



FRC SMALL AND MEDIUM-SIZED ENTERPRISES MARKET STUDY - INVITATION TO COMMENT

Issued 12 May 2025

ICAEW welcomes the opportunity to comment on the FRC Small and medium-sized enterprises market study – Invitation to comment published by the Financial Reporting Council (FRC) on 3 February 2025, a copy of which is available from this link.

ICAEW welcomes the FRC's SME audit market study, and the revival of Practice Note 26. High quality professional support for SMEs is essential to promote growth. However, the FRC needs to take a much more holistic approach to problems in this market. It should not assume that the problems can be solved simply by means of additional guidance for SMPs.

Addressing the long term decline in the number of registered auditors necessarily involves:

- a significant change in regulatory culture on the part of the FRC
- acknowledgement that the ISAs are not scalable for SME audits
- a proper, public debate about what needs to be done to render the ISA for LCE fit for purpose in the UK - not about why it cannot or should not be done
- addressing the restrictions in ethical standards that inhibit the growth of both SMEs and SMPs by preventing SMPs from providing advice to SMEs.

This response of 12 May 2025 has been prepared by the ICAEW Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the faculty is responsible for audit and assurance submissions on behalf of ICAEW. The faculty has over 25,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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KEY POINTS

Support for the Market Study, Need for the FRC to Listen, Growth

1. In preparing this response, ICAEW reached out to and obtained input from small and medium-sized entities (SMEs), small and medium-sized practitioners (SMPs), providers of capital, methodology providers and representatives of the third sector. SMEs need access to high-quality, cost-effective assurance services from a choice of providers. We therefore welcome this much-overdue market study, and the opportunities the FRC is providing for SMEs and SMPs to be heard.
2. We urge the FRC to listen carefully to constituents, and not to pre-judge the outcome of any aspect of its investigations. Many observations in this response are about the fitness for purpose of the ISAs for SME audits. While we support the project to bring back Practice Note 26 (PN 26), the FRC did not consult on this fitness for purpose. It should be willing to address issues raised by SMEs and SMPs, in addition to the revision of PN 26 and the other planned activities. The implicit assumption in the market study is that with additional FRC guidance, SMPs will conduct better quality, more efficient audits. This is only part of the story. Our outreach clearly indicates that the ISAs themselves are part of the problem. The FRC should think again about whether auditing standards, as they stand, are scalable, proportionate and fit for audits of all sizes. Some we spoke to see this as little more than a pretence. In an ideal world, the ISAs would have considerably more scaling for SME audits than they do now, and while PN 26 will help with that, it is no substitute for it.
3. We urge the FRC to engage in a public debate on the issues associated with the ISA for Less Complex Entities (LCE) and what the FRC needs to do to make it fit for purpose in the UK as an alternative for SME audits. It should devote high quality technical resource to that debate and not treat it as a communications issue. That standard has been through the same due process as all of the other auditing standards adopted by the FRC and while there are significant issues to be addressed, the lack of any reference to this standard in the FRC's campaign material is a significant defect¹. The promise in a recent podcast of a webinar on the subject is too little, and very late, and the revival of PN 26 is no substitute for a debate on the ISA for LCE.
4. The issues affecting the SME audit market reflect trends in the audit market as a whole. Firms may have the same number of staff, but the increases in the time it takes to perform an audit, combined with a much-increased reluctance of staff to stay in audit, means that fewer audits are being performed overall, while demand has remained much the same. The contraction in supply is in part a direct result of the significant increase in the regulatory cost of audit. These trends are already well-understood, not least as a result of [research conducted by the FRC](#) itself in 2024.²
5. SMEs are not simply scaled down versions of larger companies, and growth requires focused and tailored attention to SMEs and the SMPs that support them. A small number of high-growth SMP auditors will cope with whatever regulatory hurdles they are required to clear. But for the majority of SMPs, regulatory churn in auditing, ethical and accounting standards, and in audit regulation, now represent a compliance burden with little perceived value – far from the agents of improved quality they once were. The SME audit market would be better served by the FRC if it adopted more holistic approach to the audit market and a less conservative approach to SME audits.

Regulatory Culture Renders All Audits More Expensive and Riskier

6. The FRC cannot compel auditors to conduct audits by appealing to their public interest obligations. It needs to address more directly its own role in developing a regulatory

¹ Page 2 of the FRC's [Introduction to Auditing Standards](#), the first of a series of publications designed to help SMEs understand audits, states that it bases its UK ISAs on the international versions and that when the IAASB revises an ISA - or presumably issues a new one - it will consult on a UK version to ensure that UK standards stay up to date. It has failed to do this for the ISA for LCE.

² These trends are already well-understood, not least as a result of [research conducted by the FRC](#) itself in 2024.

environment that has rendered audit, especially PIE audit, a higher-risk career choice. Firms are having to incentivize and fast-track staff willing to go down this route. The reputational risks associated with performing audits of poorly governed and other higher risk companies need to be reduced if those companies are to have a genuine choice of auditors. Many are medium sized companies struggling to find more than one or two auditors willing to tender, because they are too large and complex to be served by smaller firms, but not big enough to bear larger firm charge-out rates. The same is true of charities, building societies, and others.

7. Enhanced audit quality comes at a cost that has been consistently underestimated by both government and regulators. A lack of choice of auditors for smaller companies has eased somewhat, but firms of all sizes are still turning audit work away. This is partly because of a lack of staff but also, critically, because of the enhanced independence and other ethical requirements, as well as the sheer volume of work now involved in audits that comply with the additional demands of audit regulators as well as with the ISAs themselves. The FRC should revisit its independence requirements in relation to non-audit services for SMEs and in particular the provisions and scope of section 6 of the Provisions Available to Auditors of Small Entities (PAASE) relating to advice, particularly on accounting systems, and to the recruitment of accounting staff. In the minds of many we spoke to, they represent little risk to audit quality.

Audit and Assurance Alternatives for SMEs

8. Asserting that auditing requirements are scalable and proportionate does not make them so. SMPs have a sense that too much audit work is directed at satisfying regulatory demands that are increasingly disconnected from the work genuinely needed to form a high quality audit opinion. Dealing with an excess of requirements with little relevance to SME audits has the potential to compromise audit quality, exactly the opposite of what is intended. The additional requirements in auditing standards intended to improve audit quality at the larger more complex PIE end of the market can have the opposite effect for SME audits. Requirements, particularly as they relate to controls, over-complicate SME audits, increase costs and are a distraction from the main risks. It seems highly unlikely that PN 26 - however welcome that may be - will render the ISAs scalable, particularly at the smaller end of the market.
9. We welcome the fact that PN 26 will go beyond the original focus on audit documentation. However, unlike the standard for LCE, PN 26 cannot remove ISA requirements and will have limited impact on the volume of work required. The FRC should not continue to maintain that cost and the work effort are irrelevant to this debate. The approach taken to the development of the standard for LCE was highly conservative. The possibility, seemingly remote, that a requirement might be relevant to an SME audit led to the inclusion of virtually all ISA requirements in the standard. As part of this debate the FRC should depart from established practice and consider what *more* can be removed from the ISA for LCE, as well as what might be added back, or alternatively a building blocks approach starting with what is needed for all SME audits.
10. The debate also needs to address the relationship between cost and audit quality: the ISAs cost more to implement, but that does not necessarily mean that there is any corresponding enhancement to audit quality; the ISA for LCE might well cost less, but that does not necessarily mean that there is any corresponding reduction in audit quality. A standard designed for LCE should enhance audit quality by focusing on the relevant areas and eliminate a plethora of checklists completed with the abbreviation 'N/A'.

Gold Plating

11. The audit exemption ineligibility criteria should be reviewed, and 'gold plating' removed, particularly where it derives from EU law. Government and the FRC also need to revisit as a matter of urgency the supermajority rules determining the definition of which firms can be registered as auditors, to determine whether this restriction is still needed and to prevent a further contraction in the supply of SME auditors.

ANSWERS TO SPECIFIC QUESTIONS

Question 1 – How well is the UK audit market currently functioning for SMEs?

12. The absolute number of registered auditors has been in decline since the early 1990s, when audit regulation was first introduced. Consolidation in the audit market, and latterly concentration, has accompanied this decline. Regulation initially drove poor quality out of the audit market, but risk and reward in the audit market as a whole are currently misaligned, with risks outweighing the rewards. Smaller firms struggle to persuade staff to become responsible individuals (RIs); they often have to be recruited from outside the firm, and many of the better RIs in smaller firms do not want to take the risks involved with PIE audit.
13. Larger and mid-tier firms, as well as smaller firms, can perform SME audits, but their cost structures and specialisations are very different. In practice, large firms do not perform the smallest of audits unless they are part of a group audit, because of the fees they charge. Very small firms may not perform highly specialized or medium-sized audits because they do not have the expertise or geographical reach.
14. To date though, the audit market has never seen audit firms of all sizes, particularly larger firms, declining reappointment to audits of companies that are poorly governed or higher risk for other reasons to the extent that they are now. The resulting cascade of audits to smaller firms means that companies most in need of an audit may find themselves with little, if any, choice of auditors and the firms performing them may not always be best placed to do so. This situation is unprecedented. Increased regulatory demands of auditors starting in 2016 led to more staff spending more time on the same audits, increases in audit fees and staff shortages. The pandemic greatly accelerated these trends. For the first time, audit became a sellers' market. It is disappointing that this is perceived solely as something 'to be addressed', and that there has been little recognition of the opportunities it has provided for the enhancement of audit quality.
15. The FRC has been critical of this trend, despite improvements to audit quality, but our outreach suggests that stakeholders believe that the FRC is also, at least in part, responsible for it. It should come as no surprise that a tightening of independence and other ethical requirements limiting the work that can be performed by auditors, combined with demanding auditing standards and what is widely perceived as an overly assertive regulatory culture, acts as a significant deterrent. We heard how unattractive the audit of poorly governed and other higher risk entities, and smaller, less profitable audits, is. Larger firms tend not to want this work, in some cases at any price. Many smaller firms do not want the reputational risk, or the additional PII involved in performing an FRC regulated audit, and they do not want to subject their partners to the related personal risks. This is all exacerbated by an aversion to the risks associated with audit on the part of some private equity investors. Among other things, a fundamental shift towards a much more supportive regulatory culture is needed to address these trends, together with reconsideration of the independence requirements for non-audit services for SMEs through the PAASE as they relate to the recruitment of accounting staff and to advice in relation to accounting systems.
16. Entities with a limited choice of auditor in a shrinking market include medium-sized entities generally, charities, those in specialist financial services sectors and other entities presenting technical challenges. While some of these are PIEs, for all other purposes many are SMEs. In practice they may have a choice of one or two auditors at most. They may be too specialist or complex for smaller and some mid-tier firms, and too small to bear the specialist rates necessarily charged by larger firms with significant investment in expertise.
17. The requirements of ethical standards have seen an inexorable reduction in the nature and extent of non-audit services that can be provided by auditors. This may be justified for the largest of companies, but it results in real and unnecessary inefficiencies for SMEs, who must employ two firms instead of one – and in practice simply forgo the professional advice to avoid the cost.

18. These trends should not be ignored. The SME audit market may be approaching an inflection point from which there is no return. Fewer SME audits and audit practices mean fewer trainees, fewer opportunities for staff with SME audit skills, and fewer opportunities for practice growth, investment in technology and the acquisition of niche skills. Private equity may fill some of these gaps, but investment is unlikely to be directed towards growth in audit.

Question 2 – What are the reasons for SMEs obtaining financial audits? What are the primary drivers in instances where an audit may not be mandatory to an SME?

19. A very small number of audit exempt SMEs undergo a truly voluntary financial audit. They include:
- companies with a growth agenda seeking significant access to capital
 - companies involved in buyouts
 - companies whose owners are planning an exit in the foreseeable future
 - companies and groups whose ownership and governance structures are a means by which owners exercise oversight of management – such as where owners are overseas investors, or where owners for other reasons have no involvement in the day to day running of the business, particularly where they are not engaged in the finance function.
20. The feedback we received as part of our outreach suggests that stakeholders do not believe that the FRC has been a good advocate of SME and voluntary audit. If the FRC is sincere in its commitment to SME audit, it needs to be more willing to promote non-statutory SME audit, and not simply advocate for the raising of audit exemption limits. It also needs to deal with SME audit in its own right, and not merely as an extension of PIE audit. Audit is opaque and audit-exempt small companies cannot be expected to understand the value an audit confers in terms of:
- enhancement of credibility to third party stakeholders, including HMRC, and in relation to potential competitors and business partners
 - growth through ease of access finance
 - insights and efficiency gains relating to internal control and business risk
 - more accurate management information and financial statements.

Question 3 – What, if any, challenges do SMEs experience in relation to audits (e.g. in finding an auditor, engaging with the audit process)?

Audit exemption thresholds, exemption eligibility criteria and complex accounting requirements

21. Major concerns include a lack of a meaningful rationale for audit exemption thresholds, the criteria that render an entity ineligible for exemption, and complex accounting requirements. These are all hard and time consuming for many SME accounting teams - if they exist - to understand. Much of this originally derives from EU law to which the UK is no longer bound. This lack of rationale is evidenced by the number of low-risk entities with negligible activity that are subject to audit, where larger and more complex entities are not. The FRC does not have locus in most of these matters, many of which derive from EU law, but it is in its gift to consider whether ISAs as they stand should apply to entities that are uncomplicated and very small, where for example, the only reason for the audit is the existence of a non-UK parent.

Perceptions of an audit, engagement with auditors

22. SME observations about how much time auditors spend documenting compliance, solely to satisfy QAD or other reviewers are hard to ignore. There is a perception among some that the audit is needlessly convoluted and therefore expensive. Some SMEs are challenged by

their own lack of properly controlled management information systems, which can create problems for auditors, and audit firms do not always adapt their audit approach to cater to the levels of technological maturity among SMEs. Not all audits are conducted efficiently, and not all auditors communicate effectively.

23. Some SMEs understand the audit process, but most do not, which can make finding an appropriate auditor more difficult. The appropriate response to this is for the FRC to actively engage with SME and SMP representative groups, to help raise awareness more systematically about the value of an audit, what it involves and, importantly, how to find a good auditor, how to engage with them and when. Late or last-minute tender requests were a common issue raised by SME auditors; this sometimes leads to firms turning SMEs away because they are unable to plan and resource quality audits to meet filing deadlines at short notice.
24. We note in our main points above, and in our answer to question 1, the need for the FRC to revisit its non-audit service requirements for SMPs, to help deal with the lack of auditor choice for medium-sized entities generally, those in financial services and other regulated industries, and entities engaged in technically complex activities requiring specialist expertise, as well as charities. This point was made repeatedly during our outreach by both SMPs and SMEs.

Question 4 – What, if any, challenges do audit firms experience in relation to audits for SMEs?

Auditing and ethical standards

25. We note elsewhere in this response the challenges presented by auditing and ethical standards. Challenge can have immense value, but it is not an end in itself. Excessive challenge, particularly in the form of documentation requirements designed for larger audits, shifts resource away from the things that matter in an audit and acts as a deterrent to the pursuit of a career in audit to newly qualified staff considering their options.
26. A particularly problematic standard in SME audits is ISA 540, *Auditing Estimates and Related Disclosures*. Most SME estimates do not have the complexity of fair value assessments or forward-looking information but many of the requirements, while in theory relevant to all estimates, are only applicable at such a high level to simpler estimates that they often seem peripheral.
27. Other standards stakeholders have pointed to as having particular scalability issues are ISA 230, ISA 500, and ISA 570. There are many aspects of ISA 315 – particularly as it relates to controls – which are overengineered from an SME standpoint. The requirements to test design and implementation of controls in all cases has been disputed for decades and the requirements relating to IT general controls require tortuous adaptation for small, off-the-shelf packages. The focus in ISA 315 on understanding IT and the incremental risks arising is understandable, given the evolution of technology, but for much of the SME market this is of limited significance, and there is very little scalability in the standard.
28. The going concern status of many SMEs is obvious and for them, the requirements of ISA 570 are similarly overengineered. SMPs note in this context a sense that they are engaging in building a defence, in case the file is selected for regulatory inspection, rather than performing an audit.
29. Audit quality is not free and nor is it simply a matter of auditor inefficiency. Acknowledgement is widely needed, including by the FRC, of the fact that when the changes are made increasing the number of requirements of auditing and ethical standards to improve audit quality, audit costs will rise. Auditors too often hear that ‘they should have been doing this anyway’.

Capacity and commercial challenges

30. A decade of artificially low charge-out rates was followed by a rise during the pandemic, but for many SMPs, recovery rates are falling again, and we understand that significant, inappropriate undercutting is making a comeback. Staff costs are rising, generally, and in audit in particular because of the need to incentivise staff to stay in audit. SMEs are more cost-sensitive than larger entities and SMPs - caught between the need to control costs while providing a compliant, audit designed for much larger and more complex audits - often struggle, particularly where they only perform a small number of audits.
31. To date, the regulatory approach to quality management problems that arise where firms perform a small number of audits has been to counsel such firms out of performing them. A healthy SME audit market requires the opposite approach, which means that the much enhanced regulatory risk associated with larger audits needs to be reduced for such firms if they are to grow.

Technology

32. The IAASB acknowledges that ISAs can no longer be technology agnostic and the FRC needs to do the same. SMPs need to be incentivized to invest in technology. They have been slower to adopt analytical tools partly because of the cost, with no guarantee of a return on the investment, but also because:
- SMEs often have poorer quality records and systems that may not be compatible with the use of such tools
 - the audited entity is unable to extract the necessary data
 - of regulatory uncertainty, which is widely perceived as holding the use of technology back.

Technology often has the potential to enhance audit quality, but it does not necessarily make the audit more efficient. Journal entry transaction testing can still be done perfectly well with Excel.

Question 5 – What, if anything, would you like to see change in relation to SME audits? (For example, any regulatory /policy changes and/or any specific actions taken by the FRC, Government, firms, companies or others).

FRC

33. We note elsewhere in this response our support for the FRC's renewed interest in SME audit, the importance of a choice of assurance providers for SMEs, and that the FRC should engage in a proper public debate about how the ISA for LCE might be made fit for purpose in the UK. We therefore encourage the FRC to:
- explain how it has arrived at the conclusion that disproportionate audit cost is at the heart of concerns with the SME audit market
 - heed repeated calls for a proper public discussion of the ISA for LCE
 - make greater efforts to engage directly with SME representatives on the value of audit, rather than simply publishing written material in the hope that they will read it
 - consider more carefully what changes of substance are needed in its culture, particularly its inspection culture, to address perceptions of significant regulatory disincentives to smaller firms growing the audit practice and potentially entering the PIE audit market. Perceptions matter. The FRC needs to demonstrate more clearly than it is doing now, how, in practice, it is supporting firms as an improvement regulator
 - engage to a much greater extent than it does now, with providers of software, training, and methodology to audit firms providing SME audits. The quality of a methodology has a pervasive impact on the implementation of the ISAs and perceptions of their effectiveness.

The ISA for LCE and Practice Note 26 (PN 26)

34. PN 26 is not a substitute for the ISA for LCE, and its revival is a retrograde step in that sense. Most welcomed its re-emergence, but many observed that in practice it will represent just another layer of 'things to comply with'.
35. PN 26 was summarily withdrawn by the FRC in 2018, to the dismay of SMPs. It was a valuable resource which aided the application of the ISAs to SME audits. We therefore welcome plans to bring it back. However, the FRC should:
 - ensure that it is framed as a tool to alleviate the difficulties of interpreting the standards, and not simply add to them
 - take a robust approach in PN 26 to the requirements of ISA 315 that are overengineered for SME audits, particularly in relation to internal controls
 - commence a proper, public debate in the UK about what needs to be done to the ISA for LCE to make it fit for purpose, regardless of positions taken to date. The IAASB adopted a sub-optimal ISA-minus approach to its development, and the standard is far from perfect - but it is aligned with the ISAs, it has been through full due process internationally, and we believe that it can be fixed and made fit for purpose for at least some smaller UK audits.
36. The ISA for LCE could be particularly helpful in the third sector, which the FRC needs to engage with sooner rather than later. Charities are equally - if not more - impacted by the challenges of the audit market outlined in this response. We urge the FRC to involve third-sector stakeholders in the scope of this campaign.
37. It would be helpful for the FRC to commission academic research, as part of this campaign, into the incidence of exempt entities opting for an audit, and the impact of regulatory churn on the SME sector. We understand that there is evidence that it is the extent of change, rather than regulation per se that causes firms to disengage from regulatory activities.

Government

38. We would like to see the audit exemption ineligibility criteria being revisited and 'gold plating' removed.
39. Government and the FRC also need to revisit as a matter of urgency the supermajority rules determining the definition of which firms can be registered as auditors, to determine whether this restriction is still needed and to prevent a further contraction in the supply of SME auditors.

Question 6 – What, if any, forthcoming developments might the FRC want to consider as part of this market study?

40. ICAEW is updating its 2016 publication: *Data analytics for external auditors*. The original publication focused on larger firms, but the update will cover firms of all sizes and has involved outreach to training providers, methodology providers as well as SMPs and larger firms.