SWEDISH NATIONAL AUDIT OFFICE

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Abolition of audit obligation for small limited companies

– a reform where costs outweigh benefits

Summary and recommendations

Audit background and purpose

The Swedish NAO has audited the consequences of the reform that abolished the audit obligation for small limited companies, which came into force on 1 November 2010. The reform covered almost three quarters of limited companies, which were subsequently allowed to choose whether they wanted an auditor or not.

Statutory audit requirements for companies has been discussed on various occasions since they were introduced in 1895. The discussions have weighed the costs and regulatory administration for companies against audit as a measure against economic crime and tax evasion. In the period 2006–2010 the Government focused on simplification of the rules for companies and a number of reforms were implemented. As part of that work the Government proposed abolition of the audit obligation for small companies, which was decided by the Riksdag in 2010.

The reform aimed to reduce the administrative burden on companies and the costs of audit. Another reason for abolishing the audit obligation was the Government's intention for the reform, along with other regulatory reforms, to strengthen companies' competitiveness and help more companies to grow and employ more people. The fears about the reform were reduced tax revenue, increased economic crime and poorer accounting quality.

The purpose of this audit was to examine whether the intentions of the reform were achieved for the limited companies concerned, what consequences the reform has had and how undesirable consequences were handled.

The audit was based on the following questions:

1. Have the intentions of the reform been achieved?
2. Has the reform had undesirable consequences?
3. Have the agencies concerned dealt with the undesirable consequences of the reform?

Audit findings and conclusions

The Swedish NAO's overall conclusion is that the disadvantages of abolishing the audit obligation are greater than the advantages. The reform has given limited companies increased freedom of choice, but those who opted out of audit have not had higher growth, rather the opposite. The cost savings made by the companies by opting out of audit were small, profitability did not improve and at the same time the lack of audit reduced the opportunities for control and transparency.

The reform, together with other regulatory simplification, has benefited the limited company corporate form, and a large number of new limited companies were formed after the reform. Many companies opted out of audit after the reform and the inclination to opt out of audit is greater in industries with a high risk of economic crime and tax evasion. There are also indications that the reform, together with other regulatory simplifications, may have facilitated economic crime and impaired the ability of authorities to discover such crime. Moreover, the slowing rate of growth may indicate that companies that opt out of audit withhold more tax than before. Another consequence of the reform is more errors in annual reports. This is a concern, since there are currently no procedures to rectify such misstatements. This is problematic since various stakeholders have a justified need for quality-assured financial information for the assessments they make in their operations.

The authorities concerned have not be able to compensate for the undesirable consequences of the reform. The authorities have to some extent adapted their work, but their efforts have not outweighed the disadvantages of the lack of audit of the companies.

In connection with the reform the Swedish Tax Agency was given funds and new powers of control to prevent increased tax errors by ensuring that the companies' accounts maintained a basic level of quality, but this has not resulted in the companies making fewer mistakes in tax returns.

This audit provides knowledge of the intentions and consequences of the reform. There are indications that the reform may have increased tax evasion. On the other hand, it is still not known whether the reform has led to increased economic crime. The Government has not evaluated the reform as intended, and at the same time the Riksdag has asked to Government to consider whether more companies can be exempted from the audit obligation.

It did not go better for the companies that opted out of audit

The limited companies that opted out of audit reported weaker subsequent growth, both in net sales and staff numbers. Nor did profitability improve in companies without audit. This means that the reform has not contributed to higher growth and strengthened competitiveness for companies that opted out of audit.

There are several explanations for why the rate of growth slowed among companies opting out of audit. There is much to indicate that the explanation is that companies that are not audited to a greater extent deliberately report lower economic activity in the business as a whole and thus reduce the company's profit to avoid tax. This is easier to do without being audited, since the companies run a smaller risk of the tax evasion being discovered. Thus, the reform may have facilitated tax evasion for companies that have that intention.

However, the explanation that the companies opting out of audit may have reduced their growth ambitions to a greater extent than those continuing to be audited cannot be entirely ruled out.

Companies that opted out of audit made a small saving

60 per cent of the companies that could opt out of audit after the reform had done so at the close of the 2015 financial year. The proclivity to opt out of audit was greater among small and newly started companies. Companies that opted out of audit made an average direct saving of about SEK 10 000, since they did not need to pay an auditor's fee. In total this corresponds to just less than 1 per cent of the companies' net sales and would reasonably be of small significance for the companies' profitability and growth potential. Ahead of the reform the Government estimated, using another method of calculation,

that the average audit fee for all companies that could opt out of audit would be about SEK 14 000 kronor.

Apart from the audit fee, the companies have also saved on some tasks and costs related to work that the company's representative must do to assist the auditor in his or her work. However, there is nothing to indicate that this has had a positive impact on the companies' growth or profitability.

Since the reform prices for audit services have stagnated, which has favoured companies paying audit fees.

Companies in risk sectors opted out of audit to a greater extent

The inclination to opt out of audit varies relatively much between different sectors. Companies that opted out of audit were found to a great extent in cash-intensive sectors such as hairdressing, beauty care, restaurants and taxi businesses. In these industries the risk of tax evasion and economic crime is also considered to be high, and it is therefore problematic that the transparency in the companies that audit made possible has disappeared.

Errors in annual report formalities have increased

The number of errors in the formalities of the companies' annual reports increased after the reform. Examples of errors in formalities include the lack of a certificate of adoption, notes or income statement in the annual report. This has led to the Swedish Companies Registration Office needing to order more companies to submit supplementary material. These orders mean that the companies must correct the misstatements and send in the annual report again, which may be time-consuming for both the Swedish Companies Registration Office and the limited companies. The increase in errors in formalities mainly occur in newly started companies without audit.

The Swedish Companies Registration Office controls do not cover incorrect totals in annual reports

The audit found indications that incorrect totals and other misstatements in annual reports have increased since the reform, but the Swedish Companies Registration Office does not have any procedures for ordering companies to correct these misstatements. Instead the Registration Office registers the annual report. One consequence is that the registered annual reports risk containing incorrect totals, which contravenes the requirement that annual reports must give a true and fair view of the companies' finances. The deficient annual reports are passed on unchanged to various stakeholders, such as other authorities in criminal investigations and credit rating companies, which risk making assessments on incorrect grounds. For example, a company can record incorrect financial information in the balance or income statement to present the company's finances as better or worse.

The Swedish Tax Agency does not have the knowledge of the consequences of the reform and the new controls have not led to fewer misstatements

The Swedish Tax Agency does not know if the tax gap has been affected by the reform. Nor has the Agency followed up the quality of accounting material and the companies' tax base after the reform. All in all, the Swedish Tax Agency does not either treat companies without audit in any separate way in its control procedures.

As part of the reform the Swedish Tax Agency was given a new control instrument, "control of documentation obligation", and SEK 40 million annually for increased costs to ensure companies' compliance with their obligation to keep documentation. The new control instrument was to prevent companies' accounting errors and thus prevent tax loss. It is, as it has been used, a forward-looking initiative in which the Swedish Tax Agency guides and supports new business operators so that they have order in their accounts ahead of future tax returns. The Swedish Tax Agency has used its new control instrument, but this has not resulted in companies making fewer mistakes in tax returns. The new control instrument has no preventive effect on the business operator and are only applied to a small proportion of newly started limited companies. But it has not been directed specifically at companies without audit. The new control instrument has thus not been effective in preventing errors in companies' accounts and thus tax losses.

The work to combat economic crime has been made more difficult

Since the reform the number of volume cases, related to small limited companies, referred to the Swedish Economic Crime Authority has increased. In many cases these are mistakes of carelessness such as late submission of annual reports or bookkeeping deficiencies. One consequence is that the Authority has fewer resources for cases involving serious economic crime.

Moreover, auditors' reports with suspicion of crime to the Economic Crime Authority have decreased drastically. Hence the process for enabling the discovery of economic crime has been made more difficult and it are discovered at a later stage, often at the time of insolvent liquidation. The Swedish Tax Agency has also received considerably fewer qualified auditor's reports (i.e., containing an opinion that indicates that the auditor considers the accounts to be misleading). This means that the Swedish Tax Agency misses out on early indications that something in a company is not functioning.

The Government has not followed up the reform

Ahead of the abolition of audit obligation the Government announced that it would follow up the implementation of the reform and evaluate its effects. But the Government has neither evaluated the reform nor instructed the agencies concerned to do so.

Recommendations

The Government should act to reintroduce the audit obligation for small limited companies.