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**Tobias Svanström
BI Norwegian Business School**

**Håkan Boter
Umeå School of Business and Economics**

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Regional Variation in the SME-Audit Firm Relationship*

Tobias Svanström

BI Norwegian Business School, Norway

Håkan Boter

Umeå School of Business and Economics, Sweden

The purpose of the paper is to examine how the relationship between small and medium sized enterprises (SMEs) and their auditor varies between regions. Auditing literature, regional, and network studies are used to set up hypotheses on differences between rural regions and the metropolitan urban region. Survey data from 421 SMEs are analyzed and findings support that in rural regions, especially those with a strong entrepreneurial culture and tight inter-organizational links, the SME-auditor relationship is to a larger extent trust-based compared to the urban region. In the rural region, the auditor assumes the role as a business support agent providing valuable strategic advice. The SME-auditor relationship is weakest in the urban region where the auditor's role is limited.

Keywords: SME, auditing, audit firm, business support, trust, network, service quality, regional variation

Introduction

It is a well-known fact that regional variation exists in business opportunities and firm performance (Reynolds, Storey, & Westhead, 1994; Audretsch & Lehmann, 2005). However, we investigate whether region also affects the relationship between small and medium sized enterprises (hereafter referred to as SMEs) and one of the region's most frequent service providers. We have chosen to study a relationship that is either mandatory by law or can be entered into on a voluntary basis, namely that with a firm's auditor, which originates from the standardized auditing service that ultimately serves to verify that financial statements do not contain material misstatements. The main purpose of this study is to examine how regions and regional characteristics affect the relationship between a small firm and its auditor (Certified Public Accountant, CPA), and the extent to which perceived service quality, the voluntary demand for auditing and the purchase of non-audit services (hereafter referred to as NAS) varies between regions.

Many companies hire an auditor to conduct an audit of the financial statements. Management may choose auditing in order to fulfill the legal requirements, meet demands from creditors and trade partners, or because they perceive that it adds internal value to the organization. In general, listed firms and firms over a certain threshold are required by law to have an auditor. The Eighth Directive of the European Union requires auditing for larger entities, but gives member states the right to exempt smaller entities from the statutory audit requirement¹. When an auditor is appointed a firm's management usually establishes some kind of relationship

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Tobias Svanström, postdoctoral fellow, Department of Accounting, Auditing and Law, BI Norwegian Business School.

Håkan Boter, professor, Umeå School of Business and Economics, Umeå University.

Correspondence concerning this article should be addressed to Tobias Svanström, BI Norwegian Business School, Department of Accounting, Auditing and Law, NO-0442 Oslo, Norway. Email: tobias.svanstrom@bi.no.

¹ Small firms that are excluded from the audit requirement are private limited companies and limited liability companies that for two consecutive years have not exceeded two of the following criteria (2006/43/EC): A balance sheet total of 4.4 million euro, a net turnover of 8.8 million euro or an average number of 50 full-time employees.

with the auditor and the audit firm. Management is obliged to provide the auditor with necessary information and documents that enable him or her to perform the audit, and the auditor should report findings to the management. However, the characteristics and scope of this relationship are likely to vary from one or a few contacts per year to continuous and extensive contact in order to discuss strategically important decisions.

Audit firms also provide companies with a variety of support services, some of which can be characterized as closely related to the accounting field, e.g., tax and financial advice, while other types of services are more linked to market analysis, innovation and strategic investment decisions and business management issues in general. Larger audit firms market themselves as complete providers of business services, while smaller audit firms can develop a less formal relationship with their clients and, in such partner-like constellations, also supply NAS. Previous studies have shown that between 65% and 85% of SMEs use their audit firm (or their external accountants) for advisory services (Kirby & King, 1997; Bennett & Robson, 1999; NUTEK, 2000; Boter & Lundström, 2005; Svanström, 2008). Despite the fact that many SMEs hire an auditor for the statutory audit and also rely on the audit firm for NAS, we know very little about this relationship in general and hardly anything about the relationship with regions in particular. The few available studies that relate to the use of external consultants in different regions in the U.K. provide mixed evidence (O'Farell, Hitchens, & Moffat, 1993; Vatne, 1995; Keeble, 1998; Bennett, Robson, & Bratton, 2001). In a review by Bennett and Robson (2003), they concluded that based on the existing evidence it was not possible to draw any far-reaching conclusions about differences in the use of consultants based on firm location.

Although the relationship with the auditor is important for the production of reliable financial reporting, it could also potentially complement a firm's internal resources and serve as a support for management in making financially motivated strategic decisions. In general, it is argued that auditing services serve as an important platform for the promotion and sale of different types of lucrative NAS (Kinney Jr., Palmrose, & Scholz, 2004). The joint provision of auditing and NAS is typically regarded as positive by both the auditor and the firm, since knowledge generated during the audit may spill over to NAS and vice versa. Assuming that auditors can make use of this client specific information, and that knowledge spillover exists, providing both auditing and NAS will be more efficient. Furthermore, clients would be able to buy services at lower prices if markets were competitive enough to pass on some of the cost savings to the client (Arruñada, 1999). Also, purchasing NAS from the auditor reduces the client's search costs for a credible consultant (Simunic, 1984).

We believe that potential regional differences are best captured by studying several dimensions of the relationship, including the demand for different types of services. In this paper, we compare SME-audit firm relationships in three regions of Sweden. We are not aware of any prior studies on regional variation in the SME-audit firm relationship. In contrast to most prior studies on this relationship, we choose a small firm perspective and use a survey approach to gather data on management's perceptions. The comparisons have been undertaken in order to test the hypothesis that there are regional differences with regard to: (1) level of trust and commitment; (2) perceived service quality; and (3) demand for voluntary auditing and NAS and to indicate any disparities between SME-auditor relationships in different business environments. In the paper, we also examine extracts from the relevant literature and conclude with three key hypotheses. The data collection is also described and is followed by a presentation of the results. In the final section the results are linked back to the relevant theories and policy implications are discussed.

Literature Review

Auditing and NAS are “experience goods” in the sense that it is very difficult to observe quality prior to purchase (Nelson, 1970). The quality of those services is not easily observable under and after the purchase either, since the client does not typically know the exact demand. However, the client will receive at least imperfect information about the quality of services during and after the purchase. One problem with experience goods is that it is difficult to separate high quality producers from low quality producers. Suppliers can also reduce the quality and make short-term gains before the buyer realizes what is happening (Leland, 1979; Shapiro, 1983).

In a setting with largely unknown service quality, levels of trust and commitment in the business relationship may serve as important determinants of service demand. Numerous studies indicate that inter-organizational trust between partners helps to build strong relationships and strengthen commitment (Morgan & Hunt, 1994). Lui and Ngo (2005) also proved that trust stimulates the information exchange between partners in network constellations and that in this respect trust creates stability and strengthens ongoing development processes in the alliance. Zucker (1986) distinguished between business providers with a high (low) degree of institutional trust and a high (low) degree of personal trust. He argued that in general professional specialists like auditors and lawyers have a high level of institutional trust, basically because they work within a self-regulating system that includes education, qualifications, ethical rules, standards and group insurance. We suggest that institutional trust could be beneficial when providing auditing and audit-related services to SMEs. However, in order to build and establish a dynamic business relationship involving the provision of a broad range of services, it is also necessary to have a high degree of personal trust and commitment.

Several factors determine the scope and frequency of advisory services required from an auditor or external accountant. These include a firm’s characteristics, the length of the business relationship, prior experience of services and the perceived competence of the service provider (Parksash & Venable, 1993; Firth, 1997; Gooderham, Tobiassen, Doving, & Nordhaug, 2004; Svanström & Sundgren, 2012). However, in the present study, we focus on whether there are regional variations in three dimensions of this relationship and potentially on which regional attributes are related to certain SME-auditor relationships. Three categories of regions were selected for this particular study: A rural region with strong inter-organizational network traditions, a metropolitan region and a remote and sparsely populated region. We argue that the unique attributes of the three regions may lead to the establishment of different types of business relationships and may create different incentives to engage an audit firm for different types of services.

Numerous studies have focused on how to assess the influence of regions on economic development and growth. Interregional approaches have compared the characteristics of individual firms, such as managerial qualifications, financial factors and network involvement in order to develop an understanding of firms located in different regional settings (Tötling, 1995). We also find studies based on aspects linked to business contexts that describe and analyze how regional resources, infrastructural settings and culture can be related and used to explain business performance (Sternberg & Arndt, 2001). Social science disciplines are often represented in the field of “regional studies”, such as business studies, economic geography, sociology and economics.

Region is a multifaceted concept that is often related to activities in a specified geographical area. This spatial aspect can refer to territorial, economic, political and social regional features. In general, it has been found that a region’s actors need to be in close geographical proximity in order to effectively exploit the existing resources via inter-organizational exchange processes. Porter defines regional clusters as “a

geographical proximate group of interconnected companies and associated institutions in a particular field, linked by commonalities and complementarities” (Porter, 2000, p. 16).

The first of the three regions to be compared in this study—the tight rural region—is represented by the county of Småland, an area of Sweden with a strong entrepreneurial orientation manifested in a high regional density of SMEs, family firms and local clusters, and where business activities are strongly intertwined with social and community life. McEvily and Zaheer (1999) argued that in networks social aspects are always based on a level of heterogeneity, since all member firms have an individually exclusive network set-up, and further, that one network is often composed of sub-networks that are substantially different from each other. However, Becattini (1989) found that agglomerations of companies and organizations share common resources, that this constellation of actors develops work models for increased levels of resource sharing and that over time this homogenizes the firms involved into specific districts (Parrilli, 2009). Extensive network cooperation can also develop into structural patterns, where strategic partners are organized close to the network’s core and sub-networks have more peripheral positions in the same district. As found by Burt (1992) and others, social, dense and longstanding cooperation dimensions positively influence learning and spillovers of knowledge and experience between network partners. In this context, social capital has the role of bringing the individual network partners and different subgroups of partners closer together. In addition, mechanisms that connect and bond partners and create uniformity in business undertakings are of specific importance for SMEs.

Smaller firms often need to strengthen their limited resource base by the mobilization of external resources via collaborative arrangements with others (Molina-Morales & Martínez-Fernández, 2008). The significant role of the entrepreneur, eventually complemented by a small management team, will also create a close working relationship between individuals and the firm and underline the importance of social capital as a mechanism by which individuals can connect, build bridges and develop cooperation (Johannisson, Ramirez-Pasillas, & Karlsson, 2002). Firms located in this “tight rural region” have access to support agencies, although not to the same extent as those in metropolitan areas with their vast pool of external resources in the shape of public and private support actors. However, the intertwining of professional business relations between firms with a strong social interaction implies the existence of trusting and longstanding relations with various actors in the network settings. Earlier studies (Boter & Lundström, 2005) indicated that the auditor is a close advisory partner of the small firm and that in this type of regional culture the auditor-firm relationship will develop in a similar way to those with other partners. The close relationship between the firm and the auditor also indicates that the NAS portfolio offered by the auditor will be exploited by the firm as a spill-over effect of the trust-based and sustainable relations between the partners.

The second region—the large urban region—is represented by the Stockholm area with some two million inhabitants. Like many national capital cities, this region has attracted strong investment from the private business community and resulted in a concentration of national government administration and other public sector authorities and agencies. According to cluster and network theories, there is a solid understanding that the amount and composition of resources in the same region strengthen economic development in a positive way. The rich, dynamic, and diversified contexts of large urban economies create regional upgrading mechanisms from which the business sector can benefit via knowledge flows, rivalry between firms and cooperation arrangements. Even if these upgrades are mainly focused on regional externalities and infrastructural investments, the individual firm indirectly benefits from spillovers and the dynamic business context in general. The diversified urbanization economies of firms in different and overlapping industries also

affect the region's absorptive capacity. Innovation and development processes are also stimulated when different sectors experience complementary benefits in cooperation arrangements (Giuliani, 2005).

In addition to far-reaching multi-sector arrangements, the large urban context implies the open accessibility of a wide range of external resources. Obstacles to innovation and growth, e.g., the retention and recruitment of staff, the availability of technological upgrading processes and access to venture capital, are normally lower in large resource-dense and dynamic urban regions (Ki, 2001). This environment also implies a rich supply of business support actors in the private, semi-private and public sectors, offering services in areas like strategic or operative advice and market and financial support (Isaksen & Onsager, 2010). In this respect, individual firms located in large urban regions have access to a variety of different support providers, including auditing services. The supply of audit firms is also extensive, which means that companies can select and switch audit firms as and when they see fit, which in turn may indicate less stable and more short-term relations between individual firms and their auditors. In large urban regions, with competition from a comprehensive supply of business support services in the form of private consultants and public agencies, it is often more difficult for an audit firm to provide its clients with the relevant services.

The third region—the peripheral rural region—consists of four counties in the northernmost part of Sweden. The sparsely populated inland parts of this region and the more densely populated coastal areas reflect the various activities of the business and public sectors. Many of the smaller coastal urban municipalities are dominated by one or more specialized industries that are often linked to natural resources like forestry, mining, and steel. Localization economies and regional strategies often specialize and focus on sectors that are defined by existing competences and industrial structures. Marshall (1920) found that local industrial specialization is often beneficial for business dynamics, especially when the development of competence niches produces favorable labor market effects and other types of knowledge spillover in the specific sectors. This finding was also later exploited by advocates of the concept of industrial districts. Cluster formations, such as public-private-partnerships, have also emerged in the region with the purpose of overcoming path dependence. Territorial innovation systems like this also work with transformation processes with the aim of converting obsolete industrial structures into more contemporary and future-oriented initiatives. In the more peripheral and resource meager municipalities, investment in policy measures via public support agencies are made with the purpose of solving the problems of market failure. Such institutions can mediate information, skills and other resources and facilitate the development of competitive capabilities among the firms in the region (McEvily & Zaheer, 1999).

We also note that the supply of external business support services in remote regions is limited. However, the relationship between the SME and the auditor is probably more stable in these regions than in metropolitan areas due to the limited number of audit firms. Even if the Big 4 audit firms cover all parts of the market in the country², the number of active firms in this region is both limited and scattered, which means that audit firms are unable to establish full-scale support in the small rural municipalities. However, the role of the audit firm is likely to become relatively more important to the SME as there are few other service providers. Possibilities for the local firm to either switch auditor or engage another auditor for non-audit services will also be problematic and costly. In fields like marketing, strategy and management, the private consultancy sector is significantly diluted in these regions, and such services are mainly offered by public agencies.

In short, the literature review relevant to this study has identified that structural factors like location and

² Öhrlings PricewaterhouseCoopers have a total of 130 audit offices in Sweden, KPMG 61, Ernst & Young 61, and Deloitte 30.

effects that are created by specific regional settings can help to explain the strategic aspects of the work processes related to the SME-audit firm relationship. Based on this, our three hypotheses are that:

H1: The relationship between SMEs and audit firms is to a larger extent based on trust and commitment in rural regions compared with metropolitan urban regions.

H2: SMEs in rural regions experience higher audit quality and a richer service offering from the audit firm compared with SMEs in metropolitan urban regions.

H3: SMEs in rural regions demand voluntary audits and NAS to a larger extent than SMEs in metropolitan urban regions.

Study Design and Methodology

Individual companies tend to base their main activities in one specific region. Regions exhibit differences related to a number of factors, such as performance of regional economic structures, regional labor market characteristics, technology and innovation facilities, and level of institutional thickness (Parrilli & Sacchetti, 2008). Such regional structures, as well as dynamic development processes, influence how individual companies survive and develop. The characteristics of the three selected regions in Sweden referred to as the Tight Rural Region (Småland), the Large Urban Region (Stockholm) and the Peripheral Rural Region (Norrland) have already been presented. In geographical terms Småland includes the counties of Jönköping, Kalmar and Kronoberg, while Norrland includes the counties of Västerbotten, Västernorrland, Jämtland and Gävleborg. Stockholm refers to the county of Stockholm.

The empirical data were collected in 2006 in connection with a large scale national survey on SMEs in Sweden. Stratified random sampling guaranteed sufficient responses from the three regions. A postal questionnaire was sent to 900 firms in three categories (1-9 employees, 10-49 employees, and 50-249 employees) in the three specific geographical regions presented above. Only active limited liabilities companies with at least one employee were included. Financial firms and insurance companies were excluded from the sample.

A total number of 421 responses were received, which corresponded to a response rate of 47%. The CEO responded in 60% of the firms, the CFO in 31%, while 9% of the respondents had another position in the firm. The questionnaire was addressed to the CEO of the firm. In the covering letter it was stipulated that if a CFO dealt with the contact with the audit firm then he or she should respond to the questionnaire. 70% of the CEOs owned shares in the firm, while this proportion was 20% among CFOs and other respondents. The response rate is high in comparison to internationally comparable survey studies on SMEs' demand for auditing (Seow, 2001; Collis, Jarvis, & Skerrat, 2004) and NAS (Bennett & Robson, 1999). The responses were relatively evenly distributed between size categories and regions. Two different non-response bias tests were performed. These tests did not indicate any significant differences with regard to: (1) early and late respondents (surrogate method); or (2) respondents and all firms included in the sample.

The stratified random sampling technique implies that the sample is not representative of the entire population. In order to adjust for this, weighted data were used for descriptive statistics and regression models. The weighting procedure was based on the total number of active limited liability firms in Sweden within each stratum.³ The questions included in the questionnaire related to respondent characteristics, audit firm attributes,

³ The number of active firms was taken from reports prepared by Statistics Sweden. The consequence of the weighting procedure is that small firms receive a higher weighting and larger firms a lower weighting. Furthermore, firms from Stockholm receive a higher weighting compared to firms from the regions Norrland and Småland.

perception of service quality, voluntary choice of auditing and the purchase and experience of NAS. Annual reports from the fiscal year of 2005 were used for additional information about a firm's characteristics.

Empirical Model and Results

A set of ordinary least squares (OLS) and logistic regressions were run in order to test our hypotheses. We changed the dependent variable between regressions so that we could study the different dimensions of the relationship, as proposed in the introduction, however, the same independent variables were included in all the regressions. We ran variations of the following regression:

$$\begin{aligned} TRUST = \alpha + \beta_1 \times SMALAND + \beta_2 \times NORRLAND + \beta_3 \times LNTENURE + \beta_4 \times LNSALES \\ + \beta_5 \times EXTOWN + \beta_6 \times SUBSIDIARY + \beta_7 \times GROWTH + \beta_8 \times SOLVENCY + \quad (1) \\ \beta_9 \times ROA + \beta_{10} \times BIG4 + \beta_{11-13} \times INDUSTRY_i \end{aligned}$$

In the above equation, *TRUST* is the expressed level of management trust in the audit firm measured on a scale from 1 to 7⁴. *SMÅLAND* is an indicator variable that takes the value one if the company is located in Småland, and zero otherwise. *NORRLAND* is an indicator variable that takes the value one if the company is located in Norrland, and zero otherwise. *STOCKHOLM* is an indicator variable that takes the value one if the company is located in Stockholm, and zero otherwise (used as reference category in the specified model). *LNTENURE* is the natural logarithm of the number of years that the company has appointed the current audit firm. *LNSALES* is the natural logarithm of sales in 2005. *EXTOWN* is an indicator variable that takes the value one if the company has external owners, and zero if the firm is fully owned by the management. *SUBSIDIARY* is an indicator variable that takes the value one if the firm is a subsidiary, and zero otherwise. *GROWTH* is the total sales in 2005 less the total sales in 2004. *SOLVENCY* is shareholders' equity in relation to total assets in 2005. *ROA* is net income in relation to total assets in 2005. *BIG 4* is an indicator variable that takes the value one if the company is audited by PriceWaterhouseCoopers, Ernst & Young, KMPG, or Deloitte, and zero otherwise. *INDUSTRY_i* is the indicator variable for industries. The industries are manufacturing, retail, service, and others.

Descriptive Statistics

Descriptive statistics are presented in Table 1. The mean (median) revenues reported are Euro 3.80 million (Euro 0.56 million)⁵. A handful of companies are very large, which drives the mean upwards. The median growth in terms of changes in sales is 1.6%. The mean growth is 20.5%, which indicates that some companies have grown considerably under 2005. The average solvency level is just below 50% and companies report a mean (median) return on total assets of 4.6% (4.1%). 30% of the companies are in the service sector, 25% in retail, 14% in manufacturing and 30% in other sectors. Approximately 62% of the companies are located in Stockholm, 20% in Småland, and 18% in Norrland. 41% are subsidiaries and just over a third has external owners who are not part of the management team.

Two thirds of the companies are audited by a BIG 4 auditor. On average they have used their current audit firm for about 14 years (median 10 years) with a variation from one to 140 years. However, information about audit firm tenure is missing for 15.9% of the companies. Almost seven out of 10 companies would have auditing even if they were not legally required to, 16% would choose not to be audited and 17% are undecided

⁴ The various dependent variables used to study the different dimensions of the SME-audit firm relationship are explained in detail below.

⁵ Exchange rate of 1 EURO = 8.80 SEK, as of February 29, 2012 is used.

on this issue. Excluding the undecided companies, 81% state that they want auditing, and 19% state that they do not want auditing. 66% of the companies have purchased NAS from the audit firm during the last year.

Table 1

Descriptive Statistics (Variables in Regressions)

Panel A: Continuous variables						
Variables	Mean	Median	Std. dev.	Min	Max	N
<i>TENURE</i>	14.457	10.000	15.295	1	140	354
<i>LNTENURE</i>	2.177	2.303	1.050	0	4.942	354
<i>SALES</i> (in thousands SEK)	33,467.39	4,956.00	314,625.94	0	9,159,300.00	421
<i>LNSALES</i>	8.480	8.508	1.755	3.466	16.030	414
<i>GROWTH</i>	0.205	0.016	1.373	-1.000	9.298	407
<i>SOLVENCY</i>	0.462	0.457	0.300	-0.053	1.000	418
<i>ROA</i>	0.046	0.041	0.215	-0.776	0.981	414
<i>TRUST</i>	5.85	6.00	1.331	1	7	419
<i>COMMITMENT</i>	5.18	5.00	1.542	1	7	412
<i>AUDIT QUALITY</i>	5.73	6.00	1.208	1	7	420
<i>SERVICE OFFERING</i>	5.20	6.00	1.750	1	7	298
Panel B: Discrete variables						
Variables	Percentage (%)		N			
<i>SMÅLAND</i>	19.7		421			
<i>NORRLAND</i>	17.8		421			
<i>STOCKHOLM</i>	62.4		421			
<i>EXTOWN</i>	35.6		402			
<i>SUBSIDIARY</i>	40.8		420			
<i>BIG4</i>	67.2		420			
<i>INDUSTRY</i>						
Manufacturing	14.3		421			
Retail	25.3		421			
Service	30.4		421			
Other	29.9		421			
<i>VOLUNTARY AUDIT</i> (Yes/No)	81.3		350			
<i>PURCHASE OF NAS</i> (Yes/No)	66.0		417			

Results

Characteristics of the relationship. Table 2 shows the results relating to the management's perception of their relationship with the audit firm divided by region. Four dimensions of the relationship were studied, namely the perceived degree of (1) trust, (2) availability, (3) commitment, and (4) adaptability. The results are based on the measurement of survey responses to those four specific statements (likert scale 1 to 7). Tests on the equality of variances (ANOVA) show that there are significant differences between regions in all these dimensions. Managers of firms located in Småland and Norrland responded with significant higher values to the specific relationship statements than firms in Stockholm ($p < 0.001$). Findings indicate that the relationships vary between regions to quite a large extent. For example, the management of firms in Norrland and Småland exhibit a higher level of trust and commitment in their relationships with the audit firm than the management of firms located in Stockholm. We can also see a higher perception of the audit firm being available to respond to questions (*AVAILABILITY*) and being responsive and able to adapt to a firm's needs (*ADAPTABILITY*) in

Norrland and Småland as compared to Stockholm.

Table 2

Relationship Characteristics: Management's Perceptions

	<i>SMÅLAND</i>	<i>NORRLAND</i>	<i>STOCKHOLM</i>	<i>p</i> -value
<i>TRUST</i>				
Mean	6.18	6.20	5.64	< 0.001
Median	6.45	6.35	6.02	
Std. dev.	1.28	0.97	1.40	
<i>AVAILABILITY</i>				
Mean	6.19	6.09	5.52	< 0.001
Median	6.42	6.30	5.85	
Std. dev.	1.20	1.12	1.42	
<i>COMMITMENT</i>				
Mean	5.78	5.57	4.88	< 0.001
Median	6.11	5.90	4.84	
Std. dev.	1.435	1.50	1.51	
<i>ADAPTABILITY</i>				
Mean	5.57	5.47	5.03	0.004
Median	5.79	5.66	5.23	
Std. dev.	1.31	1.36	1.54	

Notes. *P*-values are for test of equality of averages between groups (ANOVA). Perceptions are measured on a scale from 1 (strongly disagree) to 7 (strongly agree), where 4 is equal to a neutral standpoint. Number of observations (*n*): 411-419.

Table 3

OLS Regressions on the Level of Trust in the Audit Firm and the Perceived Level of Audit Firm Commitment

	Dependent variables							
	<i>TRUST</i>				<i>COMMITMENT</i>			
	Reg. 1		Reg. 2		Reg. 3		Reg. 4	
	Coeff.	<i>p</i> -value	Coeff.	<i>p</i> -value	Coeff.	<i>p</i> -value	Coeff.	<i>p</i> -value
<i>SMÅLAND</i>	0.599	0.002			0.998	< 0.001		
<i>NORRLAND</i>	0.551	0.005	-0.048	0.836	0.662	0.004	-0.336	0.217
<i>STOCKHOLM</i>			-0.599	0.002			-0.998	< 0.001
<i>LNTENURE</i>	0.266	< 0.001	0.266	< 0.001	0.340	< 0.001	0.340	< 0.001
<i>LNSALES</i>	0.055	0.252	0.055	0.252	0.091	0.108	0.091	0.108
<i>EXTOWN</i>	-0.200	0.240	-0.200	0.240	-0.125	0.530	-0.125	0.530
<i>SUBIDIARY</i>	-0.309	0.066	-0.309	0.066	-0.130	0.515	-0.130	0.515
<i>GROWTH</i>	0.070	0.467	0.070	0.467	0.126	0.271	0.126	0.271
<i>SOLVENCY</i>	0.343	0.215	0.343	0.215	0.145	0.658	0.145	0.658
<i>ROA</i>	0.053	0.891	0.053	0.891	-0.522	0.254	-0.522	0.254
<i>BIG 4</i>	0.092	0.568	0.092	0.568	-0.059	0.756	-0.059	0.756
<i>INDUSTRY_i</i>	N.R		N.R		N.R		N.R	
<i>F</i> -value	7.059***		7.059***		6.610***		6.610***	
Adj. <i>R</i> -squared	0.196		0.196		0.187		0.187	
<i>N</i>	324		324		316		316	

Notes. *, **, *** denote *p*-value < 10%, < 5%, and < 1%, respectively.

Table 3 shows the results from OLS regressions on perceptions of *TRUST* (reg. 1 and 2) and *COMMITMENT* (reg. 3 and 4), in which we include the control variables specified in section 4. In regressions 1 and 3 we include indicator variables for *SMÅLAND* and *NORRLAND*, while *STOCKHOLM* is the reference category, and in regressions 2 and 4 we include *NORRLAND* and *STOCKHOLM*, leaving *SMÅLAND* as the reference category. The models are clearly significant ($p < 0.001$) and the *R*-squares are around 20%. The number of observations for the models is approximately 320, mainly due to missing information about audit firm tenure. The regression results further support the existence of regional differences. Regressions 1 and 3 document positive and significant coefficients for *SMÅLAND* and *NORRLAND* respectively, indicating that the perceived level of trust in the audit firm and an audit firm's commitment are lowest in the metropolitan urban region of Stockholm. There are no significant differences between firms located in *SMÅLAND* and *NORRLAND* with regard to these relationship dimensions. We also note that the levels of trust and commitment are positively and significantly associated with *LNTENURE*. As the relationship between the audit firm and the SME increases the management experiences a higher level of trust and perceives the audit firm to be more committed.

Service quality. Our next focus is on the perception on service quality. We asked the respondents how they perceived the value of the auditing services and NAS. Table 4 presents how region is associated with the three audit-related statements of audit quality, continuous dialogue and key knowledge and with the three NAS-related statements of service offering, advice of strategic importance and advice to fulfill legal requirements. The reported univariate analysis shows that there are significant differences in the perception of service quality between regions. For all the dimensions of audit quality and for two out of three NAS-related statements we find that firms located in *SMÅLAND* exhibit the highest value of services provided, followed by *NORRLAND* and then *STOCKHOLM*, where management perceives the value of services provided by the audit firm to be of the lowest value. In contrast to the analyses of the audit firm-SME relationship, it should be noted that there are also some significant differences between the perceptions of firms located in Småland and Norrland.

Table 4

Service Quality: Management's Perceptions

Auditing	<i>SMÅLAND</i>	<i>NORRLAND</i>	<i>STOCKHOLM</i>	<i>p</i> -value
Audit quality				
Mean	6.17	5.88	5.54	< 0.001
Median	6.40	6.06	5.68	
Std. dev.	1.12	1.13	1.22	
Continuous dialogue				
Mean	5.81	5.40	5.20	0.003
Median	6.05	5.71	5.42	
Std. dev.	1.22	1.56	1.43	
Provides key knowledge				
Mean	5.07	4.48	4.06	< 0.001
Median	5.12	4.53	4.38	
Std. dev.	1.25	1.61	2.07	

(Table 4 continued)

NAS	SMÅLAND	NORRLAND	STOCKHOLM	<i>p</i> -value
Service offering				
Mean	5.65	5.48	4.95	0.009
Median	5.90	5.60	5.49	
Std. dev.	1.41	1.22	1.65	
Advice of strategic importance				
Mean	4.82	4.93	4.00	< 0.001
Median	4.86	4.90	4.10	
Std. dev.	1.63	1.59	1.76	
Advice to fulfill legal requirements				
Mean	5.68	5.26	4.81	0.001
Median	5.78	5.47	5.18	
Std. dev.	1.18	1.56	1.77	

Notes. *P*-values are for test of equality of averages between groups (ANOVA). Number of observations: 411-419 (audit services), 292-299 (NAS).

Table 5

OLS Regressions on Management's Perception of the Level of Service Quality

	Dependent variables							
	<i>AUDIT QUALITY</i> (Audit)				<i>SERVICE OFFERING</i> (NAS)			
	Reg. 1		Reg. 2		Reg. 3		Reg. 4	
	Coeff.	<i>p</i> -value	Coeff.	<i>p</i> -value	Coeff.	<i>p</i> -value	Coeff.	<i>p</i> -value
<i>SMÅLAND</i>	0.691	< 0.001			0.746	0.010		
<i>NORRLAND</i>	0.212	0.222	-0.479	0.021	0.758	0.016	0.012	0.973
<i>STOCKHOLM</i>			-0.691	< 0.001			-0.746	0.010
<i>LNTENURE</i>	0.155	0.018	0.155	0.018	0.323	0.008	0.323	0.008
<i>LNSALES</i>	0.173	< 0.001	0.173	< 0.001	0.144	0.095	0.144	0.095
<i>EXTOWN</i>	-0.070	0.646	-0.070	0.646	-0.094	0.706	-0.094	0.706
<i>SUBSIDIARY</i>	-0.302	0.048	-0.302	0.048	-0.023	0.932	-0.023	0.932
<i>GROWTH</i>	0.221	0.012	0.221	0.012	-0.232	0.077	-0.232	0.077
<i>SOLVENCY</i>	-0.392	0.116	-0.392	0.116	0.489	0.279	0.489	0.279
<i>ROA</i>	0.163	0.641	0.163	0.641	-0.589	0.372	-0.589	0.372
<i>BIG 4</i>	-0.168	0.248	-0.168	0.248	-0.213	0.457	-0.213	0.457
<i>INDUSTRY_i</i>	N.R.	N.R.	N.R.	N.R.	N.R.	N.R.	N.R.	N.R.
<i>F</i> -value	7.255***		7.255***		9.071***		9.071***	
Adj. <i>R</i> -squared	0.201		0.201		0.328		0.328	
<i>N</i>	323		323		215		215	

Notes. *, **, *** denote *p*-value < 10%, < 5%, and < 1%, respectively.

Table 5 reports the results of OLS regressions on management's perceptions of *AUDIT QUALITY* (reg. 1 and 2) and *SERVICE OFFERING* (reg. 3 and 4). We have chosen to focus on one key audit attribute and one key NAS attribute. All the models are significant and the adjusted *R*-squares are 20.1% and 32.8% respectively. It should be noted that only firms hiring an audit firm for NAS responded to *SERVICE OFFERING* and other specific NAS related questions. Regressions show that for *AUDIT QUALITY* firms located in *SMÅLAND* perceive a significant higher service quality than those in *NORRLAND* and *STOCKHOLM*, while firms in *SMÅLAND* and *NORRLAND* perceived significantly higher richness in *SERVICE OFFERING* than firms in

STOCKHOLM. The results are qualitatively similar if we use any of the alternative service quality indicators presented in Table 4. Similar to previous regressions, we find that *LNTENURE* is positively associated with *AUDIT QUALITY* and *SERVICE OFFERING*. *LNSALES* is also positively associated with service quality attributes, which indicates that larger companies benefit more from an audit firm's services than smaller companies. In the audit literature it has been suggested that the value of auditing increases with firm size as the role of the audit becomes more multifaceted (Knechel, Niemi, & Sundgren, 2008).

Demand for auditing and NAS. Next we study the demand for services as the final dimension of the SME-audit firm relationship. In Table 6, we present the proportion of firms indicating that they would voluntarily choose auditing, the aggregate demand for NAS and the specific demand for operational services and strategic services respectively.

Table 6

Demand for Voluntary Auditing and Different Types of NAS

	<i>SMÅLAND</i>	<i>NORRLAND</i>	<i>STOCKHOLM</i>	<i>p</i> -value	<i>N</i>
Voluntary audit?					
Yes (%)	81	73	61		420
No (%)	6	12	20		
Undecided (%)	13	15	19		
Differences (Pearson Chi square)				0.010	
Purchase of NAS?					
Yes (%)	78	69	62		417
No (%)	22	31	38		
Differences (Pearson Chi square)				0.018	
NAS fees/total fees					
Mean	0.38	0.36	0.14	< 0.001	418
Median	0.41	0.41	0.00		
Std. dev.	0.28	0.31	0.22		
Min	0	0	0		
Max	0.88	0.93	0.94		
Number of strategic NAS purchased					
Mean	0.86	0.97	0.54	0.010	293
Median	0.42	0.99	0.00		
Std. dev.	1.19	1.21	0.92		
Number of operational NAS purchased					
Mean	1.28	1.08	1.58	0.001	293
Median	1.38	1.00	2.00		
Std. dev.	1.03	1.04	0.83		

Notes. Strategic NAS includes the following services: generational shift, investments, budget and planning, mergers, and acquisitions, advice in connection with financial statements, organizational issues and marketing. Operational NAS includes the following services: accounting issues, tax advice and legal advice. *P*-values are for test of equality of averages (ANOVA) between groups (continuous variables) and for Pearson's Chi squared test for the discrete variables.

Overall, the results indicate that there are also regional differences in the demand for the different services provided by an audit firm. First, we note that firms located in *SMÅLAND* have the highest demand for voluntary audit, while firms in *STOCKHOLM* have the lowest. Including undecided respondents, 81% of firms in *SMÅLAND* say that they will continue to have an audit on a voluntary basis, while in *STOCKHOLM* this proportion is 61%. The differences between the groups are also statistically significant. Second, for the proportion

of firms purchasing NAS from the audit firm in the different regions the regional variation is similar. We note that the highest demand is in *SMÅLAND* with 78% of firms purchasing NAS, and the lowest in *STOCKHOLM*, where 62% purchase NAS from an audit firm. Third, we notice that firms in *SMÅLAND* and *NORRLAND* pay higher NAS fees relative to the total fees paid to the audit firm (sum of audit fees and NAS fees) than firms in *STOCKHOLM*. The mean (median) value is 0.38 (0.41) and 0.36 (0.41) respectively in Småland and Norrland, but only 0.14 (0.00) in Stockholm.

The fourth and fifth observations relate to the demand for different categories of NAS. Here we studied regional variations with regard to the demand for categories of NAS that we have classified as strategic and operational respectively (see the notes under Table 6 for detailed information). Table 6 shows that on average firms located in *SMÅLAND* and *NORRLAND* purchased slightly less than one strategic service from the audit firm, which is a significantly higher proportion than in *STOCKHOLM* where the corresponding average is just over 0.5. However, another pattern is identified for the demand for operational NAS (accounting, tax and legal services). Here we observe that firms in *STOCKHOLM* purchased a larger number of operational services than firms in *SMÅLAND* and *NORRLAND*, and that there are significant differences between the groups (p -value = 0.001). Findings indicate that firms in Stockholm largely focus on purchasing the necessary services in order to comply with accounting standards, tax requirement and legislation, and that these are services closely related to an auditor's core competencies. Considering the relative weak relationship with the audit firm in this metropolitan urban region, this purchase pattern probably reflects a calculated business rationale. In Småland and Norrland the relationship with the audit firm is based on trust and mutual understanding to a much greater extent than it is in Stockholm, thus making strategic advisory services more beneficial.

Table 7

Logistic Regressions on the Demand for Voluntary Audit and NAS

	Dependent variables							
	<i>VOLUNTARY AUDIT</i> (Yes/No)				<i>PURCHASE OF NAS</i> (Yes/No)			
	Reg. 1		Reg. 2		Reg. 3		Reg. 4	
	Coeff.	p -value	Coeff.	p -value	Coeff.	p -value	Coeff.	p -value
<i>SMÅLAND</i>	2.283	0.001			1.537	< 0.001		
<i>NORRLAND</i>	0.296	0.535	-1.987	0.015	0.237	0.540	-1.300	0.007
<i>STOCKHOLM</i>			-2.283	0.001			-1.537	< 0.001
<i>LNTENURE</i>	-0.228	0.305	-0.228	0.305	0.594	< 0.001	0.594	< 0.001
<i>LNSALES</i>	0.830	0.001	0.830	0.001	0.361	0.002	0.361	0.002
<i>EXTOWN</i>	-1.435	0.005	-1.435	0.005	-0.472	0.165	-0.472	0.165
<i>SUBSIDIARY</i>	2.625	< 0.001	2.625	< 0.001	1.578	< 0.001	1.578	< 0.001
<i>GROWTH</i>	0.157	0.643	0.157	0.643	1.264	0.018	1.264	0.018
<i>SOLVENCY</i>	2.372	0.022	2.372	0.022	1.624	0.005	1.624	0.005
<i>ROA</i>	-7.109	< 0.001	-7.109	< 0.001	-0.498	0.546	-0.498	0.546
<i>BIG 4</i>	1.675	0.001	1.675	0.001	-0.048	0.882	-0.048	0.882
<i>INDUSTRY_i</i>	N.R	N.R	N.R	N.R	N.R	N.R	N.R	N.R
Model Chi square	127.27		127.27		117.94		117.94	
(prob.value)	(< 0.001)		(< 0.001)		(< 0.001)		(< 0.001)	
Pseudo R^2	0.540		0.540		0.276		0.276	
N	275		275		328		328	

Table 7 reports logistic regressions on the demand for voluntary auditing (reg. 1 and 2) and NAS (reg. 3

and 4). All the models are significant (p -value < 0.001). Undecided firms have been excluded from the analysis of voluntary audit. Regressions 1 and 3 show that firms located in *SMÅLAND* have a significantly stronger demand for both voluntary audit and NAS compared to firms in *NORRLAND* and *STOCKHOLM*. There are no significant differences between *NORRLAND* and *STOCKHOLM*. It should be noted that *LNTENURE* is positively and significantly associated with the purchase of NAS from the audit firm, but not with the demand for auditing. *LNSALES*, *SUBSIDIARY*, and *SOLVENCY* are positively related to the demand for both auditing and NAS. BIG 4 are positively and significant related to the demand for auditing, but not with the purchase of NAS. Companies that hire a BIG 4 audit firm wants to signal integrity to outside interested parties (Hay & Davis, 2004) and to keep the reputation they are likely to continue with auditing. However they do not necessarily purchase NAS to a higher extent than companies that hires a non BIG 4 auditor.

In sum, we note that there are regional differences in the SME-audit firms relationship with regard to the three dimensions studies: (1) perception of trust and commitment, (2) service quality, and (3) the demand for both auditing and NAS. We find that the level of trust and commitment is significantly higher in the two rural areas compared with the urban region (support for H1). This is also the findings for perception of the richness in the service offering (partly support for H2). However, the perception of audit quality and the demand for auditing and NAS is found to be significantly higher in the tight rural area compared with both the peripheral rural region and the large urban region (partly support for H3).

Discussion and Conclusions

A large proportion of SMEs have audited financial statements. The auditing service, which is the starting point for the audit firm-SME relationship, is a standardized service that involves certain steps to be performed using established techniques. In our study we found that there are still significant regional variations in the multiple dimensions of this relationship. Based on the regression results presented, we conclude that firms in rural areas experience a stronger relationship with their audit firm than those in metropolitan urban regions. The regional variation includes perception of trust and commitment, service quality and the demand for different types of services provided by the audit firm.

The literature review indicated that in rural regions the relationship between SMEs and the auditor is more trust-based than it is in metropolitan urban regions. One of the two rural regions included in the study has characteristics similar to industrial districts with a high level of entrepreneurial activity where business and social communities are closely intertwined. This kind of business environment also determines whether the auditor and his or her traditional role as an external control agent will be extended, and whether or not the auditor is involved in the networking activities of firms and organizations. We document that strategic services are used by companies located in rural regions to a much greater extent than those in urban regions. The development of trust and commitment between these network partners also affects the auditor with a stronger interest in his or her client's undertakings and outcome. That is, the extended role of the auditor activates their role as an external control agent but simultaneously engages the auditor as a close partner, professional expert and sounding board; all of which are important for various types of business advisory services.

Some parts of the other rural region, Norrland, also have agglomerations of companies in specific sectors or strong entrepreneurial traditions in some municipalities. However, as this region is sparsely populated, the business population is thin with weak prerequisites for developing dynamic networks involving lots of different partners. Another thing to note is that in such a setting the relationship between SME and auditor is not

necessarily only control-oriented, but often has a combination of push and pull forces in order to establish cooperation agreements in an environment with few alternative partners. Findings indicate that the role of auditors as service providers becomes relatively more important to managers and to firm development in rural regions than in metropolitan urban regions.

In the metropolitan urban region there is, in general, a large and diversified supply of business support. In such a context the relationship between SME and auditor will constantly be challenged by the rich population of competitive auditors, consultants and other support agencies. Our hypothesis that the relationship between SMEs and audit firm is more often trust-based and commitment-oriented in rural regions is clearly supported by the findings. A longer relationship with the same audit firm is also found to be significantly related to the perception of trust and commitment, which indicates that these attributes develop over time.

The quality aspects of services provided by auditors were perceived differently in the three regions. As we are dealing with experience goods, clients' perceptions, typically an owner-manager, indicate the value of the services purchased, which in turn affects future purchasing intentions. From earlier studies we could deduce that the development of trust-based cooperation and committed and engaged partnerships in networks affect final service quality. In this study we identified that SMEs in Småland have more trust-oriented relationships with their auditor, and that the quality level of auditing services is experienced as higher in this region than in the other two. Similarly, when business partners are engaged in close cooperation, SMEs experience that offerings of NAS from the audit firm, like advisory services in marketing and management, are more complete and cover all the necessarily areas of business advice. Findings here show that firms located in Småland and Norrland to a significantly larger extent experience the audit firm to have richer service offerings compared with firms in Stockholm. This finding is noticeable when we consider the fact that all the major audit firms have their head offices, with a broad range of in-house expertise, in Stockholm.

In the metropolitan area, SMEs and their auditors have less opportunity to develop stable and trustful relationships due to the dynamic supply of both audit and NAS—a factor that also influences how the service quality of both these kinds of services is experienced. In line with this argumentation, we find a lower perceived service quality in Stockholm than in the two rural regions. Following the lower level of trust and service quality, SMEs in Stockholm mainly purchase operational services within auditors' core competences and do not typically use the auditor for strategic services that may require a closer relationship and mutual understanding. Trust may be the key to establishing a relationship with the auditor that goes beyond audit-related services. We also find that firm size is positively related to service quality, which can be explained by the fact that larger firms have developed better routines and business knowledge. This professionalism is likely to increase the take-up rate of participating in the auditing process as well as in the exchange of NAS.

The fact that audit firms have a relatively strong involvement in business community activities in Småland indicates that these types of alliances result in extended cooperation arrangements and a greater provision of NAS. In this type of environment, with strong relationships between the different actors in the business community, the decision not to have audited financial statements would probably cause concern and suspicion among outside investors, creditors and trade partners.

This study has several policy implications. Firstly, most SMEs have an established relationship with an audit firm, and even if this cooperation in many cases focuses primarily on the annual audit work, basic steps are taken to establish and develop the relationship as such. Further exploitation of this partnership could be

considered by the small firm, where the purchase of NAS from an audit firm should be balanced against similar offerings from private consultants and the like. There are obvious reasons for using a business provider that is familiar with the firm, although the decision to use the auditor for NAS should be based on personal experience of the value of the services rendered. Here we note the importance of regional characteristics for such experiences. Secondly, an audit firm's core competence is to professionally examine the financial outcome of business activities at firm level. In order to offer and effectively deliver NAS they have to develop their role as e.g., management consultants or market analysis experts; roles that differ when compared with those of tax authorities. Thirdly, the policy sector could actively stimulate the development of arenas for meetings and exchange between SMEs and other actors. Also, audit firms are only one type of potential SME partner. Others include consultants, banks, support agencies and other SMEs. Likewise, in many places, appropriate facilities (like meeting places, regular workshops, strategic networks, Internet-based platforms) and various exchange opportunities with diverse actors on different topics would create a dynamic and productive flow of partnerships, networking and common resource development. The demand for such policy investment is stronger in rural areas due to the lower population base, sparse business sector and weak infrastructure.

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