

Small and medium-sized enterprises market study

An invitation to comment issued by the Financial Reporting Council
Comments from ACCA to the Financial Reporting Council

25 April 2025

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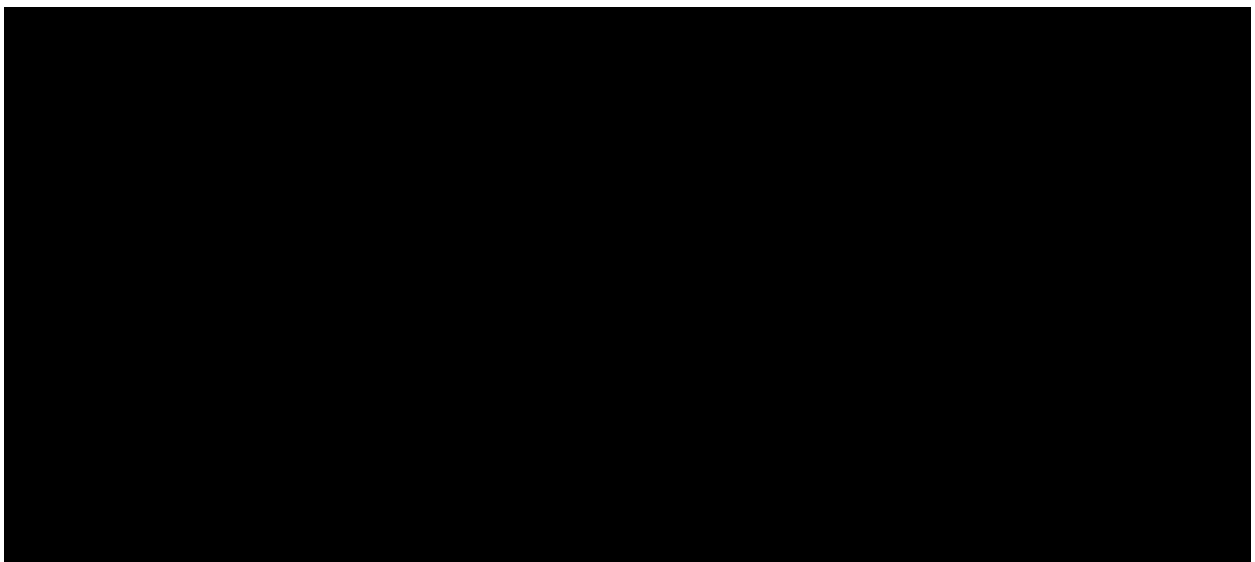
About ACCA:

We are ACCA (the Association of Chartered Certified Accountants), a globally recognised professional accountancy body providing qualifications and advancing standards in accountancy worldwide.

Founded in 1904 to widen access to the accountancy profession, we've long championed inclusion and today proudly support a diverse community of over 252,500 members and 526,000 future members in 180 countries.

Our forward-looking qualifications, continuous learning and insights are respected and valued by employers in every sector. They equip individuals with the business and finance expertise and ethical judgment to create, protect, and report the sustainable value delivered by organisations and economies.

Guided by our purpose and values, our vision is to develop the accountancy profession the world needs. Partnering with policymakers, standard setters, the donor community, educators and other accountancy bodies, we're strengthening and building a profession that drives a sustainable future for all.



GENERAL COMMENTS

ACCA welcomes the opportunity to respond to the FRC's Small and medium-sized enterprises market study. During the consultation period we held a hybrid roundtable discussion with a range of members and stakeholders including representatives from the FRC at our London office to hear more about the invitation to comment and enable members to share their views.

We commend the FRC for its initiative to address the challenges faced by both SMEs and auditors conducting SME audits in UK. ACCA is strong proponent of globally consistent standards with regard to both corporate reporting and audit and assurance. Accordingly, we believe that it would be valuable and in the public interest for the FRC, as part of its focus on SMEs and audit, to set out clearly the basis for its decision not to adopt the IAASB's International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE), its proposed alternative arrangements, and to allow stakeholders to provide their feedback once it has developed firm proposals in this area on which it wishes to consult.

In general, we consider that the focus should be on complexity rather than size given that an entity may be large in size but still be less complex. By focusing on complexity rather than just size, any initiatives by the FRC to address the scalability issues with the UK ISAs will be likely to help a much larger number of firms and practitioners.

ACCA firmly believes that audit plays a very important role in enhancing shareholders' confidence with regards to a company's financial position and trust with respect of its management and this includes SMEs.

ACCA supports the FRC in their objective to address the challenges faced by both SMEs and Auditors and makes the following suggestions to the FRC:

- Explore ways in which to address the expectation gap within the UK audit market to ensure that the public, investors and SMEs better understand what auditors actually do.
- To undertake further research and work on the benefits of Audit for SMEs. Improved communication of the benefits of audit both by the FRC and by professional bodies, such as ACCA, remains crucial to supporting SMEs with better understanding the benefits associated with time and resource investment in audit.
- We believe the FRC should consider the proportionality of the UK ISAs and that further thought needs to be given to the scalability of some of the UK ISAs, to be proportionate or 'fit for purpose' for an SME audit.
- Consider undertaking additional focused research on the application of the ethical standard to SME activities and their audit and assurance arrangements. This could

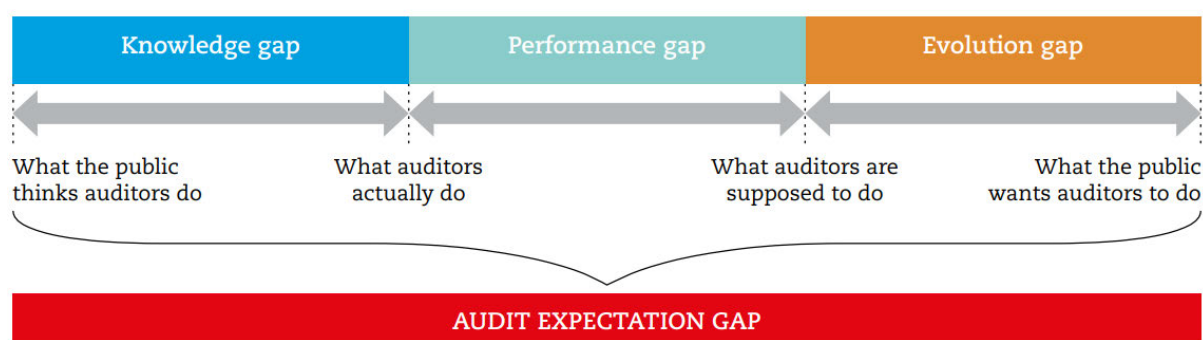
then potentially lead to the development of additional application guidance for the SME sector, depending upon the issues uncovered.

We find that addressing the points noted above can also have a positive effect with respect to the attractiveness and retention on talent in the audit profession.

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

Expectation gap

There are many challenges present in the UK audit market which can be particularly acute for SMEs. One of the key challenges is knowledge of what auditors actually do, by the public and SMEs, in financial audits, and whether that is indeed fit for purpose for SMEs. ACCA has published a thought leadership report which explored these challenges under the audit expectation gap. Supported by a global survey with 11,000 members of the public, our report titled [Closing the expectation gap in audit](#), proposes dividing the audit expectation gap into three components as shown below.



In our view, in order for the UK audit market to function well with respect to SMEs the following need to be addressed:

- The cost of having an audit shouldn't outweigh the benefits.
- All stakeholders of the profession have a role to play in addressing the knowledge gap.
- Regulators and standard setters should consider whether regulations and standards are fit for purpose and whether there is an evolution gap to be addressed with respect to SME audits
- Talent attracting and retention challenges need to be addressed.

Cost v benefit analysis

While some SMEs opt to have an audit despite having the option to be exempted, one of the key reasons for SMEs choosing not to have an audit is how demanding an audit can be in light of the regulations and revised standards in place leading to a broader sense among many SMEs that the cost is greater than the potential benefit.

Impact on talent attraction and retention

There can also be a knock-on effect with respect to talent attraction leading to another key challenge where audit may not be perceived as an attractive area by trainees seeking to specialise in a particular discipline, areas such as advisory and tax may be considered more attractive. As detailed in our recent research 'SMEs: business challenges and strategic innovation opportunities' smaller audit firms across face competitive talent recruitment challenges, especially from the "Big Four,"¹ retaining staff is also an issue due to factors like better pay at bigger firms. Some firms cited skill shortages in specific areas such as audit and tax as a key workforce challenge. Retention is difficult amid economic growth, salary disparities and competition from major players. Strategies to respond to this involve raising compensation and benefits.

ACCA's joint thought leadership report with Chartered Accountants Australia and New Zealand titled *Attract, Engage, Retain: Insights and Recommendations for Audit Talent Success*, provides a comprehensive examination of talent attraction and retention within the audit profession, supported by a global survey with more than 6,500 responses globally and a series of virtual roundtable discussions. The report finds that despite concerted efforts, the profession struggles to attract and retain talent amid declining numbers of entrants. These talent issues contribute to capacity issues within firms.

During our outreach for this consultation, our stakeholders also noted that they are experiencing particular challenges in encouraging their current staff to undertake RI status. This could be due to the increased legal responsibility that comes with an RI status, the decrease in SME audits or both.

Complexity of audit

In recent decades audit has become a more highly regulated area and audits more complex. The number of auditors has declined. Indeed, the FRC's most recent annual publication of key facts and trends in the Accountancy Profession² outlines the number of audit firms registered with the Recognised Supervisory Bodies (RSBs) and the data suggests a trend of declining numbers of registered firms. The total number of registered audit firms was 4,038 as at 31 December 2023, compared with 4,310 in 2022, 4,745 in 2021 and 5,007 in 2020 respectively.

¹https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/sme-business-challenges/PI-SME-CHALLENGES-INNOVATION%20v4.pdf

²<https://www.frc.org.uk/library/supervision/professional-bodies-supervision/key-facts-and-trends-in-the-accountancy-profession/>

Declining numbers can mean a reduction in the number of firms which SMEs can choose from, while increasing complexity can mean that many smaller audits are now non-viable for existing audit firms. One potential positive associated with the reduction in the number of registered audit firms is the increase in specialist audit firms. However the concern remains about the reduction in the number of auditors which has a corresponding impact on choice within the audit market. An updated FRC Key Facts and Trends Report with 2024 data will become available in the coming months.

Spotlight on Charity Audit in Scotland

In July 2024 ACCA responded to the Scottish Governments Review of Charity Regulation in Scotland. In addition to stakeholder engagement via a virtual roundtable, we also undertook a limited desktop research exercise exploring a sample of publicly available information relating to audit fees paid by charities. While overall it was difficult to identify obvious patterns across our data sample, there were indications that a number of charities are changing their auditor or independent examination provider year on year, possibly driven by a desire to access more competitive pricing. The data also demonstrated that the cost of audit has a disproportionate impact on smaller charities, with the fee representing an average of 0.8% of charity income for charities with income of less than £1M in 2023 compared with 0.4% of charity income for charities with income of more than £1M in Scotland. In the case of charity regulation in Scotland, ACCA believes that further analysis of data should be undertaken by Scottish Government. However, our findings further underline the finding in our expectation gap research³, that the cost of having an audit shouldn't outweigh the benefits. The department for Culture, Media and Sport are also running a consultation on financial thresholds in charity law.⁴

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?

In our view, there are a number of reasons as to why SMEs obtain financial audits. Some of these reasons include:

³https://www.accaglobal.com/content/dam/ACCA_Global/professional-insights/Expectation-gap/pi-closing-expectation-gap-audit.pdf

⁴<https://www.gov.uk/government/consultations/consultation-on-financial-thresholds-in-charity-law>

- When seeking access to finance and investment many banks may require audited financial statements in order to approve credit facilities.
- Audited results may also support the negotiation of improved payment terms or interest rates by providing additional credibility to the lender.
- Having an audit can also support the development of credibility and trust by enhancing the SME's position with suppliers, customers and partners and employees.
- Having an audit often provides more opportunities for SMEs to work with large corporates given the enhanced transparency and accountability.
- Some SMEs opt to have an audit in anticipation of seeking future investment where having completed an audit may be viewed favourably by stakeholders such as lenders, potential investors, suppliers, customers etc.
- Business owners or directors may also want an independent audit, particularly for rapidly growing or complex businesses, as it provides an additional level of reassurance. Where succession or exit planning, an independent audit can support the process of valuation and negotiation during a sale or merger, or where there is a transition to new leadership within an SME.

ACCA believes that audit plays a very important role in enhancing shareholders' confidence with regards to a company's financial position and its management and this includes SMEs. In our view, if there was a surge in SMEs not subject to independent audits, this could have a significant impact on the trustworthiness and integrity of the corporate sector, including supply chains, and the resilience of the broader economy. As highlighted in the market study, SMEs form a significant component of the UK economy. However, when it comes to SMEs and particularly for those opting to have an audit when they could be exempted, cost benefit analysis is vital.

Accountancy Europe, the representative body for accountants and professional accountancy organisations in Europe, periodically review the audit exemption thresholds set up in countries within Europe. Their latest report published in April 2021⁵ made the following observations, among others:

- Italy significantly lowered their audit exemption thresholds, recognising that smaller companies that were not subject to any audit or control system had been the first ones to become insolvent. It was also acknowledged that a certain level of controls and early-warning mechanisms could be useful to avoid business failure.

⁵<https://accountancyeurope.eu/publications/audit-exemption-thresholds-in-europe-2/>

- There was a political discussion in Denmark about potentially lowering audit thresholds, sparked by a series of stories in the media about fraud in companies that had not been audited.
- In Sweden, a study⁶ conducted by an independent body of the Swedish Parliament demonstrated through an impact assessment that audit of small entities is valuable to both these entities and the public good. Specifically, exempting them from audit increases the risk of accounting errors, tax evasion and economic crime.

We would encourage the FRC to undertake further research and work on the benefits of Audit for SMEs.

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

There are several challenges faced by SMEs in relation to audits. Given the broad range of organisation sizes that are classified as an SME these challenges can vary significantly. One of the most significant challenges relates to auditors needing to ask questions that may seem overly difficult or challenging to SMEs as well as time consuming. This could be because often SMEs are owner managed with one or very few individuals holding responsibility for a broad range of areas, lack of internal controls and policies. The auditor feels that they have no choice but to ask these questions as they are part of the UK ISAs requirements. Hence SME representatives (and auditors) often question whether the UK ISAs are written in a way which makes them scalable to organisations of any size.

The requirement to comply with demanding regulatory and standard requirements can drive audit costs upwards. SMEs therefore often struggle to find auditors due to the audit fees involved.

There are also considerations for SMEs to overcome in relation to independence and conflicts of interest. SMEs often expect the firm that provides audit services to also provide them with tax or consulting services. However, that can be particularly challenging for audit firms, particularly SMPs as it is crucial that they maintain auditor independence. Section 6 of the Revised Ethical Standard 2024, titled: Provisions Available for Audits of Small Entities would benefit from increased publicity and case studies to help support the Auditor and the SME organisation.

⁶https://www.riksrevisionen.se/download/18.26c2548c1616574394b157/1518435480894/RiR_2017_3_5_REVISIONSPLIKT_SUMMARY.PDF

As detailed in response to question one, cost benefit analysis remains a key consideration for SMEs. Improved communication of the benefits of audit both by the FRC and by professional bodies such as ACCA remains crucial to supporting SMEs with better understanding the benefits associated with time and resource investment in audit.

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

Audit firms face a significant number of challenges in relation to audits. Through engagement with our members we have been able to better understand some of the key challenges. Audit firms have highlighted that they find the requirements of the UK ISAs disproportionate for their clients. We believe that further thought needs to be given to the scalability of some of the UK ISAs, to be proportionate or 'fit for purpose' for an SME audit.

More specifically, our stakeholders raised concerns and challenges with respect to the scalability of the following UK ISAs and Ethical Standard:

- Revised Ethical Standard 2024 (Revised January 2024), Integrity, Objectivity and Independence
- ISA (UK) 315 (Revised July 2020), Identifying and Assessing Risks of Material Misstatements
- ISA (UK) 240 (Revised May 2021), The Auditor's Responsibilities to Fraud in an Audit of Financial Statements
- ISA (UK) 570 (Revised September 2019), Going Concern
- ISA (UK) 600 (Revised September 2022), Special Considerations - Audits of Group Financial Statements (Including the Work of Component Auditors)

Using ISA (UK) 600 (Revised) as an example, our stakeholders raised concerns where the group merely consists of a non-trading parent that holds the investment with a trading subsidiary (or a couple of trading subsidiaries). Applying the full requirements of ISA (UK) 600 (Revised) can be overwhelming in such situations.

Similarly, auditors have reported facing similar difficulties in applying ISA (UK) 315 (Revised), arguing that the risk assessment process is not well designed for audits of SMEs with the 'why' not being sufficiently clear, resulting in a 'tick-box' exercise with no clear understanding of its value added. This is because, in the case of SMEs, they are often lacking in controls or the required information on systems and controls may not be available, so auditors are likely to need to use a substantive approach. There is a need for the standard to be clearer on how, for example, the lack of controls may impact the risks and the substantive approach taken so

that practitioners can easily understand what they are required to do for risk assessment in these audits, rather than for example, just moving to a substantive approach with limited documentation.

We believe the FRC should consider the proportionality of the (UK) ISAs. We are happy to provide detailed comments regarding the standards listed above and the challenges identified by our stakeholders in SME audits.

In addition to challenges with ISAs, our recent joint CA ANZ report titled 'Attract, engage, retain: Insights and recommendations for audit talent success'⁷ provides a comprehensive examination of talent attraction and retention within the audit profession, conducted through a global survey and a series of roundtable discussions. The research finds that despite concerted efforts, the profession struggles to attract and retain talent amid declining numbers of entrants. These talent issues contribute to capacity issues within firms.

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 FR, Government, firms, companies or others).

As detailed in response to question four, audit firms have consistently highlighted that they find the ISAs are disproportionate when applied to their SME clients. We believe that further thought must be given to scaling some of the ISAs back so they 'fit' in an SME audit.

In addition to scaling back of ISAs, guidance on their application is key to supporting both audit firms and the clients they serve. ACCA continues to feed into practice note development and look forward to the launch of this work later this year.

The UK has a positive audit regime, and we would like to see additional comment and publicity on the positive aspects of the UK audit and governance regimes, as this is incredibly useful for inward investment on a global stage.

As detailed in the general comments section, ACCA are strong proponents of globally consistent standards with regard both to corporate reporting and audit and assurance. Accordingly, we believe that it would be valuable and in the public interest for the FRC, as part of its focus on SMEs and audit, to set out clearly the basis for its decision not to adopt the IAASB's International Standard on Auditing for Audits of Financial Statements of Less Complex Entities (ISA for LCE), its proposed alternative arrangements, and to allow

⁷<https://www.accaglobal.com/uk/en/professional-insights/pro-accountants-the-future/audit-talent.html>

stakeholders to provide their feedback once it has developed firm proposals in this area on which it wishes to consult.

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

While the FRC's Ethical Standard⁸ is designed to apply in the audit of financial statements and other public interest assurance engagements in both the private and public sectors, it presents a number of challenges to auditors and SMEs when being applied to SMEs. The confusion related to areas such as the application of safeguards, which in many cases can lead to additional costs for business, and in some cases businesses not receiving the support they expect from the auditor. As we noted in our response to Q3 above, SMEs often expect the firm that conducts their audit to also provide them with tax or consulting services. However, that can be particularly challenging for audit firms, particularly SMPs as they have to maintain auditor independence in accordance with the FRC's Ethical Standard with the necessary safeguards in place to offer any other services.

To be absolutely clear, ACCA fully supports the requirements of the IESBA Code of Ethics for professional accountants – it is paramount that accountants behave in an ethical manner so that the profession as a whole can be trusted. In this case, our suggestion is that the FRC should consider undertaking additional focused research on the application of the ethical standard to SME activities and their audit and assurance arrangements. This could then potentially lead to the development of additional application guidance for the SME sector, depending upon the issues uncovered.

⁸<https://www.frc.org.uk/library/standards-codes-policy/audit-assurance-and-ethics/ethical-standard-for-auditors/>