



December 2020

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# CONSULTATION AND IMPACT ASSESSMENT

## Proposal to Revise the UK's Quality Management Standards

# CONSULTATION PAPER AND IMPACT ASSESSMENT

## **Proposal to adopt ISQM (UK) 1 *Quality Management For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements*, ISQM (UK) 2 *Engagement Quality Reviews*, and revise ISA (UK) 220 (Revised November 2019) *Quality Control For An Audit Of Financial Statements***

### **Objective**

The Financial Reporting Council (FRC) proposes, subject to consultation, to adopt International Standard on Quality Management (UK) 1 *Quality Management For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements*<sup>1</sup> and International Standard on Quality Management (UK) 2 *Engagement Quality Reviews*, and revise International Standard on Auditing (UK) 220 (Revised November 2019) *Quality Control For An Audit Of Financial Statements*, to reflect recent revisions to the international standards on auditing issued by the International Auditing and Assurance Standards Board (IAASB<sup>2</sup>).

The three standards will, individually and collectively, improve the quality of engagements through addressing key public interest issues related to the management of quality at a firm and engagement level and the performance of engagement quality reviews.

As the three standards are being updated to reflect changes made at the international level, and we are satisfied that the revised standard has been amended in a way that sufficiently addresses matters raised by the FRC in its comment letter<sup>3</sup> on the IAASB's Exposure Drafts, the FRC is not currently proposing to add any new UK requirements. As a result, we are able to confirm in the attached impact assessment that no additional work effort, beyond that which may be required by changes in the international standard, is expected to result from regulatory decisions taken by the FRC. In issuing the revised standards for consultation, the FRC has incorporated the existing UK pluses, which mainly arise from the European Audit Regulation and Directive,<sup>4</sup> and application material into the revised standards.

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<sup>1</sup> Previously International Standard on Quality Control (UK) 1 (Revised June 2016) *Quality Control For Firms That Perform Audits And Reviews Of Financial Statements, And Other Assurance And Related Services Engagements*.

<sup>2</sup> IAASB is a committee of the International Federation of Accountants (IFAC). The IAASB's constitution and due process is described in its 'Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements'.

<sup>3</sup> <https://www.frc.org.uk/getattachment/85eae035-fbad-4e49-88a9-638e91c4349b/UK-FRC-Response-IAASB-ISQM1-and-2-and-ISA-220.pdf>

<sup>4</sup> The requirements arising from the European Audit Regulation and Directive have been incorporated into UK legislation.

## **Invitation to comment**

The FRC is requesting comments on this Consultation Paper by 5pm on Friday 19 March 2021. Comments are invited in writing on all aspects of the Consultation Paper. In particular, comments are sought in relation to questions 1-5 as discussed below.

Comments on the Consultation Paper should be sent to:

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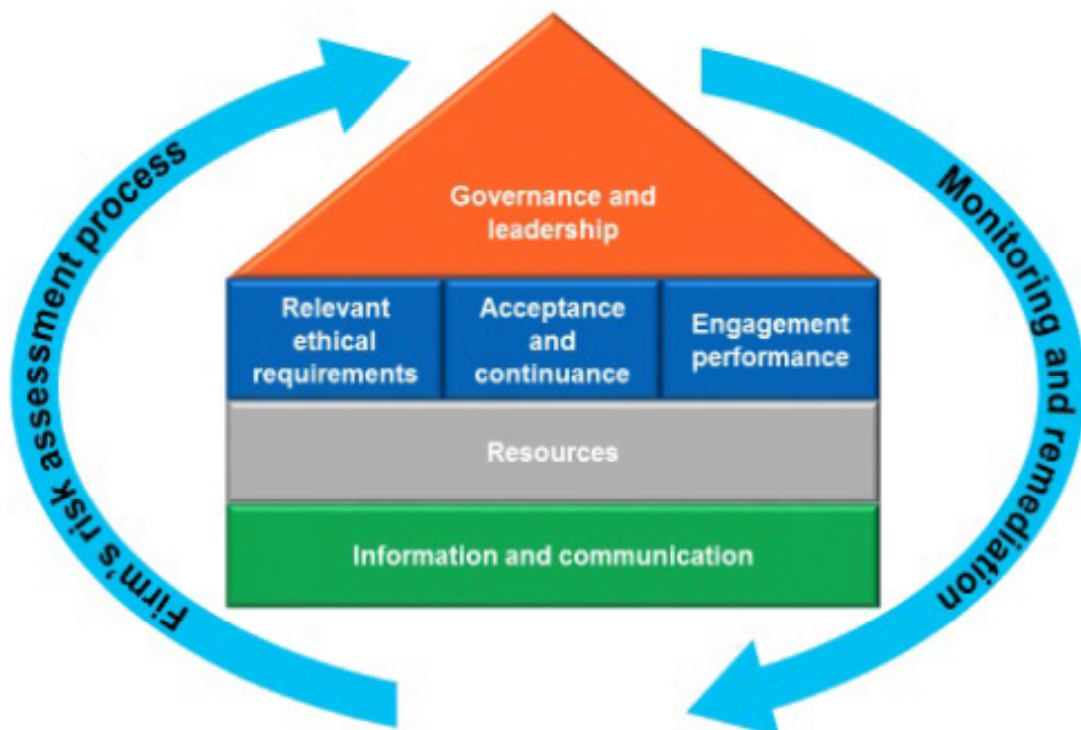
## Introduction

1. The Financial Reporting Council (FRC) is committed to acting as a proportionate and principles-based regulator, and balances the need to minimise the impact of regulatory requirements on business, while working to support the delivery of high-quality audit and assurance work, to maintain investor and wider stakeholder confidence in audit.
2. The ISAs (UK) are based on the corresponding international standards issued by the IAASB. Where necessary, the international standards have been augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context.
3. In September 2020, the IAASB approved the final versions of ISQM 1 *Quality Management For Firms That Perform Audits Or Reviews Of Financial Statements, Or Other Assurance Or Related Services Engagements*, ISQM 2 *Engagement Quality Reviews*, and ISA 220 (Revised) *Quality Control For An Audit Of Financial Statements* and relating conforming amendments to other ISAs. In December 2020, the Public Interest Oversight Board approved the due process.
4. ISQM 1 and ISQM 2 replace ISQC 1, the extant standard that deals with a firm's responsibilities for its system of quality control.
5. The FRC strongly supports the new and revised standards and related amendments, which introduce a new quality management approach that is focused on proactively identifying and responding to risks to quality. Unlike extant ISQC (UK) 1, the new approach requires a firm to customise the design, implementation and operation of its system of quality management based on the nature and circumstances of the firm and the engagements it performs. The new approach also requires the firm to transition from policies and procedures that address standalone elements, as required by extant ISQC (UK) 1, to an integrated approach that reflects upon the system as a whole.
6. This new approach is expected to generate multiple benefits for firms' systems of quality management that support the consistent performance of quality engagements, including:
  - A system that is tailored for the nature and circumstances of the firm and the engagements it performs, thereby improving the robustness and effectiveness of activities undertaken by the firm to address engagement quality. A tailored system of quality management may also result in improved utilisation of firm resources.
  - Facilitating a proactive response by the firm to changing circumstances and proactively managing or mitigating risks, and promoting continual improvement and responsiveness. This new approach will also aid in keeping the standard fit for purpose and adaptable to a changing environment.
  - Increased emphasis on monitoring the system as a whole and timely and effective remediation, to promote ongoing improvement and consideration of the appropriateness of the system, including whether it is effective in supporting engagement quality.

- Improved integration of the components of the system, thereby promoting an ongoing process of improvement, and consideration of the effect of decisions across the system.
7. This approach is intended to be adaptable to the size and nature of a firm or the services it provides.
  8. The FRC response<sup>5</sup> to the IAASB's consultation on the quality management standards was strongly supportive of the aims of the IAASB. It identified several proposals the FRC was particularly supportive of and would want to be retained in the final standards. The response did not raise any significant concerns, but it did identify some areas where the FRC believed that the proposals could be further enhanced. The FRC is satisfied that the changes made by the IAASB in finalising the revised standards are appropriate and that they can be adopted without the need for significant further FRC supplementary material.

### ISQM (UK) 1

9. As noted above, ISQM (UK) 1 introduces a new approach to quality management at the firm level that emphasises the responsibility of firm leadership for proactively managing quality, while at the same time being scalable to deal with differences in the size of firms and nature of the services they provide.
10. The key components of a system of quality management are:



<sup>5</sup> <https://www.frc.org.uk/getattachment/85eae035-fbad-4e49-88a9-638e91c4349b/UK-FRC-Response-IAASB-ISQM1-and-2-and-ISA-220.pdf>

11. ISQM (UK) 1 requires the firm to design and implement a risk assessment process to:
- Establish quality objectives
  - Identify and assess quality risks; and
  - Implement responses to address those quality risks.

ISQC (UK) 1 (Revised November 2019) included over 25 requirements which originally derived from the implementation of the EU Audit Regulation and Directive. As the UK plans to maintain equivalence with the requirements of the EU, we are retaining these in our standards. These requirements are, in the main, responses to address quality risks and therefore they have been aggregated into a new requirement, organised by components of the quality management system, at paragraph 34-1.

12. Paragraph 34(f) requires the firm to establish policies and procedures that require an engagement quality review for certain engagements. In order to be clear, we have expanded this requirement to include the following engagements in the UK:
- Audits of financial statements of public interest entities;
  - Public reporting engagements carried out in accordance with the Standards of Investment Reporting (SIRs); and
  - Engagements for which an engagement quality review is required by the FRC's *Providing Assurance on Client Assets to the Financial Conduct Authority* standard (the CASS standard).

13. ISQM (UK) 1 focuses on those findings that indicate that one or more deficiencies may exist. However, there may be “positive outcomes or opportunities for the firm to improve, or further enhance, the system of quality management” that are identified as part of the monitoring and remediation process which it would be beneficial for the firm to investigate further. Currently, the requirements in ISQM (UK) 1 focus on establishing a monitoring and remediation process that identifies and deals with any deficiencies. Where positive outcomes or opportunities are identified as part of this process, the firm is encouraged but not required by the standard to evaluate and respond to them. We have included a consultation question for respondents to explore the advantages and disadvantages of requiring firms to investigate findings that have positive outcomes or opportunities as well as those that result in one or more deficiencies.

## **ISQM (UK) 2**

14. In developing the quality management approach, the IAASB concluded that it would be better to place the more detailed requirements and related application material for engagement quality reviews in a separate standard.
15. Accordingly, ISQM (UK) 2 addresses the appointment and eligibility of an engagement quality reviewer and their responsibilities relating to that review. The revisions include:
- Extending the requirement for an engagement quality review to engagements in addition to audits of financial statements.

- Enhancing the eligibility criteria for an individual to be appointed as an engagement quality reviewer.
  - Enhancing the requirements and application material regarding the engagement quality reviewer's responsibilities, including the nature, timing and extent of the engagement quality review procedures performed.
  - Consideration of the effect of engagement quality reviews, and other forms of engagement reviews, on the appropriate exercise of professional scepticism by engagement teams.
16. Some of the extant requirements relating to these aspects that were previously included in ISQC (UK) 1 and ISA (UK) 220 (Revised November 2019) have therefore been revised and relocated to ISQM (UK) 2. This approach clarifies and reinforces the function of the engagement quality review as a firm-level activity that is undertaken by an individual who is acting on behalf of the firm. These include:
- The requirements that derived originally from the EU Audit Regulation (paragraphs 18-2, 24-1, 25-1, 25-2, 25-3, 30-1 and 30-2), along with the corresponding application material (paragraphs A48-1—A48-4).
  - The UK Plus in paragraph 18-1 that requires the engagement quality reviewer to consider the relevant ethical requirements, the safeguards applied and the corresponding audit documentation. New application material has been added (See A16-3) to cross-refer this requirement to the appropriate documentation.
17. Currently, the requirements in ISQM (UK) 2 apply to all engagements for which an engagement quality review is required to be performed. This includes audits of listed entities and public interest entities, as well as non-audit engagements such as those performed in accordance with the SIRs and the CASS standard where an engagement quality review is required. We have included a consultation question for respondents to consider whether the requirements are able to be fully applied to non-audit engagements as well as audit engagements.

## **ISA (UK) 220**

18. ISA 220 has been significantly revised by the IAASB, and with the relocation of those requirements relating to engagement quality reviews, resulting in a clear delineation of the responsibilities of the engagement partner and engagement team in relation to managing and achieving quality at the engagement level. There is also increased focus on taking into account the nature and circumstances of the audit engagement in managing quality at the engagement level.
19. Much of the UK additional requirements and application material in the extant standard relate to the engagement quality review and accordingly these have been removed from this standard and inserted into ISQM (UK) 2 as noted above.
20. We have retained in this standard a documentation requirement in respect of recording significant threats and mitigating safeguards (paragraph 41-1) as this is a requirement derived originally from the EU Audit Directive which requires this information to be recorded in the audit documentation and thus by the auditor rather than the firm (much

of the other documentation requirements for such matters lie in ISQM (UK) 1). We have drafted new application material to support this requirement (paragraph A121-1).

## Conforming amendments

21. Proposed conforming amendments to other ISAs (UK), reflecting those made by the IAASB to the corresponding international standards, are shown in mark-up in the exposure draft. These include:

ISA (UK) 200 (Revised June 2016) *Overall objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)*. Conforming edits to the application material to set out which standard deals with quality management at the firm level and at the engagement level.

ISA (UK) 210 (Revised June 2016) *Agreeing the Terms of Audit Engagements*. Minor conforming edits in the application material.

ISA (UK) 230 (Revised June 2016) *Audit Documentation*. Cross-referencing the requirement to establish a quality objective for the appropriate maintenance and retention of engagement documentation.

ISA (UK) 250 (Revised November 2019), *Section A—Consideration of Laws and Regulations in an Audit of Financial Statements*. Amendments to paragraph references in the application material.

ISA (UK) 260 (Revised November 2019), *Communication with Those Charged with Governance*. Minor conforming edits in the application material and appendix.

ISA (UK) 300 (Revised June 2016), *Planning an Audit of Financial Statements*. Minor conforming edits and cross-referencing to ISA (UK) 220 in the introduction, requirements and application material. Aligning terminology and concepts to the quality management standards.

ISA (UK) 500, *Audit Evidence*. Conforming edits in the application material in respect of acceptance and continuance.

ISA (UK) 540 (Revised December 2018), *Auditing Accounting Estimates and Related Disclosures*. Amendments to paragraph references in the footnotes.

ISA (UK) 600 (Revised November 2019), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*. Minor conforming edits in the scope of the ISA (UK) paragraphs and requirements.

ISA (UK) 610 (Revised June 2013), *Using the Work of Internal Auditors*. Minor reference amendments.

ISA (UK) 620 (Revised November 2019), *Using the Work of an Auditor's Expert*. Amendments in the application material to refer to service providers and whether the auditor can depend on the policies and procedures at the firm level. Other minor conforming edits in the requirements and application material.



ISA (UK) 700 (Revised November 2019), *Forming an Opinion and Reporting on Financial Statements*. Cross-referencing the requirement to establish a quality objective to design, implement and operate a system of quality management that provides the firm with reasonable assurance that, inter alia, the engagement reports issued are appropriate.

ISA (UK) 701 (Revised November 2019), *Communicating Key Audit Matters in the Independent Auditor’s Report*. Cross-referencing the requirement in ISA (UK) 220 for the engagement partner to consult appropriately for those matters where the firm’s policies and procedures require consultation.

ISA (UK) 720 (Revised November 2019), *The Auditor’s Responsibilities Relating to Other Information*. Minor conforming edits in the application material relating to the nature, timing and extent of direction and supervision of the engagement team and review of work.

ISA (UK) 805 (Revised), *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*. Minor conforming edits.

**Effective date**

22. The effective date of the standards is 15 December 2022. This applies to the individual standards as follows:

ISQM (UK) 1	ISQM (UK) 2	ISA (UK) 220
Systems of quality management in compliance with this ISQM (UK) are required to be designed and implemented by 15 December 2022 and the evaluation of the system of quality management required by paragraph 53-54 of this ISQM (UK) is required to be performed within one year following 15 December 2022.	This ISQM (UK) is effective for: a) Audits and reviews of financial statements for periods beginning on or after 15 December 2022; and b) Other assurance or related services engagements beginning on or after 15 December 2022.	This ISA (UK) is effective for audits of financial statements for periods beginning on or after 15 December 2022.

23. The FRC strongly supported an 18-month implementation period and was disappointed with the IAASB’s decision to opt for a 24-month implementation period from the date of PIOB approval. However, the FRC accepts that it may not be practicable for the UK to adopt an earlier implementation date, particularly given the impact of COVID on firms. However, the FRC would strongly encourage firms to adopt the standards early in order to implement the quality improvements with the urgency they require.

24. Accordingly, the FRC has included in the effective date paragraph that “Early adoption is strongly encouraged”. Further, the FRC encourages firms to communicate the stages of implementation of their quality management system in their Transparency Reports.

## Consultation questions

25. The FRC proposes, subject to consultation, to issue ISQM (UK) 1, ISQM (UK) 2, the revised version of ISA (UK) 220 and the conforming amendments to other ISAs (UK), adopting the changes made by the IAASB to the corresponding standards. This will ensure that the UK auditing standards continue to be compliant with the ISAs and maintains the FRC's support for the international harmonisation of auditing standards based on ISAs.

**Q1. Do you agree that ISQM (UK) 1, ISQM (UK) 2, and the revised ISA (UK) 220 should be adopted in the UK, alongside the related conforming amendments to other ISAs (UK)? If not, please give your reasons.**

**Q2. If you agree that the ISQMs (UK) and ISAs (UK) should be revised to adopt the revisions to the underlying international standards, do you agree that the proposed UK supplementary material is appropriate? If not, please give your reasons and explain what further additions or subtractions should be made.**

**Q3. Is the proposed effective date, which is consistent with the effective date of the IAASB's revised ISQMs and ISAs, appropriate? If not, please give reasons and indicate the effective date that you would consider appropriate.**

**Q4. ISQM (UK) 1 requires the auditor to establish a monitoring and remediation process that identifies, evaluates and responds to findings that result in one or more deficiencies in the firm's system of quality management. Do you agree with this approach or should the standard include requirements for firms also identify, evaluate and respond to positive outcomes and opportunities? Please give reasons for your response.**

**Q5. The requirements in ISQM (UK) 2 are currently applicable to all engagements for which an engagement quality review is required to be performed. Do you believe that ISQM2 could be enhanced through further requirements and/or application material for non-assurance engagements. If so, please give your detailed reasons and explain how ISQM (UK) 2 could be enhanced, in the context of a non-assurance engagement.**

## **Impact Assessment**

As a matter of policy, the FRC's auditing standards are based on the corresponding international standards issued by the IAASB. Where necessary the international standards are augmented with additional requirements to address specific UK legal and regulatory requirements; and additional guidance that is appropriate in the UK national legislative, cultural and business context. We believe that the suite of quality management standards introduce changes compared to the current ISQC (UK) 1 and ISA (UK) 220 (Revised November 2019) that are appropriate and proportionate to address issues that have been identified since the current standards were issued.

We propose to maintain the FRC's supplementary material, where appropriate, from the current standards. This should not result in additional work effort.

The revised standards have been designed to be scalable. We believe that benefits in the public interest of enhancements to the quality of audit, although not quantifiable, will outweigh the costs of changes that may be necessary to audit firms' systems of quality management.

**Financial Reporting Council**

**December 2020**

The Financial Reporting Council (FRC) is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK the FRC sets auditing and ethical standards and monitors and enforces audit quality.

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