Views of firms on entry, growth and exit in the markets for smaller PIE audits and non-PIE audits

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CONTENTS **Page**

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Touchstone Renard carried out interviews between September 2022 and July 2023 and the survey between January 2023 and April 2023. A combination of quantitative and qualitative questions were asked. Touchstone Renard were the primary authors of this report.

Frontier Economics developed the conceptual framework for the research (see **Annex A**), including hypotheses that formed the basis for developing research materials such as interview topic guides and questions. Review comments and suggestions in analysing findings throughout the project and preparing this report were also gratefully received from Frontier Economics and incorporated in this final version of the research report.

1. Executive summary

Context

The Financial Reporting Council (FRC) has a strategic objective to create a more resilient audit market through greater competition and choice.[1] A well-functioning audit market is defined by the FRC as one that consistently delivers high quality audit and is resilient. Such a market is defined as one in which competition and regulation combine to ensure the right incentives and behaviours on both the demand and supply sides to drive up audit quality and improve market resilience.[2]

This research was undertaken in support of the FRC's strategic objective and sought to enhance understanding of entry, growth and exit of firms in the Public Interest Entity (PIE) and non-PIE audit markets by obtaining the views of smaller audit firms and non-audit firms.

The research comprised surveys and/or interviews with:

- 11 Public Interest Entity (PIE) audit firms that audited fewer than 20 PIEs in 2021
- 19 larger, non-PIE audit firms that were either ex-PIE auditors (7 firms) or could potentially become PIE auditors under options for expansion of the PIE definition that the Government is considering (12 firms)
- 97 non-PIE audit firms, including 5 firms that had left the non-PIE audit market
- 8 non-audit firms and investors with a potential interest in entering the audit market

The research had two parts: one focused on the PIE audit market; the other focussed on the non-PIE market, including on the economics of firms in the non-PIE market. Some of its findings apply to both markets; some are specific to only one of them.

Overarching finding – capacity constraints in the PIE and non-PIE audit markets

The research found extensive evidence of smaller audit firms seeing an imbalance between, on one hand, growing demand for audit services and, on the other, severe constraints which limited their ability to meet that demand. This was true across all the groups of firms in scope of this research.

The firms indicated that the principal cause of this imbalance was the difficulty of attracting and retaining suitably qualified audit personnel at all levels. All 11 PIE auditors, and all 10 of the larger, non-PIE auditors that answered our survey, said that their capacity to attract or retain staff was limiting their ability to grow. 80% of the 97 non-PIE auditors surveyed reported that recruiting experienced auditors was a barrier to their growth. Across all firms, recently qualified staff and audit managers were reported to be the most challenging staff to recruit and retain.

There was widespread concern amongst the firms about the capacity shortage being driven by the unattractiveness of the profession. It was clear that the attractiveness issue stemmed from a broad range of factors and affected both the PIE and non-PIE audit markets. Typical comments from the firms included: "People don't want to do audit, there's too much pressure"; "Clients' lack of appreciation for audit and lack of understanding of the auditor's role makes being an auditor really difficult"; "[Audit is] not a fun place to be".

PIE audit market findings

70% of the PIE auditors in scope of this research expected to grow the number of PIE audits they carried out. However, most of this growth was expected to come from these firms' existing niche sectors rather than a move into auditing the larger PIE entities. We found the greatest appetite to

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[1] See: Financial Reporting Council: 3-Year Plan, March 2023

[2] A resilient audit market would have sufficient choice of audit firms and audit firms that are financially sound and focused on quality. See: FRC, Competition in the audit market: A policy paper, December 2022

grow in the PIE market was among firms that already audited more than 10 PIEs. There was limited appetite for growth among firms with only a handful of PIE audits, and almost no appetite among non-PIE audit firms.

Excluding the recruitment and retention challenge noted above, the biggest barrier to entry reported by non-PIE audit firms was the perceived difference in the requirements, as well as the supervision and inspection, of PIE and non-PIE audits. When asked about the factors that limited their ability to enter the PIE market, 80% of survey respondents cited the regulatory regime. This was also the most cited reason for having left the PIE audit market (with all seven of the ex-PIE auditors interviewed, amongst the larger, non-PIE audit firms, citing this as a reason for having left the PIE market).

The firms also indicated the presence of sunk costs[3] and economies of scale[4] as significant barriers to entry, which meant that carrying out only a handful of PIE audits annually was unlikely to be a sustainable strategy. Firms also cited the risks (reputational, regulatory penalties and audit liability claims) of PIE auditing as another barrier.

Non-PIE market findings

Among the firms that participated in the research there was appetite to grow in the non-PIE market: all the larger, non-PIE auditors said they intended to grow their audit services, and across the wider population of non-PIE audit firms that responded to our survey, 72% intended to grow. The 'waterfall effect' of work coming down from larger firms to smaller ones was cited as an important source of the opportunities to grow that are currently available to smaller firms. Firms also told us that their local networks, contacts, and reputations helped them to win work, both audit and non-audit. A reputation for quality, amongst their networks, was seen as important in this.

The research indicated that the scope to deliver both audit and non-audit services to non-PIE clients is key to the economics of most non-PIE audit firms and is central to their business models. These firms reported that non-audit work was generally more attractive to staff, perceived as more useful by clients, and in most cases more profitable than audit.

The non-PIE audit firms reported that opportunities for non-audit work were plentiful in the current market. As a result, there was a limit to the resources that these firms were willing, or able, to dedicate to audit. A number of these firms also thought that their staff would be more likely to leave if they were asked mainly to do audits.

Firms reported that the main drivers of exit from the non-PIE audit market were the retirement of audit partners and a view that standards and regulation were becoming too challenging for certain firms.

Steps forward

The research sought views from firms on ways in which both the PIE and non-PIE audit markets could be improved. A wide range of suggestions were received, with the most frequent being centred around the FRC and the recognised supervisory bodies (RSBs) both providing more education and best practice to help firms deliver high-quality audits. Some participants proposed or noted specific actions that the FRC is already undertaking, including for example the audit Scalebox which provides a means for smaller audit firms to gain input and insights from the FRC to assist them to grow.

However, the overarching findings from this research on capacity constraints driven by recruitment and retention problems points to a wider issue for the audit sector as a whole. Addressing a challenge of this magnitude may require a combination of different actions by different bodies – in effect, a whole system response, involving the FRC, RSBs, NAO, government, firms and audited entities.

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[3] Entry costs that are lost if the firm exits the market.

[4] When the average cost of providing an audit decreases as the number of audits provided increases, for example because the fixed costs of being a PIE auditor can be spread over a larger number of audits.

2. Research background and methodology

2.1. Objectives of the research

The overall objective of the research was to enhance understanding of entry, growth and exit of firms in the PIE and non-PIE audit markets.

To achieve this objective, the research focused on:

- the appetite of audit and non-audit firms to enter, or expand their presence in, the PIE and non-PIE audit markets
- any barriers firms face in achieving this
- the drivers behind the lack of appetite for entry to, and exit from, the PIE and non-PIE audit markets
- the economics of audit firms in the non-PIE audit market including what may have driven the decline in the number of such firms over the last five years

2.2. Methodology

The research comprised surveys and interviews with PIE audit firms that had fewer than 20 PIE audits when the research was commissioned, non-PIE firms, non-audit firms, and investors, the latter two having a potential interest in audit.

Frontier Economics developed a conceptual framework for the research (at **Annex A**), including hypotheses that formed the basis for developing research materials such as interview topic guides and questions.

Touchstone Renard carried out interviews between September 2022 and July 2023 and surveys between January 2023 and April 2023. A combination of quantitative and qualitative questions were asked.

There were two parts to the research: Part A for the PIE audit market and Part B for the non-PIE audit market. The groups that took part in the research are detailed below.

Group	Short description	Description	PIE Research	Non-PIE Research
1	Non-audit organisations	1. Large organisations that were active in markets similar to audit, such as the wider assurance and inspection markets, or other professional services, but that were not currently active in financial audit. 2. Institutional investors who may be a source of investment capital for new or expanding audit firms.	✓	✓
2	PIE auditors	Audit firms that had fewer than 20 PIE audits when the research was commissioned.	✓	✗
3	Larger, non-PIE auditors	1. Those audit firms with no PIE clients that may potentially become PIE auditors under options for expansion of the PIE definition that the Government is considering. 2. Ex-PIE audit firms.	✓	✓
4	All non-PIE auditors	All UK audit firms with no PIE clients (i.e. group 3 is a subgroup of group 4).	✗	✓
5	Ex-auditors	Accountancy firms that have left the audit market in recent years.	✗	✓

Our sources of information for each group were as laid out below:

Group	Short description	PIE Research	Non-PIE Research
1	Non-audit organisations	Interviews about the audit market in general with organisations not currently in the market (8 interviews), comprising: [5] ▪ Private equity organisations (2 interviews) ▪ Assurance certification providers[6] (4 interviews) ▪ Assurance certification provider membership organisations (2 interviews)	
2	PIE auditors	▪ Survey of PIE auditors (10 responses)[7] ▪ Interviews with PIE auditors (11 interviews)	
3	Larger, non-PIE auditors	Interviews and surveys with this group covered both the PIE and non-PIE aspects of the research: ▪ Survey of larger, non-PIE auditors (10 responses) ▪ Interviews with larger, non-PIE auditors (19 interviews). Seven of these firms were ex-PIE auditors while 12 of them had never audited a PIE entity	
4	All non-PIE auditors		▪ Survey of non-PIE auditors (97 responses) ▪ Interviews with non-PIE auditors (39 interviews)
5	Ex-auditors		▪ Survey responses from accountancy firms that had exited the audit market (5 responses, included in the 97 responses above) ▪ Interviews with accountancy firms that had exited the audit market (1 interview) plus phone and email discussions with a further 4 accountancy firms on their reasons for exiting

2.3. Size and clients of audit firms taking part in the research on the PIE market

The audit firms taking part in the research ranged in size from under £10 million to over £100 million (in terms of total revenue from all services), with most being within a range of £10 million to £50 million.

[5] We attempted to interview accountancy firms that do not provide audit services, but could not find any such firms that were willing to participate.

[6] Organisations that provide non-audit assurance, testing, inspection and certification services.

[7] Eleven responses were recorded, but one of these did not answer any questions beyond the initial information about the firm.

Size of firms by annual revenue:

Annual revenue	PIE auditors (11 firms interviewed)	Larger, non-PIE auditors (19 firms interviewed
Under £10 million	1	1
£10 - £20 million	4	4
£20 - £50 million	4	11
£50 - £100 million	0	0
Over £100 million	2	3

Number of PIEs audited:

More than half of the PIE auditors we interviewed audited only one or two PIEs.

# of PIE audits	PIE auditors (11 firms interviewed)
1-2	6
3-10	3
Over 10	2

Type of PIEs audited:

Investment vehicles, which are relatively small and straightforward to audit, were a particular niche for eight of the smaller PIE audit firms that were within the scope of this research. Only a minority of the firms audited more complex businesses.

2.4. Size of audit firms taking part in the research on the non-PIE market

Size of firms by annual audit revenue (survey data) [8]

Annual audit revenue	Number of firms
All non-PIE auditors	*Out of 97 respondents*
Under £200,000	19
£200,000 – 500,000	18
£500,000 - £1 million	15
Over £1 million[9]	45
Larger, non-PIE auditors	*Out of 10 respondents*
£1 - £5 million	3
£6million - £10 million	1
Over £10 million	6

Size of firms by numbers of RIs (survey data) [10]

Number of RIs	Number of firms
Non-PIE auditors	*Out of 94 respondents*
1	18

[8] This information was not provided by all interviewees and we consider the survey data to be more reliable.

[9] We do not have data showing the ranges of income above £1 million for these firms.

[10] This information was not provided by all interviewees and we consider the survey data to be more reliable.

Number of RIs	Number of firms
2	17
3	11
4	8
5	9
6-10	6
Over 10[11]	25
Larger, non-PIE auditors	*Out of 10 respondents*
6-10	3
11-20	4
Over 20	3

Number of firms from each Institute (interview data) [12]

Institute	Non-PIE auditors (39 interviewees)	Larger, non-PIE auditors (19 interviewees)
ICAEW	25	17
ACCA	8	0
ICAS	6	2

Geographical markets served (survey data)

The firms taking part in the survey saw themselves mainly as serving regional markets, as opposed to national or local.

Markets served	Non-PIE auditors (97 respondents)	Larger, non-PIE auditors (10 respondents)
National	21	1
Regional	51	8
Local	25	1

[11] We do not have data showing the ranges of RIs above 10 for these firms.

[12] This information was not requested from survey respondents.

3. Findings – market for the audit of smaller public interest entities

3.1. Overview

This section summarises the key findings for audit market of smaller PIEs, using Red / Amber / Green coding to reflect our judgement based on the research we have carried out.

3.1.1. Appetite of different types of firms to enter the PIE audit market and/or grow their number of PIE audits

Only a narrow range of firms that participated in this research reported that they were seeking to grow or expand in PIE audits. These were mainly firms that had more than 10 PIE audits and, to a lesser extent, firms with fewer than 10 PIE audits. There was little to no appetite for growth reported by non-PIE firms.

There appeared to be growing interest in investing in audit firms from private equity (PE), although the sample was small (two interviews with PE executives, plus views from some firms that received PE investment). However, these organisations were more interested in the non-PIE market than the PIE market.

Among non-audit businesses, some assurance certification providers[13] appeared to be potentially interested, in principle, in entering the audit market (bearing in mind the same caveat about small sample sizes) but were more attracted to the non-PIE audit space.

Appetite to enter / grow in the PIE market

Firms with >10 PIE audits	Firms with <10 PIE audits	Non-PIE firms	Private equity	Certification providers

Key: Green: Strong appetite to enter / grow. Amber: Some appetite to enter / grow. Red: Little or no appetite to enter / grow

3.1.2. Barriers to entry and/or growth

The research formulated and tested hypotheses about potential barriers to entry and growth. The table below summarises which of these potential barriers were indeed found to be an obstacle to entry and growth of audit firms and which were not.

Most firms indicated that the two biggest barriers were:

- their ability to recruit and retain staff (across both PIE and non-PIE audit functions), with 90% of firms surveyed selecting staffing as a serious challenge and limiting factor; and
- the perceived "cliff edge" in the requirements, as well as the supervision and inspection, of PIE and non-PIE audits.

The firms also indicated the presence of sunk costs[14] and economies of scale[15] as significant barriers to entry, which meant that carrying out only a handful of PIE audits annually was unlikely to be a sustainable strategy. Firms also cited the risks (reputational, regulatory penalties and audit liability claims) of PIE auditing as another barrier.

[13] Organisations that provide non-audit assurance, testing, inspection and certification services.

[14] Entry costs that are lost if the firm exits the market.

[15] When the average cost of providing an audit decreases as the number of audits provided increases, for example because the fixed costs of being a PIE auditor can be spread over a larger number of audits.

When non-PIE auditors were asked about the factors that limited their ability to enter the PIE market, 80% of survey respondents cited the regulatory regime. This was also the most cited reason for leaving the PIE audit market (with all seven of the ex-PIE auditors interviewed citing this as a reason to have left the PIE market).

Potential barriers to entry / growth of audit firms in the PIE market

Recruitment and retention of experienced and specialist staff	
Regulatory “cliff edge” between PIE and non-PIE audits	
Economies of scale required for service line to be viable	
Entry / growth involves sunk costs that are not recoverable on exit	
Risks involved (reputational, regulatory penalties and audit liability claims)	
The importance of firm brand and reputation in winning work	
Technology and methodology	
The importance of relationships in winning work	
Obtaining professional indemnity insurance at a viable price	
Cost of winning business (e.g. bidding for tenders)	

Key: Green: Not a barrier. Amber: A relatively minor barrier. Red: A significant barrier. Dark red: A very significant barrier

3.1.3. Drivers of lack of appetite for the PIE audit market

Firms indicated that the principal driver behind the lack of appetite to enter and/or grow in the PIE market was the reported wealth of opportunities they enjoyed in the non-PIE audit market. For example, 70% of large non-PIE auditors selected ‘better opportunities elsewhere’ as a reason for being unattracted to the PIE market.

The majority of firms (PIE and non-PIE) stated they had more opportunities for work than they could undertake, most of which was more profitable and lower risk for them than PIE audits. The opportunity cost of training and deploying scarce resources (staff) to PIE audits for these firms was therefore considered to be high.

Standards and regulation in the PIE market were also a significant deterrent reported by firms, as was the perceived impact of PIE auditing on firms’ ways of working.

Drivers of the lack of appetite for the PIE audit market

Better opportunities in non-PIE audit	
Better opportunities in non-audit	
Entry/growth would require undesirable changes in the firm or work (e.g. culture, work-life balance, nature and balance of work, methodologies, processes, policies)	
Standards / regulation becoming too challenging	
Retirement of audit partners	

Key: Grey: Not a driver. Light green: A significant driver. Dark green: A very significant driver

3.2. Appetite of firms to expand their presence in the PIE audit market

3.2.1. Summary

Most PIE auditors intended to grow only within their preferred sectors, where they already had expertise.

Most of them saw larger cap PIEs as being unattractive for a wide range of reasons, including the regulatory framework, lack of suitably skilled staff, higher costs, and the risk of audit liability claims and regulatory penalties.

3.2.2. Growth expectations

70% of PIE auditors surveyed expected to grow their PIE audits, but the appetite to expand was limited to clients in the same sector (40%) and clients that they perceived as less risky (70%).

In contrast, all the firms that took part in the survey expected to grow their non-PIE audits. In other words, **fewer of the current PIE auditors expected to grow their PIE audits compared to those current PIE auditors that expected to grow their non-PIE audits.**

3.2.3. Unattractive features of the PIE audit market for current PIE auditors

We asked the PIE audit firms which factors made areas of the PIE audit market unattractive. The table below summarises the survey responses to this question and shows the relative importance of the different factors.

Key points included:

- there was a wide spread of features that firms found unattractive, with six different features being cited by 40% or more of respondents
- the regulatory framework and its interpretation by the regulator were cited as unattractive by 80% of firms

Unattractive features of the PIE audit market	# of PIE auditors (10 respondents)
Regulatory framework	8
Difficulties in training and/or recruiting staff with relevant experience and expertise	6
Higher costs	5
Risks of audit liability claims and regulatory penalties	5
Lack of expertise	4
Reputational risk	4
Uncertainty about interpretation of audit standards	2
Difficulties in obtaining PII coverage	1

An additional feature that was not included in the survey options, but was mentioned by four out of 11 interviewees, was ‘stress and work-life balance for staff’.

“Look at what happened to [x], who had to resign his CFO job. He was nailed, publicly, and it was quite sobering for a lot of us. It makes us think twice. We understand (the quality agenda) but we want this to be a profession that people want to do.”

"We are in danger of losing the brighter people because of the drudgery in creating compliant files."

"We are seriously debating whether to stay in (the PIE audit market) - the costs of operating in this market are significant, both in terms of cash costs (in excess of £30,000) and internal time (this financial year we have charged over £60,000 of internal time to FRC compliance tasks)."

3.2.4.Attractive features of the PIE audit market for current PIE auditors

Some of the PIE auditors, in the survey, mentioned aspects of the PIE audit market that they found attractive, but the numbers were far lower than for the unattractive aspects. Firms' responses were as below:

Attractive features of the PIE audit market	# of PIE auditors (10 respondents)
Growth and development of the firm	2
Potential for staff to grow and develop	2
They only find their niche of the PIE market attractive	2
Providing a 'full market service'	1
A natural development of the firm	1
Opportunity to work on complex/ high profile audits	1
Potential for FRC support	1

Some staff like the kudos, more sophisticated clients, nuances, and complexities. We need PIEs to recruit the best staff."

3.3. The appetite of non-PIE auditors to enter the PIE market

3.3.1.Summary

The larger audit firms that were not currently in the PIE audit market expressed little or no appetite to enter or re-enter it.

Most of these firms found the PIE audit market unattractive due to better opportunities elsewhere and the regulatory framework, and half of them found it unattractive due to reputational risk.

However, some firms are watching developments and some have expressed an interest in joining the FRC's Scalebox.

"I worry that there is a serious lack of appetite amongst our peers to compete in the PIE space, which will seriously undermine some of the keystone policies of audit reform as currently planned."

Many firms believe that negative publicity, resulting from recent FRC investigations and subsequent press reporting of them, has influenced the way the profession is perceived by the public and auditors themselves, reducing its attractiveness both to new recruits and to more experienced / qualified staff and contributing to the shortage of human capital.

3.3.2.Unattractive features of the PIE audit market for non-PIE auditors

We asked non-PIE auditors, at interview,[16] which factors in particular made areas of the PIE audit market unattractive. The table below summarises their responses. Key points include:

- more than half of the firms interviewed cited better opportunities outside the PIE audit market and the regulatory framework as unattractive
- reputational risk was cited by almost half of respondents as an unattractive feature
- there was a long tail of nine other features being cited as unattractive by less than a third of respondents

Unattractive features of the PIE audit market	Larger, non-PIE auditors (19 respondents)
Better opportunities elsewhere	13
Regulatory framework	12
Reputational risk	9
Higher costs	6
Lack of expertise	5
Difficulties in training and/or recruiting staff with experience and expertise	4
Risks of audit liability claims and regulatory penalties	4
Ethical / independence rules	3
Technology issues	2
Uncertainty about aspects of starting as a PIE auditor	2
Difficulties in obtaining PII coverage	2
Uncertainty about interpretation of audit standards	1

We heard firms report a 'cliff edge' between the PIE and non-PIE audit markets. Several firms mentioned:

- the different regulators – the FRC for PIE auditors, and the RSBs for non-PIE auditors - had different ways of working, different expectations, and different interpretations of the standards
- the FRC was widely perceived as being relatively critical and antagonistic, compared to some of the RSBs which were seen as relatively helpful and constructive
- the FRC taking longer to carry out reviews than the RSBs
- the FRC raising more technical issues than the RSBs

Some audit partners with past experience of PIE audits cited a lack of information about the standards expected by the FRC, causing them to "learn the hard way" from FRC criticism of their early PIE audits.

"*You could get a grade 1 on a QAD [Quality Assurance Department of ICAEW] visit and the same audit might get a hammering from the FRC".*

"There is a huge gulf in the level of regulation and hence our own compliance cost/risk to move into the PIE marketplace (we currently service no PIEs). At the present time we are winning plenty of high-

[16] This specific question was not included in the survey for this group, to reduce the number of questions asked

quality new business in the non-PIE space, limited only by our ability to find quality audit staff. So, there's no motivation or need for us to entertain the PIE marketplace at this time."

"We don't believe an audit firm can mix PIE and non-PIE audit very easily because of the overarching regulatory environment for PIE which makes non-PIE audit unworkable (work required, cost implication and fee expectations of non-PIE clients)."

3.3.3. Attractive features of the PIE audit market for non-PIE auditors

The larger, non-PIE auditors made very few positive comments about the PIE audit market. At best, there was an acceptance by some firms that they might need to get involved in the market in future.

"Entering the PIE market is never off the table - there are always opportunities as larger firms divest."

"Given our forecast growth plans, we have to move forward into that space…. we have come to terms with it."

3.3.4. Why did non-PIE auditors leave the PIE audit market and what is their appetite to re-enter?

All seven ex-PIE auditors cited aspects of the FRC's regulatory regime as reasons for leaving the PIE audit market. They mentioned the non-chargeable time spent by partners and senior staff in dealing with the FRC's reviewers, the resulting pressures on staff, and what they perceived as the inconsiderate approach adopted by some of the FRC's personnel.

These and other reasons for leaving, given at interview, are summarised below.

Reasons for leaving the PIE audit market (ex-PIE auditors)	Number of ex-PIE auditors (out of 7 firms)
Regulatory regime	7
Better opportunities in the non-PIE audit market	5
Ethical restrictions on non-audit work	3
Reputational risk	3
Risk of regulatory penalties	3
Failure to achieve a critical mass of PIE audits	3
PII costs	2
Lack of suitable technology	2
Additional costs, maybe not recoverable	2

None of these seven firms were looking to re-enter the PIE audit market. Four firms said they had no appetite at all to re-enter and three firms did not want to re-enter now but intended to watch future developments.

3.4. The appetite of non-audit organisations to enter the PIE market

3.4.1. Summary

We had difficulty in getting non-audit organisations to discuss the audit market with us at all.

We spoke to two private equity investors, both of whom were interested in (or already involved in) the market and found non-PIE more attractive than PIE auditing.

The other organisations that we interviewed had limited appetite for entering the audit market in any way. They cited various barriers to entry, including systems and technology, a lack of human resources / expertise and aspects of the regulatory regime.

3.4.2. Major consultancies

We sought to engage with eleven major non-audit management consultancies and interviewed a senior director from one of them. Audit would not fit with their business strategy unless the conflict of interest rules were changed to enable them to retain a significant proportion of their non-audit work.

"It is a selling point that we are not subject to the same constraints as the Big Four auditors"

Three other consultancies responded that they were not interested in the statutory audit market.

3.4.3. Private Equity (PE) investors

From interviews with relevant firms and considering Private Equity (PE) companies who were already investing in the audit market, there appeared to be growing interest from PE in investing in audit firms.

We interviewed two PE senior executives out of the nine PE companies that we sought to engage with. We also contacted the British Venture Capital Association (BVCA), explaining this research and inviting participation from any of their members who expressed interest.

We also engaged extensively with audit firms that have PE involvement and interviewed relevant audit partners in three of them. However, their PE partners preferred not to participate in the research, except for one of the two senior executives that we interviewed.

The two senior PE executives that we interviewed were more interested in the non-PIE than the PIE market. Risks they identified with the latter included: complexity; unlimited liability (firms' risk assessment procedures were seen as important); high profile cases; staffing issues and skill shortages; cost inflation; and future changes in regulation.

Both investors mentioned advantages that they had over traditional audit firms, including:

- *"Audit is very traditional and some firms are set in their ways, so they can be outmanoeuvred."*
- *"All accounting firms face the challenge of being illiquid to an extent. Senior partners are paid handsomely; it is hard for junior partners to buy in to the equity that is already there; not every new partner is comfortable with making personal guarantees."*
- They perceived "great disruption" in the audit market, which presented opportunities for investors to develop better / alternative solutions.

These were the key opportunities and issues in the audit market as the two investors saw them:

- they were attracted to audit as a mandatory service that offered a steady income stream
- one investor was attracted by the model of a 'pure play' auditor, compared to "the normal, mixed service model", saying that this model could better develop learning and efficiencies and take on riskier audits
- the audit firm ownership rules[17] were seen as a concern but not as an insurmountable obstacle

[17] Paragraph 6(ii) of schedule 10 of the Companies Act 2006 requires that the decision making of a firm registered for statutory audit be controlled by persons with an audit qualification.

- the key requirement was to have a strong, professional top team in place in the audit firm with a balance of people who could run the firm as well as having the dynamism to grow it; organisations felt that this would be difficult to acquire

The table below gives details of some recent PE backed audit firms and their PE arrangements. However, this is a rapidly developing area and so the table does not include all PE activity in the audit market.

Audit Firm	PE company	Website link	Authors' Comments[18]
Gravita	Tenzing	https://tenzing.pe/portfolio/gravita/	
DJH Mitten Clark	Tenzing	https://tenzing.pe/news/our-investment-in-djh-mitten-clarke-a-top-50-uk-accounting-firm/	
Azets	HG Capital	https://hgcapital.com/portfolio/azets	
Cooper Parry	Waterland Private Equity	https://www.cooperparry.com/all-news/	Cooper Parry lost its LLP status and became a corporation after the Waterland deal.
Moore Kingston Smith	Waterland Private Equity	https://www.waterlandpe.com/moore-kingston-smith-llp-pioneers-innovative-professional-services-transaction-with-completion-of-private-equity-funding-as-an-llp/	Moore Kingston Smith secured private equity investment yet retained its partnership structure.
AAB	August Equity	https://aab.uk/news/2248-aab-announces-significant-investment-from-august-equity-to-fast-track-growth-plans/	
Galloways	Cow Corner	https://www.cow-corner.com/galloways-makes-a-further-acquisition/	

Further comments from firms and PE partners:

"Our firm has no desire to run FTSE / PIE clients…..however, we want to grow on all fronts and audit is a major part of this."

"We want to build a leading tech-enabled, business critical services group which is highly differentiated in the market."

[18] Throughout this report, the term *authors' comments* refers to the Touchstone Renard research consultants who wrote this report

3.4.4. Assurance certification providers

These are certification providers accredited by the UK Accreditation Service (UKAS) to carry out compliance checks for clients who have ISO certified management systems. We interviewed directors from four accredited certification providers, one UKAS assessor of certification providers, and CEOs of the two main membership organisations for these providers.

There were varying levels of interest amongst the different interviewees. Some had experience of financial systems from their certification work, and some felt that certification work had similarities to auditing, especially that both involved examining systems, compliance work and reporting.

For most of these bodies, the ownership rules[19] for financial audit firms were an issue that could prevent them having full control of any future audit operations.

In answer to the direct question “How likely are you to enter the audit market”, four of the five bodies that could potentially do that were ‘unlikely’ to or considered the question ‘not applicable’. Only one of these bodies seemed to have a serious potential interest in entering the audit market.

3.4.5. Non-auditing accountancy firms

We contacted eight major, non-audit accountancy firms, all from the Accountancy Age top 50 list.

Three of these firms responded and none of them was interested in entering the audit market, mainly because they offered a wide range of accountancy-related services and enjoyed the freedom to do that without the constraints and scrutiny that they felt being in audit would involve.

The other firms that we approached were not interested in exploring the issue of audit with us.

3.5. Costs of entering or expanding in the PIE audit market

3.5.1. Summary

The vast majority of audit firms (PIE and non-PIE) said that the main upfront investments needed to enter or expand in the PIE market would be in people, while the larger, non-PIE auditors also saw technology as an investment need.

The consensus was that these costs would not be fully recoverable, and the scale of work that would be necessary to fully utilise staff with specialist PIE audit skills, and to therefore take advantage of economies of scale, would take time to develop.

3.5.2. Substantial investments needed to enter or expand in the PIE audit market

In interviews we asked what substantial investments would be needed to grow in the PIE audit market (PIE auditors), or to re-enter / enter (larger, non-PIE auditors).

Nine out of eleven PIE auditors, and a significant number (about 40%) of the larger, non-PIE auditors, said that their main investment need would be for more people with relevant skills and experience.

Investing in technology was not seen as an issue by any of the current PIE auditors, but this was mentioned by about 40% of the larger, non-PIE auditors.

[19] As above.

The consensus was that these initial costs of recruitment and training would not be fully recoverable. The on-going costs, staff costs and regulatory costs, would only be fully recovered through taking advantage of economies of scale which were seen as difficult to predict and hence risky.

These views were held by a clear majority of auditors that had been exposed to PIE audits, both current and ex- PIE auditors, but were only held by a few of the larger, non-PIE auditors who had never audited PIEs. Many of the latter group had not seriously considered entering the PIE market or thought in any depth about the costs involved, so we would place less reliance on their responses.

PIE auditors cited the need for more specialist staff with experience of PIE audits and the time that it would take for a new team to become fully chargeable in a new work area and for economies of scale to kick in.

Several firms said that the skills required for PIE audits were different from those needed to audit smaller, owner-managed businesses, so the option of using expensive PIE auditors on non-PIE audits would not be cost-effective.

"We wouldn't take on staff unless we could charge them out."

"We would be paying out the salaries until the work came in."

"We are in an uncomfortable position at present, it isn't worth the risk or cost for just a couple of PIEs. We would want at least 6 and we would withdraw if we didn't have that in 5 years' time."

3.5.3. Professional indemnity insurance (PII) costs

We asked about PII costs because some larger audit firms had raised this as an issue with the FRC.

However, none of the current PIE auditors covered by this research saw PII costs as an issue. A typical comment was that: *"PII costs are going up, but not especially due to PIE audits."*

Most of the larger, non-PIE auditors did not see PII costs as an issue, though four out of 19 larger, non-PIE interviewees thought their PII costs would increase if they started to do PIE audits.

3.6. Winning new PIE audit business

3.6.1. Summary

None of the PIE auditors thought that the costs of winning new business were hampering their expansion in the PIE audit market. This was partly because they were not seeking work outside their existing sectors, where they were getting more 'warm leads' than in the past, with the resulting tenders being less time-consuming and expensive.

3.6.2. Bids, responses, and wins

We asked PIE auditors how many PIE audits they were invited to bid for, responded to and won during the past three years.

The responses were skewed by one outlier (a relatively large firm), which we adjusted for as below:

Topic	PIE auditors: average number per firm over 3 years, excluding one outlier
Number of PIE audit invitations to bid received	4.9
Number of PIE audit bids submitted	2.5
Number of PIE audits won	1.9

Apart from this single outlier, the other **eight PIE auditors said they were invited to bid, on average, for fewer than five PIE audits over a three-year period (less than two invitations per firm per year), which made the PIE audit market a very small part of their activities.**

These firms had a high average success rate of 76% for the bids that they submitted.

3.6.3. Costs of winning new business

None of the current PIE auditors thought that the costs of winning new business were hampering their expansion in the PIE audit market. The 'trickle down' effect of work from Big Four and challenger firms (mentioned by 7 firms) was seen as a driver for this, with **70% of current PIE auditors saying that demand for their PIE audit services was coming from entities previously audited by larger PIE firms**.

Several PIE auditors commented that more work was being offered to them through 'warm leads' than in the past, with the resulting tenders being less time-consuming and expensive. A related finding was that **80% of PIE auditors said that entities reached out to them with new PIE audit opportunities**, compared to 20% that proactively sought out new audit opportunities.

Five of the 19 larger, non-PIE auditors cited tender costs as a barrier to re-entry / entry to the PIE audit market, in contrast to the insignificant amounts of tender costs that these firms reported for non-PIE audits.

"Recent experience suggests that some companies are struggling to find auditors, so we have seen an increase in enquiries at short notice."

"We are not in a beauty parade. Our tenders come from warm leads."

"We are being considered for audits that would not have happened 10 years ago."

3.6.4. Number of competitors faced

Both the PIE and larger, non-PIE auditors mainly reported facing either two, or between three and five competitors, on average, when bidding for new audits.

The main difference between the two groups of auditors was that three of the ten PIE auditors that responded reported facing only one competitor on average for their PIE audits. This did not apply to any of the non-PIE auditors and, in our view, may have been due to the highly specialised nature of some of the PIE audits that these firms carried out. The PIE auditors said:

"The new PIEs [audits] have almost landed in our lap."

"The market is so resource constrained, the choice for clients is extremely limited and we would have won most of the assignments if we had wanted to."

3.6.5. How PIE entities select an auditor

We asked the larger, non-PIE auditors about how PIE entities select an auditor and how that differs from non-PIE entities.

Six of the seven ex-PIE auditors said that **PIE audits were more likely to involve formal tenders**, a view shared by three of the six other non-PIE auditors that answered that question.

Some firms also said that:

- the reputation of the firm was more important for PIE audits
- non-audit services were more important for non-PIE entities compared to PIE entities

- PIEs with Audit Committees and non-executive directors were better informed about audits than non-PIEs
- the timelines were more rigid for PIE audit tenders

"There is more formality for PIEs, and more rigid timelines. The selection processes are similar."

"Small corporates are less about formal tendering and more about relationships, referrals, and networks. AIMs and PIE's have more formal tendering. PIEs have AC's and NEDs, more people with knowledge of audit, whereas for non-PIEs the decisions are made by the Board, or the owner or FD."

3.7. Strategic advantages of incumbents in the PIE audit market

3.7.1. Summary

'Strategic advantages' are capabilities of incumbent firms that are difficult to replicate, affording firms that have them a competitive edge, and presenting a potential barrier to entry for new firms. Potential strategic advantages we have considered include aspects of human resources (section 3.9); technology and methodology (section 3.10); brand and reputation (section 3.11); and networks and relationships (section 3.12).

3.7.2. Limiting factors

We asked the firms in scope which factors limited their ability to expand in or to enter the PIE audit market.

The table below summarises the responses to this question and shows the relative importance of the different factors for PIE auditors and the larger, non-PIE auditors respectively. Key points included:

- all eleven of the PIE auditors cited audit staffing as a limiting factor
- staffing was less important for the larger, non-PIE auditors with the main limiting factor being the regulatory framework
- brand and reputation issues were significant limiting factors for both the PIE and non-PIE auditors
- technology and staffing were limiting factors for half of the non-PIE auditors
- fees and the ability to win work were not commonly seen as limiting factors

Limiting factors	PIE auditors (11 interviewees)	Larger, non-PIE auditors (10 survey responses)
Audit staff	11	5
Regulatory requirements / issues	6	8
Brand and reputation issues	5	6
Technology / methodology	0	5
Fees	0	2
Ability to win work	0	1

3.8. Human resources as a barrier to entry and expansion in the PIE audit market

3.8.1. Summary

All the PIE auditors we interviewed saw human resources as a serious challenge to their ability to carry out PIE audits. Almost all the larger, non-PIE auditors also saw it as a serious challenge, but more in the context of their non-PIE audit work.

3.8.2. Need for teams of PIE auditors

More than half of the PIE auditors said that **expansion into auditing larger / more complex PIEs would require them to hire a team of PIE auditors, rather than individual staff**.

"For larger cap entities we might need a whole new team of half a dozen people, probably Big Four types with six figure salaries, maybe a new partner. These people might have different attitudes, especially regarding risk."

"Where would we get the staff from? Probably a top 10-20 firm. We could ramp up in say 3 years."

"If we wanted to do this it would require say two RIs [Responsible Individuals] plus a new, high-salaried team."

[Auditing larger PIEs would require] "A team of 3-5 dedicated staff, plus a technical partner and a technical manager."

[Auditing larger PIEs would require] "Mainly more high-quality people. Another RI, say a Big Four Director, top dollar cost. 2-3 managers, 2-3 audit seniors. We would need a specialist PIE team in place before going for it."

"We need to allow for a review partner and partner rotation as well. Partner succession issues divert existing partners to non-PIE portfolios."

3.9.3 Specific roles

We asked survey respondents to say which specific roles were a serious challenge, for both recruitment and staff retention.

The table below summarises the responses to this question and shows the relative importance of the different factors for the two groups. Key points included:

- recruitment and retention of recently qualified staff was the most serious challenge for both groups
- recruitment of audit managers was a serious challenge for both groups
- retention of audit managers was a serious issue for the larger, non-PIE auditors but not for the PIE auditors; the reason for the latter is not entirely clear
- recruitment and retention of specialist staff was a serious challenge for most firms
- recruitment and retention of partners / RIs and trainees was a serious challenge for a minority of firms

Staff level	PIE auditors (10 respondents)		Larger, non-PIE auditors (10 respondents)	
	Recruitment	**Retention**	**Recruitment**	**Retention**
Recently qualified staff	9	7	8	8
Audit managers	6	2	9	7
Specialist staff	6	3	6	5
Partners and RIs	2	1	3	0
Trainees	1	2	2	2

Recruitment

"Candidates already have offers in place, it's them choosing you."

"The labour market as a whole is difficult right now, not just for audit."

Retention

Retention of recently qualified staff was cited as a problem across audit, with even larger firms losing recently qualified staff to other more lucrative/less intensive professions. We found some evidence of an additional problem for the firms participating in this research, which was the added risk of losing staff who remained in the profession but headed to the larger firms.

"The main constraint to growth is people and the cost of getting them is phenomenal. New post-qualifieds are asking for more than existing qualified staff. It is hard to get them in and hard to keep them engaged and motivated. Agencies have a huge number of vacancies and other opportunities can be better rewarded and more interesting than remaining in audit."

On the other hand, some firms cited staff moving away from larger firms for reasons including:

"*Covid has changed attitudes and there are more disillusioned Big Six staff than before."*

"The small firm proposition to potential staff is more attractive than for large firms, with interesting work and not doing debtors' sections for 4 weeks."

3.8.3. Are the HR challenges worse than before?

We asked the PIE auditors whether HR challenges were worse than before / no change / expected to get better. Key results were as follows:

- only about 10% of respondents expected the issues to get better, across all categories
- 9 out of 10 thought that recruiting recently qualified staff was worse than before
- 6 out of 10 thought that retaining recently qualified staff was worse than before
- 6 out of 10 thought that recruiting audit managers was worse than before
- 4 out of 10 thought that recruiting specialist staff was worse than before
- for other categories, most respondents thought there had been no change

3.9. Technology and audit methodology as barriers to entry and expansion in the PIE audit market

3.9.1. Summary

Technology was seen as a limiting factor by half of the larger, non-PIE auditors, but not by any of the PIE auditors.

70% of the larger, non-PIE auditors and 50% of PIE auditors had already made significant changes in technology and planned to do more.

3.9.2. Firms' position on IT systems and methodologies

We asked firms "Which statements reflect your firm's position on IT systems / methodologies that support your audit work?"

The table below summarises the responses to this question and shows the relative importance of the different factors for the two groups. Key points included:

- more than half of respondents had already made significant changes on IT systems/methodologies and planned to do more
- only three out of 20 respondents had made or planned to make no significant changes
- almost a third of respondents (6 out of 20) were waiting to see how the technology market developed

Statements	PIE auditors (10 survey responses)	Larger, non-PIE auditors (10 survey responses with duplication)
Already made significant changes and plan to do more	5	7
Waiting to see how the technology market develops	2	4
No significant changes have been made or are planned	2	1
Plan to make significant changes in the next few years	1	4

The largest firms were seen as having a competitive advantage in being able to resource the in-house, bespoke software development to support PIE audits. Some of the smaller PIE audit firms did not consider it worthwhile or even possible to develop that level of capability – they were more likely to adapt existing commercial software to meet the needs of their (relatively few and relatively small) PIE audits.

In doing this, smaller PIE firms came up against the **limitations of the available commercial solutions, which in their view did not match the requirements for large PIE audits and were not updated for the frequent changes in auditing and accounting standards.**

"Off-the-shelf software is designed for standard audits and has to be supplemented with checklists for PIEs."

"Consider a different way of providing audit software e.g. AICPA [The American Institute of Certified Public Accountants] have developed a product for audit for all firms funded by them. There are too few off the shelf providers in the UK and none deal with PIEs."

Several of the PIE auditors said that they had changed their audit approach and methodology to adapt to the FRC's requirements.

"As a result of the FRC inspections we have revised methodology and procedures in line with FRC expectations, so these are now fit for purpose for PIEs. This took a lot of partner time."

"We came up with new policies and procedures for the first PIE audit and that process has not stopped."

3.10. Brand and reputation as barriers to entry and expansion in the PIE audit market

3.10.1. Summary

Most firms saw brand and reputation as important factors that either limited their ability to enter the PIE audit market (larger, non-PIE auditors) or were important criteria in bidding for PIE audits (PIE auditors). Most of them thought that the big firms' brands and reputations were still seen as a proxy for quality, although some felt that this effect was diminishing compared to what it used to be.

3.10.2. Brand and reputation as a proxy for quality

Most firms agreed that **the big firms' brand and reputation were still seen as a proxy for quality in the PIE audit market**, though several firms said that this was less important than it used to be. Both the firm's reputation and the reputation and skills of key individuals were considered to be important criteria in winning PIE audits.

"The word is out that the brand is not a guarantee of quality, but there is a divide between Audit Committees that value quality and those that don't."

"Larger clients like a Big Four name on the audit report. It means they are growing, going places, serious."

"Recent issues have impacted the Big Four brands but have not reduced them to smaller firm levels."

"Reputations are getting more tainted for all of the Big Four and the mid-tier. FRC and the financial media are both culpable, allowing auditors to be blamed rather than clients."

3.10.3. Relative importance of price and quality

Both audit quality (the quality of the opinion provided) and quality of service from management's perspective (such as the speed of the audit) were cited as important criteria in winning bids for PIE audits by 8 out of 10 PIE auditors.

These firms considered quality to be more important than price in winning PIE audits, with only 20% of participants rating price as important. Comments made in interviews suggested that this was a recent development and that price had been a much more significant factor in the recent past.

3.10.4. Communicating quality

PIE auditors were split 50:50 on whether it was a challenge for them to communicate quality to prospective clients, with five firms seeing this as a challenge and five firms not. The small number of larger, non-PIE auditors that addressed this topic were also evenly split.

Interview comments included:

"We have to try harder than the larger firms."

"Our firm has a good reputation for quality, in its sector."

"Our brand is well known in some sectors but not in others."

"You don't get the best clients initially. You need to start somewhere and build a reputation first."

Firms were asked at interview how they demonstrated and/or communicated quality. The two most frequent responses, for both groups, were:

- a pre-existing reputation for quality, whether for the firms or an individual
- past experience / knowledge of quality delivered by the firm, for example through a non-audit service

Other responses included: providing evidence of quality processes; and taking a professional approach to the tender process.

"We win bigger jobs because of our experience with listed firms. A lot of firms don't have that experience."

"We have seen more questions about quality recently, including about regulatory review gradings and findings."

3.11. Networks and relationships as barriers to entry and expansion in the PIE audit market

3.11.1. Summary

Firms saw their networks and relationships as a strength that enabled them to win business, not as a barrier. Most of the firms we spoke to were not well connected with the largest PIEs, but did not see this as a problem because they were not interested in that sector of the market and were well enough connected in the markets that they were interested in.

3.11.2. Importance of networks and relationships

All the PIE auditors and six out of the seven ex-PIE auditors agreed that networks and relationships were 'very important' in identifying opportunities and winning PIE audits. **This put networks and relationships ahead of other factors including brand, reputation, and quality** in this context.

3.11.3. Difficulties in building networks and relationships

Firms did not mention any difficulties in building networks and relationships within their own localities and within their preferred sectors. Important relationships mentioned by PIE auditors included:

- personal relationships generally (8)
- fellow professionals and intermediaries, such as other accountancy firms, bankers, insurers, lawyers, trust administrators, private equity (7)
- Big Four contacts, which are important for picking up clients that the Big Four no longer want (3).
- contacts arising from non-audit work (3)
- international networks (2)
- regional contacts (2)
- past non-audit clients (1)

“Our region has a small financial community and we know the Big Four firms, advisers, brokers. It’s easier in the regions.”

“Introductions often come from existing relationships, for example with ex-colleagues who now work for the client, bankers, solicitors. This applies to PIEs as well as non-PIEs.”

“The international network is good for generating work outside the UK.”

“If we entered the oil and gas sector we would use our network to seek out UK contacts.”

However, some firms referenced difficulties in building relationships in new sectors.

“There's a lot of shoe leather involved in building relationships; you have to find a way in.”

3.12. The proposed government reforms

3.12.1. Summary

Most of the PIE auditors felt that Managed Shared Audit (MSA) was better suited to the larger, challenger firms than to smaller firms of their size, but 40% of them had an open mind and were watching future developments.

Many firms appeared to have paid little attention so far to the new definition of PIE audits and reported that they did not expect to be impacted by the changes.

Most of the larger, non-PIE auditors said that they would not retain engagements where the clients became PIEs in future, while some were uncertain or said that this was not applicable to them.

3.12.2. Managed Shared Audit in the FTSE 350

20% of the PIE auditors that we surveyed said they would potentially participate in the MSA scheme, 40% would not participate and 40% did not know.

At interview, we asked the PIE auditors for more detail. The strongest reservations, mentioned by six firms, were about the Big Four firms’ perceived attitude and approach to the scheme.

“We don't see the Big Four giving up the best clients. Access to Big Four tools and platforms would be helpful but that's not going to happen."

“The Big Four won't give you the important work.”

There were questions and uncertainty about how the scheme would work: in general (four firms); how signing the audit report and file review would work (three firms); and how risk would be shared (two firms).

“We are still unclear as to how this works in practice, in particular in regard to liability. Until this is clearer, we cannot commit.”

“Audit opinions could be a logistical nightmare with both partners having to review all the files.”

“The attitude to risk and acceptable level of audit liability claims is too different between us and the largest firms.”

On the positive side, four firms saw MSA as a potential opportunity to upskill and/or as a route into the market.

“Being a junior partner and auditing cash and bank isn’t going to get us anywhere. If we were to learn from tools, technologies, quality processes and methodologies of larger firms, and perhaps work with their deeper specialist network, I could see a benefit.”

"(MSA is) potentially a fantastic opportunity, though we want to know how it will work in practice. It will be a plus if it gives us exposure to audit committees, opportunities to collaborate with larger firms and perhaps share training and audit methodologies."

"We are happy to have a sliver of a FTSE 350 company, where otherwise we wouldn't get a look in."

3.12.3. The expansion in the PIE definition[20]

80% of current PIE auditors expressed no clear preference between 'old' PIEs (the current ones) and 'new' PIEs[21]. Most of these firms did not expect to be impacted by the changes, while those that did were content to only take on new PIE clients within their existing sectors and expertise.

None of the seven ex-PIE audit firms intended to return to PIE auditing, but two of those firms responded slightly differently to the question: "If in future any of your engagements became PIE audits, would you retain them and become a PIE auditor?"

- *"If it did happen, we would retain the audit because we are comfortable with our clients and would trust ourselves to do a good job."* Any decision to engage more widely with the PIE market "*would depend on the situation at the time.*"
- *"If the threshold were lower, we would not want to put a ceiling on our capacity to grow that is too close to where we are already."* If they retained one PIE audit, then they would engage more widely with the PIE market: *"you can't just dabble in it, you have to fully embrace it",* and they would need to spread the additional costs over a wider base.

Similarly, although the majority of the larger, non-PIE auditors had stated that they would not take on any PIE audits, a few of these firms expressed an element of doubt in the case of the 'new' PIEs, for example:

- *"It is the Board's decision, not mine …… this conversation has encouraged me to ask the Board to consider what their strategy would be."*
- *"The new PIE definition will bring a number of our AIM clients into scope, and we plan to retain those clients" (and then to embrace the PIE market more widely).*
- *"As of today, we would drop those clients, but it depends on what happens in the market in the meantime."*

3.13. Firms' suggestions for improvement

Several PIE auditors and ex-PIE auditors suggested solutions for addressing the barriers they identified in the PIE audit market.

Three or more firms suggested each of the following:

- advice and training to develop smaller firms' ability to handle PIE audits should be more readily available
- the FRC should work with commercial software developers to ensure their products are fit for purpose for PIE auditing and are kept up to date as regulations change

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[20] For details see the outcome of the Government consultation: [Restoring trust in audit and corporate governance: government response to consultation on strengthening the UK's audit, corporate reporting and corporate governance systems]

[21] Entities that would be captured by the new definition are those with both 750+ employees and an annual turnover of £750 million+.

- the FRC should be more sensitive to the needs of smaller firms, for example by giving more notice of reviews, not tying up so much of firms' scarce resource, and being aware that smaller firms do not have specialist technical departments to deal with technical queries
- regulators should do more to promote a positive image for auditing, and less to create a negative image

Several firms mentioned current and ongoing FRC initiatives such as the Audit & Assurance Sandbox, the Audit Firm Scalebox and Round Tables as positive developments that could potentially reduce the barriers.

3.14. The PIE audit market story from the audit firms' perspective

3.14.1. Smaller PIE auditors

This description is based on the broadly similar views and experiences of five of the smallest PIE auditors, each of which carried out only one or two small PIE audits.

All of them wanted to expand their audit services in general but were more wary of expanding PIE audits. They said they would expand these, if at all, in a limited way that matched their current sectors and expertise. Three of them preferred to focus on better opportunities outside the PIE market.

They were all constrained by a lack of the right staff and expertise, with four of them saying that they would need to hire a new team in order to enter the PIE market seriously. Even if it were possible to hire these people in the current market, there would be significant initial costs establishing the team that would be difficult to recover. Overall, "*putting a big PIE audit on top of the existing [staffing] challenges would be too much."*

They did not see the cost of winning business as a particular issue, believing that they could generate 'warm leads' through their existing contacts and networks and that the tender costs of winning the work would not be significant.

Several of them were attracted by the kudos of being a PIE auditor, while being put off by the additional risks (reputational and financial) and stresses that PIE audits imposed on RIs and senior staff.

3.14.2. Firms with more than 10 PIE audits

The two firms in this category saw no ultimate limit to expanding their PIE audits, but for the moment they were still proceeding cautiously and growing within their areas of expertise – *"We are confident of our quality – in our own sectors."* They were aware of the risks associated with PIE audits, but "*risks are more manageable when you have the right skills".*

Both firms had adapted their systems, methodologies and training programmes to fully accommodate PIE audits. They saw the costs of PIE audits as being fully recoverable, except for the costs of senior staff time in dealing with FRC reviews.

They had similar difficulties to other firms in recruiting and retaining staff, but one of them saw PIE audit work as an incentive for staff to join and then stay with the firm.

Both firms commented on the amount of smaller PIE audit work that was coming from the Big 4 and other large firms.

3.14.3. A larger, non-PIE auditor

This firm had annual revenue between £10-20 million, about one third of which was from audit services. Its audit clients were mainly small to medium sized owner-managed businesses (OMBs). The partner we spoke to had PIE audit experience from an earlier career with larger firms, but this firm was not a PIE auditor.

The firm would not enter the PIE market at this time. Although none of their existing clients was close to the proposed new 750/750 PIE threshold, they would not continue to audit such a client if it became a PIE.

The main driver for this decision was that the firm's systems, methodology and expertise were developed to deal with OMBs. Their quality systems and risk assessments were built around their expertise in this sector of the market, and they would expect PIE audits to have higher risks. The partner perceived the PIE audit regime as requiring a different approach – not just for PIE audits, but a 'whole-firm approach' that would affect their non-PIE audits as well.

The interviewee had a negative view of the PIE regulatory regime, which was widely shared within his professional network – in particular as regards firms' experiences of dealing with the FRC and the negative, "auditor-bashing" publicity that has resulted from recent, high-profile cases.

This was not the main factor for this firm, but it would be another obstacle to them entering the PIE audit market.

At the time of our research, they had no need or incentive to consider entering the PIE market, because they already had more work than they could handle within their existing areas of expertise. However, they were ambitious to grow their audit practice in the longer term and would "never say never". They would continue to watch developments in the PIE market closely.

4. Findings – market for non-PIE audits

4.1. Overview

This section summarises the key findings for the non-PIE audit market, using Red / Amber / Green coding to reflect our judgement based on the research we have carried out.

4.1.1. Appetite to enter / grow in the non-PIE audit market

All the PIE auditors, the larger, non-PIE auditors, and the vast majority of all other non-PIE auditors that we surveyed or interviewed expected to grow their non-PIE audits.

There also appeared to be some interest in investing in audit firms from private equity (PE) firms, although the sample was small (two interviews with PE executives, plus views from some firms that received PE investment).

Among non-audit businesses, some assurance certification providers appeared potentially interested, in principle, in entering the audit market (bearing in mind the same caveat about small sample sizes). However, investors and certification providers seemed likely to be more attracted to the non-PIE space, in line with the overwhelming majority of participants in the research.

Appetite to enter / grow in the non-PIE audit market

Firms with >10 PIE audits	Firms with <10 PIE audits	Non-PIE firms	Private equity	Certification providers

Key: Green: Strong appetite to enter / grow. Amber: Some appetite to enter / grow

4.1.2. Barriers to entry and/or growth in the non-PIE audit market

The research formulated and tested hypotheses about potential barriers to entry and growth. The table below summarises which of these potential barriers were indeed found to be an obstacle to entry and growth and which were not.

Firms indicated that the biggest barrier by far was their ability to recruit and retain audit staff, with 90% of firms surveyed selecting staffing as a serious challenge and limiting factor. Other relatively minor barriers mentioned related to the economies of scale required for auditing to be viable, and the costs of entry or growth which were not always perceived as being recoverable.

Potential barriers to entry / growth

Recruitment and retention of experienced and specialist staff	
Economies of scale required for service line to be viable	
Entry / growth involves sunk costs that are not recoverable on exit	
Risks involved (reputational, regulatory penalties and audit liability claims)	
The importance of firm brand and reputation in winning work	
Technology and methodology	
The importance of relationships in winning work	
Obtaining professional indemnity insurance at a viable price	
Cost of winning business (e.g. bidding for tenders)	

Key: Green: Not a barrier. Amber: A relatively minor barrier. Dark red: A very significant barrier

4.1.3. Drivers of lack of appetite for, and exit from, the non-PIE audit market

The firms that participated in our research generally indicated a good appetite for remaining in the non-PIE audit market and growing their auditing businesses.

Firms indicated that the main drivers of exit, or considering exiting the non-PIE audit market, were a view that standards and regulation were becoming too challenging and the retirement of audit partners.

Drivers of the lack of appetite for, and exit from, the non-PIE market

Retirement of audit partners	
Standards / regulation becoming too challenging	
Inability to attract audit staff	
Inability to charge high enough fees	
Small number of audits	
Better opportunities in non-audit services	
Entry/growth would require undesirable changes in the firm or work (e.g. culture, work-life balance, nature and balance of work, methodologies, processes, policies)	

Key: Pale green: A relatively minor driver. Dark Green: A significant driver

4.2. Firms' appetite to expand their presence in the non-PIE audit market

4.2.1. Summary

The firms involved with our research were those that were sufficiently interested in the audit market to spend time taking part in the research. However, even these firms identified more unattractive aspects of the audit market, rather than attractive ones and more firms in our sample mentioned those unattractive aspects than the attractive ones.

4.2.2. Plans for growth

72% of the non-PIE auditors and 100% of the larger, non-PIE auditors intended to grow their audit services. However, this was unlikely to be representative of the overall population of audit firms because the firms that were most interested in the audit market would be the most likely to respond to the survey.

We asked what types of audit clients the firms were targeting. The key messages were that:

- both groups (larger, non-PIE auditors and our broader sample of non-PIE auditors), but especially the larger firms, planned to target larger entities rather than smaller ones[22]
- the non-PIE auditors said that they were targeting mainly new entities in existing sectors (63%) and entities with better governance and control (48%), rather than entities in new sectors (13%) and new geographic areas (11%)

[22] For the larger, non-PIE audit firms, 71% planned to target larger entities compared to 29% for smaller entities. For the general group the results were 49% and 38% respectively.

4.2.3. What factors make auditing unattractive?

The table below summarises the responses to this question and uses approximate percentages to show the relative importance of the different factors for the two groups. Key points include:

- the two most frequent comments were: that **staff were not keen to do audit work (22 mentions); and that audit was not as profitable as other services (21 mentions**)
- aspects of the regulatory environment had 11 mentions, as did clients' lack of appreciation / understanding of statutory auditing

What factors make auditing unattractive?	Non-PIE auditors (39 interviewees)	Larger, non-PIE auditors (19 interviewees)
Staff are not keen to do audit work	45%	20%
Audit is not as profitable as other services	30%	50%
Clients do not appreciate / understand statutory audit	15%	25%
Aspects of the regulatory environment	20%	15%
Better opportunities / salaries in other professions	10%	30%
Bad reputation / negative publicity around audit	10%	15%
Auditing is less attractive than it used to be	3%	25%
Time and other pressures on RIs and audit managers	5%	5%

Several firms commented that: staff disliked the overtime / hard work involved; they had to cap the amount of time that staff spent on audit work, or staff would be unhappy / leave. None of the firms said that staff enjoyed doing audit work, although three firms said that auditing developed their skills.

Although several interviewees thought that audit was less profitable than other services, most were reasonably happy with this because audit provided opportunities for reputation building and lucrative non-audit work. Several firms noted that audit profitability was increasing, mainly because they were able to charge higher audit fees in the current market.

Several firms said that clients either did not appreciate the audit work done and/or did not see any significant added value for the fees that they paid. This could make the experience of interacting with such clients less pleasant / rewarding for audit staff and was seen by some as a reason why staff disliked doing audit work.

"People don't want to do audit, there's too much pressure."

"Clients' lack of appreciation for audit and lack of understanding of the auditor's role makes being an auditor really difficult."

"(Audit is) not cost effective and will become worse due to increasing regulation."

"(Audit is) not a fun place to be."

4.2.4. What factors make auditing attractive?

Fewer firms mentioned aspects of auditing that they found attractive as can be seen from the limited number of factors mentioned in the table below. The main positives were that, for some firms, auditing provided opportunities to win non-audit work; and that it developed staff skills.

What factors make auditing attractive?	Non-PIE auditors (39 interviewees)	Larger, non-PIE auditors (19 interviewees)
Opportunities to win non-audit work	7	-
Develops staff skills / interesting work	5	1
Contacts / networks / position in the community	4	1
Opens up other work reserved for auditors	2	-
Steady, inflation proof income stream	1	-
Job satisfaction, improving quality of accounts, value to clients	1	3

(Audit is) "10% of the turnover, 90% of the hassle."

"Audit makes the client sticky, it's harder for them to move away."

"Audit opens doors to other work, contributes to our position in the community and gives us contacts and access to networks."

4.3. Costs of expansion and of winning new business in the non-PIE audit market

4.3.1. Summary

Very few of the firms that took part in our research said they were incurring high costs for winning new business.

Some firms cited significant costs associated with expansion, which is explained below, but most firms saw these as being largely recoverable through increased fees and improved productivity.

Most firms did not see Professional Indemnity Insurance (PII) costs as an issue.

4.3.2. Substantial investments needed

Interviewees were asked what substantial investments they needed to make, in order to grow in the non-PIE audit market. **The main investments were in staff, technology, and training**, as below. However, the definition of 'substantial' is subjective and some of the interviewees may have been talking about what they saw as the main costs of continuing operations, rather than the really substantial costs of expanded operations.

The table below summarises the responses to this question and uses approximate percentages to show the relative importance of the different factors for the two groups.

Investment needed	Non-PIE auditors (39 interviewees)	Larger, non-PIE auditors (19 interviewees)
Staff hire / salaries	25%	50%
Staff training / CPD	15%	30%
Technology / IT	25%	40%
Time costs to deal with regulatory environment	10%	25%
Office space	5%	0
No substantial investments needed	15%	0

"We are ticking along nicely; we are investing mainly in staff pay increases and better packages."

"We have doubled our intake of trainees and we develop them instead (of hiring experienced auditors)."

"We are a hunting ground for the big firms because our staff are well trained."

Most (72%) of the larger, non-PIE firms thought that these costs would be recoverable, implying that they were not seen as a deterrent to expansion. The firms that mentioned staff costs generally felt that the staff would easily pay for themselves in the current market. The non-PIE interviewees were not asked about recoverability, but their views were consistent with those of the larger, non-PIE firms.

4.3.3. Cost of professional indemnity insurance (PII)

By a large majority (79%), interviewees did not see PII costs as a significant element of costs, though 26% mentioned that these costs were increasing and 21% said that they deliberately avoided areas of work that insurers perceived as high risk, such as PIE / listed audits, personal tax work and business valuations.

"The costs are increasing but we have sucked it up….. it's more of an issue for tax than audit."

4.3.4. Costs of winning new non-PIE business generally

No interviewees thought that the costs of winning new business were hampering their expansion in the non-PIE market. Some qualified this with comments that either non-chargeable time spent on winning the business, or the setup costs associated with a new job, could affect their profit margins.

"With a new client we 'take a bath' in year one due to set up costs and unfamiliarity with a new business."

4.3.5. Bidding and competition

On average, the larger, non-PIE firms reported having submitted bids for 73% of the audits they were invited to bid for and having won 68% of those audits **– a reported success rate of more than two out of three of the audits they bid for.**

70% of the same firms said that they faced between 3 and 5 competitors on average (the other 30% faced 2 competitors on average). Although further work would be needed to confirm this, it suggests that the larger, non-PIE auditors are particularly successful at winning the work that they bid for, despite the presence of other competition. This is consistent with our interview findings, with many of them telling us how easily they can win new work under current market conditions.

Survey results showed that the larger firms both actively seek out new opportunities (80%) and that entities reach out to them (70%).

"[We still proactively seek out new business] but latterly we have been less hungry due to lack of adequate resource and the fact that many audit clients are now walking in the door. This is in stark contrast to three years ago when the there was much more focus on seeking new audit work."

"Clients just want to know if I'm a sensible person, someone they can discuss things with, then they want to talk about other services, especially tax… 90% of audit clients expect tax work."

4.4. Factors that limit the entry and expansion of firms in the non-PIE audit market

4.4.1. Summary

Firms saw their capacity to recruit and retain audit staff as the main factor that limited their expansion.

4.4.2. Significant limiting factors

We asked in the surveys "Which factors limit your firm's ability to remain or expand in the non-PIE audit market?" The table below summarises the responses to this question and shows the relative importance of the different factors for the two groups – "larger, non-PIE auditors" and "all non-PIE auditors". Key points included:

- the larger, non-PIE auditors stated unanimously that their capacity to attract or retain audit staff was a limiting factor
- the non-PIE auditors were asked specifically about recruiting and retaining junior and experienced audit staff, and for them recruiting and retaining experienced staff was the main limiting factor
- increases in regulatory requirements / auditing standards were a limiting factor for a majority of non-PIE auditors, but much less so for the larger, non-PIE audit firms
- only 25-30% of respondents from either group saw audit fee levels as a limiting factor
- only 10% of respondents from either group saw technology as a limiting factor

What factors limit your firm's ability to remain or expand in the non-PIE audit market?	All non-PIE auditors (95 respondents)	Larger, non-PIE auditors (10 respondents)
Capacity to attract or retain audit staff	Not asked	100%
Recruiting junior auditors	38%	Not asked
Retaining junior auditors	38%	Not asked
Recruiting experienced auditors	80%	Not asked
Retaining experienced auditors	66%	Not asked
Increases in regulatory requirements / auditing standards	63%	10%
Ability to set fees at a profitable level	26%	30%
Technology / audit methodology	11%	10%

"We have not been tendering for some available audits as we simply do not have the labour resources to expand further."

"We have many opportunities to grow but are constrained by recruiting sufficiently good people to service this work. This increases audit risk and therefore we have limited the amount of new work we are willing to take on."

4.5. Human resources in the non-PIE audit market

4.5.1. Summary

Lack of human resources was the main limiting factor for non-PIE audit firms, especially as regards recruiting and retaining recently qualified staff and audit managers.

4.5.2. Specific roles

Larger, non-PIE auditors

The larger, non-PIE auditors cited recruitment and retention of recently qualified staff, audit managers and, to a slightly lesser extent, specialist staff as the main limiting factors, as below.

Staff level	Larger, non-PIE auditors	
	Recruitment	Retention
Recently qualified staff	80%	80%
Audit managers	90%	70%
Specialist staff	60%	50%
Partners and RIs	30%	0%
Trainees	20%	20%

Non-PIE auditors

We did not ask the non-PIE auditors which roles specifically were the main limiting factors, but their interview responses showed that:

- recruitment and retention of recently qualified staff and audit managers were a significant issue for them, similar to the larger audit firms above
- specialist staff was cited as a limiting factor by a relatively small number of firms
- developing partners and RIs to continue / develop their businesses was a significant issue for this group

4.5.3. Changes over time

We asked interviewees: "Have the resources that you need to deliver audit services, such as human resources and technology, changed over time? If so, how?"

Very few firms mentioned changes in the actual resources needed to carry out audits - the changes they cited were around recruiting and retaining the resources they needed, and their increased scarcity. Changes that were mentioned by several firms included:

- increased salary levels and expectations
- the need to offer improved benefits and working environments

  "We offer benefits such as medical insurance, critical illness cover, 27 days holiday, 5 "service days" for sickness etc, WFH 2-3 days a week (a lot of the work can be done remotely)."

“We are having to think outside the box, including making more use of contacts from previous roles, flexible working practices, salary benchmark reviews to keep up with the larger firms. We developed a programme for school leaver trainees - AAT level 4, then the ICAEW exams. We let the student drive the timetable."

- disruptions to hiring and retention caused by Covid

  “Covid made it worse, with fewer recruits being hired and older staff dropping out.”

- changing attitudes from staff, for example requiring more flexibility and being less prepared to work long hours

  “The Covid generation has different expectations, they need coddling."

- ongoing difficulties in hiring experienced staff, leading more firms to ‘grow their own’ and to put more resources into training programmes [23]
- increasing difficulties in hiring graduates, with several firms hiring more school leavers and/or looking overseas for new recruits

  “The big firms are hoovering up all the decent graduates", the quality of graduate trainees available to firms like ours has declined. We are focusing on A level recruits and trying to persuade graduates with holiday jobs to join us instead.”

- increasing difficulties in retaining qualified staff

  “30 years ago you could retain a third of the newly qualifieds, but it's much less than that now.”

- a more aggressive approach to hiring by some larger firms

  “We had 2 students poached out of their training contracts by a larger firm, offering £10k more.”

  “Larger ICAEW firms are poaching our trainees and offering off market salaries in order for them to break their training contracts. This is not ethical.”

- more audit work being done by junior staff in the absence of experienced seniors

  “20 years ago everyone would have done some audit, now it's heavily skewed towards students doing professional exams.”

- having to limit the amount of audit work they asked staff to do, because audit work was unpopular with staff

  “We do not give some staff members audit work because we know they will leave if we do.”

Some firms cited their own non-audit work as a factor that was increasingly taking scarce staff away from auditing, for example:

“Audit clients want tax work and there is an even greater shortage of tax specialists.”

We asked interviewees whether staff shortages had become worse in recent years. The results were mixed and suggested that, overall, the situation was not getting worse for the larger firms, while the smaller firms were more likely to see it as deteriorating.[24]

However, the larger non-PIE auditors perceived the ability to recruit recently qualified auditors (70%) and audit managers (60%) as ‘serious and growing’ problems, as opposed to ‘serious but stable’.

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[23] 25% of non-PIE auditor interviewees mentioned that their strategy was to ‘grow their own’ senior staff from new recruits and 31% had adapted to a shortage of graduate trainees by focusing on recruiting school leavers. These were only the firms that specifically mentioned these topics during a time-limited interview, and we believe there are likely to be additional firms adopting similar strategies.

[24] 37% of the interviewees drawn from the survey that went to all non-PIE auditors thought that it had got worse, with 22% saying there had been no fundamental change. The larger, non-PIE interviewees thought differently, with 50% saying there had been no fundamental change and none saying it had got worse.

4.5.4. Some consequences of staff shortages

Impact on cost bases:

"It takes new staff 6-9 months to get their feet under the table; training costs have increased, and managers have to spend more time training. The average portfolio of audits per manager has decreased to accommodate this."

Impact on risk:

"One resignation and it's an enormous challenge, there's not enough contingency."

Impact on staff quality:

"Larger firms suck the talent pool dry, especially for graduates. We are looking at school leavers, but graduates have better communication skills and more confidence - non graduates need more support."

"Numeracy and education skills are worsening all the time."

4.5.5. HR differences between the PIE and non-PIE audit markets

Some firms perceived a split between the sort of staff who were attracted to non-PIE audit work as opposed to PIE auditing, with the former being less inclined to spend long hours at work, more likely to have strong interests outside work (including family commitments) and be less ambitious. Some firms have reported difficulties in filling leadership roles, especially RI roles, because their senior staff did not want to take on additional responsibilities.

4.6. Technology and methodology in the non-PIE audit market

4.6.1. Summary

Technology was not seen as a factor that limited expansion, except by a small minority of firms. Many firms thought that technology currently had limited potential to improve audit quality and productivity, though this might improve in the future. Several firms mentioned barriers to using technology effectively, for example around the costs and capabilities of existing services.

4.6.2. Technology as a limiting factor

The survey asked firms which factors limited their firm's ability to remain or expand in the non-PIE audit market. **Only 11% of those responding said that technology / audit methodology was a limiting factor**.

4.6.3. Firms' responses to changes in technology

We asked interviewees and survey respondents about their response to changes in technology..

The table below summarises the responses to this question and shows the relative importance of the different factors for the two groups. Key points included:

- some firms were embracing technological changes, while others had made little change to the ways they carried out audits

- more of the larger, non-PIE auditors (70%) said they had ‘already made significant changes and plan to do more’ than of the group of all non-PIE auditors (10%). This would be consistent with a view, expressed by some, that sophisticated technology worked better with larger and more capable clients
- More of the group of all non-PIE auditors said they ‘plan to make significant changes’ or were ‘making changes incrementally.’
- Across both groups, only 10% of respondents said that ‘no significant changes made or planned.’

Responses to changes in technology [25]	**Non-PIE auditors (39 interviewees)**	**Larger, non-PIE auditors (10 respondents)**
No significant changes made or planned	4	1
Waiting to see how the market develops	2	4
Plan to make significant changes in the next few years	12	4
Making changes incrementally	14	1
Already made significant changes and plan to do more	4	7

“Constant investment in IT is just ongoing.”

“We have invested massively in my time, but we still lag the Big Four.”

“We are still using traditional methods (Caseware and substantive testing) but are just beginning to change.”

“90% of my work hasn't changed over the years.”

4.6.4. Technology as a means of increasing productivity

22% of interviewees said that technology was helping them to use scarce human resources more effectively. However, this result could be taken in two ways, as 78% either had a different view or did not see this as an issue worth mentioning.

Several firms mentioned ways in which basic technology was improving efficiency, for example: online meetings rather than travelling to meet clients; electronic filing; cloud computing; and using readily available tools to better analyse data. A few of the larger, non-PIE auditors were seeing productivity improvements resulting from technology, but most thought that dramatic increases in productivity, for example due to enhanced artificial intelligence, were unlikely to materialise until well into the future.

Some of the larger, non-PIE auditors were using data analytics software, but few of the smaller non-PIE auditors were using it. Some firms saw the quality of smaller clients’ accounting data as a constraint because this could lack consistency and required more detailed audit scrutiny of transactions.

“Tech only works in 80% of cases and sometimes it doesn't do the thing you want it to.”

“Data analytics needs strong accounting teams to be effective. It selects exceptions, that look odd, and our clients have too many of those.”

[25] Multiple responses and ‘no’ responses were possible, so percentages do not add to 100%.

"Smaller firms tend to audit smaller companies who have less resources and less sophisticated systems, this means we are more likely to adopt a substantive audit approach where a lot of larger audit firms are employing IT specialists, using software to interrogate large volumes of data and putting reliance on controls."

"Our audits are still done manually - we haven't yet seen efficiencies from audit technology."

4.6.5. Barriers to using technology effectively

Some firms saw technology costs as a barrier, especially set up costs and the costs of moving between suppliers.

"Time saved on audits is lost by setting up the tech initially."

"[One of the leading software providers] has low cost for the first year, then becomes extortionate."

"We have considered using [name of software product] and are thinking when to pull the trigger. The issue is the cost of getting out of our existing software. We have to retain audit files for a period of time and the cost of accessing them will be extortionate."

"[Our existing software] is prohibitively expensive and it takes too long to set up a sample."

Some firms mentioned a need for better information / education as regards technology.

"Technology is changing and we need guidance and support in how to use it effectively."

"There are thousands of products out there and it's difficult to know what's any good."

Some firms were critical of the commercial software products that they (the smaller firms) used, in contrast to the more sophisticated, bespoke software that they perceived the very large firms as having the resources to design and use.

"It needs to be larger firms that take on the PIE audits as they can afford the technical backup within the practice to take on the necessary regulation and be able to cover the cost. The smaller practices will then inevitably deal with non-PIEs, some of which are large audits in themselves. Need to support smaller practices to be able to implement technology to improve the quality of their audit work."

"Our audit packs are heavily slanted towards pre-formatted analysis tools. This detracts from audit quality and takes away initiative, especially for junior auditors."

"Smaller firms tend to audit smaller companies who have less resources and less sophisticated systems, this means we are more likely to adopt a substantive audit approach where a lot of larger audit firms are employing IT specialists, using software to interrogate large volumes of data and putting reliance on controls. Instead of a large entity audit being a scaled-up version of a small audit as it used to be, it seems to me that large and smaller audit skill sets are moving apart in some areas."

4.7. Brand and reputation in the non-PIE audit market

4.7.1. Summary

Most of the non-PIE auditors we interviewed were happy with their brands and reputations locally and/or within their sectors of expertise. They did not see brand and reputation issues as barriers to winning non-PIE audit work.

4.7.2. Brand and reputation as a limiting factor

The surveys for both groups asked 'which factors limited their firm's ability to expand in the non-PIE audit market'. Less than 10% of firms responded [26] with 'insufficiently strong brand to attract new clients.'

4.7.3. Brand and reputation as a source of opportunities

Most non-PIE audit firms saw their firms' brand and reputation as generating opportunities for them to win non-PIE audit work. There was a synergy between brand / reputation and networks / relationships, with many firms seeing their reputations with their local professional and client networks as being a prerequisite for winning work or introductions to prospective clients.

The larger, non-PIE auditors saw the reputations of key individuals as being more important than the firm's reputation. This was consistent with comments made by several firms at interview, by both groups, that reputations could be built quite quickly in the non-PIE audit market.

Several interviewees from both groups mentioned specific sectors of the market where they, their firms or both had good reputations, for example in the charity and academies sectors.

"Locally the firm's reputation is determined by my own reputation."

"Contacts in my two previous (large) firms have asked us to be on a list of 'friendly firms' that they can refer work to….. we did a one-off report for (one of those firms), did it well and have now had six requests for similar work in eight weeks."

Several firms made the point that their local reputations amongst their client and professional networks were linked to the quality of their audits.

"Reputation all comes back to quality."

"FDs [Finance Directors] speak to FDs and we have a lot of happy clients."

"We have a positive reputation for client service compared to similar-sized (local) firms that have been taken over by consolidators, with disruption to their systems, processes and client services."

4.7.4. Price and quality issues

All of the larger, non-PIE auditors said that 'quality of service from management's perspective' was a very important factor when competing for audits. This was cited by far more firms than either audit quality (4 out of 10 firms) or price (3 out of 10 firms). 50% of this group said that price was less important than it used to be.

None of the larger, non-PIE auditors thought that buyers of audit were 'very able' to assess audit quality when choosing an auditor.

50% thought that buyers were '*somewhat able*' and 50% that buyers were '*not able*' to assess audit quality.

The wider sample of non-PIE audit firms was split as to the importance of pricing in winning new work, with just under one third of interviewees citing low fees as a factor in winning new work while an equal number of firms said that they could set sufficiently profitable / high fee levels for new work.

[26] None of the larger, non-PIE auditors and only 10% of the smaller non-PIE auditors said this.

Just under 30% of survey respondents[27] saw '*ability to set fees at a profitable level*' as a factor that limited the firm's ability to expand or remain in the non-PIE audit market. The flipside was that more than 70% of respondents did not tick that box.

Several firms acknowledged some pressure to reduce audit chargeable hours in order to achieve an acceptable level of recovery / profit against low audit fees for some existing clients.

"*We are winning a great deal of new audit work via a 'trickle-down' from larger firms. For us these tend to be at the larger end.* ***We are not actively divesting smaller clients however, instead only divesting low quality clients of any size****. Low quality generally means low recovery and/or very challenging to work with."*

"Audit quality becomes more important (for winning new work) the larger the entity. ***For smaller entities audit quality is of less relevance compared to quality of service to management****, although there can be an overlap."*

"Audit is an undervalued service, seen by some clients as 'a necessary evil', which makes it harder to recover fees for overruns and unforeseen complications - ***clients are more willing to pay additional fees for services like tax, where they can see direct benefits.****"*

"The way that firms perceive clients has changed, from 'client' to 'entity' with more emphasis on audit quality and less emphasis on keeping the client happy. ***The emphasis is more on keeping the audit team happy now, as competition for a small pool of staff becomes more intense****."*

4.8. Networks and relationships in the non-PIE audit market

4.8.1. Summary

Networks and relationships were seen by most firms as a positive factor that enabled them to win work, rather than as a limiting factor or barrier, and as being closely linked to the firms' reputation for quality within their networks.

4.8.2. Networks and relationships generating opportunities

We asked the larger, non-PIE auditors what were the main factors that generated opportunities to win audit work. Almost all of them mentioned networks and relationships as one such factor, with many firms saying it was the most important.

"Referrals are important, especially from the local marketplace – solicitors, bank managers, other firms that can't do the work themselves."

"Introductions often come from existing relationships – with ex-colleagues who now work for the client, bankers, solicitors."

We asked the wider sample of all non-PIE auditors the same question and almost two-thirds of them mentioned networks and relationships. Several firms made the point that relationships opened doors, but winning new work also depended on other factors such as price and perceived quality of service.

"80-90% of the time we are referred by people who know us."

"Relationships create opportunities. Once you are on the short list, fees become important, as well as the client's perception of what value you can add as an adviser."

[27] 26% of the wider sample of all non-PIE auditors and 30% of the larger, non-PIE auditors.

Several firms from both groups cited opportunities arising from smaller firms' connections with larger firms, especially as those firms either shed existing clients or were unable to take entities on as new clients.

Some firms saw their networks and relationships as keeping them locked into existing sectors and geographies, especially in the current market where many of them do not need to look far for work. "*We would rather stay in our warm, cosy room*", as one larger, non-PIE audit firm put it.

4.9. Demand for non-PIE audit services

4.9.1. Summary

Reductions in market size took place when audit thresholds were raised in 2015-16 (meaning that fewer private companies were required to obtain an audit).[28] Most firms said that the impact of higher audit thresholds on market demand had faded, although several firms cited an ongoing reduction in the supply of senior / experienced auditors due to firms hiring fewer trainees after thresholds were reduced.

Most firms perceived that the non-PIE audit market that they competed in had grown in recent years.

4.9.2. Firms' perceptions of changes in the non-PIE audit market size

The main reasons for the perceived increase in market size were:

- **Inflation bringing new clients over the income threshold**, despite there being little or no change in their businesses in real terms.

  "One of our clients has passed on increased costs to customers and increased its turnover. It's still the same size business, but now it needs an audit."

- **Larger clients becoming more accessible to smaller audit firms**, due to the 'waterfall effect' of audit work coming down from larger firms.

  "The size of our target market has increased because we have invested in developing our audit practice with strategic people hires, so we have geared up in terms of the size of client we can handle, and other firms have dropped their larger clients. In terms of size of revenue, there is more audit work to be done because of increased regulation around new ISAs [International Standards on Auditing]."

  "We are having discussions with clients who would never have approached us five years ago. We are performing a number of engagements covering group reporting to Big Four parent auditors internationally. This type of work was never done by our firm five years ago, our market is expanding all the time."

- **The volume of audit work per client increasing**, due to additional regulations and standards and the way that these are interpreted by regulators and software providers.

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[28] In January 2016, the thresholds above which a company must obtain an audit were changed as follows:

– Annual turnover: from £6.5 million to £10.2 million,

– Assets: £3.26 million to £5.1 million, and

– Employees: 50 (unchanged).

GOV.UK, [Audit exemption for private limited companies]

"Increased regulation means increased work ….. we use [name of software product] and for one (uncomplicated) client there were 683 questions in the audit pack and 174 questions in the disclosure checklist."

"The audit market remains buoyant for those firms which have invested in people over the last few years, with many opportunities arising from large audit firms' capacity and regulatory challenges."

- **Work coming from firms that had exited the audit market**

  "Our market has increased from the top and bottom, with work coming down from larger firms and smaller firms giving up audit."

- **Changes in specific markets**

  "Brexit has increased the workload for firms owned outside the UK."

4.9.3. Firms' perceptions of changes in clients' needs

Clients' needs were not perceived to have changed, but statutory audit was seen by some firms as increasingly failing to meet them. More than half of the firms (56%) that expressed an opinion on clients' needs saw audit reports as mainly a tick in the box, required for statutory purposes, that added little or no value for clients. This compared with 11% who felt that the audit added value for clients.

More than one third of non-PIE audit firms said that their clients were more interested in the non-audit services that the firm had to offer.

The larger, non-PIE auditors were more likely to say that audit added value for clients (three of the eight firms that discussed this topic), but the majority (five firms) perceived that clients did not get sufficient added value for their audit fees.

"A lot of clients just need a tick in the box."

"There appears to be a lack of understanding of the very different attitudes of [non-PIE] management / shareholders to the service they require from the audit firms.

These entities often rely on the audit firm for wider (routine) advice which they cannot resource internally and which is necessary for their businesses to operate and ultimately drive the economy."

"Clients never see the file. They don't understand what we do or appreciate the hard work we put in."

"We are being asked to do things that are just ridiculous, like risk assessments and anti-fraud measures - the client looks at you as though you're off your head."

"Some (prospective) clients just desperately want an audit ….. and those are the ones you want to avoid."

4.10. Supply of non-PIE audit services

4.10.1. Summary

We have only been able to research firms' subjective opinions about the supply of non-PIE audit services, as opposed to objective evidence. For example, we know that the number of audit firms is in decline, but statistics for the numbers and skills of individual auditors is less readily available. It may be that the same number of individual auditors are being employed by a reducing number of firms. However, the research suggested that there are issues perceived by the firms that, if unresolved, will continue to exacerbate pressures on audit supply in the future.

4.10.2. Trends in audit supply

Firms

The number of registered statutory audit firms has declined steadily, from 11,172 at the end of 2001 to 4,143 at 16th August 2023 [29], a rate of decline of about 5% per year over the past 20 years. The intentions of our survey respondents, with 5 firms out of 97 saying they have exited or intend to exit the audit market, appear to be broadly consistent with the continuation of that trend.

Not all of the registered firms carry out audits, which further reduces the number of firms that participate in the audit market. **We do not know what the true decline is because we do not know the number of truly active audit firms**, as opposed to firms that held a license but did not or do not use it.

Individual auditors

We have not found any clear data on the numbers of individual auditors working in the audit market. This is the main driver of audit supply, irrespective of how many firms these auditors are working for.

Audit work as a proportion of work done

As explained in the next section, audit work was a minor percentage of revenue for sample of all non-PIE firms and their staff that are actually in the current audit market. Some participants have told us that the proportion of audit work relative to other services has declined during their own careers.

4.10.3. Firms' intentions to grow their audit services

100% of the larger, non-PIE auditors and 72% of the wider sample of non-PIE auditors said that they intended to grow their audit services. This was despite a shortage of human resources, which was seen as the main constraint on growth.

4.10.4. The impact of certain factors on audit supply

Human resources

The vast majority of firms said that a lack of key HR resources was limiting their capacity to deliver audit services, as detailed earlier.

Technology

Many firms reported gaining productivity improvements from the use of technology, but in most cases not at a level that made a significant impact on audit workloads at this stage, as detailed earlier.

4.10.5. Specific sectors of the market

Charities

Firms raised questions about the value of audit to smaller charities, as well as charities' ability and willingness to pay audit fees that reflect the costs incurred by audit firms.

Firms indicated that the situation appeared worse in Scotland, which had a lower audit threshold than the rest of the UK. For clarity, we did not find evidence of weakness in other not-for-profit sectors such as academies.

"The audit market is generally very difficult given many factors - regulation, too few profitable opportunities, difficulty in attracting quality staff, retention of existing staff - which is why we have

[29] *FRC, Key Facts and Trends in the Accountancy Profession, 2023.*

ditched all charity/academy audits (risk v reward factor) and other non-profitable work. If we cannot expand our staff, we would prefer fewer more profitable audit clients."

"For smaller audit entities, particularly charities, there is a mismatch between the level of work needed to conduct a compliant audit and the fees that these clients are able to pay. £1 million charities require an audit but expect a lower audit fee. This doesn't correlate to the complexity of those audits in terms of their activities, and the governance and reporting requirements. I foresee that some small charities will either not be able to find auditors, or will be required to pay significantly more than they can afford."

4.11. Business models of non-PIE audit firms

4.11.1. Summary

Non-PIE firms in this research received, on average, less than 20% of their income from audit.

However, many of them saw audit as an important part of a full accountancy service, that enhanced their networks and, in some cases, opened the door to more profitable, non-audit work.

Most firms reported being able to pass on cost pressures to new clients, for whom audit is less of a buyers' market than in the past, but they found it more difficult to raise fees for existing clients.

Some firms, especially the larger ones, had reviewed their client lists and shed the less profitable ones, but some smaller firms had found this more difficult to do.

4.11.2. The role of audit in firms' business models

16 out of 17 of the larger, non-PIE audit interviewees that addressed this topic saw audit as an integral part of their business models. This was also the case for most of the wider sample of non-PIE audit firms.

Many firms saw audit as part of an overall package that provided access to clients and networks and enabled them to offer other, more lucrative services. A connected factor was that some non-audit services, such as solicitors' accounting rules work, could only be provided by approved auditors.

Audit itself only generated a minority of the income of these firms. 67% of the interviewees who answered a question about the audit share of the firm's income told us that audit revenue was only 20% or less of total revenue. For 89% of these interviewees, their audit revenue was 30% or less of their total revenue.

Audit revenue as a % of total revenue	Non-PIE auditors (39 interviewees)
0%	1[30]
<10%	9
11-20%	14
21-30%	8
>30%	4
Not stated	3

[30] Audit revenue is 0% because this firm had left the audit market.

4.11.3. Profitability of audit services

Most firms saw audit as being less profitable than other services, a view held by almost 60% of the larger, non-PIE audit firms.[31] However, 40% of the same sample of firms thought that auditing was becoming more profitable, for their firm, as they improved their client base.[32]

Several firms said that they were able to increase fees for new clients but found it harder to do this for existing clients.

Firms mentioned factors that drive profitability down, including:

- staff shortages causing firms to increase their salary offers to new staff, with knock-on effects on salaries for existing staff
- increasing amounts of work having to be done on each audit, due to increasing reporting requirements
- problems in recruiting and retaining audit seniors had skewed audit workforces towards more junior staff, with the additional training costs and inefficiencies that this entails

Ideas for reducing the cost base were thin on the ground. Some firms mentioned technology as a way to improve productivity and drive down costs in future, but the consensus was that this is not yet a reality (although it may become so in the future).

4.11.4. Changes in client turnover

We asked the larger, non-PIE audit firms whether they had experienced an increase in client turnover. The results were neutral, with just over half [33] of the firms that commented on this issue saying there had been no significant increase and just under half saying there had been. More interestingly, in all except one of these cases the increase in turnover had occurred because the firm had actively reviewed its client base.

4.11.5. Firms' plans to consolidate

Consolidation was seen by some firms as a way to spread overhead costs across a wider chargeable base. A quarter[34] of the firms that expressed a view said that they would consider consolidation with another firm, while about one in six firms would not rule it out. For the larger, non-PIE audit firms, just over half of the firms that expressed a view would either consider consolidation or would not entirely rule it out.

Firms' preferred route to consolidation was to acquire another firm or firms to take them over, but not to participate in an equal merger or in a subordinate role. Potential drivers for consolidation included:

- need for economies of scale / expanding the chargeable base
- retirement of key people
- acquiring future partners or skilled staff, or both

There was less interest in consolidation as a route to acquire new clients, with some firms commenting that such clients might not remain with the firm for long.

[31] 12% of the larger, non-PIE audit firms thought audit was more profitable and 29% equally profitable compared to other services.

[32] This 40% applied across the whole sample of firms, irrespective of how they had answered the question about overall profitability

[33] 8 out of 15 firms.

[34] 7 out of 29 firms.

"We are approached by consolidator firms quite regularly; they are crying out for firms like ours in [our area]."

"Mergers rarely work due to culture clashes. We have acquired sole practitioners over the years, we just take the work off them and I become the RI. The first year can be a challenge because the files are rarely compliant. But the clients drift away and 2-3 years later half the clients have gone and you're left with staff that you wouldn't have hired."

"We have a good record of integrating acquisitions because we try to put our own partners in."

4.11.6. Firms' plans to exit the non-PIE audit market

Only 5% of respondents to the wider survey of all non-PIE firms said that they expected to exit the market for audit services in the next few years, with another 6% expecting their audit revenue to shrink.

A full analysis of the responses provided by the firms expecting to exit the non-PIE market is at **Annex D,** along with summaries of brief interviews with six firms that have exited or plan to exit. Firms' reasons for exiting were wide-ranging, and included:

- inability to attract audit staff (several firms)
- inability to charge clients at acceptable fee levels (several firms)
- increased regulation (two firms)
- difficult to get audit work (one firm)
- audit not part of core work (one firm)
- retirement (one firm)

40 firms out of 94 answered a more conditional survey question: "If you foresee exiting auditing, please indicate why" with responses including:

- standards / regulation becoming too challenging (20 firms)
- retirement of key audit partners (14 firms)
- small number of audits not cost-effective (7 firms)
- lack of business (2 firms)
- consolidation (1 firm)

4.12. Firms' suggestions for improvement

We asked interviewees "Are there areas where regulatory support would help your firm to expand or stay in business as auditors?" Most interviewees interpreted the question quite widely and offered a range of suggestions to improve the market generally.

<u>Auditing and accounting standards</u>

The view most commonly expressed by both groups of non-PIE auditors[35] was that the standards should be tailored and simplified for their main clients, i.e. the small owner-managed businesses (OMBs). Points included:

- completing checklists for issues that were not relevant for OMB clients took time that could have been better spent in assessing the "real risks" that were relevant to these clients

[35] By 16 of the wider group and one of the larger, non-PIE firms.

- The scope of audit continued to expand into areas where auditors had no particular expertise, such as carbon emissions, increasing audit workloads.
- A view expressed by [one/ two/some] of the respondent[s] was that when one of the Big 4 get something wrong "*extra work rolls down to us*".

"Regulations should be tailored more towards the mass of audit clients, which are non-PIEs, rather than towards PIEs as now."

"The level of audit responsibility is out of proportion to the size and nature of the clients we carry out audit work for and the requirements are in some respects counter-productive to carrying out an effective job in the SME marketplace."

"Too much time spent making files compliant with poor standards is sucking resource from thinking about real issues."

"Does the FRC consult sufficiently before introducing new standards? UK tends to add things to EU requirements, not reduce them."

"They (regulatory changes) haven't delivered anything to our clients except fee increases."

However, a couple of firms put a different point of view:

"Increased regulation means increased work, but there does need to be regulation. Lighter touch regulation sounds attractive, but would that regime become a bit of a joke, a poor relation? Where are the boundaries? How to transition? You have to have the same regulations for everyone."

Education and best practice support

A similar number of firms[36] made suggestions around providing education and support.

The most common request was for guidance on best practice in areas that firms find problematic, for example:

- adapting to new regulations such as ISA 315
- reviews and recommendations on the best technology products
- more precise guidance on how audit standards should be interpreted, for example regarding materiality, sample sizes, in order to satisfy regulators
- providing more clarity on future regulation, so firms and software providers can plan ahead
- providing more precise guidance on ethical boundaries

Several firms said that different regulators – the FRC for PIE auditors, and the RSBs for non-PIE auditors – had different interpretations of the same standards, and they wished for greater consistency across regulators on issues such as the grading of files, sample sizes and materiality levels. They also highlighted inconsistencies in the rules for registration of Ris across different RSBs.

Other points included:

- share the results of successful remedial work arising from reviews of other firms, so all firms could learn lessons from them
- liaise more closely / put pressure on software providers to ensure their products reflected best practice and responded more quickly to regulatory changes

  "Courses and regulatory visits are not enough – there is not a lot in between."

[36] By 11 of the wider group and five of the larger firms.

"We would like clearer guidance on materiality and sample sizes – we over-audit to be safe."

"The audit standards are too vague and firms have to interpret them themselves."

<u>Ways that regulators could be more helpful</u>

Several firms cited possible improvements in:

- speeding up review and investigation processes and taking less of senior staff time
- responding more quickly to administrative issues, providing feedback more quickly

"It was fairly painful dealing with [a regulator]. They didn't engage until two weeks before the deadline, then they said a signature was out of date after not responding for 3 months."

"Investigations go on for far too long, with a cloud hanging over the people being investigated."

"ICAEW is proactive, helpful and consultative, we get value from the relationship."

<u>Other suggestions</u>

"Consider relaxing the requirement that more than 50% of the partnership must be audit registered."

4.13. Illustrations from specific firms

4.13.1. Sole audit partner

This small firm has an annual turnover of about £2m, of which about 10% is audit.

We interviewed the audit partner / sole RI, who is looking to grow audit services by 50% a year "in a managed way", from a mix of new clients and fee increases. They see plenty of opportunity, mainly due to "big firms shedding audits." However, regulation is a serious concern.

"I live in fear of the QAD [Quality Assurance Department of ICAEW] visit….. 'I'm constantly looking over my shoulder'….. 'The burden of being an RI is massive'….. 'I manage all the quality myself; I have no-one else to blame'…… 'My fear is that somehow I've missed something regulatory, that doesn't impact on anybody".

This partner is committed to audit – *"Audit has never been attractive to most people but I do love my job."*

4.13.2. Winning business

This small- to medium-sized regional firm offered 'general practice' services, including accounts and tax, with about one third of its fee revenue coming from audit. They sensed a major opportunity in growing their audit practice – *"Too few firms, too few staff, too many clients"* – but at times were *"hanging on by our fingernails"* due to difficulties in recruiting staff as they expanded.

Their costs of winning business were negligible – they did not incur marketing costs and "*I can't remember the last time we had to tender for an audit."* New work came to them mainly from networks and contacts, with whom their reputation for good quality audits was pivotal. Two sources of work stood out in particular: smaller local firms that were ceasing to act as auditors; and larger firms that were *"driving clients away with a combination of higher fees and poor service."*

They could choose which clients they wanted to take on and saw themselves as being risk averse in this area – *"Some clients just desperately want an auditor, at any price, and those are the ones you want to avoid."*

4.13.3. Impact of staff shortages

This small- to medium-sized regional firm prided itself on quality, comparing its own standards favourably with those of other firms as evidenced by working papers that they had seen – both from larger and smaller competitors. They were the only firm that made any positive comments about ISQM1 (International Standard on Quality Management 1), which they said had caused them to improve their audit processes, staff appraisal systems and ethical guidelines.

They perceived a threat to audit quality due to a lack of experienced senior staff, which had caused them to ‘grow their own’ auditors. They had developed a bottom-heavy organisation structure, with higher numbers of trainees and lower numbers of experienced auditors and managers, many of the latter having moved to non-audit work or having been poached by larger firms.

Senior staff now spent more time on training junior staff, which reduced the hours they had available for chargeable work. Their chargeable hours could also be less productive due to time spent mentoring less experienced staff members.

4.13.4. Adopting technology

This small- to medium-sized regional firm prided itself on keeping up to date with technology – *“tech is becoming more accessible for firms like ours.”* They had moved to “electronic auditing” some 15 years ago and updated their software and audit methodology (from one of the main providers) regularly. They had enthusiastically adopted online auditing, which they saw as both reducing audit costs and giving staff more opportunities to work from home.

The firm’s next major expenditure was likely to be on data analytics. They anticipated that this would be of limited use for some of their audit clients, whose accounts were relatively unsophisticated, but they saw major opportunities in selling non-audit / business consultancy services based on data analysis to clients. They recognised the ethical issues that this might involve and planned to introduce more rigorous separation between their business consultancy and audit teams.

5. Future scenarios and further work

5.1. Introduction

In this section we consider the implications of our findings for the future of the PIE and non-PIE audit markets, and for future research that could shed further light on the issues. This section, unlike the rest of our report, is not based directly on what firms have told us, though we have included comments from the firms where relevant.

5.1.1. The future of the audit market generally

Most of the firms that expressed a view were pessimistic about the future of the market.

"(There is) likely to be increasingly less choice for companies in the future as firms consolidate or exit market."

"These feel like unprecedented times to me (with nearly 30 years in the industry) and there is a danger that with a combination of more regulatory pressure and less resource, the industry will get into a downward spiral that will be hard to reverse."

However, some firms saw increased opportunity for themselves, both now and in the future.

"The audit market remains buoyant for those firms which have invested in people over the last few years, with many opportunities arising from large audit firms' capacity and regulatory challenges."

Some firms anticipate the PIE and non-PIE audit markets moving further apart, due to:

- different regulatory standards being applied to the two markets
- different types of staff being attracted to the two markets
- only the very large firms having the resources – mainly skills and technology – to manage large, complex audit clients to the regulator's satisfaction

"There is a huge difference between the market that we are in (almost all clients are "small") and that which the "Big Six" etc operate in, and there should be greater acknowledgement of that in terms of legislation and requirements."

"We don't believe an audit firm can mix PIE and non-PIE audit very easily because of the overarching regulatory environment for PIE [audit] which makes non-PIE audit unworkable (in terms of) work required, cost implications and fee expectations of non-PIE clients."

"It needs to be larger firms that take on the PIE audits as they can afford the technical backup within the practice to take on the necessary regulation and be able to cover the cost. The smaller practices will then inevitably deal with non-PIEs, some of which are large audits in themselves."

Some firms predict that clients will increasingly experience difficulties in finding auditors, especially in certain sectors (notably charities) and certain geographies (notably parts of Scotland). The intersection of charities and Scotland was perceived as being especially difficult because the audit threshold of £500,000 turnover is half of the threshold required for the rest of the UK (£1 million turnover).

"For smaller audit entities, particularly charities, there is a mismatch between the level of work needed to conduct a compliant audit and the fees that these clients are able to pay e.g. £1 million charities require an audit but expect a lower audit fee. This doesn't correlate to the complexity of those audits in terms of their activities, and the governance and reporting requirements. I foresee that

some small charities will either not be able to find auditors or will be required to pay significantly more than they can afford."

There is evidence that some of the limiting factors mentioned above are getting worse, which could further impact on choice, competition, and quality in some areas of the market.

"I worry that audit is no longer seen as an attractive career which is leading to a brain-drain as graduates choose different career paths, while newly qualified and more experienced auditors leave the profession."

5.2. Barriers to growth in audit supply

Firms identified staffing constraints as the main barrier to growing their audit operations and expected them to continue.

"Who are the managers and RIs of the future? What happens when the existing RIs retire? The profession is not attractive to younger people who value work life balance and are less career focussed. This is a huge issue in the coming years."

Most firms did not see technology as being able to significantly reduce staffing needs by increasing productivity in the near future.

"Software and methodology providers for mid-tier lack competition and do not deliver efficient products. If these products were better, then audit firms could take on more work without compromising quality (which is the key concern)."

"Time costs of audit are increasing with additional regulation and therefore the additional work needed, and technology is assisting with some efficiencies, but the tech prices increase dramatically once you've passed your first year (and are essentially tied to that piece of software), so any savings achieved from tech efficiencies are soon eroded."

5.3. Future of the PIE audit market

Most of the PIE audit firms that we researched were reluctant to take on a significant amount of new PIE audit work. However, there were some hopeful signs:

- the firms that were already well established, with more than ten PIE audits, were keen to grow their PIE audits further, subject to staffing constraints
- some interest in MSA
- some interest in working more closely with the FRC

"I worry that there is a serious lack of appetite amongst our peers to compete in the PIE space, which will seriously undermine some of the keystone policies of audit reform as currently planned."

"At the minute it looks like the recent changes will actually drive down competition as less firms are now registered. However, this may help quality in the short term."

"I worry greatly that the level of regulation will stifle the market, and competition will gradually reduce."

The two private equity companies that we interviewed were either interested in or already involved in the non-PIE audit market. However, they had little interest in PIE auditing and saw the regulatory regime as a barrier.

One of the certification providers that we interviewed expressed an interest in the non-audit market but would have to draw resources from existing firms.

The PIE audit market may itself be expanding, subject to Government reforms.

5.4. Future of audit fees

If audit prices are a function of supply and demand, the evidence suggests that fee increases may continue, because:

- on the demand side, firms expected the trend towards increased regulation and the roll out of large firm / PIE quality standards to the rest of the market to continue; if audit thresholds remain unchanged, inflation will bring more clients into the audit market
- on the supply side, the shortages of experienced auditors and managers were widely perceived to be an increasingly serious challenge

Recent experience of procurement in the local audit market indicates that:

"Generally there are fewer firms competing for an increasing workload therefore audit tenders are becoming more realistic in terms of the fee that can be achieved."

5.5. Future of choice and competition

"Firms dropping out of audit, for whatever reason, makes the remaining pot of clients easier to pick up."

Firms have told us that they feel more empowered, given the current balance between supply and demand, to shed clients that no longer fit their requirements for profitability, risk profiles and preferred market sectors.

Most firms feel more able to charge higher fees to new clients than in the recent past, due to a shift in the balance between supply and demand.

"Strong client demand but a lack of employee resources across the market is driving up salaries and making it difficult to be able to resource new work. When potential clients are approaching us, it is clear they have been turned down in many cases by firms due to lack of capacity."

Current market dynamics may in time alleviate some supply issues, as higher fees supporting higher salaries creates the potential to attract new auditors into the market (firms and employees).

GLOSSARY

Acronym	Description
ACCA	Association of Chartered Certified Accountants
AC	Audit Committee
AIM	Alternative Investment Market
CEO	Chief Executive Officer
CFO	Chief Financial Officer
ESG	Environment, Sustainability and Governance
FD	Finance Director
FTSE	Financial Times Stock Exchange index of the companies listed on the London Stock Exchange with the highest market capitalisation
FRC	Financial Reporting Council
ICAEW	Institute of Chartered Accountants in England and Wales
ICAS	Institute of Chartered Accountants Scotland
ISA	International Standards on Auditing: a framework of professional standards for auditing financial statements.
ISO	International Organisation for Standardisation: a voluntary organisation whose members are recognised authorities on standards
ISQM	International Standard on Quality Management
MSA	Managed Shared Audit
NAO	National Audit Office
NED	Non-executive Director
Non-PIE	An organisation that is not a Public Interest Entity
PE	Private Equity
PIE	Public Interest Entity
PII	Professional Indemnity Insurance
OMB	Owner-managed Business
QAD	The Quality Assurance Department of the ICAEW
RI	Responsible Individual, responsible for audit work and signing audit reports
RSB	Registered Supervisory Bodies: professional accountancy bodies to which the FRC has delegated certain tasks concerning the regulation of statutory audit
SME	Small to Medium Enterprise

ANNEX A: Conceptual framework

The design and approach to the research in this report has been supported by a conceptual framework developed by Frontier Economics. This Annex sets out the conceptual approach adopted for exploring competition in the PIE and non-PIE audit markets, which provided a framework from which to design research questions.

Entry, growth and exit in the markets for smaller PIE audits and non-PIE audits

The objective of the research was to better understand entry, growth and exit in the markets for smaller PIE audits and non-PIE audits. In order to do so we first considered the conditions under which markets may not be competitive and well-functioning. The Competition Commission (the predecessor to the CMA) has established guidelines for market investigations that sets out the features of a market that may harm competition, which underpinned the CMA's analysis in their statutory audit market study (and all other investigations).[37] The guidelines set out potential features of a market that could influence competition that include:

- unilateral market power;
- barriers to entry or expansion;
- coordinated conduct by firms;
- vertical relationships; and
- weak customer response.

The issues raised in previous analysis of the audit market have primarily been focussed on barriers to entry or expansion and weak customer response (i.e. the demand-side of the market). However, demand-side factors were less relevant for this research, given the objective and scope of the exercise was more focussed on exploring potential issues in the *supply* of audit services.

Focusing on costs and barriers to entry and expansion, the Competition Commission guidelines explain that there are three broad categories which may be relevant, and which we considered:

1. **Natural or intrinsic barriers**, which cover the unavoidable costs of entering a market (e.g. building a production facility, acquiring IP), economies of scale, network effects and switching costs.
2. **Barriers due to first mover advantages**, which includes investments by incumbents that disadvantage potential entrants and increase risk (e.g. lowering incumbent costs, or cost structures of entrants or changing conditions for demand through branding). First mover advantages such as customer loyalty and reputation can have similar effects.
3. **Regulatory barriers**, which arise particularly where there is disproportionate effect on new entrants or smaller firms – common when compliance is a fixed cost of doing business.

All three of these categories have been under consideration in the audit market by regulatory bodies and external commentators in recent years. Questions have been raised including in relation to the role of regulation (and changes to regulation), the cost and risk of entry and potential economies of scale, and potential barriers due to first mover advantages of incumbent firms.

In designing the framework we believed it was important to explore (particularly for research into the PIE market) the nature of any strategic advantages (or 'distinctive capabilities') that some audit firms could potentially hold over others.

[37] Competition Commission, Guidelines for market investigations: Their role, procedures, assessment and remedies, 2013

We consider that strategic advantages, which are necessary for companies to compete in a market, could potentially derive from:

- **architecture**, which covers the ways in which a firm is organised and the people within the firm (i.e. human capital);
- **reputation and brand**, which covers the perception of the firm held by potential customers and how this affects competition for non-price factors such as quality;
- **innovation**, which encompasses the capacity of a firm to innovate successfully; or
- **strategic assets** held by the firm, which may be important inputs to compete successfully in the market that are available to a firm, and not to rivals.

It was therefore important for the research questions to explore each of these potential areas.

We considered that it would be beneficial for the research to also explore the existence and nature of any strategic advantages, including questions such as:

- Do individuals within audit firms have human capital that is scarce and valuable? Why is it difficult / costly for others to acquire it? What drives individuals to move from incumbent firms to smaller firms?
- Does the brand / reputation of incumbent audit firms provide advantages that are separable from the personal reputation of the relevant individuals who work within them?

Extensions to explore the economics of non-PIE audits

The framework above was considered applicable for both PIE and non-PIE audit firms, given the broad similarities in the work that they undertake (at a high level), and given that in some cases firms may undertake both PIE and non-PIE audits.

In addition to exploring barriers to effective competition, the research scope also sought to explore the economics of non-PIE audits, and the potential drivers of trends including the decline in the number of audit firms. To do this, starting from the demand side, we considered that the dynamics of the non-PIE audit market could be affected by changes to the market size or changes to market needs. Changes to market size may reflect either a change in the number of businesses that demand non-PIE audit services, or the market-wide price for non-PIE audits. This could be driven either by market-based factors such as a lower propensity of companies to demand audit services, or regulatory-based factors such as an increase in the audit exemption threshold. Changes to market needs could reflect whether audit consumers change what they are looking for when purchasing audits, for example considering non-price factors such as brand.

Regarding the supply side, there were two specific changes that could have impacted volumes that we felt it was important to explore. Whether:

- the market changed over time such that the relative importance of any sources competitive advantage has changed; and
- there has been a change in technology which may affect the cost of delivering audits.

Changes to the relative importance of competitive advantages could be driven either by market-based factors such as increasing complexity of company audit, for example due to innovations in the structure of companies, or by regulatory-based factors, for example more stringent requirements and processes which must be completed to sign-off an audit. These changes have the potential to increase the strategic advantage of companies in two ways: first, they may favour companies which are better able to leverage or acquire any scare resources needed to address this change, for example recruiting or training specialist staff, or fostering the changes in culture required; and second, they may advantage companies with larger scale in cases where changes increase scale economies.

Changes to technology could also affect the unit economics of non-PIE auditors, for example by changing economies of scale and the sources of competitive advantage. A company with a legacy first mover advantage, potentially due to an old piece of technology which has been made obsolete or less effective, will need to regain its strategic advantage to remain competitive in light of technology changes.

In principle, such changes could manifest in the economics of audit firms through, for example, rising unit / investment costs or falling demand and reductions in successful tenders.

Non-PIE audit firms could respond to changes in market dynamics in a number of ways:

- **Transform**. This action would see non-PIE audit firms investing capital into acquiring and developing sources of strategic advantage, e.g. through bolstering their brand and reputation, hiring specialist staff or reducing their overall costs to undertake audits.
- **Consolidate**. This action would see non-PIE audit firms look to partner or acquire the resources, brand and assets of competitors in order to exploit synergies related to scale, expertise or technology.
- **Exit**. This may occur if companies are unable to or unwilling to consolidate or transform as required, due to economic and non-economic reasons. Exit can be rapid, either through a dissolution or liquidation of the company, or gradual whereby the company reduces the intensity with which it bids for new audits, fails to adapt to changing market needs and slowly declines.

In general, the choices that companies make will be driven by their perception on whether they can compete in the market in light of changes in supply and demand. Therefore, we considered that it would be important to explore how perceptions have influenced the decisions made, as this would be important for understanding the changes in the non-PIE audit market overall, and to the economics of the firms that continue to operate within it.

The research framework

Following the reasoning described above, we developed a framework describing the main issues to explore with firms. This framework was subsequently used as the basis for developing the set of questions for the interviews and surveys with audit firms that formed the basis of the research.

The research framework used to explore competitive dynamics in PIE and non-PIE audits

<table>
<tr><th></th><th>Appetite to enter or expand</th><th>Sunk cost, economies of scale, costs of expansion</th><th>Brand and reputation</th><th>Human capital</th><th>Relationship effects</th></tr>
<tr><td>Issues to explore</td><td>▪ The extent to which firms are interested in entering / expanding.
▪ Underlying reasons: opportunity cost for other work, impact on the firm (i.e. reasons distinct from the barriers explored in other issues).</td><td>▪ Nature and extent of costs incurred in entering / expanding (technology, insurance…).
▪ Recoverability of costs.
▪ (Perceived) relative cost for incumbents compared to new entrants</td><td>▪ Lack of brand / reputation as a barrier.
▪ Difficulty in building brand / reputation.
▪ Separation of brand of firms from e.g. reputation and value of individuals.
▪ The extent to which firms believe competition is based on price and quality
▪ The challenge of signalling quality and the role of brand and reputation</td><td>▪ Scarcity of senior staff and relationship to complexity of audits.
▪ Scarcity of junior staff.
▪ Means of developing human capital in-house.
▪ Challenges in acquiring human capital, especially from large audit firms.</td><td>▪ Extent to which there are opportunities (or not) to bid for audit work.
▪ Reasons for opportunities: people, brands, non-audit work etc.</td></tr>
<tr><td>Relevance to current audit firms</td><td>▪ Their appetite to expand</td><td>▪ Capacity to expand and compete cost effectively</td><td colspan="3">▪ Firms currently in the audit market will be considering whether they can build on or develop factors that are currently scarce, or acquire them through their own investments or via mergers and acquisitions.</td></tr>
<tr><td>Relevance to firms looking to enter the market</td><td>▪ Their interest in entering (and reasoning for why not as distinct from challenges covered elsewhere)</td><td>▪ Costs and risks of entry</td><td colspan="3">Firms looking to enter the market will consider their ability to:
▪ acquire the scarce factors needed to gain competitive advantage; and
▪ modify the business to gain scarce factors (e.g. technology and brand investments).
▪ compete with others on price and non-price factors.</td></tr>
<tr><td>Relevance to</td><td>▪ Extent to which the audit market is within their mandate, they</td><td colspan="4">▪ How acquisition would affect the extent to which the acquired audit firm is able to successfully compete.</td></tr>
</table>

	Appetite to enter or expand	Sunk cost, economies of scale, costs of expansion	Brand and reputation	Human capital	Relationship effects
potential investors	could deliver growth and sufficient IRRs	▪ For example, does access to the skills / capital of investors make it easier to build brand and reputation or acquire human capital? Are there unintended consequences to acquisition – e.g. making it harder to retain non-partner staff who may have reduced prospects.			
Amended PIE regulation	▪ Explore the extent to which this changes factors influencing appetite.	▪ Explore the extent to which the proposed definition will change entry and expansion cost as well as the size of economies of scale.	▪ For relevant firms, explore the extent to which the proposed definition will change: ○ the scarcity of each factor or the required scarcity. E.g. whether it reduces complexity of audits, and the skills / experience required and their ability to obtain that factor. ○ The segments of the market which are contestable without significant sunk costs and investments in acquiring scarce factors		
Wider regulation	▪ Explore the extent to which regulation affects factors influencing appetite to enter and expand	▪ Explore the extent to which each key regulatory requirement affects sunk and expansion costs. ▪ For example, new requirements for audits may reduce expansion costs.	▪ Explore the extent to which each key regulatory requirement changes the scarcity (or necessity) of each factor. Relevant regulation may potentially include: enforcement and fines, 'cliff edges', audit firm governance code and any others brought up by interviewees / respondents. ▪ For example: Does the audit firm governance code change the seniority / experience of staff required to conduct the audit? How difficult has it been hiring or training staff? What are the difficulties you've faced in doing so?		
Wider market trends	▪ Explore whether e.g. changes in the nature of the work affects appetite, and how firms see this evolving.	▪ Explore whether changes to technology will affect expansion costs and / or increase economies of scale	▪ Explore the extent to which changes in technology and reputational damage to larger auditors are changing the sources of scarcity for audit firms or the perception of what buyers of audit services look for.		

ANNEX B: Findings mapped to hypotheses

The Conceptual Framework in **ANNEX A** set out a number of hypotheses to be investigated. Our findings for each set of hypotheses are set out below.

The Conceptual Framework applied to both PIE and non-PIE audit firms, with further hypotheses added for the non-PIE market. Hypotheses were grouped by topics as below.

Topic #	Topic[38]	PIE Research	Non-PIE Research
1	The appetite of firms to enter the market or expand their presence there	■	■
2	The upfront costs of entering or expanding in the market	■	■
3	The costs of winning new business	■	■
4	Difficulties competing profitably due to a lack of a sustained strategic advantage	■	■
5	Response to the proposed government reforms to the PIE audit market	■	■
6	Demand and supply issues in the non-PIE audit market		■
7	Impacts on firms' business models of changes in the non-PIE audit market		■
8	Implications for choice, competition and audit quality in the non-PIE audit market		■
9	Any other factor or barrier that firms want to raise	■	■

Hypotheses for the PIE audit market

Topic #1: Firms' appetite to expand their presence in the PIE audit market

"There are firms who do not have the appetite to expand their presence in the PIE market."

[38] Topics 1-4 are potential barriers to entry and expansion while the others are summaries of the results of our research.

Hypothesis	Authors' comments
.6. Expansion would require undesirable changes in the firm or work (e.g. culture, work life balance, nature of the work etc).	This view was held by some of the PIE and most of the non-PIE auditors. Auditing was perceived as being harder work than other accounting services, and PIE auditing was widely considered to be more onerous than non-PIE auditing.
.7. There is a high opportunity cost to expansion, by crowding out more profitable streams of work, either because of regulation or because of time / attention required to succeed.	This view was held by most of the firms that did not already have a strong presence in the PIE market. Most firms said that they could easily find other, less challenging audit work.
.8. Firms are unwilling to take on additional risk.	Firms were not completely unwilling to take on risk, but they reviewed risks carefully and weighed up risks and rewards for any new audit client. The additional risks associated with PIE audits, especially reputational risk and the risk of regulatory penalties, were seen as a factor that limited their willingness to take on PIE audits in general.

Topic #2: The upfront costs of entering or expanding in the PIE audit market

"The upfront costs of expanding in the market are high due to sunk costs and (lack of) economies of scale".

Hypothesis	Authors' comments
Some sunk costs are non-recoverable, such as marketing and recruitment fees or specialist IT development and integration fees, which are large and prevent businesses from entering the market.	Firms did not mention these as being significant costs, but most firms believed that significant elements of staff costs would be unrecoverable because they would need different, more expensive staff with different skills to do PIE audits. Several interviewees thought that these staff could be used for non-PIE audits, but not always cost effectively, because different skills were required for PIE audits compared to smaller, owner-managed businesses.
The presence of non-price competition (e.g. competition on perceived quality) may require significant upfront capital to invest in non-price aspects.	See above.
There are economies of scale, meaning the average cost of undertaking an audit decreases as the number of audits undertaken by the firm increases.	Many interviewees believed that this was the case, because a larger base of chargeable work made it easier to recover overheads generally, while the investments required to enter the market for larger PIE audits needed a critical mass of PIE audits to make them worthwhile.

Hypothesis	Authors’ comments
Professional indemnity insurance (PII) costs are substantially higher for smaller firms, compared to larger firms.	We found no evidence for this. Several interviewees said that PII costs were driven by riskier audits (including some PIEs but that would apply as much for large firms as smaller ones), and riskier activities such as personal tax, rather than being driven by the size of the firm.

Topic #3: The costs of winning new business in the PIE audit market

“**The costs of winning business (in the PIE audit market) are too high.”**

Hypothesis	Authors’ comments
The cost of winning new business (e.g. submitting responses to tenders) is higher for new entrants or smaller players.	We found no evidence to support this.
The cost of producing tenders for new clients and market segments may be higher initially.	Many interviewees said that it cost more to produce tenders for unfamiliar sectors and clients.
Tender costs may not be fully recovered by embedding them in the price charged of all tenders.	Interviewees said that tender costs were mainly non-chargeable and would be recoverable, if at all, as overheads. Some firms managed to set fees to fully recover overheads, while others did not.

Topic #4: Difficulties competing profitably in the PIE audit market, due to a lack of a sustained strategic advantage

The overarching hypothesis in the conceptual framework was:

“It is difficult to compete profitably in the market due to a lack of a sustained strategic advantage. New entrants or existing small auditors are less able to compete successfully (i.e. have a lower probability of winning a tender) due to the absence of important, but scarce factors.”

This hypothesis is broken down as follows:

- Human resources
- Technology
- Brand and reputation
- Relationship effects

Topic# 4.1: Human resources

It is difficult to compete profitably in the PIE market due to a lack of a sustained strategic advantage as regards human resources.

“Running a successful audit requires experienced auditors and teams. Experienced partners are required to manage and deliver audits; the more complex the audit, the smaller and scarcer the pool of individuals who are able to manage them.”

Hypothesis	Authors’ comments
There is a potentially limited pool of auditors which mean hiring them may be very difficult for small audit firms or potential entrants.	This was the main barrier to firms’ expansion.
The human capital required to manage the most complex audits can only be developed through direct experience of such audits, limiting the ability of challengers to directly build their own human capital. This will include exposure to audit methodologies but also technological advancements that can increase the effectiveness of audits.	Some interviewees said that there were different methodologies for PIE and non-PIE audits, and that some commonly used software packages had not been adapted to handle PIE audits. Most firms said that they would have to buy in PIE experience, rather than attempting to grow it in—house.
There are barriers to smaller auditors / potential entrants being able to hire either partners or other senior staff with scarce human capital.	Several firms told us that they were able to hire partners and senior staff with PIE audit experience skills – however in some cases these staff were seen to be moving to smaller firms to get away from larger PIE audits.

Topic #4.2: Technology and methodology

It is difficult to compete profitably in the PIE market due to a lack of a sustained strategic advantage as regards technology and methodology.

We found limited evidence for this hypothesis. Some firms said that there were different methodologies for PIE and non-PIE audits, and that some commonly used software packages had not been adapted to handle PIE audits. Technology was not mentioned as a limiting factor by any of the PIE auditors, but it was mentioned by 50% of the non-PIE auditors that responded to the survey.

Topic #4.3: Brand, reputation and quality

It is difficult to compete profitably in the PIE market due to a lack of a sustained strategic advantage as regards firms’ brand and reputation.

Hypothesis	Authors’ comments
Brand and reputation. Larger audit firms may have strong brands that are a necessary signal that they have sufficient capacity / expertise to deliver the audits and otherwise lower the perceived risks associated with choosing an auditor. This is crucial in cases where the choice of audit is dependent on non-price factors such as perceived quality.	PIE and non-PIE auditors believed this to be the case, although some of them thought that the power of the large firm brands (and their reputation for quality) was beginning to decline.
Corporate brands and reputations take decades to build and are difficult to achieve or replicate.	We found no evidence for this amongst the firms that we interviewed, which did not include the larger PIE auditors.
The corporate brands and reputations are distinct from the individual value / brands of specific senior staff and so cannot be acquired by challengers / potential entrants e.g. by directly hiring such individuals.	Some interviewees thought that their firms could quickly gain credibility by hiring individuals with the right expertise.

Hypothesis	Authors' comments
Corporate brands can be specific to a certain sub-segment of the market which may be difficult to replicate (e.g. we are the auditor for industrial SMEs in the North West).	Some PIE auditors said that they had developed known brands in specific (smaller) sub-sections of the PIE market. In the non-PIE market, many interviewees mentioned their local and regional firm / personal networks as an important source of new work, and in several cases said that these took time to develop.
Brand and reputation are used as important signals of quality. As costly signals small firms find it difficult to compete on quality even if they have equal or better services. Alternatively, if all firms struggle to signal quality competition is focused primarily on price.	Several PIE auditors have argued that PIE clients hire Big Four auditors for reasons other than perceived audit quality, such as to signal their own ambitions and importance.

Topic #4.4: Networks and relationships

It is difficult to compete profitably in the PIE market due to a lack of a sustained strategic advantage as regards networks and relationships.

Hypotheses	Authors' comments
Some larger auditors are able to access opportunities to bid for audit work that existing firms and potential entrants are unable to access.	Several of the smaller firms that we interviewed were unable to access opportunities to bid for audits in certain sectors of the market, especially the larger PIE audits.
Opportunities arise in the form of connections that partners (or other staff) have built with those commissioning audits.	Several interviewees cited the importance of networks and connections in winning audit work.
Opportunities arise because of the non-audit work undertaken by larger auditors.	See above.

Hypotheses for the non-PIE audit market

Topic #1: Firms' appetite to expand their presence in the non-PIE audit market

"There are firms who do not have the appetite to expand their presence in the PIE market".

Hypothesis	Authors' comments
There are firms who do not have the appetite to expand their presence in the market.	Some interviewees said that their firms did not have an appetite to grow their audit practices, but far more of them did have an appetite to do so. The firms that we spoke to were sufficiently interested in the audit market to take part in the research , so they may not be a representative sample for testing this hypothesis.
Expansion would require undesirable changes in the firm or work (e.g. culture, work life balance, nature of the work etc).	Some firms were reluctant to take on additional audit work because they saw it as being unpopular with staff, compared to some non-audit work.
There is a high opportunity cost to expansion, by crowding out more profitable streams of work, either because of regulation or because of time / attention required to succeed.	This appeared to be true for the PIE market, but not for the non-PIE market. Most firms wanted to expand as far as human resources allowed it. Many of them were able to easily and inexpensively win new work and reported being able to set higher fees for new clients as opposed to existing clients.
Firms are unwilling to take on additional risk.	There was no indication of this being a significant issue in the non-PIE audit market.

Topic #2: The upfront costs of entering or expanding in the non-PIE audit market

"The upfront costs of expanding in the market are high due to sunk costs and (lack of) economies of scale".

Hypothesis	Authors' comments
Some sunk costs are non-recoverable, such as marketing and recruitment fees or specialist IT development and integration fees, which are large and prevent businesses from entering the market.	Many firms perceived significant costs being associated with expansion, but saw them as being largely recoverable.
The presence of non-price competition (e.g. competition on perceived quality) may require significant upfront capital to invest in non-price aspects.	Firms did not cite this as a particular issue in the non-PIE audit market.
There are economies of scale, meaning the average cost of undertaking an audit decreases as the number of audits undertaken by the firm increases.	This was an issue for some smaller firms that had only a few audit clients.
Professional indemnity insurance (PII) costs are substantially higher for smaller firms, compared to larger firms.	PII costs were not seen as an issue by most firms. Several firms mentioned personal tax services as a more significant driver of PII costs than audit services.

Topic #3: The costs of winning new business in the non-PIE audit market

"**The costs of winning business are too high."**

Hypothesis	Authors’ comments
The cost of winning new business (e.g. submitting responses to tenders) is higher for new entrants or smaller players.	We found no evidence to support this. The ‘smaller players’ did not report incurring high costs for winning business.
The cost of producing tenders for new clients and market segments may be higher initially.	Firms’ familiarity with particular clients and market segments enabled them to use materials and knowledge that are already in place. However, most firms did not see this as an important issue since most work in this sector was not tendered.
Tender costs may not be fully recovered by embedding them in the price charged of all tenders.	Some firms reported good overhead recoveries through fees, while others did not but most new business was not tendered.

Topic #4: It is difficult to compete profitably in the non-PIE market due to a lack of a sustained strategic advantage.

Topic #4.1: Human resources

Hypothesis	Authors’ comments
Running a successful audit requires experienced auditors and teams. Experienced partners are required to manage and deliver audits; the more complex the audit, the smaller and scarcer the pool of individuals who are able to manage them. There is a potentially limited pool of auditors which mean hiring them may be very difficult for small audit firms or potential entrants.	This hypothesis was intended more for the PIE market, but parts of it apply to the non-PIE market. A lack of experienced auditors and managers was cited as a major limiting factor for expansion in this market.
The human capital required to manage the most complex audits can only be developed through direct experience of such audits, limiting the ability of challengers to directly build their own human capital. This will include exposure to audit methodologies but also technological advancements that can increase the effectiveness of audits.	We found that, within the non-PIE market, many firms were operating within their comfort zones and were avoiding complex audits.
There are barriers to smaller auditors / potential entrants being able to hire either partners or other senior staff with scarce human capital.	Several of our interviewees had themselves come from larger firms and had colleagues that have done so too. The consensus was that it was relatively easy for smaller firms to hire partners who wanted to step away from a ‘big firm’ environment, but much harder to hire audit managers and senior / qualified auditors.

Topic #4.2: Technology and methodology

We considered the hypothesis that lack of exposure to up-to-date technology, and lack of relevant expertise in using such technology, would limit firms’ ability to expand in the non-PIE audit market.

We found no evidence to support this hypothesis.

Topic #4.3: Brand, reputation and quality

Hypothesis	Authors' comment
It is difficult to compete profitably in the market due to a lack of a sustained strategic advantage as regards firms' brand and reputation.	This hypothesis was intended mainly for the PIE market. Most non-PIE auditors were happy with their brands and reputations locally or within their sectors of expertise.
Larger audit firms may have strong brands that are a necessary signal that they have sufficient capacity / expertise to deliver the audits, and otherwise lower the perceived risks associated with choosing an auditor. This is crucial in cases where the choice of audit is dependent on non-price factors such as perceived quality.	This hypothesis was intended mainly for the PIE market. It did not hold for the non-PIE market because many of the smaller firms reported having good reputations locally and being able to win business easily.
Corporate brands and reputations take decades to build, and are difficult to achieve or replicate.	Some of the smaller firms said that they could build brands and reputations quickly, especially in niche sectors such as charities where strong networks existed. One firm was able to establish itself as an auditor of UK subsidiaries of certain international firms within a matter of a few months.
The corporate brands and reputations are distinct from the individual value / brands of specific senior staff, and so cannot be acquired by challengers / potential entrants e.g. by directly hiring such individuals.	This was not the case in local / regional / niche markets, where hiring the right individual could transform the ability of a smaller firm to win business.
Corporate brands can be specific to a certain sub-segment of the market, which may be difficult to replicate (e.g. we are the auditor for industrial SMEs in the North West).	This was very much the case for smaller firms. We did not find evidence as to whether these sub-brands were difficult to replicate.
Brand and reputation are used as important signals of quality. As costly signals, small firms find it difficult to compete on quality even if they have equal or better services. Alternatively, if all firms struggle to signal quality, competition is focused primarily on price.	Competition was reported as being no longer focused primarily on price, but that did not necessarily mean that it was focused on quality. Other factors came into play, especially networks and contacts, recommendations, personal relationships and whether clients perceived the audit partner and team as being people they could work with ('quality from management's perspective' rather than audit quality per se).

Topic #4.4 Network and relationship effects

Hypothesis	Authors' comments
Some larger auditors are able to access opportunities to bid for audit work that existing firms and potential entrants are unable to access.	There were aspects of local markets for owner managed businesses that the larger firms were unable to access at fee levels acceptable to them.
Opportunities arise in the form of connections that partners (or other staff) have built relationships with those commissioning audits.	This was true for many different types of contacts and connections, of which relationships with those commissioning audits was one example.
Opportunities arise because of the non-audit work undertaken by larger auditors.	Several firms used audit work as a route in to winning more profitable non-audit work, rather than vice-versa.

Topic #6.1: Market demand

Hypothesis	Authors' comment
There has been a reduction in market size – either due to fewer firms which require non-PIE audits or clients being less likely to demand non-PIE audits.	Reductions in market size took place when thresholds were reduced. Many firms perceived that their market had grown since then, mainly due to inflation bringing clients above the threshold, and work coming 'down' to their market from larger firms.
There has been a change in market needs – due to clients changing the characteristics they look for in an auditor.	We found no strong evidence for this. However, several firms told us that their audit work and reporting had little relevance to their clients' businesses, and this was seen as increasing as auditing standards continued to change.

Topic #6.2: Market supply

Hypothesis	Authors' comments
There has been a change in the relative importance of competitive advantages – e.g. an increase in complexity of audits requires different (and costly to obtain) skillsets.	Staffing was seen as being increasingly scarce and correspondingly more important, especially as regards experienced auditors.
There has been a change in technology – e.g. investment is required in new IT to deliver audits, with additional costs and an increase in economies of scale.	Technology was seen as changing and firms had very different responses to the changes. Technology, in its current state, was widely seen as offering limited competitive advantages in the non-PIE audit market.

Topic #7: Business models of non-PIE audit firms

Hypothesis	Authors’ comments
Firms are required to invest and transform themselves – the willingness and ability of firms to invest in new sources of strategic advantage and / or invest to improve the unit economics of undertaking audits.	We did not find much evidence of major investment / transformation amongst the smaller firms. Firms were keen to invest in more skilled and experienced staff, where these were available. Most firms were investing in technology, at various rates.
Firms are required to consolidate - the willingness and ability of firms to acquire (or merge with) competitors, as a way to secure or develop new strategic advantages and / or exploit synergies stemming from technology, expertise or scale.	Some firms were consolidating or planning to consolidate, but only a minority. Key motivations included acquiring skilled staff and developing a wider chargeable base to recover overheads from.
Firms feel they must exit the market – whether companies feel they are unable to transform or consolidate to meet the changing market dynamics. (We note this is most challenging to fully explore, and will depend on finding willing participants to discuss their reasoning).	Firms were exiting the market for various reasons as discussed below.

ANNEX C: Firms' suggestions for improvement

PIE audit market

For current and ex-PIE auditors we asked interviewees "Are there any other barriers to expanding the PIE audit market that you would like to mention? Are there any solutions you would like to propose?", and in the survey "The FRC wants to see healthy competition in the PIE audit market driving up the quality of PIE audits and the resilience of the market. Please provide any suggestions that would help to achieve this."

The table below summarises the interview responses, which were more comprehensive than the survey responses.

Suggestion	Current PIE auditors (11)	Ex-PIE auditors (7)
Education	6	3
(Included above) Offer advice / training re best practice / develop smaller firms' capabilities	3	1
(Included above) Work with commercial software developers to ensure their products are fit for purpose for PIE audits / updated for regulatory changes	1	2
(Included above) deliver CPD for PIE auditors	1	-
(Included above) Use inspections to educate firms, have more of a dialogue	1	-
(Included above) Best practice help line	1	-
(Included above) Set clearer expectations re the standards expected, 'what good looks like'	1	1
Less emphasis on punishment when errors are found, more on improvement	-	2
Less public criticism of auditors	-	1
Better balance between audit quality and regulation / FRC 'review its regulatory stance' / reduce 'box ticking' and improve real quality	2	-
Reduce the costs of operating in the PIE audit market	-	2
Be more sensitive to the needs of smaller firms, for example by giving more notice of reviews, not tying up so much scarce resource. Be aware that they do not have specialist technical departments to deal with technical queries.	3	-
Differentiate regulations for different types of PIE audit and different risk levels	1	-
Use the audit sandbox / Round Table / similar initiatives to build trust and understanding	3	3
Link up large and small firms to promote collaboration	1	-
Work with a pool of interested smaller firms to progress them to becoming PIE auditors	-	1

Suggestion	Current PIE auditors (11)	Ex-PIE auditors (7)
Develop PIE audit methodology that is available to all (not just the Big 4), for example policies and procedures, templates for files and key documents	2	1
Clarify the timescales, processes and requirements to become a PIE auditor	1	-

Non-PIE audit market

We asked both groups of non-PIE interviewees "Are there areas where regulatory support would help your firm to expand or stay in business as auditors?" The table below summarises the responses to this question and shows the relative importance of the different issues for the two groups.

Suggestion	Larger, non-PIE auditors (19)	Wider non-PIE auditors (39)
Tailor auditing and accounting standards for small / owner managed / less complex businesses	1	16
Raise the audit threshold	1	4
(Included above) specifically for charities	-	2
(Included above) specifically for UK subsidiaries of international firms	1	-
Relax the requirements for audit registration (50+% audit qualified)	-	2
Educational / best practice support	5	11
(Included above) share the results of remedial work from other reviews	-	1
(Included above) best practice approaches to new regulations such as ISA 315	-	2
(Included above) guidance / review of tech products	-	2
(Included above) clearer guidance re interpretation of audit standards: materiality, sample sizes	-	2
(Included above) review live audits in addition to completed audits	-	1
(Included above) use monitoring visits for improvement more than criticism (ICAS, ACCA)	1	1
(Included above) more resource for ICAEW helpline	-	1
(Included above) ongoing dialogue and information	-	1
(Included above) make ACA exams more relevant for smaller firms	1	-
(Included above) continue ICAEW webinars and focus more on practical details	1	-
(Included above) do more to communicate 'what good looks like' to firms	1	-
Provide more clarity on future regulation, so firms and software providers can plan ahead	1	3

Suggestion	Larger, non-PIE auditors (19)	Wider non-PIE auditors (39)
Liaise more closely / put pressure on software providers to ensure their products reflect best practice / respond more quickly to regulatory changes	2	-
Provide more clarity on ethical boundaries	1	2
Stop changing the rules, or change them less frequently	1	5
Respond more quickly re admin matters	-	2
Hold company directors more to account for company failures	-	2
Reviews should be more positive / helpful / less stick and more carrot	-	2
Do a better job of selling audit / restore the public's faith in audit / stop bashing the auditors	4	2
Changes to the review and investigation processes	-	11
(Included above) speed them up	-	1
(Included above) root cause analysis rather than blame culture	-	1
QAD is already supportive and helpful	1	7
(Included above) but becoming less so	1	-
Improve consistency across RSBs	-	2
(Included above) consistent grading of files	-	2
(Included above) consistent approach to materiality levels	-	1
(Included above) registration of RIs	-	1
(Included above) FRC should be the sole regulator	-	1
Enforce quality more strictly and consistently for small firms	1	-
Prevent trainees from moving during their training contracts	1	-

ANNEX D: Responses of firms that planned to exit the audit market

1. Survey responses

The following table provides the survey responses given by the five firms who said they planned to exit the audit market within the next three years:

Q No.	Question (summarised)	Respondent # 4	Respondent # 53	Respondent # 55	Respondent # 85	Respondent # 94
1	Annual audit revenue 2022 & No. of RIs	£500k - £1 million 2 RIs	Under £200k 1 RI	Under £200k 1 RI.	Under £200k 1 RI	Under £200k 1 RI.
2	Majority of clients, from base office	Regional	Local (e.g. County)	Regional	Local (e.g. County)	Regional
3	In the next 3 years	Stop i.e. exit audit market. Due to lack of suitable staff	Stop i.e. exit audit market. Due to not core to firm.	Stop i.e. exit audit market. We exited at end of 2022	Stop i.e. exit audit market. Retirement	Stop i.e. exit audit market
4	If selected 'Grow' ….	skipped Q	N/A	N/A	0	skipped Q
5	Considering consolidation with other firms?	No	No	No	No	skipped Q
6	Why firm exiting the audit market?	Lack of suitable staff	Closing down audit practice due to lack of business	Auditing standards / regulation becoming too challenging. Independence issues: conflict between audit and non-audit services.	Retirement of key audit partners.	skipped Q
7	Which audit clients are you targeting?	skipped Q	N/A	Not targeting - exited the market at end of 2022.	Smaller entities.	skipped Q
8	Has the size of the audit market you compete in increased,	Remained the same	Remained the same. We do not look to external	Higher compliance costs.	Decreased. Larger firms downsizing audits.	skipped Q

Q No.	Question (summarised)	Respondent # 4	Respondent # 53	Respondent # 55	Respondent # 85	Respondent # 94
	decreased or remained same in recent years?		market to try to grow.			
9	What, if any, are the factors that limit your firm's ability to remain or expand in the audit market?	Recruiting experienced auditors	N/A	Increases in regulatory requirements / auditing standards. Conflict between audit and non-audit services.	Ability to set audit fees at a profitable level. Increases in regulatory requirements / auditing standards.	skipped Q
10	Do you have any further comments to make?	skipped Q	None	None	No	skipped Q
11	Please provide contact details …..	skipped Q	None	Contact details supplied and partner subsequently interviewed.	Contact details provided but no response.	skipped Q
12	May we contact you, where necessary, to discuss key points made.	No	No	Yes	Yes	No

2. Interviews

Firm 1

They have withdrawn due to:

- Ever increasing compliance requirements – *"ISQM1 was the final straw."*
- The requirement for independence - they pride themselves on *"depth and breadth of service"* and struggled to demonstrate independence, put Chinese walls in place.
- They would consider going back to audit if ethical requirements change, but are *"not champing at the bit."*
- Even so "*it was a wrench for me to give up audit, it's part of my DNA." Other partners were 'hugely relieved' to give up audit."*

The firm had five partners, one RI and had six audit clients when they decided to exit the market.

Firm 2

Why they have decided to leave the audit market

We interviewed a firm that planned to exit the audit market within 12 months. Our interview notes for this firm included:

- Audit is declining – have recently put up fees and are losing clients to a larger local competitor.
- Even so, audit is still unprofitable and adds no value for their clients.
- There is 'Too much' regulation and box ticking e.g. for one recent relatively uncomplicated client there were 683 questions in the audit pack and 174 questions in the disclosure list.
- Already approached an external firm to take over their existing audits (with no success).
- Interviewee said they "will be sad to leave audit, which is what their career has been built on".

The firm had two partners, one RI and fifteen audit clients when they decided to exit the audit market.

Firm 3

Why they have left the audit market

'Over time the larger clients of this firm have sold out, got smaller or no longer required an audit.' Then just one large client remained with them for a period until they lost that client and so were left with no audit clients apart from charities. However, 'these charity audits typically only last for one year as they move auditors each year.'

'Audit continues to have even more regulations applied and increasing requirements under the quality remit. In consequence, additional fees have to be paid and other costs are incurred when cold file reviews have to be arranged – all this activity takes time and energy. Auditing is much more complicated now and much more hassle, it's not worth it.'

'Also, we were not doing enough audits to train staff or to improve our auditing approach. Staff do not like doing audits, they feel isolated as an auditor and become adversarial. If a staff member does not do many audits they get out of the habit of doing it and need more training.' This firm also struggled to get practical advice and support for audits.

'The best talents do not want to go into auditing. It's no longer attractive due to the bad publicity related to the big audit firms. It is a major worry that audit by its nature needs the very best talent but it will not always get the best talent because of the present circumstances.'

Firm 4

Why they have left the audit market

Regulation has been continually increasing. Monitoring visits from their RSB have increased. When he joined the firm as a partner they had around 25 audit clients. As the audit thresholds increased their audit client base declined to just 5.

'Over the years there has been a continuous increase in the amount of regulation, form filling, box ticking that is of irrelevant use to our clients. Audit monitoring visits have become a bind, requiring unnecessary work to be done. Audit has ceased to be rewarding work and has become very dull. Clients see no value in it and it is not possible to pass on all the costs to clients.'

Their reason for leaving audit is not just to do with regulation issues. The practicalities have become more and more difficult as the interviewee was the only RI. Monitoring visits required 'cold file' reviews to be carried out by other auditors at extra cost and a delay of some months during an audit. In the last cold file review he was told that in future files would have to be 'hot reviewed', which would take many months of advance warning. 'This was the last straw - it became too difficult and commercially unsustainable.'

Then they just had 4 audit clients. Two decided to stay with them but no longer have an audit (which was optional). Remaining two were lost as clients as they required an audit but he found it difficult to find other auditors for them.

Firm 5

This small firm made the following points on their decision to leave the audit market:

- Small practice – an elderly AQ partner and the partner who now holds the majority of voting rights is not AQ so it was not possible to continue AR.
- Concerns with increasing regulatory requirements.
- Not feasible for the firm to implement ISQM.
- Only had 2 audit clients which have mainly stayed with the firm through loyalty.

Firm 6

This firm had decided to leave the audit market and stressed the following points:

- Issues with the ethical requirement due to being a sole practitioner – feels that these are disproportionate for sole practices for both firms and clients.
- Becoming more of a risk area, more expensive with more regulatory requirements.
- "It is difficult to get enough audit experience to become an RI."