



GUIDANCE FOR AUDITS OF SMALLER AND/OR LESS COMPLEX ENTITIES PRACTICE NOTE EXPOSURE DRAFT

Issued 17 October 2025

ICAEW welcomes the opportunity to comment on the Guidance for audits of smaller and/or less complex entities Practice Note Exposure Draft published by the Financial Reporting Council (FRC) on 17 July 2025, a copy of which is available from this [link](#).

For questions on this response, please contact the ICAEW Audit and Assurance Faculty at tdaf@icaew.com quoting REP 88/25.

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KEY POINTS

1. ICAEW welcomes the opportunity to comment on the exposure draft (ED) of this Practice Note (PN) on audits of smaller and/or less complex entities, the previous version of which was withdrawn by the FRC in 2018. The FRC's attention to this part of the audit market is welcome.
2. A combination of factors is responsible for the significant changes to the conduct of SME audits over the last 25 years. They include changes to audit exemption limits, changes in the regulatory approach and changes in the wider audit market. Significantly, they also include an exponential increase in the length and complexity of the ISAs. This has rendered ISAs scalable for SME audits only with considerable difficulty, and some artifice. That is why some SME audits are disproportionately expensive. The ISAs are no longer scalable or proportionate for the audit of SMEs, which is why the ISA for LCE was developed.
3. The most important omission in the FRC's proposals is an acknowledgement that the cumulative revisions to ISAs over many years have led to a widespread consensus that the scalability and proportionality of ISAs for many SME audits has been severely compromised. That lack of scalability is a major cause of difficulties in the performance of those audits. The ED is based on the assumption that the ISAs *are* scalable and proportionate, but the FRC's own market study shows that there is no longer any stakeholder group, other than the FRC itself, that agrees with this. The FRC's struggle to provide good quality examples in the ED of how to apply the more challenging areas of the ISAs to SME audits is evidence of that lack of scalability.
4. Practitioner inefficiency is only a small part of the problem. The FRC has asserted in recent webinars that auditors are 'throwing the kitchen sink' at SME audits and 'gold plating' the ISAs. We see little evidence of this. Practitioners in firms of all sizes would welcome examples of gold plating provided by the FRC because it would clarify what auditors do *not* need to do. The ED gives no examples of procedures to comply with the requirements of ISAs that may not be relevant to SME audits. Such examples would have more value than some of the examples currently provided – such as the example relating to service organisations.
5. Neither the ED nor the ISA for Audits of Financial Statements of Less Complex Entities (ISA for LCE) is a silver bullet, but the ISA for LCE is the most important development in SME audits in thirty years. ICAEW continues to call on the FRC to engage in a public discussion on how the FRC might adapt the ISA for LCE for use in the UK. To date, no such discussion has taken place and the FRC has sought only to explain, informally, its reasons for not doing so. A holistic discussion on how the ISA for LCE might be made adapted for use in the UK would have greater impact than the current proposals. The FRC is an autonomous standard setter and has the power to adapt the ISA for LCE as it thinks fit.

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6. We disagree with FRC assertions that there is no case or support for consideration of the ISA for LCE in the UK. Of a total of 35 [responses](#)¹ to the FRC's February 2025 consultation in the SME audit market, 13 respondents noted in varying ways that consideration of the ISA for LCE has or might have value, including the Quoted Companies Alliance. A large majority of the remainder were silent on the issue, which is to be expected because the FRC did not ask about it. Only a handful were against. While larger firms have less need for an ISA for LCE than smaller firms, at least some are already incorporating it into their systems, because other jurisdictions are using it.
7. We also disagree with FRC assertions that there is no support for the ISA for LCE globally, or that it was only ever intended for micro-entity audits. We understand that IFAC continues to monitor adoption of the ISA for LCE globally and that it is planning to publish relevant data in the foreseeable future. It is clear from the IAASB's publicly available work papers that while some believed that the ISA for LCE's scope should be restricted to micro entities, IAASB as a whole disagreed with that approach.

Exposure Draft (ED)

8. The ED is short on good quality examples in some important and challenging areas, and long on repetition of the sometimes lengthy requirements of the ISAs in those areas. As it stands, it is of limited value to the audience for which it is intended. It does not, and probably cannot, provide adequate support to efficiently scale ISAs 315 and 540 in SME audits generally, particularly in relation to the design and implementation of controls, and the documentation of ITGCs, application controls and systems more generally. Some of these requirements are incapable of scaling without some artifice, because they are derived from the COSO Framework which was never intended to apply to entities as defined as small in the UK.
9. The examples of audit documentation in the ED are unlikely to be used unless software providers change audit methodologies. Methodology providers are clear that specific ISA requirements drive the number of forms to be completed and that the PN is therefore unlikely to result in any change to methodologies. The unmodified requirements of the ISAs on planning group audits when applied to SMEs, for example, invariably give rise to excessive documentation.
10. The ED's recommendation of the use of a 'free-form planning memorandum' is particularly unhelpful. Forays into this space rarely if ever result in such memoranda becoming common practice, because they require a very detailed knowledge of the ISAs. The ISAs are mediated in firms of all sizes through audit methodologies. The assertion in paragraph 124 that excessive, irrelevant and costly documentation arises from a lack of tailoring on the part of junior staff who need better training may have an element of truth, but it appears to be anecdotal and is not appropriate for a PN. It is not borne out by QAD reviews, it fails to acknowledge the role of the underlying ISAs in requiring excessive documentation and implies that this is a particular problem for smaller firms. We think this highly unlikely. The statement effectively holds SMPs to a higher standard than larger firm auditors because for larger firms it matters less, because they are better able to bear the cost of such inefficiencies.
11. We set out in our answers to Questions 3 and 4 below a raft of areas in which the ED needs a significant amount of work if it is to effect any change. There could be more diagrams, the headings are not useful and there needs to be an index.
12. Firms of all sizes, and methodology providers, expressed concerns about the FRC's past challenges to firms seeking to develop SME audit systems. Both the ISA for LCE and the PN have the potential to create a two tier system and the FRC states in the SME Audit Market Emerging Findings consultation that it will seek to ensure that the PN '...is embedded into both the FRC and RSB's approaches to audit

¹ Counting three responses from one individual as one

inspections'. For the PN to make a difference it does indeed need to be embedded in systems which means that it will need to be adapted as an option for smaller audits only by methodology providers, and developers of in-house systems. This means that the FRC and RSBs must accept two different methodologies, one applicable where the PN is applied and another where it is not. While the ISA requirements are the same for both the PN and the ISA for LCE, forms and checklists would need to be adapted to accommodate either. A strong business case is needed if either the PN or the ISA for LCE is to be developed by firms and methodology providers, and the FRC's take on this is critical if any investment is to be made. A 'wait and see approach' by the FRC is not enough to justify the time, effort, cost and risk involved in making the changes. The FRC needs to engage directly with methodology providers on this issue, and not simply facilitate conversations among RSBs, firms and methodology providers.

13. The PN cannot make the ISAs truly scalable. It cannot remove requirements, nor render requirements designed for much larger entities coherent or relevant to smaller entities without considerable artifice, in relation to controls, for example. This is why we continue to advocate for consideration of how the ISA for LCE might be rendered suitable for use in the UK. If the FRC decides to proceed with the PN, the ED should be re-exposed, and the FRC should concurrently initiate a public discussion of how the ISA for LCE might be adapted for use in the UK as an alternative approach. The work already performed on the PN might then support the application of the ISA for LCE. **Absent both of these further actions, ICAEW does not support publication of the PN, as it may confuse rather than clarify how auditors of smaller and less complex entities are expected to apply the ISAs, and create expectations about improvements to SME audits that cannot be met.**

ISA for LCE.

14. The shortcomings of the ISA for LCE have been well-rehearsed by the FRC but only informally. It has, to date, failed to clarify publicly, comprehensively and in writing, why it has chosen to ignore an ISA which has been through the full rigour of due process internationally. There has been no meaningful opportunity for a public discussion or challenge of this decision. This apparent lack of regard for the output and due process of the standard setting body which issues all of the other standards on which UK ISAs are based, and of which the FRC is a long-standing and well-regarded member, is regrettable, particularly in the context of the Government's agenda for growth in the SME sector.
15. We do not underestimate the work required to engage in a meaningful discussion of how the ISA for LCE could be adapted for use in the UK. These include issues relating to the integrity and robustness of the ISA for LCE, and the potential need for additional FRC guidance to make it fit for purpose. However, we stand ready to contribute to that debate and we set out below six potential areas for initial discussion:
 - a. scoping of the ISA for LCE in the UK - qualitative and quantitative criteria
 - b. the modification of requirements rendered less relevant or irrelevant, arising from scoping decisions
 - c. requirements relating to controls, estimates, going concern and analytical procedures
 - d. the ability to look through the standard to individual ISAs in certain cases without triggering reversion to all of the ISAs, including the limitations to this, how it might address concerns about two-tier auditing and how it might facilitate the proper conduct of high quality SME audits
 - e. documentation requirements, including those relating to scoping decisions
 - f. the regulatory and supervisory approach to ownership and conduct of audits performed under the standard.

RESPONSES TO SPECIFIC QUESTIONS

Question 1: Do you support the development of the PN, and do you believe it will help give practitioners the confidence to apply the ISAs (UK) in a scalable and proportionate manner for the audits of smaller and/or less complex entities?

And

Question 2: Do you believe the PN addresses the issues arising in the SME market sector when it comes to audit?

16. We do not believe that the ED addresses issues in the SME audit market. The FRC needs to properly explain how the market study informed its decision to develop the ED, and how the market study informed the ED's content.
17. As noted in our main points above, significant enhancements are necessary for the ED to have any impact on the conduct of SME audits. The extent of these means that re-exposure of the PN will be needed together with a concurrent, FRC-led public discussion of how the ISA for LCE might be adapted for use in the UK. Absent both of these further actions, ICAEW does not support publication of the PN, as it may confuse, rather than clarify, how auditors of small and less complex entities are expected to apply the ISAs and create expectations that cannot be met.
18. The FRC assumes that the main issues in the SME audit market are poor quality auditing and over-auditing by SME auditors who do not understand the ISAs, and poorly supervised junior staff. None of these shortcomings - to the extent that they exist - will be addressed by the PN, because the FRC has failed to address the root cause of the problem, which is the adverse effect of the ISAs themselves in the performance SME audits.
19. Our outreach suggests that while the PN may help auditors who need a refresher on the ISAs, to change behaviour, it requires more and better quality examples addressing the more difficult areas in the ISAs. We suspect that the FRC is likely to struggle to obtain such examples because the ISAs on which they are based are only scalable for SME audits with difficulty.
20. Firms have in the past attempted to develop separate audit approaches for smaller, simpler audits. The main reason for their demise was FRC challenge of such audits. If the FRC is serious about enabling firms of all sizes to conduct better SME audits, and if it believes firms are gold plating, it needs to address more clearly in the ED what auditors do *not* need to do and to reflect that in its approach to audit inspections. It also needs to be more open to the idea of smaller audit systems in general, and to actively engage with firms that might consider their re-introduction.
21. An idea of what SME auditors do not need to do is missing both from the ED and the FRC's thinking about SME audits more widely. Practitioners will always do more if doing less exposes them to regulatory censure. The ED will not change their behaviour if there is no change in the regulatory approach. The idea that doing less must somehow by definition lead to poorer audit quality represents an ineffective approach to audit inspection that actively encourages overkill. We heard anecdotally that the increasing number of stand-backs in ISAs and the regulatory interpretation thereof, have resulted in some practitioners assuming that audit inspectors will always expect additional audit work in response to the stand back requirement, and spreading the total planned audit effort across all audit requirements, including the stand-back. This is a highly undesirable outcome. We also heard that following PIE audit inspections, firms have been encouraged by the FRC inspectors to apply changes to methodologies and guidance arising from PIE audits to all audits, including SME audits, not just PIE audits.

Question 3: Are there other ISAs (UK) or specific requirements within ISAs (UK) that you believe this PN should provide guidance in their application to the audit of small and/or less complex entities?

22. The ED does not currently cover a raft of areas that are troublesome to firms of all sizes,

particularly SMPs. The ED includes cautionary material regarding the specific circumstances of SME audits, with little explanation of what can be done about it. The statement in para 41 about ‘opportunities for a more scalable and proportionate audit’ is particularly unhelpful. Areas that need better coverage include:

- Planning: a full planning document, rather than an extract would help practitioners understand better what is *not* needed. In practice, systems can generate a large number of planning windows to be completed for very tiny companies, because of the number of requirements in the ISAs, the majority of which result in N/A comments. We note in our main points above the use of smaller audit systems by firms in an attempt to reduce this level of redundancy and the need for the FRC as an improvement regulator, to take a more positive approach to such systems
- What in practice is meant by paras 29-31 on the calculation of performance materiality (para 32 is of little help to an experienced auditor)
- The design and implementation of controls, particularly where monitoring controls are absent (para 50)
- What to do when, as is often the case, management is too busy running the business to deal with the auditors (para 46) and management and those charged with governance are the same (para 47)
- The documentation of ITGCs, application controls and systems
- What is meant in practice by ‘using professional judgement to determine whether the risk assessment process is suitable’ (para 49)
- Substantive analytical procedures and how they might replace detailed testing
- The meaning of ‘likelihood and magnitude’ in the risk assessment
- What to do in areas in which there is no risk of material misstatement (para 80) and what assertions to consider when performing required substantive work on material balances. There is a risk of over-auditing where there is no RoMM as there may be no need to test any assertions. Even if there is a risk, there is no need to test all assertions. The example does not work and is not in IAASB implementation guidance
- The going concern section generally, the scoping of which is unclear and incomplete. What auditors should do where budgets and forecasts are not prepared by management, or are prepared by management only to meet audit requirements (para 64)
- What auditors should do when, as is invariably the case in smaller audits, management has not performed a going concern assessment (para 80)
- The presumption of fraud in revenue recognition; letters of support in group audits; the recoverability of inter-company balances; and related parties
- The level of documentation required for small group audits where a single firm is conducting the whole audit.

23. The ED is unnecessarily long. Much of it is obvious or background material and direct repetition of material lifted from the ISAs, particularly in the more difficult areas that lack examples. This material could at least be summarised, and there is too much wording that points out the obvious in straightforward areas.
24. The ED is also light on the more difficult areas noted above, and because it gives no sense of procedures or processes than may be irrelevant or unnecessary. The ED should focus on areas in which time and cost savings can be made.
25. The material in paragraphs 112 to 120 on the critically important area of audit documentation provides good auditors with nothing new. The statement in paragraph 116 referring to ‘these special considerations’ makes little sense because the issues apply to audits of all sizes and include repetition of the ISAs. The ISA 230 requirement that ‘audit documentation for the audit of a smaller entity is generally less extensive than that for the audit of a larger entity’ might be useful for auditors who have never performed an SME audit, or someone returning to audit after a break, but most auditors fall into neither category. The PN should assume a

working knowledge of the ISAs.

Question 4: Are the examples included within the PN and the Appendix helpful or could they be enhanced? Are there other scenarios that we could include in the final version of the PN?

26. There are multiple issues with the appendix. The overall observation was that it is simplistic, and that it is too similar to the old PN which derives from a time when the ISAs (UK) permitted a more bespoke approach. Directors are assumed to be doing all the right things and it is assumed that an abundance of third party audit evidence is available. Scepticism was expressed regarding the acceptability of the example documentation to audit inspectors in practice. We were told that these examples will not be used and that FRC needs to work with methodology providers to provide examples that will be used.
27. We understand that many Section 1A audit engagements are not voluntary audits, as per the example, but audits of subsidiaries in the context of much larger group reporting engagements. In practice, the audits of such subsidiaries are often conducted by smaller firms who are not in a position to challenge larger firm group auditors who are disinclined to confirm intercompany balances that are eliminated on consolidation. The PN should deal with such situations.
28. In practice, planning, including work on systems and controls takes up more time than it should do, because of the need to explicitly demonstrate how each ISA requirement has been met. The ED would benefit from a full scope planning document rather than the bolt-on provided in the appendix, to give some idea of how the ISAs can be scaled to circumscribe the volume of documentation. A complete document will reduce the likelihood that firms will seek to avoid censure by covering areas not provided in the example.
29. In the appendix, the material covering the directors' valuation of buildings, receivables and internal controls are weak. In each case, a relatively simple scenario is described, in which the directors are providing good quality information on a timely basis, which is not the case in practice, more often than not. The appendix would be more useful if it covered more common situations in which controls were weaker, records poorer, expensive valuations had not been performed (this also applies to Box 3), receivables were not paid post year end so promptly and in which the third party audit evidence was generally less clear.
30. Thornier issues such as revenue recognition, leasing and the fraud risk - all of which are as common in SME audits as they are in larger audits - are not touched on. They should be addressed in the appendix and in the main body of the PN. The assumption that there is a written management assessment of the going concern assumption is wholly unrealistic for many audits and the PN should set out what can be done in such circumstances.
31. PN 26 was withdrawn because it was not maintained by the FRC. It had not been updated for changes to the ISAs (UK). If published, this PN needs to be an ongoing project for the FRC to which examples are added over time, to avoid the same thing happening again.