



**ACCOUNTANCY
EUROPE.**

REDISCOVERING THE VALUE OF SME AUDIT

Recent developments in Sweden and
Denmark

Information paper

FACTS.

**AUDIT & ASSURANCE
FEBRUARY 2018**

INTRODUCTION

This information paper reports on the current developments in Sweden and Denmark, where national authorities are assessing the consequences of exempting small and medium-sized enterprises (SMEs) from mandatory audit.

SMEs are the backbone of the EU economy. They represent 99,8% of all enterprises which operate in the non-financial sector of the 28 EU Member States. SMEs account for 66,6% of total employment and generate 56,8% of value added in this sector.¹ These figures are comparable with the contribution of large enterprises. Therefore, policy instruments that also instil confidence and trust in this part of the market are indispensable. An audit of the financial statements (audit) is one of these policy instruments; it ensures that financial information is reliable, which is crucial for the functioning of the economy and its growth.

However, policy-makers seem to focus on audit of large or listed companies rather than SMEs. In recent years, the requirement for auditing SMEs has been increasingly perceived as an administrative burden. As a result, regulators in some countries have introduced an audit exemption for SMEs. At the same time, Sweden has just evaluated the impact of one such reform abolishing the SME audit requirement, concluding that the reform was unsuccessful as its costs outweigh the benefits.

SWEDISH IMPACT ASSESSMENT

In 2010, Sweden abolished a regulatory requirement for audit of small limited liability companies. In December 2017, the Swedish National Audit Office (NAO), an independent body of the Swedish Parliament², published a report *Abolition of audit obligation for small limited companies – a reform where costs outweigh benefits*³ that put this abolition into question. The report demonstrates through an impact assessment that audit of small entities is valuable to both SMEs and the public good.

FINDINGS

The main findings of the impact assessment outline numerous downsides of abolishing the SME audit obligation and show that the companies' competitiveness and growth have not been enhanced by the reform:

1) SLOWER GROWTH

Those companies which opt out of audit do not have higher growth, rather the opposite. They report weaker subsequent growth, both in net sales and staff numbers.

2) SMALLER SAVINGS

The cost savings made by the companies that opt out of audit are small, profitability does not improve.

3) LACK OF TRANSPARENCY AND CONTROL

Without audit, overall transparency is reduced and authorities have less information to exercise control and enforcement in various areas.

¹ These data relate to micro, small and medium-sized enterprises and are based on the European Commission's *Annual Report on European SMEs 2016-2017*; available at https://ec.europa.eu/growth/smes/business-friendly-environment/performance-review_en?pk_source=ec_newsroom&pk_medium=link&pk_campaign=spr17

² The Swedish National Audit Office is an independent agency charged with the audit of government institutions and the oversight of the state finances through financial and performance-based audits of state agencies, state-owned companies and the Government of Sweden. It operates directly under the Swedish Parliament (Riksdag) and is independent of political or other stakeholder interests. More information is available at <https://www.riksrevisionen.se/en/Start/About-us/>

³ A summary of the report in English is available at https://www.riksrevisionen.se/PageFiles/27902/RiR_2017_35_REVISIONSPLIKT_SUMMARY.pdf
The full report is available in Swedish at https://www.riksrevisionen.se/PageFiles/27733/RiR_2017_35_REVISIONSPLIKT_ANPASSAD.pdf

4) INCREASED RISK OF ECONOMIC CRIME INCLUDING TAX EVASION

The inclination to opt out of audit is greater in industries with a high risk of economic crime and tax evasion. The slowing rate of growth may indicate that companies that opt out of audit withhold more tax than before.

5) MORE MISTAKES IN THE ACCOUNTING

Without audit, the number of errors in the financial statements increases.

RECOMMENDATION AND NEXT STEPS

Based on the conclusion that this reform's costs outweigh its benefits, the Swedish NAO recommends to the Swedish Government to reintroduce the audit obligation for small limited liability companies. The Government will respond to the report's findings at a plenary meeting in early April 2018.

DENMARK FOLLOWS SUIT

The Swedish NAO's report has sparked a debate on the consequences of the SME audit exemption in Denmark. The Danish audit exemption threshold has been raised three times in the last twelve years - in 2006, 2010 and 2013. The Danish Ministry of Business has now announced to carry out a study into the consequences of easing the audit obligation.

RISKS OF AUDIT EXEMPTION FOR SMEs

Exempting SMEs from audit increases a number of risks to the economy. The Swedish report has highlighted in particular the risk of accounting errors, tax evasion and economic crime.

ACCOUNTING ERRORS

As demonstrated by the Swedish example, without audit, SMEs tend to have more errors in their accounting. This undermines the reliability of their financial statements and reduces users' trust in them.

NEGATIVE IMPACT ON TAX COLLECTION

The Swedish assessment indicates that exempting SMEs from the audit obligation may increase tax evasion and impair the ability of authorities to detect such crime. Without being audited, companies run a smaller risk that tax evasion will be discovered. It is easier for companies to deliberately report lower economic activity and so reduce the profit to lower their tax.

FRAUD, CORRUPTION, MONEY LAUNDERING AND TERRORIST FINANCING

Audit serves as a deterrent to fraudulent and criminal behavior. For instance, it helps deter crime such as fraud, corruption and money laundering in companies.

Given today's heightened risk of terrorism in Europe, the deterrence effect of audit is critical in particular for SMEs as it reduces the risk that they are used for terrorist financing.

BUSINESS INSOLVENCY

SMEs have a corporate responsibility to third parties such as their suppliers, creditors, investors, employees and the state itself. If a company is not audited, these stakeholders' confidence in the financial statements and accuracy of business performance diminishes. Subsequently, the lack of confidence makes it more difficult for SMEs to operate and flourish.

Many SMEs enjoy the privilege and protection of a 'limited liability'. This poses a risk for creditors in case a limited liability company cannot pay its debts. Audit may reduce this risk and provide more security to creditors and other users of the financial statements. Without audit, this counterbalance disappears.

LIMITATIONS ON ACCESS TO FUNDING

Access to credit/loans and financing enables SMEs to grow, which is in every country's interest. According to a European Central Bank's survey⁴, in recent years, SMEs' demand for external financing has been increasing in Europe. However, the availability of this financing still poses a challenge to SMEs. This challenge might become even greater if a company has not had an audit which provides more credibility to its financial statements.

CONCLUSION

There are diverging national policies and views on SME audit. Given this backdrop, it is interesting to see countries like Sweden and Denmark taking an empirical facts-based approach to evaluate the effectiveness of reforms abolishing the SME audit requirement. Policy-makers will further discuss the policy implications of the assessment findings.

The Swedish example is a good practice of sound policy-making. It is important to be pragmatic in policy-making and to be able to adapt or even revert a policy if it proves unsuccessful or worse, counterproductive.

In the context of SME audit, we encourage all policy-makers to take informed decisions based on facts and evidence and to consider the benefits of SME audit, both for SMEs themselves and for other stakeholders.

Accountancy Europe has formed a group of experts to enhance the debate at European level on how best to respond to the challenges of SME audit. We will also keep analysing national developments in the area of SME audit policy.

⁴ Survey on the Access to Finance of Enterprises in the euro area; available at <https://www.ecb.europa.eu/pub/pdf/other/ecb.accesstofinancesmallmediumsizedenterprises201705.en.pdf?17da4ff2a730b7ababea4037e4ce8cae>





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