



# **The FRC's Future Audit Supervision**

**Discussion paper on the future approach**

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# THE FRC'S FUTURE AUDIT SUPERVISION

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## KEY POINTS

1. ICAEW welcomes the proposals within the FRC Discussion Paper on the Future of Audit Supervision. In particular, the intention that the revised approach will provide proportionality in audit supervision, as well as consistency across the audit market.
2. The proposed FRC approach to audit supervision may require a cultural shift away from checklists and a focus on documentation to a more holistic overview of an audit firm's performance with judgements made on the effectiveness of audits overall.
3. In the interests of proportionality, we consider that a more balanced approach for monitoring and supervision would be one where the largest proportion of time should be that which has been spent on the audit work. The middle proportion of time should be the firm's review of the audit such as SoQM and other quality check activities; and the smallest proportion of time should be spent on FRC or RSB oversight of the work and the firm's quality procedures.
4. We believe that there are areas where the FRC could go further than the proposals within the discussion paper. For example, we believe that the FRC could consider a more fundamental change to the reviews of the largest firms by breaking the long-standing 'annual cycle' of inspections at the current Tier 1 firms. Equally, ICAEW can also review its annual cycle of non-PIE monitoring at the Big 4 firms. One approach would be for the FRC and ICAEW to conduct monitoring every other year so that regulatory visits alternated each year at these largest PIE firms. We believe this would provide better opportunities for the firms to address matters arising from external inspections.
5. In addition, we believe the FRC should consider a change to the approach for public reporting and no longer publish individual AQR scores for individual firms. Rather, the FRC could report on the whole PIE audit market at an aggregated market level such that individual firms are not named or otherwise identified. The end to the current approach of "naming and shaming" would be a welcome move that removes one of the existing disincentives for firms to enter the PIE audit market.

## RESPONSES TO QUESTIONS

***Q1: Do you agree that SoQMs should be a key focus of our supervision approach? If not, please explain why.***

6. Yes, we agree that it is appropriate for SoQMs to be the key focus of the FRC's supervision approach. In particular, at the top 12 firms this would support the overriding need for the firm's own SoQM to be the primary mechanism that safeguards audit quality.
7. A proportionate approach would need to be taken for smaller PIE firms however, which may legitimately have a less formalised approach to a SoQM with less extensive documentation. If the FRC has not already tested this approach against recent experience at Tier 3 firms, there may be merit in doing so.
8. We note the reference to firm resilience forming part of the FRC's risk assessment of a firm. Our understanding from the discussion paper is that the FRC is looking at measures of financial resilience as an indicator of risk to the quality of audit work performed within a firm. While we can see that financial resilience issues could in some circumstances impact audit quality within a firm, we believe that it is important that any assessment of financial resilience is taken in the round with a range of other factors, given the complexity that can underlie measures of a firm's financial resilience. In our view, this should include appropriate work on the SoQM and file inspections, including consideration of actions taken by the firm over previous years to address identified deficiencies. These factors would help support appropriate conclusions on whether firms have both the willingness in terms of culture and leadership, and the financial ability to invest in audit quality. In our view, the scope of the monitoring that ICAEW conducts is sufficient to address any audit quality concerns without needing to examine a firm's financial resilience.
9. If, as we believe it should, a review and assessment of financial resilience would only form part of the scope of reviews of the largest PIE audit firms, all such reviews would be conducted by the FRC rather than the RSBs. However, should financial resilience assessment end up forming part of the risk assessment for a wider part of the audit market, there are a number of practical implications for ICAEW as an RSB that would need to be explored.
10. ICAEW's QAD reviewers may not currently have relevant skills and experience in evaluating the financial resilience of firms depending on what this entails. Therefore, should this work form part of ICAEW's future audit monitoring activities, sufficiently skilled and experienced staff may need to be recruited, or the requisite training provided to upskill existing staff. Additional costs would need to be passed onto audit firms through higher regulatory fees.
11. Metrics would also need to be developed by which to measure financial resilience of firms. These metrics would need to cater for a range of factors that could influence the headline profitability figures for firms, such as having invested substantial sums in new systems which could in fact improve audit quality. In such circumstances, decreased firm profitability should not be seen as an indicator of decreased financial resilience such that a higher risk rating should be applied to the firm when determining the level of graded file reviews required.
12. Guidance would also be needed on what the appropriate regulatory response would be should a firm score poorly on financial resilience metrics. While an increased number of graded file reviews could form part of the response to increased overall firm risk, it is likely that there would be other steps that a regulator should consider to identify any consequential impacts on or risks to audit quality.

13. It will be important that there is a shared understanding between the FRC and RSBs on the scope of risk assessments and how financial resilience features (or not) for different sizes of audit firms.

**Q2: Do you agree that these would be useful additions to our future supervision approach? If not, please explain why.**

14. Yes, we agree that the addition of other types of file inspection would provide useful flexibility in the FRC's regulatory approach. A greater focus on ungraded inspections, whether these are corroboratory reviews, follow up reviews or thematic reviews, would help to direct attention away from scores and percentages. We think these are not only negative to public perception but also risk unintended consequences within firms; the incentive to push back on any audit finding to avoid a lower grading conflicts with any more important objective to build and maintain a positive culture that learns from mistakes and strives for continuous improvement.
15. In principle, we suggest that weaknesses in audit work that have already been identified by the firm and are still in the process of remediation or further monitoring should be viewed by the regulator as positive outputs from the SoQM rather than drive additional publicity or other sanctions.
16. A firm's SoQM that has failed to identify a significant thematic weakness or is unable to remediate an identified issue within a reasonable period would be of greater regulatory concern.
17. This approach would align with the concept of improvement regulation where the firms would be encouraged and supported to improve and address shortcomings where possible. It would also encourage a culture of openness with the regulator and incentivise firms to look for ways to identify issues in audit work and address them proactively.

**Q3: Should the FRC reduce the number of graded file inspections at larger firms as the other types of inspection are introduced?**

18. We think this would be the logical consequence of the key focus being on the SoQM and introduction of other types of ungraded inspections.
19. ICAEW already undertakes a proportionate number of graded file reviews at each of its monitoring visits to the larger firms that we consider is appropriate. We would not envisage the number of file reviews for an individual visit changing, although the sampling approach could be reviewed.
20. We believe that the FRC could consider a more fundamental change to the reviews of the largest firms by breaking the long-standing 'annual cycle' of inspections at the current Tier 1 firms. Equally, ICAEW can also review its annual cycle of non-PIE monitoring at the Big 4 firms.
21. One approach would be for the FRC and ICAEW to conduct monitoring every other year so that regulatory visits alternated each year at these largest PIE firms. We believe this would provide better opportunities for the firms to address matters arising from external inspections. If FRC and ICAEW reviews at these firms alternated each year this would also facilitate co-ordination between the two regulatory bodies.

**Q4: Do you agree that, given the other information the FRC publishes, the five-year cycle of inspections of the FTSE 350 is no longer necessary? If not, please explain why.**

22. We have no comments in relation to this question.

**Q5: Do you agree with the FRC's proposal to have a transition period? If not, please explain why. Do you have any other suggestions for the FRC's initial year of implementing FASS?**

23. We understand that the FRC intends 2026/27 to be the transition period and this will include elements of ISQM1, and both graded and ungraded file inspections. We agree that there will need to be a period of transition, and it must also be expected that the inspection approach will evolve over time. We understand that full implementation is unlikely before 1 April 2029 which would seem an appropriate timescale that would allow refinements following the pilot stage.

**Q6: Do you agree that "tiering" should be removed. If not, please explain why. If you do agree, what consequences do you think this might have, including for:**

- **Market dynamics; and would these consequences be affected by any names of groupings of firms developed by the market itself;**
- **The information that the FRC makes public, and hence transparency about what the FRC does; and**
- **Users of FRC information – which users might find this proposed approach helpful or less helpful?**

24. In our view, the concept of "tiering" is inextricably linked to public reporting of firm inspection results. If there is a differentiation between which firms are subject to individual public reports, and which are not, then there is effectively a tier of firms, whether this explicit label is applied to a firm or not.

25. We believe the FRC should consider a change to the approach for public reporting and no longer publish individual AQR scores for individual firms. Rather, the FRC could report on the whole PIE audit market at an aggregated market level such that individual firms are not named or otherwise identified. The end to the current approach of "naming and shaming" would be a welcome move that removes one of the existing disincentives for firms to enter the PIE audit market.

**Q7: How can the supervisory approach be adapted to ensure a smoother alignment between FRC and RSB oversight, particularly for firms operating near the PIE/non-PIE boundary?**

26. We agree that a smoother alignment between the fundamental elements of FRC and RSB oversight would be advantageous and ease the transition for firms moving from the non-PIE into the PIE audit market. We would support consistency of approach so that there are fewer disincentives for firms to move into this space.

27. We believe there is little justification for a PIE audit to be treated differently to a non-PIE audit and therefore the supervision approach should be more aligned than it is currently. Our holistic approach is more aligned with ISQM1 and therefore would likely require minimal adjustment to

comply with the proposed future audit supervision framework if the level of detail applied in practice is as suggested.

28. If there are broader concerns about the weight of regulation, particularly at the largest firms who are visited 'year round' by the FRC and RSB, we believe there would be merit in exploring whether the annual monitoring cycle could be broken. As outlined in response to question 3 above, we think that a move to alternate years of monitoring might facilitate more meaningful interaction with the firms, with both the FRC and ICAEW visits better able to reflect on results and potential risks identified by the other body the previous year. It would also give firms more time to make progress on issues before each regulator returned.
29. There is also a fundamental issue of proportionality in that many firms tell us that the time spent by the AQR team in reviewing an audit file exceeds the time spent by the audit team conducting the audit in reality, and/or the time spent on quality review by the firm.
30. We consider that a more balanced approach for monitoring and supervision would be one where the largest proportion of time should be that which has been spent on the audit work. The middle proportion of time should be the firm's review of the audit such as SoQM and other quality check activities; and the smallest proportion of time should be spent on FRC or RSB oversight of the work and the firm's quality procedures. These elements of time would resemble a pyramid with the audit work at the base and the regulator review at the apex.
31. We believe that the UK regulator's review is (or is expected to be) 'top-heavy'. We can see how the FASS approach has the potential to redress this balance and appreciate that some firms may need more guidance than others to increase the scale and/or effectiveness of their own internal quality management processes at the lower levels of the pyramid.
32. Firms also comment that there appears to be an expectation that not only things that have been done are documented, but all things that haven't been done with justification for the reason why not. We acknowledge that some audits are more complex and a high degree of documentation is necessary, but it seems disproportionate for every judgement to have to be documented on every audit.

***Q8: What practical steps can the FRC and professional bodies take to support a proportionate supervisory approach that reflects the varying risk profiles across the market, including taking account of the size and complexity of the entities being audited?***

33. We would suggest that the best way to achieve a proportionate and risk-based supervisory approach that maintains an element of consistency throughout the market, would be to flex the balance of emphasis on SoQM compared to file inspections. The balance may be primarily driven by the nature and scale of the firm, as this may determine how much weight should be placed on the SoQM.
34. We envisage that there could be three broad categories. For the largest firms, an SoQM approach would be the most suitable, whereas for the smallest firms it should be file inspection led. The medium sized firms could have a balanced approach with equal elements of both SoQM and file inspections.
35. It would be useful for the RSBs to have a clearer insight into the FRC's planned supervision for Tier 1 and Tier2/3 firms and how this would be operationalised into a single 'visit'. In particular, it would be useful to have examples of the information that the FRC might provide from its risk-

based work on the SoQM and the likely timings of such communications. This would allow the RSBs to consider how these FRC insights could be incorporated into the RSB's monitoring work.

36. As mentioned above, we think the FRC should consider establishing a two year cycle where one option would be for the FRC and RSB to alternate monitoring at the largest firms. We believe this would give the firms more chance to remediate and action recommendations.

***Q9: In what ways can collaboration between the FRC and RSBs be strengthened to improve consistency in audit quality across all market segments?***

37. We suggest that the first step is for the FRC and RSBs to explore their common understanding of 'audit quality' for the purposes of audit regulation. The SME audit market study highlighted concerns from firms about the level of documentation expected on these 'less complex' audits, including justification of what hasn't been done. We believe that the concerns are likely to be mirrored across all audits, including PIE audits where the nature of the entity will clearly require greater level of audit work but the same overriding scalability and proportionality allowed by the ISAs applies.

***Q10: Does the ARAQ achieve this objective? Are there alternative ways to achieve this objective?***

***- How do you currently use the ARAQ, and how could it be developed to improve usability?***

38. Our main observation is that the current approach of aggregating Tier 2 and 3 file outcomes can lead to misinterpretation by readers given that the results represent the findings from a small population of firms and a small number of audits, both of which differ year on year. This means that the data fails to show meaningful and reliable trends. A more useful way to present the data would be to aggregate the PIE audit quality findings across all PIE firms, compared to the same aggregation of the non-PIE audit findings across all PIE and non-PIE firms. This would provide the most comprehensive public overview of audit quality in the UK for each of these tranches of audits.

***Q11: Do other stakeholders find firm-specific reports useful? If so, for which firms in particular? If not, please explain why.***

39. We have no comments in relation to this question.

***Q12: Would it be more useful if firm-specific reports continue to be published at the same time as each other (and the ARAQ), or in "real time" as soon as the FRC finishes annual work on a particular firm?***

40. We have no comments in relation to this question.

***Q13: How much of the FRC's assessment of audit firms should be published and how much should remain private to the firm and FRC?***

41. As noted above in our response to question 6, we believe the FRC should consider a change to the approach for public reporting and no longer publish individual AQR scores for individual firms. Rather, the FRC could report on the whole PIE audit market at an aggregated market

level such that individual firms are not named or otherwise identified. The end to the current approach of “naming and shaming” would be a welcome move that removes one of the existing disincentives for firms to enter the PIE audit market.

42. Should the FRC continue to publish individual reports on firms, then we would suggest that the firms named ought to have the right to have their responses either incorporated in the report or published alongside it.

***For the published material:***

***- Should it focus more on quantitative data or more on qualitative narrative, or are they equally useful and support each other?***

***- If you find quantitative information useful, given our decision to increase our focus on SoQMs, what kind of data would be most valuable? AQR grades, and/or a Red/Amber/Green rating for a firm’s SoQM either overall or by component, or something else?***

***- Is the level of qualitative detail in these reports useful or could any of it be more streamlined or focused (e.g. the level of detail on the findings and good practices)?***

***- Do you find the firm’s responses to be a useful aspect of the reporting?***

43. On the basis that the new supervision strategy places an increased focus on the SoQMs, we would suggest that reporting should be led by conclusions on the SoQM rather than AQR grades. In the reporting on the SoQMs, there should be a clear basis for evaluating effectiveness of the SoQM. For example, has the SoQM meant that weaknesses identified by external file inspections or other external work had already been identified by the firm and are subject to root cause analysis and remediation? Also, can the regulatory body see tangible progress on the resolution of previous weaknesses as a result of the firm’s quality management processes?
44. Red/Amber/Green ratings could be used but adverse results should be determined on the basis of objective evidence. There is a risk that such ratings are subjective and conclusions drawn by simple comparison with what other firms do, driving all firms to identical systems over time. No system will be perfect and we suggest that a regulatory body should support variation and innovation in the regulated sector and accept that one size does not fit all, otherwise there is a danger of group think that stifles innovation and proportionality. If a traffic light system is considered, it would be beneficial for further discussions on its design and operation to take place between the FRC and RSBs.

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- **provide** robust anti-money laundering supervision and monitoring;
- **monitor** ICAEW firms and insolvency practitioners to ensure they operate correctly and to the highest standards;
- **investigate** complaints and hold ICAEW firms and members to account where they fall short of standards;
- **respond** and comment on proposed changes to the law and regulation; and
- **educate** through guidance and advice to help stakeholders comply with laws, regulations and professional standards.

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