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Small and medium-sized enterprises (SME) market study

Response from ICAS

FRC Small and medium-sized enterprises (SME) market study

Introduction

ICAS welcomes the opportunity to submit a response to the FRC's small and medium-sized enterprises (SME) market study.

Responses to consultation questions

Q1. How well is the UK audit market currently functioning for SMEs?

The SME audit market covers a lot of different entities, including small and medium sized companies, limited liability partnerships and other entities such as charities and co-operative and community benefit societies. Whilst in general many such entities have access to a sufficient supply of audit firms, that is not the case for all such entities e.g. charities. Cost of audit is also sighted as a concern by at least some SMEs and Small and Medium Practices (SMPs). The FRC will therefore need to be careful in analysing this market as it is not homogeneous.

It is also likely that the recent increase in the Companies Act 2006 ('the Act') audit exemption threshold will have an impact on the SME audit market, and while it is far too early to estimate how audit firms will respond to the reduction in the number of entities requiring a statutory audit, it will be important that any conclusions drawn from this market study and related recommendations are made with the potential impact of this recent development in mind.

There are also other challenges on the supply side for audit firms which include their ability to apply the International Standards on Auditing (UK) in a proportionate manner; and attractiveness of the profession related issues, such as retention of audit staff and succession planning. These are highlighted in our responses to the other consultation questions below.

Q2. 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?

Statutory requirement

For those companies which are medium-sized, the main reason is that this is a statutory requirement under the Act, although some medium sized companies do not have an audit as their parent company provides a parental guarantee under sections 479A to C of the Act which allows the companies concerned to take advantage of audit exemption.

The vast majority of small companies avail themselves of the audit exemption conferred by section 477 of the Companies Act 2006, though small companies which are components of a medium or large sized-group are not eligible for such exemption and therefore fall into the statutory requirement although, some may use the parent company guarantee route noted above to claim exemption from audit.

Reasons for entities voluntarily having an audit

For small companies which voluntarily elect to have an audit this is usually due to at least one of the following reasons:

- this is required by shareholders with not less than 10% of the company's share capital.
- an audit is required by a lender or investor.
- the company has ambitions to scale.
- an audit is required as part of the conditions of a contract tender process which the company is participating in e.g. the construction sector.
- the owners may be looking to sell the company and having an audit gives greater comfort to potential buyers on the accuracy of the company's financial performance and position.

Charities and other similar entities

However, there are various other entities which fall into the SME market, including charities where the applicable audit thresholds are much lower than those for companies. This will still be the case despite plans for increasing the charity audit exemption thresholds being proposed by both the UK and Scottish governments. The UK government is likely to increase the gross income criterion of the audit exemption threshold for charities in England and Wales from £1m to £1.2m or £1.5m shortly, following the launch of a consultation on charity law financial thresholds. Having presented the argument for an increase in the threshold over a number of years, we are also pleased to note the recent announcement by the Scottish government of its commitment to raise the gross income criterion of the audit exemption threshold for Scottish charities from £500k to £1m.

Q3. What, if any, challenges do SMEs experience in relation to audits (e.g. in finding an auditor, engaging with the audit process)?

Availability of audit firms

Most SMEs do not currently appear to have any difficulty in finding an auditor although there is a gradually shrinking pool of audit firms. However, there are audit procurement issues facing certain SMEs in certain sectors e.g., the charity sector. It is also noticeable that over time, the extent of choice of audit firms in the SME audit market has decreased due to:

- increases in the company size thresholds;
- increased regulation;
- the exit of smaller firms from the market; and
- a trend of increasing consolidation of audit firms operating in the SME audit market, including where there is private equity investment, leading to reduced choice for SMEs due to a reduction in the number of audit firms.

Indeed, many small firms have merged with larger ones, leading to fewer independent auditors and increased costs for SMEs seeking audit services, especially in the charity sector. There are far fewer audit firms now than there were 10 years ago. This decrease is not necessarily due to a lack of qualified auditors but rather because many are now part of larger organisations, which raises service costs. This creates a challenge for SMEs in finding affordable audit services, particularly for charities that have lower audit exemption thresholds. Smaller firms with only a few responsible individuals are more likely to exit the market due to the burdens of maintaining an audit practice versus the perceived benefits.

Cost of audit

Despite, there generally being sufficient supply of audit firms, SMEs may still face other challenges in relation to audit. These include high costs that can be seen as disproportionate when compared to the respective business complexity of the SME concerned. The regulatory burden, particularly for smaller audit firms, has increased their operational costs and complicated the audit process for SMEs. Recently revised auditing standards, in particular ISA (UK) 315 (Revised July 2020) 'Identifying and Assessing the Risks of Material Misstatement', ISA (UK) 540 (Revised December 2018) 'Auditing Accounting Estimates and Related Disclosures' and the introduction of International Standard on Quality Management (UK) 1 have driven up audit related costs.

Lack of understanding/Perception of audit/Value of audit

The lack of understanding of what an audit is, is also an issue. Many SME owners lack knowledge about what an audit entails, often viewing it as a mere compliance cost rather than a valuable process. This perception can hinder their engagement with auditors.

SMEs prefer to engage with accountancy firms that provide broader business support rather than just specific services like tax advice or auditing. They desire a trusted advisor who can assist them in various aspects of their business growth. The value of audits for owner-managed businesses, particularly when the owners are actively involved in day-to-day operations and have no external stakeholders requiring an audit, can be questionable. The burdensome nature of audit requirements for

family-owned businesses that exceed the audit threshold but do not have significant external financial interests can be an issue unless the owners appreciate the value that audit can bring to their business, especially where there may be non-director shareholders.

Complexity of financial reporting

Also, SMEs often struggle with the financial reporting requirements due to limited expertise in-house, particularly in understanding complex accounting topics such as IFRS 16 on leases (the principles of which will soon be applicable in FRS 102) and accounting for financial instruments. In this regard, the recent change to the company size thresholds may benefit those smaller entities who will now be able to claim micro-entity status. However, we believe that the micro-entity regime requires a review to ensure that the information needs of stakeholders are met, as the required disclosures for such entities are extremely limited.

Having limited in-house expertise is a particular challenge for charities who are unable to take advantage of the micro-entity regime and must comply with FRS 102 in full as well as the Charities Statement of Recommended Practice (SORP). The challenges SMEs face with regards to financial reporting can have a knock on effect on the role of auditors and possibly create challenges to their independence: Auditors frequently find themselves in a position where they must educate SME owners about necessary financial reporting disclosures and accounting policies, which can be met with resistance or misunderstanding by SMEs.

Timing of audit tenders

The timing for SME audit tender exercises is very important, and it is critical for SME owners to be aware that engaging an auditor requires foresight. For example, if an SME issues an invitation to tender at short notice (either with little lead time or even after the year-end) this can cause resourcing challenges for audit firms as staffing plans for audits will have already been planned up to 18 months ahead. Therefore, SMEs, including charities, need to be aware of the lead time needed when running a tender exercise.

Technological developments

The impact on the SME sector of technological advancements, including AI tools, on reporting and related assurance thereon, has not yet become clear but undoubtedly there will be an impact for both preparers and auditors.

Charity specific issues

Charities often face difficulties due to lower audit thresholds compared to incorporated non-charitable entities, which can lead to unexpected audit requirements e.g. when charities receive a large donation in a particular year which may lead to them having to have an audit for one year only. Charities in this position based in England and Wales have the option of applying to the Charity Commission for England and Wales for dispensation from having an audit under regulation 34 of the Charities (Accounts and Reports) Regulations 2008. There is no similar mechanism or year's grace available under the Charities Accounts (Scotland) Regulations 2006 and this is an issue.

For a Scottish charity receiving a legacy near the year end which pushes them over the audit threshold, it may not be feasible for them to plan ahead with sufficient lead time for a tender exercise, and accordingly procuring an auditor with sufficient staffing flexibility to accommodate the audit within the applicable filing deadlines can prove a challenge and place the charity's trustees in difficulties not of their making. For example, a Scottish charitable company in this position may find itself unable to file audited accounts on time with OSCR and with Companies House. We are aware that Companies House are taking a robust approach to late filing of accounts, with company directors, the trustees under charity law, being asked to file accounts which are currently late or strike off the company, with failure to do so having the potential to lead to significant fines, a criminal record or to being struck off as a company director.

Additionally, a charity audit has added complexity relative to a non-charitable company of a similar size and for some sizes of charity, access to specialist accountancy resources is a factor. For example, a company with a £10 million turnover would have an equivalent sized finance team to a

charity of the same size. However, charities tend to be more complex, for example, they have fund accounting requirements, so there is relatively more risk involved in auditing a charity relative to a company of the same size. For charities in the £500k to £1 million gross income bracket, they have less sophisticated finance teams. While these are less complex than larger charities, finance staff still have to deal with more complex accounting matters.

Q4. What, if any, challenges do audit firms experience in relation to audits for SMEs?

Applying ISAs (UK) in a proportionate manner

The biggest challenge is applying the ISAs (UK) in a proportionate manner. This is particularly the case in relation to the application of ISA (UK) 315 (Revised July 2020) and ISA (UK) 540 (Revised December 2018) 'Auditing Accounting Estimates and Related Disclosures'.

Financial reporting

Another issue is that a lack of qualified accountants within SMEs and charities in particular, complicates compliance with accounting standards, leading to challenges for auditors in managing risk, ensuring accurate financial reporting and in complying with auditing standards. Some clients may just not have the necessary financial knowledge to provide the required information. The use of fair values in financial reporting is a case in point as many SMEs neither appreciate the need to use financial models to value certain financial instruments nor the benefit obtained from doing so, and there is a concern that the same will apply to roll out of the leasing requirements in FRS 102 of the IFRS 16 'right of use' asset approach. Related to this, the identification and use of discount rates where relevant in financial reporting can prove challenging to SMEs and subsequently to audit. SMEs generally don't have the expertise to ascertain what is an appropriate discount rate. Auditors are then often left with having to 'get comfortable' with the discount rate(s) clients have applied and why, and this can lead to some challenging discussions.

SMEs may therefore need more support from their auditor than large entities. For smaller entities the complexity of judgements about accounting estimates and going concern will be disproportionate to the entity, but nevertheless, these issues need to be considered when deciding whether to take on an engagement. This can make it challenging at the smaller end both to comply with the FRC's Ethical Standard and provide the client with the support they need, which can add to commercial pressures. For example, the concept of going concern poses significant challenges for SMEs, particularly with new disclosure requirements. Clearer guidance that is accessible to smaller entities could help them navigate these requirements effectively. The need for better forecasting and budgeting support for small clients is also an issue. Could auditors play a more proactive role in helping clients prepare robust financial forecasts whilst still satisfying applicable ethical requirements? Current ethical standards and regulatory frameworks can hinder accountants from acting fully as trusted advisors to SMEs, highlighting the need for proportionality in applying these standards to entities of different sizes.

Staffing

Another challenge being experienced by audit firms is that increasing regulatory demands make the audit profession less attractive, contributing to difficulties in staffing and retention. Firms have been struggling to recruit and retain audit staff, particularly at the senior and manager levels, which impacts their ability to meet client needs effectively. While there are still a fair number of accountants qualifying each year, many choose to enter industry roles rather than remain in practice, exacerbating the recruitment issue within auditing. There is also a perception among young people in certain jurisdictions that pursuing a professional accountancy qualification is daunting, which may deter them from entering the profession. Student numbers for professional accountancy bodies in the UK are holding steady, although there are concerns about the declining interest in accounting degrees. The importance of maintaining a pipeline of qualified accountants to support the audit sector is essential.

Societal and technological developments

Post-COVID, the shift to remote and hybrid working environments has complicated audit processes, affecting communication and the quality of information exchanged between auditors and SMEs. If audit firms are employing greater use of technological tools, including AI on their audits, then for this to be utilised on SMEs, such entities need to have a good control environment and reliable data. This

may result in certain audit firms not seeking to audit SMEs if they have to adopt an alternative, more substantive based audit approach.

Charity-specific issues

March year-ends are very dominant in the charity sector, about 40% of the Scottish sector. That can cause issues in terms of staff planning. For long-standing clients, the timing of their year-end audit visit is well established. However, for a new client, especially a larger charity (which is still an SME) that is more challenging as their audit visit has to be fitted around plans for existing clients. This can mean that charities do not change their auditor. Having an audit visit later than previously can mean that any issues which could hinder the audit being completed emerge later, which can create issues with the filing deadline. There is a risk to charities of not having an audit visit until six or seven months after the year-end whereas some funders expect charities to have their final audited accounts within five or six months of the year-end.

For audit firms currently auditing charities and other similar specialist entities they face:

- Increased regulatory requirements leading to an increase in the level of audit work.
- Increased opportunities in the corporate audit market which has increased demand for audit services.

Firms are also looking more closely at opportunities for commercial return and it has become more difficult to make a recovery on the audits of small charities compared to medium-sized charities. The cost of planning for a small charity audit and undertaking administrative tasks related to the audit could incur costs up to an amount a charity would expect to pay for the whole audit. Therefore, firms sometimes choose not to respond to invitations from charities to tender for audit services. This is a change from past practice.

For firms which do have a focus on charities, a decision to tender for a charity audit needs to balance commercial considerations with making sure that audit quality can be maintained through having the appropriate staff resources.

Public sector

In relation to the public sector's approach to audit tendering, including public sector bodies which are also charities, where tenders are managed through the public procurement process, there is no opportunity for face-to-face discussions with the client. This approach does not enable the auditor to scope the work and tailor a proposal to the needs of the potential client. This approach treats an audit as a commodity. It also means that finance teams don't have the opportunity to gain a better understanding of what an audit is. Many firms may now decline any invitation to tender which comes through a public sector procurement process.

Q5. 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).

ISA for LCEs/Proportionality

We believe that there is a need for the FRC to consult on the International Standard on Auditing (ISA) for Less Complex Entities for possible introduction in the UK. We acknowledge that there are mixed views across the profession and indeed other stakeholders, but the best way forward would be for the FRC to consult on this to properly gauge market sentiment. Whilst presenting certain challenges, a UK standard for less complex entities could be seen as beneficial in making the audit process more accessible for smaller clients

There is potentially a need to explore more innovative solutions in the market place to better support SMEs. The need for a better understanding from regulators that "one size does not fit all" in terms of audit requirements for SMEs is a common theme. More flexible or "audit light" frameworks tailored for SMEs, which could alleviate some of the burdens of full statutory audits, including potential further reliefs within the FRC's Ethical Standard could be considered in this regard.

For at least some SMEs who are currently subject to a mandated audit this may not be the optimum product from an assurance perspective. Consideration could be given instead to mandating other alternative forms of assurance which could be based on the international review assurance standard. The US market possibly provides an example of greater use of review type engagements in an environment where statutory audit requirements are minimal.

The difficulty in creating auditing standards that apply universally to both large corporations and small owner-managed businesses is also a commonly raised concern, emphasising the need for scalable standards. The FRC's planned launch of a Practice Note ('PN') for SME audits later this year provides an opportunity to support SME auditors, identify and leverage existing flexibilities within ISAs (UK). However, there is also a need for consistent interpretation of what the auditing standards, and indeed any guidance offered in the PN, require. Firms are reluctant to adopt innovative approaches when applying the ISAs (UK) as they fear being held to account and accused of not having complied with a requirement in a standard if doing so. This acts as a barrier to innovative, potentially proportionate, and compliant solutions being applied. Guidance by itself will not change behaviours as audit firms are risk averse, and worried about failing a review. We therefore harbour concerns that the PN will not have a tangible impact on the objective that it's trying to achieve.

Qualitative approach to setting thresholds

There would be merit, although practical challenges presented, in government adopting a more qualitative approach regarding the SME audit thresholds to better address the unique challenges these businesses face.

Content and value of audit reports

The length and complexity of audit reports may not provide the necessary information for smaller entities, raising questions about their value. Condensing these reports to make them more readable and meaningful for SMEs should be considered.

Increased charity audit exemption thresholds

As noted above we welcome announcements by the UK and Scottish governments to increase their respective audit exemption thresholds.

Q6. What, if any, forthcoming developments might the FRC want to consider as part of this market study

Digital reporting and emerging technologies could play a role in transforming audit practices. Furthermore, current reporting standards may not adequately reflect the needs of smaller businesses.

Therefore, there is a need for a re-evaluation of how businesses engage with stakeholders in a digital age. While technology like AI has the potential to enhance audit efficiency and effectiveness, it may also create barriers for smaller firms due to the costs involved in its implementation.



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