greater extent than what is the case in SMEs in general.

2.4 Studies on accounting in entrepreneurial entities

In the early phase of carrying out this study, there was a group of researchers in Sweden studying accounting in relation to entrepreneurial entities. In most of the studies, the focus was on entrepreneurs’ use of accounting information with no distinction between management information and statutory financial reporting. None of the studies were neither conducted with the aim of sorting out the usefulness of statutory accounting information per se. Still, they provided with suggestions of important areas of financial reporting in relation to entrepreneurial entities.

Dergård’s (2006) study of seventeen successful entrepreneurs contend that these entrepreneurs use accounting information for decision-making in the processes of discovery and exploitation of entrepreneurial business opportunities as well as in on-going business operations. In the study the concept of accounting information is defined in a wide sense including all information that the entrepreneurs use in their endeavour to achieve economic goals. According to the empirical data and results of the study, the entrepreneurs use financial as well as non-financial information about both external and internal conditions. The studied entrepreneurs, who use internally as well as externally based sources of information, consider both information about the past and the future to be valuable. The nature of the accounting information used, however, varies between the different stages of the product life cycle. The entrepreneurs in Dergård’s study use financial information about the entity mainly in the exploitation stage and in the management of on-going operations. In the exploitation stage, information to evaluate the opportunity, to acquire resources and to combine the resources in a new way is considered significant. Concerning the management of on-going operations, the studied entrepreneurs use ex post financial information to evaluate the success of exploited opportunities. In both exploitation and management of on-going operations, the entrepreneurs tend to
rely on information related to sales, profit, profitability and cash flow. In planning and evaluation of on-going operations, the greater part of the studied entrepreneurs focuses on contribution margin.

Lundell (2005) studied a financially successful entrepreneur’s (that is the owner and manager of a company that can be characterized as an SME) use of accounting information in perceiving risk. The results of the study show that the entrepreneur uses accounting information in order to perceive risk in managing operations as well as in entrepreneurial processes. In the daily management of operations, the entrepreneur keeps himself updated on sales, variable costs and cash flow, which are seen as fundamental figures in terms of the short-term control of the business. In entrepreneurial processes, accounting information is considered crucial in determining whether an opportunity should be exploited or not. Since the entrepreneur is constantly involved in the update of accounting figures, he can quickly decide whether an entrepreneurial opportunity is economically feasible to exploit or not. In cases where an opportunity turns out to be appealing as well as economically feasible, additional and more exact information – including accounting information – is collected. With respect to financial reporting the entrepreneur studied by Lundell supplements the balance sheet and income statement with a cash flow statement - even though this is not required by Swedish accounting legislation - since he believes that it incorporates important information that is “hidden by the accounting figures” in the statutory reports. Regarding financial risks the entrepreneur prefers the financial independence that a high equity ratio offers, which confirms the suggestion by Berggren, Lindström & Olofsson (2001) that growth-oriented managers, just as managers of SMEs in general, consider internally generated financial resources as the most important source of capital (see section 2.3.2 above).

Hansen (2005) inquires into the use of accounting information in two entrepreneurial companies operating in quite different contexts. Since one of the studied companies in terms of size by far exceeds the limit for being an SME, it is only the smaller case company that can be characterised as an SME. The study shows that accounting information is vital and is used actively for decision-making, control and organizational learning in both companies. The reports these entrepreneurs are mostly interested in are relatively short-termed but the monthly profit and loss accounts as well are considered important. In the SME that operates in a less complicated environment that is easier to survey than the context of the larger company, a more standardised accounting system is in use. The entrepreneur managing the SME relies to a high extent upon formal reports where the focal point is on revenues, variable costs (COGS are considered to be of certain significance) and gross margin. In the larger company, the formal systems are to a greater extent complemented by oral information and discussions, and the most important factors are believed to be non-financial, such as production yield and volume.

In short, these three studies are mainly concerned with the use of accounting information for internal decision-making purposes. The Australian longitudinal
study by Collier (2005) illustrates how a simple spreadsheet model designed by the entrepreneur himself successively grows into a sophisticated tool for accounting control as well as for informing external financiers. The original spreadsheet model, which was intended for internal use and cash-flow dominated, was used not only as a historical record but also as a forecasting device and a tool for ongoing decision-making. Since heavy investments were made regularly in R&D and market development, a recurrent issue was how to access funds for expansion. Even if most of the capital needs were met by internally generated profits, the rapid development required additional funds in terms of bank loans. Due to bankers’ unwillingness to lend against financial projections there had been situations when the entrepreneur had to invest funds, that otherwise would have been invested in R&D and market development in, real estate. Gradually however the entrepreneur experienced that the spreadsheet model facilitated his communication with his bankers and, as a consequence, the expansion of the business within the cash flow and borrowing capacity.

When the enterprise studied by Collier (2005) grew bigger, the cash-flow spreadsheet was developed to include industry and market share modelling in order to reflect the long-term goals of sales growth. Since the matching principle was not applicable due to the lead time between investments in research and development (R&D), export market development and patent litigation, and the subsequent inflows of cash, traditional accounting reports were not considered to provide with the relevant information on profitability. Accordingly, income statements and balance sheets were only prepared at year-end to satisfy external requirements.

The final study of this section looks into the involvement by entrepreneurs in the year-end procedures of constructing financial statements. Blomkvist’s thesis (2008) consists of two empirical inquiries where the first one is a qualitative pilot study investigating the involvement of five entrepreneurs managing small growing enterprises in the year-end procedures of constructing financial statements. The aim of her study is to describe if and how entrepreneurs engage in the process of constructing financial statements and to explain the reasons for the entrepreneurs’ participation. The results of the study show that the studied entrepreneurs are not merely participants in the process of creating annual accounts but highly active in both discussions on how to give accounts in a proper manner, and the very procedure of doing so. Among other things, the entrepreneurs’ wish to influence the content of the financial statements in order to assure that the information needs of users are satisfied. Three of the five entrepreneurs studied by Blomkvist mention shareholders and other financiers – of which one is a venture capitalist - as important in this respect. The other two entrepreneurs, who are the sole owners of their businesses, consider customers to be significant to inform by means of the financial reports.

21 All five enterprises of Blomkvist’s pilot study have less than 50 employees.
Four of the entrepreneurs studied by Blomkvist also consider it important to stay informed about the financial aspects of the business at an early basis in order to be able to provide well-founded answers to questions from shareholders and other financiers. Three of the entrepreneurs state that they participate in order to inform themselves, i.e. for decision-making purposes of their own, on past performance and to make well-founded decisions for the future. As expressed by one of the interviewed entrepreneurs: “if you do not know where you are and where you have been, you will neither know where you are heading” (Blomkvist, 2008, p. 45). In the process of constructing the financial reports, one of the entrepreneurs further states that information is also produced on contribution and margins that is significant future-oriented information for the pricing of the company’s products.

The entrepreneurs are particularly attentive to intangible assets, stock and work-in-progress, and accounts receivable, and among these the treatment of intangible assets receives the most attention (Blomkvist, 2008). In this respect the discussions centre on whether the investments in intangibles should be treated as assets or not, and the consequences of the different procedures. In addition, one of the entrepreneurs calls attention to the importance of being well-informed on present intangible assets since this item contains significant information for the planning and monitoring of future intangible projects. All of the studied entrepreneurs also write the directors’ report of their entities’ financial reports.

Blomkvist’s (2008) quantitative main study compares entrepreneurs in successful fast-growing firms (Gazelles) and managers of non-growing firms and their participation in the year-end procedures, with respect to the valuation of the items of intangible assets, stock (including work-in-progress) and accounts receivable. She contends that entrepreneurs in fast growing firms use and produce formal financial accounting information, and they participate in the year-end procedures to a greater extent on the whole than managers of non-growing firms of similar size, leverage and profitability. Concerning the different assets in focus, the entrepreneurs spend more time compared to managers of non-growing firms discussing the value of stock and work in progress and accounts receivable. Concerning the valuation of intangible assets, the result of the quantitative analysis shows no significant difference between the two groups of firms, even though the mean time that the entrepreneurs spend on discussions on the valuation of intangible assets is three times the time spent by managers of non-growing firms.

Table 2.1 below summarizes the items of accounting information put forward as important by the entrepreneurs of the studies reported on in this section. The item of accounting information that has received most attention in the analysed studies is sales/revenue; in four out of five studies, the studied entrepreneurs list information on this item as significant. This is in line with Davidsson and Wiklund (2000) who suggest, with reference to Hoy, McDougall and D’souza (1992) and Barkham et al. (1996), that sales growth is the most common
performance indicator among entrepreneurs (see section 2.3.1 above). It should be noted however that all of the studies bringing forward information on sales/revenue are mainly concerned with accounting information for the purposes of internal decision-making by the entrepreneurs themselves.

Besides sales, and sales in combination with variable costs, accounting information on cash flow has received attention in several of the studies presented in this chapter. The studies by Dergård (2006), Lundell (2005) and Collier (2005) all indicate that entrepreneurs find information on cash flow significant in their economic decision-making. Collier’s study (2005) also suggests that cash flow information can be significant in negotiations with financiers.

Table 2.2 Important items of accounting information in an entrepreneurial context according to previous empirical studies

<table>
<thead>
<tr>
<th>Accounting information</th>
<th>Study</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales/revenue</td>
<td>Dergård (2006)</td>
</tr>
<tr>
<td></td>
<td>Lundell (2005)</td>
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<tr>
<td></td>
<td>Hansen (2005)</td>
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<td></td>
<td>Collier (2005)</td>
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<tr>
<td>Cash flow</td>
<td>Dergård (2006)</td>
</tr>
<tr>
<td></td>
<td>Lundell (2005)</td>
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<tr>
<td></td>
<td>Collier (2005)</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>Collier (2005)</td>
</tr>
<tr>
<td></td>
<td>Blomkvist (2008)</td>
</tr>
<tr>
<td>Variable costs</td>
<td>Lundell (2005)</td>
</tr>
<tr>
<td></td>
<td>Hansen (2005)</td>
</tr>
<tr>
<td>Contribution margin</td>
<td>Dergård (2006)</td>
</tr>
<tr>
<td></td>
<td>Blomkvist (2008)</td>
</tr>
<tr>
<td>Ratios</td>
<td>Dergård (2006)</td>
</tr>
<tr>
<td></td>
<td>- profitability</td>
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<tr>
<td></td>
<td>- Hansen (2005)</td>
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<tr>
<td></td>
<td>- gross margin</td>
</tr>
<tr>
<td>Profit</td>
<td>Dergård (2006)</td>
</tr>
<tr>
<td>Stock (including work-in-progress)</td>
<td>Blomkvist (2008)</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>Blomkvist (2008)</td>
</tr>
</tbody>
</table>
Another item that has been listed as significant in an entrepreneurial context according to my literature study is information on intangible assets. Four out of the five entrepreneurs studied by Blomkvist (2008) are involved in the valuation of intangible assets in the process of constructing financial reports. Among the accounting transactions that the studied entrepreneurs discuss with other participants during the year-end procedures, investments in intangible assets are the most discussed ones. The discussions on intangible assets are in this respect focused on whether the investments in intangibles should be capitalized as assets or expensed, and the consequences of the different procedures. In addition, one of the studied entrepreneurs stresses the importance of being well-informed on present intangible resources since this item contains significant information for the planning and monitoring of future intangible projects. Furthermore, the entrepreneur studied by Collier (2005) consider traditional financial reporting practices - where investments in research and development are poorly matched to the subsequent inflows of cash - to be deficient for the purposes of measuring profitability.

2.5 Areas of financial reporting information of specific importance in relation to entrepreneurial entities

The analysis above of previous studies on accounting in entrepreneurial entities, provides with indications that the areas of sales, cash flow and intangibles are likely to be of significance with respect to statutory financial reporting. As concerns information on cash flow and intangibles, there are varying requirements of accounting regulations for smaller entities as compared to large and/or publicly listed ones. In the following section, the two areas are therefore discussed further with respect to regulation as well as research.

2.5.1 Financial reporting on cash flow

IAS 7 “Statement of Cash Flows” requires a statement of cash flows to be presented as an integral part of a reporting entity’s financial statements. When developing the IFRS for SMEs the IASB considered eliminating the requirement to prepare a cash flow statement, and in the exposure draft of the standard issued in 2007 respondents were specifically requested to comment on this issue. The majority of respondents who provided an opinion in the matter supported the suggestion that there should be such a requirement, and the most common argument was the significance of cash flow information to users. The IASB decided to make the cash flow statement mandatory and included this requirement in the final IFRS for SMEs published in 2009 with the argument that
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cash flow statements are not very difficult to prepare, and since the great majority of lenders and other users of SMEs financial statements who had communicated with the Board – including particularly lenders and short-term creditors - had indicated that the cash flow statement was useful to them (IASB, 2009).

In line with IAS 7, the IFRS for SMEs requires the reporting entity to present statement of cash flows providing information about the changes in cash and cash equivalents, classified by operating, investing and financing activities. With respect to operating activities the reporting entity can, in correspondence with IAS 7, choose either to use the direct method or the indirect method for reporting cash flows. The IFRS for SMEs is a simplified version of IAS 7 in the sense that it is more straightforward and includes less of detail when describing what should be included in the different categories of the statement.22

With reference to the Swedish context, the Swedish standard setter Bokföringsnämnden followed the example of IFRS for SMEs in their draft of the accounting standard for larger, non-public entities, K3, and included a requirement for cash flow statements23. The accounting standard for smaller limited companies, K2, does not include a requirement for reporting entities to publish cash flow statements, for reasons of simplification. Also, smaller entities that belong to size category K2, but voluntary choose to apply K3, are excluded from the requirement of K3 to include cash flow statements in their financial reports.

According to previous research in relation to smaller entities, information on cash position and/or cash flow is generally ranked highly as a source of financial information for management (e.g. Halabi, Barret & Dyt, 2010; Sian & Roberts, 2009; Collis & Jarvis, 2002). It has also been shown that bankers, which are commonly seen as the main external user group with respect to SMEs financial reporting, rely on cash flow information to a large extent (e.g. Svensson, 2003; McMahon, 1999).

Collis & Jarvis (2002) examine the use of financial information in small companies, to identify the sources and utility of financial information used by managers24. The results show that “there is a strong emphasis among managers on controlling cash and monitoring performance in the context of maintaining relationships with the bank”. The most useful general sources of information are the periodic management accounts, cash flow information and bank statements (a bank statement is another, externally generated, form of cash flow information). The circumstance that these three sources of information are used

22 Also, the directions of IAS 7 for the reporting of investments in subsidiaries, associates and joint ventures, and changes in ownership interests in subsidiaries and other businesses, are excluded from the IFRS for SMEs.

23 In line with IFRS for SMEs, K3 provides an option for reporting entities to choose between the direct and indirect method for the reporting of cash flows from operating activities.

24 The research is drawn from a questionnaire survey of 385 private limited UK companies that conform to the 1999 EU size criteria for a small company, representing a wide range of regions and industries.
by over 80 per cent of companies demonstrates, according to the authors, the importance denoted to controlling cash in smaller entities.

In a study by Svensson (2003) the focus is on creditors’ views on what constitutes useful financial reporting information in the assessment of SMEs’ creditworthiness. The study, which is based on interviews with both institutional and non-institutional creditors such as suppliers, focuses on regulated financial reporting information as well as information reported to creditors as a consequence of contractual agreements. According to the interviewed creditors, the information contained in SMEs’ financial reports is not sufficient for their decisions. In their assessments of SMEs’ creditworthiness, both institutional and non-institutional creditors consider information on cash flow to be an important complement to the regulated financial reports. While institutional creditors prefer to construct their own cash flow statements from the financial information received from companies, most non-institutional creditors believe that the information they receive on cash flows is sufficient. Still, several non-institutional investors believe that formally constructed cash flow statements would improve the usefulness of the financial reporting information.

2.5.2 Financial reporting on intangibles

The IASB has taken a restrictive approach when setting the criteria for recognition of intangible investments as assets in the reporting entities’ balance sheets. IAS 38 “Intangible assets” offers limited possibilities to recognize investments in intangible resources as assets, especially concerning intangibles that are generated internally by the company itself. With reference to internally generated intangibles, IAS 38 differs between costs for basic research and costs for development, permitting only the latter to be recognized as assets, and only if the recognition criteria, which are more restrictive as compared to acquired intangibles, are met. Further, investments in certain types of intangibles are without exception prohibited from recognition, and in this respect the decision by the IASB to prohibit the recognition of internally generated brands has been exposed to criticism by reporting companies (Artsberg & Yström, 2002).

The IFRS for SMEs issued by the IASB in 2009 takes an even more restrictive approach than the IAS 38 in prohibiting all internally generated intangibles as assets unless they form part of another asset that meets the recognition criteria of the standard. The Swedish standard K2 goes even further when requiring all

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25 Expenditure on internally generated goodwill, brands, mastheads, publishing titles, customer lists and items similar in substance is not considered to be able to distinguish from the cost of developing the business as a whole. Therefore, such items should not be recognized as intangible assets according to IAS 38.

26 As examples of applying this regulation, an entity shall recognise expenditure on the following items as an expense and shall not recognise such expenditure as intangible assets: internally generated brands, logos, publishing titles, customer lists and items similar in substance; start-up costs, which include establishment costs such as legal and secretarial costs
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investments in internally generated intangible resources to be expensed immediately when incurred. With reference to larger non-public companies, the IFRS for SMEs acted as the point of departure to standard setter Bokföringsnämnden when developing the accounting standard for the size-category K3. Still, the K3 draft issued in 2010 is less restrictive than IFRS for SMEs concerning internally generated intangibles in that it includes an option for reporting entities to choose to treat all development costs as expenses or to capitalize the expenses as assets. The probable economic and social consequences of the regulation have been discussed quite extensively in the academic literature. It has been argued that inadequate information about investments in intangibles, financial reports will be less informative on a company’s current financial position and future prospects since they provide reliable but not relevant estimates of the value of companies (e.g. Cañibano, García-Ayuso et al., 2000). Also, the differences in recognition criteria depending on what type of intangible is under consideration for recognition have been argued to have detrimental effects upon the comparability of companies’ financial reports (Artsberg & Yström, 2002). Further consequences suggested in the literature are information asymmetries in the capital market with the accompanying undervaluation of intangible-intensive enterprises (Lev, 2001; Lev, Sarath & Sougiannis, in Lev 2001), insider gains (Lev, 2001; Aboody & Lev, 2000), decreases in trade and, subsequently, decreases in the social benefits of large transparent capital markets, such as the efficient allocation of investors capital (Lev, 2001).

In a study by Artsberg & Yström (2002) the consequences of the restrictive recognition regulation of “IAS38 Intangible assets” concerning internally generated intangible assets were inquired into from the perspective of large public companies as well as in privately held SMEs. Two sets of data were collected for the study. First, the comment letters of the 29 companies – all large, public and multinational entities – commenting on the IASB exposure draft on intangible assets (E50) were analysed. According to the results of the study there was a widespread concern among the commenting companies about the effect that the suggested restrictions would have on the quality of financial reports. Among other things the suggested standard was considered to disregard the real economic conditions of businesses and cause arbitrary accounting, resulting in insufficient quality of financial reports. This in turn was presumed to effect the level of comparability between companies negatively (e.g. when evaluating the profitability of potential acquisitions).

The other set of data of the Artsberg & Yström (2002) study consists of case studies of four companies selected by their character as knowledge-intensive SMEs. By way of interviews with chief financial officers or representatives with equivalent positions within the companies, information was obtained about the incurred in establishing a legal entity, expenditure to open a new facility or business and expenditure for starting new operations or launching new products or processes; training activities; advertising and promotional activities; relocating or reorganising part or all of an entity; and internally generated goodwill (IASB, 2009).
perceived economic consequences associated with the restrictive accounting treatment of internally generated intangible assets. The result of the case studies shows that there was awareness among the companies that recognition of internally generated intangible assets would make financial reports better illustrate a company’s “true” profitability and financial position. Still, none of the four representatives believed that the restricted possibility to activate intangible investments would be problematic at the moment, in case of a need for additional financial capital. All four companies had been very profitable in the past with no financial problems, and all interviewed representatives stressed their company’s close relationship with the bank as more important, in case of a need of additional financial capital, than having their intangibles capitalized in the balance sheet. Even so, three out of the four case companies stated that it might be important to capitalize in the future, for the reason of attracting investors in case of a need of additional financial capital or if there is a decision by the owner to sell the company. In all that the respondents argued that various external stakeholders could be informed sufficiently about important aspects of the business by other means than financial reports. All four representatives expressed a somewhat greater concern for the effects the restrictions to capitalize the very important intangible investments might have upon the outcome of internal decision-making processes and management. It should be noted that only one of the case companies of this study – a former Gazelle - could be categorized as an entrepreneurial SME according to the definition in this study, where high growth makes up a significant criterion.

2.5.2.1 Additional disclosure on intangibles

In the accounting literature, the criticism on the restrictive approach taken by standard setters when setting the criteria recognition of intangible assets could be categorized into main lines of argument (Cañibano, García-Ayuso et al., 2000). One of the two views followed the argument that there was a need of a fundamental revision of the accounting regulation in order to improve the possibilities for enterprises to recognise their investments in intangible resources as assets. The other main line of argument advocated the voluntary disclosure of information on investments in intangible resources. By supplementing the traditional balance sheet and profit and loss account with information on intangibles, financial as well as non-financial, financial reports would in a better way incorporate the "new" intangible values that traditional accounting did not attend to sufficiently. Within this line of argument various reporting models have been developed, and which approach the measurement and reporting issues more or less differently. Common to the various approaches is however the objective of, to a greater or lesser extent, "synthesising the financial and non-financial value-generating aspects of the company into one external report" (Petty & Guthrie, 2000). Also, there seems to be a general acceptance of the division of an entity’s intellectual capital into the categories of human, structural and relational capital (e.g. Dumay, 2009).
The "Guidelines for managing and reporting on intangibles" (MERITUM, 2002) were developed by the research program *Measuring Intangibles to Understand and Improve Innovation Management* (MERITUM) supported by the European Commission. The purpose of the Guidelines was twofold: On the one hand it was to aid management in developing information systems that increase management efficiency and financial performance; on the other it was to, by way of assisting management in their disclosure of relevant and comparable information on intangibles, help providers of capital to more efficiently estimate future earnings and the risk associated with their investment.

In the MERITUM (2002) report the different categories of intellectual capital is presented in a pedagogical way. Human capital is defined as the knowledge that employees take with them when they leave the firm, including the knowledge, skills, experiences and abilities of people. Structural capital is the knowledge that stays within the firm at the end of the working day, and comprises organizational routines, procedures, systems, cultures, databases, etc. Relational capital is defined as all resources linked to the external relationships of the firm, such as relations with customers, suppliers, R&D partners, investors and creditors.

While discussions and empirical studies on intellectual capital reporting have been focused on large public companies to a large extent, a few studies may be mentioned, that pay attention to the specific conditions and possible consequences of privately held SME's. Firstly, Watson (2010) discusses conceptually the relevance of the shortcomings of conventional financial reporting concerning intangible assets to the SME context. With reference to a study by Huggins & Weir (2007) he suggests that in the majority of SMEs the time and resources needed to produce and manage “a viable intangibles asset management system” most likely will far outweigh the benefits of such an exercise. Rather, the valuing, managing and reporting of intangible resources is according to Watson (2010) likely to be of most benefit to SMEs that are in the process of growth and/or life cycle changes that bring about a need of new outside financial – equity and debt – capital is required, when the entrepreneur is seeking a public listing or when there is a wish to attract potential acquirers; or in the very start-up stage of a new business.

Secondly, the institutional creditors interviewed by Svensson (2003) (see section 2.5.1 above) consider information on intangible assets to be significant when assessing the creditworthiness of SMEs. They request additional standardized information/ratios with respect to human and structural capital, information about key persons’ relations to the company, competence development and networks. Even so, several of the respondents prefer to collect such information orally when meeting personally with managers/owners of the companies. Concerning capitalized intangible investments several of the respondents believe that the information is too brief and hard to assess, and therefore request more detailed information on such assets.
Thirdly, Alwert, Bornemann & Will (2009) investigated whether intellectual capital reports of SMEs generated any impact on the valuation behaviour of financial analysts. The study combined several sources of empirical data, including expert interviews, a quantitative survey and a qualitative-oriented case study experiment. The participants of the study represented experienced bankers, auditors, and financial analysts from leading German financial institutions. According to the study results basic elements of an intellectual capital report should cover the business environment, business strategy, and a detailed analysis of intellectual capital as well as planned measures to develop intellectual capital in order to achieve strategic objectives. Qualitative descriptions were considered important, but still more important were indicators, which were considered specifically helpful in quantifying the information. “Adding intellectual capital reports to the classic set of annual report and audit certificate contributes to more homogenous results in the rating of credit worthiness of organizations and to more homogenous results in the assessment of the future development of organizations”. The results of the study “indicate that IC reports help to reduce risks for banks as they allow a more homogenous evaluation of the company”. Hence, IC reports could contribute to more accuracy and fairness in the process of raising capital for both SMEs and banks.

Not only do the above refereed studies provide support for further research on intellectual capital reporting by SMEs. In 2006 an expert group set up by the Directorate General for Research of the European Commission (EC) issued the RICARDIS Report (Reporting Intellectual Capital to Augment Research, Development and Innovation in SMEs) with the aim of stimulating reporting of intellectual capital in research intensive SMEs (European Commission, 2006). The report provides a survey of regulations and guidelines on the treatment of intellectual capital in accounting and identifies several policy recommendations on how to improve identification, measuring and reporting intellectual capital. Among these recommendations is a request - directed to the European Commission as well as universities, business schools and applied science researchers - to conduct further research in the area. Among the arguments is the enhancement of learning from IC reporting in practice, to test IC reporting, and to develop a systematic knowledge base. It was also suggested that further research would support future managers’ understanding of the importance of intellectual capital.

2.5.3 Implications for this study

The analysis of previous empirical studies on accounting in entrepreneurial entities in section 2.4 provided with indications that financial reporting information on cash flow and intangibles is likely to be of specific importance in relation to entrepreneurial SMEs. With respect to cash flow, research on the usefulness of cash flow information to management as well as external users of cash flow information, together with smaller entities of size K2 being exempted
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from the requirement to prepare cash flow statements, provides argument for further empirical inquiry into the importance of statutory cash flow information, in relation to entrepreneurial SMEs. Further, with innovation being central to the entrepreneurial process (Acs & Audretsch, 2003; Wickham, 2004), and given the importance of human capital and intangible assets in modern companies (Zimmerman, 2015), further study of the information needs of users of entrepreneurial SMEs’ financial reports with respect to intangibles becomes relevant. This not least considering the restrictive approach taken by standard setters towards recognition of investments in intangible resources as assets.
3  Methodology

In this study, the empirical inquiry into entrepreneurial SMEs’ financial reporting has been conducted in two parts. In the first part, the focus is on the perspectives of standard setters, auditors and academics, while the second part, focuses on the perspectives of managers of reporting entities and immediate user groups of financial reports.

This chapter starts with a discussion of the philosophical assumptions of the study and then discusses the research strategy and the choice of a qualitative approach used for the study. This chapter also discusses the dynamics of the research process vis-à-vis the relationship between theoretical knowledge and empirical material. Thereafter, it presents the overall design of the study providing an overview of the empirical work carried out in the two parts of the study, and how different steps relate to each other. The details of the procedure followed for carrying out the two empirical parts of the study is then presented including methods of data collection, interpretation, and analysis.

3.1 Acquiring knowledge about the role of financial reporting – a point of departure

This study follows a qualitative approach. The strategy for collecting empirical data encompasses semi-structured interviews, which is the main method, but also document studies of comment letters to drafts of accounting standards. With regard to interviews with managers of entrepreneurial SMEs included in the second part of the study, their entities’ financial reports were also studied. Before attending further to the research strategy and design of the study and the methods applied in the different steps of the data collection; the study clarifies the ontological and epistemological assumptions that it builds on. Such a clarification is important not only because assumptions about ontology and epistemology should permeate the entire research process in a consistent way but also because the choice of concrete ways of tackling a problem inevitably follow on the assumptions of the researcher regarding the nature of reality and the character of the knowledge that can be gained about this reality. Hence, the quality of research is highly dependent on the researcher’s articulation and awareness about his or her assumptions in these respects (Alvesson & Sköldberg, 2009).

In this study, the role of entrepreneurial SMEs’ financial reporting is inquired into by posing questions about purposes of use, users’ information needs, and the extent to which users’ information needs are fulfilled by financial reports. In this way, the study aims to increase our understanding of what overall objective
3. Methodology

financial reporting can fulfil with respect to this group of entities. The concept role in the study is used with reference to the function of financial reporting in practice, while the term objective refers to the intended function as expressed by standard-setters and in accounting literature. However, just as the role of financial reporting is not “out there” to observe directly (see Section, 1.4, c.f. Mellemvik et al., 1988), there is also no established view of what should be the meaning of the concepts of users, purposes of use and information needs. Different actors may assign different meanings both to the concepts and to the categories related to the concepts depending among other things on previous knowledge and experience. Following an interpretivist view, accounting – and, hence, financial reporting - is considered a social activity that cannot be captured objectively since its role is shaped by different actors’ subjective perceptions (Collis & Hussey, 2014). From an interpretivist perspective, each social actor has his or her sense of reality and, consequently, there are multiple realities (Collis & Hussey, 2014; c.f. Denzin & Lincoln, 2005, on relativism). Accordingly, scientific knowledge cannot be restricted to what is objectively identifiable since social actors act based on their subjective views and experiences of reality. It is further a constructivist view in the sense that its meaning as a social phenomenon is co-created by social actors (Denzin & Lincoln, 2005). As such, it is not static but instead it is continuously changing. Not only is the meaning of a social phenomenon and its categories created through social interactions, it is also in a constant state of revision (Bryman, 2016).

Following the view of the role of financial reporting as socially constructed a predominant view of this role at a specific point in time is the result of the negotiations between different actors in the financial reporting environment. The overall objective of financial reporting as expressed by standard-setters and restated in accounting textbooks is the result of such negotiations. As discussed in Chapter 2 of this thesis, the focus of contemporary frameworks on the decision-usefulness of financial reporting (Whittington, 2008b; O’Connell, 2007) and the subsequent assumptions of users and users’ decisions (Young, 2006), has been criticized for not being sufficiently grounded in accounting practice. As the construction or negotiations of meaning take place continuously, they can also change. These circumstances provide arguments for posing the questions of this study to different actors who are affected by and have a stake in the requirements of accounting regulations for SMEs. By including several groups of actors in the financial reporting environment, this study opens the possibility of shedding light on the views held by different actors about entrepreneurial SMEs27.

A constructivist perspective on the role of financial reporting also has consequences in forming research strategy and a study design. Of importance is the recognition that the researcher, just as the social actors under study, brings his or her previous experience and knowledge to the research setting which

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27 As illustrated in Chapter 2 of the thesis, previous studies have attended to the usefulness of financial reporting in relation to smaller entities or SMEs in general, focusing on one group of users (e.g. Sian & Roberts, 2009; Svensson, 2003; Collis & Jarvis, 2000).
inevitably influences the creation of knowledge. That is, the researcher takes part in the creation of knowledge not only by way of the conclusions that are eventually drawn from the study, but also through the whole research process including choices of limitations, selection of respondents, formulating interview questions and search words; and interpreting, analysing and presenting empirical data. Hence, an assessment of the quality of the research entails that these different choices are made visible and are clarified.

3.2 Research strategy

Not only is the choice of research strategy and design contingent on the philosophical assumptions concerning the nature of the phenomenon under study and what counts as knowledge about this phenomenon, this choice also depends on previous knowledge in the area under study. This study sets out from an area of research – accounting in entrepreneurial entities – with few studies and limited discussions on the role of statutory financial reporting and the related concepts of users their information needs. This study integrates the perspectives of several different groups of actors within the financial reporting environment of entrepreneurial SMEs. These circumstances made it clear at an early stage of drawing up the study design that there was a need for an explorative and flexible research strategy following a qualitative approach. While a quantitative research strategy centered around statistical sampling allows inferences to be drawn about a larger population, requires assumptions to be made about the concepts and related categories for formulating the questionnaires. Hence, to open up the possibility of different actors ascribing different meanings to the concepts under study, and hence what categories would be important in relation to the concepts (see Section 1.5 on the complexity of the financial reporting environment), there was a need for a strategy that made it possible to pose open questions without pre-specified alternatives.

Further, the complexity of accounting regulation with different requirements of different regulations concerning specific accounting transactions (for example intangible assets), would not make it easy to translate the questions in this study into survey questions, even if important concepts and categories where known beforehand. While many of the respondents had broad expertise in matters of accounting regulation, it was not a matter of course that all respondents were familiar with the full complexity of different accounting regulations and the variations between them. In this setting, the use of semi-structured qualitative interviews opened up the possibility of explaining the content of accounting regulations, to pose attendant questions and to adjust focus during an interview.

Semi-structured interviews allow respondents to talk freely about what they consider important, providing fuller answers from which a with deeper understanding can be gained, than would be the case using a questionnaire with pre-specified alternative answers. The problem of leading questions may also be
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higher in a questionnaire with pre-specified answers. To be able to pose questions from different angles also has the advantage of letting respondents think through their answers more thoroughly than in a questionnaire where they may be tempted to ignore the category “others”. An interview provides the possibility to of posing questions from different perspectives, with control questions, and hence for triangulation during an interview. As an example, on the question of whether management was considered a main user of financial reporting information, the most common answer given by the respondents in both parts of the study was that the financial reports had limited value for internal purposes. Still, from respondents’ commentaries during continuing discussions, or in discussing financial reporting from an overall perspective, it cannot be excluded that statutory financial reports are helpful for management even though the respondents themselves did not express this as a “use”. An example in this respect is the reference by managers to the importance of financial reporting in providing an audited check of the management accounts or as noted by venture capitalists in their position as board members in keeping track of the balance sheet. In this way, semi-structured interviews make it possible to appreciate the different meanings denoted to concepts such as ‘usefulness’ and ‘users’. If the question of the usefulness of financial reporting for management had been posed in the form of a questionnaire instead, the possibility of such an interpretation would have been restricted.

Even though a qualitative research strategy with semi-structured interviews makes it possible to hold a more flexible inquiry into fewer cases than would be feasible in a large-scale survey study, the opportunity of generalizing the results to a larger population is limited. However, when conducting a qualitative study, the aim is rather to gain deeper understanding from fewer cases than drawing broader inferences to a larger population. Still, even a qualitative study, if not purely descriptive, should provide explanations that are generalizable in some way, or at least have a wider resonance (Mason, 1996). In this study, generalizability is sought with reference to previous knowledge and theory rather than to a larger population (Silverman, 2013). In this respect prior knowledge consists of theoretical discussions in the accounting literature, previous research on financial reporting, and the assumptions made within accounting regulation from a general perspective and in the SME context. The focus on entrepreneurial SMEs in this study hence makes a deviant case (Silverman, 2013) against which previous knowledge is tested.

3.3 Logic of research: The relationship between theoretical and empirical work

The concepts of deduction and induction refer to the logic of research, attending to the relationship between theory and empirical work (Collis & Hussey, 2014).
A deductive study departs from existing theory with the aim of testing this theory in an empirical setting (ibid.). An inductive study, on the other hand, departs from an empirical reality with the aim of building new knowledge based on observations of this empirical reality (ibid.). While the two models are often presented as either-or alternatives, it is more likely that a research project following a deductive reasoning will include an element of induction, and the other way around (Bryman, 2016). Alvesson and Sköldberg (2009) are critical to the general presentation of deduction and induction as mutually exclusive alternatives, arguing that it is difficult to force all research into them, and that “those who follow them too strictly risk putting a straitjacket on their research” (p. 4).

While the research strategy formulated for this study opens up the possibility of getting various answers and also answers that may not be expected from an empirical reality, the data collection always departs from previous knowledge to some extent – theoretically, empirically and/or experientially (c.f. Section 3.1 on the researcher as a social actor taking an active part in the creation of knowledge). In this study, one such point of departure was the choice for inquiring about the role of financial reporting of entrepreneurial SMEs by posing questions about users, practical purposes and information needs. Managers of reporting entities were assumed to make use of financial reports when informing other actors. Another point of departure was the choice to pose questions of information needs with respect to items or areas of financial reporting information. Yet another refers to the assumptions of the study about the overall objective of financial reporting. As it turned out, the logic of research in the present study with respect to the relationship between theoretical and empirical work was brought to the fore when approaching the completion of the data collection for the second part of the study.

The empirical inquiry of this study initially departed from the assumption that users rely on financial reporting when making economic decisions. While acknowledging that there may be other objectives, the provision of information useful for users’ economic decision-making was presumed as an important objective of entrepreneurial SMEs’ financial reports (Yström, 2010). From such a perspective followed the importance of studying users’ information needs and the conditions for users to be able to use this information (Artsberg, 1992, 2005). Accordingly, the intention of this study was inquiring about the information needs of users, considering the practical purposes of using financial reporting information, and to what extent these information needs were met within the current accounting regulations. That is, the empirical study departed from the assumption of decision-usefulness, but not in the sense that it was intended to test whether this construct (Pelger, 2016; Young, 2006) was valid in an empirical setting. Knowledge about information needs, the major focus of this study, was to be induced from the empirical inquiry.

However, during the process of collecting and analysing empirical data collected for the second part of the study, patterns appeared that invoked the
3. Methodology

question about the extent to which the fundamentals of decision-usefulness, as presented in the accounting literature, explained the role of financial reporting in practice. As it later turned out, the theoretical foundation of decision-usefulness was tested against reality, but not in the sequence generally connected with the logic of deduction. In this respect the logic of inquiry of this study can be paralleled with Alvesson and Sköldberg’s (2009) reasoning about abduction. Abduction, they state, sets out from an empirical setting just like induction but is closer to deduction in the sense that it does not discard theoretical pre-conceptions:

*The analysis of the empirical fact(s) may very well be combined with, or preceded by, studies of previous theory in the literature; not as a mechanical application on single cases but as a source of inspiration for the discovery of patterns that bring understanding. The research process, therefore, alternates between (previous) theory and empirical facts whereby both are successively reinterpreted in the light of each other.* (Alvesson & Sköldberg, 2009, p. 4)

Accordingly, even though this inquiry was not initially designed to test the theoretical construct of decision-usefulness, the collection and analysis of empirical data was both preceded by and combined with a review of the academic literature on the main objectives of financial reporting. When patterns in the empirical data increasingly pointed in a direction that actualized the question of the extent to which the assumptions behind the decision-usefulness objective explained the role of financial reporting in entrepreneurial SMEs, or if there was something missing, further theoretical work was necessary. This work led to the widening of the frame of reference to include a discussion on the accountability/stewardship objective. Hence, the focus shifted from information needs, and the fulfilment of these information needs, with respect to economic decisions, to what overall objective financial reporting can fulfil in an entrepreneurial setting given the purposes of use in different situations, and the information needs of users with respect to these situations.

3.4 Overall design of the study

At the outset of this study, when the idea of inquiring into the information needs of users of entrepreneurial SMEs’ financial reports from the perspectives of different actors within the financial reporting environment started taking form, the study was divided into two parts. In the first part (Yström, 2010), the focus of the empirical inquiry was on perspectives of actors in the financial reporting environment outside the immediate user groups. Data was collected in several sequential steps where the results of each step provided inputs and structure for carrying through the following step/s. The first empirical step and main source of data for the first part of the study was interviews with accounting experts.
engaged in the discussion on the development of accounting standards for SMEs. The respondents were selected based on their documented knowledge and expertise on accounting and regulation issues, representing groups of auditors, standard setters and academics.

The questions posed to the respondents during the interviews centered around the issues of users, purposes of use and information needs of users. In relation to information needs, the aim was to sort out areas of financial reporting information of specific importance with respect to entrepreneurial SMEs, together with respondents’ views on the information needs of users in these areas. An analysis of previous studies on accounting in entrepreneurial entities presented in Chapter 2 (Section 2.4) provided inputs for formulating interview questions (see further Section 3.5.2.2). The first part of the study also included document studies of comment letters to the two drafts of the Swedish standard Financial reporting in small companies (K2) (BFN, 2006a, 2007), and the exposure draft of the IFRS for SMEs (IASB, 2007a).

The analysis of the empirical results of the first part of the study presented in the licentiate thesis (Yström, 2010) was structured around users and purposes of use, and users’ information needs. Figure 3.1 shows how the different steps of the first part of the study relate to each other. A more detailed account of the procedure for the first part of the study is given in Section 3.5.

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28 The relevance of respondents’ views follows the interpretivist perspective of the study (Section 3.1), acknowledging that actors act based on their views and perceptions. Further, in their character as experts, the views and attitudes put forward by respondents during interviews were likely to correspond to the attitudes they would put forward in other public discussions.
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Figure 3.1 Overall design of the first part of the study

The focus of the second part of the study is on the immediate user groups of entrepreneurial SMEs, and interviews were conducted with managers as well as other users of entrepreneurial SMEs’ financial reports, in this study represented by venture capitalists and bankers. The reasons for starting with expert interviews and document studies, rather than interviews with managers and external users, was to receive as much knowledge as possible at an early stage of the inquiry from actors with a broad understanding in the area of financial reporting and SMEs. Subsequently, the collected results of the first part of the study constituted a point of departure for the second part in terms of choice of respondents representing external users and in formulating interview questions. Section 3.6 presents the process used for carrying out the second part of the study.

In the initial analysis and interpretation of the interview data collected in the second part of the study, the transcripts were categorized according to themes as per the purpose of use and users’ information needs. As described in Section 3.3, this analysis resulted in further theoretical work on the objectives of financial reporting. The interview transcripts were analysed once again, now in relation to the fundamentals of decision-usefulness on the one hand and

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29 Figure 3.1 is slightly different from the corresponding figure presented in the licentiate thesis, since the discussion on previous studies on accounting in entrepreneurial contexts is included in the frame of reference as opposed to the licentiate thesis where this discussion formed a part of the data collection under the heading “Literature study” (Yström, 2010, p. 17).
Although this additional analysis did not change the structure of Chapter 5, 6 and 7, the text was complemented to some extent to make clearer in what part of the discussion a specific statement was made. Figure 3.2 shows how the collection of empirical data for the second part of the study departs from the results of the first part of the study, the licentiate study, and is followed by further theoretical work on financial reporting objectives.

Figure 3.2 Overall design of the second part of the study

The analysis presented in Chapter 8 of this thesis is structured according to the three research questions posed in Chapter 1 (Section 1.4). With respect to the third research question, the discussions and statements made by the respondents in the different steps of the two parts of the study, with respect to purposes, users and information needs, are analysed in relation to the fundamentals of decision-usefulness and stewardship/accountability respectively.
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3.5 Empirical study: Part I

The empirical focus of the first part of the study is on the perspectives of actors in the financial reporting environment outside the immediate user groups. In the following, the process followed for the empirical steps of the first part of the study is presented. First, a discussion of the interviews with accounting experts - the main source of empirical data for the first part of the study. Thereafter, the processes for carrying out the two document studies are described.

3.5.1 Interviews with accounting experts

In the first part of the study, whose main focus is on actors in the financial reporting environment outside the immediate user groups of entrepreneurial SMEs’ financial reports, the first empirical step consisted of expert interviews with accounting experts engaged in the contemporary discussion on developing accounting standards for SMEs. The aim of the interviews was to sort out the views held by accounting experts concerning the main users and purposes of entrepreneurial SMEs’ financial reports, and areas of financial reporting information likely to be of significance to entrepreneurial SMEs in their provision of information to users. The respondents were chosen for their extensive and documented knowledge and expertise of accounting and regulation issues and represent groups of auditors, academics, and standard setters.

3.5.1.1 Choice of respondents

In a study by Jönsson (1985), subsequently updated by Sandin (1988), the most renowned authorities on the development of accounting practices in Sweden - the so-called accounting elite - was categorized into four groups including advisors/auditors, opinion leaders/academics, rule makers/standard setters and accountants/preparers. Even though the studies by Jönsson (1985) and Sandin (1988) are somewhat dated, individuals with expert knowledge of accounting and regulation are still expected to be found in the four groups. With reference to the fourth group, however, it is more likely that many accountants/preparers of large and/or public companies hold expert knowledge of accounting and regulation.

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30 Sections 3.5.1 and 3.5.2 correspond to the descriptions of the procedure in the licentiate thesis (Yström, 2010, Sections 4.1, 5.1 & 6.1), with minor linguistic improvements and changes in the mode of expression.

31 In Jönsson (1994) a comparison between the results of the original study and the update is provided.

32 Even though Jönsson (1985) does not clearly express the focus on larger and/or public companies, the limited extent to which both academics and standard setters have attended to accounting issues in the SME environment in the past, legitimizes the assumption that the results of the Jönsson study bear reference to this context, at least to a greater extent than to the SME context.
issues - and also engage in the development of accounting practices - than it is concerning their counterparts in SMEs. Therefore, since this part of the study aims to sort out the view held by experts with extensive knowledge and experience in accounting and regulation issues concerning SMEs in specific, and who are also engaged in the current public debate on accounting standards for SMEs, respondents have been selected from the first three groups of the categorization by Jönsson (in the following named auditors, academics and standard setters).

In order to find possible respondents, the electronic database of the Swedish leading professional journal Balans - which was identified in the study by Jönsson as a significant forum for the development of accounting practices in Sweden - was searched for articles containing the search word “accounting”, “accounting regulation”, “SME” and/or “entrepreneur” and similar. This search, together with an additional search in the databases Affärsdata (includes Dagens Industri) and Libris (books and dissertations) provided with 21 names of individuals with the relevant skills to qualify for this empirical study. In order to include respondents from all three groups of experts, two auditors, two academics and two standard setters (representing Bokföringsnämnden) were selected. In addition to these six accounting experts representing the Swedish context, two standard setters were also selected from the IASB SME group (IASB, 2006a), giving a total of eight respondents. After several unsuccessful attempts to get into contact with one of two academics, the number of experts for interviews was reduced to seven.

Respondents and their respective category belongings are illustrated in Table 3.1 below. Even if all the respondents have been selected from their belonging to one of the three groups of experts several of the respondents hold positions that qualify them as members of more than one group, which is illustrated by the x-marks of Table 3.1. With reference to the group they were selected to represent in the first place, the x is printed in extra bold type.

**Table 3.1 Accounting experts interviewed**

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Auditor</th>
<th>Academic</th>
<th>Standard Setter</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard setter CD</td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Standard setter HE</td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>Standard setter RJ</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Standard setter PP</td>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
<tr>
<td>Auditor BS</td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Academic PT</td>
<td></td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>Auditor BÅ</td>
<td></td>
<td></td>
<td>x</td>
</tr>
</tbody>
</table>

*Standard setter CD was initially chosen for this study because of her membership of Bokföringsnämnden and for taking an active part in the public debate on the development of accounting standards for SMEs. Standard setter CD was also an*
authorized public accountant with experience from working with accounting issues concerning growth-oriented SMEs.

_Standard setter HE_ was at the time of the interview the chairman of _Bokföringssämnnden_ with experience from working as an authorized public accountant and former head of the Stockholm Stock Exchange’s Surveillance Department. Standard setter HE’s participation in this study was based on his quality as a standard setter and his active participation in the SME debate in the journal _Balans_.

_Standard setter RJ_ was professor of accounting at Brunel University (UK), a member of the IASB’s Panel for SMEs (representing the International Federation of Accountants, IFAC) and Head of SME Affairs at the Association of Chartered Certified Accountants (ACCA), United Kingdom. Standard setter RJ, who was selected for this study in his capacity of standard setter representing the IASB SME group, is a certified public accountant and an active researcher in the field of financial reporting in SMEs.

_Standard setter PP_ held the concurrent positions as Director of _IFRS for SMEs_ at the IASB and Director at the Global IFRS Office of Deloitte Touche Tohmatsu in Hong Kong. He also worked for the US FASB for 16 years. Standard setter PP, who is a Ph. D. and a certified public accountant, was initially chosen for this study because of his quality as a standard setter.

_Auditor BS_ was an approved public accountant with many years of experience of auditing in owner-managed SMEs, former SME-responsible at FAR SRS (the Swedish trade association for auditing and counselling) and (June 2009) additional/co-opted member of the management group of FAR SRS Small business sector. Auditor BS has also for many years been a recurrent writer and debater on SME issues in the journal _Balans_.

_Academic PT_ was a member of the staff of the Ernst & Young Technical Department in Stockholm and associated to the Stockholm Centre for Commercial Law. Academic PT was a former professor at Uppsala University and member of _Redovisningsrådet_.

_Auditor BS_, an authorized public accountant and a member of the management group of _FAR SRS_33 Small business sector, had extensive experience from working with growth-oriented businesses. Auditor BS was also engaged in the public debate on the development of accounting standards for SMEs.

### 3.5.2.2 The interviews

Five of the interviews (standard setter CD, standard setter HE, Auditor BS, Academic PT and auditor BÅ) were carried out during personal meetings, and two of the interviews (standard setter PP and standard setter RJ) were conducted on telephone. Before the interviews the respondents were e-mailed a short

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33 _FAR SRS_ was the institute for the accountancy profession in Sweden before changing the name to the concurrent designation of _FAR_.

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presentation of the research project together with the questions that have guided the discussions during the interviews (see Appendix 2). In order to secure that the discussions during the interviews centered on the concept entrepreneurial SME as defined in this study, the meaning of the term was presented both in the e-mails sent to the respondents in advance and when introducing the research project at the beginning of the interviews. Accordingly, the term entrepreneurial SMEs has been described to the respondents as the growth-oriented entities within the SME-group that are characterized by an eagerness to engage in new development projects and to exploit new product areas or markets, in order to take advantage of new business opportunities faster than competitors. The significance of growth to this concept has been further concretized by referring to entities where the success of their managers’ entrepreneurial mission has rendered them qualified for the label Gazelle (see Section 2.3.1). The concepts related to the term entrepreneurship – such as growth, development projects and business opportunities – have also been recurrently referred to during the interviews in order to maintain the respondents’ attention to the meaning of the concept of entrepreneurship as defined in this study.

During the interviews the respondents have been asked for their views on who the main users of entrepreneurial SMEs’ financial reports are, for what decision-making purposes, or in what situations, they regard the information contained in entrepreneurial SMEs’ financial reports to be of particularly relevant to the users; and what kind of financial reporting information they consider to be specifically important to the managers of entrepreneurial SMEs in their provision of information to the users (see Appendix 1 for the interview questions).

From the analysis of previous empirical studies, information on cash flow, intangible assets, and the division of costs into variable and fixed costs (contribution/contribution margin) was identified as likely to be of specific importance in an entrepreneurial context (see Section 2.4). Therefore, concerning the question of what constitutes specifically important information in an entrepreneurial context the respondents have been asked not only for their general view on this issue, but also, if not already mentioned by the respondents, about the extent to which they consider information on cash flow, intangible assets, and the division of costs into variable and fixed costs, to be significant in an entrepreneurial setting.

Concerning decision-making purposes respondents have also been asked for their view of the usefulness of the information contained in the financial reports to management in their internal decision-making, which is an issue where the results of previous studies in the SME context diverge (see Section 2.2 above).

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34 See Section 2.3 for a discussion on the definition of the concept of entrepreneurship.
The respondents’ identities have been anonymized.

3.5.2.3 Processing, interpreting and presenting the interview data

All interviews were tape-recorded on permission of the respondents and transcribed verbatim after the interviews. The subsequent analysis of the transcriptions have centered on the two main issues of 1) the respondents’ views on main users and purposes of financial reports and 2) what areas of financial reporting information that respondents consider to be of specific importance to managers of entrepreneurial SMEs in their provision of information to users. The aim of this analysis has been to find out the main themes of the respondents’ views on these issues.

3.5.2 Document studies

3.5.2.1 Document study of comment letters to BFNs K2 drafts

In June 2008 Bokföringsnämnden (BFN) approved the general advice of Financial reporting in small companies (K2) to be optionally applied on financial reports drawn up on December 31, 2008, and onwards. By including limited companies with less than 50 employees, less than €2,5 million in assets and a net turnover of less than €5 million the K2 category aims at enterprises that in terms of size make up the smaller part of the SME group as defined in this study. As a part of the process of developing the final accounting standard for K2, drafts were referred for consideration on two occasions, in February 2006 (BFN, 2006a), and in February 2007 (BFN, 2007).

The first K2 draft of 2006 was referred to 27 instances and 32 comment letters were received. When the same respondent has handed in more than one comment letter, the documents from this respondent have been interpreted as a single comment letter, and after adjusting the total number of comment letters for two such cases the total number of comment letters amounts to 29. This number has been reduced to 27 after adjusting for two comment letters that include only the statement that no comment will be made. To the second draft of 2007, which was referred to 42 instances, comment letters were received from 35 respondents, and after reducing this number by the six “no comment” letters, the number of relevant comment letters amounts to 29. Consequently, a total of 56 (27 + 29) comment letters have been included in the document analysis.

All the 56 comment letters were scanned through with the aim of finding sections where users and purposes of financial reports, and items of financial reporting information, are discussed in relation to general entrepreneurship terms such as entrepreneur, growth and innovation. This scanning through of comment letters has also included a search for comments on the specific areas of financial reporting information that have been identified in the analysis of previous studies on accounting in entrepreneurial contexts, and from the results
of the expert interviews, as significant in an entrepreneurial setting, i.e. cash flow, intangible assets, growth ratios and contribution margin. The survey of documents resulted in the identification of a total of 21 comment letters where the discussions of relevance to this study exclusively focus on the proposed regulation concerning accounting for internally generated intangible assets. The respondents to the 2006 draft returned in several cases in 2007 with identical or as good as identical comments, or the statement that the 2006 comment was maintained, which does not come as a surprise considering that no changes were made concerning the treatment of internally generated intangibles in the 2007 draft as compared to the 2006 version. Such recurrent comment letters by the same respondent have been interpreted as a single document, leaving a total of 17 documents to analyse in this step of data collection. The authors of these documents represent professional accountants, accounting and auditing firms, trade organizations, government authorities and academic institutions (see Appendix 2 for a list of the structure of respondents in terms of organization categories).

The document study of the comment letters to the two K2 drafts sets out from the assumption that the representatives of the organizations to which the proposed accounting standards for smaller companies (K2) were referred for consideration hold expert knowledge of issues related to accounting in the SME-context. In the process of carefully reading through the comment letters sorted out, one comment letter was found where the respondent bases his comment on the conclusions of his bachelor thesis. Since the argument provided in this comment letter is in line with one of the most frequent arguments put forward by the other respondents – and thereby do not change the conclusions of the document study as a whole to any appreciable extent – this comment letter is not excluded from the analysis. Eight of the remaining 16 documents have been written by auditors/advisors which makes this group the predominant category of authors to the comment letters that has been sorted as being of immediate interest to this study. Out of the other eight documents four have been authored by representatives of trade associations, two by government authorities and yet another two by academics. Accordingly, the authors of the comment letters included in this document study represent actors of the financial reporting environment outside the immediate user groups (cp. Beaver, 1998).

The relevant discussions of the 17 comment letters sorted out for this document study have been carefully read and categorized according to the opinion put forward regarding the treatment of internally generated intangible assets, and this categorization provides with structure to the presentation of the results in Chapter 4.
3. **Methodology**

3.5.2.2 **Document study of comment letters to the IASB draft IFRS for SMEs**

As a part of the process of developing the IFRS for SMEs the IASB published an *Exposure Draft of an IFRS for SMEs* (IASB, 2007) in February 2007. The draft received comments from 161 respondents including professional accountants, auditors, representatives of accounting and auditing firms, trade organizations, government authorities and academic institutions. A list of the respondents to the draft is presented in Appendix 3. Even though the respondents were not asked to comment on the information needs in the context of entrepreneurial SMEs specifically, which is the focus of this study, the comment letters provide with relevant data for several reasons. Firstly, from the analysis of previous studies on accounting in entrepreneurial contexts cash flow was sorted out as likely to be of specific importance in an entrepreneurial context with respect to financial reporting information (as well), which was confirmed by the accounting experts interviewed for the first empirical step of the study. Since the exposure draft includes a requirement for SMEs to publish a cash flow statement, and the respondents were explicitly requested to comment on this suggestion, the comment letters are of interest to this study. Secondly, both the expert interviews and the document study of comment letters to the K2 draft provided support for the indication of previous empirical studies that financial reporting information on intangible assets should be of importance in an entrepreneurial context. Since the *Exposure Draft of an IFRS for SMEs* includes an option for reporting entities to choose to either capitalize or expense their development costs, the respondents’ comments on this issue are also of high interest to this study.

The aim of this step of the data collection has been to sort out comments where items of financial reporting information are discussed in relation to the context of entrepreneurial SMEs, both in general and concerning the areas of financial reporting information that have been identified in the previous steps of data collection in this study (and in line with previous research), i.e. cash flow, intangible assets, growth ratios and contribution margin - in specific. The analytical choices are further described in connection to the presentation of the results of the document study in Chapter 4.

3.6 **Empirical study: Part II**

In the second part of this study, the focus has been on the perspectives of managers of entrepreneurial SMEs and external users of entrepreneurial SMEs’ financial reports, in this study represented by venture capitalists and bankers.

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35 The final standard IFRS for SMEs was published in July 2009 (IASB, 2009).
According to the collected results of the first part of the study, the main groups of external users of entrepreneurial SMEs include bankers, venture capitalists and other external owners. In this study venture capitalists also represent external owners. The reasoning for this choice was the extensive experience of venture capitalists, as compared to non-institutional investors, in investing in the types of companies in focus in this study, which would offer a more comprehensive picture concerning important issues when investing in entrepreneurial growth-companies. In general, venture capitalists were expected to be engaged in the companies invested in to a greater extent than other external owners. In all that, as suggested by the results of the expert interviews of the first part of the study (see chapter four, section 4.1.1.3), they could also provide valuable knowledge of the role of financial reporting in connection to the initial investment and at exit.

In the early work with developing the strategy for the second part of the study, the initial plan was to conduct interviews with external users connected to each of the entrepreneurial SMEs chosen for the study. However, for reasons of confidentiality such a procedure might not be feasible. Therefore, the respondents representing venture capitalists and bankers were selected independently of the entrepreneurial SMEs included in the study.

The definite number of interviews for this part of the study was not decided on before the very process of interviewing was in progress. The aim was to reach a state of repletion when additional interviews were not expected to provide with any further information that would significantly change the conclusions of the study.

3.6.1 Choice of respondents for interviews

3.6.1.1 Managers of entrepreneurial SMEs

In line with Davidsson et al (2002) and Wiklund & Davidsson (1999) respondents for this step of the second part of the study were expected to be found among organically growing entities (see section 2.3.1 above). In line with previous studies about accounting in entrepreneurial contexts (e.g. Blomqvist, 2008; Dergård, 2006), the entities should have experienced an increase in sales turnover of at least 100 percent over a period corresponding to the last three financial years. The choice of sales turnover as an indicator of growth is justified by the preference among entrepreneurs to use sales growth as a measure of performance (Hoy, McDougall and D’souza, 1992; Barkham et al., 1996; Davidsson & Wiklund, 2000). Further, the growth process as such tends to be driven by an increased demand for the products and services offered by a firm (Davidsson & Wiklund, 2000).

The criteria of at least 100 percent increase in sales turnover will make the group of Gazelles a relevant population for this study. The concept Gazelle, which refers to small and organically fast-growing enterprises, was originally developed by Birch (1979) who showed that this group of entities created most
new jobs in comparison to larger and established enterprises. To inspire growth and entrepreneurship, the Swedish business paper *Dagens Industri* yearly rewards the fastest growing enterprises in the country with a Gazelle diploma, which has made the concept well known in the Swedish business world. To achieve the label Gazelle, there are a number of criteria that should be fulfilled, including a 100 percent increase in sales turnover throughout a period of three financial years; the growth of the entity should in all essentials be organic and not achieved through mergers or acquisitions, and the entity should be in a healthy financial position (*Dagens Industri*, 2009).

The Gazelles are presented yearly in a list where all enterprises that meet the Gazelle criterion are listed, starting from the fastest growing company. In 2012 there were 678 Gazelles in total. By starting from the top of this list, picking out entities meeting the SME definition of this study, located within the regions of Småland, Västra Götaland and Östra Götaland, areas that are geographically close to Jönköping, a number of entities was identified, one by one, as possible study objects. Since the results of the first part of the study (Yström, 2010) had shown that information on intangible investments would likely be of significance in an entrepreneurial context, capitalized intangibles and/or emphasizing intangible values in the form of disclosure was made a condition for the companies to be selected. After confirming the entrepreneurial orientation of the companies by checking their web pages and financial reports, the companies were contacted one by one, following the order of the Gazelle list. One possible respondent declined to be interviewed because of extensive workload, another declined with the argument that the company engaged an external accounting bureau and, also, that they did not find financial reporting to be useful to any greater extent(!). After a couple of unsuccessful attempts, three companies were contacted for interviews: *Weave Tech*, with 37 employees, a sales turnover of 45,4 million SEK and two times winner of the Gazelle award (in 2011 and in 2012); *Cloud Books*, with 35 employees, a net turnover of 30,5 million SEK and winner of the Gazelle award in 2012; and, finally, *Search Consultancy*, with 53 employees, a sales turnover of 43 million SEK and winner of the Gazelle award in 2012. A prerequisite was that respondents should be engaged in the management team of their respective company. With respect to *Weave Tech* (high-technology manufacturing) and *Search Consultancy* (consultancy), interviews were conducted with the companies’ chief financial officers (CFO) at the companies’ headquarters in Borås and Gothenburg respectively. The chief executive officer (CEO) of *Cloud Books*, who was also the founder and joint owner of the business, was interviewed via Skype. The common denominator of the three companies interviewed was a successful history with internally and equity financed growth. Early in the process of data collection – including webpages, financial reports and interviews - it was clear that all three companies had made, and continued to make, a substantial imprint on their specific niches of the market. The focus on continuing growth was clearly articulated by all three companies, as well as their efforts in managing not
only their initial innovations but also in developing related products and/or services.

3.6.1.2 Venture capitalists

*Svenska Riskkapitalföreningen* (Swedish Private Equity & Venture Capital Association, SVCA) is an association representing the interests of actors within private equity (buyout and venture capital) and business angel networks. The members of SVCA include venture capital companies with extensive experience in investments, development and finance of growth-oriented entrepreneurial entities. In order to find respondents representing venture capitalists, the membership list of SVCA was searched through for companies with extensive experience in investments, development and finance of growth-oriented entrepreneurial entities. The focus of the search was on venture capitalist companies located within an area geographically close to Jönköping, including the regions of *Småland*, *Västra Götaland* and *Östra Götaland*. Three venture capitalist companies were initially sorted out for interviews. Interviews were conducted with representatives of *Initial Stage Invest* and *Early Expansion Invest*, while several attempts to get into contact with the respondent representing the third company failed. In all that, the two interviews conducted turned out to be highly informative. Accordingly, a state of repletion was considered to be met (ref.), where an additional interview was not considered to provide with further information that would change the conclusions of the study to any considerable extent.

In this study the interviewed venture capitalists represent both the user group of external investors in entrepreneurial SMEs – when entering into a new company - and, because of their engagement as board members after initial investment, owners engaged in the governance of companies.

3.6.1.3 Bankers

Initially four of the largest business banks in Sweden was contacted for interviews. After several unsuccessful attempts to get into contact with one of the banks, the number of respondents was reduced to three. Hence, interviews were conducted with representatives of three of the largest business banks in Sweden: bank A, B and C. All three respondents had experience from working with company credits for many years and with companies from all types of industries and of different sizes, including entrepreneurial and growth-oriented businesses in different stages - ranging from start-ups to full-fledged entrepreneurial and growth-oriented medium-sized entities. After conducting the interviews, a state of repletion was met, and further interviews were not considered to provide with additional information of significance to this study.
3. Methodology

3.6.2 The interviews

The interviews with both managers and other users have been semi-structured and guided by the interview questions presented in Appendix 4 (questions to managers) and Appendix 5 (questions to venture capitalist and bankers). With respect to the interviews with managers, it should be noted that the interview questions related to managers’ perceptions of users and the purposes for which these users make use of their entities’ financial reports. In several instances, managers referred to their communication with a specific user or user group. An example in this respect is the request by customers of Search Consultancy, which lead to the decision to prepare group accounts on a voluntarily basis (see chapter five, section 5.3.1). On other occasions, managers’ statements were understood as expressions of more general perceptions. From an interpretivist view of financial reporting however follows an acknowledgement that the actions taken by social actors to a large extent are affected by the views and perceptions held by these actors. Further, considering that the development of financial reporting regulation is a continuous process, an understanding of, and shedding light on, the views held by different actors of the reporting environment – including managers of reporting entities – becomes significant (see Section 1.5 on the reference by Scott, 2015 to a constantly changing and evolving reporting environment). In all that, it is significant to present the results of the interviews in such a way that statements by respondents are not separated from the overall discussion in which these statements were made. While this is critical in all interpreting of qualitative data, it would be even more so in relation to expressions of perceptions as compared to expressions referring to verifiable circumstances.

With respect to the internal use of financial reporting information, there are indications that the views put forward in the literature and in previous studies, on the one hand, and standard setters on the other, do not correspond. Also, the views held by the accounting experts interviewed for the first part of the study to some extent diverge on this issue. Accordingly, managers have also been asked to what extent financial reporting information is used in the internal management of their businesses.

As regards information needs of users, questions have been posed to respondents both from a general perspective and with focus on the areas of financial reporting information identified in the first part of the study, i.e. cash flow, intangibles and sales/growth.

When introducing the research project to respondents in the beginning of the interviews, this study’s definition of entrepreneurship has been communicated to respondents. During interviews with bankers, who work with different types of companies – not just entrepreneurial – recurrent references was made to the concepts related to this study’s definition of entrepreneurship, including growth, innovation and development projects. The definition was also emphasized in the initial interview requests sent by e-mail to respondents.
The respondents’ identities and the organizations they represent have been anonymized.

3.6.3 Processing, interpreting and presenting the interview data

All but one (the respondent representing bank A) interview were tape-recorded and transcribed verbatim after the interviews. With respect to the interviews with managers, the subsequent analysis and interpretation of the transcriptions centred on the discussions during interviews related to the first two research questions (Chapter 1, Section 1.4). That is, the discussions were structured in accordance with interviews respondents’ perception of the main users of their entities financial reports, and for what purposes these users make use of the information contained in the reports; and respondents’ perception of the information needs of users in relation to different purposes. For each of the three companies, the financial report of year 2012 has also been analysed, with focus on the director’s report. In this way, the views and perceptions of respondents could also be related to financial reporting practices in terms of financial reports (see Section 1.4 on the interpretation of talk and action on accounting, as suggested by Mellemvik et al, 1988). The result of the analysis and interpretation of interview transcripts and financial reports, together with supplementary information provided by the companies’ webpages, is presented in chapter five of this thesis.

The analysis and interpretation of the transcriptions of the interviews with venture capitalists and bankers centred on the purposes for which respondents make use of entrepreneurial SMEs’ financial reporting, and the respondent’s information needs with respect to these purposes. The results of these analyses are presented in chapter six and seven.

The structure of the presentation of the results of the interviews conducted within the second part of the study (Chapter 5, 6 & 7) differs to some extent from the presentation of the results of the interviews conducted within the first part of the study (Chapter 4). That is, in the first part of the study, the results of the expert interviews were reported on and discussed in the same section, categorized according to respondents views on user groups and related purposes, and areas of financial reporting information of specific importance, with respect to entrepreneurial SMEs (Section 4.1 in this thesis, corresponding to Section 4.2 of the licentiate study reported on in Yström, 2010). When reporting on the interviews with managers, conducted within the second part of the study, company-specific aspects such as industry, business orientation and ownership structure called for separate presentations for each of the companies respectively. With respect to the interviews with venture capitalists (Chapter 6), the two companies represented in the study invest in entities at different stages of development, which called for separate presentations of the results of the two
3. Methodology

interviews with venture capitalists as well. Hence, in order to present the empirical material in such a way that statements by respondents were not separated from the overall discussion in which different statements were made, the results of the interviews conducted within the second part of the study (chapter five, six and seven) is reported on in separate sections for each respondent.

3.7 A concluding note on analysis

The research reported in this thesis was conducted over a long period of time. It has been carried out in different parts and it includes the perspectives of several different groups of actors, with different roles and interests, in the financial reporting environment of entrepreneurial SMEs. In order to fulfil the purpose of the study, the role of financial reporting has been studied by posing questions on different aspects relating to users, purposes of use and information needs of users. Further, the empirical material has been collected in different steps following and, to some extent, building on each other. These circumstances, together with the interpretivist approach and abductive reasoning of the study, has constituted a bit of a challenge in terms of holding the different parts together, not only when interpreting and analysing the empirical results, but also related to the presentation of the results of the analysis. The analysis and presentation of the findings has been guided by theory, following the abductive reasoning presented in this chapter, but it possibly needs to be acknowledged that the theoretical perspective of the author changed over time. The discussion presented in Chapter 8 on analysis have been guided by a wish to bring clarity to the reader on the different steps of the analysis and the choices made during the process, in relation both to the empirical material and to theory.
4 Empirical results of the licentiate study

This chapter presents the empirical results of the first part of the study, focusing on perspectives of actors of the financial reporting environment outside the immediate user groups. Firstly, the discussion attends to the interviews with accounting experts, representing standard setters, auditors and academics. Thereafter, the results of the two document studies of comment letters to drafts of accounting standards issued by the Swedish standard setter BFN and IASB are presented in separate sections. The chapter is concluded with a summary of the collected results of the steps of data collection carried out within this part of the study.

4.1 Interviews with accounting experts

In the following, the results of interviews with accounting experts are firstly discussed with respect to respondents' views on users and purposes of entrepreneurial SMEs' financial reports. The discussion on users and purposes is structured from the viewpoint of reporting entities, addressing the different groups of users to which their financial reports are directed. Information needs of users are then discussed with respect to the different areas or items of information put forward by respondents as specifically important regarding entrepreneurial entities.

4.1.1 Users and purposes of financial reports in the context of entrepreneurial SMEs

4.1.1.1 Communicating with capital providers

All respondents put forward the continuous high demand for financial capital as a great challenge to managers of entrepreneurial and growth-oriented SMEs, and

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36 Sections 4.1, 4.2 and 4.3 corresponds with the presentation of results in the licentiate thesis (Yström, 2010, Sections 4.2, 5.2 & 6.2), with minor linguistic improvements and smaller changes in mode of expression, including a few corrections. In Section 4.1, reporting on the results of the interviews with accounting experts, respondents’ names have been replaced by initials and designated according to their main group belongings, i.e. standard setter, auditor or academic.

37 The modes of procedure for the data collection carrying out within these three steps have been discussed in Chapter 3 (Section 3.6) above.
that the principal purpose of the use of financial reports in this context is to communicate with external capital providers. Financial reports make up an important informational role not only when new investments require new or additional financial capital but also to ensure the continued capital provision from existing financiers (e.g. standard setter CD, auditor BE). Among capital providers bankers are put forward by all respondents as the most frequent user group of entrepreneurial SMEs’ financial reports. Further, all respondents believe that the continuously high demand for financial capital makes the extent to which entrepreneurial SMEs are financed by venture capitalists and other external owners greater than what is the case in SMEs in general. As suggested by auditor BÅ, managers of entrepreneurial and growth-oriented SMEs might turn to venture capitalists not only because of the limited supply of funds from other sources but also to get access to the venture capitalists’ expert knowledge of the area of business the company intends to explore. With reference to the use of financial reporting information, two of the respondents suggest that venture capitalists, as soon as they become owners of a business, usually get access to all information that is used in its internal management, and consequently the financial reports no longer make up their main source of information (standard setter HE, academic PT). Nevertheless, in the initial phase of negotiation financial reports make up a significant tool for informing venture capitalists about the financial position and prospects of the business (e.g. standard setter CD, auditor BÅ).

Financial reports are according to two of the respondents representing standard setters extremely important to managers of entrepreneurial SMEs in the process of acquiring the financial capital needed to secure the continuous growth of their entities (standard setter CD, standard setter HE). Auditor BÅ also contends that in order to provide a venture capitalist that is considering investing in the business with the relevant information, or if the entity is about to be valued at the prospect of a new share issue, a higher standard of the financial reports is required. Managers in such cases usually turn to professional advisors for assistance in the preparation of the financial reports (auditor BÅ). The financial reports make up a valuable starting point for an external stakeholder considering investing in the entrepreneurial entity since they provide with the very important historic perspective of the business under evaluation (auditor BÅ). Even though the historical reports often are difficult to interpret, not least concerning newly started companies where the success of a business idea is not yet reflected on results, auditor BÅ believes that the information contained in the reports certainly constitute important and useful information together with additional information about such things as the business idea, the product and the market (auditor BÅ).

Two of the respondents representing auditors (auditor BÅ, auditor BS) also emphasize that managers of growth oriented and entrepreneurial SMEs generally are aware of the importance of providing capital providers with financial reports of high quality. According to standard setter CD the entrepreneurs themselves
are not always aware of the significance of the financial reports but wise enough to turn to professional advisors who tend to the very important issues of financial reporting.

4.1.1.2 Communicating with customers, suppliers and employees

When asked for their view on which the main users of entrepreneurial SMEs’ financial reports are, six of the seven respondents mention customers and suppliers. Even if customers and suppliers in general turn to credit rating agencies for the information needed to assess the credibility of a counter party (e.g. academic PT), there are situations when the credit rating information needs to be supplemented by financial reports. One such situation is when a transaction is of a considerable amount (standard setter HE), another when the customer or supplier is dependent upon just one or a few other counter parties (standard setter RJ). Yet another situation when a buyer or seller would like to assess the solvency of a potential counter party more thoroughly is when a contract involves large initial investments and when the profitability of the contract is contingent upon the continuous future deliveries/inflow of orders (standard setter CD, standard setter PP). Standard setter (CD) exemplifies the last-mentioned situation with reference to a business that is about to order a new software system from a high-tech company. Due to the high costs of installing such a system the customer would certainly be interested in making an assessment on the probability that the delivering company will be around in a couple of years and that it will have the capacity to deliver continuously. In such a situation, the financial reports of the supplier constitute an important source of information according to standard setter CD.

Employees make up another group of users who according to two of the respondents might have a specific interest in the financial reports of an entrepreneurial SME (standard setter CD, standard setter PP). According to standard setter PP it is very common in the United States that entrepreneurial SME employees are compensated in some kind of share-based payment. Because of liquidity constraints it is in general not possible for high-tech and bio-tech research-oriented entities to pay the highest salaries to their employees, and in order to be able to compete with larger entities they may offer their employees equity share ownership in the entrepreneurial company as a compensation for a lower salary. In such companies, a pension is also often related to the success of the company, and it is certainly of interest to the employees to be able to assess the company’s prospects of fulfilling the obligations when the pensions become due (standard setter PP).

4.1.1.3 Communicating with potential acquirers

Three of the respondents put forward potential acquirers as an important user group of entrepreneurial SMEs’ financial reports. With reference to his own experience, standard setter RJ states that entrepreneurial and growth-oriented
4. Empirical results of the licentiate study

owner-managers in general plan for a future exit strategy already at the start-up of their businesses. In this respect, the financial reports make up an important tool for communicating the wellness of the business to competitors and other potential buyers. For this reason, the respondent argues, the target-oriented entrepreneur is certainly keen on keeping the accounts in good order and to publish high-quality financial reports. As compared to what is usually the case in SMEs in general potential acquirers therefore make up an important user group of entrepreneurial SMEs financial reports (standard setter RJ).

The common procedure among venture capitalists is according to standard setter CD to plan, already at the very beginning of their investment, for a future exit on a stock exchange. In the trade that precedes this exit, the financial reports make up a very important tool for communicating with investors (standard setter CD). Standard setter CD further argues that the high-quality requirements of the financial reports of a business that is to be noted on a stock exchange in general encourages tightly managed financial reporting procedures already in an early phase of the development of the entrepreneurial business.

Standard setter PP also states that it is very likely that entrepreneurial managers who are successful in managing the high growth of their entities eventually will introduce their companies to the public stock market. Such a procedure requires “good financial numbers and supporting narrative information so that the investors who are putting in money into these companies can do it with their eyes open” (standard setter PP).

4.1.1.4 The use of financial reporting information in the internal management

Two of the respondents answered in affirmative to the question of whether financial reporting information is useful to the managers of entrepreneurial SMEs in their internal decision-making. Even though the close connection between the information contained in financial reports, on the one hand, and the information provided by internal management accounting systems, on the other, is attended to by the other respondents (e.g. auditor BÅ, standard setter PP), the predominant view is that financial reports are marginally useful to managers of entrepreneurial SMEs in the internal management of their businesses. Five of the interviewed accounting experts believe that managers find their information for internal decision-making mainly from other sources than financial reports. According to one of the auditors the information used by management in the evaluation and follow-up of new development projects comes mainly from the internal management accounting system (auditor BÅ). With reference to previous studies, including his own research, standard setter RJ argues that financial reports in general are used for internal decision-making purposes to greater extent in smaller businesses than in larger ones. In the smaller entities within the SME continuum the main users of the financial reports tend to be the owner-managers in general, while other users become more important in larger entities.
In entrepreneurial and growth-oriented SMEs, RJ continues, the financial reports tend to be of less use for making decisions within the business and managers tend to orient their use of the financial reports to the communication with external actors.

Standard setter PP maintains that the financial reports provide with important information on “the big picture of the company”, trends and long-term profitability to managers of entrepreneurial SMEs. In all that, the respondent adds, the general-purpose financial reports are not designed to produce sufficient management information such as more detailed information about profitability by product line or segment. Also, while financial reports mainly attend to historic information about past events and transactions – which is important from a management perspective but not sufficient - management decisions usually involve forecasts that are not included in the financial reports (standard setter PP). Examples of questions will not be answered by means of financial reporting information are: “What business areas are potential for growth and what areas are declining?” or “Is the continued operation of a specific factory profitable in the future, or should the production equipment be rented or owned?” (standard setter PP).

Two of the respondents however consider the information contained in the financial reports to be an important tool for internal management purposes and points to the importance of financial reports in confirming the management accounts (standard setter CD, auditor BS). Financial reporting information is according to one of the auditors crucial in the processes of budgetary follow-ups in general, and – because of the great importance of keeping track of liquidity in growing entities - in the management of liquidity in specific (auditor BS). Auditor BS also believes that there is a greater awareness of the usefulness of the financial reports as a tool for internal decision-making among SME-managers with ambitions for growth and development than among managers of SMEs in general.

Standard setter CD draws attention to the legal demands for a certain level of share-capital that are critical to the continued existence of the reporting entity, and therefore of crucial importance to its management. Since the Swedish bankruptcy legislation is aimed at the information contained in the financial reports, the management accounts will not provide with the relevant information needed by the management of an entity that is close to being forced into liquidation (standard setter CD).

4.1.1.5 Summary

Table 4.1 presents a summary of the views held by the accounting experts concerning the main users of entrepreneurial SMEs’ financial reports. According to the interviewed accounting experts, the main user groups of entrepreneurial SMEs financial reports include financiers – mainly bankers but also venture capitalists and other external owners – customers, suppliers, employees and potential acquirers. Concerning the internal use of financial reports by managers, two of the respondents consider financial reporting information to be valuable
4. Empirical results of the licentiate study

to managers for internal decision-making purposes. Several of the other respondents put forward the close connection between management accounting information and financial reporting information, and the confirmatory value of financial reports. In all that, the opinion among the majority of respondents is that management finds their information for internal purposes mainly from other sources.

**Table 4.1 Users of entrepreneurial SMEs' financial reports according to accounting experts**

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Bankers</th>
<th>Venture capitalists</th>
<th>Customers &amp; suppliers</th>
<th>Other external owners</th>
<th>Potential acquirers</th>
<th>Employees</th>
<th>Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard setter CD</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<td>X</td>
</tr>
<tr>
<td>Standard setter HE</td>
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<tr>
<td>Standard setter RJ</td>
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<td>X</td>
</tr>
<tr>
<td>Standard setter PP</td>
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<td>X</td>
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<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Auditor BS</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<td>X</td>
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<tr>
<td>Academic PT</td>
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<td>X</td>
<td>X</td>
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</tr>
<tr>
<td>Auditor BÅ</td>
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</tbody>
</table>

**4.1.2 Financial reporting information of certain importance in an entrepreneurial context**

**4.1.2.1 Information on cash flow**

All respondents consider financial reporting information on cash flow to be particularly relevant in the context of entrepreneurial SMEs. “Hard facts” (academic PT, auditor BÅ), “the most important statement of the financial reports” (standard setter CD), and “an underrated tool for control” (auditor BS), are examples of designations ascribed to information on cash flow by the interviewed accounting experts. By providing investors with the very important information on how the cash flow of an entity has been generated, the cash flow statement makes according to standard setter CD up the most essential part of the financial reports. Examples of questions answered by the cash flow statements in this respect are: “Has the cash been generated internally by the sales of the company's products or services?”, or “Are there continuous deficits from operations that have been compensated by contributions from financiers or the
selling off of assets - implying that the company is in fact bleeding?” (standard
setter CD).

Auditor BÅ gives prominence to the merits of cash flow not at least in the
evaluation of businesses in their early stages of development, or businesses that
are in the early research phase of a development project. In such companies, the
balance sheet gives in general a somewhat weak image of the business and
investors tend to turn to cash flow statements in order to get the “hard facts” of
the prospects of the business:

…[a business plan] may be as gorgeous as ever, but you also need to know what is
actually happening and then, it is my opinion, cash flow is what first of all shows how
[the business] is coming along… (Auditor BÅ)

Auditor BS considers the cash flow statement to be an underrated tool for
control that should be required for all companies, not just larger and/or publicly
held ones. Standard setter HE believes that it is somewhat unfortunate that there
is no requirement for smaller companies to publish cash flow statements. Even
so, auditor BÅ contends, it is common practice in entrepreneurial SMEs with
high ambitions to grow to incorporate cash flow statements in the financial
reports even if there is no such requirement by law.

Cash flow information is according to standard setter HE of specific
importance in high-growth entities not only because of the importance to keep
track of the demand for financial capital but also since the greatest differences
between profit and cash flow in general occur in this group of entities. The cash
flow statement will also very clearly illustrate potential financial difficulties of an
entity that is growing too quickly (standard setter HE). Furthermore, academic
PT argues that the extent to which entrepreneurial entities often rely on
intangible investments, which are not sufficiently reflected in the general-purpose
financial reports, makes cash flow superior as performance measurement.

A consequence of a regulation with no requirement for SMEs to publish cash
flow statements is according to standard setter PP that external users will
construct such statements on their own. Even so, standard setter PP expresses
some scepticism towards the competence of external users in this respect. Standard
setter HE also expresses some doubt in this respect. Even though it is
possible for external users to reconstruct cash flow statements from the
information contained in two balance sheets, an income statement and a few
more pieces of information such as dividend payments, there would certainly be
some guesses in such statements, standard setter PP contends. With reference to
the entrepreneurial entities in the SME context, however, the common practice
among users in general, and bankers in specific, is according to standard setter
PP to request cash flow statements to be included in the financial reports.

Standard setter RJ believes that cash flow information is very important but
raises some doubt against the custom practice to report on cash flow of the past.
It is noticed, however, that even if users would benefit from cash flow predictions
rather than historic reports, there might certainly be a hesitance among managers to disclose information that would provide users with information on delicate matters that should remain business secrets (standard setter RJ). Standard setter RJ also criticizes the disposition of the cash flow statement required under the draft IFRS for SMEs of being too complicated and therefore requests statements produced in a more sympathetic way that is easier for users to understand:

Perhaps there should be a reassessing of what users want in terms of cash flow historic statements. (Standard setter RJ)

### 4.1.2.2 Intangibles

All respondents consider information on intangible assets to be of particularly important in the context of entrepreneurial SMEs. Apart from the legal aspect, which certainly may be critical to the continuing existence of a company (standard setter CD, standard setter HE, auditor BS), the respondents are uncertain about the consequences of not having investments in intangible resources capitalized as assets in the balance sheet of the entrepreneurial entity. Concerning the informational aspect of capitalization, however, the predominant view is that disclosure of information on intangible investments makes up a fully conceivable/relevant option (standard setter CD, standard setter HE, standard setter PP, academic PT, auditor BÅ).

Both standard setter CD and standard setter PP argue that an investment in intangible resources that meets the definition of an asset and is possible to measure reliably in terms of value, should be recognized as such. In cases when capitalization of an intangible investment is not an option, good additional disclosed information on the investment is vital (standard setter CD, standard setter PP). When the law restricts capitalization, or if the company chooses not to do so in prudent precaution, the disclosed description should according to standard setter CD include information on the reason for the decision not to capitalize to avoid sending unjustified signals to users that there is an uncertainty concerning the prospects of the investment. Furthermore, narrative descriptions of development projects are according to standard setter CD not only important when the accounting regulation prohibits capitalization, or when the reporting entity for some reason have chosen not to capitalize the expenses for intangibles, but also as complementary information to intangible assets that are capitalized (standard setter CD).

Concerning development projects that have been recognized as assets, standard setter CD argues for additional disclosure on the estimated lifetime of the project and the reasons for the choice of depreciation period. If the depreciation period of a specific asset for instance is very long, information should be disclosed on the reasons for the choice of depreciation period together with an estimation of the probability that the development project will generate revenues during the estimated useful life of the asset. On the other hand, if a capitalized intangible asset has not yet been depreciated, it is significant to
disclose the reasons for such a strategy. Concerning capitalized development projects standard setter CDs also argues that it is important to disclose information on the components of the capitalized asset, i.e. the expenses included in the capitalized amount.

It is suggested by several of the respondents that the disclosed information on research and development projects should include not only the amount of resources that has been invested in research and development, but also a description of the expected future development of the projects (standard setter CD, standard setter PP, academic PT). To avoid revealing business secrets to competitors it is according to standard setter CD significant that the future expectations of ongoing projects are described in general terms. With respect to the expected future development of intangible projects CD further maintains the significance of cash flow information:

… then it is all about cash flow. Anything else is completely uninteresting. (Standard setter CD)

Standard setter PP draws attention to the circumstance that high-tech companies in general rely on human capital in terms of knowledge and technical skills to a considerable extent and in his opinion information on the access to such human capital should be included in the disclosed information in addition to the information on product-related intangibles.

With reference to his own research, standard setter RJ states that growth-oriented and entrepreneurial SMEs in general rely to a great extent upon intangible resources, and he is critical to the way in which financial reports fail to display such assets which he argues restricts the availability to financial capital. According to RJ, there is a trend towards supplementing the quantitative numbers with descriptive accounts:

[Concerning intangibles] I think there is a case in using the descriptive things [rather] than using quantitative things. I am not as convinced anymore that the quantitative ways for financial reporting captures what the business does, how well the business is performing. (Standard setter RJ)

In all that, standard setter RJ believes that the issue of whether there is a need to capitalize intangible investments as assets, or if it is sufficient to describe such investments in narrative form, has not yet been inquired properly into:

I think it is of great importance, and we haven’t addressed the issue. Financial reports, in my view, do not reflect business reality. (Standard setter RJ)

With reference to the, at the time for the interviews, forthcoming Swedish accounting standard for limited liability companies (K2), auditor BÅ cautions that the prohibition to capitalize investments in internally generated intangible
resources will not be seriously detrimental to the entrepreneurial entities belonging to this group. According to BÅ it would be in line with the growth-orientation of such entities to choose to comply with K3 even if they at the moment are of K2-size, since they eventually - if successful in their efforts to grow - will end up in the size of K3, or even K4. Even so, auditor BÅ believes that the very possibility to capitalize internally generated intangible assets may contribute to the decision to go for an accounting standard aimed at larger entities (K3 or K4 in the Swedish context). Standard setter CD and HE also believe that K3 will be the primary choice for entrepreneurial entities of K2-size, partly for the possibility to capitalize internally generated intangible assets.

4.1.2.3 Financial ratios

Most of the respondents consider financial ratios of various kinds to be of specific interest regarding entrepreneurial SMEs. Standard setter HE, to start with, strongly supports the use of financial ratios in general, and ratios on sales and growth in specific, for entrepreneurial and growth-oriented entities. In line with HE, auditor BS also believes that financial ratios are an underrated tool for financial control that should be used to a greater extent by companies than what is the case today.

On the question of whether information on ratios makes up significant financial reporting information in the context of entrepreneurial SMEs, standard setter PP responds:

*Wearing my hat as a standard setter, it is beyond our expertise. If I was one of the users, I would say I would like to have information on those ratios for my decision-making. I would even like to have a standard for how those ratios were calculated.*

(Standard setter PP)

Financial ratios are according to auditor BÅ used by analysts to a great extent in the evaluation of entrepreneurial businesses, and in this respect analysts are explicitly interested in industrial-specific financial ratios and ratios measuring various aspects of growth. For entities that have been in business more than just a few years it is according to BÅ significant to communicate to users that previous targets of growth have been reached continuously and, in this respects, financial ratios provide with important information.

According to standard setter HE and academic PT there is an increasing tendency among financiers - especially venture capitalists - to include covenants in their contracts, which means that the continued provision of financial capital is contingent upon the fulfilment of some pre-set requirements often expressed in the form of financial ratios. A credit contract may for instance include a covenant regarding solvency, implicating that the loan expires if the solidity falls below a certain level (standard setter HE). As put forward by academic PT, creditors tend to make use of covenants in contracts with entrepreneurial entities
in specific, which makes information on financial ratios important in relation to this group of entities.

In academic PT’s opinion financial ratios are in general harder to interpret in the context of entrepreneurial and growth-oriented businesses than what is the case concerning non-growing businesses. “When it comes to entrepreneurs, standardized solutions are out of order”, PT argues and further requests accounting solutions that are adapted to the specific circumstances of the individual entities. To the question of the importance of growth ratios in specific academic PT however replies that such ratios of course provide with important information in an entrepreneurial context, and standard setter CD, RJ and PP express equivalent standpoints. Standard setter PP however argues that if financial reports contain sufficient historical information it is not difficult to calculate growth ratios. Even though auditor BS points out that he has limited experience in the use of growth ratios in entrepreneurial and growth-oriented SMEs in specific, it is a matter of course that such information is of high interest concerning this group of entities. Standard setter CD attends to the importance of industry specific ratios and makes a reference to the consulting industry where it is significant to measure growth in sales and profit (and profitability) in relation to employees. Auditor BS argues for the importance of industry-specific accounting information in general.

4.1.2.4 Other disclosed information

Several of the respondents consider additional disclosure to be particularly important in the entrepreneurial context (auditor PT, standard setter RJ, standard setter PP), and that the trend is towards more disclosure in the future, especially concerning entrepreneurial-oriented entities (auditor PT, standard setter RJs). According to standard setter PP there is a lot non-financial information that may be even more important in the entrepreneurial SME than the numerical financial information:

Every company has to tell their story. Accounting numbers is just a part of the story, there is a lot more that they must tell besides accounting numbers. (Standard setter PP)

Besides the suggestion to disclose narrative information on intangibles (Section 4.1.2.2) and growth ratios (Section 4.1.2.3), the majority of the respondents give suggestions of other additional disclosure that they believe to be of specific importance in the entrepreneurial context. In this respect three of the respondents have mentioned the importance of disclosed information on aspects related to the business concept of the reporting entity. Standard setter PP mentions information on the technology of the entity’s products and information about the market in this respect. Auditor BÅ argues for the importance of

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38 Information provided in addition to the standardized general-purpose financial statements (income statement and balance sheet).
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providing information on the business concept of the reporting company – its products and its services – and to supplement the numerical numbers of cash flow and turnover with descriptions of the marketability of the business concept. Standard setter CD maintains that it is significant that the financial reports of the entrepreneurial SME incorporates a description of “what you are doing” and also, in broad outline and without revealing business secrets, a description of the expected development of the projects carried out by the entity, together with the arguments behind these expectations.

Three of the respondents consider additional disclosed information on liabilities to be of specific importance to the users of entrepreneurial SMEs’ financial reports. In this respect, standard setter HE stresses the importance of additional disclosure of information on loan promises, expiry dates and covenants (see Section 4.1.2.3 above) connected to the loan agreements. Academic PT also argues for the importance of transparency in terms of loan structure and the conditions/terms of the different loan agreements, not at least when there are more than just a few actors providing finance to the entrepreneurial entity. Standard setter RJ requests a greater focus on liabilities in the financial reports of entrepreneurial SMEs’ financial reports, and in this respect he considers information on leasing contracts to be of specific interest to users.

Besides transparency in terms of liabilities academic PT also requests disclosed information on dividends and compensations to management which he believes to be of specific importance in the context of entrepreneurial SMEs. Standard setter PP states that it is important to disclose information on items that have been charged directly to equity and therefore do not show up in the income statement.

On the asset side of the balance sheet, standard setter RJ specifically requests additional disclosure on outstanding debtors – “how long they are and how old they are” - of the entrepreneurial and growth-oriented SME, since such information should be of high value to financiers in their assessment of possible future cash flow problems of the reporting entity. Concerning assets, standard setter PP argues for the importance of fair value information, particularly regarding financial instruments, using future cash flow information.

With reference to the income statement, academic PT maintains that the very general principles for measuring revenues signifies the disclosure of information on the methods applied when calculating the revenues; this in order to inspire the users of the entrepreneurial entity’s financial reports with confidence in the reliability of the item. Furthermore, by supplementing the numbers presented in the income statement with additional information about the contracts that the reported entity has entered with customers will provide the users with significant information in their evaluation of the substance of the revenues accounted for (academic PT). The importance of disclosing information on the contracts that the revenue number is based upon is also attended to by auditor BÅ.

Standard setter HE notes that since privately held entities do not have to conform to the regulation on insider trading that is imposed on publicly held
entities; the need of disclosure is not as extensive in the first mentioned group as in the latter. When a stakeholder to a privately held SME requests comments or clarifications on items of the financial reports it is possible to obtain such information in an uncomplicated way. In all that, HE believes that financial reports of non-public entities in general are too formal, and he requests specifically more information on why different items of the financial reports have developed the way they have, and, also, what items that are occasional and what items are recurrent. In HE’s opinion, the financial reports of non-public entities in general, and of high-growth entities in specific, usually provide with insufficient information on these issues, which are of great importance to the evaluation of the financial position and the prospects for the future. The financial reports of high-growth entities often “do not make it out”, standard setter HE continues; you see the on-the-spot account at the end of the accounting period, and the development of the turnover, but rather than answering the questions the user might have concerning the development of different items, the numbers often raise additional questions.

4.1.2.5 Contribution margin
In the literature study of previous studies of accounting in entrepreneurial contexts information on contribution margin was sorted out to be of specific importance by entrepreneurs in their internal management of their businesses. During the interviews with accounting experts the respondents were asked for their view of disclosing information on contribution margin to the financial reports of entrepreneurial SMEs, and, also, of an alternative tentative contribution-oriented disposition of the income statement where the cost part is divided into fixed and variable costs.

The idea of disclosing information on contribution margin did not gain any support to talk of from respondents; neither has the tentative idea of an alternative disposition of the income statement where the cost part is divided into fixed and variable costs (except for standard setter RJ who mainly talks about very small businesses in this respect). Auditor BÅ states that he has experienced an interest among entrepreneurs in an alternative contribution-oriented income statement, but in his own opinion the possibility to disclose information on contribution ratios is sufficient. Standard setter HE believes that contribution margin is a useful tool for the internal management, but he is rather sceptical concerning the external users’ interest in such information (HE however suggests posing the question to the users themselves). According to standard setter CD the issue of providing information on contribution margin is irrelevant since such a disclosure would involve too much exposure of trade secrets.

4.1.2.6 Summary
Table 4.2 below illustrates the areas of financial reporting information that two or more of the interviewed accounting experts consider to be of specific
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importance to managers of entrepreneurial SMEs in their provision of information to users.

The respondents consider financial reporting information on especially cash flow, intangible assets – capitalized or in narrative form – and growth ratios, to be of specific importance in the entrepreneurial context. All respondents also provide suggestions of additional disclosed information and in this respect information on business concepts, information on liabilities and contracts with financiers, and additional information on sales/revenues has received the most attention.

Table 4.2 Significant items or areas of information according to accounting experts

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Cash flow</th>
<th>Intangible assets</th>
<th>Growth ratios</th>
<th>Business activities (disclosure)</th>
<th>Liabilities (disclosed)</th>
<th>Revenues (disclosed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard setter CD</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
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<tr>
<td>Standard setter HE</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Standard setter RJ</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Standard setter PP</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
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<tr>
<td>Auditor BS</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Academic PT</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Auditor BÅ</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

4.2 Document study of comment letters to BFNs K2 drafts

In both the 2006 and 2007 drafts of K2, the possibility of previous regulation to capitalize investments in internally generated intangible resources as assets in the balance sheet was removed. In two of the comment letters sorted out for this document study, this suggestion is supported with the argument that internally generated assets are more risky than other items of the balance sheet and also very complicated to evaluate (the Swedish Tax Authority, 2006), and that a removal of internally generated intangible assets from the balance sheet would facilitate the credit rating process (SRF, 2006).

The 15 documents that contain negative criticism towards the suggested prohibition to capitalize investments in intangible resources have in Table 4.3 below been categorized according to the focus of the arguments provided (note that the same respondent may have put forward more than one argument and
thereby ends up in more than one category). It has not been possible to discern any significant pattern of the arguments depending on what category of respondents (accounting firms, trade associations etc.) the authors belong to. In two of the comment letters no argument for the opposition towards the suggested accounting solution is presented, and in the following the main arguments of the remaining 13 documents will be presented.
4. Empirical results of the licentiate study

Table 4.3 Arguments against the suggested K2 regulation concerning internally generated intangibles

<table>
<thead>
<tr>
<th>Argument</th>
<th>Balance sheet for liquidation purposes</th>
<th>Increased administrative burden</th>
<th>Restructuring of development projects</th>
<th>Less relevant information to users</th>
<th>Prevention of development projects</th>
<th>No specific argument provided</th>
</tr>
</thead>
<tbody>
<tr>
<td>Företagarna (2006, 2007)</td>
<td></td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
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</tr>
<tr>
<td>Sydsvenska Industri-och Handelskammarens redovisningskommitté (2006)</td>
<td>X</td>
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<tr>
<td>KPMG (2006, 2007)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
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<tr>
<td>Svenskt Näringsliv (2006)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
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<tr>
<td>Revisorsamfundet (2006)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<td>LRF (2006)</td>
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<td>FAR (2006)</td>
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<td>FAR SRS (2007)</td>
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<td>SRF (2007)</td>
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<tr>
<td>Gothenburg School of Economics (2007)</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
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<tr>
<td>Företagsrevision Cederlund/Grabe (2007)</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>J. Bornhager (2007)</td>
<td>X</td>
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<td></td>
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</tr>
</tbody>
</table>

39 The indication of (2006, 2007) means that in 2007 the respondent has provided with identical or as good as identical comments as presented in their comment letter to the 2006 draft.
40 Even though S-I. Danielsson co-authored the comment letter by L. Nilsson, S-I. Danielsson & C. Stavegren, his individual comment letter includes comments that are not identical to the content of the co-authored comment letter. Accordingly, the comment letter by S-I. Danielsson is included in the analysis.
41 J. Bornhager bases his comments on the conclusions of his bachelor thesis.
4.2.1 The need to set up a balance sheet for liquidation purposes

A frequent argument against the suggested prohibition to capitalize investments in intangible resources, which is put forward by eight of the 15 respondents, is the legal consequences of the negative effect that an obligation to write off the expenses for investments in intangible resources may have on the share capital of the reporting entity. According to Swedish law, limited liability companies are required to set up a balance sheet for liquidation purposes when half of the registered share capital is used up. Then, there is a time limit of eight months within which the share capital has to be completely restored; otherwise the company is forced into bankruptcy. Consequently, for development intensive companies with continuous investments in internally generated intangible resources the suggested solution of the K2 drafts may have far-reaching consequences (e.g. Revisorsamfundet, 2006).

4.2.2 Increased administrative burden and restructuring of development projects

One way to avoid the reduction of share capital and the consequent requirement to set up a liquidation balance sheet, and the subsequent risk of being forced into bankruptcy, is to apply a more complex regulation that allows capitalization of investments in internally generated intangibles. The alternative offered by the Swedish accounting regulation in this respect will be in the form of the coming accounting standard for K3 entities. If the K3 accounting standard is chosen the reporting entity must follow this regulation in its entirety, not only regarding the reporting of investments in internally generated intangible assets. According to seven of the 15 respondents, however, this alternative does not legitimize the suggested prohibition of capitalization of internally generated intangible assets of K2, since this would bring about increased administrative burdens for those entities that on all other aspects are content with the simplified regulation of K2.

Another way to evade the prohibition to capitalize internally generated intangible assets, which is put forward in seven of the comment letters as a likely consequence of the suggested regulation, is for the reporting entities to find new ways to restructure development projects. As described in the comment letter of Gothenburg School of Economics (2007) the reporting entity may start up a completely new business where the research and development projects are carried out. Later, when this new business is acquired by the primary company, the acquisition contract will make it possible to include the acquired investments as assets in the balance sheet of the primary/principal company. The representatives of Svenskt Näringsliv (2006) who also put forward the formal reorganization of development projects as a likely consequence of a more restrictive regulation concerning internally generated intangible assets as
4. Empirical results of the licentiate study

compared to the acquired equivalents, maintain that such a procedure would bring about nothing but unnecessary costs for the reporting entities (Svenskt Näringsliv, 2006).

4.2.3 Less relevant information to users of financial reports

The consequences of the suggested regulation concerning internally generated intangible assets on the informational value of financial reports are mentioned in five of the analysed comment letters. It is suggested that a prohibition to capitalize such investments as assets would lead to the provision of less relevant information to users of financial reports, among which capital providers are considered to hold a prominent position (Revisorsamfundet; Nilsson, Danielsson & Stavegren; KPMG). According to representatives of Revisorsamfundet (2006) a very important purpose of the financial reports of smaller entities is to provide financiers with information for credit ratings and credit decisions. The suggested prohibition to capitalize such assets will in this respect lead to the provision of less relevant information for such decisions, which in turn may bring about a shift between different forms of credit, such as the increased use of leasing (Revisorsamfundet, 2006).

The sustained provision of financial capital is according to Nilsson, Danielsson and Stavegren crucial to newly established innovation and development intensive companies in their efforts to reach the market and to expand. To these companies a possibility to capitalize internally generated intangibles is critical since losses that originate from expensed development costs decreases the confidence in the reporting entity concerning the prospects to survive and continue to develop its innovations. In addition, a requirement to write off expenses for further development of innovations – as suggested in the drafts of K2 – creates further losses for the reporting entity that need to be covered by additional financial capital, often in the form of risk capital. Nilsson, Danielsson and Stavegren further maintain that the possibility for innovative entities to raise finance is rendered even more difficult by the circumstance that venture capitalists and business angels in general require that the balance sheet of an innovation company considered for investment is without deficits for a period of three years before the investment.

The representatives of Gothenburg School of Economics refer in their comment letter to previous research when maintaining that financial reports of entrepreneurial entities are not only used to inform external users but, for reasons of cost efficiency, play a significant role in the internal management of the business as well. The proposed regulation concerning intangibles is in this context considered to lead to the provision of less relevant information to entrepreneurs managing innovative businesses.
4.2.4 Prevention of development projects

In the 2006 comment letter authored by representatives of the trade association Företagarna it is argued that the lack of access to risk capital restrains the development of smaller businesses, not at least with respect to entities that are in the early phase of developing their businesses. An accounting regulation that prohibits capitalization of intangibles will lead to an increasing need for risk capital to fulfill the legal demands for a minimum level of share capital, with the consequence that the development of new ideas and products is obstructed (Företagarna, 2006). Therefore, the representatives of Företagarna maintain, it should be allowed to distribute the expenses for research, development and marketing over several years by activating such investments as assets.

Several of the respondents argue that the possibility to capitalize expenses for internally generated intangible assets is especially critical to growth-oriented and development intensive business and that the suggested regulation would have a restraining effect upon the development and lead to that many innovations would never come about (Nilsson, Danielsson & Stavegren; Företagarna; Svenskt Näringsliv; Revisorsamfundet). Considering the role of knowledge-intensive businesses to the development of the economy as a whole such a scenario is also believed to bring about severe consequences not only for the reporting companies but also for the development of society at large (Nilsson, Danielsson & Stavegren; Gothenburg School of Economics; Företagarna). Even if the entities where it is critical to capitalize intangible investments such as research and development costs only make up a smaller part of the SME group, it is noticed in the comment letter by Företagarna, such entities are certainly important from the perspective of the growth of the economy.

The representatives of Svenskt Näringsliv also maintain that the suggested treatment of internally generated intangibles would counteract entrepreneurs that are about to further develop high-potential projects, which in turn would lead to the obstruction of the enterprising spirit of the economy. Furthermore, Nilsson, Danielsson & Stavegren draw attention to the importance of the establishment of new innovation and development intensive companies in creating new productive job openings/opportunities, and that the success of smaller entities is the most significant growth factor within the Swedish economy. The supply of licensed technology from smaller development intensive companies is also considered to be critical to the competitiveness of larger companies (Nilsson, Danielsson & Stavegren).

4.2.5 Summary of results

According to the proposed regulation for K2-companies it is prohibited to capitalize investments in internally generated intangible resources as assets in the balance sheet, a solution that all respondents except the Swedish Tax Authority and SRF (2006) raise objections to. The most frequent argument against such a
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prohibition is that it may create a need for many companies to set up a balance sheet for liquidation purposes with the consequent risk of being forced into liquidation. To avoid the requirement to write off development costs directly to profit, the reporting entities will pursue different strategies, including the choice to comply with a more complex accounting standard (K3 in the Swedish context) or to restructure their development projects. Such procedures are by the respondents considered not only to counteract the aim of simplification of the accounting regulation, but also to impose indefensibly high administrative costs on reporting entities.

Several of the respondents to the K2 drafts also maintain that the suggested prohibition to capitalize internally generated intangible investments will result in the provision of less relevant information to users of financial reports. The suggested regulation is also considered to have a detrimental effect on development intensive companies’ access to financial capital, with the accompanying risk that many companies with potential to succeed with their development projects will not carry through such projects. This in turn is not only considered to be detrimental to the individual companies carrying out the projects, but to the development on the societal level as well.

4.3 Document study of comment letters to the IASB draft IFRS for SMEs

The IASB received a total of 161 comment letters to the Exposure Draft of an IFRS for SMEs. A glance through a number of the comment letters showed that the large total number of pages of the comment letters would make a reading through of all documents too time consuming in relation to the scope of this study. Furthermore, thirteen of the comment letters were written in Spanish or German and, because of my limited knowledge of these languages, these comment letters were excluded from further analysis. By means of the search function of Adobe Reader, which makes it possible to search through a large number of PDF files simultaneously, the remaining 148 comment letters were searched for the search words displayed in Table 4.4 below.

The search words represents both general concepts related to entrepreneurship such as entrepreneur, innovation and growth, and items of financial reporting information that are expected to be of specific importance in relation to entrepreneurial entities, based on previous studies (Chapter 2, Section 2.4) and the interviews with accounting experts conducted within this study (Section 4.1.2).

The term user/s is not included as a separate search word in Table 4.4 since it received an enormous number of occurrences (1 177 occurrences in 100 CLs). The time-consuming task of going through all comments related to user/s were not considered to be worthwhile, since respondents to the draft IFRS for SMEs...
were not requested to comment on users in the context of entrepreneurial SMEs in specific. However, in cases where users are discussed in relation to comments on other search words of Table 4.4, such discussions are presented in Sections 4.3.1-4.3.3.

With reference to the exclusion of the search word user/s, the terms venture capital and risk capital (search words 7 and 8) make up an exception, since previous research has shown that entrepreneurial SMEs generally are financed by risk capital to a larger extent than what is the case in SMEs in general (see section 2.3.1). The search venture capital (search word 8) initially received 8 hits in 5 comment letters, but since one of the comment letters mentions venture capital as a form of risk capital (and is therefore included among the hits on risk capital, search word 7), these numbers were reduced to 7 and 4 respectively.

Table 4.4 Search word occurrences in comment letters to the draft IFRS for SMEs

<table>
<thead>
<tr>
<th>Search word</th>
<th>Number of CL's with matches</th>
<th>Occurrences of search word</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 entrepreneur(ship/ial)</td>
<td>6</td>
<td>17</td>
</tr>
<tr>
<td>2 innovat(ion/ive)</td>
<td>3</td>
<td>4</td>
</tr>
<tr>
<td>3 business opportunit(y/ies)</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>4 growth</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>5 gazelle</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>6 IPO</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>7 risk capital</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>8 venture capital</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>9 develop(ment)</td>
<td>91</td>
<td>570</td>
</tr>
<tr>
<td>10 cash flow statement</td>
<td>37</td>
<td>72</td>
</tr>
<tr>
<td>11 intangible</td>
<td>59</td>
<td>320</td>
</tr>
<tr>
<td>12 research and development</td>
<td>21</td>
<td>37</td>
</tr>
<tr>
<td>13 contribution margin</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

The number of comment letters that provides with matches on a specific search word is illustrated in Table 4.4 together with the number of occurrences of the search word. Comment letters with matches on one or more search words have been further examined in search for comments of relevancy to this study. This examination has resulted in the division of comment letters into three categories where the first category includes comments where information needs and consequences of different accounting solutions are discussed in relation to concepts of entrepreneurship and growth, covering the search words 1 - 8 in Table 4.4. The search word develop(ment) (search word number 9) received a considerable number of matches but was excluded from further analysis since a glance through a number of sections with occurrences on the term showed that many of the hits on this search word bear upon insertions on the development
4. Empirical results of the licentiate study

of the accounting regulation in general rather than discussions on entrepreneurial development of a business or a business idea. The term, however, remains in the study as a component of the search term research and development (search word 12).

The second category includes comments on cash flow (search word 10). The initial search for the term cash flow provided with a total of 157 matches in 58 documents. A glance through the matches found that the concept appeared very often in comments on the calculation of fair value of assets (revaluations) which comprises the prediction of the future cash flow directly traceable to a specific asset – a signification of the term that is not of immediate focus to this study. This problem was, however, solved by changing the search word to cash flow statements – a procedure that reduced the number of occurrences to 72 in a total of 37 documents.

The third and final category includes comments on intangible assets (search word 11-12). The search for the term research and development was initially supplemented by a search for R&D, which provided with eight hits in a total of four documents. Since this search did not provide with any matches in excess of the matches already identified by the search for research and development, the search word R&D was excluded from Table 4.4

The search word contribution margin (13) did not receive any matches and is consequently excluded from any further analysis.

The comment letters belonging to the same categories have been analysed in search for similarities and differences in order to identify any major themes of discussions. In Sections 4.3.1-4.3.3 the results of this analysis is presented for each of the three categories in turn.

4.3.1 Comments on entrepreneurship, innovation and growth

The term entrepreneurship (search word 1 of Table 4.4) occurs in six of the comment letters, and in all but one of the documents it is used as a synonym of smaller entities in general. In the comment letter authored by the accounting organization Certified General Accountants of Canada (CL 46) - the single exception - it is pointed out that entrepreneurial SMEs with growth aspirations would benefit from preparing their financial statements according to the IFRS for SMEs since it would facilitate the transition to full IFRS as the entity transforms and evolves.

When the search word innovat(e/ion/ive) (search word 2 of Table 4.4) appears in the comment letters it generally refers to innovative accounting solutions rather than the innovative activities carried out by entrepreneurial businesses. A German trade association (CL 105) makes up the only exception when stating that the ability to innovate, together with decisiveness and flexibility, makes up the success factors for many small and medium-sized entities. In addition, to secure their growth and competitiveness, small and medium-sized entities are looking for new markets and low-cost production facilities across borders which
make the need of developing a single set of international standards for SMEs critical.

Two to the comment letters that contain the term growth (search word 4) have already been mentioned above in relation to entrepreneurship and innovate(e/ ion/ ive). In addition, the authors of CL 134 are concerned that a specification in quantitative terms of entities for application of the standard, such as number of employees and turnover (which has been discussed by the IASB), may cause entities to restrict growth to avoid having to comply with the IFRS for SMEs. It is suggested that “if businesses arrange their affairs to avoid compliance with what they consider to be onerous burdens this action may hinder best practice for economic development” (CL 134, p. 7). What specific area, or areas, of the suggested standard that is considered to lead to such behaviour of reporting entities is not discussed in the comment letter, however. In the remaining three comment letters with hits on the search word growth, the concept is mentioned in relation to growth of different items of the financial reports in general, with no clear connection to the entrepreneurial context in specific.

In all of the six comment letters with hits on the search words risk capital and venture capital (search words 7 and 8 of Table 4.4), the terms are mentioned with reference to user groups of SMEs financial reports. In five of the comment letters, venture/venture capitalists are considered to belong to the user groups of SMEs financial reports, and in one of these comment letters the wording “significant user” is used with reference to venture capitalists (CL144). In one comment letter (CL 11), venture capitalists were mentioned with reference to stakeholders whose information needs were not considered to be substantial enough to legitimize the development of an accounting standard with the purpose of increasing the comparability across borders.

4.3.2 Comments on cash flow statements

In developing the draft IFRS for SMEs, the IASB considered some recognition and measurement simplifications not incorporated in the final draft. Some of the potential simplifications were identified in existing national accounting standards for SMEs and some were proposed by the Board’s constituents. One such simplification that the IASB considered was to eliminate the requirement to prepare a cash flow statement. However, since a cash flow statement according to the Board is not very difficult to prepare and since the great majority of lenders and other users of SMEs financial statements who had communicated with the Board had indicated that the cash flow statement is useful to them, a requirement to prepare a cash flow statement was included in the draft IFRS for SMEs (IASB, 2007b). Consequently, the reporting entities are according to the draft required to “present a cash flow statement that reports cash flows for a period classified

42 With respect to the restrictive criteria for recognition of development costs as assets, see Section 6.2.3 below.
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by operating activities, investing activities and financing activities” (IASB, 2007a).
The respondents were specifically requested to comment on whether they
consider that the IASB made the correct decision when deciding not to eliminate
the requirement to prepare a cash flow statement.

The search for the term cash flow statement (search word 10 of Table 4.4)
resulted in matches in 37 comment letters, of which 21 documents include
comments on the issue of whether the cash flow statement should be mandatory
for SMEs. The authors of 14 of the 21 comment letters give support to the
suggestion to make the cash flow statement mandatory for SMEs, while the
authors of 7 comment letters express the opinion that there should be no such
requirement.

4.3.2.1 Support for mandatory cash flow statements

The 14 comment letters that express a positive attitude towards the cash flow
statement requirement are displayed in Table 4.5 below.

Table 4.5  Comment letters providing support for a mandatory cash flow statement

<table>
<thead>
<tr>
<th>Argument</th>
<th>Respondent</th>
<th>CL</th>
<th>Significant to capital providers</th>
<th>Significant to management</th>
<th>Significant to users in general</th>
<th>Cash management</th>
<th>Easy to prepare</th>
<th>No specific argument provided</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>South African professional accountant</td>
<td>4</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>CPA Australia</td>
<td>11</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>CGA Canada</td>
<td>46</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>ICPAK</td>
<td>48</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>CPA Ireland</td>
<td>54</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>IDW Germany</td>
<td>62</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>FIDEF</td>
<td>67</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Chartered accountant of Pakistan</td>
<td>98</td>
<td></td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Deloitte</td>
<td>114</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Prof. acc. Argentina</td>
<td>131</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>CPA Hong Kong</td>
<td>140</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>IFAC</td>
<td>142</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>South African prof. acc.</td>
<td>155</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>EFRAG</td>
<td>161</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>

The most frequent argument for making the cash flow statement mandatory is,
as illustrated by the four first columns (“Significant to capital providers”,

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“Significant to managers” etc.) of Table 6.2, that it provides with significant information to users of SME’s financial reports, among which capital providers receive the most attention. In the comment letter by Deloitte, UK (CL 114), to start with, the cash flow statement is referred to as a key financial statement that users of SME's financial statements place significant reliance on, and that there should be no significant divergence between the cash flow statement of the IFRS for SMEs and IAS 7 Cash Flow Statements. In yet another comment letter authored by representatives of the CPA Ireland (CL 54), banks are put forward as a major source of external funding for many SMEs and, since bankers in general attach importance to information on cash flow, that the financial reports of SMEs should incorporate a statement of cash flow. In the comment letter by IFAC (International Federation of Accountants, CL 142) a similar line of argument for making cash flow statements mandatory for SMEs is followed when referring to previous research carried out by the authors where the results show that creditors in their role as the main capital providers of SMEs demand such statements.

In two of the comment letters of Table 6.2, management is included among the users who benefit from information on cash flow (CL 48, 155), implicating that financial reporting information is considered not only to be important to external users but to managers of SMEs in their internal management of their businesses. Furthermore, in yet two comment letters the significance of cash management is provided as an argument for making the cash flow statement mandatory for SMEs. In CL 98 authored by a chartered accountant of Pakistan it is emphasized that cash management is significant in the SME context and that managing cash as a fundamental financial resource is critical to the survival of a business. In the comment letter authored by EFRAG (CL 161) the general argument is that the cash flow statement helps understand how and why the cash position of the entity has varied over time, in terms of investments, changes in financing structure and the impact of relationships with owners etc.

In two of the comment letters, it is argued that the cash flow statement is easy to prepare and that it therefore is not reasonable to remove the requirement for reasons of simplification (CL 48, 98). Altaf Noor Ali, a chartered accountant of Pakistan, also finds it “puzzling why SME could find it difficult to produce, given the level of technology” (CL 98).

### 4.3.2.2 Criticism against mandatory cash flow statements

The seven comment letters claiming that the cash flow statement should not be mandatory for SMEs are displayed in Table 6.3 below. Most of the respondents do not provide with any argument for their critical view on this issue. All three respondents who provide an argument for their position are however sceptical towards the usefulness of a cash flow statement to the users of SMEs financial reports.
4. Empirical results of the licentiate study

Table 4.6 Comment letters providing the view that the cash flow statement should not be mandatory for SMEs

<table>
<thead>
<tr>
<th>Argument</th>
<th>CL</th>
<th>Burdensome to prepare</th>
<th>Not significant to users</th>
<th>No specific argument provided</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kingston Smith LLP</td>
<td>8</td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>ZDH Germany</td>
<td>27</td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>CIMA</td>
<td>41</td>
<td>x</td>
<td>x</td>
<td></td>
</tr>
<tr>
<td>AAT</td>
<td>100</td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SCAA China</td>
<td>102</td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>ASB India</td>
<td>126</td>
<td></td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>DGRV Germany</td>
<td>132</td>
<td></td>
<td></td>
<td>x</td>
</tr>
</tbody>
</table>

The most explicit criticism towards making the cash flow statement mandatory is offered by representatives of CIMA, who cannot see how the benefit of a cash flow statement to users outweighs the burden on preparers in small companies (CL 41). The AAT (CL 100) is somewhat gentler when stating that the cash flow statement is not in general essential to users of SMEs’ financial statements, and that it therefore should not be an obligation for SMEs reporting under IFRS for SMEs.

Furthermore, ASB India argues that the benefits of cash flow statements are limited in case of SMEs, and that other financial statements provide sufficient information on financial health and liquidity position (CL 126):

*A few users may find CFS useful but not all. Perhaps the only interest group interested in CFS would be lenders, who can demand CFS when required. Thus, CFS is more a special purpose financial statement for SMEs rather than a general purpose financial statement. (CL 126)*

4.3.2.3 Other comments concerning cash flow statements

Besides the issue of whether the cash flow statement should be mandatory or not, most comments concerning cash flow are focused on the different items of the cash flow statement. The issue that has received most attention in this respect is whether the direct or indirect method is preferable when calculating cash flow from operations. Among the 17 respondents who take a stand on this issue 14 advocate the indirect method (frequent arguments: easy to prepare, the ultimate choice by larger and/or publicly traded companies) while 3 prefer the direct method. In addition, 4 respondents are of the opinion that the reporting entities should be able to choose between the methods.
4.3.3 Comments on research and development (R&D) and other intangible assets

With reference to internally generated intangible assets, “IAS 38 Intangible assets” requires all research costs to be charged as expenses when incurred, while development costs that are incurred after a project is deemed commercially viable are to be capitalized. The draft IFRS for SMEs proposes an option not available under IAS 38 for reporting entities to choose to treat all development costs as expenses even if the development project meets the criteria for capitalization as an intangible asset. This also means that if the criteria for capitalization are met the reporting entity can choose to capitalize the development cost as an asset. Consequently, the restriction concerning internally generated intangible assets that is incorporated into the K2 drafts by the Swedish BFN is without parallel in the draft IFRS for SMEs.

The search word research and development (12) received matches in 21 comment letters of which 14 address the issue of whether the IFRS for SMEs should include an option to expense all research and development costs when incurred. 13 of the 14 respondents provide support for the expense option, while only one respondent take part against such an option. Most of the respondents who are positive towards the expense option do not provide with any argument for their standpoint, two respondents put forward reasons of simplification and one respondent believes that such a solution would reduce the divergence between the IFRS for SMEs and the national legislation.

Of the 13 respondents providing a view on the issue of whether the expense option should be included in the IFRS for SMEs it is only the INAA Group (The International Network of Accountants and Auditors, CL 124) that expresses criticism against such an option. It is emphasized in the comment letter that many SMEs engage in research and development - particularly in the IT sector – and if all their research and development costs were treated as expenses the overall picture provided by their financial statements would be significantly influenced and, consequently, not reflective of the economic lifecycle in the industry.

According to the expense option provided by the draft IFRS for SMEs it is permitted for the reporting entity to choose to capitalize development costs as soon as the criteria for recognition are met. Among the comment letters with matches on the search word research and development one single document have been identified discussing the consequences of the restrictive criteria for recognition of development costs as assets. In the comment letter authored by representatives of (CL 134), it is emphasized that even if it may not be preferable economically to contract out R&D, the reporting entities might choose such a strategy if this means that they can capitalize the cost of a purchased ‘secret recipe’ or brand name as an asset in the balance sheet.

Besides commenting on whether the option to expense development costs is appropriate or not, respondents have focuses on the measurement of intangible assets in general to a great extent. A survey of the 59 comments letters with hits
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on the term *intangible* (search word 11) shows that respondents have mainly focused their discussions concerning intangible assets on three issues. Firstly, the opinion is widely spread among respondents that the separation of assets with indefinite lives from the ones with definite lives is too complicated for SMEs, and that the *IFRS for SMEs* should incorporate an option to amortize on all intangible assets. Secondly, the requirement to calculate fair value has received a lot of criticism since the necessary calculations are considered as too hard and burdensome for SMEs (the cost model is the preferred alternative among respondents). Thirdly, extensive criticism has been directed towards the suggested requirement to test assets on an individual exclusively, and never as a part of a group of assets.

4.3.4 Summary of results

The document study of comment letters to the draft *IFRS for SMEs* provided with occurrences related to the search words of “cash flow”, “intangible” and “research and development”. With reference to cash flow, 21 of the totals of 148 comment letters include an opinion on whether SMEs should be required to publish cash flow statements. The majority of the respondents providing their opinion on the issue believes that there should be such a requirement, and the most frequent argument is that cash flow statements provide with information that is significant to users. Besides the issue of whether the cash flow statement should be mandatory or not, most comments on cash flow focus on different items of the cash flow statement and whether the direct or indirect method is preferable when calculating cash flow from operations. In this respect, the indirect method is in great majority.

Concerning the item of research and development, the majority of the respondents support the suggested option to expense all research and development costs rather than requiring capitalization whenever the recognition criteria are met. Few respondents provide with an argument for their standpoint on this issue. The comments with hits on the term intangible(s) turned out to be mostly concerned with different aspects of measurement of intangible assets.

4.4 Summary of the results of the licentiate study

The accounting experts interviewed for this study refer to the continuous high demand for financial capital as a challenge to entrepreneurial SMEs aiming at development and growth. In this context, financial reports make up an important tool mainly for informing external capital providers, among which bankers hold a prominent position. The high demand for financial capital also makes venture capitalists and other external owners more important as financiers of
entrepreneurial SMEs than what is the case in SMEs in general, which is in line with previous research (Berggren, Lindström & Olofsson, 2011; Storey, 1994). Other important user groups put forward by accounting experts are customers, suppliers, employees and potential acquirers. While the predominant view is that financial reporting is mainly directed towards external users, respondents also attend to the usefulness of financial reports in confirming the management accounts, as well as providing information on capital retention.

According to the collected results of the licentiate study, information on cash flow and intangibles stand out as significant with respect to entrepreneurial SMEs’ financial reporting. The importance of cash flow information follows on the need to secure the financial capital needed in the continuous development carried out within the entrepreneurial entity. As suggested by accounting experts, entrepreneurial entities tend to rely on intangible assets to a high extent, and these assets are in general not sufficiently reflected in the balance sheets. In this respect, cash flow provides straightforward and reliable complementary information which is important when assessing the prospects of the business. Considering that privately held SMEs according to Swedish accounting regulation are not required to prepare cash flow statements, the results of this first part of the study makes further inquiry into the importance of financial reporting of cash flow relevant.

The collected results of the licentiate study suggest the possibility to capitalize expenses for investments in intangibles to be crucial not at least to avoid the legal consequences of bankruptcy law, which may be critical to the very survival of development intensive entrepreneurial SMEs. The importance of innovation as a central part of the entrepreneurial process also makes financial reporting information on intangibles highly relevant from an informational perspective. Even so, there has been a great concern among accounting regulators regarding the possibility to measure reliably the costs of intangible assets. In cases when the accounting regulation restricts the possibility to capitalize such assets, a conceivable alternative to capitalization is according to the accounting experts interviewed for this study to disclose information on the investments in narrative form and/or in numbers.

In addition to cash flow and intangibles, accounting experts consider disclosure of financial ratios in general, and financial ratios measuring various aspects of growth in specific, to be of specific importance in relation to entrepreneurial SMEs. Besides additional information on individual intangible assets, additional disclosure of information related to the collective earning capacity of ongoing projects - including the business concept of the reporting entity - has also been identified as significant in the entrepreneurial context.

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43 In the licentiate study, empirical results with respect to users and purposes of entrepreneurial SMEs’ financial reporting are mainly provided by the interviews with accounting experts.
5 Interviews with managers of entrepreneurial SMEs

This chapter presents the results of the interviews with managers of the three entrepreneurial SMEs included in the second part of the study. Besides the interviews, the companies’ financial reports and webpages provided additional information. For each company a short presentation of the business is first provided. The content of each company’s financial report for 2012, i.e. the year all three companies were appointed winners of the Gazelle Award, is also reviewed with focus on descriptive information. Thereafter follow separate sections on respondents’ views concerning users and purposes of their entities’ financial reports, and the areas of financial reports that respondents consider to be of particular importance in relation to their respective companies. The two areas of cash flows and intangible assets, which in the first part of the study were identified as significant with respect to entrepreneurial SMEs, are also dealt with in separate sections. When needed to clarify the regulatory context of a company, references to the applicable accounting regulation are provided.

5.1 Weave Tech Manufacturing

Weave Tech Manufacturing (hereafter referred to as Weave Tech) develops, produces and markets tape woven fabric under their own registered brand name, mainly using carbon fiber. The company was founded in 2003 by a researcher who together with three university students developed a new weaving technology. This technique made it possible to weave fabric using broad bands instead of round yarn, thereby achieving reinforcement fabric much thinner and more lightweight, and with better mechanical qualities, than conventional woven fabrics. The company’s products are today used by manufacturers of advanced aerospace, racing, sports, automotive and industrial products, all with extreme demands for the material’s performance.

Weave Tech has shown high growth since the start and was the first-place winner of the Gazelle award in the region of Västra Götaland in 2010 and in 2012 the company received the Gazelle Award again. As the market leader of reinforcements using their own technique, Weave Tech aims to become the leading supplier of high-performance composite reinforcements for the advanced composite industry.

In 2012 the company shares were distributed among 36 shareholders. Out of the total shares, approximately 70 percent were owned by institutional investors.
while the rest of the shares were held by board members, the management and other private investors.

Weave Tech Manufacturing AB is the parent company sole owner of two subsidiaries. At the end of the financial year 2012 the group had 42 employees, a turnover of 50 MSEK and a total capital of 49 million SEK. The company’s income before tax was 663 KSEK in 2012.

In Spring 2013, Weave Tech’s CFO was interviewed at the company’s headquarters. The CFO, who has previous experience of working with growing entities, had at the time of the interview been employed by Weave Tech for one and a half year. As the company’s CFO he was a member of the management team. In addition to the interview transcripts, information was provided by the company’s financial reports of 2012 and the company’s webpage.

5.1.1 Weave Tech’s financial report

Weave Tech’s 2012 financial report includes group accounts and opens with a one-and-a-half-page long director’s report setting out from a general description of the business and discussing its manufacturing technology and the technology and quality of their products. The company is presented as the world leader in ultra-light carbon fiber fabrics, with F1-cars and sports equipment as examples of its fabrics’ applications with high usage of their products. It also notes on the high growth in the market for carbon fiber composites, driven by more and more industries wanting to lower the weight of their products to save energy.

The 2012 annual report also describes the ownership and structure of the group which is followed by a couple of sentences on significant events during the financial year. Reference is made to the continued high growth of the use of products carrying the company’s brand name in sports and recreational activities applications, the increased use in ultra-light aero planes and an increased interest from commercial aviation. Moving into new and larger premises adapted to the business, with increased production capacity, is also put forward as a significant event. Thereafter, it states the decision to issue options to subscribe for new shares.

With respect to the company’s expectations for future development, the director’s report states that the company’s ambitions are continued growth with profitability and increasing the turnover considerably over the coming few years. Under the headline ‘Activities within research and development’ the report says that Weave Tech continuously works with developing both weaving techniques and products. Activities related to product development, it states further, is for the most part carried out in collaboration with customers with the aim of adapting the company’s weaves to their customers’ needs. The director’s report concludes with a comment on the risks and uncertainties facing the company. As the company is in an early phase of expansion, there is a risk of delayed revenues in relation to invested resources. It notes the exposure changes in foreign currencies, together with the company’s policy of handling currency exposure.
Finally, it refers to the inherent risk of fluctuations in volumes as a consequence of the company’s focus on sports and leisure applications of their products.

The director’s report includes a 4-year summary including net sales, EBIT\textsuperscript{44}, EBITDA\textsuperscript{45}, income before tax, total assets, adjusted equity and solidity.\textsuperscript{46} The proposed treatment of the unappropriated earnings is then provided, followed by income statements and balance sheets with adherent annotations of the group as well as parent company.

Because of their ambitions for continuous growth, Weave Tech’s financial reports from the year-end closing of the books in 2014 are prepared according to the K3-regulation, even though the company at the time of the interview was of K2-size.\textsuperscript{47}

### 5.1.2 Users and purposes of Weave Tech’s financial reports

According to Weave Tech’s CFO, owners make up an important user group of Weave Tech’s financial reports. The institutional investors \textit{Latour}, \textit{Early Expansion Invest} and \textit{Initial Stage Invest}, who together own 70 percent of the company’s shares, hold a specific position as members of the board. In this position they have access to the more informal and detailed monthly management reports. In the CFO’s belief the institutional investors mainly use the official financial report for their own reporting purposes and, in the case of the publicly listed \textit{Latour}, for consolidating group accounts. Private owners not engaged as board members or management are sent the report “so that they just see it”, even though the CFO believes that it mainly provides them a picture of how the company is getting on.

Even though Weave Tech is not heavily indebted they hold an overdraft facility with the bank. The bank requests the reports for their running assessment of credit worthiness, the company’s CFO continues. Besides the official financial reports, the bank is also provided with internal management information. These reports are voluntary and not as detailed or frequent as the reports that institutional owners receive. The bank is further informed during personal meetings where strategies and such are discussed. In all that, the financial reports are in the respondent’s belief of importance to the bank since they provide an audited account for the company’s performance during the year.\textsuperscript{48}

\textsuperscript{44} Earnings before interest and taxes.

\textsuperscript{45} Earnings before interest, taxes, depreciation and amortization.

\textsuperscript{46} C.f. the Swedish Annual Accounts Act (\textit{Årsredovisningslagen}) (1995:1554, Chapter 6, Section 1, Paragraph 1).

\textsuperscript{47} The categories of K2 and K3 are described in Chapter 2, Section 2.2.3.1.

\textsuperscript{48} Weave Tech’s CFO also mentions auditors as a user group of the company’s financial reports. However, according to the framework of this study auditors are not considered to belong to the users of financial reports, even though they belong to the financial reporting environment of entities.
Weave Tech’s CFO further mentions suppliers as a potential user group of Weave Tech’s financial reports. Even though there have not been any requests for financial reports from suppliers during the respondent’s time at Weave Tech, he believes it fully possible that suppliers obtain the officially available reports on the internet. Since Weave Tech’s customers are mostly foreign, they are not expected to make any extensive use of the company’s financial reports which are published in Swedish and prepared according to Swedish accounting regulation.

Another possible group of users of Weave Tech’s financial reports is potential acquirers. Even so, the interviewed CFO believes that the investors that are presently on the board of directors had access to internal information at the time of their entry, and that the financial reports acted as a starting point but not as the main document for the valuation of the shares. Recently there has been a directed share issue, but since the acquirers were already involved as owners, the financial reports were not the main document, but rather auditors’ valuation of the shares, the respondent believes.

With reference to the group of employees, the company’s CFO believes that Weave Tech’s financial reports are quite difficult to read and understand for someone without education in financial matters. The respondent also notes that Weave Tech’s financial reports almost exclusively consist of hard facts which most likely make them more difficult to read compared to financial reports of other companies where more informative directors’ reports and pictures and figures make the content of the reports easier to grasp. Hence, the CFO does not believe that the financial reports of Weave Tech are commonly used by employees as evening readings.

For management purposes the financial reports are considered important in providing a yearly and audited check that the accounts are in order and that everything that should be in the reports is included. Such a check-up is not provided by the management reports which are prepared in U.S. format and where the focus of analysis often is on other measures of income, such as EBIT or EBITDA, not adjusted for such things as value changes in currencies adjustment of the effect of untaxed reserves on net income. The CFO further adds that even though the document itself is not used internally as a tool for management control, the numbers depart from and to some extent contain the same numbers as the management reports. That is, the input to the financial reports are the same numbers as the input to the financial reports.

5.1.3 Financial reporting information of specific importance

According to Weave Tech’s CFO, the most important information to show in the company’s financial reports is the income statement and the balance sheet. The CFO further believes the director’s report to be of high interest to external users and that they most probably would like to see more information here, with focus on future-oriented aspects of the business in specific. Even so, because of the ambition for continuous growth, the company is prudent and deliberately
chooses to disclose as little information as possible. In the CFO’s opinion, the
director’s report is “quite lean” with no major changes between years. As shown
in section 5.1.1 above, many of the items of the director’s report of 2012 refer to
the potential further growth of the business, but in general terms (author’s note).

Considering the large investments made during the years, information on fixed
assets and depreciation is further of high importance according to the CFO.
Information on cash flow is also considered important - not least to illustrate cash
flow security in terms of available funds, including the overdraft facility of the
check account (see further section 5.1.3.1 below). Growth in sales is also important
to show, which in the financial reports is illustrated by a four-year historical
account of net sales.

According to the company’s CFO, the company is not exposed to any
competition to talk of, as they have created “their own little market within the
market”, with patented technique. Still, the reasoning is to publish as little as
possible in the publicly available financial reports. As a private company, the
reports are kept as simple as possible but with all contents required by accounting
regulation. Weave Tech uses their discretion when possible, being careful not to
reveal too much information.

...after all, we wish to send out as little as possible, [...] it is not a four-color [printing]
or any pictures, but we rather make it as simple as possible, but with all [required]
content. [...] 

For instance, the respondent notes, they are not eager to disclose information on
sales on different markets. Another example of an item of information that can
be sensitive to disclose in the public reports is absence due to illness. When there
is no requirement to disclose information that can be sensitive, Weave Tech
chooses not to. In all that, the CFO adds, if Weave Tech had been a listed
company the situation would have been different, and they might have included
a reasoning in the director’s report about volume of orders and such, to set the
market at rest.

[...] we do not have that many competitors in that way, but in companies where I have
worked before, that have been similar, you know that competitors are the first to read,
and then you may want to give as little, you don’t want to tell that ‘now we have
developed this product that we’re going to launch’, but we rather keep that to ourselves.

Furthermore, as things are at present the owners of the company are few, which
is another motive for keeping the reports less informative. The respondent also
notes on the increasing cost of producing more extensive financial reports.
5.1.3.1 The relationship between financial reports and reports for management purposes

While Weave Tech deliberately chooses to disclose as little as possible in excess of what the accounting requires in their financial reports, the monthly management reports, which institutional owners receive as well, are much more comprehensive and detailed. While sales are disclosed only in total in the financial reports, it is divided into different markets and segments, groups of customers and product groups in the internal management reports. The management reports also include additional information on growth, contribution margin, profit, cash conversion cycle, cash flows and investments. There is also a "dashboard" with information on order status and personnel (how much personnel there is, as compared to budget). There is also a graph focusing solely on the order status for the coming period, including order intake in different segments and in relation to sales, which is important information that is not included in the financial reports.

The income statement is in another format than in the public financial reports, with contribution margins on different level and more detailed information on different types of costs. This information is something that the company keeps to themselves, the CFO continues, in order not to inspire the thought of customers that "do you have to earn this much?"

In the management reports a balance sheet compared to budget as well as previous year is disclosed. The balance sheet for management purposes is less formal than the official one; to a large extent the numbers are the same, but since the internal one is prepared in US format the "others" item is larger due to differences in evaluation principles concerning for instance untaxed reserves. For internal management purposes exclusively (i.e. not communicated to owners) there are additional numbers on productivity, quality, precision of delivery etc.

Different ratios – financial and non-financial - related to production, sales and purchases are used to a great extent internally. Among the most important ratios the CFO mentions growth in sales, order intake and the difference between order intake and invoicing, and gross margin. These ratios are not included in the financial reports because of the need for additional explanations of the measurement of the ratios as well as for reasons of secrecy. Still, the ratios for internal management depart from the information found in financial reports, and many of the ratios – such as cash conversion cycle and sales growth – can be calculated directly from the information disclosed in the financial reports. Even so, Weave Tech is not eager to provide the calculations to the reader of the reports.

Weave Tech’s CFO summarizes sales growth, cash flow, gross margin and contribution margin as information that is in greatest focus internally.

As a growth company, sales growth, cash flow and holding up the gross margin, and the contribution margin, that’s like the building stones we work on/keep at.
5. Interviews with managers of entrepreneurial SMEs

With contribution margin being an exception, this information is either included in the financial reports or can be calculated from the numbers in the reports. Contribution margin is a piece of information that Weave Tech prefers keeping to themselves.

5.1.3.1 Information on cash flow

Since Weave Tech’s financial report includes group accounts a cash flow statement is disclosed in accordance with accounting regulation. As a growth company cash flow information is denoted high importance in Weave Tech, the CFO states, not at least considering the extensive investments during the years. Also, when growth is high, accounts receivable tends to grow as well, tying up capital. Even though this information can be derived from the income statement and balance sheet, the cash flow statement makes up a significant complement.

[…] if we, during a period, charge some more costs, need new buildings and personnel and things like that,…, that the net profit falls a little during a period, just because we have too high costs really, you do not see it as ill-boding as it would be in other companies, since later on when the turnover appears you may have like quite stable costs.

Cash flow information is not only considered an important part of the financial reports, but for management purposes as well:

…cash flow is very important to us. It is those things that we use for internal control as well.

The different items of cash flow are analyzed a lot internally, with comparisons against budget. The management reports of cash flow, which institutional owners receive as well, follow a somewhat different and more detailed format than the formal cash flow statements included in the financial reports. In the internal reports the different items of cash flow are decomposed into sub-items to a greater extent. Also, in the internal reports cash flow from operating activities departs from EBITA instead of income before financial income and expense, which is the point of departure in the formal cash flow statement.

For management purposes, the different components of working capital are considered especially important and therefore scrutinized carefully together with coherent ratios. The CFO puts forward changes in inventories and the rate of inventory turnover, and accounts receivable together with age analysis and average collecting period, as items of specific importance. Considering the large amount of resources put on investments, cash flow relating to investing activities is also of specific importance to Weave Tech, and an important piece of information in this respect is investments compared to plans. All in all, the different items of cash flow are considered very important tools for control.
5.1.3.2 Information on intangible assets

The intangible assets on the balance sheet of Weave Tech, carrying the heading “concessions, patents, licenses, trademarks and similar rights”, amount to 3 million SEK out of the total assets of 49 million SEK (Weave Tech, 2012). The opening balance capitalized development costs of 264 KSEK (historical value of 1 MSEK) was depreciated in its entirety at the end of financial year 2012.

Generally, the company’s CFO considers information on intangible assets to be significant in growing entities. Still, he does not believe that a prohibition to capitalize would have been critical considering the position of Weave Tech today. The respondent points out that the situation most probably would be different for a newly started company where the positive effect of capitalization on net income, and the visibility of intangibles in the balance sheet, can be critical in order to attract financiers.

As things are at present there is little discussion with owners about intangibles; most focus is on aspects of growth and cash flow. In all that, the CFO stresses the importance of legal rights and patents to protect intangible values, not least in the case of a hypothetical exit/sell-out. Even though accounting for intangibles is not an issue for discussion at Weave Tech today, the intangibles as such make up the very foundation of the business. The most important intangible values of Weave Tech are, according to the CFO the trademark/brand and the customer base. There has also been a great focus on building the company culture. Furthermore, the publicity from receiving the Gazelle award is also considered very valuable. The soft values in general are in focus at Weave Tech, according to the respondent. In all that, to have these values in print in the financial reports has not been an urgent issue at Weave Tech.

The disclosed information on intangibles includes, as described in section 5.1.1. above, comments on customers and market share and, with respect to research and development, the continuous development both of techniques and products, where the latter to a great extent is carried out in cooperation with customers.

With respect to the choice of accounting regulation for the future, Weave Tech will go for K3 which is considered to be the only alternative for a company of Weave Tech’s size with ambitions for continuing growth. To choose K2 in this situation would have been defensive, the CFO emphasizes. Still, even though there has been no need for a profound analysis of the differences between K2 and K3 because of the growth ambition, a survey of the new regulations has given by hand a better fit of the K3 regulation in many aspects, one of them being the possibility to capitalize intangible investments.
5.2 Cloud Books Software

Cloud Books Software (hereafter referred to as Cloud Books) is a fast-growing software business offering cloud computing services in bookkeeping and invoicing to small businesses and associations. The company was founded in the year of 2000 and has since then become the leading supplier of web-based bookkeeping in Sweden. Cloud Books’ services are unique in the sense that they are the only supplier on the market offering bookkeeping automatically connected to the customer’s bank account and internet bank. Cloud Books works closely with their collaborating banks and their services are available for customers of several major banks in Sweden.

Cloud Books AB is the parent of a group that also includes the wholly owned subsidiary Cloud Books LTD, which is part of the company’s at the time for the interview newly initiated establishment abroad, starting in the UK. For the financial year ending on 2012-06-30 the group reported a net turnover of 37 million SEK and the net income before tax amounted to 10 million SEK. At the end of financial year 2011/2012 the company had 55 employees and the total capital amounted to 29 million SEK. Besides the head office located in Gothenburg the company also has offices in Stockholm and Piteå.

The business concept of Cloud Books is to make enterprising easier and more fun by automatizing the routine work and keeping the finances under control. At Cloud Books there is a belief that small businessmen can manage their bookkeeping in a correct and easy way, even though they may not find a deeper interest in bookkeeping and finances. Bookkeeping is going through a change towards increased automatization and less paper and Cloud Books’ vision is to lead this change. Cloud Books was one of the fastest growing companies in Sweden and in 2012 the company achieved the Gazelle Award (Dagens Industri, 2013). Other distinctions for rapid growth that the company has received are Deloitte Technology Fast 50 (Sweden) and Deloitte Technology Fast 500 (EMEA).

In April 2013 Cloud Books’ CEO was interviewed via Skype. The CEO is the founder of the company and owns approximately 30 percent of the company’s shares. The following text reports on this interview with additional information provided by the company’s financial report of 2011/2012.

5.2.1 Cloud Books’ financial reports

Since the financial year 2010/2011, the financial reports of the Cloud Books group are prepared according to full IFRS. The 2011/2012 financial report, in which texts are alternated with pictures and charts, opens with a commentary by the CEO and a description of the company’s products. Thereafter follows
comments by four of Cloud Books’ customers, expressing their satisfaction with the bookkeeping services offered by the company. The market for cloud computing services is then addressed, including an assessment of opportunities for further growth, with respect to the Swedish market as well as in Europe. The discussion further attends to target customers as well as relationships with commercial banks and bookkeeping agencies, which are considered important channels for the company’s services. Trends within the area of cloud computing services are then discussed with reference to industry statistics, including the estimated growth rate for cloud computing services in general as well as estimations of future use by smaller companies. Industry specific ratios are mentioned, with disclosed information on the company’s position with respect to these ratios. The company’s vision, business concept and business model is also presented.

After the above described sections, covering five pages, follows the director’s report beginning with the company’s business activities in short, and its ownership. The section on significant events during the financial year refers to the establishment of a new sales office in Stockholm, increases in personnel, sales and net income; an increased customer base and deepened collaboration with business banks. Reference is also mentioned to the Gazelle Award and the distinction by Deloitte as one of the fastest growing technology companies in Europe, both for the third year in a row. The results of the company’s gender equality work are further mentioned.

It is further noted in the director’s report that the company applies the same accounting standards (IFRS) as their business partners, the banks. Reference is also made to “the very good” financial position and liquidity of the company. Under the headline ‘Investments’ it is stated that the company has mainly invested in intangible assets during the year, and that an essential part of the company’s resources for development have been used in developing the company’s main products and services. Significant risks and uncertainties are further attended to, covering financial risks, operational risks and market risks. With reference to liquidity it is pointed out that the company’s revenues are based on customers’ subscriptions, which together with costs of personnel making up the greatest part of the company’s costs, provides with good possibilities to make accurate prognoses of liquidity. Accordingly, it is stated in the report, the liquidity risk is limited.

After a short section on significant events after the end of the financial year, including the completed development of the company’s software, follows a discussion on prospects for the future, mostly in relation to the company’s potential for further growth at the Swedish market. Under the headline ‘Research and development’ it is further attended to the development of the company’s software carried out during the year.

50 The requirements of the Swedish Annual Accounts Act concerning the director’s report are presented in Chapter 2 (Section 2.2.2) of this thesis.
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A five-year summary graph of net sales, net income and solidity is also provided, as well as the proposed treatment of the unappropriated earnings. All in all, these texts cover seven pages of Cloud Books’ financial reports. In addition to the detailed annotations to the income statements and balance sheets of the group and the parent company respectively, there are also additional comments to many of the items of the income statement and balance sheet of the group.

5.2.2 Users and purposes of Cloud Books’ financial reports

Cloud Books’ CEO divides the users of the company’s financial reports into two groups, with owners, potential investors and creditors making up “the closest circle”, and business partners “outside”. In the closest circle, the owners of the company is considered an important user group of the company’s financial reports. As the CEO states: “It is evident that it is interesting to them”. In case of a need of additional financial capital, the reports would also be of interest to a potential provider of finance. However, this has not been an issue backwards due to self-financing. The respondent attends to the greater effort made on the content of Cloud Books’ financial reports as compared to what generally is the case in private entities. This approach to financial reporting is considered an investment made to be prepared in case of a need in the future to bring additional investors into the business, or in case of a future stock-exchange quotation. The main reason behind Cloud Books’ advanced and solid financial reports, as compared to other companies of similar size, is to facilitate the process of acquiring financial capital when needed. The conversion to IFRS three years ago is according to the company’s CEO a way to prepare for such instances - to be able to report on a higher level and in this way “signal to investors” that Cloud Books “has got the finger on the pulse and can manage the higher demands of reporting”.

Cloud Books’ CEO further attends to the availability of financial reporting information of today and that everything reported externally can be found on the internet. The first thing you do when checking-up a potential collaboration partner or supplier, the respondent contends, is to check up their website. Then you turn to allabolag.se for the financial numbers, where you easily can download financial reports. In this setting it is significant to keep the financial reports in order and of high quality.

If you find us and see our financial report and see our numbers, then you understand, well, this is a company of this size…that grows in this way, and, yes, that is important

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52 The financial report of 2011/2012 lists 14 shareholders including the company’s CEO.
53 A Swedish internet service providing public company information.
54 Financial reports and auditor reports of Swedish limited (liability) companies are public documents (see Chapter 2, Section 2.2.2.1).
We are a growing company and people like having to do with companies that grow; then it is important to show that.

In addition to the yearly financial reports, owners receive quarterly reports, which the CEO refers to as another way of practicing to be a listed company and part of the strategy to prepare for a possible quotation on a stock exchange in the future. The quarterly reports include an income statement, a balance sheet, a cash flow statement and a couple of pages of text about the performance of the business.

With respect to the use of financial reporting information for internal purposes, the CEO refers to Cloud Books’ financial report as a document for external purposes only, that is used “to communicate with the world around”. In all that, he adds, the information used internally by management evidently overlaps and connects with the information in the financial reports: “Of course we’re not re-doing everything once again”. Further, the respondent continues, the financial reporting numbers are directly connected to the spreadsheet calculations used internally. This connection is not restricted to numbers, since the texts included in the financial reports are used internally as well. However, when publishing texts in the publicly available financial reports, the words are weighed more careful:

\[
\text{You must be a little bit more careful/prudent, and the wordings are a bit fluffier [in the financial reports].}
\]

Inversely, the information used internally, both in numbers and in texts, are more detailed and “raw” than the information in the financial reports.

With respect to competitors, the CEO elaborates a little bit on the choice to disclose more information in the financial reports than what is required by accounting regulation. In his view, the reporting strategy of Cloud Books is rather different than what would generally be expected for a company that is not publicly listed. Three or four years ago, when the company was in an earlier phase of development, and before their conversion to IFRS, the reporting strategy was different, according to the interviewed CEO. At that point in time the ambition was rather to disclose as little as possible in the publicly available financial reports, and to keep the reports as lean as possible, in order not to tell too much and to avoid exposure to competitors. However, when such a reporting strategy is chosen, there is a greater need for different versions of the report, the CEO continues. As the situation is at present, Cloud Books has made the choice to report on a level corresponding to that of a publicly held company and, hence, not to be so cautious with information that might be of interest to competitors. Even so, as is the case in publicly held entities, the degree of transparency is always a balancing act.
5. Interviews with managers of entrepreneurial SMEs

Of course, we keep a great deal of information to ourselves also, but in comparison I believe we are quite open. Considering that we’re unlisted. We do not believe that it is so…it is rather much information [in the reports] that wouldn’t be hysterically harmful if ending up in the hands of competitors.

Even though a lot of information can be found by competitors on their own, the CEO emphasizes that they try to make it harder for them:

\textit{Now, we do not try to be unnecessarily helpful to competitors, of course we [don’t].}

5.2.3 Financial reporting information of specific importance

The interviewed CEO’s straightforward answer to the question of what information is most important in Cloud Books’ financial reports is “the growth”. The company’s shareholders want to see growth, and that is what attracts investors as well, the respondent emphasizes. Of highest importance is to show this growth in numbers but also texts about potential growth – what is going on in the company that can create further growth – are important as complement. Everything that concerns growth is highly significant, the respondent stresses, with accompanying analyses of the potential of the market and whether there is room for further expansion of the cloud services concept.

\textit{Everything that concerns growth is more important than anything else. In our type of business. Right now. Then, some day we will also mature, and then there will be other parameters that may be as important. But [right now] profitability is clearly subordinate.”}

Even though it is evident that profitability cannot be disregarded, it is subordinated growth in sales. Profitability is a prerequisite for doing business and not to run out of money; it is a prerequisite for partners to enter into co-operation with Cloud Books and “for owners to sleep well at night, so that they will not need to put in more money”, the CEO contends. Still, its exact level is not near as important to Cloud Books as growth in sales. In all that, the respondent adds, there will be a day when the company enters a more mature stage of development and when other parameters [of performance] may become as important. At present, however, growth is the most important parameter.

With respect to the different measures of growth, Cloud Books’ CEO emphasizes growth in sales as most important. Growth in net income or in terms of number of employees, or market share, is also subordinate sales growth.

In the CEO’s own words:

\textit{First there is growth, then there is nothing, then there is nothing, and then there is a number of other ratios that are important…}
Some of these ratios Cloud Books keeps to themselves. For instance, the exact number of customers and how long the average customer stays with Cloud Books is information that is significant for management purposes but that they are not eager to reveal publicly. The ratios disclosed in the 2012 official financial report includes solidity, pay-back time of sales- and marketing costs, increase in total capital, development costs and accrued expenses.

5.2.3.1 Information on cash flow

Since Cloud Books follows IFRS, their financial report includes a cash flow statement. The company’s CEO expresses that he is not completely familiar with the importance of information on cash flow to the external users of the company’s financial reports. Even so, in the voluntary quarterly reports that owners receive in addition to the yearly financial reports, Cloud Books has chosen to disclose a cash flow statement in addition to the income statement, balance sheet and the text about the performance of the business.

For management purposes, information on cash flow is considered an important complement to the income numbers. Cloud Books has developed an income statement for internal purposes that is structured a little bit differently than the one in the financial reports. In the internal income statement, which is prepared monthly, the cash flow numbers are stated separately before periodized revenues and costs/items.

5.2.3.2 Information on intangible assets

Out of the 29 million SEK of total capital on Cloud Books’ balance sheet of 2011/2012, 14 million SEK refers to capitalized expenses for development (Cloud Books, 2012). Compared to the 0,4 million SEK of tangible assets, intangibles make up the largest item among the assets of Cloud Books financial report (ibid.). According to the company’s CEO, information on intangible assets is tremendously important. In all that, the respondent believes that it is hard to give a clear-cut answer to the question whether this information should be in terms of capitalized expenses for intangibles or if a disclosed text about intangible values serves the purposes just as well. Whether to capitalize or not is a judgment for the board to make. Even though Cloud Books has not been in a situation where capitalization is critical in order not to use up the share-capital, they still believe that the higher level of equity that capitalization brings about is advantageous. By capitalizing an intangible asset Cloud Books demonstrates to the world around that this is an asset that exists, and will exist for many years to come, and that there is an investment behind this asset. However, in the CEO’s opinion it is above all important that it is clear to the reader of the financial report whether a company has chosen to capitalize its intangible assets or not, since the net income/result has to be read in the light of this.

The choice to prepare their financial reports according to IFRS three years ago was not affected by the restricted possibilities of the Swedish accounting
regulation (K2) developed for companies of Cloud Books’ size. Again, the CEO stresses that the conversion to IFRS has been a deliberate strategy to impress and inspire the world around with respect - analysts and investors - and, thereby, to facilitate a possible future quotation on a stock exchange. Also, the conversion to IFRS would also facilitate the entrance at a “more serious stock exchange list”.

When asked about what intangible values are of greatest importance to Cloud Books, the respondent puts forward the development of the product. Generally, the CEO perceives the IFRS criteria for capitalization of [internally generated intangibles] as reasonable. In reverse, the restrictions concerning capitalization considers the CEO as fair as well:

\[\textbf{Of course, it is investments, you do not build trademarks over the night, it is a long-term venture….it is difficult to put value[s] on [such things], so you understand why it is not possible. But it is not a big problem for us. We make money anyway. We do not rise and fall with that.}\]

In cases when accounting regulation prohibits capitalization, such as expenses for organizational structures, marketing and human capital - values that should not be underestimated according to the CEO - there is always the possibility to describe the investments in text. Accordingly, in addition to the capitalized expenses for development of Cloud Books’ balance sheet, the company’s 2012 financial report also includes information on other intangible values. In addition to the two-pages directors’ report, five pages of text illustrated by pictures and graphs are denoted to descriptions of collaborations with business partners (banks and accounting agencies), relations to customers, organization and structure (the establishment of an external operating central, follow-up of new customers etc.), the market, and research and development projects.

5.3 Search Consultancy

Search Consultancy is a search consultancy business founded in year 2005. At the time for the interview all three founders were engaged in the company’s management and operations, and as members of the board. Since the start-up, Search Consultancy has grown from a single office business to a leading search solution provider with offices in Sweden, Norway, Denmark, Poland and Australia, with a client base even broader geographically. Search Consultancy’s customers are mainly large companies and organizations active within a variety of areas such as manufacturing, retailing, transport, finance, media and entertainment; telecommunication and the public sector. At the end of financial year 2011/2012 the company had 66 employees and reported a net turnover of 53 million SEK, the net income before tax amounted to 8 million SEK and total capital to 23 million SEK.
A key to Search Consultancy's success and continuing growth is, as presented at the company’s web page, the vendor independence that enables building solutions based on any leading search engine, including open source technology. A further core strength is stated to be the strong innovative profile with high research ambitions. Search Consultancy has enjoyed profitable growth from the start and has been awarded “Gazelle” by the Swedish business daily Dagens Industri two years in a row. After a short time in business Search Consultancy received a triple A rating from Soliditet.

This text reports on an interview with Search Consultancy’s CFO at the company’s headquarters in Gothenburg in June 2013. The respondent has held this position since she first got employed at the beginning of the great expansion of the company four years ago. In addition to the interview transcripts, the company’s web page and the financial report of year 2011/2012 have provided information to the presentation at hand.

With respect to the successful development of the company, Search Consultancy’s CFO adds the timing of entering a business with few competitors in Sweden focusing solely on search technology, which gave the company a head start, as a significant factor. Of further importance is the entrepreneurial spirit that always has permeated the organization, the CFO continues and refers to the spontaneous character of the three founders. At Search Consultancy one dares to take risks and try out new things, even when this involves great resources to be spent. It’s a spirit of: “This could be fun – let’s try it out!” Sometimes a new project succeeds, sometimes it doesn’t, the company’s CFO contends.

Yet another success factor mentioned by the CFO is the ability to take care of the knowledge and competence developed within the organization and. High priority is given to staff welfare, which is considered a great challenge not least considering the high growth of the company. In order to motivate and engage employees long-term, all employees are invited as shareholders (and there are no other shareholders except the employees). Employees and their knowledge are the company’s most valued resources, and as such significant to take good care of, not least considering the large amount of resources spent on training of new employees - most of the new recruitments come directly from the university.

It’s our resource, that we have. And then we don’t want somebody to come and get it [from us].

With respect to employee welfare the company’s CFO also emphasizes the freedom with responsibility which permeates all activities at Search Consultancy: “You trust people to do what they should, and in return one gets treated very well.” At Search Consultancy there is no formal managerial body and the business is structured in the form of a process organization where responsibility comes with management of processes. Anyone who has an idea can address one of the founders directly – there is no hierarchical structure to follow but rather a spirit of “everyone is talking to everyone”. The respondent also mentions the process
of talent management which is solely focused with how to take good care of the company’s employees. This process is at the time for the interview managed part-time by the accounting assistant but from autumn 2013 the responsibility of a full-time post. All in all, the company spends a lot of resources on employee welfare, according to the company’s CFO.

5.3.1 Search Consultancy’s financial reports

The Search Consultancy group consists of the parent company Search Consultancy AB and two subsidiaries in Denmark and Norway. At the end of financial year 2011/2012 the company had 66 employees and reported a net turnover of 53 million SEK, the net income before tax amounted to 8 million SEK and total capital to 23 million SEK.

Search Consultancy’s financial report55 of year 2011/2012 begins with a director’s report56 covering a good one and a half page, including a description of the business, its resources and values; the present state of affairs, on-going projects – including development projects and a survey study - and prospects and goals for the future. The presentation attends to the increase in the customer base, the process-oriented organization with great focus on customer benefits, and activities undertaken during the year in order to get closer to the long-term goal of becoming market leader globally. The report further describes the company’s collaborations with students and researchers at the universities by taking part in examination projects and research projects. The aim of the collaboration is to increase the academic interest in the area, which is considered to be beneficial to Search Consultancy in the future, by way of an increased focus and knowledge in the business are. A separate section refers to an extensive study carried out by Search Consultancy during the financial year, with the aim of mapping out organizations’ need of the services provided by the company.

The director’s report further refers to the work carried out during the year to strengthen and cement the company culture and values, which resulted in a document describing the spirit of the company. The aim of the document was mainly to facilitate the assimilation and understanding of the foundation of the business for new employees. The text further attends to the related work carried out on further refining the vision of the company, which is to facilitate knowledgeable decisions.

Even though the search technologies used by Search Consultancy are developed and owned by their partners to a great extent, the company also continuously work with developing their own frameworks and components. The aim of these projects, as put forward in the director’s report, is to shorten delivery

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55 Search Consultancy prepares their financial reports in accordance with Swedish Companies Act (Aktiebolagslagen) and Bokföringsnämnden’s general advice.
56 The Swedish Annual Accounts Act (Årsredovisninglagen) do not require smaller companies to include information in the director’s report about expected future development, or activities related to research or development.
time and increase the quality of the company’s services. One example of such a project, which is also brought up by the company’s CFO during the interview, is the successful development of a document-processing framework, which in part was released as open source during the financial year.

In addition to the mandatory four-year summary of net sales, net income after financial income and expense, and solidity; it is informed in the directors’ report of the growth in net sales for the financial year and the increase in number of employees. A profitability measure is also disclosed in terms of operating margin.

Because of the ambition for continuing growth, Search Consultancy will from the year-end closing of the books of June 2014 prepare their financial reports in accordance with the K3 regulation. Even though the company at the time for the interview is of K2 size, they aim to grow out of this category in the foreseeable future. To be able to provide a total picture of the company’s business activities, group accounts will also be prepared on a voluntary basis as from the current financial year (2012/2013). According to the interviewed CFO, there has been a situation recently when a large customer asked for the totality and they had “to put something together to hand over”. According to respondent, the decision to prepare formal group accounts is also in line with the growth ambition.

5.3.2 Users and purposes of Search Consultancy’s financial reports

The most important users of Search Consultancy’s financial reports are according to the company’s CFO interest groups external to the organization such as customers and business partners. “After all”, she says, “they are the ones you want to show the numbers to”. Even though Search Consultancy has worked with large companies for many years, it is still a small company that is unknown to many, and there has been requests from customers and potential business partners of financial reports before agreement of co-operation. Also, as noted on in the previous section, it was a request of a customer that firstly drew attention to the need of providing a totality of the business in the form of group accounts. Since Search Consultancy is not heavily indebted (the company holds an idle overdraft facility) the bank is not considered a significant user group of the company’s financial report, even though they according to the CFO request the reports for their granting and extension of credits. Suppliers are not considered significant stakeholders in Search Consultancy and therefore not seen as a main user group of financial information.

Shareholders is another interest group making use of Search Consultancy’s financial reports, mostly when informed about its contents at the shareholders’

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57 According to the Annual Accounts Act, Chapter 7, Section 3, parent companies of smaller groups are not required to prepare group accounts.
meeting once a year. During the shareholders’ meeting once a year, shareholders tend to engage considerably posing questions about the content of the reports. However, the use of the reports during the year, the respondent believes is less extensive. Since all shareholders are employed by Search Consultancy, they take part in the daily operations and have access to the continuous management accounting reports. This means that the net income and the financial position communicated by financial reports at the end of each financial year never comes as a big surprise. In this context financial reports make up a summary and a comprehensive picture of the net income and the financial position of the company, which the respondent perceives to be of interest not least to employees who have been with Search Consultancy for a longer time period. Of the total shares, just over 80 percent are owned by the founders of the company.

With respect to the internal management, financial reporting information is not used in ongoing operations. With respect to internal management, Search Consultancy relies more on management accounts than on financial reports.

You continue working, then you submit a report, and then someone responds to that report. We do not really work like that, but rather try to react on a daily basis.

An essential part of the strategy to react on a regular basis is the replacement of the yearly budget by rolling three-month prognoses. In this way Search Consultancy is well prepared and can react quickly when needed, according to the company’s CFO.

Once a month there are meetings in each of the offices where the proceeds/results of the different production units are followed-up, monthly as well as accumulated so far for the present financial year, following a more informal, simple form of reporting. Since consultants do not spend as much time at the offices as in the field with customers, these “monthlies” make up an important tradition where all meet and discuss what is going on, such as visited conferences and events, new customers coming in, and monthly sales as well as accumulated earnings so far for the present year.

In Search Consultancy the financial report provides more of a summary and something final, before moving on to the next year, than a tool for management in daily operations. As such it is highly important, however, since it provides an audited “ok” of the past year and to start fresh in the upcoming year, the CFO contends.

Earlier years the company prepared quarterly reports in addition to the annual financial reports. However, since they perceived that no one really used the quarterly reports, this practice was discontinued in order to spare the time for more important things. Overall, Search Consultancy’s CFO believes that financial accounting – both in terms of the reports and the administrative systems - is quite inflexible and old-fashioned and do not keep up with the fast changes of the business environment. In this context it is desirable, but not always easy,
to strive towards adjusting the reporting system so that it supports the organization.

5.3.3 Financial reporting information of specific importance

The most important information of Search Consultancy’s financial reports is according to the company’s CFO the performance of the business, that they have done well during the year. Of significance is also that the reports show that the growth has been organic with no external finance, which tells a lot about the success of the business. At the shareholders’ meeting the CFO considers it significant to bring up the net income and what to do with it, whether to pay dividend or retain the profit in the business; and also the indebtedness of the company, i.e. the solidity.

Internally, Search Consultancy works a lot with ratios of various kinds. In this respect profitability is considered the most important ratio and followed up continuously. Other process-related ratios are also used to a large extent throughout the organization, with comparisons made both between different production units and externally against other companies in the industry. Among these ratios the respondent mentions level of chargeability and ratios connected to hourly prices. Net Promoter Score, which is a measure of the loyalty of a company’s customer relationships, is also mentioned as important, as well as the number of blog posts on the company’s website.

5.3.3.1 Information on cash flow

Search Consultancy has not previously disclosed cash flow statements to their official financial reports. However, this will change from the financial year 2013/2014 because of the voluntary inclusion of group accounts. For management purposes cash flow information is considered tremendously important and liquidity budgets are used extensively internally. As emphasized by the company’s CFO, an unbalance in liquidity “goes quickly on the rocks”. Also, since salaries are fixed costs it is particularly important to keep track of liquid capital. The cash flow reports for internal purposes however follow a more basic model - with focus on inflows and outflows - than the model drawn up by accounting regulation where separate sections are required on cash flow from operating activities, financing and investments.

5.3.3.2 Information on intangibles

From reading the directors’ report as well as listening to company’s CFO talking about Search Consultancy and the values that permeate the organization, it is clear that intangible values make up the most important resources at Search Consultancy. Still, during the four years that respondent has been the CFO of the company – a time period that has been characterized by high growth - the question of capitalizing expenses for intangibles has never been up for
5. Interviews with managers of entrepreneurial SMEs

discussion. All costs are expensed when incurred “not to build castles in the air” but rather show “correct and true values”, the CFO states. A consequence of this, and being a knowledge-intensive company, Search Consultancy’s income statement is charged with a minimal amount of depreciation. When discussing the accounting treatment of intangibles, the respondent also puts forward that Search Consultancy does not have any depreciation on tangible assets to talk of. In all that, to expense costs for investments in intangibles for tax purposes has neither been an issue for discussion at Search Consultancy. The way of thinking has rather been to expense while possible, and thereby show the current status of the business – what is happening right now. There has been a wish to get rid of the costs right away, not least to be prepared in case of negative development of a project coming years; to avoid carrying along capitalized expenses if it later shows that they should not have been capitalized at all.

When asked about the most important intangible resource/s, Search Consultancy’s CFO returns to the knowledge and the employees. One challenge that they work with continuously at the company is knowledge sharing within the organization. At the same time as the company looks after their employees, the respondent stresses the importance of “a structure that looks after the knowledge” and keeps it within the organization. In this way new employees can quickly become acquainted with the knowledge built up within the company.

With respect to the descriptions of intangible values in the directors’ report, the company’s CFO puts forward the complexity of knowledge intensive companies in that there is no [physical] product:

It is so much more than just these numbers….it is not possible to put a figure on everything. And then you will have to write this, you certainly want to write a little bit more…you don’t want someone to read [the directors’ report] and think that we are just an ordinary consulting company.

According to the interviewed CFO, there has not been a concern at Search Consultancy of keeping business secrets, but rather a wish to inform about the journey of the company:

…you do not just want to hand over the result/net income – you want to tell…you want to tell about our journey and what we do……and if you look through all five, six reports you will surely see in the text, that things happen [over the years].

In the CFO’s view, the wish to tell what happens in the company goes hand in hand with the focus on building relationships.

The respondent also mentions that the quite technical formulations in the director’s report being a consequence of the author – one of the three founders – being an engineer, and that the very formulations would have been a bit different if CFO had written the report.
5.4 Summary of the results of the interviews with managers of entrepreneurial SMEs

All three companies discussed in this chapter show successful histories in terms of stability of finances, growth and profitability, with high positions on the 2012 Gazelle list. Common to the three companies is also the ambition for further growth, and the choice to go for a higher accounting regulation than their current K2 size. In Weave Tech and Search Consultancy the choice has been made to prepare their financial reports in accordance with K3 when the new Swedish accounting regulation comes into force. Cloud Books has prepared their financial reports according to full IFRS for three years.

In all three companies, the main source of external finance has been share-capital, which is also reflected in the respondents’ views of main users and purposes of their entities’ financial reports. Even so, in all three companies, shareholders are to a great extent engaged in the companies, either by taking part in management, as board members or both. In this way they have access to additional management information. Bank loans have not been a significant source of finance in none of the three companies, except for overdraft facilities. In all three companies the main source of finance over the years has been retained profits.

Although all three companies have ambitions for further growth, none of the respondents consider financial reporting information to be significant for purposes of acquiring financial capital from new sources as things are at present. Still, potential investors are mentioned by the respondents representing Weave Tech and Cloud Books as possible users of their entities’ financial reports. Cloud Books explicitly expresses the possibility of a future quotation on a stock exchange, which is also the reason for converting to IFRS.

Although respondents point to the overlap between management accounts and financial reporting (Cloud Books, Weave Tech), the financial report in itself is not considered helpful in internal management. However, as put forward by two of the respondents, the financial reports are important from a management perspective in that they provide an audited and yearly check that everything is in order.

Table 5.1 summarizes the user groups put forward by the interviewed managers.
5. Interviews with managers of entrepreneurial SMEs

Table 5.1 Users of financial reports according to managers of entrepreneurial SMEs

<table>
<thead>
<tr>
<th>Company</th>
<th>Shareholders</th>
<th>Bankers</th>
<th>Other external users</th>
<th>Potential investors</th>
<th>Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weave Tech</td>
<td>Institutional investors and private owners</td>
<td>×</td>
<td>Suppliers</td>
<td>×</td>
<td>An audited check</td>
</tr>
<tr>
<td>Cloud Books</td>
<td>×</td>
<td>×</td>
<td>Business partners</td>
<td>×</td>
<td>Numbers and texts overlap and connect with management information</td>
</tr>
<tr>
<td>Search Consultancy</td>
<td>×</td>
<td>×</td>
<td>Customers and business partners</td>
<td>×</td>
<td>An audited ok</td>
</tr>
</tbody>
</table>

With respect to financial reporting of specific importance, there is some variation in respondents’ answers. The CFO of the manufacturing company Weave Tech first of all mentions, in addition to the income statement and balance sheet, investments in fixed assets and depreciation. The CEO of the cloud computing services company Cloud Books emphasizes growth in sales as the most important pieces of information. In Search Consultancy, it is important to show net income and organic growth, according to the company CFO.

In all three companies, information on cash flow is important for management purposes. The CFO of Weave Tech also emphasizes the importance of cash flow in the financial reports. While intangible resources are considered key values in all three companies, it is only the CEO of Cloud Books who put forward the importance of capitalization of expenses for intangible investments.

The view of disclosed information differs between respondents, which is also illustrated in their respective entities’ financial reports. According to the manager of Weave Tech, it is a deliberate choice to disclose as little as possible in addition to the requirements of accounting regulation. The director’s report of Search Consultancy discusses intangible values to a great extent, which is both seen as a complement to the balance sheet and a wish to tell the reader about the company’s journey. The IFRS-based financial reports of Cloud Books includes additional disclosure both in numbers and in texts, relating both the present and the future.

Table 5.2 summarizes respondents’ views on significant areas of financial reporting information.
Table 5.2 Significant areas of financial reporting information according to managers of entrepreneurial SMEs

<table>
<thead>
<tr>
<th>Company</th>
<th>Cash flow</th>
<th>Intangible assets</th>
<th>Growth</th>
<th>Disclosure</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Weave Tech</td>
<td>X</td>
<td>Possibly</td>
<td>X</td>
<td>As little as possible</td>
<td>IS &amp; BS, director’s report, investments</td>
</tr>
<tr>
<td>Cloud Books</td>
<td>(X)</td>
<td>Important</td>
<td>X</td>
<td>Texts on growth, development and relationships</td>
<td>Profitability, ratios</td>
</tr>
<tr>
<td>Search Consultancy</td>
<td>X</td>
<td>All expenses charged as costs</td>
<td>X (organic)</td>
<td>&quot;Not an ordinary company&quot;</td>
<td>Solidity, net income</td>
</tr>
</tbody>
</table>
6 Interviews with venture capitalists

This chapter presents the results of the interviews with the two venture capitalists included in the second part of the study. For each venture capital company, a short presentation of the business and the respondent is first provided. The following discussions on the role of financial reporting, considering purposes of use and information needs, are structured in accordance with the stage of investment and or the phase of development of the company invested in.

6.1 Initial Stage Invest

Initial Stage Invest is a venture capital provider focusing on finance and development of companies within the university college sphere in the Gothenburg area. The organization is small, and the company relies on networking to a great extent. Initial Stage Invest invests in companies in their initial stage of development and in addition to capital they provide expertise within company development, primarily through their network of board members. Initial Stage Invest aims to take part in the creation of successful growth companies and thereby create value growth for both key people and the venture capital company itself.

During the first years of investment Initial Stage Invest takes part as active owners in the companies invested in. As soon as a company is established and has started to grow, additional and larger investments makes capital infusions from other investors essential. On Initial Stage Invest’s behalf, the aim is for another main financier after one year of commitment. After two years, Initial Stage Invest will in general only act as supervisors, until the company is later sold or noted on a stock exchange.

This text reports on an interview with the CEO of Initial Stage Invest, held at the company’s office in Gothenburg in spring 2014. At the time for the interview Initial Stage Invest had engagement in nine companies. The respondent has worked in the borderline between Chalmers University of Technology, Gothenburg, and the trade and industry for 25 years. Even though the respondent has a research degree in technology from Chalmers University, he refers to his main working tasks as “counting money and negotiating contracts”. Since he has taken part in investing the first few coins in a considerable number of companies, there has been a lot of money counting and negotiating of contracts over the years. In addition to the interview transcripts, the company’s webpage has provided with additional information.
6.1.1 Investing in a new company

When considering investing in a newly started business, the interviewed venture capitalist gives little attention to formal financial reports. In many cases, the company or project for start-up is novel to such an extent that no financial report does yet exist. In this setting the underlying calculation/cost estimation and the economic model for the hypothetical or newly started business is of greatest interest to the venture capitalist. Often the company considered for investment offers only one single product to start with – a product with a uniqueness expected to generate a good deal of income. Rather than formal accounting numbers, the venture capitalist is more interested in the innovation built into the product, potential customers’ willingness to pay for the product, and the cost of production and delivery.

When Initial Stage Invest enters a company after a year or two in business, information on cash flow is unconditionally one of the most important pieces of information to the venture capitalist. The calculations of cash flow are almost exclusively made in Excel, displaying historical flows a couple of months back together with forecasts for the future, often for the next twelve months.

The majority of the companies invested in shows negative cash flow from operating activities during the first few years in business. In these cases, the respondent stresses, the cash flow calculations are the be-all and end-all. As a member of the board of the company invested in, it is significant to keep track of both inflows and outflows. Important questions to address in this respect are: What does the forecast look like? When do we need additional financial capital? When do we need to issue new shares? Is there a need of a loan in between?

With reference to accounting numbers, the second most important thing in an ongoing business is according to the respondent to keep track of the balance sheet. It is especially critical to be able to act in advance to avoid capital deficits in equity capital and the subsequent requirement to set up a balance sheet for liquidation purposes. For cash management purposes it is also significant to keep track of accounts receivables and other short-term claims - information that is partly achieved through the Excel-model of cash flow.

With reference to the importance of keeping track of the balance sheet the respondent tells the story of when he was interviewed for his first position as a managing director. The well-experienced chairman of the board asked the respondent about his knowledge in the area of finances. The respondent himself, who at that time worked for the ASEA group with his own profit responsibility for a small business area, believed his skills in the area of finances to be quite decent.

Well, well, [the chairman] said, wait till you get [your] own responsibility for a balance sheet. (CEO of Initial Stage Invest)
6. Interviews with venture capitalists

This phrase by the interviewing chairman the respondent has carried in his mind for more than 25 years. In the respondent’s own words:

*If you just know how it all goes together, and what you can do..., if you just know how to do it, it is actually possible to set a lot of capital free.* (CEO, Initial Stage Invest)

This knowledge and experience, the respondent points out, entrepreneurs in general do not have. Rather they tend to focus on cash flow and the income statement. However, the very income statement only confirms what is seen in the cash flow Excel spreadsheet, the respondent stresses.

### 6.1.2 After initial investment

After the initial investment, and when engaged as a board member, the interviewed venture capitalist gets greater insight into the investment company’s affairs as well as finances. The formal financial reports of the companies that Initial Stage Invest has invested in are always audited - even in the smallest companies where there is no such requirement. The design of the financial reports of companies in their early phase of development is not a high priority task at Initial Stage Invest. It is only in exceptional cases when other owners demand specific reporting that an extra effort is made on the formulation of the report of the directors. The reasoning is that financial reports are publicly available, and even though products are unique there are competitors, the respondent argues, to whom they are reluctant to disclose too much information.

Bankers are in general not included among the main users of financial reports of companies that Initial Stage Invest is engaged in, according to the respondent. In their early development phases, companies almost exclusively show negative cash flows, which makes it too risky for banks to provide loan finance. Rather, the finance mainly comes from shareholders, venture capitalists and other high-risk loan providers. To these stakeholders, information in terms of business plans and project descriptions is according to the respondent’s experience more important than formal financial reports.

In time, when the break-even point is passed and there is a positive net income it is almost exclusively, according to the venture capitalist’s experience, the case that the margin of the business is such that the further expansion of the balance sheet can be financed by retained profits. On the very occasions when the bank does provide finance, besides services in relation to transactions, they surely want to see the financial reports. This is however not what the bank makes its credit decision upon, in the respondent’s experience. More important are securities of different kinds, such as invoice mortgage or machinery mortgage. Consequently, the financial reports and their design rarely have a crucial role in the companies that Initial Stage Invest invests in, the respondent states.
6.1.3 Second phase of development

When a company invested in has entered into development phase two, using Initial Stage Invest’s terminology, the interviewed venture capitalist’s engagement in general decreases and he is no longer a member of the board. At this stage, sales should have reached a certain volume and there should be realistic expansion plans. The company’s organization should be in place and staffed, there should be a well-balanced and able board, and there should also be a very good organization of finances and administration.

Initial Stage Invest demands quarterly reports from all companies invested in. Significant information in these reports is sales turnover, sales turnover in relation to budget, cost levels, cash flow and net income. Numbers of growth are important, particularly with respect to sales turnover and net income. The higher the growth, the higher the value of a company, the respondent contends. Other important information mentioned by the respondent is gross margins, different levels of income such as EBITDA (and sometimes EBIT), and number of employees. Taxes is in general not a critical issue in these companies because of the deductions for losses during the first years in business. When there are segments or subsidiaries, Initial Stage Invest wants to see reports for each part of the business separately. There is a variation between the companies invested in, but this is in general the information that Initial Stage Invest requires, the respondent tells. The information is generally provided in a less pretentious format than the formal financial reports. In all that, with respect to the importance denoted to different types of information:

*What is interesting with respect to different items of information is after all what measures that is taken by management because of the information.* (CEO, Initial Stage Invest)

Even when Initial Stage Invest is no longer engaged as a member of the board, active engagement is taken in the appointment of board members and, subsequently, the communication with board members. Even though Initial Stage Invest often communicates directly with the management of companies that they have invested in, the respondent stresses the importance of not disregarding the board in communicating their point of view on managerial and financial issues.

When an exit is getting closer in time, either by selling the companies’ shares or by a quotation on the stock exchange, the financial report is in general of limited importance, according to the interviewed venture capitalist under the condition that it does not include deviations for what is “normal”. For instance, if a balance sheet for liquidation purposes has had to be prepared, or if a composition has been made with creditors, or if the auditor’s report includes an adverse opinion, a good deal of work is devoted to providing explanations and justification.
The attention that the respondent gives to the financial reports depends on their level of engagement in a specific company, the venture respondent summarizes. When he receives a financial report of a company that he is not yet involved in, he starts from the back with the auditor's report. Thereafter, he checks the balance sheet and assets above all, together with some of the accompanying footnotes. Skimming through the report of the directors comes next and thereafter he takes a look at the income statement.

In a company that the respondent is already engaged in and consequently is familiar with, the skimming through of the financial reports mainly aims at confirming that everything is in order. Lastly, the financial reports of a company of which respondent is a member of the board, he reads very carefully.

6.1.4 Information on intangible assets

When a company invested in has grown even bigger, often in the form of a group of companies not seldom with foreign subsidiaries, its financial department becomes more organized and the financial reports more extensive. This is partly a consequence of a business becoming larger and more complex, but also of the higher demands of the accounting regulation. According to the interviewed venture capitalist there are two main reasons why developing companies choose to prepare their financial reports according to the K3 regulation even though they have not yet passed the size limit of K2. First, since the aim is for continuing growth a higher regulation is a natural choice to these companies. Secondly, K2 do not allow the capitalization of development costs as assets.

On the question of whether it is important to capitalize intangible investments as assets, the respondent believes that it in general is not critical in the companies that he is engaged in:

…after all, the most important thing is of course that we’ve got the property…

(CEO, Initial Stage Invest)

Even so, the respondent believes that it is relevant and correct to capitalize intangible investments, since this will show what you have invested in:

Since there has been investments in this, and…, for this type of companies, they are know-how companies, and there are investments in knowledge rather than investments in machinery that you will find in more traditional companies. For that reason, I believe that it is relevant and correct to capitalize intellectual assets. (CEO, Initial Stage Invest)

The interviewed venture capitalist continues by attending to the importance of a reasonable accounting regulation, which he believes there is in the sense that smaller entities can choose a “higher” accounting regulation (i.e. K3). However, respondent further notes on the inconsistency of K2 in allowing capitalization of
machinery while investments in intangible resources are not allowed in the balance sheet.

…it is a bit unfortunate that K2, which obviously is intended to be a simplified regulation; that it is not allowed to capitalize/activate development costs… (CEO, Initial Stage Invest)

With respect to liquidation situations the venture capitalist also emphasizes that the possibility to capitalize investments in intangibles can be highly critical to the very survival of a company. When there are reasons to suspect that the share capital is used up to 50 percent by continuous losses Swedish law requires a company to set up a balance sheet for liquidation purposes, with the following risk of bankruptcy [authors note]. In this respect the capitalization of investments in intangible resources increases the “height of fall” until such a procedure becomes necessary.

From the perspective of venture capitalists, the respondent does not see an urgent need for the alternative to capitalizing investments in intangible resources by disclosing additional information on these investments. As owners, even when passive with no engagement on the board, Initial Stage Invest receives information on the development projects a company undertakes, their patent applications as well as information on the progress of different projects. That is, this kind of information is normally included in the regular reporting from companies. Still, in cases when investments in intangibles are expensed when incurred, voluntary or when accounting regulation requires so, the follow-up of different projects becomes less precise than what is the case when expenses for intangible investments are capitalized.

### 6.2 Early Expansion Invest

*Early Expansion Invest* is a leading independent venture capital firm investing in innovative growth companies in the Nordic region. *Early Expansion Invest* invests in start-up, early-stage, or early expansion stage companies and the primary focus is on the areas of information and communications technology, and healthcare and life science. *Early Expansion Invest* is looking for innovative, high-growth, high technology companies, with the ability to create dominant or defensible positions on the market. Since *Early Expansion Invest* was founded in 1994 on the initiative of Chalmers University of Technology, they have made over 70 investments in the life sciences and technology sectors and has today commitments of EUR 323 million. As a venture capital firm *Early Expansion Invest* provides capital, but also, and most importantly; experience, commitment and engagement, knowledge, seasoned advice and previous track record. With years of experience and a strong network within both academia and industry, *Early Expansion Invest* has been able
6. Interviews with venture capitalists

to invest in successful science and research-based companies over the years. (www.innkap.se)

The following text reports on an interview with the CEO of Early Expansion Invest at the company’s office in spring 2014. The respondent is the founder of Early Expansion Invest and one of the most experienced venture capitalists in the Nordic countries. In addition to the interview transcripts, the company’s webpage has provided with additional information.

6.2.1 Investing in a new company

When a new company is considered for investment, the very first documentation Early Expansion Invest asks for is according to the respondent generally the business plan. The business plan is read rather briefly to make a first judgement of the potential investment, with the aim of sorting away uninteresting objects as early in the process as possible. If interest remains after meeting with the management, and if both parties sense that there is a match between what they want to accomplish, a preliminary due diligence starts. The focus of this process is to get an understanding of the company’s business and conditions, and to assess whether there is potential for outstanding development in the future. At this stage, people from outside of Early Expansion Invest often consulted. It could be technical experts, consultants with specialist expertise, people with unique insight into the specific industry, or market researchers.

If the result of the “sanity check” is satisfactory, the negotiation starts and a term sheet outlining the terms, conditions and fundamental requirements of the investment is drawn up. Thereafter, the careful process of due diligence continues. In this process, the greatest focus is according to the respondent on qualitative aspects such as conditions and potential of the market, technologies, patents and individuals since “after all – people are what counts”. In this way, the respondent continues, the venture capitalist finds out “what needs to be done in a company in order to make something out of it”.

[…] As a part of the due diligence we of course go through the accounts and have a look at all agreements...but this comes fairly well into the process. So, if the other parts are not there, we never even look at the financial reports. (CEO, Early Expansion Invest)

The due diligence is future-oriented to a large extent, and since financial reports relate to the past, they do not get much attention besides checking-up that everything is in order. In this process, auditors are also consulted.

It is not the financial reports that get us to [invest] in a company, but rather the prospects of the business. But the financial reports show the financial position at a specific point in time and this has to do with pricing and such. (CEO, Early Expansion Invest)
When asked about what he attends to first when getting the financial report of a company considered for investment in his hand, the respondent’s answer is that “what is important is growth”. Still, he elaborates, to make a company valuable is to a large extent about positioning. When the positioning of a company succeeds, the price may not at all be based on financial ratios. While this is an aim to strive for, it is not the most common case. Hence, in general financial ratios become important as a basis for pricing, and growth ratios in specific. In this respect, growth in sales is most important in general. The venture capitalist further mentions gross margin and the level of profit and cash flow - which is of specific importance - and “that’s about it.”

To the question of whether information on intangibles is important, the respondent answers in affirmative, but not with respect to the information provided in the financial reports.

*It is not that much that is within the reports that is that important, but you must rather check the quality of it.* (CEO, Early Expansion Invest)

With respect to intangibles, it is rather the quality of the assets that is important, and this must clearly be checked up by other means, the respondent contends, since the financial reports only display what the company believes the assets to be worth. In this check-up, Early Expansion Invest often requests assistance from engineers with expert knowledge in the specific area. Still, even if it turns out that an asset is technically good, it is all about the judgement of its commercial value which is seldom in parity with its book value. In this respect, it doesn’t really matter what the balance sheet looks like over time, the respondent states.

### 6.2.2 After initial investment

During the journey after the initial investment the focus is on understanding how the business is developing rather than on the financial reports. What is important is that there is a satisfactory growth, that everything is in order in the company, and that the cash flow is under control. The focus is more on management accounting than financial accounting. The venture capitalist is generally represented on the board at this point in time, and in this role the respondent makes limited use of the financial reports of the company.

*No, I don’t use it specially, [since] it is accounting for how the company has performed during the year; that it is valued and ready and finished. As member of the board I receive reports every month…, I [already] know everything. That is more a matter of form, really. Of course, I read it very carefully, as we shall approve it…that it is correctly accounted for. And we always meet the auditor, before we sign.* (CEO, Early Expansion Invest)
When the financial report is reviewed at the board meeting the auditor is in general there, and then the respondent usually look him straight in the face and ask if all assets are correctly valued, or if there is some doubt from the auditor’s perspective, if he has made any specific observations, or if there is anything else that he thinks that he should tell the board to “unburden his heart”.

The respondent also reads the directors’ report very carefully, in order to make sure that it accounts for what it should:

*If the company performs poorly, for instance, then it is important that you write in the directors’ report that it has performed poorly but now we have fixed it so now the performance is good again.* (CEO, Early Expansion Invest)

When asked about to whom the financial report is addressed, the respondent puts forward suppliers, customers, the tax authority and also potential acquirers. The bank provides capital for operations, but they do not financial risk, he further states.

Even though financial reports do not have the forward-looking perspective, and thereby not used to any greater extent by the venture capitalist, not even in the initial investment process, the respondent emphasizes that the reports are tremendously important in that they show the status of a company at a certain point in time. The respondent also stresses the importance of keeping track of the development of the balance sheet.

*…when you are at the board of directors of a company you have to follow the development of the balance sheet, and that is connected to cash flows and everything, so it is tremendously important […] when you work with these things you have to understand the dynamic of the balance sheet, and understand what you can do with it.* (CEO, Early Expansion Invest)

Already at the time for the initial investment there is a plan for an exit, by selling the company or introducing it on a stock exchange, within a period of ten years. When an exit gets closer in time, the financial report becomes significant in another sense since a settlement of the accounts in general make up an important input to the calculation of the price of the shares.

In some cases, when the positioning of a company has been successful, and the company’s value has become very high, the acquirer may pay a price that is not at all based on financial ratios. In most cases, however, the valuation of the shares is based on financial ratios.

*When we’re going to sell a company to someone, and if it is not on strategic value but on financial ratios, well, then they estimate the value [of the company] from growth […] and from EBITDA, and it is not more difficult than that.* (CEO, Early Expansion Invest)
In all that, the respondent notes, the reports only represent a reflection/mirror image of reality:

*What you normally do when you are about to sell a company, it is a rather long-term process that begins a couple of years in advance, and then you try to ‘dress up the bride’, so to speak, you try to make it look good, as much as you can stretch it, so to speak. You are careful with costs and you […] try to get the sales up, and so forth.* (CEO, Early Expansion Invest)

When asked about the importance of capitalized intangible investments when an exit is close in time, the respondent states that in general this is not a crucial issue. The useful lifespan of intangible rights is generally very long, and at the time for exit the expenses for intangibles has already been financed. Hence, when an exit gets closer in time the issue of whether to capitalize expenses for investments in intangibles or not does not puzzle the respondent and his colleagues at Early Expansion Invest to any greater extent.

When asked about his opinion on the difference between the K2 and the K3 regulations regarding the possibilities to capitalize expenses for internally generated intangibles, the respondent contends that this is in general not a critical issue during an investment when the venture capitalist is already engaged in a company, since their main focus at that stage is on keeping track of and understanding cash flow. What the balance sheet looks like over time is not important in this respect, according to the respondent.

Still, the respondent adds, the level of capitalization is almost always discussed in companies with intangible rights/property. According to the respondent, it is easy to deceive oneself when it comes to estimating the amount to be capitalized. In this respect the respondent draws a parallel to management accounting: For internal purposes calculations of EBITDA converted to cash make up important measures that provide more prudent values as compared to the calculations that are based on the numbers in the financial statements. The focus on cash is in this respect a manifestation of caution, which again adds to the importance of information on cash:

*[Cash] is of greater importance than anything else.* (CEO, Early Expansion Invest)

Statements of cash flow with its components is considered to be of specific importance when following-up the performance of the companies that Early Expansion Invest has invested in. Even though there is no pre-specified or preferred format of the cash flow statement, its structure varies between companies, the respondent emphasizes the importance of understanding how the cash is generated and for what it is used. For this purpose, it is important to separate the different components of cash flow from operations, investment and financing. For instance, when a company grows, the working capital may need to develop concurrently. Also, in order to be able to grow without bringing in new
external money, you must understand what the cash flow looks like, the respondent emphasizes. All in all, they keep a strict check on the development of cash flows. And, again, the time perspective of cash flow information is always forward-looking:

\[ \textit{We don’t give a damn about the past.} \quad \textit{(CEO, Early Expansion Invest)} \]

### 6.3 Summary of the results of the interviews with venture capitalists

To the venture capitalists interviewed for this study, the importance and use of financial reporting information depends on what stage the investment process is in, and the stage of development of the company considered for investment. When investing in a newly started company, the representative of Initial Stage Invest gives little attention to formal financial reports. When entering a business after a year or two, the greatest focus is on cash flow and the balance sheet. At Early Expansion Invest financial reports make up a part of the due diligence but since the focus is mostly on forward-looking aspects the reports mainly provide a general check-up that everything is in order. In this check-up the focus is on sales, gross margin, net income and cash flow.

During an investment both venture capitalists are generally engaged as board members with continuous access to internal management information. Even in cases when they are not members of the board, they have access to more information than what is included in the formal financial reports.

Both venture capitalists emphasize the importance of cash flow information at all stages of investment. Most companies show negative cash flows the first years in business and in these cases the cash flow calculation is the be-all and end-all (Initial Stage Invest). As expressed by the respondent representing Early Expansion Invest, cash is generally of greater importance than anything else. Both respondents also emphasize the importance of keeping track of the balance sheet – to understand the dynamics of it and know how to manage it, and to be able to act in advance to avoid capital deficits.

The capitalization of investments in intangibles as assets is according to the interviewed venture capitalists generally not a critical issue regarding companies they are about to invest in or during an investment. The existence of intangibles is more important than accounting for it. Even so, as attended to by one of the respondents, capitalization may be critical from a capital deficiency perspective.

During interviews both venture capitalists continuously return to the importance of future-oriented information, which is not provided by financial reports. In this setting, financial reports make up a point of departure in providing the historical perspective. When an exit approaches in time financial
reporting may become important in another sense, as the price of the shares is generally based on financial performance ratios. The content of the director’s report generally gets attention if something extraordinary has happened that needs to be explained. Table 6.1 respondents’ views on significant areas of financial reporting information.

Table 6.1 Significant areas of financial reporting information according to venture capitalists

<table>
<thead>
<tr>
<th>Venture Capital Company</th>
<th>Cash flow</th>
<th>Balance sheet</th>
<th>Sales growth</th>
<th>Levels of net income</th>
<th>Gross margin</th>
<th>Intangible assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Stage Invest</td>
<td>X</td>
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<td>Early Expansion Invest</td>
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7 Interviews with bankers

This chapter presents the results of the interviews with representatives of three of the largest business banks in Sweden. After a short introduction of the respondents the text reports on the interviews with the three bankers sequentially. The presentations are structured around the questions posed during interviews of the role of financial reporting in different stages of the credit process, whether it is a new credit or a running credit, and in relation to different stages of development of customer companies.

7.1 Bank A

Banker A works at bank A’s office in Jönköping with customer services towards the bank’s company customers. Banker A holds an MBA from Gothenburg University and has worked at bank A for more than thirty years with all diverse types of companies, from one-man make-a-living firms to large Swedish multinationals. The following text reports on an interview with banker A in April 2014.

7.1.1 The use of financial reports in credit assessments

When discussing granting and follow-up of credits in relation to SMEs, it is important, banker A asserts, to set out from the very smallest and often newly started entities. Even though 80 percent of the bank’s company customers have less than 10 employees, bank A is not a small company bank in the traditional sense. The usual procedure is that companies become customers with the bank when they are very small and that the bank follows them during their journey to come. In growth-oriented development companies, growth is often exponential, and it may very well take years before things get moving, as the respondent puts it. Therefore, to see the full potential of a newly started business or a smaller company, the credit analysis is forward-looking to a considerable extent.

Banker A mentions three aspects that are of specific importance to the bank in their evaluation of new customers for credits. Firstly, the bank must make an evaluation of the credit risk, which involves an analysis of the company’s business concept. The second aspect has to do with the performance of the leader of the business, including creditability. The track record is under scrutiny and if there is a history of non-payment of debt, the credit process becomes steeply uphill. The trustworthiness of the business leader – whether the banker “believes in him or her” - is also significant to the outcome of the evaluation. Third, the bank applies
a portfolio strategy, which means that the local market is also taken into consideration with the aim to spread the risk.

Banker A returns to the future-orientation of the credit process continuously during the interview stressing the importance of customers being committed to the future.

_We do not lend capital to pay off old debt. [...] When we open the bin of money, it should be invested in the future._ (Banker A)

To be able to estimate what the new funds will lead to for the business, the banker wants to see plans for the future. In this respect, important documents are the business plan, budgets and prognoses and, later, the follow-up of the budget, which is carried out in shorter intervals and repeatedly during the year.

Banker A emphasizes that the bank makes judgment based on risk with focus on capacity for repayment rather than the current status of the bank account. In this respect information on liquidity and cash flow is of extraordinary importance. In the respondent’s experience keeping track of liquidity is in general elusive to new entrepreneurs. The business may be very successful according to the first income statement or monthly report, and at the same time be out of money. The respondent’s experience is that enterprises that fail in the first year of business do so from liquidity problems, and those that resign in the coming few years do so because of deficiencies in the business plan.

If the credit assessment of new customers is future-oriented in general, this is even more the case when it comes to entrepreneurial and growth-oriented SMEs. In this setting, banker A finds financial reports to be out of date and of limited help to bankers, not least considering that the latest annual report may be up to one-and-a-half-year-old.

_Financial reporting of today – there is nothing in it that helps us. It doesn’t help anyone._ (Banker A)

For a company with a financial year ending in December the bank often receives the financial report in April. At that time of year, the focus is already on the first quarter of the present year, and, after that, on the middle of the year. As banker A puts it, “most entrepreneurs make an evaluation of their assets midyear, to be in peace during holidays”. To fill the information gap, the banker asks for periodical financial reports at least half yearly, to be compared with budget and analyzed against forecasts. Important questions to ask is according to the respondent: Was the budget met or not, or was it exceeded, and why? What can we expect from the future? Are there any changes from the past? In case of an undesirable deviation from budget, what is the action plan for the future?
Banker A attends to the abolishment of the audit obligation for the smallest limited liability companies in Sweden\textsuperscript{58}, which he believes has had a negative effect on the quality of these companies’ financial reporting. Consequently, the bank does not attach as much importance to the financial reports of these entities as before. Accordingly, the financial report of a newly started or smaller company is read with a somewhat skeptical eye:

\begin{quote}
What we see is that here is a reasonable chance that it gives a true picture, if there is a positive net income. (Banker A)
\end{quote}

Even so, banker A emphasizes, there are always possibilities to be creative with figures when entering invoices into the books or estimating whether inventories are saleable or not.

\begin{quote}
There is a lot to do without transgressing the law. How to give accounts is a matter of judgment. There is no right or wrong in absolute terms. (Banker A)
\end{quote}

Financial reports separately and “taken out of its context” are not sufficient considering the demands that the bank has for granting credits. In all that, the reports make up a part of a historical description, which is significant to understand the dynamics of the business.

\begin{quote}
Without financial accounts there will be heavier and harder talks for the entrepreneur. (Banker A)
\end{quote}

Hence, there must be a history.

\begin{quote}
If a company shows no coins – the credit assessment will inevitably be problematic. (Banker A)
\end{quote}

Accordingly, the confirming role of financial accounts shall not be neglected. In this respect, banker A emphasizes that it is only the formal financial reports that provide the possibility to keep track of the equity capital of a company.

\section*{7.1.2 The importance of financial reports at different stages of development}

The importance attached to the historical account of financial reports in the credit assessment process depends on what stage of development a company is in. Financial reports gradually become more important to the credit decision process as a company grows bigger. In the early phase of development, the budget is more important than financial reports. The financial accounts are

\textsuperscript{58} See Chapter 2, Section 2.2.3.
looked through, without digging too deep into historical numbers. Important questions to ask in this process are according to banker A: Are the numbers “black”? What is the net income and what resources have been used to produce this net income? Is equity intact so that there is no need for actions to restore equity? Budgets are continuously engaged in this process, and an important question to pose whether the sales budget realistic. Another important issue is whether there are enough resources to cope with the estimated increase in sales? If the financing of working capital is weak, there is a need for external finance.

After a couple of years in business, when the company has expanded, the bank puts new demands on the customer and at the same time the demands of the customer becomes more challenging. The focus turns to trends and financial reports become interesting to the banker in a quite new way.

At the bank, they work a lot with ratios, and in this respect Banker A mentions the consolidation of capital and solidity as important. Turnover becomes important, since “the faster you spin the capital, the less you need to borrow”. With respect to turnover ratios, the respondent refers to differences between industries. In companies where inventories make up a heavy item in the balance sheet, the rate of turnover of inventories becomes important, and in relation to growth of sales. In services companies, trends become important and growth in sales in specific.

Irrespective of what stage of development a company is in, Banker A emphasizes cash flow and liquidity as central to the process of evaluation and granting of new credits and in the follow-up of running credits. For smaller companies, the bank constructs their own charts of liquidity and statements of cash flow. The charts are future oriented and illustrate the current position of the company under scrutiny and what the situation would be taken additional credits into consideration. If there is a need of additional capital, information on the inflows from operations and current financing is significant to the assessment made by the bank.

The cash flow statements constructed by the bank follow to a large extent the same format as the formal cash flow statements prepared according to accounting regulation, but with somewhat more detail. When companies grow bigger, reaching a turnover of 75-100 million SEK and above, they generally provide cash flow information, even when they are not required by accounting regulation to prepare cash flow statements. In most cases this information can be used by the bank without any adjustments to talk of.

7.1.3 Information on intangibles

With respect to the restricted possibilities to capitalize investments in internally generated intangible assets, especially in smaller companies following the Swedish accounting standard K2, the respondent expresses severe criticism towards the regulator:
7. Interviews with bankers

*The legislator is disobliging towards thoughts and ideas. Do we turn [wood] or bend threads – then all is well/fine.* (Banker A)

Intangible assets such as goodwill, trademarks and film rights are hard to value, and no help is according to the respondent offered by the regulation which he believes flagrantly disfavours that innovative companies. In the respondent’s experience, companies find ways to get around the restrictions of accounting regulation. As an example, if the work-in-progress item expands “with some strange costs”, it is generally expensing for intangible investments that has been added on in order to avoid charging the costs directly to net income.

*Companies of course share the same view as we do, that it is not satisfactory to blow up the balance sheet, but what [other options do they have]?* (Banker A)

Investments in intangible resources do not only add complexity to the credit decision process because of companies’ creative ways of dealing with the restrictions of accounting regulation, they also increase the risk that the bank’s analysis ends up incorrect. In cases when intangibles are recognized as assets, and make up heavy items of the balance sheet, the general procedure at the bank is to make their own estimations of values and depreciation. If a company needs additional finance for a new development project a personal meeting will be held, providing the opportunity for the company to present their ideas and for the banker to pose questions. Still, the respondent stresses, it is far from always that the credit request is approved.

Banker A continues by pointing out that a growing share of entrepreneurs and entrepreneurial companies in the economy will ultimately lead to a growing share of technically difficult business processes and products, with more complex and fast-changing markets. With respect to entrepreneurial companies, comparisons between entities generally becomes complex as “there may not only be apples and pears – there may be peaches as well”:

*The word entrepreneur itself signifies that it is something that is hard to get [the meaning of].* (Banker A)

In this context, the respondent sums up, financial reports become less helpful in the process of making credit decisions:

*The financial report is a hygiene factor, as we see it.* (Banker A)

As a hygiene factor the financial report is indispensable as a point of departure and a historical account, but “taken out of its context” it is not sufficient to the future-oriented credit process by the bank, the respondent contends.
We look at the financial reports; we talk about budgets and prognoses, and cash flow.
(Banker A)

7.2 Bank B

At bank B’s office in Jönköping there are seven co-workers with responsibility for the bank’s relations with companies and company credits. This text reports on an interview in spring 2014 with banker B, deputy manager of the company group and former head of the local office. Banker B has worked at the bank for 25 years, of which 20 years as a manager.

7.2.1 The use of financial reports in credit assessments

In the process of making formal credit decisions, audited closing of the books and financial reports act as a label of quality, according to banker B. However, the time delay of the reports in general makes them insufficient as a single basis for the credit decisions by the bank. Hence, the credit decision is to a great extent based on other grounds. Above all, the qualities of the leader of the business such as experience, background and reputation are of highest importance. These qualities contribute to the confidence of the banker in the leader of business which is critical to the outcome of a credit application. The banker’s expectations of the company’s capacity to repay its debt is further crucial to the credit assessment, as well as the securities offered by the company applying for credit. In this context the financial report is important as a “quality-document that shows the actual development [of a company]”:

[Informal] income reports and such, budgets, do not show the whole truth, in that sense.
[...] In a sense the financial report is an audited document with a quality label/mark.
(Banker B)

Banker B emphasizes that the operations in entrepreneurial companies are largely dependent upon the entrepreneur/manager, who is often also the owner and founder of the business. As a consequence, if the entrepreneur leaves the business, this would have a greater effect not only on the company’s operations but also on its income statement and balance sheet. Hence, the entrepreneur/manager and his or her experience, capabilities and intentions play an important role in the credit appraisal. In making decisions on credits to entrepreneurial companies in general, and in newly started entrepreneurial companies in specific, where there often is a lack of real assets, the focus is to a large extent on the entrepreneur himself/herself together with the expected

59 Swedish accounting regulation offers a possibility for the smallest limited liability companies to prepare a simplified annual closure of the books instead of a financial report.
future development of the business which to a large extent is seen as contingent on the qualities of the entrepreneur.

In a newly started company or in a company in its early development, where no financial reports have yet been published, the bank generally requests a budget drawn up together with an auditor. In a company that has been in business for a while, the financial reports, and to analyse its different parts, form a point of departure in the credit-decision process.

The information requested by the bank varies depending on what stage of development a company is in. The most comprehensive information is requested in credit assessments of start-ups and in granting of credits to new customers in genera. Thereafter, if everything is in order, the follow-up will mostly focus on the year-end closing of the books including credit ratings to assess whether the company will have difficulties in repaying its debt. This procedure applies to all customers, not only entrepreneurial companies. The request for additional information such as budgets and prognoses is generally connected to a specific situation, such as when large investments require additional financial capital, or if a company faces difficulties to repay its debt. In such cases there is always a need for additional information.

Most of the information the bank receives is about the past. Still, it is the historical account that shows how a business has been managed, and what the conditions are for development and growth. However, the time delay of half a year makes the financial reports quickly out of date, not least in growing entities. In this context the reliability of budgets and prognoses and the extent to which they are realistic becomes ever more important concerning companies facing increased need of credit because of rapid growth. Accounting reports for parts of the year, and revised budgets during the year, is then requested by the bank.

Cash flow is according to the respondent of crucial importance in the banks approach to their customers and the credit assessment. Besides confidence in owners/entrepreneur, the capacity to re-pay is essential and significant to the credit assessment. Generally, the bank constructs their own cash flow statements including the different components of operating, investing and financing activities. When analysing cash flow all components are significant, including its sources, i.e. where the cash comes from, and for what it is used. It is extremely important to be able to see whether there is sufficient cash flow inflows to afford additional credits, banker B emphasizes. While the time perspective concerning running credits generally covers the current financial year, larger investments that requires additional credits involve estimations of cash flows for the years to come. This presumed cash flow, which may cover five years or so, is calculated to see whether there is room for the additional loan payments, with otherwise unchanged numbers.

When looking through the financial reports of a growing company, banker B considers the balance sheet and its various components to be of highest priority. Capitalized development projects and other intangible assets receive specific attention because of the experience that capitalization is often a sign that a
company cannot afford to charge the expenses directly to the income statement. It is evident, however, that the extent to which such a procedure becomes critical is dependent on what the underlying assets are and, concerning development projects, the current stage of development. Still, specific attention is needed and important questions to pose are what the real value would be of such assets, and the value in relation to equity, in case of a hypothetical negative development in the future or, even worse, in case of insolvency. Is there a second-hand value of the assets? Would it be interesting to acquire a project/an asset in a possible future situation of the company becoming insolvent? According to the respondent’s experience this is in most cases doubtful. Rather, assets such as accounts receivables and inventories, in their qualities of being more tangible, are in a sense more important, and more important in showing the true development of a company.

With respect to the issue of intangible assets, banker B emphasizes that the role of the bank in principle is to provide financial capital for companies’ operations, i.e. to finance accounts receivables, inventories and such. Intangible assets such as development costs touch upon risk capital and the financing of such assets are consequently outside the bank’s field of activities. Therefore, it is significant, from the bank’s perspective, to critically scrutinize the content of the debit side of the balance sheet in relation to the capital needed, in order to sort out “what the money is used for”. The limited possibilities to capitalize expenses for intangible assets/projects is not considered a problem, according to the respondent, rather the opposite/on the contrary.

Besides a balance sheet that shows a solvent company, banker B adds, the bank wants to see a positive net income of the company under scrutiny for credit. Information about entrepreneurs’ salaries is also of importance in entrepreneurial entities, as well as in newly started businesses. In many cases it is positive that the owner chooses to “let the capital work in the business” rather than withdrawing a salary, if possible. Still, it is important that the company, at some point in time after the start-up, shows that it can afford a salary adjusted to the conditions on the market.

When asked about ratios banker B tells that they calculate their own ratios from the numbers of the income statement and balance sheet, such as operating margin, interest coverage ratio and solidity. However, ratios should according to Banker B be analysed with a certain degree of caution, not to divert attention from more important aspects.

Towards the end of the interview the respondent notes that the bank’s focus is not so much on the technicalities of accounting but that the analysis is rather basic.

_We talk to our customers, we follow their operations, we visit them, [we] build sort of a mutual confidence/trust… (Banker B)_

[…]
7. Interviews with bankers

The financial report has to be there, and it has to be of good quality, but it is not… We also do another….it is also the gut feeling […] it also has to be there. (Banker B)

The historical records of financial reports are certainly needed, and they must be trustworthy, reliable and of good quality. In all that, the granting of credits builds to a large extent on prognoses for the future, where a realistic capacity to repay and cash flow is in focus.

7.3 Bank C

As midcorp manager at bank C’s office in Jönköping banker C is responsible for the banks relations with companies with a turnover of about 100 million SEK. Banker C has experience from working with all types of businesses, of different sizes, in all types of industries - ranging from manufacturing companies to knowledge-intensive services companies - both in relation to credits and all other bank services demanded by customers.

7.3.1 The use of financial reports in credit assessments

Even though financial reports are significant to the processes of credit rating and follow-up of current credits, banker C stresses that they only form a part of the basis for evaluation. The reports act as a point of departure to the bank but are not the most important documentation. The credit evaluation process is about making a judgment about future development, the respondent emphasizes, and in this respect additional information in the form of financial reports for parts of the year, which are not audited in general, as well as budgets are equally important:

The most important thing on our behalf is not the [standing] a year ago, when the financial reports were produced, but actually what is happening right now and ahead. Then it is […] the budget, perhaps a calculation, and financial reports for parts of the year that actually is the most important part. (Banker C)

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60 Total capital of approximately 500 – 600 million SEK and above. Number of employees is not as relevant to the bank as monetary measures, according to banker C, but a common approximation for small and medium-sized companies in the bank sector is up to 100 employees (i.e. a little bit lower than the definition of this study). I clarify that my interest first and foremost is in what is specific in the context of entrepreneurial and growth-oriented companies, and less in size-related issues. In all that, size is a contingent factor – as well as entrepreneurship and growth-orientation - when discussing accounting information that should not be neglected. Also, of significance with respect to methodology and the comparability of study results.
In all that, on a good history will generally follow a good development in the future. This on the condition that the market and other aspects will not change, but that is also a judgment to make. A well-managed company in general shows well-managed figures, according to the respondent.

When looking through the financial report of a new customer applying for credit, important information is according to banker C the net income, to see that the business generates a net income. However, this is not an indisputable demand, since occasional losses or losses caused by heavy investments very well may have positive effects in the future.

The information in the balance sheet is supplemented by a cash flow calculation to see where the funds come from, i.e. its sources of finance, and for what it has been used. Most commonly cash flow information is not provided by customers and the bank makes their own calculations. Even though the bank’s disposition of the cash flow calculation does not follow the format of accounting regulation, with pre-specified items of cash flow from operations, financing and investments, the content is principally the same. Of importance is historical flows in general and budgets of cash flow in specific.

With respect to the higher need for financial capital in entrepreneurial and growing entities, banker C stresses the importance of keeping track of liquidity. When you grow fast you tie-up more money. This money will eventually be compensated by a higher income, but with a delay. Therefore, budgets of cash flow or liquidity become critical. The respondent believes that the undue attention to cash flows is a significant reason for failure among many companies that grow too fast. In the respondent’s experience growth-oriented and entrepreneurial companies that have been in business for a while, even those that still are quite small, are generally highly professional and aware of the importance of keeping track of liquidity.

Besides the cash flow calculations, the bank also calculates ratios, and what ratios that are considered most important, besides the general ratios such as solidity/solvency and turnover ratios, differs between companies and industries.

Concerning the content of financial reports at different stages of a company’s development, banker C put forward the continuously higher need for financial capital following on growth, which is reflected in the reports by a higher share of tied-up money. Also, in some industries there will increasingly be a higher share of intangible assets which are “harder” to assess/finance.

With respect to intangible assets, the bank is according to banker C restricted form providing finance to growing IT companies or other services businesses because of the absence of a mass of assets. Rather, the assets of these companies tend to “walk out of the door every day at six or seven, or when they leave work” for the day. The implication is that such businesses are hard to finance, even though they generally show good figures. These companies must show a greater share of equity capital before the bank will consider a credit.

In cases when companies have capitalized expenses for intangible resources as assets, it is significant to question not only what has been activated, but also
why this has been done. In this respect there is a difference between capitalization for the reason of showing the actual value of an asset, which is considered positive by the banker, and because there is not enough capital to afford to charge the expenses directly to the income statement.

In general Banker C is not as sceptical to capitalization in a company that are not a new customer to the bank, since in this case the bank is familiar with the company’s business and also with its intangible assets, including values and reasons for capitalization. The discussions about the assets are more important to the bank, what kind of assets it is and the reasoning for their accounting treatment, than whether the assets have been capitalized or not. “As long as there is a reasonable explanation behind any costs, it doesn’t matter” if the expenses for intangibles are capitalized as assets or charged directly to the income statement, the respondent states. Still, respondent considers intangible assets “not to be the nicest thing you can have in the balance sheet”:

They are going to be depreciated anyway, but they do not have a [fixed] value - you do not know the value of it. But of course, if you have an explanation for it [this is not problematic]. (Banker C)

According to banker C, there is no difference in what specific type of information, or what items of the financial reports, that is considered most important as a basis for evaluation of entrepreneurial companies when compared to non-entrepreneurial companies. All companies, irrespective of direction, must show a cash flow. Similarly, in his opinion the bank’s information needs do not differ to any greater extent depending on the phase of development of a company, whether it is in a period of high growth or has passed this stage and become more stagnant. The respondent considers the same information to be important irrespective of the stage of development.

Of greater importance in these companies, Banker C believes, is to have a dialogue with all interested parties. It is of greatest importance in growing and entrepreneurial companies, whatever the business, to have a dialogue with their banker, auditor and all other important interesting parties, the respondent argues. Even so, the information flow should be similar irrespective of stage of development. Of course, the faster you grow, the more frequently you will have to meet with your interested parties. When you have grown bigger you have already built confidence among interested parties, otherwise the information is the same. Likewise, there is no difference in the bank’s formal information needs whether the customer is a stable manufacturing business or a growing entrepreneurial business.

Banker C further contends that, in relations with growing businesses information on the market becomes of interest. Even though the bank focuses on numerical information to a great extent, the situation in the market and with customers and suppliers needs to be taken into considering in the credit process. Of interest in this respect is for example the number and standing of the
company’s customers and the company’s relation to suppliers, such as if the company is dependent on only one supplier.

…it is not only the figures, in this, but also everything around […] and, the management, above all, perhaps. That is probably one of the greatest aspects. The bank’s impression of and confidence in the management. Everything all around is almost as important as the numbers. (Banker C)

In banker C’s opinion the information in the financial reports together with supplementary information meet the bank’s information needs quite well. It has not come to the respondent’s mind that there could be a need for improvements to the content of financial reporting information in general:

You are so much into how it is, what accounting should look like, all the way back from senior high school - after that you have not given it a thought. (Banker C)

7.4 Summary of the results of the interviews with bankers

As put forward by respondents representing bankers the main role of the bank with financing for operations rather than risky development projects. In all that, the interviewed bankers consider themselves as important financiers of entrepreneurial and growth-oriented companies, even though they are generally not the main financier. In this role the banker makes use of financial reports in the process of rating and granting of new credits and in the follow-up of running credits.

All three bankers emphasize that financial reports make up an important tool in the process of credit assessment, but that it is only a part of the basis for forming their judgment. Even though the reports provide the significant historical perspective, they are not sufficient to the future-oriented evaluation process because of the time-delay and focus on historical numbers. If the credit evaluation of new customers is future-oriented in general, this is even more the case when it comes to entrepreneurial and growth-oriented SMEs. Other aspects such as the qualities, capabilities and earlier performance of the leader of the business, and the business concept, are put forward by respondents as at least as important as accounting numbers in evaluating entrepreneurial entities for credits. With respect to financial numbers, financial reports for parts of the year, budgets and prognoses, are considered as important as the annual financial reports.

All three bankers consider cash flow information to be tremendously important and critical both in the process of credit assessments of new customers and in the follow-up of running credits. As put forward by respondents, keeping
7. Interviews with bankers

Inadequate track of liquidity is the most common reason for failure among entrepreneurial and growth-oriented SMEs.

All three banks construct their own cash flow calculations in general, dividing the different items into cash flow from operations, investments and finance, in a similar way as the model prescribed by accounting regulation. Respondents also emphasize forward-looking cash flow information in terms liquidity budgets as particularly important in the entrepreneurial context.

The interviewed bankers further express that the presence of intangibles in companies’ balance sheets, and making estimates of the value of intangibles, makes the credit evaluation process more difficult. Two of the bankers emphasize the importance of questioning the reason for capitalization, to assure that this is not a way to deal with a capital deficit. One of the bankers further refers to the creative ways used by companies to get around the restriction of accounting regulation, such as adding expenses for intangibles to the work-in-progress item of the balance sheet.

Table 7.1 Significant areas of financial reporting information according to bankers

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Cash flow</th>
<th>Balance sheet (solvency)</th>
<th>Solidity</th>
<th>Net income</th>
<th>Other ratios</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banker A</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>Turnover</td>
<td></td>
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<tr>
<td>Banker B</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>Operating margin, interest coverage ratio (with caution)</td>
<td>Salaries</td>
</tr>
<tr>
<td>Banker C</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>×</td>
<td>Turnover</td>
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</tbody>
</table>
8 Analysis

With the frame of reference as a point of departure, this chapter presents an analysis of the results of the empirical work carried out in the two parts of the study. The analysis is structured according to the research questions formulated in the first chapter of this thesis. This chapter first discusses the questions of users and purposes of use, and information needs of users. The aim of this discussion is to shed light and discuss similarities and differences in the views expressed by different actors included in the study, and in relation to previous research and accounting regulations. Thereafter, the discussion moves to the overall objectives of financial reporting, relating the empirical data to the fundamental principles of decision-usefulness and stewardship/accountability as expressed by standard setters and in the accounting literature.

8.1 Users and purposes of use

Throughout the different steps of data collection of this study, the respondents emphasized the role of financial reporting in informing external stakeholders. With regard to the question of who the main users among external stakeholders are, and the extent to which these actors make use of financial reports and reporting, the views held by the different actors included in the study diverged to some extent. Respondents representing accounting experts, including standard setters, auditors and academics, put forward the continuous high demand for financial capital as a challenge for the management of entrepreneurial SMEs. In this respect they emphasized the importance of financial reports in informing external capital providers. This argument was also put forward in several of the K2 comment letters analysed in the first part of this study. The interviewed accounting experts emphasized bankers among the external capital providers who make use of financial reports.

The entrepreneurial SMEs included in the second part of this study were financed mainly by equity and retained profits. Even though bank loans were not the main source of finance for any of the three companies, the interviewed managers still included bankers among users since they provided overdraft.

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61 The respondents to the two K2 drafts (Chapter 4, Section 4.2) were not requested to comment on the issues of users and purposes in specific, and neither were the respondents to the draft IFRS for SMEs (Section 4.3). Considering the role of intangibles in entrepreneurial entities, the comment letters to the K2 drafts including discussions on the suggested accounting regulation on internally generated intangible assets were sorted out as relevant for this study (see Chapter 3, Section 3.5.2.1). Further, several of the comment letters refer to innovative and entrepreneurial businesses, even though they do not define ‘entrepreneurial’, in relation to their comments on intangibles.
facilities. Both the interviewed venture capitalists and the bankers themselves emphasized that the main finance in growth-oriented and entrepreneurial SMEs generally comes from other sources than bank credits. As put forward by both these groups of respondents, the main role of the bank is to provide finance of operations rather than risky development projects. In this role, the interviewed bankers make use of financial reports as it provided the historical perspective of a company’s finances, which is an important part of the information used in the process of appraising and granting new credits, and in the follow-up of running credits.

The shareholders of the three entrepreneurial SMEs were engaged in their company’s business, as part of the management, board members and/or employees. Through these engagements, shareholders had access to additional information besides the public reports. Even so, the interviewed managers considered shareholders as important users of their entities’ financial reports. In this respect a parallel can be drawn to the contrasting statement of the IFRS for SMEs draft that users in a position to demand information tailored to meet their specific needs, such as owner-managers, are excluded from the target audience of the standard (IASB, 2006b). This view of management was also included in the final standard (IASB, 2009a, 2015). Further, the project report preceding the first draft of the Swedish K2 standard excluded shareholders and employees from the main user groups for the very same reason (BFN, 2006b).

It should be noted that the interviewed managers’ views on the usefulness of the financial reports prepared for their entities to other users than themselves in many cases were based on the managers’ own (subjective) expectations. Even so, the views held by managers are relevant to this study as they represent reporting entities, which is a central group within the financial reporting environment (c.f. Beaver, 1998). Further, as put forward in Chapter 3 (Section 3.3), this study set out from the assumption that managers make use of financial reports in order to inform other stakeholders. As representatives of their respective entities, the managers’ views of who these stakeholders or users are thus relevant, not least since the actions they undertake are based on these views (Chapter 3, Section 3.1).

With reference to the interview data collected for this study, an example of an action taken based on views or assumptions of users was the adoption of full IFRS by the cloud computing business included in this study. According to the interviewed CEO this was a deliberate choice to facilitate the process of acquiring financial capital in the future, possibly by way of a public listing (see Section 5.2.2). The intent to signal to potential investors that the company can manage the higher demands of reporting that follow a public listing can be interpreted

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62 In the search consultancy company, all shareholders are employed and thereby have access to continuous management reports, the main users put forward by the CFO are customers and business partners. Even so, shareholders tend to engage in the content of the financial reports at the shareholders’ meeting once a year.

63 In some cases, managers refer to external users’ requests of financial reporting information.
not only as a manifestation of a wish to make a certain impression on others, but also as an action taken based on the view held of the potential investor as a user. The disclosed texts on potential growth, in addition to growth in numbers, on the reasoning that both shareholders and investors “want to see”, or are “attracted” by, this information, is another example of an action taken based on the manager’s view of users’ purposes and information needs.

While standard setting bodies generally exclude management from the main user groups of financial reports, previous studies, including Blomkvist’s (2008) study of entrepreneurial entities\textsuperscript{64}, discuss the usefulness of financial reporting to management. A similar view was put forward by authors of a comment letter to the K2 drafts, with reference to innovative and entrepreneurial entities in particular. Previous research has also shown that the importance of financial reporting to management is contingent on the development of the accounting system as a whole, which in turn tend to correlate with company size (Thomas, 1986; Collis & Jarvis, 2002). With respect to this study’s focus on entrepreneurial SMEs, previous studies also show the importance given to accounting information for management purposes in entrepreneurial companies of different sizes (Dergård, 2006; Hansen, 2005; Sexton, Upton, Wacholtz & McDougall, 1997). The results of this study thus correspond to previous research considering the extent to which respondents of the different groups included in this study discuss the use of management accounting. Respondents also made recurrent references to well-developed management accounting systems.

Even though several of the accounting experts interviewed for this study considered the connection to be close between financial reporting and management accounting, and noted the importance of financial reports in confirming the management accounts, a majority considered financial reports to be of limited use to managers in their internal decision-making. The interviewed managers expressed similar views as accounting experts in this respect. Although the financial reporting document was not used internally by management, respondents noted that the information in the financial reports overlap and depart from the same sources as the management accounts. In the case of the company applying IFRS, this connection was not limited to numbers, since the texts in the financial reports were used internally as well. Furthermore, respondents representing the group of managers talked of the importance of financial reports in providing an audited and yearly check that the accounts were

\textsuperscript{64} None of the previous empirical studies on accounting in entrepreneurial entities presented in Chapter 2 of this thesis (Section 2.4) explicitly investigate the role of statutory financial reporting with respect to users and purposes of use. Even so, in Blomkvist’s (2008) qualitative pilot study the entrepreneurs belonging to the $\text{Small}$ entity with the SME group emphasized their wish to ensure that the information needs of users were met as an incentive for their participation in the year-end procedures of constructing financial reports. In this respect, shareholders, other financiers and customers were considered as important users. The studied entrepreneurs also emphasized the significance of being updated on the financial aspects of their businesses, to be able to make well-founded decisions for the future, and also to be able to respond to questions from shareholders and other financiers.
8. Analysis

in order. The confirmatory value of financial reports was also discussed by respondents representing venture capitalists and bankers.

The two venture capitalists interviewed for this study attended to financial reports when investing in a new company, but this was in the form of a general check-up of the company’s finances. After initial investments, the venture capitalists are generally engaged as board members, with access to internal management information. Conversely, with respect to statutory financial reports, the respondents emphasized the importance of keeping track of and managing the balance sheet. When an exit gets closer in time, financial reports generally made up a basis for the calculation of share price, and, as expressed by one of the respondents, an effort was made at making the figures look good. The other venture capitalist interviewed however downplayed the importance of financial reports at exit, unless there were specific circumstances that urged explanation. Examples of such circumstances were the preparation of a balance sheet for liquidation purposes during the year or if the auditor’s report included an adverse opinion.

8.2 Information needs of users

During the interviews with representatives of the different groups of actors included in the two parts of this study, respondents recurrently referred to the importance of information on sales and sales growth in specific. Information on cash flows and intangibles was also discussed extensively during interviews.\(^{65}\) Even so, the views on whether the information in the three areas should be communicated by way of financial reports or by other means varied between the different groups of respondents, and to some extent within the different groups as well. In the following, these three areas of information are discussed in turn, with focus on similarities and differences of the views held by different actors, and in relation to previous research and regulation. Further, the views on information on cash flows and intangibles put forward by respondents related to the fundamental differences between decision-usefulness and stewardship/accountability. Therefore, the sections on cash flows and intangibles got more attention by respondents. While intangibles become important in relation to entrepreneurship by definition, comments on cash flow in relation to SMEs in general were considered important to this study, considering the emphasis of cash flow information in previous studies of accounting in entrepreneurial entities as well as by the accounting experts interviewed for this study (see Chapter 4, Section 4.3.4).

\(^{65}\) As presented in Chapter 4, the survey of the comment letters to the Swedish K2 drafts identified comments on the suggested regulation of internally generated intangible assets as relevant to this study were the focus is on entrepreneurial entities (Section 3.5.2.1). Regarding the study of comment letters to the draft IFRS for SMEs, there were few comments on aspects related to entrepreneurial and growth-oriented entities in specific. Cash flow and intangibles got more attention by respondents. While intangibles become important in relation to entrepreneurship by definition, comments on cash flow in relation to SMEs in general were considered important to this study, considering the emphasis of cash flow information in previous studies of accounting in entrepreneurial entities as well as by the accounting experts interviewed for this study (see Chapter 4, Section 4.3.4).
intangibles conclude by relating the discussions to the overall objectives of financial reporting\(^\text{66}\).

### 8.2.1 Information on sales and growth in sales

According to previous empirical studies on accounting in entrepreneurial entities, information on sales or revenue is specifically important mainly for management purposes (Dergård, 2006; Lundell, 2005; Hansen, 2005; Collier, 2005). Throughout the interviews carried out in the two parts of this study, respondents repeatedly referred to the importance of information on sales regarding statutory financial reporting. Further, respondents representing all groups of actors within the reporting environment included in this study emphasized the importance of growth in sales in specific in relation to entrepreneurial SMEs.

Several of the accounting experts mentioned information about sales/revenue as input to the calculation of financial ratios in general, and all accounting experts considered financial ratios measuring various aspects of growth to be essential information in entrepreneurial contexts. The managers interviewed in the second part of the study emphasized growth in relation to sales. In the manufacturing company, growth in sales was one of the most important pieces of information to be included in the financial reports, although numbers in percentage had to be calculated from the four-year historical account of net sales by the users themselves. In the cloud computing services company, sales growth was the most important information to show in the financial reports – in figures\(^\text{67}\) but also with supplementing texts describing what was going on in the company that could create further growth. The respondent representing the consulting company discussed the importance of showing that the growth had been organic with no external finance, as this said a lot about the success of the business.

Further, both venture capitalists interviewed for this study emphasized information on growth to be of specific importance in the companies they invest in. According to the venture capitalist who also invests in companies that have moved a bit further in their expansion, the first issue that is checked in the financial reports of a company being considered for investment is that the company grows in terms of sales. Sales growth is further of significance when an exit comes closer in time since potential investors as input to the evaluation of the acquisition price. The bankers interviewed for the study discussed sales in relation to net income and budgets. With respect to growth they referred to the complexity for the credit analysis that follows on the growth of the entrepreneurial company rather than the importance of numbers of growth in

\(^{66}\) In Section 8.3, the empirical data of this study will be further discussed in relation to the fundamental principles of the two objectives.

\(^{67}\) In the directors’ report growth in sales and net income is illustrated in a five-year summary graph.
itself. Accordingly, the bankers’ approach differed from that of managers and venture capitalists. However, this difference should be seen in the light of the role of the bank, which is to provide finance for operations at a risk-adjusted and more secure return, rather than risk capital.

As a matter of course, information on sales or revenue becomes important in any business organization. In this study, the focus is on entrepreneurial entities with growth aspirations. The emphasis by respondents on financial reporting information on growth in relation to sales, rather than growth in net income or profitability, can be paralleled with studies within the entrepreneurship literature showing that sales is the most common indicator of growth among entrepreneurs themselves (Barkham, Gudgin, Hart & Hanvey, 1996; Davidsson & Wiklund, 2000).

8.2.2 Information on cash flows

Previous empirical studies show the importance of cash flow information for management purposes in entrepreneurial entities (Sexton et al, 1997; Hansen, 2005; Dergård, 2006), and in the form of voluntary disclosure to external users (Collier, 2005; Lundell, 2005). During the interviews conducted within the two parts of this study, respondents repeatedly and without exception referred to the importance of information on cash flows with respect to entrepreneurial and growth-oriented SMEs. Several of the accounting experts interviewed for this study held cash flow as the most important item of information that should be, and often is, included in the financial reports of entrepreneurial entities. Among the arguments was the continuous demand for financial capital in entrepreneurial entities. Also, in situations when intangible values are not sufficiently reflected in the balance sheet, which is often the case in entrepreneurial entities, cash flow statements will provide information needed in estimating the prospects of the business. Accounting experts also suggested that cash flow statements should be mandatory for all companies irrespective of size. This view was also put forward by most respondents commenting on the question of mandatory cash flow statements in the draft IFRS for SMEs.

The managers interviewed for the second part of the study considered cash flow information to be important for management purposes. With reference to

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68 Regarding the document study of the K2 drafts, it should be noted that the drafts did not include a requirement to prepare cash flow statements, and neither did respondents comment on information related to cash flow.

69 The Swedish accounting standard K2 does not require cash flow statements to be disclosed to the financial reports of smaller limited companies. In the accounting standard for larger, non-public entities, K3, the Swedish standard setter Bokföringsnämnden follows the IFRS for SMEs when including a requirement for cash flow statements. Smaller entities belonging to size category K2, but voluntarily choose to apply K3, are however excluded from the K3 requirement of cash flow statements.
statutory financial reports, the CFO of the manufacturing company expressed the importance of complementing the income statement and balance sheet with a cash flow statement, not least in light of the continuous extensive investments in fixed assets. The respondent further discussed the importance of illustrating available funds such as the overdraft facility of the check account. Information on cash flows was also one of the most important pieces of information for internal control in the manufacturing company. At the time of the interview with the CFO of the search consultancy company, they were about to disclose their first cash flow statement to their financial reports because of the voluntary inclusion of group accounts. The respondent emphasized the importance of keeping track of liquidity for management purposes, not least considering that salaries were fixed costs. The CEO of the company offering cloud computing services was not familiar with the importance of cash flow statements to external users. Nevertheless, cash flow statements were included in the voluntary quarterly reports provided to shareholders. Further, the monthly income statement prepared for management purposes started out from cash flow numbers. In the company’s 2012 financial report reviewed for this study reference was made to the accuracy of liquidity forecasts and, hence, the limited liquidity risks, that follows on revenues being based on customers’ subscriptions and most of the costs being related to personnel.

The venture capitalists interviewed for this study strongly emphasized the importance of cash flow information both when investing in a new company and during the investment. The respondent representing the firm investing in start-ups and smaller entities, stated that most of the companies invested in shows negative cash flows from operations in the first few years of business, and in these cases keeping track of in- and out flows is of tremendous importance and the cash flow calculation the be-all and end-all. The respondent representing the firm investing in companies in various stages of development, emphasized cash flow as “of greater importance than anything else”. When a company grows the need for financial capital grows as well, and in order to be able to grow without bringing in new external money, it is significant to keep a strict check on cash flows.

The bankers interviewed for this study considered cash flow information to be tremendously important and critical both in the process of credit assessments of new customers and in the follow-up of running credits. As put forward by two of the bankers, keeping inadequate track of liquidity is the most common reason for failure among entrepreneurial and growth-oriented SMEs. However, they stated, entities that has been in business for a while are in general highly professional and aware of the importance of keeping track of cash flows. The bankers constructed their own cash flow calculations in general, dividing the different items into cash flow from operations, investments and finance, in a similar way as the model prescribed by accounting regulation. The respondents representing venture capitalists and banks emphasized future-oriented cash
flow information to be of specific importance with respect to entrepreneurial and growth-oriented entities.

8.2.2.1 Cash flow information and the overall objectives of financial reporting

When considering decision-usefulness as the fundamental purpose of financial reporting, there is no question about the significance of cash flow information since the aim of the reports according to this approach is to be helpful to users in predicting future cash flows (c.f. Zeff, 2013; Scott, 2015). Indeed, the importance of future-oriented information on cash flows was articulated by respondents from all groups of actors included in this study. However, as put forward by one of the respondents representing the group of accounting experts, to include this information in the public reports is a delicate issue for reasons of confidentiality (c.f. Ijiri, 1983, on protecting privacy).

In the reporting entities and also among the venture capitalists and bankers interviewed for this study, information on cash flows was to a large extent communicated by other means than financial reports. Even though it was only one of the managers who clearly expressed the importance of including information on cash flows in the financial reports, all three companies provided stakeholders with additional information on cash flows. In the manufacturing company, institutional investors received management reports with more detailed information on cash flows, with the different components broken down into more components, than what was the case in the public reports – in retrospect as well as in comparison with the budget. In the consulting company, where all shareholders were employed by the company with continuous access to management reports, liquidity budgets were used extensively. In the company offering cloud computing services, which prepared their financial reports according to full IFRS, information on cash flows was included in the voluntary quarterly reports provided to shareholders.

All respondents representing venture capitalists and bankers emphasized that the historical statements of cash flow do not provide sufficient information to the future-oriented assessments that are particularly critical in relation to entrepreneurial and growth-oriented companies. To be able to make decisions for the future, historic statements of cash flow must be supplemented by budgets and forecasts (c.f. Collin, Umans, Lindqvist & Tjörnebrant, 2019). Accordingly, cash flow information was considered highly useful in making assessments for the future but was in this respect received by other means than financial reports.

From the perspective of stewardship/accountability, reliability of measurement is of specific importance. Ijiri (1975) argued for a measurement system that gave little room for dispute between an accountor (the reporting entity) and the accountee (the user). He used the concept ‘hardness’ of measure as an expression of a measure which left limited room for dispute, with cash balance as an example of a hard measure. Several respondents representing the
different groups included in this study connected the importance of cash flow with aspects of reliability. Respondents representing accounting experts used the term “hard facts” with reference to cash flow information. As stated by one of the auditors interviewed, in evaluating a company in its early development or in the early phase of a development project, cash flow provides with “hard facts” of the prospects of the business; however gorgeous a business plan may be, cash flow is what first of all shows what is actually happening and how the business is getting along. Furthermore, one of the venture capitalists clearly expressed the connection between cash flow information and a wish for prudent values and caution. For internal purposes, calculations of earnings converted to cash made up important measures that provided more prudent values as compared to calculations based on the figures in the financial reports. According to the respondent, the focus on cash was in this respect “a manifestation of caution”.

Further, many of the comments by respondents on cash flow centered on the importance of keeping track of cash flow to secure available funds and not to run out of liquidity. Even though these comments are more related to caution of management than caution in accounting measurement, they anyhow illustrate the importance of information on cash flow, and not only for the future. As expressed by one of the accounting experts, the cash flow statement very clearly illustrates potential difficulties of an entity that is growing too quickly. Another accounting expert put forward the importance of cash flow statements in answering questions of whether inflows of cash have been generated by the sales of a company’s products, or if continuous deficits from operations have been financed by contributions by capital providers or by selling off assets.

8.2.3 Information on intangible assets

In Blomkvist’s (2008) pilot study, four of the five interviewed entrepreneurs said that the transactions that received the most of their attention in the construction of financial reports were investments in intangible assets. The respondents’ attention was centered on whether the investments should be capitalized as assets or not, and the consequences of the different alternatives. In line with Blomkvist (2008), the accounting experts interviewed for this study considered information on intangible investments to be of specific importance with respect to entrepreneurial SMEs. However, besides the legal aspect of writing off expenses for intangible investments to profit, which was considered critical to the very survival of entrepreneurial entities, the predominant view among the respondents was that disclosed information on intangible investments, in narrative form and/or in figures, makes up a fully conceivable alternative to capitalization.

In the document study of the comment letters to the K2 drafts, all comment letters that were sorted out as relevant for this study aimed at the suggested prohibition to recognize expenses for internally generated intangibles as assets. In the great majority of the comment letters attending to this issue, the suggested prohibition was criticized. Among the frequent arguments was the risk that too
many development intensive companies would be compelled to set up a balance sheet for liquidation purposes with the subsequent risk of bankruptcy. As a consequence, they argued, reporting entities will take measures to avoid writing off expenses for intangible investments, with increased administrative costs. An example of such strategies is the compliance with a more complex regulation (K3) or the restructuring of development projects. Several of the respondents to the K2 drafts also believed that the suggested regulation of internally generated intangible assets will lead to the provision of less relevant information to users of SMEs financial reports, and the restraining effect upon the development of new innovations. Such an effect was not only considered to bring about severe consequences for the individual companies following the K2 regulation but for the development of the economy as a whole as well.\(^7^0\)

In the three entrepreneurial companies included in this study, intangibles made up the most valued resources. All three companies had chosen a “higher” accounting regulation than “their” current K2 size, the main reason being the ambition for continuing growth, i.e. the possibility to recognize expenses for intangible investments as assets was not critical to this choice, which was also in line with the view put forward by respondents representing accounting experts. In none of the three companies has capitalizing expenses for intangibles been critical for reasons of maintaining equity capital, neither in order to attract financiers. Even so, the importance denoted to the capitalization of expenses for intangible investments as assets and/or disclosing additional information on intangibles, varied in the companies.

The CFO of the manufacturing company did not consider a prohibition to capitalize investments in internally generated intangible resources to be critical considering the position of the company today. Even though the company was not exposed to any competition to talk of, they still used their discretion not to reveal too much information. While intangibles made up the very foundation of the company there were just a few phrases in the directors’ report attending to the continuous work with developing the company’s techniques and products.

\(^7^0\) While the two K2 drafts prohibit capitalization of investments in internally generated resources, the draft *IFRS for SMEs* is less restrictive in that it includes an option for reporting entities to choose either to capitalize or to expense such investments as costs when incurred. There are relatively few comments on this option – only 9.5 percent of the total of 148 comment letters includes a comment on this issue – but most of the respondents (13/14) commenting on this issue provides support for the capitalization/expense option. In all that, in the published final version of the *IFRS for SMEs* of July 2009 the IASB has taken away the possibility to capitalize development costs even if the recognition and measurement criteria of ‘IAS 38 Intangible assets’ are met (IASB, 2009). In other words, by the prohibition to capitalize not only expenses for research but development costs as well, the *IFRS for SMEs* is in its final version more restrictive than the IAS 38. With this fact by hand, one might wonder whether the responses to the draft *IFRS for SMEs* would have been different if respondents would have known about the decision the IASB was about to make in this respect?
The CEO of the cloud computing services company referred to information on intangible assets as tremendously important. This was also reflected in the company’s financial report where capitalized expenses for development made up nearly 50 percent of the total capital. Even though the company had not been in a situation where capitalization had been critical to avoid a capital deficit, the interviewed CEO considered it important to demonstrate to stakeholders that the assets existed and would do so for many years to come. This was also illustrated in the financial reports, which included comprehensive texts describing the intangible values of the company, such as relations with customers and business partners, organization and structure, and research and development.

In the consultancy company, all expenses for intangible investments were charged directly to the income statement. According to the interviewed CFO the reasoning was to show “correct and true values” and to avoid “building castles in the air”. Even though there were no intangible assets on the company’s balance sheet, the director’s report attended to intangible values to a great extent. Among the intangibles described was the company’s focus on customer benefits, marketing activities and collaborations with universities. Further, even if most of the technologies used by the company had been developed by their partners, they continuously worked with developing their own frameworks and components, which was also described in the report.

According to the venture capitalists interviewed for this study, to capitalize expenses for intangibles as assets or not was in general not a crucial issue in the companies they were engaged in. A company’s possession of the property and its quality was more important than their accounting treatment. Even so, one of the respondents considered it relevant and correct to capitalize intangible investments since this would show what a company had invested in. The respondent also noted that capitalization can be critical to companies that risk ending up in a liquidation situation. With respect to the prohibition in K2 to capitalize investments in intangibles the respondent considered the possibility to choose a “higher” accounting regulation as an opportunity rather than a problem.

With respect to the differences between K2 and K3 concerning capitalization of internally generated intangibles, one of the venture capitalists emphasized that capitalization of intangibles is not critical when they are engaged in a company, since the main focus is on cash flows rather than periodized transactions. The respondent also expressed caution with respect to the amount to be capitalized, as it is “easy to deceive oneself”. For this reason, earnings were calculated on cash basis to get lower and more prudent values. The issue of capitalization was neither a critical issue when an investment got closer in time to an exit, since investors estimate the value of the company from growth and from EBITDA.

The bankers interviewed for this study saw the presence of intangibles in companies’ balance sheets, and to estimate the actual value of such assets, as rendering the credit evaluation process more difficult. The respondents emphasized the importance of questioning the reasons for capitalization, for ensuring that it was not a way of dealing with a capital deficit. In relation to this,
one of the bankers believed that the restriction of accounting regulation was not a problem, but rather the opposite. Another respondent expressed that he was not as sceptical towards capitalization in companies that were not new customers to the bank and when the bank was familiar with their business activities and intangible assets.

Even though capitalized intangibles increase the risk that the bank’s credit analysis ends up incorrect, one of the respondents directed severe criticism towards the regulator that he believed was “disobliging towards thoughts and ideas” when restricting the possibilities to capitalize investments in internally generated intangible resources. In this respect the respondent talked of the “creative” ways that companies used to get around this restriction of regulation by adding expenses for intangibles to the work-in-progress item of the balance sheet.

8.2.3.1 Information on intangibles and the overall purpose of financial reports

When a company invests in intangible resources, there is generally a gap between the time of expenditure and the economic benefits arising from the investment, which calls for their capitalization as assets. In all that, there has been a great concern among standard setters for the difficulties involved in making reliable measurements of investments in intangible assets – not least with respect to internally generated intangibles – leading to the development of a restrictive regulation in this area. If decision-usefulness is assumed as the overall objective of financial reporting, we would expect information on intangibles to be useful to users. In addition to numerical values, which are needed to appreciate the future performance in terms of cash flows, users may also be aided by additional disclosed information as a complement to the capitalized amount (c.f. Scott, 2015, on disclosures for the sake of improving the decision-usefulness of financial reports). The suggestions in the literature of the consequences of a restrictive regulation concerning intangible assets, where large and/or public companies generally are in focus, generally seem to be deduced from a decision-usefulness perspective of financial reporting. These suggestions include the insufficient quality of financial reports (Artsberg & Yström, 2002), financial reports that are less informative to users (e.g. Cañibano, García-Ayuso et al., 2000), the undervaluation of intangible-intensive enterprises (Lev, 2001; Lev, Sarath & Sougiannis, in Lev, 2001), and the inefficient allocation of investors’ capital (Lev, 2001). The suggestions of supplementing the financial reports by voluntary disclosures on intangible resources, in order to compensate for restrictions in terms of capitalization, would also be deduced from a decision-useful perspective. From the perspective of stewardship, however, users would be interested in how well the intangible resources held by the company have been managed. Information on the management’s performance in intangible investments would provide input to the overall evaluation of management of
resource use. Further, the capitalization of expenses for intangible resources would be dependent on its reliable measurement. Also, as the stewardship perspective takes into consideration not only the information needs of the users, but also the right of the reporting entity to protect privacy (Ijiri, 1983), disclosures would be seen in the light of the risk of revealing trade secrets, as intangibles are about the future.

In this study the focus is on SMEs that have been successful in seizing new business opportunities, by their engagement in development projects and exploitation of new product areas and markets. The consequence of their achievement is growth, and this growth is organic. Accordingly, intangible resources become significant as per its definition for the entities in focus in this study, not only in retrospect but also in their efforts to stay innovative and competitive in the future.

Suggestions by respondents representing accounting experts, to disclose information not only in text but also in figures when accounting regulation restricts capitalization would from a decision usefulness perspective be interpreted as a measure to achieve more decision-useful financial reports (c.f. Scott, 2015). Still, when it comes to expected future development, respondents called for general descriptions and collected earning capacity not to reveal business secrets to competitors. This desire to protect privacy of the reporting entity, even though users would certainly be helped by more specific information, is one of the fundamentals of the stewardship/accountability approach to financial reporting. In the entrepreneurial SMEs included in this study the views put forward diverged. The CEO of the cloud computing company applying full IFRS with potential investors in mind contended that it was “tremendously important with information on intangible investments”, “to demonstrate to the world around that the company holds the assets.”

In the manufacturing company, the choice was made to disclose as little as possible in excess of the regulatory demands; no details concerning capitalized intangibles were provided in the public report and activities related to research and development were expressed in general terms in the director’s report. While intangibles were the very foundation of the business, there was still little discussion in the company about the accounting for these assets. With respect to accounting numbers, the focus was rather on growth and cash flow (i.e., performance measures) than the accounting for intangibles.

In the search consultancy company, all expenses for intangibles were charged directly to net income in order to show “correct and true values” and avoid “building castles in the air”. This statement by the company CFO appears to be more related to the concepts of reliability and Ijiri’s (1975) “hardness of data”, or Whittington’s (2008a) call for prudence, than providing information that is helpful to users in predicting future economic benefits. Even though the director’s report was dominated by descriptions related to intangible values, these were largely concerned with the company’s position at the present time being, (leading/leading-edge competencies within search technologies and related
disciplines), and what had been achieved during the financial year including the new international market establishments. The descriptions related to the future (collaborations with universities and the research study conducted to be able to follow trends and changes in the environment) and the company’s view of future prospects were expressed in general terms.

Respondents to the K2 drafts suggested that the prohibition to capitalize internally generated intangible assets would lead to less relevant information in the processes of credit rating and credit decisions, as well as difficulties for innovation and development intensive companies to raise risk capital. The results of the interviews with the venture capitalists and bankers interviewed for this study are not in accordance. According to the venture capitalists, capitalization was not critical when investing in a new company or during investments, neither at exit. What is significant is the possession of the property and its quality, rather than how it is accounted for. As suggested by one of the respondents, when considering a new company for investment the venture capitalist often requests assistance from engineers with expert knowledge in the specific area. Still, even if it turns out that an asset is technically good, judging the commercial value, which seldom is in parity with the value in the balance sheet, adds to the complexity of the evaluation process. These statements further illustrates the importance given to reliable measures by venture capitalists, both during investment and at exit.

Accordingly, the results of the interviews with venture capitalists and bankers, who represents external users in this study, point in a direction where financial reporting information on intangible investments is not critical to their decision-processes. According to respondents, it is not the financial reports that provide the information needed on intangibles, but rather the informal information received besides the official reports, including face-to-face meetings.

### 8.3 Overall objectives of financial reporting: Decision usefulness and/or stewardship/accountability?

In Chapter 2 of this thesis, the objectives of decision-usefulness and accountability/stewardship were discussed, and the major differences between them identified. According to the decision-usefulness perspective the aim of financial reporting is to provide users with information that is helpful in making economic decisions. Information is decision-useful when it helps users in assessing the future cash flows of the reporting entity. In contrast, from a stewardship/accountability perspective the aim of financial reporting is to provide information on the accountability of management of resource use.
Hence, from this perspective information on past transactions and events becomes particularly important.

From a decision-usefulness perspective, users and users’ information needs are in focus, implicating that more information is always preferred to less (Ijiri, 1975 & 1983), as long as the benefits to users are not outweighed by the cost of producing the information (Ijiri, 1975 & 1983; IASB 2015). Current and prospective investors and creditors are reference users and relevant information is information that helps them assess the future cash flows of the reporting entity. In contrast, from a stewardship/accountability perspective the relationship between the reporting entity and the users is of central importance. The relationship is interactive (Ijiri, 1975 & 1983; Whittington, 2008a & 2008b; Lennard, 2007); not only are the information needs of users important to this relation but also the perspective and rights of the reporting entity.

Depending on which of the two objectives that are in focus, different qualitative criteria will be emphasized. From a decision-usefulness perspective, relevance to economic decisions becomes central. Information is relevant when it helps users to predict future cash flows. To the evaluation of management of resource use, on the other hand, reliability of measurement becomes an essential characteristic of financial reporting.

In the following the results of the different steps of data collection of this study are discussed in relation to the fundamental principles of the decision-usefulness approach and stewardship/accountability control respectively.

8.3.1 Decisions for the future vs control of management of resource-use: Future-oriented or historic information?

According to the decision-usefulness perspective, the relevance of financial reporting of past or current performance to the investor’s predictions for the future is based on decision theory and the probabilistic relationship between the past and the future (Scott, 2015). The importance of future-oriented information has been emphasized by respondents throughout the different steps of data collection of this study. Even though respondents were not questioned specifically about the predictive capability of financial reports, the limitations of financial reporting in this respect appeared all the clearer during the interviews carried out for the second part of the study.

The accounting experts interviewed for the first part of the study considered financial reporting to be of high importance in the process of acquiring financial capital to secure continuous growth, and by two of the respondents representing standard setters the wording “extremely important” was used. With reference to future-oriented information, several of the accounting experts considered additional disclosed information to be of high relevance to users of entrepreneurial SMEs’ financial reports in specific, on the reasoning that these entities tend to rely on intangible resources to a high extent (c.f. Zimmerman,
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2015; Acs & Audretsch, 2003). Financial reports of entrepreneurial entities not only considered to insufficiently reflect the future earning capacity of individual research and development projects, but also to pay too little attention to expectations in terms of the future collective earning capacity of ongoing projects. Besides disclosure of additional information on individual intangible projects, several respondents therefore also argued for the importance of disclosing more general narrative information related to the business concept of the reporting entity. In all that, one of the respondents emphasized the importance of descriptions in broad outline not to reveal business secrets.

With respect to the interviews with managers of entrepreneurial SMEs carried out within the second part of the study, shareholders were to a great extent engaged in their companies’ businesses, as management, board members and/or as shareholding employees. In this role shareholders had access to additional information in terms of management reports, including budgets/prognoses and their follow-up. The manufacturing company disclosed as little information as possible in addition to what the accounting regulation requires, and the director’s report referred briefly and in general terms to the prospects of the business, in terms of growth ambitions and the continuous development of products. In the consultancy company, the director’s reports, which was dominated by intangible values, mainly referred to the company’s position at the present time being, achievements during the financial year and the company’s view of future prospects expressed in general terms.

The approach to financial reporting in the cloud computing services company deviated from the other two by their voluntary adoption of full IFRS and extensive disclosures relating to future prospects. Among other things, it was in the publicly available financial report referred not only to the current market but also to the company’s plans to expand on other markets, with details about compositions of potential markets. Although the CEO did not expressively refer to users’ decisions, the company’s attitude towards disclosures, not just about the current position but with reference to the future as well, can be understood as a way of making the reports more decision-useful. Further argument for such an interpretation is provided by the CEO’s reference to the need for different versions of the report that would follow on a more restrictive and cautious attitude towards publicly available disclosures. Further, the additional disclosures relating to growth, in numbers and in text, with reference to the current position as well as the potential for future expansion, on the reasoning that this was what investors “want to see”, can also be seen as an effort made to make the reports more useful to users in making decisions for the future.

The bankers interviewed for this study emphasized that financial reports make up an important tool in the process of credit assessment, but that they are only a part of the basis for forming their judgement. Even though the reports provide the significant historical perspective, they are not sufficient to the future-oriented credit evaluation process, mainly because of the time delay and the focus on the past. If the credit evaluation is future-oriented in general, this is even more
the case when it comes to entrepreneurial and growth-oriented SMEs. Other aspects such as the qualities of the leader of the business and the business concept are at least as important as accounting numbers in evaluating entrepreneurial entities for credits. With respect to financial numbers, financial reports for parts of the year, budgets and prognoses are considered as important as the annual financial reports.

The venture capitalists interviewed for this study also emphasized the importance of future-oriented information, both when they are about to invest in a new company and during investment. The respondent representing the venture capitalist firm that generally entered new companies in their initial stage of development generally gives little attention to the (if yet existing) formal financial reports besides a “skimming through”. What is more important is the innovation built into a company’s product and the underlying cost estimation. According to the respondent representing the firm that invests in companies at different stages of expansion, the greatest focus when considering a new company for investment is on qualitative information related to market conditions and potential, technologies, patents and individuals. In this context the financial reports make up a historical account that do not get much attention besides a general check-up. As expressed by the respondent, it is not the content of the financial reports that is decisive to the choice of investing in a new company.

Even though the venture capitalists interviewed for this study do not make use of financial reports to any larger extent when they are about to invest in a new company, the content of the reports is according to one of the venture capitalists in focus in another sense when an exit comes closer in time. The effort made in ”dressing the bride”, to “make the accounting look nice”, seems to be based on the view that the potential investor is different from themselves, to the extent that is assumed that this potential investor will see potential of the business from the financial numbers and pay a higher price for the shares. In all that, the financial reporting numbers that the share price is calculated from are based on past performance. Also, as put forward by the venture capitalist investing in companies at earlier stages of development, an extra effort is in general only made on the formulations in the director’s report when there is something extraordinary that needs to be explained.

As the discussion in this section up till now illustrates, respondents of all groups of actors included in this study put forward the limitations of (general-purpose) financial reporting in providing the future-oriented perspective that is of significant in relation to growth-oriented and entrepreneurial entities. To come to terms with these limitations, accounting experts interviewed for this study argued for the importance of additional disclosures not only regarding research and development projects but also on aspects related to business concepts, the technology of products and information about the market. As shown by the results of the second part of the study, including interviews with managers, venture capitalists and bankers, information on future-oriented information
seems to be provided in addition and besides the statutory financial reports to a large extent.

Although financial reporting was not considered to provide the future-oriented perspective that respondents emphasized as significant in relation to entrepreneurial and growth-oriented entities, respondents of all groups of actors included in this study referred to the confirmatory value of financial reporting. Contrary to management accounting information, the confirmatory value of financial reporting was as suggested by respondents reinforced by regulation and by the audit. As highlighted by one of the standard setters interviewed in the first part of the study, following on Swedish company law it is the statutory financial reports that provide the information needed in order to keep track of and maintaining equity capital. The importance of keeping track of the balance sheet in order to avoid equity capital deficits was also put forward by respondents representing bankers and venture capitalist. As put forward by both accounting experts, venture capitalists and bankers, the extent to which entrepreneurial companies rely on intangible resources, which are generally not recognized as assets, makes it even more important to keep track of the balance sheet of these entities in specific. All in all, the view put forward by the respondents of this study regarding the confirmatory value of financial reporting in general, and the importance of keeping track of capital retention in specific, is more in line with the control perspective of stewardship/accountability than with decision-usefulness.\textsuperscript{71}

8.3.2 Focus on users’ information needs vs the relationship between users and the reporting entity

While the decision-usefulness approach to financial reporting mainly focuses on users and users’ information needs, the relationship between the reporting entity and the user is central to the stewardship/accountability perspective (Ijiri, 1975 & 1983; Whittington, 2008a & 2008b; Lennard, 2007), taking into consideration not only the information needs of users but also the perspective and rights of the reporting entity (Ijiri, 1975, 1983). From the perspective of stewardship/accountability, present shareholders have by tradition a specific status among users in their role of proprietors of the business.

Ijiri argued for an accounting system mainly aimed at making possible “a fair system of information flow” between the parties within an accountability relationship. In Ijiri’s view, a system departing from accountability relationships holds the reporting entity’s right to protect their privacy as equally important as the information needs of users. While the accounting experts interviewed for this study’s first part suggested additional disclosed information on future-related aspects to be of specific importance with respect to entrepreneurial SMEs, it was

\textsuperscript{71} The relation between this finding and what should be attended to by standard setters is however not straightforward.
also noted by one of the respondents that the descriptions should be in broad outline not to reveal business secrets. However, the interviews with the managers of entrepreneurial SME in the second part of the study, together with the reviews of their entities’ financial reports, show that they to various extent used their discretion not to disclose information that may be harmful to the reporting entity even though users might benefit from the information. All three companies provided users with additional information besides the publicly available reports. In the manufacturing company, financial reports were kept as simple as possible but with all contents required by accounting regulation. Although there was a belief that external users would like more information especially on future-oriented aspects, the company used its discretion on the reasoning of not revealing too much information in the publicly available reports. Additional information including budgets was then provided to owners and to the bank. Institutional investors held a specific position among owners, with access to more informal and detailed management reports. The bank was also provided with internal management information, which was voluntary, although not as detailed and frequent as the reports provided to institutional investors. The CFO of the search consulting company contended that the company’s financial report complies with accounting regulation with limited information in addition to the legal requirements. Still, the director’s report described resources and values not reflected in the financial numbers, such as ongoing development projects and prospects and goals for the future. The interviewed CFO referred to these descriptions as a consequence of the company’s focus on building relationships. According to the CFO, the company was proud of their success and “wanted to tell” their related parties what they had accomplished. The reasoning was further that they didn’t want “someone to read [the directors’ report] and think that [they were] just an ordinary consulting company”. From these statements it appears to have been a greater concern in the company of making a certain impression and maintaining relationships than providing information that increases the decision-usefulness of the information provided by the financial statements.

The financial report of the cloud computing services company applying full IFRS included comprehensive texts about future prospects. As suggested in section 8.3.1 above, this reporting strategy can be understood as a measure taken to increase the relevance of the financial reports to users’ decisions for the future. At the same time, the references by the company CEO to the importance of keeping the publicly available reports in order and of high quality, to signal to investors that they can manage higher demands of reporting and “to impress” and “get respect”, illustrate a desire to communicate the responsibility and honesty of management (c.f. O’Connell, 2007; Zeff, 2013) and the “compliance with established rules” (Ijiri, 1983). In this way, the CEO of the cloud computing services company seems to express a desire to demonstrate stewardship.

When considering investing in a new company, the venture capitalists interviewed for this study stressed the importance of other documentation than financial reports, that to a great extent was provided by the company itself. After
initial investment, the venture capitalists are generally engaged as board members with access to internal management information and the financial reports get limited attention except for keeping track of the balance sheet. Even when not engaged as board members the venture capitalists in general have access to additional information in excess of formal financial reports or are able to keep themselves updated on what is happening in the company through observer rights. With respect to the content of the financial reports, one of the venture capitalists stressed that even if the products of the companies invested in are unique, they are careful not to disclose too much information to competitors.

To bankers, the historical perspective of financial reports makes additional information critical in their assessments of new credit requests and follow-up of running credits (Section 8.1.1 above). Some of this information was received by customers, such as financial reports for parts of the year, budgets, prognoses, and business plans. Other information was in general produced by the bankers themselves, such as cash flow statements and budgets, and ratios. In addition to documentary information, bankers were also informed during personal meetings discussing planned projects and during visits. According to one of the bankers, these face-to-face meetings become more frequent the faster an entity grow. As suggested by another banker, the meetings and dialogues with customers aim at building mutual trust. The importance of good relationships between the bank and its customers was emphasized by all three bankers interviewed. Even though the bankers mainly referred to the importance of the individual qualities of the leader of the business in building trust and mutual confidence, the trustworthiness of financial reports were also attended to. References by bankers to financial reporting as a “hygiene factor” that “has to be there”, a significant “point of departure”, and that they “look at financial reports, meet and talk about the future”, are examples of expressions showing that well-managed accounts and reports are prerequisites for a fruitful conversation to take place between the bank and a customer. In this respect respondents’ statements clearly connect to Ijiri’s theorizing of accountability as a tool for building trust. Further, following on a financial reporting system based on accountability is that the accounts become useful even when they are not used (Ijiri, 1975; Lennard, 2007; Lambert, 2001). The respondents’ views on financial reporting information in relation to conversations for building relationships also point in a direction close to Lennard’s (2007) proposition that financial reporting from a stewardship perspective makes up the foundation for a constructive dialogue between the reporting entity and users. In this way, Lennard contends, financial reporting is useful to both parties even if all they do is to confirm prior information. The statement by one of the bankers interviewed for this study, that “without financial accounts there will be heavier and harder talks for the entrepreneur”, may be illustrative of the usefulness to both parties in the way suggested by Lennard (2007).

In accounting frameworks giving prominence to the decision-usefulness objective, current and prospective investors and creditors are considered
reference users of financial reports. Proponents of the stewardship/accountability as the main objective of financial reports, on the other hand, argue that existing proprietors – i.e. present shareholders - have a specific status among users, even though it is acknowledged that other groups of stakeholders hold enterprises accountable for their actions as well.

8.3.3 Relevance to economic decisions vs reliability of measurement

From the decision-usefulness perspective, financial reporting fulfills the relevance criterion when it is useful to users in making predictions of future cash flows. According to the stewardship tradition, information on past or current position is crucial to the evaluation of management of resource use. From this perspective, the reliability of measurement becomes an essential qualitative characteristic. In the accounting literature, the importance of reliability is mainly established with reference to the asymmetries of imperfect markets (Whittington, 2010), and the agency aspects of the accountability relationship (Whittington, 2008a; Gjesdal, 1981). Departing from agency theory, the stewardship relationship is considered an agency relationship with the implication that the management and/or board of the reporting entity may have incentives to misrepresent performance, which in turn makes reliable information about past events of highest importance.

If information asymmetries form a natural part of the business environment of companies in general, this is even more the case in the context of entrepreneurship, since the dispersion of information among different market actors is the very reason why entrepreneurial opportunities exist. If markets were complete and information about the existence of business opportunities and the outcome of exploitation were easily accessible without effort, there would be no entrepreneurial profit. To try out new and uncertain products, services and markets involves uncertainty and taking risks. There is a risk that the market does not welcome a new venture idea in a positive way, and there is also the risk of competitors being proactive “get there first”. It is reasonable that the existence of information asymmetries and uncertainty affects not only what principles should guide financial reporting but also the extent and form of the disclosed information. This in turn affects the usefulness of the financial reports and what information needs the reports reasonably can be expected to fulfil.

Neither the accounting experts, nor the managers and other users of entrepreneurial SMEs’ financial reports, were asked about the importance of the qualitative criteria of relevance and reliability. In all that, differences related to these criteria were identified when comparing the results of the interviews with accounting experts conducted within the first part of the study with the interview data of the second part of the study. To start with, the focus by accounting experts on additional disclosure to be included within the financial reports can
be interpreted as a wish to make the reports more complete and, as a consequence, more helpful to users in making decisions based on the information contained in the reports (c.f. Scott, 2015, on increasing decision-usefulness of financial reports by way of additional disclosures). It can also be seen as a manifestation of increasing the reliability of the information contained in the reports (c.f. Scott, 2015). For one thing, several of the interviewed accounting experts requested increased transparency on liabilities, such as terms and structure of loan agreements and outstanding debtors, to be of specific importance in an entrepreneurial context.

The collected result of the interviews of the second part of the study, on the other hand, suggest that there is a need for additional information besides financial reports to be provided to users. Such a reporting strategy was according to the respondents partly induced by reporting entities’ using their discretion not to disclose sensitive information in the official report, and partly because of the insufficiency of financial reports in providing information on future-oriented aspects. Accordingly, the interview data illustrates not only how the reporting entity, or accountor, using Ijiri’s (1983) terminology, protects their privacy, but also importance of ensuring the “accountee’s right to know” (Ijiri, 1983). Hence, if decision-usefulness is the main purpose of financial reports, the information provided by the reports does not seem to be sufficient to its purpose. If the role of financial reports is instead studied through the stewardship lens one might argue for the relevance of the reports, as they provide a yearly control, as suggested by both venture capitalists and managers, and, as suggested by venture capitalists and bankers, an audited document with a quality label.

It has been suggested by proponents of the stewardship perspective to financial reporting that information asymmetries lead to agency problems with the implication of reliability being essential to financial reporting (Whittington, 2008b). However, the presumption of agency theory that managers act in their own self-interest at the expense of shareholders or other stakeholders can be questioned in the entrepreneurial context where harvesting short-term profits certainly would hinder future development and growth. The results of the interviews of the second part of this study provide indications in favour of such an argument. In the companies included in the study there were clear ambitions for further growth. The three companies had been internally financed by retained earnings to a large extent during the years, that is, rather than paying dividends earnings had been reinvested in the business. Also, shareholders were to a great extent engaged in their companies’ businesses, as management, board members and/or as employees. As already noted in Section 8.1.2. the three companies provided their most important users with additional information besides the official financial reports. The venture capitalists interviewed for this study generally become members of the board of the companies they invest in, and in this role, they have access to internal management information.

In this context it seems relevant to pose the question whether the relationship between shareholders and management in the entrepreneurial context has more
in common with the notion of stewardship as expressed in the field of management and organization theory than with the agency-relationship often put forward by accounting scholars in connection to the stewardship objective of financial reporting. Could it be that the element of supervision for the sake of protecting funds flowing from shareholders to managers might not be that critical in the context of entrepreneurial SMEs? Could it be that reliability of financial reporting information is induced by the uncertainty caused by information asymmetries in an uncertain business environment as such, rather than by agency problems caused by information asymmetries between stakeholders and management? If the stewardship theory notion of collectivistic behaviour of managers holds, i.e. if “managers are not motivated by individual goals, but rather are stewards whose motives are aligned with the objective of their [organization/]principals” (Donaldson & Davis, 1989; 1991, in Davis et al., 1997), reliability would be required because of the uncertainty inherent in the conduct of entrepreneurial activities rather than the risk of funds flowing in the direction of individual managers/board members.

In Section 8.3.1 above it is referred to the confirmatory value of financial reports, which makes them an important complement to the management account. This emphasis on the confirmative value of financial reports by respondents of all groups of actors interviewed for this study can be interpreted as an expression of the importance of reliability. Among the expressions used in this respect was a banker’s reference to financial reports as a “quality check” and the reference by managers and venture capitalists to the “yearly control” provided by the reports. The confirmatory value was further attended to by the venture capitalists when emphasizing the importance of keeping the balance sheet under control. To conclude, when decision-usefulness is considered the main objective of financial reporting, and the focus is on users’ information needs, it is reasonable to exclude management from the main user groups of financial reports. From a stewardship/accountability perspective, it is reasonable to expect the historical account and confirmatory quality of financial reports to be of as crucial value to management as to external users (c.f. Ijiri, 1975).

The audit of financial reports was also emphasized by respondents representing all the different groups of actors included in the study. For one thing, as mentioned by the venture capitalists investing in start-ups and companies in their early phases of development, the formal financial reports of the companies invested in are always audited, even in the smallest companies where there is no such requirement. Further, the venture capitalist investing in companies that have moved a bit further in their development pointed out that as board member they always meet the auditor before signing the financial reports. During this meeting the auditor is asked face-to-face whether the assets are correctly valued and whether he or she has made any specific observations that calls for an “unburdening of his [or her] heart”. From the perspective of agency theory, the importance put forward by both venture capitalists of the correctness of the financial reports can on the one hand be interpreted both as a
wish to control the reliability of numbers provided by managers and, hence, their management of resource used (c.f. Miller & Oldroyd, 2018). If departing from the concept of stewardship as used within the disciplines of management and organization, on the other hand, it may be interpreted as a reflection of the venture capitalist’s concern for his own accountability as a board member (c.f. Davis et al., 1997).
9 Conclusions, contributions, and further research

This study is an inquiry into the purposes of use and information needs of users of entrepreneurial SMEs’ financial reporting with the aim of increasing our understanding of what overall objective/s financial reporting can fulfil with respect to this group of entities. The study was conducted in two parts attending to the perspectives of different actors within the financial reporting environment of entrepreneurial SMEs. In the first part, the focus was on actors outside the reporting entities and users, with the main source of empirical data provided by interviews with accounting experts representing standard setters, auditors and academics. The first part also included document studies of comment letters to drafts of accounting standards for SMEs published by national and international standard setters. In the second part of the study the focus was on managers of reporting entities and other users, in this study represented by venture capitalists and bankers. This chapter first presents the overall conclusions of the study by attending to each of the three research questions formulated in the first chapter of the thesis. Thereafter follows a discussion of the contributions of the study and, lastly, some suggestions for further research.

9.1 Conclusions of the study

9.1.1 Users and purposes of use

In entrepreneurial and growth-oriented SMEs, continuous access to financial capital is of utmost importance. In this setting, communication between managers of reporting entities and financiers becomes particularly important. According to the results of the empirical data collected for this study, financial reporting is mainly useful in the communication with external stakeholders, among which financiers hold a specific position.

While accounting experts referred to the importance of bankers among financiers, which is in line with previous studies on SMEs in general, managers and venture capitalists, as well as the bankers themselves, expressed that the main finance in general comes from sources other than bank credit. Because of the restrictions on banks in providing risk capital, a banker’s role is mainly to provide finance for operations. Financial reports provide the important historical perspective which makes up a starting point for bankers in the process of rating, granting, and following up credit.
The entrepreneurial SMEs whose managers were interviewed for this study had been financed by retained profits to a large extent with external financing mainly from their shareholders. Since shareholders were engaged in their company’s business as board members, part of the management, and/or employees, they had access to additional information besides financial reports. Still, the managers interviewed for this study considered shareholders important users of their entity’s financial reports.

When considering a new company for investment, the venture capitalists interviewed for this study looks at financial reports for a general check-up. After initial investment, the venture capitalist is generally represented on the board of director’s with access to additional management information. When an exit comes closer in time, the price of the shares is normally based on the numbers of the financial reports and, therefore, measuring sales, growth and earnings get specific attention.

The accounting literature does not provide a clear picture of the usefulness of financial reporting for the management of a reporting entity. In this study, it was assumed that managers use financial reports to communicate with other stakeholders. The results of the study show that the views held by the managers of the users of financial reports affects the content of the reports. For the internal management of operations, the interviewed managers considered financial reporting information to be of limited utility, which is in line with the what the accounting experts said. However, the confirmatory value of the financial reports made them highly significant for managers as they provided yearly audited confirmations of the information used for internal purposes. The importance of the confirmation provided by audited financial reports was also emphasized by the venture capitalists in their role as board members.

Overall, the results of this study show that financial reporting mainly provides users with a historical perspective and an audited confirmation, which is an important point of departure for their judgments that otherwise largely focus on future-oriented information on qualitative aspects.

### 9.1.2 Information needs of users

In this study, the question of users’ information needs was approached by posing questions related to specific areas or items of financial reporting information. Representatives of the different groups of actors included in this study emphasized information on sales and/or sales growth as particularly important with respect to entrepreneurial SMEs. The focus on sales growth is in line with the suggestion in the entrepreneurship literature that sales is the most common indicator of growth among entrepreneurs themselves (Davidsson & Wiklund, 2000). Respondents further attended to cash flow and intangible resources to a large extent. With respect to cash flow and intangibles, respondents’ views on users’ information needs and also whether the information should be communicated by way of financial reports or by other means varied.
9.1.2.1 Information on cash flows

Information on cash flows was without exception emphasized by respondents representing the different groups of actors included in this study as being of particularly importance with respect to entrepreneurial and growth-oriented SMEs. When a company grows, the need for financial capital grows as well, not only considering the investments needed in order to create this growth, but also since the need of working capital tend to grow concurrently. To be able to grow organically it is critical to keep track both of the sources of financial capital and for what it is used. Accounting experts suggested that cash flow statements should be mandatory for all companies irrespective of their size and direction not least because cash flow information can be easily understood by users. This view was also put forward by most of the respondents commenting on the suggestion of mandatory cash flow statements in the draft IFRS for SMEs.

Representatives of the different groups of actors interviewed for this study emphasized the importance of future-oriented information on cash flows. In the reporting entities as well as among the venture capitalists and bankers interviewed for this study, information on cash flows was to a large extent communicated by means other than financial reports. For the venture capitalists included in this study, information on cash flows was unconditionally one of the most important pieces of information both when investing in a new company and during the investment. The bankers considered cash flow information to be tremendously important and critical in both credit assessments and in follow-up of running credits. In line with the venture capitalists, the bankers also emphasized the importance of future-oriented information on cash flows with respect to entrepreneurial and growth-oriented entities, which was not provided by financial reports.

9.1.2.1 Information on intangible assets

With innovations being a central part of the entrepreneurial process, there is no doubt that intangible resources are critical for entrepreneurial SMEs. Even so, there has been a great concern among standard setters regarding the possibility of measuring the cost of intangible assets reliably. In the Swedish context, the standard setter has eliminated the possibility for smaller limited companies to capitalize expenses for internally generated intangible assets.

Representatives of all groups of actors included in this study emphasized the importance of intangible values in entrepreneurial SMEs. With respect to statutory financial reporting, respondents from different groups of actors attended to the legal aspects of restrictive accounting regulations with expenses for internally generated intangibles charged directly to the income statement and the subsequent risk of equity capital deficits. From an informational perspective, a prominent view among the accounting experts interviewed for the first part of the study, representing standard setters, auditors and academics, was that
disclosed information on intangibles made up a fully conceivable alternative to capitalization.

In none of the three entrepreneurial SMEs included in the second part of the study management considered capitalizing expenses for intangible crucial, neither for reasons of equity capital retention, nor because of a need of additional financial capital. However, the approach to financial reporting on intangibles differed between the companies. In the manufacturing company, there were minimum disclosures on intangibles in order not to reveal too much information in the publicly available reports. In the consultancy company, all expenses for intangibles were charged to the income statement to show correct and true values. Even so, the director’s report was almost exclusively devoted to descriptions of intangible values. In the cloud-computing services company applying full IFRS, information on intangibles both in numbers and in text was highly important, which was reflected in their financial report including comprehensive texts on the company’s intangible resources.

For the venture capitalists interviewed for this study, the greatest focus when assessing a new company for investment was on qualitative and intangible aspects of the business such as market conditions, innovations, technologies and individuals. However, with respect to statutory financial reports, the issue of capitalization and/or disclosure of additional information about intangible assets was in general not critical with respect to the companies invested in and neither was it important when an investment got closer in time to an exit. The interviewed bankers as well emphasized qualitative aspects, mainly with reference to the qualities and capabilities of the managers of the customer companies. Regarding financial reports, however, the presence of intangible assets in companies’ balance sheets and estimating the actual value of such assets makes the credit evaluation process more difficult and increases the risk that the banker’s credit analysis ends up incorrect. The respondents further emphasized the importance of questioning the reasons for recognizing intangible investments as assets since capitalization may be a way of handling a situation where charging expenses directly to the income statement would have led to a capital deficit in the balance sheet.

9.1.3 Overall objective of financial reporting: Decision-usefulness and/or stewardship/accountability?

Just as the decision-usefulness objective of financial reporting has become prominent in the accounting literature and among standard setters, proponents of the traditional view maintain that financial reporting aims at stewardship and accountability. From the decision-usefulness perspective, financial reporting aims at providing information that is helpful to users in predicting future performance of a reporting entity (Scott, 2015; c.f. IASB, 2018). According to the stewardship/accountability perspective, the major focus of financial
reporting is the evaluation of management of resource-use (Mellemvik et al., 1988).

With respect to entrepreneurial and growth-oriented SMEs, which are in focus in this study, the significance of information for assessing future performance is a matter of course. While the accounting experts interviewed for the first part of the study suggested additional disclosures on future-related aspects to be particularly important with respect to this group of entities, evidence from the second part of the study shows the limitations of financial reporting in predicting future performance. To venture capitalists and bankers, financial reports provided yearly control of the performance and financial position of the reporting entity. However, due to the time delay and the historical perspective of financial reports, additional information on financial as well as non-financial aspects of a business is essential for making judgments about future performance. Additional information is partly provided by reporting entities and partly produced by the users themselves. Reporting entities, on their part, use their discretion not to disclose sensitive information and to describe information related to prospects for the future in general terms in the publicly available financial reports. Besides financial reports additional information is provided to the closest related interested parties. Accordingly, the relationships between reporting entities and users are based on a two-way communication, which is a distinguishing character of the interactive relationship proposed by the stewardship/accountability perspective. When additional information is disclosed in the financial report, interviewed managers expressed concerns for making a good impression on stakeholders in a way that illustrates a desire to communicate the responsibility and honesty of management (c.f. O’Connell, 2007; Zeff, 2013) and “the compliance with established rules” (Ijiri, 1983).

The importance of building trust and mutual confidence emphasized by bankers not only in face-to-face meetings but with reference to financial reporting can be paralleled with Ijiri’s (1975, 1983) suggestions of the role of trust in accountability relationships. The financial reports must be there, even though they are not very helpful in assessments of future performance. In this way, the results of the study illustrate how financial reporting can be useful even when the information contained in the reports is not used to any greater extent (c.f. Ijiri, 1975, 1983; Lennard, 2007).

When evaluating the stewardship/accountability of management, reliability of measurement becomes crucial. Representatives of the different groups of actors included in this study referred to the confirmatory value of financial reporting, which was considered to be reinforced by the audit. Further expressions relating to reliability were the references by respondents to the provision of a “quality check” and a “yearly control” offered by financial reporting. Several respondents also emphasized the importance of keeping track of the balance sheet in order to avoid equity capital deficits. Repeated references were also made by respondents to the importance of the “hard” measure of cash flows, not least considering the uncertainty involved in the valuation of intangible investments. With respect to
intangibles in specific respondents suggested information on cash flows to provide straightforward and reliable complementary information which was considered important when assessing a business’ prospect.

In the academic literature, arguments in favour of the reliability of performance measures are generally based on agency theory and the conflicting interests between the management and owners and the risk of funds flowing in the direction of individual managers (Lambert, 2001; Jensen & Meckling, 1976; Eisenhardt, 1989). However, the empirical results of this study indicate that the inherent uncertainties and risks of the entrepreneurial process call for reliable measures. The results of the study further provide tentative suggestions regarding the importance not only of accountability of management but of capital providers as well, which is in line with the pro-organizational and collectivistic behaviours that are central to the theoretical concept of stewardship (Hernandez, 2012; Le Breton-Miller & Miller, 2018) within the disciplines of management and organization.

9.2 Contributions

This study provides insights into the role of financial reporting with respect to entrepreneurial SMEs by posing questions on the purposes of use, information needs of users, and the extent to which users’ information needs are fulfilled by financial reports. By finding answers to these questions the study increases our understanding of what overall objective/s financial reporting can fulfill with respect to this group of entities.

The contemporary discussion on the overall objectives of financial reporting mainly focuses on large and or/publicly listed companies. This study contributes to the discussion by providing insights from the perspective of different actors within the financial reporting environment of entrepreneurial and growth-oriented SMEs. By showing the limitations of entrepreneurial SMEs’ financial reporting in providing information that is useful to users in assessing future performance of the reporting entity, the study’s empirical results challenge the theoretical assumption of decision-usefulness which is based on the probability relationship between the past and the present (c.f. Scott, 2015), with respect to this group of entities. Further, by bringing forward the importance of interactive relationships between reporting entities and users and of building trust and mutual confidence (Ijiri, 1983; Lennard, 2007), the study’s results contribute to the theoretical discussion of the concept of stewardship/accountability within the accounting literature. The importance of the confirmatory role of financial reporting reinforced by reliable measures and the audit brought forward by different actors including managers further contributes to the theoretical discussion of the concepts of stewardship and accountability. The indications provided by this study that it is the inherent uncertainties of the entrepreneurial process that call for reliability of measurement provide nuances to previous
studies of stewardship/accountability which generally depart from the agency theory and the conflicting interests between a principal and an agent (c.f. Jensen & Meckling, 1976).

For the development of sound and purposeful financial reporting standards, for SMEs as well as large and/or publicly held companies, knowledge of what purposes and information needs financial reports can fulfil becomes crucial not least since the financial reporting objectives should be reflected in valuation principles and disclosure requirements. The IFRS for SMEs refers to stewardship as secondary to the decision-usefulness objective. The Swedish K3 standard for privately held companies refers to the usefulness of financial reports to users’ decisions on economic issues, with no further specification of what economic issues the standard setter has in mind. The Swedish K2 standard for smaller limited companies does not state an overall objective of the financial reports prepared according to the standard. Even though the focus on economic decisions in the standards aiming at SMEs is not reflected in the qualitative criteria and principles of measurement to the same extent as in the IASB’s conceptual framework, it is notable that the development of accounting regulations for privately held entities has departed from the accounting regulation aimed at larger and/or publicly held companies to a large extent. A concrete example of this is the IASB’s argument for the Framework as a logical starting point when developing the IFRS for SMEs on the ground that users’ information needs are sufficiently convergent between privately held and publicly held companies (IASB, 2009b). The IASB considered a “fresh start” which could have resulted in different objectives, qualitative criteria, and concepts for recognition and measurement as too costly and time-consuming (IASB, 2009b). In light of this, empirical research on financial reporting objectives with respect to SMEs becomes highly relevant. This study contributes to this discussion by taking the perspectives of different actors within the reporting environment of entrepreneurial SMEs into consideration.

By involving not only managers of entrepreneurial SMEs and other external users of entrepreneurial SMEs’ financial reports, but also actors of the financial reporting environment outside the immediate user groups, including the groups of auditors, standard setters and academics, this study takes into account several different perspectives of actors who have a say in and/or are affected by the accounting regulation for SMEs (c.f. Beaver, 1998). It is important to shed light on the views of different actors not least considering the criticism directed towards standard setters for not anchoring their work with developing the accounting regulation in practice (Ram & Newberry, 2013; Zeff, 2013; Young, 2006). Previous studies further suggest that users tend to engage in the standard setting process to a limited extent (Jorissen et al., 2012). It has also been suggested that there is a knowledge gap between professional accountants and users of financial reports (Jonas & Young, 1998). This study takes into account the

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72 The standard uses the term financial ‘statements’.
9. Conclusions, contributions, and further research

perspectives of several groups of actors not with the intention to compare views in terms of empirical relevance but rather to shed light on overall patterns as well as differences in perspectives, including not only those actors who are continuously engaged in the development of accounting regulation but those who are directly affected by the accounting regulation and, hence, should have a say in its development.

Previous research on the role of SMEs financial reporting is rather limited. This study provides some nuance to the picture provided in the literature which has mainly been centered around on the context and information needs of large and/or listed enterprises. Also, despite the significance of information in the entrepreneurial processes (Venkataraman, 1997), only a few studies explicitly inquire into accounting in an entrepreneurial setting, and even fewer focus on statutory financial reporting information. This study contributes to our understanding of role of financial reporting with respect to entrepreneurial and growth-oriented SMEs. Even though entrepreneurial and growth-oriented SMEs make up a limited group within the SMEs group, the importance of innovative and entrepreneurial entities to the development of the economy at large makes knowledge of the role of financial reporting with respect to this group of entities important as well. Lastly, considering that many contemporary textbooks in accounting give prominence to the decision-usefulness of financial reporting from a capital market perspective, this research may also provide nuances to the picture provided to accounting students.

9.3 Suggestions for further research

The empirical inquiry of this study initially departed from the assumption that financial reports were useful to users in making economic decisions. After an initial analysis and interpretation of the data collected in the second part of the study, further theoretical work on the objectives of financial reporting was called for. This work lead to a shift in focus from users’ information needs with respect to economic decisions to what overall objective entrepreneurial SMEs’ financial reporting can fulfil. Accordingly, during the data collection, the questions posed to the respondents were centered on the situations of use and decision-making purposes of users, without considering the fundamental differences between the objectives of decision-usefulness and stewardship/accountability. If the fundamental differences between the two objectives had been in focus at the outset of the empirical enquiry, the interview questions could have been complemented with questions relating to the fundamentals of the two objectives. For one thing, discussions on stewardship/accountability often depart form agency theory, focusing on conflicting economic interests between a principal and an agent. The agency relationship between the management of an entity and its proprietors gives the former an incentive to misrepresent performance, which is the justification prudence which can enhance reliability (Whittington, 2008a).
During the interviews, questions were not on whether management compensation was based on financial reporting performance measurements, neither did the respondents refer to management compensation as a purpose of use of financial reporting information. If financial reporting is a tool for decisions on management compensation, it is fully possible that this did not come to any of the respondents’ minds when asked open questions about purposes of use. Considering that respondents of the different groups of actors included in the study emphasized the importance of internal finance through retained profits, the absence of references to management compensation by respondents may also be a consequence of a focus on reinvestments of profits for continued development and growth. Hence, a future research project on financial reporting objectives could shed light on this issue.

Further, this study contributes to our understanding of entrepreneurial SMEs’ financial reporting not only by showing the overall patterns of the views held by different actors of the financial reporting environment, but also by elucidating differences in views. In comparison to the interviews with accounting experts in the first part of the study, there was greater variation in the views put forward by respondents in the second part, with the greatest variations between respondents representing entrepreneurial SMEs. This variation can partly be explained by the fact that the views put forward by accounting experts referred to entrepreneurial SMEs in general, while the managers of entrepreneurial SMEs talked about their specific entities. Further, the accounting experts, who represent the groups of auditors, academics and standard setters, were all included in the study not only for their knowledge and expertise, but also from their engagement in the debate on the development of accounting standards for SMEs. This circumstance may very well be explanatory of some of the similarities in views put forward by respondents of the first part of the study. These similarities may also be illustrative of the impact of the articulation of financial reporting objectives by standard setters, in conceptual frameworks and in the accounting literature on the construction (c.f. Denzin & Lincoln, 2005) of the contemporary view of what overall objective financial reporting can fulfil. Irrespective of reason, the patterns provided by the empirical results of this study, provides argument for further inquiry into the perspectives of different actors when discussing roles and consequences of financial reporting.

The results of this study further shed light on an accountability relationship that is different from what is generally assumed in discussions departing from agency theory and its traditional focus on companies with a wider group of shareholders (Rimmel, 2016; Jensen & Meckling, 1976; Eisenhardt, 1989). After investment, the venture capitalists interviewed for this study were generally represented on the company’s board of directors with responsibility for the content of the financial reports. In this way, the venture capitalists represented both the reporting entity and its shareholders/proprietors. While a proprietor not engaged as a director of the board would be interested mainly in the management’s use of entrusted resources, a membership of the board of
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directors would bring about an additional accountability in the sense of a responsibility for the company’s financial reporting. Here a parallel can be drawn with the proposition in the stewardship theory of a principal that is as accountable as the steward (Davis et al, 1997). This is also a phenomenon discussed in relation to governance in the field of family business research (Florin Samuelsson, 2002; Le Breton-Miller & Miller, 2018). In this respect, further empirical research into these dual accountabilities as well as different versions of accountability could contribute both to the accounting literature on financial reporting objectives as well as the concept of stewardship within the disciplines of management and organization.

The three entrepreneurial SMEs included in the second part of the study showed financial stability with no capital shortages. Also, the discussions by venture capitalists have mainly centred around companies that they had invested in, focusing on important information for the investment decision and afterwards. The focus of a possible future study could be on companies in the early stages of development that have not yet reached the level of financial stability of the entrepreneurial SMEs included in this study. Since companies may be innovative and entrepreneurial without reaching Gazelle status and/or without access to venture capital, further research focusing on companies not (yet) as successful could provide a further nuanced picture of the knowledge contributed by this study.

Lastly, given the different approaches to disclosures expressed by the three entrepreneurial companies included in this study, another possible direction for a future research project could be a further study of the reasoning behind disclosure practices by entrepreneurial companies. In this study, the discussions by the interviewed managers of entrepreneurial SMEs related to certain views of users of their entities’ financial reports. In a future research project, an inquiry into managers’ views and actions in this respect could combine interviews with content and textual analyses. In line with the discussion above, such a study could preferably also include the views of other actors within the financial reporting environment of entrepreneurial SMEs.
References


References


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References


References


References


References


Appendices
Appendix 1: Interview questions to accounting experts

1. According to your opinion, who are the main users of SMEs’ financial reports? For SMEs in general and for growth-oriented entrepreneurial SMEs in specific?

2. For what decision-making purposes, or in what situations, do you regard the information contained in SMEs’ financial reports to be of special importance? For SMEs in general and for growth-oriented entrepreneurial SMEs in specific?

3. What kind of financial reporting information (for example what items) do you consider to be of greatest importance for the decision-making purposes, or in the situations, of question 2?

4. Swedish SMEs are according to law required to draw up annual financial reports including a profit and loss account and a balance-sheet. Do you believe that there is another form of disposition that would present the financial information to the users of entrepreneurial SMEs’ financial reports in a better way?

5. If managers or owner/managers of entrepreneurial and growth-oriented SMEs were not required by law to publish financial reporting information in a certain way, what kind of information and in what form would they present this information?
### Appendix 2: Respondents to BFN’s K2 drafts

<table>
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<td>Accounting firm</td>
</tr>
<tr>
<td>Företagarna (2006, 2007)</td>
<td>Trade organization</td>
</tr>
<tr>
<td>Sydsvenska Industri- och Handelskammarens redovisningskommitté (2006)</td>
<td>Trade organization</td>
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<tr>
<td>KPMG (2006, 2007)</td>
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<td>Svenskt Näringsliv (2006)</td>
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<td>Företagsrevision Cederlund/Grabe (2007)</td>
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Appendix 3: Respondents to the draft IFRS for SMEs

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<th>Date</th>
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<td>Chris Nobes</td>
<td>University of Reading</td>
<td>30/03/2007</td>
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<td>CL3</td>
<td>-</td>
<td>&quot;-&quot;</td>
<td>CL3A</td>
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<tr>
<td>CL5</td>
<td>C. Morrill, J. Morrill and K. Shand</td>
<td>University of Manitoba</td>
<td>30/03/2007</td>
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<td>CL6</td>
<td>Christoph Frohlich</td>
<td>Vienna University of Economics and Business Adm.</td>
<td>26/07/2007</td>
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<td>CL7</td>
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<td>Kingston Smith LLP</td>
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<td>CL9</td>
<td>Mr H. J. Schadewitz</td>
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Appendix 4: Interview questions to managers of entrepreneurial SMEs

1. In your opinion, who are the main users of your entity’s financial reports?

2. For what purposes, or in what situations, do you regard the information contained in your entity’s financial reports to be useful to users (including yourself/other internal users)?

3. What kind of financial reporting information (for example what items) do you consider to be of greatest importance to the users of question 1, and for the decision-making purposes or in the situations of question 2?

In addition to the above general question, the respondent was asked questions related to the following items/areas (if not discussed already):

a. Cash flow (statements)
b. Intangible resources
   - Capitalized as assets, and/or
   - Disclosed information
c. Growth and/or other financial ratios
Appendices

Appendix 5: Interview questions to venture capitalists and bankers

1. For what purposes, or in what situations, do you find the information contained in the entrepreneurial SMEs’ financial reports useful?

2. What kind of financial reporting information (for example what items) is of greatest importance to you with respect to the decision-making purposes, or in the situations, of question 2?

In addition to the above general question, the respondent was asked questions related to the following items/areas (if not discussed already):

   a. Cash flow (statements)
   b. Intangible resources
      - Capitalized as assets, and/or
      - Disclosed information
   c. Growth and/or other financial ratios?
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