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Commission de Surveillance
du Secteur Financier

ISQM 1 implementation
Thematic Report

PUBLIC OVERSIGHT OF THE AUDIT PROFESSION

JANUARY 2024

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1.   Introduction

The International Standard on Quality Management 1 (hereafter "ISQM 1" or the "Standard") has been adopted and supplemented by CSSF Regulation N°22-01 and entered into force on 15 December 2022 for the design and implementation part, with the first evaluation to be performed one year later by 15 December 2023.

ISQM 1 deals with an audit firm's responsibilities to design, implement and operate a system of quality management for audits or reviews of financial statements, or other assurance or related services engagements. The Standard is scalable and useable by all firms. The use of professional judgment and professional scepticism is expected to ensure the firm's system of quality management is appropriately tailored to the nature and circumstances of the firm and the engagements it performs.

ISQM 1 consists of 8 components[1]:

The key changes compared to the former quality control standard include:

- an integrated approach that reflects upon the system as a whole and which operates in an iterative manner that is proactive with a continual flow of remediation and improvement,
- a risk assessment process that applies to all the components of the system of quality management except the monitoring and remediation process,
- enhanced emphasis on the firm's governance and leadership with increased leadership responsibilities and accountabilities,
- consideration of factors affecting the firm's environment such as the use of technology, external service providers and network resources, services and requirements,
- new information and communication requirements including communication with external parties.

Luxembourg's supplement to this ISQM 1 aimed to reflect the requirements of the Audit Law[2] stemming from the Audit Directive and Regulation as regards the internal organisation of audit firms and the organisation of their work.

The objectives of the present thematic report were defined as follows:

- Analyse how audit firms in Luxembourg implemented ISQM 1,
- Assess the design and implementation of the system of quality management for a sample of firms that were in scope of the quality assurance reviews in 2023,
- Review how these firms have dealt with the Luxembourg's supplement to ISQM 1 in their new system,

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[1] The source of the chart is IAASB – Fact Sheet Introduction to ISQM 1

[2] Law of 23 July 2016 related to the audit profession.

- Analyse and assess how firms that are member of a network have dealt with the requirements of the Standard when applying network requirements or using network resources and/or services.

The study was based:

- On a survey of audit firms supervised by the CSSF in Luxembourg on ISQM 1 implementation,
- On the analysis of documents and information provided by the firms in scope of inspection in 2023, including interviews with designated persons in charge of operational responsibilities within the system of quality management.

The report may be used by audit firms for benchmarking purposes and by audit committees to gather information about how audit firms manage quality.
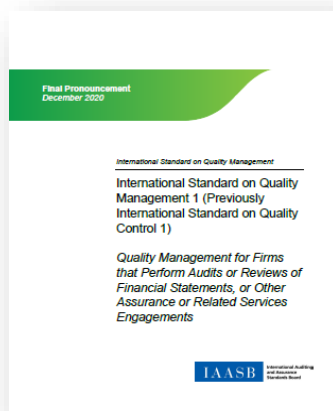
2. Analysis of the results of the survey on ISQM 1 implementation

2.1. Introduction

In September 2023, the CSSF conducted a survey to determine the progress made by all audit firms under its supervision in implementing ISQM 1. It was also an opportunity to gather information about how firms had organized themselves to tackle this regulatory change. Finally, the survey aimed at understanding the difficulties encountered and the benefits expected by audit firms from the implementation of this Standard.

To collect as much information as possible from firms, the CSSF elaborated a set of 54 questions which were sent to 52 audit firms. All responded to the Survey in October 2023.

The questionnaire was structured in 10 sub-sections: profile of the firm (activity, headcount), membership of a network, use of external service providers, responsibilities within the system of quality management, quality objectives, quality risks, mandatory responses (Standard, Luxembourg supplement), documentation, internal communication and implementation (difficulties, investment (time, human and financial), benefits expected).

Among the 52 firms to which the questionnaire was sent and on the basis of the responses received, 3 firms were excluded from the analysis of the survey results because they did not carry out audits or reviews of financial statements, or other assurance and related services engagements.

Hence, the statistics and information broken down by the CSSF in the body of this document are based upon 49 audit firms' responses.

2.2. Results of the survey

2.2.1. Firms' profile and network[3] membership
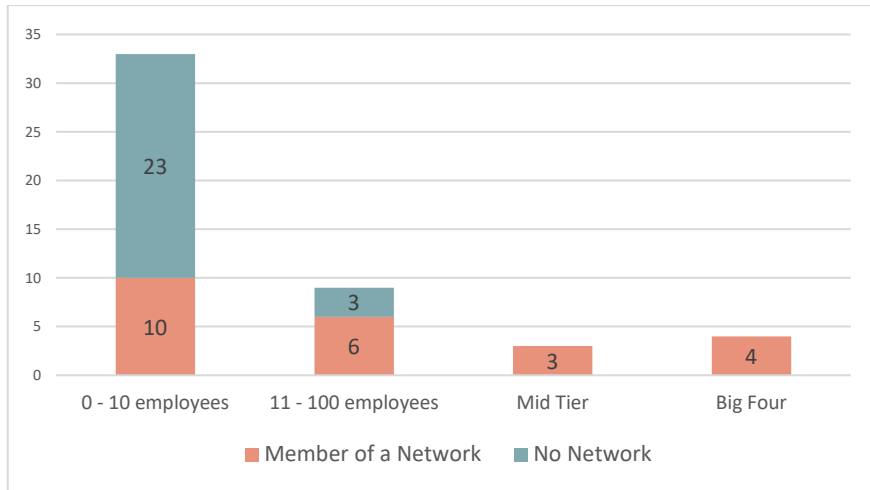
Among the population of 49 audit firms, 23 are members of a network, representing 47%, while the remaining 26, representing 53%, are not affiliated to any network.

We can also notice in the diagram above that the more employees a firm has, the more likely the firm belongs to a network.

As expected, almost all the firms being part of a network (22 out of 23) have received specific requirements from the network regarding the firm's system of quality management.

20 firms out of 22 having received these specific requirements also leveraged resources or services provided to them by the network for the system of quality management or the performance of engagements, and 18 firms indicated that they have adapted these network-provided resources or services to make them appropriate for their use.

Moreover, we observe that the 23 networked audit firms had the opportunity or planned to gather information on the monitoring activities carried out by their network (including deficiencies identified and remedial actions) mainly based on:

- the use of common tools in place within the network (12 firms) for documenting and monitoring responses; and/or
- the use of reports on agreed or specific procedures (7 firms).

Finally, as of the date of the responses to the Survey, the system of gathering of information on monitoring activities from the network with respect to ISQM implementation was still under progress for 4 firms.

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[3] *ISQM 1 defines a network as a larger structure: (i) that is aimed at cooperation; and (ii) that is clearly aimed at profit or cost-sharing or shares common ownership, control or management, common quality management policies or procedures, common business strategy, the use of common brand name, or a significant part of professional resources. Networks and the firms within the network may be structured in a variety of ways. For the purpose of ISQM 1, any network requirements or network services that are obtained from the network, another firm within the network or another structure or organization in the network are considered "network requirements or network services".*

2.2.2. Use of external service providers

ISQM 1 recognizes that a firm may use service providers when it does not have all the resources needed internally. Resources from service providers include technological, intellectual or human resources used by the firm in the operation of its system of quality management or in the performance of engagements. Component auditors from other firms not within the firm's network are also considered as service providers.

Responses gathered show that, out of the population of 49 audit firms, 35% (17 firms) used external service providers in the operation of their system of quality management or the performance of engagements. Looking at the size of these 17 audit firms we can notice that 57% of the 7 biggest firms used services providers while only 21% of the smallest firms did (0-10 employees).
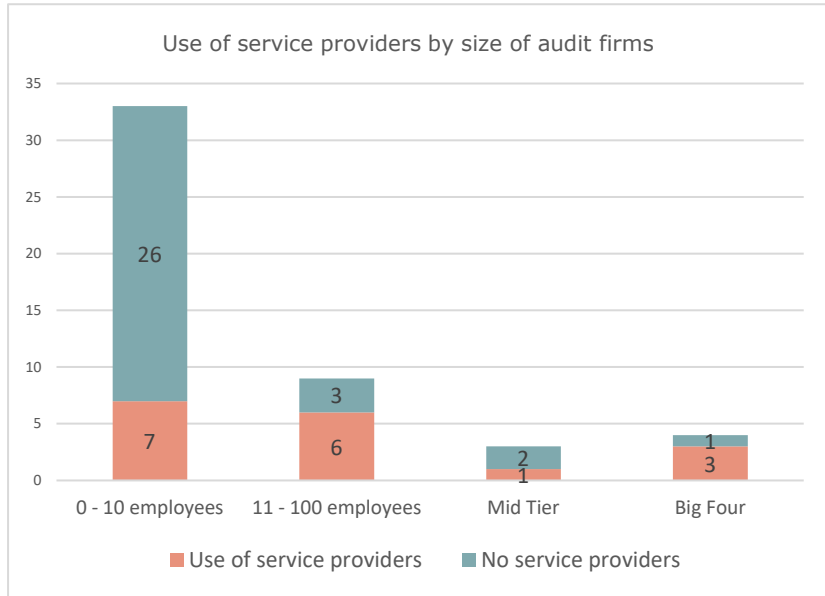
Based on the chart below that outlines the <u>components for which firms used service providers</u>, we observe that "Resources", "Engagement performance" "Information and communication" and "Engagement Quality Review" are the most quoted ones which is in line with examples provided by the Standard (e.g., Component auditors, consultation, IT application…), but no audit firm reported having used service providers for the "Monitoring and Remediation process". This observation is surprising considering that ISQM 1 requires the inspection of completed engagements in the firm's monitoring activities and that numerous small audit firms count only one audit practitioner. The CSSF would have expected that these small practices use service providers for this purpose.

Use of service providers by size of audit firms

Components involved
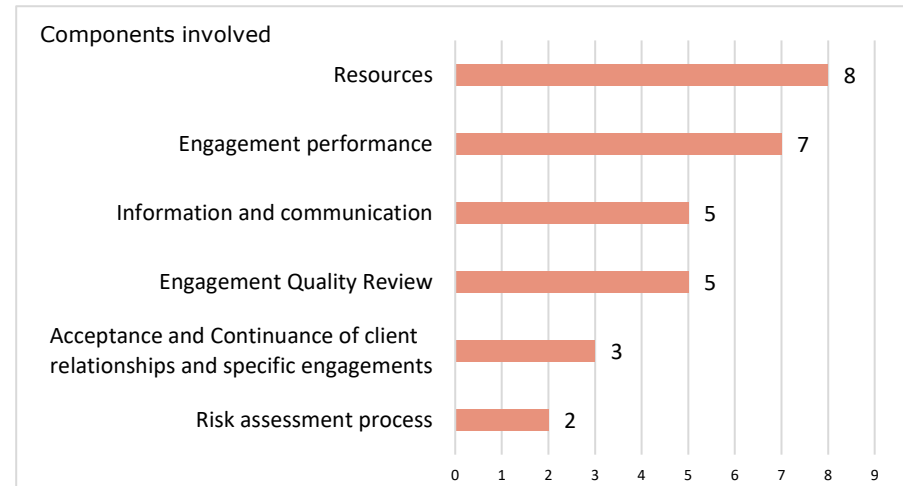
It is also interesting to note that there is no correlation between using service providers and belonging to a network. Indeed, we would have expected firms that are members of a network to give priority to using network resources or services. However, the diagram below shows that out of the 17 firms using service providers, 9 are members of a network. Similarly, we would have expected firms that are not part of a network to make greater use of service providers, but only 8 out of 26 did.

Relation between network membership and use of service providers

	Member of a Network	No network
Use of service providers	9	8
No service providers	14	18

■ Use of service providers   ■ No service providers
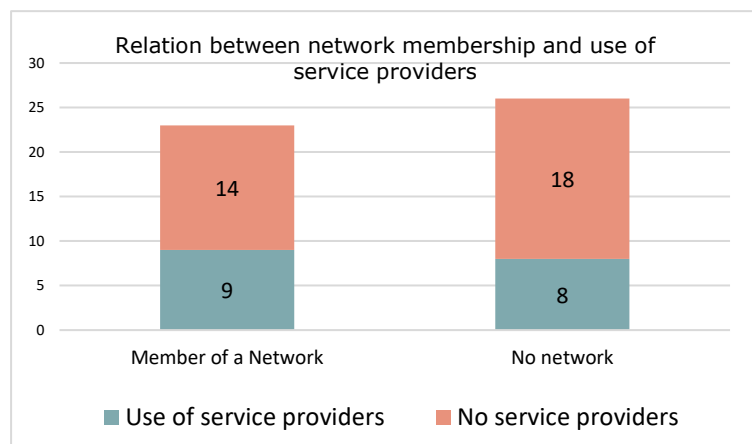
2.2.3. Responsibilities within the System of Quality Management

ISQM 1 requires the firm to assign responsibilities for the system of quality management, and other aspects of the system of quality management, and to hold the individuals accountable for their assigned roles. These individuals to whom the responsibilities are assigned, are not themselves expected to perform all procedures, tasks or actions

necessary to fulfil that responsibility, they may delegate parts to others, provided they remain responsible and accountable for their assigned responsibilities.

The role and responsibilities the firm is required to assign to individuals are:

- *Ultimate responsibility and accountability for the system of quality management,*
- *Operational responsibility for the system of quality management,*
- *Operational responsibility for specific aspects of the system of quality management*
  - o *Compliance with independence requirements,*
  - o *The monitoring and remediation process.*

ISQM 1 clearly states that the firm cannot outsource leadership responsibilities to a service provider because the firm is responsible for its own system of quality management and that the individual(s) with responsibilities is(are) required to have the appropriate influence and authority within the firm.

The Luxembourg supplement to ISQM 1[4] states that the firm shall ensure that the operational responsibility for the system of quality management lies with a person who is qualified as approved statutory auditor.

When it comes to the allocation of the responsibilities within the firm, the size of the audit firm is logically one of the main drivers. The results of the survey, in particular the analysis of the average number of individuals with responsibilities for the system of quality management, clearly demonstrate that the bigger the players are, the more they make a clear segregation of responsibilities by having one different responsible person for each of the four main responsibilities required by ISQM 1.

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[4] Based on article 24(1)g of the Audit Law

Average number of individuals with responsibilities for ISQM

0 - 10 employees	11 - 100 employees	Mid Tier	Big Four
1,3	2,6	3,0	4,0
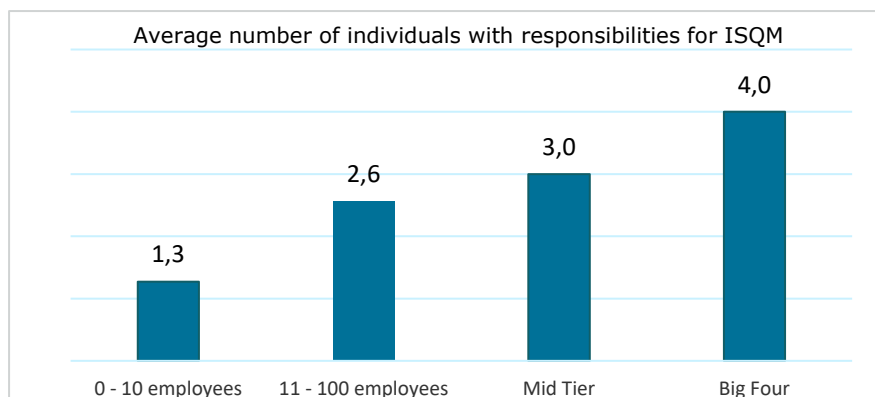
However, we have noticed for 6 audit firms that the operational responsibility for the system of quality management was not assigned to an approved statutory auditor. The CSSF will revert directly to these firms for them to assign the adequate person.

Moreover, 10 firms out of 49 have indicated that certain operational responsibilities have been delegated mainly to the business process owners or functions leaders.

While ISQM 1 does not specify who is required to perform monitoring activities, 17 firms have made within their system of quality management a distinction between those responsible for operational aspects and those responsible for monitoring activities, while 32 firms did not. Here again, the size of the practice determines the distinction.

Distinction between operation and monitoring activities

Yes	No
17	32
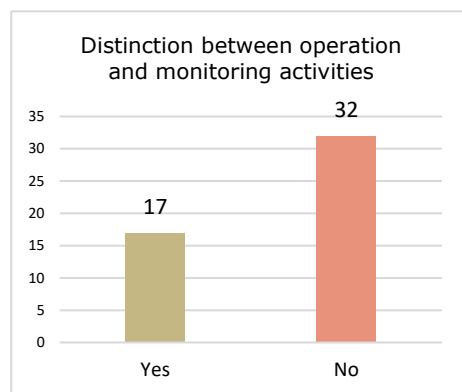
2.2.4. Establishing the quality objectives

The firms shall establish quality objectives specified by ISQM 1 and any additional ones considered necessary by the firms to achieve the objectives of the system of quality management.

ISQM 1 requires specific quality objectives for the following components as specified in its paragraphs 28 to 33:

- *Governance and Leadership,*
- *Relevant Ethical requirements,*
- *Acceptance and Continuance of Client Relationships and Specific Engagements,*
- *Engagement Performance,*
- *Resources, and*
- *Information and Communication.*

However, there may be circumstances when a quality objective, or an aspect thereof, is not relevant because of the nature and circumstances of the firm and its engagements.

The survey highlighted that 100% of the approved audit firms declared having established all the quality objectives required by paragraphs 28 to 33 of the Standard for the abovementioned various components.

In the details, for 33 firms (67%) the quality objectives established are identical to the Standard, while 11 (23%) established them with adjustments, by creating sub-objectives or for instance by making other groupings.

For 5 firms (10%), the adaptation of internal procedures and the quality objectives' requirements are still being formalised.

Quality objectives

- Yes identically
- Yes with changes (establishment of sub-objectives, other groupings)
- Yes partially
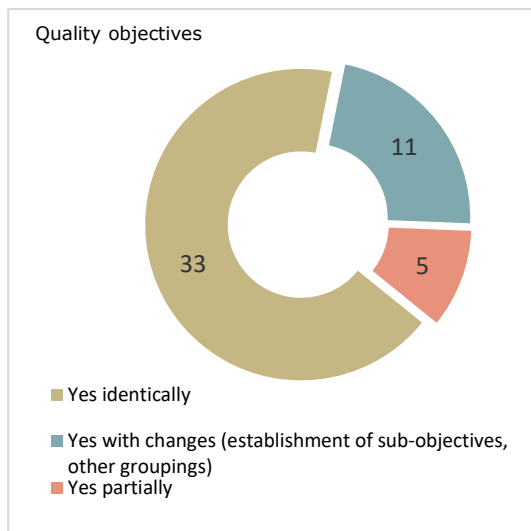
In addition to the quality objectives prescribed by paragraphs 28 to 33 of the Standard, 3 firms (6%) have established additional quality objectives mainly for the "Acceptance and Continuance of Client Relationships and Specific Engagements" to include specific risks and responses for anti-money laundering and combatting the financing of terrorism.

2.2.5. Identifying and assessing quality risks

Identifying and assessing quality-related risks focuses on what can go wrong in achieving quality objectives. ISQM 1 aims to focus on the risks that have the greatest impact and includes a threshold in the definition of quality risk. A risk qualifies as a quality risk when it meets both criteria:

- *The risk has a reasonable possibility of occurring,*
- *The risk has a reasonable possibility of individually, or in combination with other risks, adversely affecting the achievement of one or more quality objectives.*

The firm exercises professional judgment in determining whether a risk meets the threshold.

Quality risk assessment does not necessarily have to involve formal ratings, although audit firms are not prevented from using them.

In this context, the survey revealed that most of the firms (78%) have adopted a quality risk assessment matrix putting in perspective the probability of occurrence of identified quality risks and their related impact on the achievement of the quality objectives.

This matrix, for 66% of those firms, embeds 3 <u>levels of risks</u> (usually being "high", "medium" and "low"). It is also interesting to notice that 29% of the firms have created very detailed in-house matrices underpinned with a spectrum of 4, 5 or more than 5 different levels of identified risks.

Levels of risks

- 2 levels
- 3 levels
- 4 levels
- 5 levels
- > 5 levels
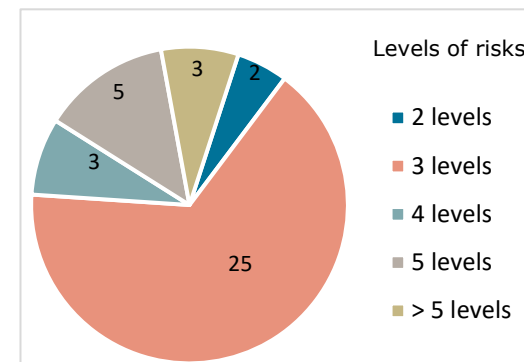
2.2.6. Implementation of the mandatory responses

*ISQM 1 requires the firm to design and implement responses that properly address the quality risks. In doing this, the firm needs to think to the reasons for the assessments given to the quality risks and to consider whether a response alone is sufficient or whether a combination of responses is needed. A firm may also design and implement a response that addresses multiple quality risks related to more than one quality objective across different components.*

Paragraph 34 of ISQM 1 includes some specified responses that the firm is required to design and implement. These specified responses would not fully address all quality risks and the firm is expected to design and implement additional responses. Although these responses are specified, the nature, timing and extent of the response will vary, given the nature and circumstances of the firm.

The Luxembourg supplement to ISQM 1 also includes additional responses that the firm is required to design and implement based on the Audit Law requirements.

The firms' responses to the survey highlight that 98% of the firms declared having implemented or partially implemented the specified responses required in paragraph 34 of the Standard and the additional responses required in the Luxembourg supplement to ISQM 1, pursuant to CSSF Regulation N° 22-01 dated 11 January 2022.

Implementation of responses

- Full implementation of the specified responses required by the Standard and the Luxembourg supplement to ISQM 1
- Partial implementation of the specified responses required by the Standard and the Luxembourg supplement to ISQM 1
- The specified responses required by the Standard were not implemented
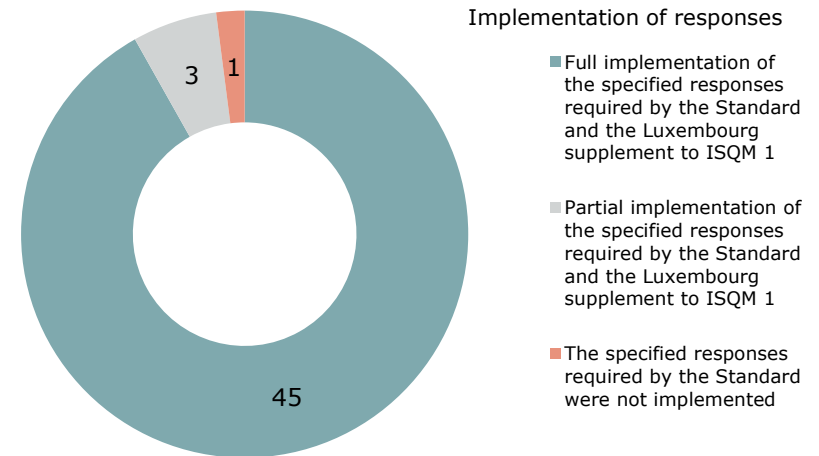
2.2.7. Documentation of the system of quality management

ISQM 1 does not prescribe every matter that needs to be documented by the firm as it will depend on the size and complexity of the firm and the types of engagements it performs.

ISQM 1 has set 3 principles in the preparation of the documentation, it shall be sufficient to:

- *Support a consistent understanding of the system of quality management by personnel, including an understanding of their roles and responsibilities with respect to the system of quality management and the performance of engagements,*
- *Support the consistent implementation and operation of the responses, and*

- *Provide evidence of the design, implementation and operation of the responses, to support the evaluation of the system of quality management by the individual(s) assigned ultimate responsibility and accountability for the system of quality management.*

In the survey, we asked firms how they documented their risk assessment, their monitoring activities and remedial actions.

Firms responded that they use different types of software or a combination of several software for the documentation of their system of quality management.

Microsoft Excel is the most represented software, used by 33 firms and for both their risk assessment and their monitoring activities/remedial actions. 16 audit firms have turned to service providers that developed manuals, toolkits and software solutions for all or part of their ISQM 1 activities, and network integrated software is also quite well represented with 9 audit firms.

Lately, some firms are currently developing their own specific software and a few others indicated making use of tools such as Microsoft Word for ISQM 1 internal documentation purposes, in complement to Microsoft Excel, specific software or network integrated software.
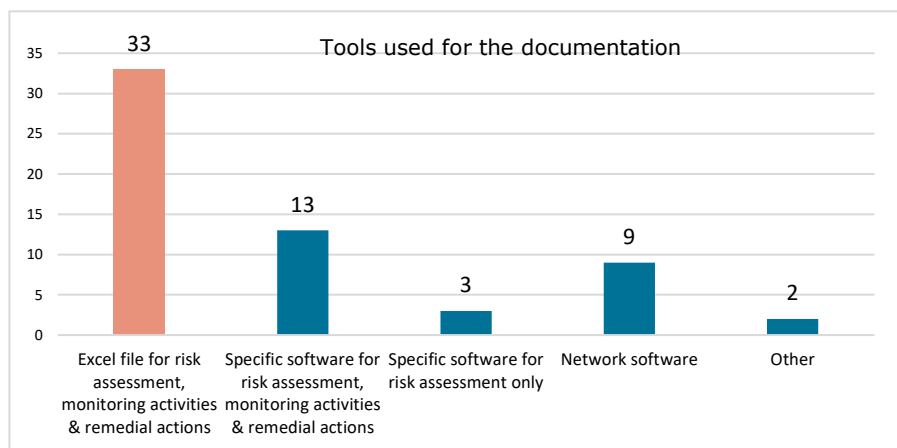
2.2.8. Other aspects linked to the implementation

2.2.8.1. Communication to personnel

94% of the firms have trained or made all their employees aware of their system of quality management.

For 40 firms out of 49, the documentation of the system of quality management is accessible to all personnel, which according to them reinforces employees' awareness.

The firms make the quality management documentation available via different supports, by using one or a combination of several supports and tools, such as:

- dedicated folder(s) on the firm's internal IT system,
- dedicated folder(s) on the IT server of the international global network the firm belongs to,
- software,
- internal training/presentations,
- Intranet/SharePoint,
- procedures and quality manual, and/or
- dedicated communication.

#### 2.2.8.2. Main difficulties encountered by the audit firms

While designing and implementing their system of quality management based on ISQM 1, except for 5 firms having reported no issues, many firms faced the following main difficulties and/or challenges:

- the size of the firm: as reported by several actors, being a small or very small audit firm made the exercise of designing and implementing a system of quality management very challenging, considering the large spectrum of requirements of the Standard that, according to them, hardly fits into such small or very small audit practice environments,
- the time dedicated to ISQM 1 implementation by the personnel involved in each audit firm was reported as one of the main constraints by the entities concerned. This is further detailed in paragraph 2.2.8.3.,
- analysing and interpreting the Standard, putting in perspective its own audit firm activities and environment in order to design and implement the appropriate and adapted system of quality management was another challenge,
- the intrinsic exercise of identifying and assessing quality risks was difficult to perform for several firms, and
- the documentation: the firms struggled to formalise and/or update the policies and procedures manuals.

2.2.8.3. Human, time, and financial investment needs

First Time implementation

The survey included questions relating to the human, time, and financial effort that the firms needed to implement ISQM 1. We are pointing here, some of the main outcome of the analysis of responses.

Human investment in FTE to implement ISQM
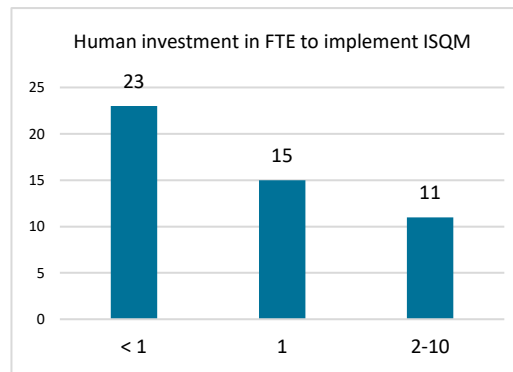
As represented in the table on the left-hand side, 1 or less than 1 "full-time equivalent" (or "FTE") was assigned to ISQM implementation in 38 audit firms and between 2 and 10 FTE in 11 firms (mainly Big Four and Mid-Tier Firms at the top of the range).

Most of the firms dedicated a significant number of hours for the purpose of designing and implementing the system of quality management as required by ISQM 1. The spectrum of time spent by dedicated personnel spreads out from less than 1 month to more than 6 months.

The period of involvement of the FTEs of the Big Four and Mid-Tier firms was generally longer than that of small firms, i.e. almost 6 months or more than 6 months, due to their size and more complex organisation.



Time investment (to implement ISQM)
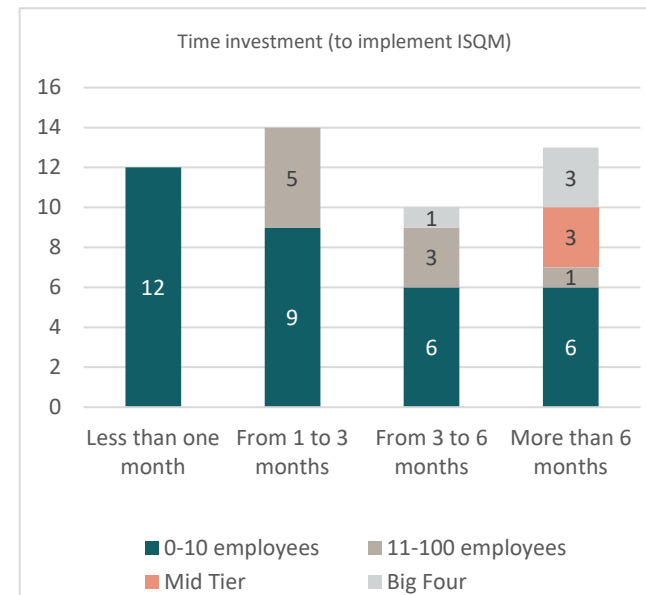
Nevertheless, while the large firms spent more hours and over a longer period developing or creating their system of quality management in line with the requirements of the Standard, small firms, due to the reduced number of people involved, were the most impacted in their day-to-day operations and business.

As regards the financial aspect, apart from the cost of cumulative hours spent by the personnel and responsible persons involved in implementing ISQM 1, the financial cost of compliance with the Standard also includes for several firms the one-off cost of acquiring dedicated software, adapting in-house software, or existing network software.

Budget for annual maintenance and update of the system of quality management and monitoring and remediation activities

As for the estimated human resources plan for the monitoring activities, 44 firms indicated that 1 or less FTE would be dedicated to this activity, which is in line with what the firms have declared for implementation.

Human needs in FTE for monitoring activities

< 1	1	2-10
23	21	5
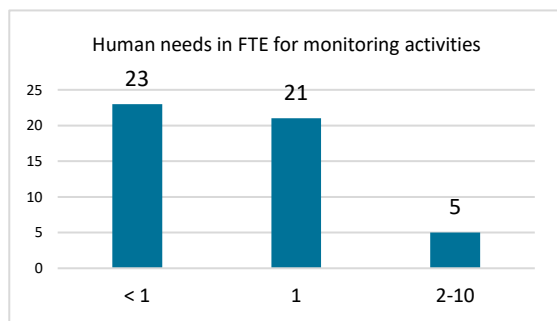
The diagram below points out the budget in days/person that the firms intend to allocate to the maintenance of their system of quality management and to the monitoring activities and remedial actions, on an annual basis:

Budget in days/person

	< 10	11-50	51-100	> 100
Monitoring activities and remedial actions	29	10		1
Update of the system of quality management	28	11	2	

■ Monitoring activities and remedial actions
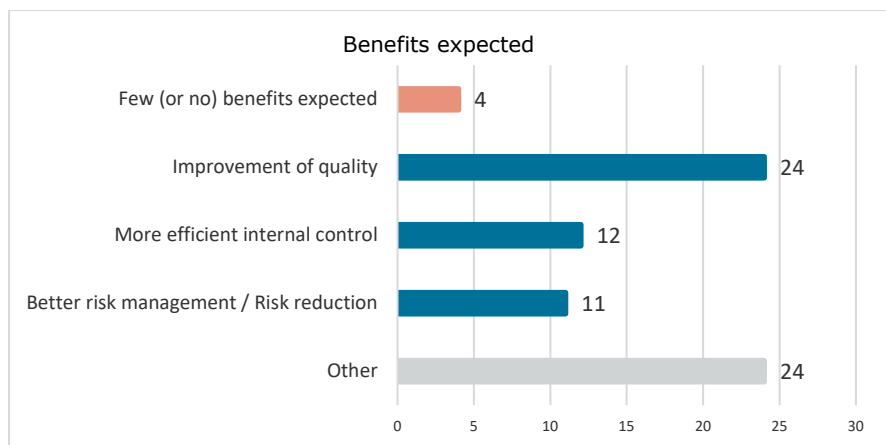■ Update of the system of quality management
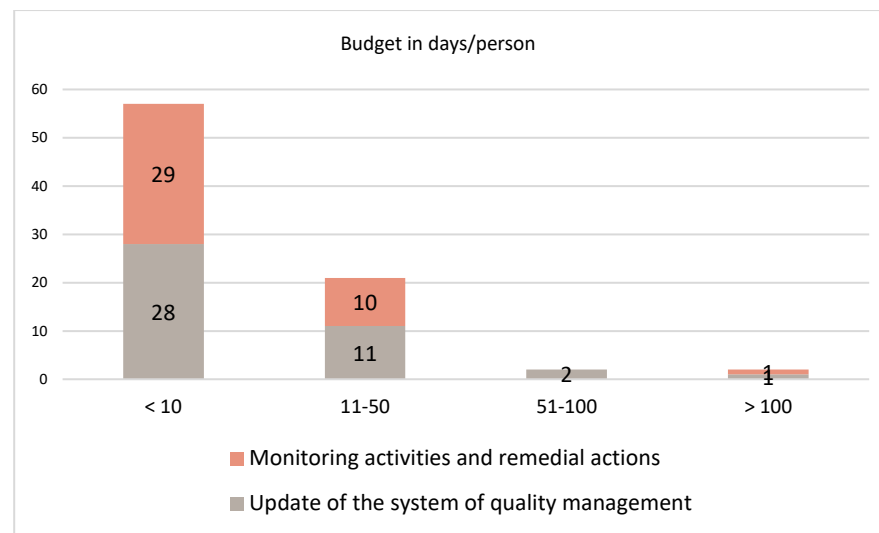
We can note a similarity between the time allocated to maintaining and updating the system of quality management and the time allocated to monitoring and remedial activities. Overall, the vast majority of firms (39) planned to allocate less than 50 days per person for each of the 2 activities, bearing in mind that firms dedicate 1 or less FTE for each activity.

2.2.8.4.   Benefits expected by the firms

Finally, the survey was also an opportunity to collect the benefits expected by the firms following the investments made to implement and comply with the requirements of the Standard.

The diagram below highlights the most quoted expected benefits, that are the improvement of the quality of the audits performed, a more efficient internal organisation and internal control and a better risk management.

Benefits expected

Category	Value
Few (or no) benefits expected	4
Improvement of quality	24
More efficient internal control	12
Better risk management / Risk reduction	11
Other	24

The "Other" category in the table above provides other interesting expectations mentioned by other players, such as:

- awareness / culture for quality enhancement,
- clarifying expectations of external service providers,
- identify and respond to deficiencies more promptly and effectively,
- better documentation and control of certain activities, and
- more transparency towards the public.

2.3. Key takeaways and follow-up actions

Based on some responses to the survey it appears that scalability and more precisely the scale back to fit the nature and circumstances of smaller firm with low complexity, is raising many application concerns. The CSSF is convinced that scaling back ISQM 1 requirements for smaller firms with low complexity is achievable at the level of:

- the objectives that are adaptable,
- the risks that can broad and overarching without needing any granularity, and
- the responses that can be built on what was already in place with the previous standard but that nevertheless need to address risks identified for the new components of ISQM 1.

The CSSF has identified several areas for follow-up action in 2024:

- the use of external service providers and the application of ISQM 1 requirements to those,
- the people to which responsibilities foreseen in the Standard are assigned (in terms of experience (including qualification), knowledge, time, influence and authority),
- for firms that are member of a network, the network requirements and the network resources or services that are used locally in the system of quality management (see also paragraph 4.),
- the implementation of the specified responses required by the Standard and the requested responses of the Audit law that are reflected in the Luxembourg supplement to ISQM 1 (see also paragraph 3.4.), and
- the evolution of the resources involved in the System of quality management (in terms of number of people involved and allocated time).

3. Assessment of the design and implementation of the system of quality management for a sample of firms in the scope of the 2023 inspections

3.1. Scope of inspected firms and inspection in 2023

As part of its 2023 annual work programme, the CSSF started analysing the implementation of ISQM 1 in the different firms reviewed by examining their risk assessment process in order to ensure the quality objectives have been established, that the quality risks have been identified and assessed and that responses have been put in place to address these risks.

Under the 2023 programme, 10 firms were reviewed:

- 5 firms that have more than 100 employees, all members of a network,
- 2 firms that have between 11 and 100 employees, including 1 member of a network, and
- 3 firms that have between 0 and 10 employees, none is a member of a network.
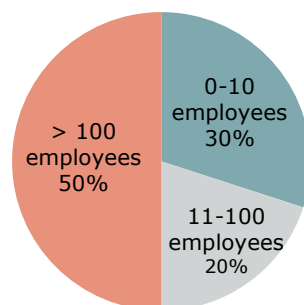
The review consisted of interviews and requests for information relating to the risk assessment process. Based on the documentation submitted to the CSSF, the latter analysed compliance with ISQM 1 requirements considering the flexibility of the Standard which provides that the processes must be adapted depending on the circumstances and the nature of the engagements carried out by the firm.

As it was a first-time implementation review, the CSSF mainly provided recommendations on areas for improvement.

3.2. Risk assessment process

All firms have conducted a risk assessment process in accordance with the requirements of the Standard and produced a matrix of quality objectives, quality risks and responses to these risks for all components. The 6 audit firms that are member of a network were provided a software tool to document their risk assessment, the 4 other ones use an Excel file.

Firms that belong to a network had to consider the network requirements that include globally prescribed quality objectives, quality risks and responses in building their own risk assessment matrix.

Following the risk assessment process, none of the firms defined additional quality objectives but 50% of them defined sub-objectives or made other groupings. Only one firm identified additional quality risks in order to assign the responses foreseen in the Luxembourg supplement to ISQM 1.

For almost all the firms inspected, the quality risks were derived directly from the quality objectives specified in the paragraphs 28 to 33 of the Standard, with a level of granularity that varies according to the size and complexity of the firm but also according to the complexity of the component.

For example, for the Relevant Ethical Requirements component, the quality objectives the firm shall establish are the following:

a) *The firm and its personnel:*

   i. *Understand the relevant ethical requirements to which the firm and the firm's engagements are subject; and*

   ii. *Fulfil their responsibilities in relation to the relevant ethical requirements to which the firm and the firm's engagements are subject.*

b) *Others, including the network, network firms, individuals in the network or network firms, or service providers, who are subject to the relevant ethical requirements to which the firm and the firm's engagements are subject:*

   i. *Understand the relevant ethical requirements that apply to them; and*

   ii. *Fulfil their responsibilities in relation to the relevant ethical requirements that apply to them.*

The number of quality risks that the firms identified and assessed for these objectives varies from 2 derived from the 2 parts of the objectives (with different grouping in some cases) to several dozen when the firm has thought in terms of business processes.
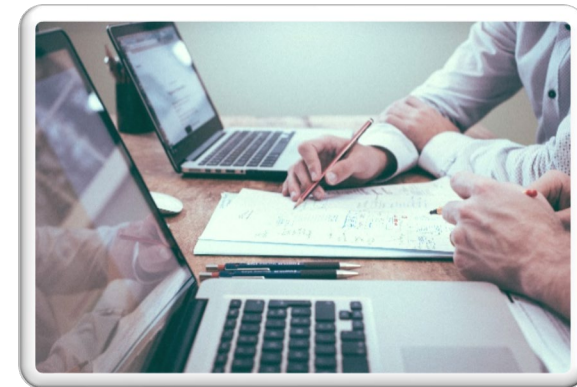
8 firms adopted a 2-Levels or 3-Levels risk assessment, one firm did not specify quality risk levels and another one has a model with 12-levels.

The quality risks assessed as "High" by the firms also vary widely depending on their professional judgment and on the nature and circumstances of the firm and the engagements they perform.

3.3. Analysis of the responses provided by the firms to the quality objectives and quality risks

The CSSF has analysed all responses to quality risks the audit firms documented in their risk assessment per component. The number of responses varies widely from an objective to another and from a quality risk to another. This amplitude is also linked to the size and complexity of firms.

We have identified here after, for each component, the most frequently designed responses and/or most appropriate ones. The CSSF wants to reiterate that all these responses do not need to be implemented, firms have to exercise professional judgement in determining the responses that are appropriate to the size and complexity of their organisation and the engagement they performed.

3.3.1. Governance and Leadership component

• Adoption of a code of conduct and mechanisms to sanction behaviours not aligned with this code.
• Setting up of channels (internal and external) for reporting concerns and issues of a sensitive nature (whistleblowing, complaints and allegations), designation of an appropriate responsible in charge of investigating, responding, and proposing actions and eventually sanctions to the cases.
• Adoption of an accountability framework to support the commitment to quality.
• Establishment of a consistent and fair process to evaluate personnel for their accountabilities (including the individuals assigned with system of quality management responsibilities).
• Process for the appointment of individuals to senior management roles and system of quality management responsibilities (including assessing that they have the appropriate competency and capability based on their experience and knowledge and sufficient time based on the workload information).
• Preparation of a strategic plan (including a commitment to obtain sufficient Human, Financial, Intellectual and Technological Resources to support the quality) and an annual budget that is consistent with the strategic plan.
• Maintenance and execution of a quality communication plan that delivers through different channels and mechanisms clear and consistent quality-focused messages.

• Execution of the budget includes analysis of the deviations and the review of Key performance Indicators (KPIs) or Audit Quality Indicators (AQIs) in terms of financial results, human resources need, operational priorities, risks and quality.
• Implementation of annual survey(s) to obtain personnel feedback on the firm's quality culture and on the effectiveness of ethical culture and ethics resources. Responses to the survey(s) are analysed and actions are taken on issues identified.
• Process to evaluate the deficiencies identified during external inspections and in monitoring the System of quality management, perform root cause analysis, implement remediation action plan, and communicate internally and externally.

3.3.2. Relevant Ethical Requirements component

- Implementation of policies, procedures and guidance on Relevant Ethical Requirements that are regularly updated and comply with laws and regulation.

- Setting up of communication and awareness plan on Relevant Ethical Requirements (including Confidentiality, Security and Privacy topics).

- Establishment of a taxonomy of permissible services.

- Implementation of policies and procedures for identifying, communicating, evaluating, and reporting breaches of ethical requirements, including action plan to address and remediate the causes of the breaches.

- Mandatory Ethical and Independence consultations. These consultations are assigned to the appropriate experts and reviewed at different level depending on the complexity of the subject.

- Process to evaluate Business or other direct and indirect relationships prior acceptation and annually (Acceptation and continuance forms, risk profile, independence, and conflict checks) and ensure agreements/contracts contain appropriate ethical requirements.

- Process to ensure timely and accurate information on audit clients (including global ultimate parent and affiliates) are included in the independence systems.

- Process to ensure relevant personnel and firm do not hold restricted investments.

- Personnel are required to complete an annual confirmation (and when joining the firm or being promoted) that they have read, understood, and complied with the Relevant Ethical Requirements (including confidentiality and privacy and awareness and understanding of the disciplinary policies).

- Mandatory Ethical and Independence learning requirements are communicated on an annual basis to all staff and to relevant third parties.

- Performance of on-going and periodic monitoring activities:
  o Monitoring of timely completion of independence confirmation, follow up and resolution of exceptions (including disciplinary procedures).
  o Monitoring of compliance with the learning requirements, results to training tests, resolution, and escalation procedures.
  o Monitoring of the permissibility of firm's financial investments and business relationships.
  o Monitoring of personnel reported financial investments to identify outstanding and exceptions (including conclusion on regulatory breach or policy violation).
  o Annual Personal Independence Compliance Testing (including reporting of exceptions and disciplinary process).
  o Monitoring of inducements received and given.
  o Monitoring of the rotation requirements (partners, EQ Reviewers, Firm, Senior personnel).

3.3.3. Acceptance and Continuance of Client Relationships and Specific Engagements component

- Development of a strategic business planning including:
  - focus on terms of clients, markets, and industries,
  - consideration for resources need, compliance with laws and regulation, reputation risk, commercial risk.

- Establishment of processes to obtain the information needed to make Acceptance and Continuance decisions:
  - Backgrounds checks and Anti Money Laundering due diligence procedures on prospective clients and name screening of the client, its legal representatives, the beneficial owners, and its shareholders. Analysis of any hit.
  - Independence and conflict check with required consultation when issues have been identified.

- Use of dedicated forms/questionnaires and tools for Acceptance & Continuance with an approval grid based on the potential risks associated with the Acceptance & Continuance of the engagement

- Training on completion of the Acceptance & Continuance questionnaires and requested documentation

- Setting up of IT controls on the Acceptance & Continuance system:
  - All mandatory fields must be completed to submit the questionnaire.
  - Overall risk rating automatically calculated based on the answers to questions.
  - Generated risk can only be manually increased not decreased.

  - Only approved individuals are permitted to submit questionnaires (interface between Human Resources system and Acceptance & Continuance system to transfer the list).
  - Acceptance & Continuance questionnaires are approved based on the approval grid and all high-risk clients require Risk Management approval.
  - The engagement code can be opened only after the Acceptance & Continuance process is completed and approved.

- Implementation of policies and procedures including mandatory consultation when:
  - The firm becomes aware of information subsequent to accepting or continuing a client relationship or specific engagement that would have caused it to decline the client relationship or specific engagement had that information been known prior to accepting or continuing the client relationship or specific engagement.
  - The firm is obligated by law or regulation to accept a client relationship or specific engagement.

- Establishment of a standard template for engagement letters, any deviation to the standard should be approved by Risk Management function.

- Performance of an annual portfolio risk review

- Performance of on-going and periodic monitoring activities:
  - Periodic compliance testing with Acceptance & Continuance policies and procedures.
  - Periodic critical review of the questionnaires.
  - Monitoring of compliance with learning requirements for Acceptance & Continuance.

3.3.4. Engagement Performance component

- Training on firm's methodologies including professional scepticism and professional judgement.

- Implementation of policies, procedures, methodology and guidance on the planning and performance of engagements including roles and responsibilities for partners, engagement leaders and other members of the team.

- Requirement for each engagement to have a Resources plan (including the types of resources (individual roles, specialists), the related estimated number of hours and the expected schedule) that is approved by the partner/engagement leader.

- Establishment of policies and procedures to identify engagements that require an engagement quality review and to perform engagement quality reviews.

- Requirement to use an audit tool when performing an audit engagement.

- Implementation of policies and procedures on consultations including a list of mandatory topics for consultation and list of individuals responding to consultations by topics and industry that are selected based on their knowledge, seniority end experience.

- Implementation of a policy setting the steps to resolve differences of opinion within the engagement team, or between the engagement team and the Engagement Quality Reviewer.

- Implementation of policies on file assembly date and retention.

- Setting up of IT controls on the audit and archiving tools:
  - Engagement documentation is protected by security access during engagement performance and when archived.
  - Integrity checks performed on the assembled audit file prior to archiving to prevent corrupt or non-functional audit documentation.
  - Automatic reports are sent to ensure archiving deadlines are met.
  - System prevents the deletion of any document from an archived audit engagement.

- Performance of on-going and periodic monitoring activities:
  - Implementation of an ongoing monitoring at engagement level (including Milestones, Hot reviews, Partner/Engagement Leader/Engagement Quality Reviewer involvement, etc.).
  - Annual review and approval of individual partner's workload.
  - Monitoring of late archiving without valid reasons.

3.3.5. Resources component

3.3.5.1. Human Resources

▪ Establishment of an annual resource plan that drives the recruitment strategy and facilitates the identification of external resources needs.
▪ Implementation of a recruitment process that involves skilled recruiters and a method for evaluating the candidates.
▪ Implementation of a learning policy including mandatory trainings, continuing professional education, and licensing requirements, identification of the audience, selection and training of instructors, development of materials, minimum pass rates for courses with an assessment, evaluation of trainings and instructors, and actions to be taken when training requirements are not completed.
▪ Organisation of induction trainings as part of the on-boarding process for new joiners.

▪ Establishment of an evaluation process including:
   o the evaluation criteria (including commitment to quality).
   o the setting of individual objectives to achieve based on roles.
   o the annual evaluation based on agreed objectives.

▪ Establishment of a compensation and promotion policy that is linked to the evaluation process.

▪ Establishment of policies and procedures to assign engagements to partner/engagement leader/Engagement Quality reviewer depending on industries, competence, capabilities, workload and including an evaluation whether potential safeguards should be implemented.
▪ Setting up of an annual engagement assignment process for engagement teams and specialists taking into account their skills, competencies, availability and permissibility.
▪ Setting up of a process to assign individuals to perform activities within the System of quality management taking into account their competence and capabilities including sufficient time.

▪ Performance of on-going and periodic monitoring activities:
   o Monitoring of the relevance and reliability of employee's records.
   o Monitoring of the compliance with continuing professional education and licensing requirements.
   o Monitoring of the timely completion of mandatory trainings.
   o Monitoring of partner's and staff workload.

3.3.5.2. Technological Resources

• Requirement to use the Audit tool provided by the network.
• Identification (list) and ongoing maintenance of the IT systems that enables the firm's System of quality management.
• Individual evaluation of each IT system relevant for the System of quality management to determine the prioritization and the

frequency, nature and extent of testing on General Information Technology Controls (GITCs).
• Establishment of a procedure to contract with and evaluate service providers used for the development and support of technological resources.
• Development of trainings and practical guidance for end-users to facilitate the use of technological resources and implementation of a system (call center, ticket) for IT related questions or issues encountered.

• Performance of on-going and periodic monitoring activities:
   o Annual review of technological resources used by the firm in terms of relevance and reliability.
   o Monitoring of the effectiveness of GITCs on the firm's IT environment.

3.3.5.3. Intellectual Resources

• Creation of an approved list of intellectual resources (from network, locally developed, from service providers, and legal and regulatory resources), which is made available to personnel and the use of which is actively promoted.
• Implementation of a process to maintain the resources up-to-date and to update the training materials accordingly.
• Establishment of a procedure to contract with and evaluate service providers used for the development and support of intellectual resources.

3.3.6. Information and Communication component

• Implementation of a process owner's assessment of the relevant information that enables and supports decisions regarding the System of quality management.
• Establishment of processes to facilitate two-way communication with the network, network firms and service providers in order to fulfil the respective responsibilities relating to the requirements or services used.
• Definition of communication channels and mechanisms within the firm for distributing resources and to report non-compliance.
• Preparation of an annual Transparency Report that is approved and published on the firm's website.

3.4. Observations related to the mandatory responses

3.4.1. Specified responses in ISQM 1

In general, the specified responses in ISQM 1 have been included by the firms when designing and implementing responses. Some firms have even refined the granularity of their quality risks to take account of some of these responses.

Regarding paragraph 34 (c), several firms, in their implemented responses, have limited complaints and allegations to ethical and behavioural failures reported through dedicated channels. The CSSF would like to point out that the Standard is broader and encompasses "*failures to perform work in accordance with professional standards and applicable legal and regulatory requirements or non-compliance with firm's policies or procedures established in accordance with ISQM*". This point should also be read in conjunction with article 25(6) of the Audit Law, CSSF Regulation N° 16-07 relating to out-of-court complaint resolution (Section 2) and Circular CSSF 19/717 (Section 1.6).

The CSSF would also like to draw firms' attention to paragraph 34 (f), which should be read in conjunction with the definition of listed entity[5] (which will be superseded at the end of 2024 by the definition of publicly traded entity[6]). The CSSF reminds firms that audits of the financial

statements of listed entities must be subject to an engagement quality review in accordance with ISQM2 "Engagement Quality Reviews".

3.4.2. Required responses in the Luxembourg supplement to ISQM 1

This aspect is clearly an area for improvement for most of the firms inspected in 2023, mainly network member firms, as the requirements were not included in the risk assessment matrix/tool provided by the network and the firms did not complete this reconciliation.

The CSSF expects firms to integrate these responses into their risk assessment process and to ensure that the related quality risks have been identified and assessed, but also that firms ensure that theses responses have been implemented when applicable.

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[5] **« Listed Entity »:** In Luxembourg, it means entities governed by the Luxembourg law whose transferable securities are admitted to trading on a recognized market. (effective for audits of financial statements for period beginning before December 15, 2024).

[6] **« Publicly traded entity »:** In Luxembourg, it means entities governed by the Luxembourg law whose transferable securities are admitted to trading on a regulated market as defined in the MIFID Directive, as well as any other regulated, recognized market open to the public that operates regularly. (effective for audits of financial statements for period beginning on or after December 15, 2024).

4. Assessment of the design and implementation of the requirements of ISQM 1 dealing with Network Requirements or Network Services

4.1. ISQM 1 requirements analysis

The postulate of the Standard is that the firm is responsible for its own system of quality management.

As a result, to place reliance on network requirements or network services used in the system of quality management, the firm shall **understand** them and their **impact** on the firm's system of quality management, but also its **responsibilities** for any actions that are necessary to implement the network services or network requirements[7].

The Standard provides guidance on how the firm can understand the network requirements or network services. It may be obtained through **inquiries** of, or **documentation** provided by the network about matters such as:

- The network's governance and leadership,
- The procedures undertaken by the network in designing, implementing and, if applicable, operating, the network requirements or network services,
- How the network identifies and responds to changes that affect the network requirements or network services or other information, such as changes in the professional standards or information that indicates a deficiency in the network requirements or network services,

- How the network monitors the appropriateness of the network requirements or network services, which may include through the network firms' monitoring activities, and the network's processes for remediating identified deficiencies.

Based on this understanding the firm is required to[8]:

- Determine how the network requirements or network services are **relevant to**, and are **considered** in, the firm's system of quality management, including how they are to be **implemented**,
- Evaluate whether and, if so, how the network requirements or network services need to be **adapted or supplemented** by the firm to be appropriate for use in its system of quality management. Although the network may drive network requirements to promote consistent quality across a network, the firm may need to adapt and supplement the network requirements or network services so that they are appropriate for the nature and circumstances of the firm and engagements it performs.
  ⇨ **This evaluation shall be specifically documented.[9]**

Monitoring activities:

The network may perform monitoring activities across the network firms[10]. The nature, timing and extent of these monitoring activities varies across networks and may also vary from year to year within a network.

When the network performs monitoring activities of the firm's system of quality management, the firm is expected to:

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[7] ISQM 1 par. 48 and A177

[8] ISQM 1 par. 49

[9] ISQM 1 par. 59

[10] ISQM 1 par. 50

- Determine the effect of the monitoring activities performed by the network on the nature, timing and extent of the firm's monitoring activities,
- Determine the firm's responsibilities in relation to the monitoring activities, including any related actions by the firm,
- As part of evaluating findings and identifying deficiencies, obtain the results of the monitoring activities from the network in a timely manner.

Documentation:

The **documentation related to network requirements or network services** may vary based on several factors, including:

- The nature of the network requirement or network service,
- The documentation provided by the network in relation to the network requirement or network service, and whether it is at a **sufficient level of detail to fulfil the requirements of the Standard**[11]. However, the firm is responsible for its system of quality management, and therefore is **also responsible for the documentation**.

4.2. CSSF expected implementation of the requirements

The CSSF has identified several steps that it expects audit firms that are member of a network to implement and document when dealing with network requirements or network services:

1) Identification of the network requirements/resources and/or network services that supports the different business processes within the system of quality management and/or the performance of engagement,
2) Understanding, determination and documentation of the relevance of the network requirements and the network services for the different business processes[12] and endorsement of the responsibility to implement those,
3) Evaluation of the need to adapt and supplement the network requirements/resources/services at local level and documentation of this evaluation,
4) Monitoring by the firm of the dedicated responses: this could include obtaining agreed upon/specified procedures reports on the testing of the responses by the network with the findings identified, corrective and remedial measures. It could also be controls that the local firm performs over the use of network resources,
5) Evaluating the findings communicated through the report in combination with additional findings at local level or with compensating controls within the firm, to determine whether there are deficiencies,
6) Communication of results of monitoring activities to engagement teams and other individuals that have been assigned responsibilities within the system of quality management for appropriate action.

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[11] ISQM 1 par. 58 and 59

[12] That implies for the local firm, identification and assessment of quality risks of using the network requirements/resources/services and design and operation of

the responses (with identification of the responsible of the responses (local firm, network resource owner, service model…)) to mitigate the quality risks and documentation of the risk assessment process.

5. Conclusion and next steps

Quality is not just a matter of compliance, but an essential pillar for the sustainability of the audit profession. Implementing the requirements of ISQM 1 is part of the process to act in the public interest and to enhance the role of the audit profession for the credibility of the financial reporting ecosystem.

There are many benefits to be expected from implementing the Standard:

- o Creation of a culture of quality, a mindset, a way of being that is integrated into day-to-day operations,
- o A proactive approach to quality management rather that a reactive approach, with the identification of the root causes for deficiencies and the mitigation of risk of them happening again, that drives continuous improvement,
- o The components and objectives defined by the Standard provide clear goals that need to be achieved,
- o The approach is risk-based with tailored and focused responses rather than to comply with a checklist of controls,
- o Enhanced communication with stakeholders.

During the 2023 inspection campaign, the CSSF has focused its work on the risk assessment process and the design and implementation of responses. As identified in the various sections of this report, there are points to monitor and areas for improvement on which the CSSF will focus in the coming months.

In the 2024 inspection campaign, the CSSF will continue this work for other firms that are on the scope of the year's inspections. For firms that are reviewed on an annual basis or every 3 years, the work programme will also include the review of the operating effectiveness of the responses for selected components, the assessment of the monitoring and

remediation process and the first evaluation of the system of quality management.