What factors affect Capital structure choices in partnership companies

- A case study of the “Big four” auditing firms in Sweden

Bachelor Thesis in Industrial and Financial Management

School of Business, Economics and Law, University of Gothenburg, Spring 2011.

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Acknowledgements

First of all we would like to thank everyone that supported us during the writing of this thesis. Without the time of others this thesis would not have been possible to complete.

Secondly we would like to thank Lars Svantemark (Deloitte), Håkan Gustafsson and Sven-Arne Gårdh (Ernst & Young), Jan Malm (KPMG) and Magnus Götenfelt (PWC) for taking the time to talk with us. We are very grateful for this, as we know you are very occupied people with little time to spare.

Thirdly we would want to thank our supervisor Taylan Mavruk (Gothenburg. Uni.) for providing help when we needed, for the insightful comments and for the desire to help us reach the potential of this thesis. Your support has been invaluable to us.

Lastly we would like to thank Stefan Sjögren (Gothenburg. Uni.) for being a valuable sounding board.

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26th of May, 2011.
Abstract

Title: What factors affect Capital structure choices in partnership companies

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Background: The firms’ choice of capital structure has an effect on the firms’ performance, both short-term and long-term. Many theories have been developed with the objective to explain the factors that determine the firms’ choice of capital structure.

Purpose: The objective of this thesis is to contribute to the research regarding the decision-making process, the determinants and the factors behind the choice of capital structure in Swedish firms. Furthermore, we aim to determine whether the existing theoretical framework, e.g. the trade-off and pecking order theory, can explain the firms’ considerations. The firms chosen as our focal point are the so-called “Big four”, i.e. large partnership firms that consult other firms in matters related to capital structure.

Method: The thesis consists of a case study of the “Big four”, i.e. Deloitte, Ernst & Young, KPMG and PWC, firms in the auditing business. A qualitative approach is used in order to conduct the study. Interviews are made with partners in management positions and sufficient insight in capital structure matters of the respective firms. To fulfil the purpose of the thesis the interview template was designed to provide a foundation to answer the problem formulation, by retaining the necessary empirics to ensure a well-founded analysis and conclusion.

Result: In the conducted study some support was found for the established theories especially the pecking order theory but the underlying factors behind the determinants of the firms’ capital structure were different from our expectations. The research led to some similarities to the findings of Lindblom et al’s (2011). The owner structure had an effect on the choice of capital structure for the firms, but the reasons behind this, had weak support by established theories. The choice of qualitative method was shown to be of importance since a quantitative study would have concluded a strong support for, especially the pecking order but also some support for the trade-off theory.

Suggestions to further research:
1. Agency costs in partnership firms, i.e. between national and international member firms, between individual partners and between partners and associates.
2. The effect of homemade leverage in Swedish firms with no or low levels of external debt.
Prelude

During our bachelor level course in corporate finance we were introduced to the fundamental concepts of capital structure, mainly through the theories of Modigliani & Miller. The capital structure, which is the way of how organizations finance their assets, affects company value, risk and profitability. We found this subject especially interesting so we decided that we wanted to deepen our knowledge through writing our bachelor’s thesis on the subject.

Concerned parties

Due to the absence of a similar study being conducted, we considered to whom our study would be beneficial to and to whom it might be of interest. We found it to be of interest to the companies that consume the services that our studied firms provide, mainly to see whether they live as they learn. The partners of the company might be unaware of how the “Big four” determine overall policy for capital structure and who actually has the formal say in questions regarding financing. Since all partners are considered to be significant stakeholders through their partnership the results of this thesis ought to be of interest for them. From our point of view and for all others interested in capital structure, it is interesting to analyse how the alleged experts work and develop their capital structure and which aspects are considered, while doing so.
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1. Introduction

1.1. Introduction

Since the publication of Modigliani & Miller’s article on capital structure, this subject has been a relatively current and discussed subject in the economical sphere. The article named “The Cost of Capital, Corporate Finance and Theory of Investment” (Modigliani & Miller, 1958) provided new perspectives on the company’s capital structure through a theory stating that the capital structure has no impact on a company’s value with the prerequisite of the presence of perfect capital markets. The perfect capital market solely exists in theory, which enables companies to utilize the existing imperfections in order to gain value through choice of capital structure (Modigliani & Miller, 1963). The theories of Modigliani & Miller became the cornerstone for further studies in the subject and the development of new models (E.g. Myers, 1984). In the after lapse of the most recent financial crisis, the debate of companies’ capital structure, especially leverage and debt, has been a focal point of many economists due to the risk associated with debt. This further contributed to make the subject even more current, hence our interest on the subject.

1.2. Background

The Modigliani & Miller prepositions only hold in the theoretical perfect market; this led to companies striving to use its choice of capital structure to affect its performance in returns, cost, risk, and other similar aspects of the companies’ performance (Modigliani & Miller, 1958). The more prominent theories developed are the trade-off and the pecking order theory. The trade-off theory suggested an optimal capital structure, i.e. an optimal mix of debt and equity, while the pecking order theory proposed a hierarchy when choosing sources for financing the companies’ investments. Examples of other theories developed are window of opportunity and market timing theory. These theories were identified as frameworks for determining companies’ capital structure and whether the theories are used and how they are used in practice is widely debated, both in the academic and the commercial world (E.g. Lindblom et al, 2011). Other considerations or aspects that may have an effect on the above mentioned theories when determining the companies’ capital structure are the so-called agency costs. Agency costs are costs that arise when there are different conflicts of interest or difference in preferences and interests, e.g. between owners and management (Copeland et al, 2005)
The company’s choice of capital structure is important, since it has an effect on the company’s present and future. There are studies implying that factors such as leverage, risk, and financial distress are central when determining capital structure, and when analysing the chosen structure (Lindblom et al, 2011). However, there is uncertainty in the process of how companies decide its mix of equity and debt and how they choose to finance its investments. Different studies have led to diverse results regarding which considerations the decision makers of the companies choose to consider the most (See e.g. Graham and Harvey, 2001, Myers, 1984, Donaldson, 1961, Lindblom et al, 2011).

1.3. Problem discussion and problem statement

“The consequences of today are determined by the actions of the past. To change your future, alter your decisions today.” ~ Anonymous

The issues regarding capital structure have been important matters for top management in most firms as it affects numerous factors. Choices regarding capital structure are found to affect the firm’s possibility to pursue and realize investments, implying that good investment opportunities might be lost if a firm has a capital structure that is suboptimal for their requirements. The capital structure also has an effect on the firms’ liquidity, and therefore their financial flexibility, since it can have a smoothing effect on cash flows (Lindblom et al, 2011).

As the capital structure is considered to be of such importance, a vast amount of research has been made in the subject (e.g. Lindblom et al, 2011, Minton & Wruck, 2001, Myers, 1984, etc.). Although a large amount of studies have been conducted on both capital structure and managerial ownership, we found a deficiency of studies made on Swedish partnership companies, but also on companies advising other companies in matters regarding capital structure. We define partnership companies as firms with so called managerial ownership, i.e. the management and ownership are integrated. However, partnership firms are different to regular firms with managerial ownership since, they e.g. use partnership agreements containing certain benefits, but also certain obligations. All employees of the partnership firms have the possibility to become a partner and the partnership is not static in the sense that the partnership is for life; it ends when employment terminates. For this reason, it is
reasonable to believe that partnership firms have other incentives, when choosing capital structure, than firms with a separation of management and ownership and firms with regular managerial ownership, such as family owned firms. For example, future partners need to be considered, as it does not seem fair if current partners take on debt and benefit from this, while future partners, who did not take on the debt, will have to pay the interest. Partnership is a special kind of ownership structure from other perspectives, as all the partners are significant stakeholders; hence, they have increased personal interest in how the company performs. Firms in the advisory/auditing industry, i.e. companies that consult other firms in capital structure matters, commonly use a partnership structure. Furthermore, the most part of the more recent studies have been of quantitative nature, and we intended to conduct a qualitative study. The reason for this is that we intend to find the underlying factors of capital structure decisions. The interest was not solely focused on which aspects the firms considered when determining capital structure, which has been studied by e.g. Lindblom et al (2011), but also why and how the firms do it. Furthermore, we need to have a flexible approach when facing these questions, i.e. an explorative approach, which further motivates the qualitative method and the study’s uniqueness.

Established theories such as the trade-off theory suggest an optimal mix of debt and equity, in order to maximize firm value. Moreover, firms can use debt to gain tax advantages. There are many consultancy firms on the market, which advise other firms in matters regarding capital structure and hence are alleged experts in the subject. Most of these firms have low leverage, and in most cases no long-term debt. Although being restrictive in taking on debt of their own, these firms advise other firms to take on debt on daily basis. We found it interesting to examine the reasons for this behaviour, to see how the alleged experts work with their capital structure, how it is determined and whether a theoretical reasoning could support it (Modigliani & Miller, 1958, 1963, Myers, 1984).

Studies have been conducted regarding capital structure in large Swedish firms. Lindblom et al (2011) concluded that the utilization of established theories, such as trade-off and pecking order, is common. We intend to investigate whether this is the case in the “Big four” (Deloitte, Ernst and Young, KPMG and PWC), i.e. large partnership companies. Furthermore we aim to examine if the firms follow the theories even though they have a low level of leverage, i.e. almost zero debt, and are managed by their owners. The companies are called the “Big four” since they are the four largest auditing/advisory firms, and among them, they
constitute a large part of the market in both business segments. The firms audit approximately 85 percent of the listed companies in Sweden (Fristedt & Sundqvist, 2009). Through the auditing business segment, they have good insight in companies and how they work with their capital structure. Furthermore they consult companies in matters regarding how to finance investments, making their insight and understanding of capital structure even better.

This led us to the following problem statements and sub-questions:

- Why are the “Big four” not using leverage while advising other firms to use debt?
  - Is this choice supported by existing theories on the subject, e.g. pecking order and trade-off theory?
- Which are the underlying factors of the capital structure determinants of the Swedish the “Big four”?
  - Which are the determinants and how do they differ from Lindblom et al’s (2011) findings regarding determinants of capital structure in large Swedish firms?

1.4. Purpose

The purpose of this thesis is to identify why the “Big four” have chosen a restrictive capital structure with no leverage, despite advising other firms to take on debt on a daily basis. We further aimed to study if and how the partner ownership affected these choices. Lastly, we wanted to examine if the considerations could be supported by established theories and current research, i.e. Lindblom et al (2011).
2. Method

2.1. Introduction

In this section we will describe the approach used to answer the stated problem. A detailed explanation and motivation of the steps and used methods are described. Furthermore, the validity and reliability of the methods are addressed in each of the sections.

2.2. Scientific approach

2.2.1. Qualitative method

In the qualitative method, data is collected for example through interviews and usually analysed by interpretive and subjective methods (Patel and Davidson, 2003). We wanted to understand not only which factors affected the choice of capital structure but also why the specific factors were considered. A quantitative method would not have been sufficient for this purpose, as it would have been difficult to anticipate which questions to ask since the knowledge in the area of partnership firms and in the “big four” is limited, thus an explorative approach was necessary. A close proximity to the studied units was essential for us to gain enough depth in our understanding, e.g. by asking follow-up questions in interviews, to be able to answer our problem statement (Backman, 1998). High flexibility was important, since it enabled small changes in the structure of the interviews when conducted, meaning increased quality in the collected data. This was not only positive, as it was a potential problem for the comparability of the results between interviews. In the end this did not become a problem since we were able to complement our data from the early interviews through e-mail and phone contact with the interviewees. Despite some shortcomings of the qualitative method we felt that the advantages of a deep understanding of the process was essential for the outcome of this thesis, and more important than objective comparability; consequently, we chose to use a qualitative method.

2.2.2. Inductive approach

Although it is hard to approach a social phenomenon through simplifying theories, there is still a need for theoretical anchoring when approaching this type of an ad-hoc phenomenon (Holme & Solvang, 1997). We used an inductive approach to address this problem. According to Holme & Solvang (1997) a large share of the research conducted within in social sciences
break the limits for a logical deductive system, this was also the case in this study. Furthermore, we did not want to limit our understanding of the examined process by basing the study entirely on existing theory. The goal was rather firstly to thoroughly understand the process of deciding capital structure in a partner owned firm, and secondly, to examine whether our findings could be related to existing theories on the subject of capital structure.

2.3. The basis of the study

2.3.1. Case study
A case study is considered to be further applicable when the objects of the study are complex, and when trying to understand a large phenomenon, organisation or system not easily examined by other methods (Backman, 1998). The process we examined in this thesis is complex and difficult to gain an understanding with enough depth to answer our problem statement, hence the choice to conduct a case study. Unlike previous quantitative studies where the focus was on finding support for theories as trade-off or pecking order, we also aimed to gain understanding of the underlying factors behind the decisions regarding capital structure choices. For this reason a case study was the most suitable alternative. A case study includes one or a small number of cases. It is often interesting to compare different case studies in order to find the relevant aspects of a process (Lundahl & Skärvad, 1992). We conducted a case study covering four companies in order to gain a sufficient amount of information. The choice of number of cases was a trade-off between depth and width of the study. The time limit was also taken into consideration. We found four to be a good number for the study providing sufficient depth, while maximizing use of the limited amount of time for writing this thesis. However, we got the chance to conduct an interview with the Stockholm as well as the Gothenburg office of Ernst & Young. We decided to do both interviews as we felt that it was respectful to do when they gave us the chance, this resulted in five conducted interviews.

2.3.2. Choice of companies
Our two main criteria when choosing companies for the study was that they had partner ownership structure and that one of their areas of business was to consult other firms in their choices of capital structure.
We chose partnership companies as they have a special ownership structure where management and ownership is not divided. They differ both from companies where ownership and management is divided and from regular managerial ownership companies, as they have a system were it is possible for any associate to become a partner and thus owner in the firm.

The reason for our second criteria for company choice was that we wanted to study how “experts” work with their capital structure, and it is reasonable to believe that firms consulting other firms in an area are experts on the subject. Lundahl & Skärvad (1992) argued that it is important to look for typical cases that are highly representative for the industry when conducting a case study, this lead us to the “Big four”. Together the firms constitute a large part of the entire capital structure advisory market, they give advice to small, large, listed and non-listed firms in all industries. They give advice through both their advisory and their auditing departments.

2.3.3. Literature study

The literature study included four steps. Methodology and general thesis theory were studied to gain a basic understanding of the work associated with the process of writing a thesis. A thorough study on the capital structure subject was also conducted. Furthermore, the financial statements of the research objects were studied to examine the firms’ economic status relative to each other. A study on past and recent dissertations was conducted to ensure up to date knowledge in the area of research.

2.3.4. Choice of theoretical frameworks

The literature study of former dissertations and theses revealed that some theories concerning capital structure are more commonly used in research than others. The two most widely recognised theories are the trade-off and the pecking order theory. This was one of the contributing factors to why we found these frameworks to be the most interesting and suitable to use in our study. We also used the agency theory, as the interviews revealed possible agency costs. Both evidence supporting and contradicting the theories have been found; hence, it was interesting to examine whether the alleged experts used the common theories when choosing their capital structure.
2.4. Gathering of data

This study is based on both primary and secondary data. Primary data is information gathered from a person who was there when the event actually occurred: in our case this means data from a person who was involved or had insight in the decisions regarding capital structure. The primary data in this thesis was collected through face-to-face and telephone interviews. Secondary data is originally collected for other purposes than the research it is used in, e.g. the data collected for annual reports is collected for financial reporting purposes and not for the purpose of this study. The main sources of secondary data in this thesis were annual reports, and primarily balance sheets and the income statements. Primary data is generally considered more reliable than secondary data, due to the reduced risk of distortion (Kylén, 2004, Patel & Davidsson, 2003).

2.4.1. Interviews

This thesis was mainly based on primary data collected in five interviews. During the interviews, two aspects were important to consider; degree of standardisation and degree of structure (Patel & Davidson, 2003). In this study, we faced a trade-off when designing the interview questionnaire. The goal was to construct an interview template that was standardised to enable possibilities for comparison between interviews, without making them unnecessarily structured, thus constraining the interviewees in their answers. When conducting a qualitative analysis, an unstructured and unstandardized interview was the best alternative according to Patel and Davidson (2003). However, we found that some degree of primarily structure but also standardization was important for us to be able to collect enough data in the limited timeframe of approximately 30 minutes per interview, and also to be able to compare the results from the different interviews. Our role in the interview was to guide the interviewee in the desired direction while still giving the concerned person freedom in the answers. We found this to be the best way for us to gain a deep understanding of the process of choosing capital structure. Overly specific questions could have led to gaps in the data provided, resulting in lower understanding of the studied process. On the other hand, absence of structure and broad questions would have made the interviews inefficient, and probably insufficient due to the limited amount of time for each interview.

The interview template (Appendix 2) was sent to the interviewees one week prior to the interviews. The reason for this was to prepare our interviewees to get effective interviews.
During the interviews, broad questions were asked, and depending on the precision of the responses subsequent follow-up questions were asked.

2.4.2. Interviewees

To ensure suitability of interviewees, i.e. persons with sufficient insight in capital structure decisions, we contacted the chosen companies by sending e-mails to their respective student relations person. In the e-mail we explained the purpose of our study, the problem statement of our study, and what competence/knowledge we were looking for in our interviewees (appendix 3). When the appropriate persons were located we proceeded by contacting them by phone to schedule a personal interview.

2.4.3. Secondary data

The secondary data used in this thesis is mainly from annual reports, but also from past theses and dissertations. When using secondary data two aspects need consideration; comparability and reliability (Bjerke & Arbnor, 1994).

Comparability was not likely to be a problem in in the case of the data from the annual reports. Although an amount of slack in the accounting principles, meaning the companies have possibilities to manipulate the numbers stated in the annual reports to some extent, the annual reports were considered reliable. Lindblom et al (2011) used a similar theoretical foundation leading to possibilities for comparison.

In order for a secondary source to be accounted for as reliable, it is important that the process of collecting the data, the studied population and the made definitions are described in detail in the source (Bjerke & Arbnor, 1994). The extensive rule framework for accounting ensured the fulfilment of reliability regarding the study of annual reports. Lindblom et al’s (2011) study is considered as reliable due to a precise report of the usage of the methodology.
3. Theoretical framework

3.1. Theoretical introduction

The capital structure refers to how a firm chooses to finance its assets. There are a number of financing alternatives; the two most common are debt financing and equity financing. The combination of the two is what is commonly referred to as the structure of the liabilities, the capital structure. Moreover, a company can use so called leverage in order to reduce its needs for equity capital by taking on debt. This is often considered to be a cheaper alternative for financing different company activities. As the leverage increases, less equity capital is required, hence profits or losses are shared among a smaller number of stocks which leads to proportionately larger profits or losses, i.e. a multiplier effect which can lead to an increase in risk (Berk & DeMarzo, 2007).

3.2. Trade-off theory

3.2.1. Interest tax shield

A tax shield is the reduction in corporate taxes paid as a result of deducting certain costs from the income. The interest tax shield is the gain to the investors from the tax deductibility of interest payments. The value of the tax shield is the present value\(^1\) of the extra amount that a firm would pay in taxes if it did not have leverage. (Berk & DeMarzo, 2007)

3.2.2. Modigliani & Miller

Modigliani & Miller conducted two studies on capital structure, in year 1958 respective year 1963. These studies became the starting point for modern corporate finance, and many studies on the topic have been conducted (E.g. Myers, 1984, Harris & Raviv, 1991, Minton & Wruck, 2001).

Modigliani & Miller (1958) stated; firm value is not affected by choice of capital structure, given perfect capital markets, and the management of a firm should only be concerned with attracting the amount of capital needed in the business. The results of this study may seem irrelevant as perfect capital markets do not exist in practice, however this fact implies that

\(^1\) The value of a cost or benefit computed in terms of cash today, i.e. a discounted cash flow.
choice of capital could affect firm value if the assumptions of perfect capital markets are violated.

As perfect capital markets do not exist in practice, Modigliani & Miller (1963) conducted a second study where some of the shortcomings of the first study were corrected. Corporate taxes were considered, and the study concluded that debt could reduce corporate taxes paid by the firm through the deductibility of interest payments. This lead to the theory that company value could be increased through taking on debt. For this reason firms should be financed entirely by debt as this would result in a maximized firm value.

### 3.2.3. Financial distress costs

When a firm’s leverage increases, the risk of default increases due to e.g. higher interest payments, thus higher costs. This is an example of a so called financial distress cost. The magnitude of financial distress costs is primarily affected by two factors; the probability of financial distress and the magnitude of the costs that arise in the firm when it experiences financial distress (Berk & DeMarzo 2007). The costs can be both direct and indirect (Ross et al, 2004). Direct costs are directly associated with the situation when a firm is becoming financially distressed, e.g. administrative costs of hiring accounting and legal experts for consultancy in the matter (Ross et al, 2004). Indirect costs occur when a firm is in financial distress. The indirect costs are often difficult to measure, but are often larger than the direct costs. Examples of indirect costs are loss of customers, loss of suppliers, loss of employees, loss of receivables and fire sale of assets (Berk & DeMarzo, 2007). Further examples are higher interest rates for credit and shorter payment lead-times from suppliers due to the increased risk that the firm will not be able to fulfil its payment obligations (Brigham & Houston, 2009). Myers (1977) argued further that indirect financial distress costs might arise through lowered investment activity. This is a consequence of capital becoming increasingly expensive to attract as a firm is going into a situation of financial distress. The deficiency of available capital might lead to lost investment opportunities.

### 3.2.4. Trade-off theory

The trade-off theory is based on Modigliani & Miller’s (1958, 1963) two studies, but the influences of market imperfections on firm value were further considered in studies conducted by e.g. Rajan & Zingales, 1995, Leland, 1998, Jensen & Meckling, 1976, Stiglitz, 1969, etc.
Not only corporate taxes and thus tax shields were accounted for, but also the effect of financial distress occurring in a firm using excessive leverage. The trade-off between using leverage, thus gaining advantages through tax shields, and using excessive leverage, leading to disadvantages through financial distress costs, is the foundation for what Myers (1984) called the static trade-off theory. Berk & DeMarzo (2007) summarize the theory with the following sentence:

“According to the trade-off theory; the total value of a levered firm equals the value of the firm without leverage plus the present value of the tax savings from debt, less the present value of financial distress costs.” (Berk & DeMarzo, 2007, p. 501).

The trade-off theory resulted in the theory of an optimal capital structure. An optimal structure refers to an optimal balance between debt and equity where the weighted average cost of capital is minimized, and the relationship between pros and cons of both debt financing and equity financing is at an optimal level. Graham & Harvey (2001) further argue that all companies should identify the optimal level of debt and equity and then strive to reach and maintain this ratio. See figure 1 for a graphic illustration of the relationship between debt level and company value.

![Figure 1. Trade-off](image_url)

The figure illustrates the trade-off between increasing firm value due to interest tax shield and decreasing firm value due to bankruptcy costs. As the a firm takes on debt the value of the
firm increases until the margin present value of the bankruptcy costs exceed the margin value of the interest tax shield. The optimal level of debt-to-equity is shown by D/E*.

3.2.5. Recent empirical findings on trade-off theory in Swedish companies.
Lindblom et al (2011) argued: “It must be considered as a prerequisite that firms at least keep track on their capital structure if they aim at an optimal capital structure”. The results of the study showed that a majority of large Swedish firms do work with a target capital structure, hence supporting the trade-off theory. This is true for listed and non-listed companies.

However, the empirical results have not only been in support for the trade-off theory. Lindblom et al (2011) found weak support for the statements: “A capital structure with a high leverage contributes to increasing firm value” and “Tax consequences mean that high leverage creates value for the shareholders”, implying that Swedish large firms believe there is not much to be gained by high leverage.

3.3. Pecking order theory

3.3.1. Pecking order theory
The pecking order theory has been discussed and examined in several academic articles (Myers, 1984, Brennan & Kraus, 1988, etc.) but was introduced by Donaldson (1961). Donaldson (1961) claimed managers of firms follow a well-defined plan of actions when making new investments. Furthermore Donaldson (1961) concluded that management prefer internal generation of funds as a source of funding to external funding (Myers, 1984).

Myers (1984) further examined the theory and invented the term “pecking order”(Lindblom et al, 2010). In the article written by Myers he suggested a pecking order, i.e. an order of preference, when choosing sources for financing the firms’ investments. The suggested preference of sources state that firms firstly tend to finance its investments through utilization of retained earnings (available liquid assets), secondly financing through debt and lastly through external equity financing (Myers, 1984). This hierarchy denied the existence of an optimal capital structure, which was contradictory to the trade-off theory, since equity was considered both as an internal and external mean of financing (Myers, 1984).
The difference in preferences of stakeholders regarding the managers’ choice of source for funding was explained through the asymmetric information existing between the stakeholders and the people governing the firms. Myers (1984) assumed that the managers’ incentives were perfectly aligned with maximizing shareholder value (Lindblom et al, 2010). Modigliani & Miller (1958, 1963) disregarded the asymmetric information in their theories through the prerequisite of perfect capital markets. Perfect capital markets are rarely found between companies in the real world and asymmetric information between firms is considered to exist.

A factor explaining why companies preferred internally generated funds to e.g. debt or issuance of new equity was the costs avoided through using internal funds (Myers, 1984). When comparing debt finance and issuance of new equity the latter is considered more risky and therefore not a priority for companies deciding between the two.

### 3.3.2. Recent empirical findings on pecking order theory in Swedish companies.

More recent research made regarding pecking-order theory established that at least on average Swedish firms tend to make financial decisions in line with the pecking order theory (Lindblom et al, 2010). Approximately 66 percent of the respondents marked a preference of using internally generated funds as a first choice for funding the investments in the conducted study. Bank loans were preferred by less than one out of five (17,9%) as a preferred source of funding, while almost every second (44,7%) respondent ranked bank loans as a second choice. Long-term loans were preferred prior to short-term loans by the respondents. Equity was preferred prior to securities such as convertibles and bonds, which is non-consistent with the pecking order but could be explained through the deficiency of such markets in Sweden (Lindblom et al, 2010).

Lindblom et al (2010) found indications that larger firms rely more on internally generated funds in comparison to small companies. The authors also stated that managers in non-listed firms reported higher reliance of internally generated funds as their main source of financing than their counterparts in listed firms. Thus the study implied strong evidence for the utilization of the pecking order theory within Swedish firms, deviations were found supporting mainly the opposing theory, the trade-off theory (Lindblom et al, 2010).
3.4. Financial conservatism/Pecking order style financial policy

Financial conservative firms are defined, by Minton & Wruck (2001), as firms having significantly less debt than the established theories of capital structure (trade-off, etc.) expect. Graham (2000) argued that a typical firm borrows substantially less than what would be expected to be optimal. Minton & Wruck (2001) determined that financially conservative companies follow what they define as pecking order style financial policy. By pecking order style financial policy Minton & Wruck (2001) meant a version of the pecking order theory with exception of that the low-leverage firms do not empty all internal funds before seeking external funding, and when doing so they do not exclusively turn to debt financing, even though this was found to be most common. The pecking order predicted that external financing was used only when internal funds are insufficient to cover the discretionary expenditures making the theory differ from the pecking order style theory (Minton & Wruck, 2001). The article also found that financial conservatism is an essentially transitory financial policy where 70 percent of low-levered firms abandoned the conservative policy and the most part, more than 90 percent, never return to a financially conservative policy. Furthermore, Minton & Wruck (2001) established that financial conservatism is not an industry-based phenomenon. However, the authors found some characteristics of the industries financially conservative operate in, e.g. the firms usually operate in industries considered to be sensitive to financial distress and generally have high market-to-book ratios (Titman, 1984). They also implied that conservative firms have solid flows of funds, strong cash balances, no direct problems related to shortage of information and are highly profitable. Finally, they concluded that the firms using a restrictive financial policy did not appear to have low tax rates or non-debt tax shields. By this conclusion Minton & Wruck (2001) did not infer that tax considerations are unimportant when determining capital structure, which Graham (1996a) implied to be a factor. Minton & Wruck (2001) found the tax factors affecting choices regarding capital structure, but not being the primary factor.

3.5. Agency theory

The agency theory has its origin from the fact that managers, who are considered to be the agents of investors, make decisions. This could potentially lead to conflicts of interests between management and investors, which possibly could inflict on the firms’ strive for an optimal allocation of its resources (Copeland et al, 2005). The term agency costs is part of the agency theory and are costs that arise when conflicts of interest between stakeholders exist,
usually due to separation of ownership and control of the firms (Jensen, 1986). One of the conflicts found by Jensen & Meckling (1976) was the conflict between shareholders and managers that occurs through managers not owning all the equity, which infers that they do not capture the entire gain from their value enhancing actions. Examples of agency costs are cost of monitoring and the cost of informational asymmetries (Copeland et al, 2005). An increase in debt level, achieved through either additional dividend pay-outs, repurchase of stocks or issuance of new debt capital, could be a good tool for absorbing cash surpluses and furthermore minimize waste and unnecessary spending made by managers (Jensen, 1986). Thus could debt capital be seen as a monitoring device, aligning management actions with the interest of shareholders (Lindblom et al, 2011).

An increased debt or debt-to-equity ratio leads to the problems related to agency theory grow through the conflict of the interests of lender and shareholders, since both want to benefit as much as possible from the deal (Brigham and Houston, 2009). Jensen (1986) also argued that increased leverage involve additional costs, not only the costs associated with an increased risk of bankruptcy. Jensen (1986) stated that there were additional costs, costs related to agency theory. One of the agency costs arises when the company take on riskier projects that might be beneficial for shareholders at the expense of bondholders. Jensen (1986) defined an optimal leverage ratio where marginal costs of debt and marginal benefits of debt are aligned (Copeland et al, 2005).

3.6. Homemade leverage

Modigliani & Miller (1963) further argued that if investors prefer a different capital structure they could borrow or lend on their own and achieve an equal result to when the firm they invest in borrow or lend. A prerequisite is that the investor can borrow and lend at the same interest as the firm, i.e. perfect capital markets. Homemade leverage is a perfect substitute for the use of leverage by the firm, as long as the prerequisite of perfect capital markets is fulfilled (Berk & DeMarzo, 2007).

3.7. Summary of theory

The trade-off and pecking order theories are used to explain and to structure the empirical results. They are both needed to answer the problem statement and to ensure the purpose is
fulfilled. The agency and homemade leverage theories are not essential to answer the problem this thesis is addressing. However, they are needed for a deep understanding of the empirical findings.
4. Empirics

4.1. Introduction
In the following sections summaries of the conducted interviews with representatives from each of the firms in the "Big four" are presented. The interviewees are Lars Svantemark (Partner and COO, Deloitte Sweden), Håkan Gustafsson (Partner and COO/CFO for the Nordic sub-area, Ernst & Young, Sweden), Sven-Arne Gårdh (Partner, Ernst & Young Sweden), Jan Malm (Partner and Head of the Gothenburg Office, KPMG Sweden) and Magnus Götenfelt (Partner and Head of the Gothenburg Office, PWC Sweden).

4.2. Interviews

4.2.1. Jan Malm – KPMG
KPMG has a strict financial strategy meaning they do not, under any circumstances, use external sources for attracting capital, i.e. no debt. Jan Malm argues: “We want to be completely independent and avoid conflicts of interest as we might consult some of the banks or financial institutes”. Furthermore, he is aware that debt financing could be beneficial but for the purpose of KPMG Malm finds the capital structure to be optimal.

Despite no use of debt or new issuance of shares Malm says KPMG works actively with their capital structure through constant improvements of the management of account receivables. This is primarily for financial flexibility and cash management purposes. Malm states: “this is an area where the industry traditionally have been deficient and we are working actively to improve this aspect”. Furthermore, KPMG’s need for investments is low. The auditing industry is considered of being predictable and non capital intensive, according to Malm. The investments are in most cases possible to finance through retained earnings, as the firm has steady cash flows. Malm says “in the rare case of a large investment, for example purchase of new office computers, it can be financed through deposits/borrowing of cash from the partners if the retained earnings do not suffice”. When the firm is in need of capital from its partners the partners, are obliged to contribute. On the rare occasion when a partner has to contribute financially a favourable interest rate, above market rate, is received.

Malm argues that the purpose of the partnership is not to earn money through increased value of the equity but through dividends. KPMG strives to maximize dividends each year, i.e.
almost emptying the outgoing cash balance. Becoming a partner gives the concerned the right to buy shares and to vote in the semi-annual shareholder meeting. Every partner has their own responsibility to finance their partnership by debt or savings. Malm says the most common way of financing the partnership is through personal debt. The number of shares is fixed, meaning when a new partner is selected the shares are reallocated among partners. Furthermore, the shares are unevenly divided among partners and the number of shares is depending on performance and responsibilities of each partner. The performance is measured on a number of factors, e.g. charged auditing/consulting hours and commissions of trust, and are presented in monthly scorecards. All partners have the possibility to affect major decisions concerning the firm, for example Malm says: “a couple of years ago a discussion regarding the acquisition of KPMG office buildings took place, but it was not accepted by a majority of the partners as external capital would have been needed, therefore the proposal was rejected”.

The partner ownership structure is a way for KPMG to attract and retain employees by giving them economic incitements. Furthermore, Malm argues: “it is a way to keep them on their toes and motivate them to perform at the top of their abilities”. There are no bonus or incentive systems for partners. However, some associates have higher salaries, with bonus and incentive systems.

4.2.2. Håkan Gustafsson & Sven-Arne Gårđh – Ernst & Young

A couple years ago Ernst & Young decided to try to globalize its partnership structure in order to align global operations, increase efficiency and facilitate global cooperation. As a consequence of this the partners in a number of countries exchanged their shares for voting rights in Ernst & Young Europe. However the partners still have basically the same structure regarding e.g. claim on dividends.

Håkan Gustafsson (COO) introduces the company strategy with saying that the firm’s greatest asset is the intellectual capital, since their business model is based on selling the time and knowledge of employees. The COO states that the company strategy is closely related to the financial strategy of the firm. The company goals for Ernst & Young are to have a strong brand, the best relations to stakeholders and the largest share of the market.
Gustafsson admits that the capital structure is of importance but in a different way compared to a conventional company since there are no incentives to increase market value of the company. Ernst & Young has a low level of leverage and the main reason for that is that they do not need it for either company operations or most of their investments. A main reason for the ability to finance their investments through retained earnings is that the major investments are in human capital, i.e. in education and recruiting of employees. These investments are quickly repaid, as the employees become profitable within a short timeframe.

Another reason explaining its low demand for external financing is that they act in a highly predictable and stable industry, where Gustafsson states that the firm could predict about 70-80 percent of the cash flows. Ernst & Young are open to borrow money in the case of a high demand for such a loan in order to accomplish necessary investments when internally generated funds are inadequate. Gustafsson admits that in a company with a conventional ownership it would be reasonable to take on more debt in order to increase company value and make a larger dividend pay-out to owners. This is not reasonable for Ernst & Young, according to Gustafsson, since this would not be fair to future partners, as they would be forced to pay for old partners dividends. Gärdh further emphasises why Ernst & Young try to avoid external financing through the statement: “we can not under any circumstances be in financial distress as an auditing firm”.

The decisions regarding major investments, which are unusual according to Gustafsson, are made by the board of Ernst & Young Sweden and in some cases with the consultation of the Nordic board. An average partner does not have the possibility to affect large decisions.

Regarding dividend policy Ernst & Young strive to maximize pay-outs every financial year mainly to avoid excess liquidity and to make it as fair as possible for current and future partners. The predictable cash flows, mainly through the oligopoly market they act in, enable Ernst & Young to almost empty the cash balance every year.

Several factors affect the choice to use the owner structure partnership, but the main factor is according to Gustafsson, that nothing else is suitable for Ernst & Young’s purpose. Gustafsson further motivates why partnership is suitable with arguments as the importance of independence and with regard to regulations. He explains that research has been conducted with the aim to find an optimal structure. So far the research has not been able to determine a better suiting structure than the current. Ernst & Young basically has 150 different levels of
partnership, as many levels as they are partners. Every partner has a different amount of shares depending on factors as performance and duration of partnership. To assess the performance of partners Ernst & Young uses a performance based balanced scorecard where the individual performance is measured.

The number of shares issued by Ernst & Young is fixed but can be reallocated. The reallocation is unusual and when it occurs it is usually associated with a partner leaving the partnership or/and when an associate becomes partner. A junior partner most often starts off with a small amount of shares and in most cases this amount increases over time in a quite linear manner, as long as the performance targets are fulfilled. Further incentive for the partner, except from gaining more shares, is to take part of the 10 percent of profits that are allocated among the best performing partners. Regular associates take part of the year’s profits through bonus and incentive system based on company and individual performance.

Partnership is usually financed through personal debt, according to Gustafsson. Ernst & Young has an agreement with a local bank that enable partners to borrow money at a reasonable rate which enables all partners to finance their partnership. Furthermore, Ernst & Young pays interest, a so-called risk-premium, on the money borrowed from the partners.

4.2.3. Lars Svantemark – Deloitte
Lars Svantemark presents the financial strategy as an area that is not highly prioritized. The reason for this is that the partner ownership structure infers there are no other stakeholders than the partners. The investment needs are generally low, and can most often be financed through the continuous cash flows, implying a low need of financing through external sources. Svantemark further argues the business is run in a way to avoid debt financing as well as borrowing money from partners. This is possible as the cash flows are, although changing by season, relatively stable. Svantemark is of the opinion that Deloitte’s capital structure is optimal for their purposes due to primarily two factors; the partnership structure and the low investment need.

In the case of a large investment Deloitte analyse whether it is needed to use debt or not, the goal is however to avoid this. The policy of the firm is to avoid taking on projects unrelated to
the core business of the firm. Thus, as the industry generally has low investment needs, large investments are rare.

The firm uses a partnership structure for a number of reasons. Primarily since it is the only structure that works for a large auditing firm, as rule frameworks state that at least 75% of the owners in an auditing firm has to be auditors. Secondly, it is a way to provide incentives for young employees to stay with the firm. There are different levels of partnership within the firm, and consequently different benefit levels. The partnership levels and thus shares in the firm depend on performance and what each partner’s present tasks are. The partners finance their partnership through either savings or debt through a company wide deal with a bank. However, the amount that a new partner has to pay is moderate.

4.2.4. Magnus Götenfelt – PWC

PWC’s financial strategy had its foundation in maintaining independence. Independence was one of the main reasons for PWC’s choice of capital, i.e. low levels of external debt, mainly to avoid conflicts of interests with firms that PWC are consulting, according to Magnus Götenfelt. PWC had an overdraft credit if the firm would be in desperate need of capital, which was a rare occurrence.

PWC considered themselves to work actively with the capital structure, with focus on the assets, i.e. accounts receivables and overall management of invoices. Götenfelt further emphasise the importance of the capital structure and to control the firm’s finances with the statement: “an auditing firm cannot risk to be in financial distress”.

Investments are usually financed through retained earnings. A couple of years ago PWC made a large investment when acquiring a number of auditing firms. The acquisitions were to the most part financed through internally generated funds. If the retained earnings are insufficient borrowing from partners is used as a source for capital. But according to Götenfelt substantial investments are uncommon mainly since the business is not considered as capital intensive. The main investments are made in human capital, i.e. recruitment and education of employees. The human capital is the firm’s greatest asset since PWC actually sell working hours, Götenfelt says. Furthermore Götenfelt states that the cash flows are predictable to a great extent and the firm is not considered to be sensitive to the economic cycles.
The choice of the owner structure partnership is based on a mixture of factors. The first reason, according to Götenfelt, is from historic and traditional aspects. Secondly the ownership structure is the most suiting for their purpose. Thirdly, it would not be fair for future partners to take on debt as they would have to pay for the benefits of present partners. The last factor is affected by legal frameworks saying that auditing firms must be owned by auditors working in the firm, forcing the firm to use the partnership form of owner structure.
5. Analysis

5.1. Overview and comparison of empirics

5.1.1 The Partnership

The partnership agreements of the examined firms show substantial similarities, especially regarding core attributes. The agreements include benefits but also obligations. Obligations differ to some extent among companies. KPMG has a clear policy stating that when the firm needs additional capital the partners are forced to lend capital while Ernst & Young said that a small external loan is possible, but added that this is a rare occurrence. The benefits include taking part of the yearly dividend pay-out, interest on deposited capital and the possibility to vote at the shareholder’s meeting, hence ability to affect general decisions. However, the decision-making process regarding capital structure showed differences, e.g. at KPMG all partners can affect the decisions while in Ernst & Young most decisions are made by either partners in top management, the Nordic-board or the EMEA-board. All firms have high demands on the partners regarding maintaining a high level of performance, and all stated that the amount of shares depends on present and historic performance to a certain extent. All firms have a yearly evaluation of performance, which established reallocation of shares. Ernst & Young and Deloitte rarely reallocated shares but stated that most partners follow a close to linear development regarding amount of shares held, the performance and additional responsibility determined the slope. However, KPMG and PWC reallocate the shares on a yearly basis depending on the individual partner’s performance.

The firms all said that the choice of owner structure depends on the fact that it is considered the most suitable for their purpose. Furthermore, historical and traditional aspects also have an effect, i.e. the firms are founded as partnerships. Also the fact that legal frameworks constituted a limitation when choosing ownership structure, affected the choice. Independence and avoiding conflicts of interests with the clients of the “Big four” were major reasons motivating the partnership.
5.1.2 The Financing of Investments and the Capital Structure

The interviewees all stated the firm’s greatest assets are the employees and they account for a large part of the yearly investments. According to Gustafsson the investments in human capital have a short payback period, a reason for the low need of debt financing. Furthermore, the industry is non-cyclical and 70-80 percent of next year’s revenues and costs can be estimated with high certainty, enabling avoidance of debt financing through planning of future cash flows. Svantemark stated “Deloitte is working goal-oriented with planning of investments to avoid debt and partner financing”, and the other firms are doing it as well. Furthermore, the interviewees stated the occurrence of large investments is close to non-existent since the auditing industry is not considered of being capital intensive. Another factor affecting the low investment need was a pronounced attitude against undertaking investments not related to the core business and there are few investment opportunities apart from the investments in human capital. The aspect of fairness to future partners also affected the attitude towards debt financing. It was not considered fair to take on debt to gain advantages for present partners and then let future partners pay the interest payments.

The examined firms show no or low levels of long-term debt from external sources. According to all interviewees the explanation for the low debt is that retained earnings usually suffice to cover the investment needs and daily operations. Accounts receivables were, due to long invoice lead times, another factor that could have an indirect effect on the capital structure in all interviewed firms. Accounts receivables have a decreasing effect on liquidity. By working actively to shorten the lead times the studied firms were able to increase inflow of cash, i.e. liquidity, and financial flexibility thus avoid the need for debt financing. Furthermore, the firms keep a cash buffer to retain financial flexibility.
Figure 2 displays the key ratios for the "Big four" in Sweden. The size of the firms is clearly affecting turnover, balance sheet total, number of employees and to some extent debt. The firms carrying debt, from both external lenders and partners, are the two largest firms of the four.

### 5.2. Trade-off theory

All firms were aware of the tax benefits of taking on debt. However, the “big four” used a system where the shares do not increase significantly in value as the partners are meant to earn their income through dividends, not increasing share value. For this reason the benefits of an interest tax-shield is partially cancelled. Furthermore, Malm (KPMG) argues it would not be fair to take on debt, thus gaining the advantages of an interest tax-shield, to pay extra dividends to existing partners, as future partners would have to pay for the interest payments. This further motivates the low leverage in the studied firms.

Gårdh (Ernst & Young) said: “we can not under any circumstances be in financial distress as an auditing firm”, which implied the financial distress costs to be of such magnitude making debt financing an exceedingly expensive option. This supports the firms’ choices to carry a
small amount of debt, as the capital structure could still be optimal from a trade-off theory perspective.

Although some support for the trade-off theory was found and the firms might have an optimal capital structure for their specific needs, the reasons for the chosen the capital structure are not due to the cornerstones of the trade-off theory. The firms acknowledged the benefits of interest tax-shields and also the costs of being financially distressed, but the factors were consistently ignored when deciding capital structure. The underlying factors for determining capital structure differed from the trade-off theory factors, e.g. reduction of cost of capital, tax-shields and financial distress costs. The firms main underlying factors were maintaining independence, lack of investment needs, legal frameworks and fairness for future partners.

According to Lindblom et al (2011) a clear majority of Swedish large firms stated to have a target capital structure. This is different from our findings, as the “Big four” do not use a target structure. The firms have low levels of debt since they do not need it, due to low investment needs and stable cash flows, and not due to a specific target. The only firm that one might argue used a capital structure target is KPMG, as KPMG do not accept any externally generated funds and thus have a target of zero debt. In general the use of a target structure seems absent in the studied firms, thus from this perspective the support for the trade-off theory is lower than observed in Lindblom et al’s (2011) study on large Swedish firms.

All interviewees agreed debt and consequently an interest tax-shield could be a value-enhancing factor. Despite this, the firms choose not to use debt for reasons stated, e.g. independence and legal frameworks. However, even though the firms basically do not use debt-financing, their attitude towards the effects of the debt financing, e.g. the effect of tax-shields, is significantly more positive compared to an average Swedish company (Lindblom et al, 2011). This implies support for the trade-off theory to a larger extent than in other Swedish firms.
5.3. Pecking order theory

The hierarchy of sources for financing investments in the examined firms have similarities to the hierarchy implied in the pecking order theory. The firms clearly preferred internally generated funds as the primary source of funding. Although most of the firms did not consider debt financing, the borrowing from partners have similarities to borrowing from a regular credit agency hence a somewhat ambiguous attitude towards debt. Whether the pecking order consider the partner loans as external funding or internal is difficult to determine. If the loans from partners would be considered as external funding this also strengthens the similarities to the pecking order theory. One substantial difference was that KPMG did not consider any other sources of funding than internally generated funds or borrowings from partners.

The reasons to why internally generated funds are preferred seemed to be a mixture of factors. The cost reduction factor mentioned by Myers (1984) was not the only reason, even though it probably was a consideration. We found the main reason for choosing retained earning as the preferred source for funding to be the fact that the firms do not have the demand for the usage of debt since the cash flows are stable as well as the overall liquidity of the firms. The firms have a sufficient financial flexibility without the usage of debt. Independence and being objective, i.e. avoid conflicts of interest, make the firms avoid external sources of funding.

New issuance of equity was not considered as direct alternative when financing investments for the firms. Mainly since other sources for funding was considered more convenient. The amount of shares were basically fixed, and new issue of equity was considered when an associate would become a partner and the firms current partners found the amount of share of being insufficient, a rare event.

The examined firms showed characteristics resembling those of so called financially conservative firms. The firms showed low levels of leverage compared to an average company, which was an identified feature of a financially conservative firm. Furthermore the firms had solid flows of cash, which was in line with Minton & Wruck (2001). But the firms were not considered to act in an industry sensitive to financial distress, which was a feature of the industries where most financially conservative firms were active in.

A major concern regarding the evaluation whether the examined firms were financially conservative and following the pecking order theory was that the low leverage was
fundamentally not a financial decision. The choice of financing was not based on creating company value or competitive advantages but rather for the obedience of various legal frameworks, avoid conflicts of interests and sustaining independence.

The findings of Lindblom et al’s (2011) showed similarities to ours. In line with Lindblom et al (2011) the “Big four” preferred internally generated funds as source of financing. Lindblom et al (2011) found the overall hierarchy of preferred funding was similar to Myers (1984), which was rather consistent with our findings but with the pretence of the “Big four” did not use issuance of debt as a source for financing.

5.4. Agency costs

None of the firms had a separation of ownership and management since partners possessed the top management positions leading to a theoretical eradication of agency costs due to e.g. the absence of asymmetric information (Jensen, 1986). The absence of debt also contributes to less conflicts of interest, since the firms could focus on what was best for them and not bargaining with credit agencies. The fact that the firms strived to maximize the payout of dividends could lead to a reduction of excessive and unnecessary spending. The reduction of such spending was found likely, among partners, but whether this permeates through the organization as a whole was unclear. Whether associates and regular employees that possess management positions have the same strive as partners to reduce costs in order to increase dividends was unclear and could lead to potential excess spending of company cash. Cost awareness and cost responsibility were important factors throughout the firms, which potentially would reduce unnecessary spending and usage of company capital, but the risk of agency costs were still present. Different preferences or interest among partners could be possible since the people in the partnership changed regularly when e.g. associates become partners or a partner retired, thus relieved of the partnership. Agency costs could arise between partners through different personal agendas, e.g. an old partner with an approaching retirement might have a more short-term focus, thus prefer to capitalize more in form of dividends when a newer partner might have a more long term focus and refrain from larger dividends in order to increase the dividends in the future. This might have been avoided through the annual maximization of dividends and emptying of cash surpluses.
5.5. Homemade leverage

Another factor needed to be addressed was how new partners financed their partnership. According to all interviewees it was common that new partners finance their purchase of shares by taking on personal debt. Although perfect capital markets do not exist, the fact that the partners of the firms use personal debt to finance their ownerships implies that some level of homemade leverage might exist.
6. Conclusion

In order to make the conclusion easy to follow we present each problem statement first and the answers subsequently.

- Why are the "Big four" not using leverage while advising other firms to use debt?
  - Is this choice supported by existing theories on the subject, e.g. pecking order and trade-off theory?

The interviewed firms were all well aware of the cornerstones of the trade-off theory. The firms acknowledged the tax benefits of debt financing as well as the costs occurring when a firm is in risk of financial distress. Furthermore, the attitude towards financial distress was consistent among the studied firms; they could under no circumstances be in financial distress. All firms also stated that they had an optimal capital structure for their purposes. When examining this further we found that the reasons behind their choice of capital structure were not in any way anchored in the trade-off theory. The factors affecting their choice of capital structure were in fact due to a number of industry attributes, as importance of independence, peculiarities of the partnership structure etc. This leads to the conclusion that the "Big four" are not considering the trade-off theory when deciding their capital structure.

Furthermore, indirect tax benefits could still be obtained through the potential homemade leverage. It is not the firm that receive the benefits but the person who carry the debt, i.e. the partner, but the overall impact is similar.

All examined firms do follow an established pecking order when choosing source of financing. Once again the reasons behind this fact cannot be tied to a theory, in this case the pecking order theory. Asymmetric information and the differences in cost of capital are not taken into consideration when choosing among the sources of financing, thus diminishing the support for the pecking order theory. The reasons for all studied firms having equal pecking orders when choosing sources of financing is again due to industry attributes, e.g. they can under no circumstances be in risk of default. Retained earnings are preferred since the investment needs are low and the cash flows are stable. Furthermore, fairness between current and future partners is considered and affecting the pecking order. This leads to the conclusion that a pecking order is followed, but not due to the factors in line with Myers’ (1984) pecking order theory.
Which are the underlying factors of the capital structure determinants of the Swedish “Big four”?

- Which are the determinants and how do they differ from Lindblom et al’s (2011) findings regarding determinants of capital structure in large Swedish firms?

When comparing the “Big four” to other large Swedish companies, the results are somewhat ambivalent. In some aspects, as the use of a target structure, the result was that the studied firms do not use one whereas Swedish large firms generally do. In other aspects, as the tax effect of debt financing, the results are opposite. In total, it seems like the “Big Four” have a different approach to capital structure compared to the average large Swedish firm.

In line with the findings of Lindblom et al (2011) the “Big four” preferred internally generated funds as their first choice of source for financing investments. Debt was the firms’ second choice, but from internal partners and not from external parties, as we assume Lindblom et al’s (2011) study focused on. Furthermore, the examined firms did not consider new issuance of equity as a source for raising capital, which is inconsistent with Lindblom et al (2011). All of the examined firms, except KPMG, did consider external debt as a last resort for raising funds, but this was an action that most firms strived to avoid. The fact that it is only the two largest firms, in terms of turnover and employees (see figure 2, section 5.1.2.), that have both internal and external debt makes us believe that they can carry debt without jeopardizing independence and legal frameworks.
7. Summary

The methodology, i.e. a qualitative method, was proven to be the right choice for the purpose of the thesis since the preference of funding alternatives could otherwise have been incorrectly interpreted as support for a theory. E.g. the preference of funding for the studied companies are basically identical to the pecking order theory, but the reasons for this are not from an economical perspective but from legal and independence reasons, facts that would have been overlooked with a quantitative method. As a final comparison to Lindblom et al’s (2011) study; the firms studied in our thesis did show overall weak support for the established theories, i.e. trade-off and pecking order, when underlying factors were considered while the results of their study were ambivalent with both support and opposition for both theories.

8. Suggestions for further research

During the period of writing this thesis we found many interesting subjects and matters that we could not cover since it was not within the frame of our purpose, which we found unfortunate and thus this section. The suggestions are listed below:

1. Agency costs in partnership firms, i.e. between national and international member firms, between partners and between partners and associates.
2. The effects of homemade leverage in Swedish firms, with no or low levels of external debt.
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Books


Articles


**Internet**

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**Financial statements**


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**Interviews**

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Jan Malm, Partner and Head of the Gothenburg Office, KPMG Sweden, 2011-05-09

Lars Svantemark, Partner and COO of the Stockholm Office, Deloitte Sweden, 2011-05-18

**Figure**

Appendix

Appendix 1 – Company presentations

Deloitte

Deloitte, which refers to Deloitte Touche Tohmatsu Limited’s (DTTL) member firms, is a company providing a diverse selection of services in auditing, taxes and consulting etc. Deloitte consists of many independent member firms active throughout the world, where DTTL acts as a coordinator to these independent firms. DTTL was founded in the United Kingdom. The Swedish offices, consolidated under Deloitte AB, employed about 1076 professionals in 2010 (Deloitte AB, Financial statement 2009/2010). Globally Deloitte are active in about 140 countries with about 170’000 professionals employed. Both DTTL and the member firms are all separate and legal entities (www.deloitte.com).

The financial year 2009/2010 Deloitte AB had a turnover of 1 355 706 (kSEK) with no long-term debt. The balance sheet total was 552 209 kSEK. The closing amount of cash was 179 161 kSEK (Deloitte AB, financial statement 2009/2010).

Ernst & Young

Ernst & Young is a global actor in providing services in auditing, tax and consulting etc. Spread over the 140 countries where Ernst & Young are active they have about 141 000 employees, where about 1814 are employed in Sweden in 2010, where 168 are partners. Ernst & Young is organized into three regions: America, EMA/EMEA (Europe, Middle East and Africa) and Asia Pacific (www.ey.com).

Ernst & Young Sweden had a turnover of 2 729 863 kSEK in the financial year 2009/2010 with 61 875 kSEK in long-term debt and debt to partners of 32 351 kSEK. The balance sheet total was 1 348 569 kSEK. The closing cash balance was 183 890 kSEK (Ernst & Young AB, financial statement 2009/2010).

KPMG

KPMG is a company providing services in auditing, tax and consulting etc. KPMG has 138 000 employees divided among 150 countries. In Sweden KPMG has about 1 465 employees.
and 83 partners in Sweden, divided among 60 local offices. The Swedish KPMG, KPMG AB, is a member firm of KPMG International, which is a Swiss cooperative. KPMG International is organized into three regions: America, EMA/EMEA (Europe, Middle East and Africa) and finally Asia Pacific (www.kpmg.com).

The financial year 2009/2010 KPMG had a turnover of 1 991 122 kSEK without long-term debt and debt to any credit agencies. The balance sheet total was 824 313 kSEK and closing cash balance was 122 099 kSEK. (KPMG AB, Financial Statement 2009/2010)

PWC

PWC has about 161 000 employees in 154 countries worldwide. There are 130 offices in Sweden employing about 3 107 professionals, where 242 are partners. They offer services in auditing, accounting, consulting and taxes etc. (www.pwc.com, PWC AB, Financial Statement 2009/2010).

PWC Sweden had a turnover of 4 1 74 587 kSEK in 2009/2010 with long-term debt of 8 859 kSEK and debt to partners of 216 825 and a balance sheet total of 1 852 210 kSEK. The closing cash balance was 318 409 kSEK(PWC AB, Financial Statement 2009/2010).
Appendix 2 - Interview template

The interview template was originally written in Swedish when sent to the concerned firms but was translated for the purpose of the thesis.

Part I.
- What is the firm’s overall financial strategy?

Part II.
- How does the capital structure affect the firm’s operations?
- Do the firm actively work with the capital structure?
- How are potential investments financed?
- Why have you chosen to basically not use leverage?
- Is the current capital structure considered to be optimal?
- Who decides in matters regarding capital structure?
  o Is it possible for all partners to affect decisions regarding capital structure?

Part III. Partnership
- What are the reasons behind the choice of owner structure, partnership?
- How does the partnership function?
  o Are there different levels of partnership?
  o Is the number of partners fixed?
  o Is it possible to deny the offer of becoming a partner?
- Are there a fixed number of shares or are shares issued when a new partner is selected to become a partner.

Part IV. Other questions
- Are there additional bonus and incentive systems for partners?
  o Are there the bonus and incentive systems for associates?
- How come such a large part of the profits are paid out in dividends?

We wish to cover the above mentioned areas during the interview. Additional questions depending on firm specifics and follow-up questions depending on the responses to the
interview questions will be added during the interview. We hope to have the interview as flexible and fulfilling as possible.

We look forward to meeting You!

Best Regards,

Alexander Eriksson Ejdelind & Jonas Sandström,
School of Business, Economics and Law, University of Gothenburg
Appendix 3 - Initial e-mail to the firms’ student coordinators

The e-mail sent to the respective firms was originally written in Swedish and was translated for reasons related to the consistency of the thesis. The e-mail follows below:

Dear xxxx,

We write to You regarding the possibility to have an interview with you for our bachelor thesis at School of Business, Economics and Law, University of Gothenburg. Information of what we hope you could help us with follows below. We would love to have an interview with someone in Your company.

Contact information:

Jonas Sandström
Tel: xxxx-xxxxxx

Alexander Eriksson Ejdelind
Tel: xxxx-xxxxxx

Education: Bachelor thesis in Industrial and Financial Management.
University: School of Business, Economics and Law at University of Gothenburg.
Subject: Corporate Finance

Purpose: The objective of this thesis is to contribute to the research regarding the decision-making process, the determinants and the factors behind the choice of capital structure in Swedish partnership firms. Furthermore we aim to determine whether the existing theoretical framework, e.g. the trade-off and pecking order theory, could explain the firms’ considerations. The firms chosen as our focal point are the so-called “Big four”, i.e. large partnership firms that consult other firms in matters related to capital structure.

Problem statement:

❖ Which are the underlying factors of the capital structure determinants of the Swedish the “Big four”?
- “Which are the determinants and how do they differ from Lindblom et al’s (2011) findings regarding determinants of capital structure in large Swedish firms?
- Why do the "Big four" use zero leverage while advising other firms to use debt?
  - Is this choice supported by existing theories in the subject, e.g. pecking order and trade-off theory?

Appropriate person for interview: We would like to interview a person in your organization with insight regarding your capital structure and how decisions are made. Preferably a partner in some kind of management position, e.g. CFO/COO/CEO.

Data collection: A face-to-face interview would be optimal. If that is not possible we could do a telephone interview.

Great thanks in advance and thank You for helping us!

Best Regards,
Alexander Eriksson Ejdelind & Jonas Sandström