BRIEFING PAPER ON THE URGENT NEED TO HELP FIX THE ECONOMY BY STREAMLINING SME AUDITS, AND HOW TO ACHIEVE IT

1. Introduction

1.1 The purposes of this briefing paper are to:

* indicate that startups are more likely to succeed and SMEs and the UK economy to grow if a misguided policy announced by the previous Government in March 2024 and due to be implemented by this Government in October 2024 is abolished;

* explain that 132,000 SME companies and their directors are at immediate risk;

*highlight a massive regulatory disproportionality that should be eliminated and how it can be achieved;

*indicate that audits help put in place the essential 'building blocks' needed for business and economic growth and that they would provide more value if the excessive audit bureaucracy and box-ticking load put on SME audits is removed;

*explain how the UK is now at a competitive disadvantage to France and Germany which is putting UK SMEs at risk and stifling growth;

*propose that an obvious alternative is applied not only to small and medium-sized companies, but also to audits of many charities, low risk subsidiaries of larger companies and various public sector bodies. It could be that a root cause of the crisis in local audit is the 'audit process' problem that afflicts SME audits; and

* indicate how a regulatory drift that has caused this type of problem and that has put SMEs at a disadvantage could be eliminated going forward.

1.2 Potential benefits include:

*removal of a massive regulatory disproportionality;

*time and cost reductions by reducing the audit bureaucracy and the mountain of box-ticking associated with SME, charities and various public sector bodies' audits;

*more sustained business growth by audits drawing the attention of owner directors to how and where to put the right 'building blocks' for growth in place;

*abolition of a totally misguided policy due to be implemented in October which will put 132,000 companies and their directors at immediate risk and many other SME companies going forward;

*time and cost reductions for audits of low risk subsidiaries of larger entities thus enabling more time to focus on the big issues such as fraud, going concern, illegal dividend distributions and greenwashing;

*reduction of regulatory compliance costs as inspectors will be measuring compliance against a much shorter standard;

*better recruitment and retention of auditors by freeing them from excessive audit bureaucracy and box- ticking, enabling them to focus better on the essentials and delivering more value;

*alleviation of a current existential threat to small practice firms that carry out audits of SMEs;

*no increase in Government's spending;

*installation of an ongoing mechanism to help prevent future disproportionalities in this area; and

*Improvements in the Exchequer and the 'tax gap', ie the difference between tax receipts due and received by the Government.

2.SPOILER ALERTS !!!

2.1 Small and Medium-Sized enterprises are not inconsequential. As of October 2023 there were 5,547,000 SMEs representing 99.05% of UK businesses. They are the life blood of our economy.

2.2 As of January 2022 SMEs employed 16.3 million people, contributing to 60% of all jobs in the UK.

2.3 Audits are an essential 'enabler of business growth' and are not boring, and should not be treated as a compliance cost. Without them, our capital markets and the reputation of the UK as a great place to do business, invest, maintain a sound economy, succeed and prosper would simply not exist.

3. The massive disproportionality

3.1 Unfortunately the UK seems to have drifted into a situation whereby massively disproportionate auditing standards are continuing to be imposed on the SME sector. This arises because in the UK we have a 'one size fits all' 1,000 pages plus set of auditing standards that has been developed with listed companies, banks and insurance companies in mind, but not enough engagement has taken place with small practice firms and SMEs. These auditing standards continue to get longer, more complex and onerous. When they are applied to SMEs they are effectively a "sledgehammer to crack a nut'. This has created not only burdens on auditors but also on the SMEs at the receiving end of audits.

4. Audit exemption and the value of audit to the wider economy

4.1 There is an argument that 'one size fits all' auditing standards do not matter as statutory audit exemptions remove the need for audits of small companies. However, this is misconceived. I have been told by auditors of SMEs that there would be greater demand for audit if audits of SMEs were less costly and provided the level of value that they originally delivered.

4.2 Furthermore, because of the Economic Crime and Corporate Transparency Act 2023 micro-entities and other small companies will no longer be able to file abridged accounts, and profit and loss accounts will be expected to be filed again at Companies House. The option of abbreviated accounts has also been removed. In addition, filings will be subject to probing checks under powers arising under the Act, and new offences will arise for delivering or causing to deliver documents that are false, misleading or deceptive in a material particular. These include a basic offence for being without a reasonable excuse and an aggravated offence with tougher penalties.

4.3 These offences will apply to the company and the officers that have been in default. This is against the backdrop that the requirements relating annual reports and accounts are demanding. Owner directors of SME companies cannot just 'wing it ', such is the complexity of the requirements set out

in the Companies Act and a stringent 424 page financial reporting standard for recognition, measurement and disclosure when full annual accounts are required.

4.4 Consequently many directors will want to make sure that what they file is right. Part of the value of an audit is therefore about giving directors some peace of mind.

4.5 Also, exemption from small company audits does not apply where more than 10% of the shareholders request an audit, providers of finance insist on an audit or purchase agreements require an audit for earn out calculations. In addition, an audited track record is needed for companies wanting to list and is useful for companies wanting to grow properly. Another part of the value of an audit therefore is that it helps decision-makers such as stakeholders, and provides them with a level of trust in the numbers presented to them. Furthermore, audit exemptions do not apply at all to medium-sized companies or to many charities as the monetary thresholds for exempting charities from audit are much lower.

5. The obvious alternative and why it needs to be adopted

5.1 There is an obvious alternative that is being steadfastly ignored by the regulators and surprisingly without public consultation here in the UK. In December 2023 the International Auditing and Assurance Standards Board approved the International Standard on Auditing on the Audit of Financial Statements of less Complex Entities ('the ISA for LCE') and just one country abstained, the UK. This alternative standard then gained the support of the International Federation of Accountants and was certified by the highly respected Public Interest Oversight Board as having been developed in a manner consistent with agreed due process and being responsive to the public interest.

5.2 To put this in context, the full set of International Standards on Auditing (UK) exceeds 1,000 pages whereas the ISA for LCE and its accompanying documents run to only 158 pages. So, what are the consequences of this massive disproportionality? Here are some of many quotes in comments received from small practice firms of accountants and their file reviewers:

** For the types of companies that we audit it feels that (the current auditing standards) are far too demanding*

** (The ISA for LCE) would be perfect for small firms. (It) would make audits by smaller firms simpler and cost effective*

** There would definitely be time and cost savings if pointless box-ticking was eliminated allowing auditors to think clearly where the risks truly lie and concentrate on them*

** Regulation for small LCEs has become a box-ticking exercise which is not what our clients expect of us*

** Ticking boxes is not achieving anything*

** Streamlining the standards would encourage software providers to condense the endless pages of what for the most part are irrelevant boxes*

** Everyone would find the ISA for LCE much better. It would be cheaper, less to learn and enable staff to concentrate on the the essentials*

** It's obvious to all ….except our regulators that one size won't fit all*

** There is nothing (in the existing full set of ISAs) that gives guidance on proportionality to a firm such as mine. What I need is proportional guidance for a firm such as mine with small audits. This anti-competitive*

** What is unhelpful is that we have a set of standards geared to the perceived needs of large listed companies*

** (The ISA for LCE) …is a far superior product.. In my view it gives the auditor time to think*

** (The FRC for LCE is) bound to save time and reduce costs*

** (The ISA for LCE) would make audits cost effective for audits and firms. Staff would be more focused as some of the bureaucracy of audit would be taken out*

** The current standards are not proportionate and scaleable*

** Doing (audits) based on the existing ISAs (is) too burdensome*

** The sheer drudgery of completing 800+disclosure checklists and 3000+question audit packs… The constant change .. A feeling that the regulations are aimed at larger firms*

** It will be easier to explain to the client and less work for the client to prepare*

** Why is the FRC preventing charities from using the ISA for LCE? They continue to pay over the odds for their audits that follow over-engineered standards. This is money that could be spent on their charitable activities.*

** (The ISA for LCE would result) of course (in) more time to sit back and consider useful business advice*

** When regulators… perform file reviews on their inspections then on (ISA for LCE audit engagements) they will be measuring compliance against a much shorter, straightforward standard, this would take less time, be less expensive and reduce the amount of non-compliance and conflict between regulator and firm.*

5.3 The comments from small practice firms and their file reviewers are available on request. They rebut firmly any assertions that the application of the ISA for LCE will not result in time and cost savings and will lead to a reduction in audit quality. No comments were received that audit time and cost would remain the same. However the comments are also worrying. Although there have been reports of improvements in the quality of audits of a few very large firms, it seems that the full series of auditing standards is not fit for purpose when applied to SMEs and other less complex entities. This is because the current auditing standards are clearly disproportionate and not sufficiently scalable. This is resulting in far too many unintended and negative consequences for audits of SME entities, and these consequences are becoming progressively worse as ISAs become even longer and more complex.

5.4 Individuals who have experience as directors of smaller companies and whom have been at the receiving end of audits have told me that the modern auditing standards "have turned audits into burdens …created box ticking audits that don't add value and result in auditors filling in forms and checklists in audit rooms or by ZOOM….result in a lack of third party evidence, insufficient challenge and audits competed under time pressures…

5.5 It has been reported to me that it is now virtually impossible to recruit trained audit staff and trainees want to avoid audit if they can as it is seen as tedious, boring and pointless box- ticking. The current UK auditing standards are therefore creating an existential threat to small UK audit practices, and this will progressively undermine the SME sector on which the economy depends.

5.6 The UK needs to stop being a laggard rather than a trailblazer internationally by returning to much shorter principles-based auditing standards for SMEs. Such a move to a more principles-based approach as set out in the ISA for LCE would be in line with one of the recommendations in the Government appointed Brydon Report on the quality and effectiveness of audit. This would reduce for SMEs the current lengthy work programmes and checklists and the ensuing mountain of box-ticking. Auditing standards may work for listed and other public interest entities, but they impose unnecessary burdens on SMEs. The ISA for LCE would also create more time for auditors of SMEs to think critically and to deliver more advice by way of helpful discussions with, and management letters to, owner-directors and other management. This would improve the quality of SME audits and the value that they deliver. It would also reduce the burdens on SMEs.

5.7 The ISA for LCE would also result in an improvement in the quality of auditing of SMEs instead of the current Byzantine bureaucracy and box-ticking of the modern audit. It would result in more time for professional judgement, professional scepticism and stand back before signing-off on an audit report. I am told that it would make audits of SMEs more attractive and less boring to potential entrants into the accountancy profession, help retention rates, widen the audit market (when small practice firms have exited or are currently considering exiting auditing entirely) and provide better insights to SMEs.

6. Why is this matter important and needs to be dealt with as a priority

6.1 Dealing with this matter would be timely as the Government is seeking to grow the UK economy more than any other G7 country. In particular sustained business growth would be helped by an annual financial MOT on the essential 'building blocks for growth' that include good accounting records, effective systems of controls, sensible plans and forecasts, reliable financial information, some meaningful external financial challenge of the business's ongoing finance and the increased trust of the business's stakeholders. Otherwise, as businesses grow, so does the risk of overtrading and of key decisions being made on the basis of faulty numbers, poor systems and inadequate levels of finance that cannot cope properly with growth ambitions. If the right building blocks are not in place, then startups fail, jobs are lost and business owners can lose their homes when banks send in receivers.

6.2 To use an analogy, if vehicles older than three years were not subject to an MOT, the condition of such vehicles would progressively deteriorate so that there would be far more incidents of cars breaking down, being involved in accidents or being sold when not roadworthy. Likewise, without an annual financial audit, there would in many companies be a progressive deterioration in accounting records, systems, business probity, financial information and trust by stakeholders. It could be that a root cause of the flatlining of the economy in recent decades has been the misguided policy of exempting too many companies from audit.

6.3 An absence of audit would also progressively result in more tax evasion, fraud and accounting cheats. This would result in the UK becoming less suitable as a place to invest, do business, create jobs and prosper. It would also increase the Government's tax gap ie. the difference between the tax receipts expected and actually received. This was reported as being £39.8 Billion in 2022 to 2023 which is huge, and with 60% being attributed to small businesses. This is at a time when there are: resourcing

problems within HMRC; Government plans to increase HMRC staff that would increase the Government's spending when there is a huge funding gap in the Exchequer and spending constraints; and new IT or AI systems would be expensive to install and may not improve the tax gap because they would involve remote working. Meanwhile an audit includes inspection of assets and of bank statements, tests of the accounting records, checks for understatement of income, consideration of laws and regulations and of fraud and effectively a test of the company's probity at no cost to the Government. This is another part to the value of an audit.

6.4 Some of the UK's major competitors such as Germany and France have already 'seen the light' and have acted accordingly. They have issued auditing standards for smaller or less complex entities. The German standard setter said in 2023 that auditing standards are becoming increasingly disproportionate for, and difficult to apply in a scalable manner to, audits of financial statements of less complex entities. Post Brexit we will therefore be lagging various key EU member states which makes no sense. It is also strange that the FRC continues to plod on with massively disproportionate auditing standards and to ignore the needs of SMEs on which so much of the UK economy and of its jobs depend.

7. Safeguards for areas of significant risk or complexity and ways of working more smartly

7.1Various arguments have been made by the FRC that the ISA for LCE should not be a standalone document. I see some merit in these arguments. However, these arguments can be overcome by expecting auditors to apply professional judgement (which should be fully documented) to design and perform principles-based procedures to address areas of significant risk or complexity on the basis of relevant International Standards on Auditing. There is also much opportunity to make other sensible UK additions to an ISA for LCE (UK). This could include signposting to the relevant ISA when particular areas of significant risk or complexity are identified. For example:

*ISA 402 where there is a service organisation is involved

*ISA 540 where there are complicated accounting estimates

*ISA 570 where there may be significant going concern risks

* ISA600 when there are component auditors

* ISA 610 where an internal auditor's work is used

*ISA 620 where the auditor uses the work of an expert.

7.2 This would deal easily with situations where a significant risk or complexity is identified during an audit engagement and enable the ISA for LCE (UK) to be used more widely than some of the qualitative characteristics and quantitative guidance set out in part A of that standard. It would also prevent what some describe as two types of auditors arising because SME auditors would need to continue to learn and then refer to relevant ISAs when significant risks or complexities arise. This would help ensure that SME auditors can enter the market for public interest entities. It would also cope with situations where other ISAs are updated.

7.3 It also needs to be borne in mind that part A of the ISA for LCE recognises that ultimately jurisdictional authorities have much ability to determine the local scope of the ISA for LCE including for the public sector. Furthermore policy makers in the UK need to recognize that various other G7 countries (such as Germany and France) do not adopt ISAs in their entirety for small or other less

complex entities or because they want more control over their auditing standards. A good example of a country which has much more control over its auditing standards is the USA which has gone through an exercise of conformity with ISAs, but whose auditing standards currently run to only 664 pages which is much less than the 1,000 plus pages of ISAs. We therefore need to wake up to the policy-making reality that for economic and other policy reasons we do not need to follow ISAs in their entirety for particular types of entity . Interestingly and significantly, even though the US Public Company Accounting Oversight Board has its own auditing standards for audits of financial statements, the Chair of the IAASB is from the USA.

7.4 We also need to recognise and respond to the fact that there is a significant problem of under-representation of the SME sector and its auditors in the standard setting processes globally and locally here in the UK even though as indicated above that sector represents 99.05% of UK businesses. The SME sector also has 16.3 million people contributing to 60% of the UK's jobs and it is the life blood of our economy. On the basis of the comments received from small practice firms and audit file reviewers, it seems that for far too long the needs of such a key part of the UK economy have not been given sufficient attention in this area. With the arrival of a new Government, the time has now come for change.

7.5 There is also an opportunity to include in an ISA for LCE (UK) some of the thinking set out in the AICPA's White Paper on the 'Risk Assessment Auditing Standards: How to efficiently and effectively comply on smaller and less complex audits engagements'. This is about how to work smarter when identifying and assessing risk of material misstatement. This is necessary as the comments received on the 181 page ISA(UK) 315 (Revised) on 'Identifying and assessing the risks of material misstatement' and particularly on the extent of the box-ticking that it generates on audits are scathing. Added to this is the need to provide 'being smart from the start' guidance. From my experience the earlier that significant risks are dealt with on an audit the better. One of the main root causes of audit failure is that work on significant risks can be left too late for company directors, management and auditors to address them properly. Sufficient time for 'stand back' for the directors and the auditors should therefore be planned from the outset between the cessation of the main field work and the sign-offs. Succinct and brief 'guidance on these better ways of working could usefully be included in an ISA for LCE (UK).

8. The need to deal with time pressure and stress

8.1 Outreach to file reviewers has identified 36 audit areas for potential improvement on different audits. These can be obtained on request. Many of these give the impression that the main problems are time pressure and stress arising from auditing standards that are too long and complex for less complex entities. The ISA for LCE would help not only alleviating the time pressure and stress that SME auditors are enduring, but also those of the directors, management and staff of SME who have to cope with a mountain of questions and requests for information that should really be confined to listed and other public interest entities.

8.2 The areas for improvement also suggest that there needs to a package of quality improvement measures which would include not only the adoption of an ISA for LCE (UK) but also the development of some 'what good looks like' and some model work papers specifically and solely for SME audits. It has also been suggested to me that there needs to an equivalent of a' Speed Awareness Test' as an alternative to heavy monetary sanctions for problem SME audits. I have been told by various-sized firms that overzealous regulation and sanctions are a significant problem particularly when it needs to be viewed through the lens of auditing standards that are massively disproportionate and insufficiently scaleable.

9.Various types of entity that could benefit from the ISA for LCE

9.1 The ISA for LCE should also be applied not only to SMEs (note the inclusion of medium-sized companies) but also other less complex entities including charities and various public bodies. I would suggest that a root cause of the crisis in local audit may actually be an 'audit process problem' similar to that affecting SMEs. There also seems to be a problem with the audit market for charities arising from cost.

9.2 There is also an opportunity to apply the ISA for LCE to the low risk subsidiaries of larger entities. The argument has been made that this is not needed given the audit exemptions available to subsidiary companies. However many parent companies do not avail themselves of audit exemptions for subsidiaries as this would require the parent companies to guarantee the debts of its subsidiaries which they are not willing to do. Also post Brexit audit exemption for UK subsidiaries is not available to any overseas parent companies.

9.3 Extending the ISA for LCE to low risk subsidiaries of larger entities would alleviate the mountain of box-ticking that also afflicts larger audits and the audited entities' management and staff including around the close down of the audit. The elimination of some of the audit bureaucracy currently attaching to often a multitude of low risk subsidiaries would take some pressure off the group engagement partner and enable more time to be given during audit close down to the consideration at the group level of the big issues including fraud, going concern, the legality of dividend distributions and the possibility of greenwashing.

10. The way forward

10.1 One of the firms has suggested to me that a Steering Group for Audits of Less Complex Entities should be established and that it should include not only representatives from SMEs and their auditors but also the Charities Commission and the NAO. It is important that it does not include members or a Chair who do not have hands-on experience of signing off the accounts or audits of SMEs or of other less complex entities. It would give the wrong impression if they came from a Big 4 background.

11. Other reasons why change is needed

11.1 The adoption in the UK of the ISA for LCE is long overdue as the International Accounting Standards Board issued the 'IFRS for SMEs' in 2009 and its UK equivalent, FRS 102 was originally issued in 2013. FRS 102 has been a success for which the FRC should be commended. As streamlining has been so successful with financial reporting standards, why can't it be with auditing standards? Of course it should be noted that the FRC, as an arms-length body of the Government, is expected by the standards on the accounting officer's organisation as set out by HM Treasury in 'Managing Public Money' to "impose no more than proportionate and defensible burdens on business". See Box 3.1 in page 20. It follows that there is always a need to ensure that regulatory creep does not overwhelm the resources and needs of SMEs, other less complex entities, different sized practice firms and stakeholders.

11.2 Also the FRC is statutorily required under the Legislative and Regulatory Reform Act 2006 to follow the Regulators' Code. This makes it clear that regulators should choose proportionate approaches to those they regulate based on relevant factors, for example business size and capacity. See page 3 and much else in that code. The FRC also has to comply with a Growth Duty under the Deregulation Act 2015. See the sections in that Act on 'the exercise of regulatory functions', its Secretary of State letters and the Growth Duty: Statutory Guidance-Refresh issued in May 2024 and in particular 'Behaviour 4: Proportionate, Efficient and Responsive'.

11.3 The FRC normally adopts the auditing standards issued by the International Auditing and Assurance Standards Board and then adds material for UK auditors. The time has now come for the FRC to do the same with the ISA for LCE and to extend it to medium-sized companies so as to take unnecessary burdens off all SMEs and to enable them and the UK economy to grow sustainably. Some imaginative thinking about eliminating what is a massive disproportionality rather than constant blocking would be well received by the accountancy profession and other stakeholders. Furthermore, it would help the Government and the FRC itself at a time when some radical change is required.

12. Some recommendations

12.1 The UK should not wait to be in line with other countries or dither. It should take a leadership position on adopting the ISA for LCE in the manner suggested above. The current economic problems in the UK and the related wider policy needs require prompt action in the manner suggested above. It should be borne in mind that it would take several years for the IAASB to make any significant global amendments to the ISA for LCE as the agreed process for IAASB standard setting is far from speedy and any attempt to make changes is not certain to succeed. I have been told that the whole development process of the ISA for LCE was difficult and contentious throughout.

12.2 A situation of regulatory drift should not be allowed to happen again. It is therefore recommended that the forthcoming Act of Parliament to establish an Audit, Reporting and Governance Authority should contain provisions to:

* create a council of representatives from SMEs and their auditors to exercise a watching brief to identify developments relating to ARGA and potential disproportionalities in regulation, standards or guidance that need to be curbed for the public benefit; and

* require ARGA and any bodies to whom it delegates powers to report annually and publicly on compliance with the Regulators' Code and with the Growth Duty under the Deregulation Act 2015 and on what steps they have taken to achieve compliance.

12.3 When there is more accountability to stakeholders and more transparency, the needs of the SME sector and of society generally are more likely to be met properly and in a truly proportionate manner. Also, when massive disproportionality is removed and misguided policy is eliminated, better economic outcomes can be achieved.

12.4 There is an adage that the Americans innovate, the Chinese imitate and the UK overregulate. There is a need to change the latter part to say " and the UK regulates truly proportionately. That would really help our economy particularly in the vital SME sector.

13. Acknowledgements and status of this briefing paper

13.1 I hereby express my gratitude for the comments received from members of the Society of Professional Accountants Ltd. which is an independent association of over 1,000 professionally qualified accountants in small practices. I also thank like minded people in different sized firms and Peter Henry from the business sector who have given me encouragement and help in developing this briefing paper.

13.2 This briefing paper expresses my personal views.

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See Martyn E. Jones Brunel University London for some further biographical details

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