An External Auditor's Guide to

Improving Audit Quality Using Root Cause Analysis

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About this guide

This guide has been developed by Chartered Accountants Australia and New Zealand (CA ANZ) on behalf of the Australian Auditing and Accounting Public Policy Committee (APPC), which comprises representatives of BDO, Deloitte, EY, Grant Thornton, KPMG, PwC, CA ANZ, CPA Australia and the Institute of Public Accountants (IPA). The APPC is committed to playing a part in improving the quality of audits across the profession and hopes this guide will be a useful tool for firms of any size.

The guide defines root cause analysis ("RCA") and explains how audit practitioners can use it to identify and address the root causes of review and inspection findings. RCA is an effective and efficient way to improve audit quality.

Implementing remedial actions without having identified the real cause(s) or audit quality issues can be costly. RCA enables you to tackle problems instead of 'putting out fires.' This guide contains suggested steps for performing RCA that can be adapted, depending on your firm's needs and circumstances.

It is intended as non-authoritative guidance to help external auditors improve audit quality. It does this by offering pointers on key things to consider, based on what other practitioners have found useful in practice. However, this guide is not a quality control standard; the writers do not seek to impose specific ways of performing RCA, but instead offer guidance on key questions to ask to ensure a firm is undertaking RCA in a practical way.

Contents

Introduction 1

What is root cause analysis? 1

What is root cause analysis in an audit firm? 1

What is a finding? 1

What is the difference between an engagement review, an engagement quality control review and an internal inspection? 1

What action should a firm take in the case of a finding? 2

Should a firm have a remedial action plan for each and every finding? 2

Is root cause analysis worthwhile for smaller firms? 4

The RCA Process 5

Preparing for RCA 5

Performing RCA 8

Appendix 1: Differences Between Engagement Reviews, Engagement Quality Control Reviews and Internal Inspections 13

Appendix 2: The Benefits of Root Cause Analysis 14

Appendix 3: Illustrative Review of the Results of Inspection Findings 15

Appendix 4: More on Tagging (Taxonomy) 17

Appendix 5: The RCA Process 20

Appendix 6: Illustrative Remedial Action Plan 21

Introduction

What is root cause analysis?

In general, RCA is a way of preventing faults by identifying the real reason why it has occurred. In business, RCA is used to improve the quality of products and services.

What is root cause analysis in an audit firm?

In the context of auditing, RCA is the process of identifying the root cause of a review or inspection finding.

What is a finding?

A finding is a quality issue that has been identified during an engagement review, an engagement quality control review, or an internal or external inspection. A quality issue is generally related to compliance with auditing standards.[1]

The severity of a finding depends on its facts and circumstances. A finding does not necessarily indicate that a particular audit engagement was not performed in accordance with the standards or that the auditor's report was not appropriate.[2]

What is the difference between an engagement review, an engagement quality control review and an internal inspection?

An engagement review is where more experienced team members review the work of less experienced team members (of the same audit engagement team) so that the sign-off partner is satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached in the auditor's report. Each working paper is reviewed by someone other than the person who prepared it.

An engagement quality control review is also done before the auditor's report is signed off, but it is carried out by a more experienced person with the necessary authority and technical competence. The review focuses on significant judgements, and also examines the conclusions reached in the draft auditor's report. This type of review is carried out on certain clients with public interest.

An internal inspection is a cyclical process that is usually performed after the audits selected for inspection are completed. The focus areas and file selection depend on the firm's risk management procedures (e.g. new standards, current trends, public interest, complaints or external inspection findings).

For a more detailed discussion of the differences between an engagement review, an engagement quality control review and an internal inspection, refer to **Appendix 1**. A finding can result from a review or an inspection.

[1] This includes relevant ethical requirements, and applicable legal and regulatory requirements, as required by auditing standards (hereinafter referred to collectively as 'the standards').

[2] ASA 220 *Quality Control for an Audit of a Financial Report and Other Historical Financial Information* and ISA (NZ) 220 *Quality Control for an Audit of Financial Statements*, para. A36.

What action should a firm take in the case of a finding?

Maintaining audit quality is imperative, so audit firms should have remedial action plans to deal with findings. Firms need to evaluate deficiencies, and remedy systemic and significant ones,[3] by communicating the deficiencies and recommendations for appropriate remedial action to relevant engagement partners and other appropriate staff members,[4] and implementing appropriate remedial action.

Should a firm have a remedial action plan for each and every finding?

No. Some findings from engagement reviews or engagement quality reviews do not necessarily indicate that a particular audit engagement was not generally performed in accordance with the standards or that the auditor's report was not appropriate. Likewise, findings from cyclical internal inspections (focusing more on thematic, i.e. possible systemic issues) do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with the standards or that the reports the firm issues are appropriate in the circumstances.

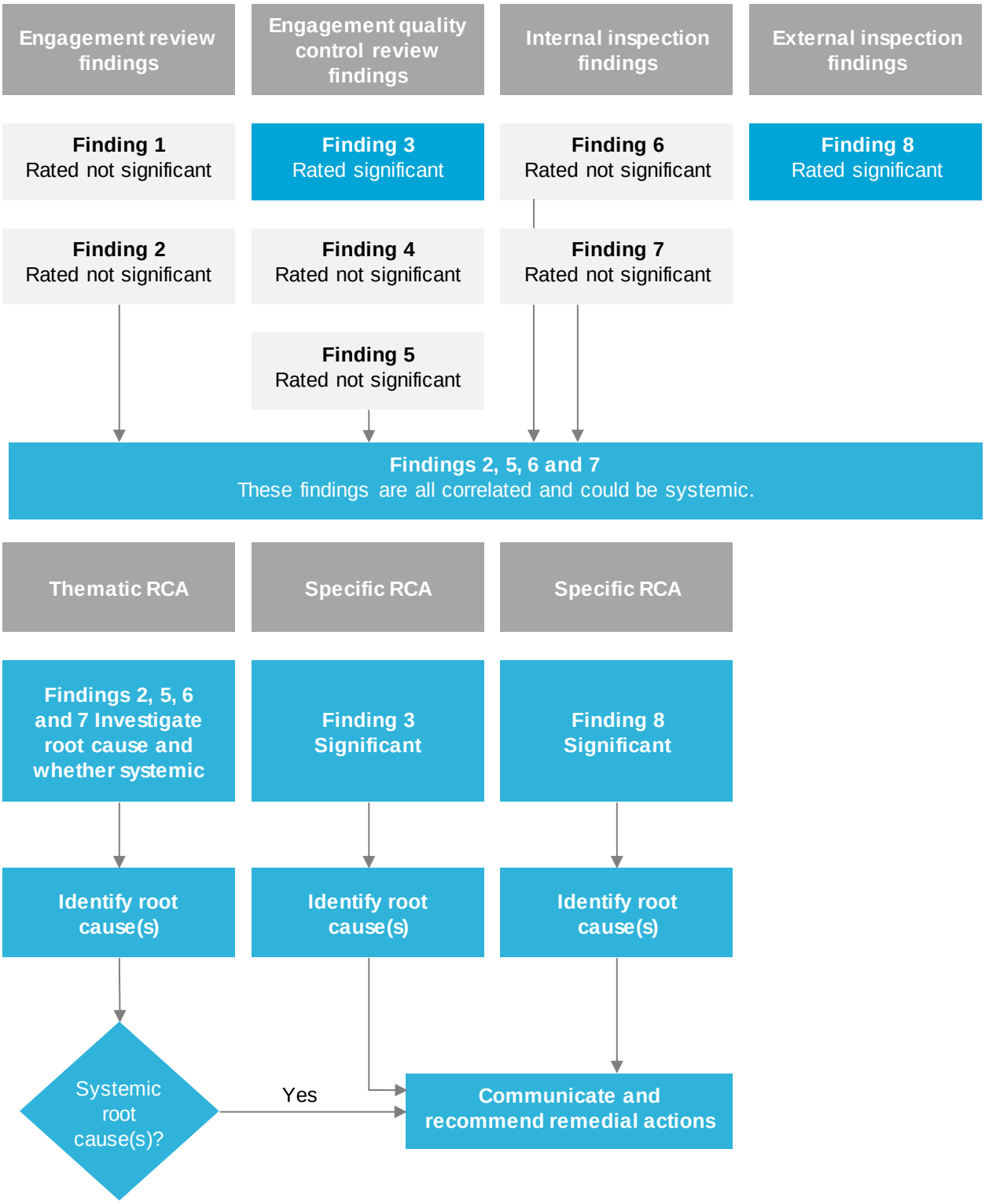
As mentioned above, this is because the severity of a finding depends on its facts and circumstances. Only **significant** or **systemic** (i.e. repetitive) deficiencies require prompt corrective action.[5] This is why it is useful to rate the severity of each finding, which can be done with reference to a rating scale designed by the firm. Most significant findings typically indicate both non-compliance with the standards and the likelihood that the conclusions reached were not appropriate. Firms should resolve such findings before sign-off. If not, it may indicate an additional issue related to the review process.

When performing RCA, significant findings are analysed as a **specific RCA** process, whereas all findings should be analysed for correlations in order to identify systemic themes for further investigation and analysis to determine their causes (this is called **thematic RCA**).

[3] Auditing Standard ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements* and Professional and Ethical Standard 3 (Amended) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*, paras. 49–54.

[4] ASQC 1/PES 3, para. 50.

[5] ASQC 1/PES 3, para. 49.



It is easier for larger firms to perform thematic RCA due to the large number of file reviews. However, it should be noted that even though engagement review findings and engagement quality control review findings are resolved before sign-off, they can still inform the RCA process.

Is root cause analysis worthwhile for smaller firms?

In terms of the standards, each engagement file must undergo at least an engagement review. While not all engagement review queries will necessarily be retained for RCA purposes, there will likely be ample 'coaching notes', 'queries' or review findings to build a database of findings and themes with relatively little effort. It benefits even a sole practitioner to make a list of things to look out for, which may include common mistakes or mistakes they have made personally.

Every firm should have engagement quality control reviews of certain clients, depending on the jurisdiction and the firm's own set policies. Each firm should have internal inspections as part of its monitoring, and during each cycle, at least one engagement file per partner must be inspected. Therefore, regardless of a firm's size, there will be a number of findings over time from various reviews and inspections. An efficient way to evaluate and put in place effective remedial action for significant and recurring findings is to perform specific RCA on significant findings and thematic RCA on systemic issues.

If a firm does not know the significant and systemic underlying causes, it will not be able to determine appropriate remedial action, which is a requirement under the standards.

Appendix 2 contains a case study that explores this further.

The RCA Process

Preparing for RCA

Step 1 – Make efficient use of reviews and inspections

As discussed above, reviews and inspections are required under the standards. They also provide valuable information that firms can use for RCA to efficiently and effectively improve their audit quality. The size and circumstances of a firm will influence the structure, scope and volume of reviews and inspections. For instance, in smaller firms, inspections may need to be performed by the same individuals who are responsible for designing and implementing the firm's quality control policies and procedures, or who act as the engagement quality control reviewers.

Smaller firms may also choose to use suitably qualified external persons or another firm to carry out engagement quality control reviews or inspections, or they may choose to share resources with other smaller firms. Whatever the case, it is worthwhile paying for good reviewers or inspectors.

An external reviewer or inspector may also advise on recurring issues (year on year or otherwise), emerging trends and focus areas. Even if the firm uses an external engagement quality control reviewer or external quality monitoring inspector, someone in the firm should coordinate the reviews or inspections and be in charge of the data/results – preferably a senior partner or someone with relevant technical skills, experience and authority.

Helpful Hints

- It is beneficial to openly discuss differences of opinion about the findings and to agree on findings. This will help firms obtain buy-in from staff when implementing remedial action.
- The partner and manager being reviewed should document their answer to each of the findings, regardless of whether they agree or disagree. The reviewer's response should also be documented. This may provide useful information and insights when analysing findings.
- Firms should also make use of the findings from external inspections conducted by regulatory and professional bodies, though they are not to be substituted for internal inspections.

Refer to **Appendix 3** for an illustrative review of the results of inspection findings.

Step 2 – Roll out good practices

Implementing 'good practices' is, in essence, the same as implementing remedial action to address audit quality deficiencies (refer to **Step 9**). Good practices may be identified from files that have no findings or demonstrate good audit quality. It is easier to build on good audit quality practices than to chase after the possible correlated root causes of various findings. It is also easier to copy good-quality work delivered by teams or personnel already employed by the firm than it is to hire new staff or find a solution outside the firm.

Helpful Hints

A firm has to budget both money and time to build on good practices. Time needs to be planned to analyse files with good review or inspection results, to identify what practices and processes produced the good-quality work. One of the ways this can be done is by comparing files with no findings and isolating common factors.

Example

The common factor may be something simple; e.g. a staff member is more qualified, skilled or experienced than average. A typical long-term remedial action may be to consider employing people with a certain level of qualifications, skill and experience. But for many practitioners, especially those in rural areas, this is easier said than done and is often not possible.

An alternative solution may be to train existing staff using the exemplary work. Another solution is to consider changing policies and procedures and to improve key performance measures. Refer to **Step 9** for more on remedial action.

Small firms have the advantage that remedial action can often be implemented more quickly, as their size makes them more agile. However, smaller firms have fewer resources and may often be challenged to find innovative and cost-effective plans to improve audit quality, and to practise implementing the plans. Therefore, proactive audit quality improvement plans (whether they are remedial or involve rolling out good practices) are often implemented on a 'trial and error' basis, especially when the root cause is uncertain.

Helpful Hints

- The easiest way to build on a firm's good work is to find common factors of excellence.
- Common factors of excellence are often the team members behind the good work.
- The most economical way to duplicate good work is to task the people behind it with training other staff, based on each one's strengths. The trainers will probably know what works best and why, based on the firm's specific circumstances; will use relevant case studies – the firm's client files; and will be available for follow-up after the training. An expensive training company may not offer all these things.
- Sometimes a team's work improves dramatically from one quality review to the next, or the same team has both a good file and a file with findings. Interview the team members and ask what they could have done differently. Implement good practices on a trial and error basis.
- By interviewing team members about their good file ratings first, it accustoms them to RCA interviews **as a support function**, not a career performance appraisal. Later, when interviewing audit team members about negative findings to ultimately analyse the root causes of them, they will be used to audit quality improvement interviews as a support function, and they will be more open and honest about what went wrong or why something was not done.

Taking note of the root causes of good quality is more proactive than hunting root causes in the aftermath of problems. It also creates a positive attitude that fosters staff morale and makes it easier to have uncomfortable conversations when negative findings are discussed. It is helpful to compare notes with other practitioners, either informally on a one-on-one basis or at forums. Implementing good practices (or rooting out undesired practices) will always be experimental, but it gets easier with experience.

Helpful Hints

Implementing remedial action following RCA will become easier as staff members learn how to roll out good practices. They will also be more willing to accept such actions because they will be used to troubleshooting, training and regular changes to processes.

The same responsible person mentioned in **Step 1** should coordinate the rollout of good practices and act as the custodian of the data in **Step 3** onwards.

Step 3 – Make a list

The findings from reviews and inspections (see **Appendix 3**) can be collated in a database. The database should be updated regularly as new review or inspection results become available. As can be seen from the illustrative list in **Appendix 3**, more information fields can be added, such as year/cycle, name of reviewer, date of review, client industry, complexity and size – whichever may be useful in determining correlated themes.

Step 4 – Tag the list

'Tag' each finding record in the list with information that may be correlated (e.g. themes for thematic RCA) or can identify significant findings (for specific RCA), by adding information fields per the discussion in **Step 3** above and as indicated in **Appendix 3**. For instance, each finding can be tagged with a main theme, a sub-theme and references to standards. It is advisable to make effective use of reviewers and inspectors in this regard by letting them go beyond a 'regular' review or inspection, and also provide input into the taxonomy.

Helpful Hints

If you plan on using an external consultant for engagement quality control reviews or inspections, obtain an example report before hiring them, or agree on a report format and level of detail, so it is easy to process the findings data afterwards.

There is no one set template for tagging or listing findings results. It depends on the nature of the findings, the size and circumstances of the firm, and ultimately what works. The firm's taxonomy may change over time as the list becomes more comprehensive, the size of the firm changes or learning what taxonomy or theme categories work best. Refer to **Appendix 4** for more helpful hints on, and examples of, tagging.

Step 5 – Share the list

The illustrative list in **Appendix 3** suggests that the reviewer or inspector has already shared feedback individually with each relevant engagement partner and that feedback has been obtained from them. At a minimum:

- Findings from the engagement quality control review need to be resolved and documented before audit sign-off[6]
- Findings noted from inspections (monitoring) must be communicated to relevant engagement partners and other personnel, along with recommendations for appropriate remedial action.[7]

A simple way to achieve this is to share a summary of the findings list (which may or may not include preliminary recommendations) with engagement partners and the firm leaders on a regular basis – at least annually. (Do not share all the details, as inspection review responses and staff names may be tagged in the list). This can be done in many ways, including:

- Providing a simple summary of the list's themes
- Conducting a workshop or debrief after the quality review to discuss significant findings and common themes
- Having relevant staff members who are involved in rolling out good practices present and discuss examples of exemplary files
- Updating the firm's audit programs and quality control checklist to include checks for specific recurring findings
- Having each audit team member build their own personalised list based on normal engagement reviews, which they can update with things to look for – e.g. documentation they tend to omit.

[6] ASQC 1/PES 3, para. 42.
[7] ASQC 1/PES 3, para. 50.

A firm may refrain from sharing this list until RCA has been performed, so that recommendations and remedial action plans can be included. However, sharing this information before having formulated recommendations may help later when analysing possible root causes in the steps below, and recommendations may be shared later as an update.

Helpful Hints

A workshop and other communication discussing or summarising the review or inspections results can be used to signal the end of an annual quality review process. This will come in handy later because it helps separate staff performance processes from technical support functions, the latter of which includes RCA.

Performing RCA

Steps 1 to 5 outline a suggested way to support compliance with various quality control requirements in the standards, such as:

- Having engagement reviews for each engagement, and resolving issues (or findings) before sign-off
- Performing engagement quality control reviews on certain engagements and documenting the findings
- Communicating findings (identified deficiencies) from inspections during cyclical monitoring and communicating those to relevant engagement partners and other personnel
- Identifying significant and systemic deficiencies for remedial action.

Steps 1 to 5 discussed above are therefore not the only way in which to comply with quality control requirements. They are a recommended way to prepare information to ensure RCA is efficient and effective. Not only do they prepare a firm for the RCA process, as illustrated in **Appendix 5**, but they also put it into perspective.

Step 6 – Set parameters

As discussed above, the standards require remedial action for significant and repetitive findings. Significant findings are fairly easy to identify to conduct specific RCA on, and this is obviously based on the severity of ratings attached to the findings. For systemic root causes, a firm must set parameters due to the volumes, even in a smaller firm, because the findings are less severe. Setting parameters involves determining the scope of data analysis (to follow in **Step 7**), i.e. which taxonomy themes to investigate for thematic RCA analysis.

The most significant findings can be identified with a ‘severity’ tag or field, as illustrated in **Appendix 4**, and the most prevalent or repetitive themes can be identified by analysing different ‘theme’ tags or fields. Finding correlations can extend beyond ‘themes’. Specific references to standards, certain personnel or client industries can also be recurrent.

The smaller the number of findings, the more challenging it becomes to determine a correlation for thematic RCA, in which case more focus may be placed on specific RCA.

Step 7 – Gather information

After a firm identifies significant findings and repetitive themes (**Step 6**) by setting parameters, it should gather information on the facts and circumstances relating to each theme selected within the parameters set. This is usually done with one or more hypotheses about the possible root cause. This information can then be analysed (**Step 8**) to determine the various root causes. Information is gathered by:

- Inspecting selected working papers
- Interviewing relevant engagement team members based on questions that arise from inspecting the working papers.

Inspecting the working papers

It is imperative that the firm leaders make it clear that the RCA team or individual enjoys free access to all relevant engagement files and information. The prevalent themes will be linked to various related findings, which will indicate which engagement files to select and which working papers in each file to inspect. During the inspection of the working papers, possible hypotheses may be generated, with interview questionnaires prepared for each possible root cause, theme or finding.

Example – specific RCA on a significant finding

Finding (Steps 1 to 5): The auditor did not obtain sufficient appropriate audit evidence to come to a conclusion about the valuation of an intangible asset.

Confidential RCA notes – inspection of the working papers (Step 7):

The financials do not even specify whether cost or revaluation is used – did we even consider which measurement basis we must audit? Can we now ask which policy they think was appropriate then? If either cost or revaluation was appropriate, I cannot find any work being done on the carrying value, anyway – see procedure X.

Interview questionnaire (Step 7):

Question 1: What accounting policy was used to subsequently measure the intangible asset? Cost or revaluation? *This will lead to the next question.*

Question 2: What was appropriate? If there was not an active market, was the revaluation basis then accordance with the appropriate financial reporting standard? Did you evaluate the appropriateness of accounting policies? *This will lead to the next question.*

Question 3: What did you do to test the carrying value? *This will lead to the next question.*

Question 4: What of this did you or did you not document? *This will lead to the next question.*

Question 5: What was the material misstatement, or possible material misstatement, that you may have missed?

Additional standard question (e.g. for a training project): What audit assertions did you test and how did this fit into your risk assessment?

General questions (end): What would you have done differently? What do you think the finding was about? What do you think was the root cause(s) of the finding?

Note that the example interview questions above are not attempting to analyse the root causes, but are simply obtaining more information about the facts and circumstances related to the finding (specific RCA) or correlating facts and circumstances (thematic RCA). The questions to relevant engagement team members are therefore phrased using ‘what’ rather than ‘why’.

Team member interviews

Before starting the RCA process – and obviously before booking time for interviews – you must have support from the firm leaders. They are ultimately responsible for quality control, and their support will ensure that personnel take the RCA process seriously, make time for it and prioritise interviews.

Interviewers

Technical personnel (those responsible for RCA) and/or senior partners from the audit practice unit should be the interviewers. Industry champions (e.g. a technical person or experienced partner from the business unit or industry) will have a good idea of the issues relating to the relevant industry and will be able to speak the industry 'language', while an audit technical person will have a good idea of root causes and firm-wide issues.

It is advisable that the interviewer is someone other than the person/partner looking after the relevant staff member's career appraisals. This sends a clear message that the RCA process is not a performance measure process but a support function. Where possible, the interviewer should not also be a reviewer or inspector, as RCA is more effective when fact gathering is separated from assessment. Depending on the size of the firm, this will not always be possible, and in such cases the interviewer should be extra careful to approach the RCA objectively.

Regardless, interviewers must have sufficient experience, technical skills and authority to enable them to conduct the interviews effectively. It is advisable to conduct RCA as soon as possible after the reviews or inspections (**Steps 1 to 5**), while the information is fresh.

Interviewees

The partner should be interviewed as the individual in charge of the audit. The manager or accountant 'in charge' of the audit should also be interviewed, as they will have a better working knowledge of some of the issues, and possibly a different perspective. Other team members can be interviewed if it is necessary to obtain more detailed information from them.

Other data

Firms often consider what other data may be useful or available. Timesheet records, evidence of the extent and timing of partner reviews on file, office meeting minutes and HR records may all be useful sources of data relevant to a particular finding.

Case study

A firm did not make use of senior partners as interviewers because they were too busy. Instead, they asked a bright junior to do the interviews. The interviews took longer than expected, as the junior did not want to disappoint, knowing he lacked the years of experience the senior partners had. He gave feedback to the partner, and things did not entirely make sense, because the interviewees – partners and managers whose files had undergone reviews ¬– were feeding the junior misinformation, either knowingly or subconsciously, as it was embarrassing or difficult to talk to a junior about their mistakes and shortcomings. This meant the RCA was not effective and took more time and emotional energy than necessary.

Helpful Hints

- Instead of asking 'why' something was not done or was done wrong, ask 'what' happened. A 'what' answer tends to be factual and triggers a cognitive response, while a 'why' answer tends to be an opinion and may trigger emotive responses.
- A great question to ask is 'What would you have done differently?'
- At the end of the interview, consider asking the audit team member(s) what they think the root cause is.
- Keep in mind that people behave differently in one-on-one interviews compared to group interviews.
- Unless the interviewee deviates from the relevant findings and issues and time is of the essence, do not interrupt too much so that the person interviewed does not lose their thought process when reflecting on what happened.
- Do not ask leading questions, such as 'Do you agree this is the root cause?'

- Stick to the allotted time and to the prepared questions – you can always follow up side issues later. If the interviews go over time, it will become a habit, and the firm will go over the time budget. RCA will be perceived as a time-consuming process that is not worthwhile, and the firm will be unlikely to try RCA again in future. Interviews need not be much longer than roughly an hour each, so it is best to prepare notes to make the most of the time. To stick to the time, both interviewer(s) and interviewee(s) must come prepared. Therefore, have some notes or elementary questions prepared based on the review findings. If setting up questions beforehand is not feasible, at least let everyone go through the relevant review findings you will focus on. Tell the interviewee(s) beforehand that you will stop them when they start discussing other findings you do not want to discuss, and tell them why.

Step 8 – Analyse data

After sufficient information has been gathered, the person or team responsible for RCA will analyse the information, either with the quality team or with other personnel or partners who have the necessary technical skill and experience. This will provide plenty of facts and a balanced array of views to determine root causes.

The easiest way to analyse the information gathered (**Step 7**) to determine a root cause is to simply ask 'why'. However, there are many established methods to analyse root causes, including the fishbone, the five whys[8] and the fault tree.[9] These techniques are outlined below.

- **Fishbone:** Known as a cause-and-effect diagram or Ishikawa diagram, the fishbone is a visualisation tool for categorising the potential causes of a problem, to identify its root causes. A fishbone diagram is useful in brainstorming sessions to focus conversation. After the group has brainstormed all the possible causes of a problem, the facilitator helps the group to rate the potential causes according to their level of importance and draw a hierarchy. It is a technique used in the 'analyse' phase of the Six Sigma DMAIC (define, measure, analyse, improve, control) methodology.

- **Five whys:** The five whys technique, which is also used in the analysis phase of the Six Sigma DMAIC, does not involve data segmentation, hypothesis testing, regression or other advanced statistical tools. In many cases, it can be completed without a data collection plan. By repeatedly asking 'why' (five is a good rule of thumb), you can peel away the layers of symptoms, which can lead to the root cause of a problem. Very often the ostensible reason for a problem will lead to another question. Although this technique is called the five whys, you may find that fewer or more questions are needed before you find the root cause behind the problem.

- **Fault tree:** The fault tree is a decision support tool that uses a tree-like graph or model of decisions and their possible consequences, including chance event outcomes, resource costs and utility. It is one way to display an algorithm that only contains conditional control statements.

The best way to analyse root causes is to workshop them with selected partners and other relevant personnel, some of whom may have been the interviewers or interviewees, industry champions or technical staff.

Helpful Hints

- A focus group can help you 'think outside the box'. You should highlight themes and trends visually, summarise information obtained from interviews, share hypotheses you have and separate facts from opinions.
- During the workshop, always go back to the data.
- Compare 'good' files (those with no findings) and 'bad' files (those with significant or many findings) to determine what differences may have caused the findings.
- Root causes can be one shared root cause with several resultant types of findings, or several root causes causing one type of finding.

[8] Also known as the 'whys' approach – it does not have to be five.
[9] Also referred to as a 'logic tree'.

Step 9 – Remedial action

Once the root causes are agreed on, feedback is presented to the firm leaders, along with a remedial action plan with responsibilities, budget and milestones. The standards require firms to communicate quality control monitoring results to the firm leaders, engagement partners and relevant staff at least annually. The communication must be sufficient to enable remedial action where necessary, and therefore must include:

- A description of the monitoring procedures performed
- The conclusions drawn from the monitoring procedures
- A description of significant or systemic deficiencies and remedial actions to fix these deficiencies.[10]

A common remedial action is training. However, this should not be seen as a panacea for each root cause. If training has been provided but findings still occur, it could be that the training is ineffective and a thorough RCA may establish why. It may be that there are other factors such as client pressure, lack of industry skills or unreasonable deadlines, and these may be remedied by action other than training or by a combination of remedial actions.

Some firms use audit quality indicators (AQIs)[11] to assess whether the root causes might be factors other than lack of competence. Other firms use AQIs to select files for review. According to the standards, remedial action includes, but is not limited to, the following:

- Taking appropriate remedial action with specific engagement teams or individual staff members
- Communicating the findings to those responsible for training and professional development
- Changing quality control policies and procedures
- Taking disciplinary action against those who repeatedly fail to comply with firm policies.

Keep in mind

Any remedial action needs to be supported by the firm leaders. This extends to the content of training, communiques to staff, and updating templates, policies and procedures. The firm leaders have to understand and accept the root causes and be satisfied that the remedial actions will address these causes. A failure to implement appropriate remedies will mean that the RCA process will not bring the required value and benefits to the firm.

Refer to **Appendix 6** for an illustrative remedial action plan.

Step 10 – Repeat (and follow up)

It is important to keep on practicing RCA, as it involves a learning curve. Although RCA is largely evidence-based, it does involve hypothesis. It is therefore important to conduct a form of post-implementation review in order to learn whether the remedial actions were effective. This is a challenge, because the firm's and clients' circumstances change, as well as the environment, including changes in financial reporting standards, regulations, and the economy. It is therefore best to expedite the above steps as soon as possible in order to get the best results and to be able to do a post-implementation follow up before many factors change.

[10] ASQC 1/PES 3, para. 53.

[11] AQIs are quantitative measures designed to establish insights into audit quality in the form of metrics or benchmarks; e.g. percentage of engagement time spent on file review. Though AQIs are largely experimental, to inform discussions on definitive audit quality findings, they act as leading audit quality indicators in the absence of hindsight findings.

Appendix 1: Differences Between Engagement Reviews, Engagement Quality Control Reviews and Internal Inspections

Engagement reviews (part of 'engagement performance')

An engagement review examines whether sufficient appropriate audit evidence has been obtained to support the conclusions reached in an auditor's report before it is issued[12] and whether work has been carried out in accordance with the standards. Consideration is also given to whether appropriate consultations have taken place on significant matters, and whether there is a need to revise the nature, timing and extent of work performed.[13] The whole file is reviewed, and the more experienced team members review the work of less experienced team members.[14]

Engagement quality control reviews (part of 'engagement performance')

An engagement quality control review is required for audits of certain clients with a higher level of public accountability or public interest.[15] An engagement quality control reviewer performs the review, but the firm leaders retain overall responsibility for maintaining audit quality. The engagement quality control reviewer is not part of the engagement team and is someone who can evaluate the work of the team objectively and with the necessary skills, experience and authority.[16]

The engagement quality control review objectively evaluates the significant judgements made by the engagement team[17]; therefore, only selected documentation in the engagement file is normally reviewed. It also evaluates the conclusions reached in the draft auditor's report. The engagement review and engagement quality control review take place before the auditor's final report is released.[18]

Internal inspections (part of 'monitoring')

While engagement reviews and engagement quality control reviews are part of 'engagement performance', internal inspections are part of the monitoring process designed to provide firm leaders with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and applied on an ongoing basis. A firm's own internal monitoring inspection includes inspecting, on a cyclical basis, at least one completed engagement for each engagement partner. Normally, those performing the engagement or the engagement quality control review are not involved in inspecting the engagement[19], except in smaller firms where resources are limited.[20]

One or more experienced partners in the firm are usually responsible for the monitoring process. Some larger firms also select engagements for monitoring on or before the date of the auditor's report. These are colloquially referred to as 'hot reviews' or 'in-flight inspections'.

Though the objective of inspections is similar to that of engagement reviews and engagement quality control reviews, the results obtained from inspections also inform whether the firm's system of quality control has been appropriately designed, effectively implemented and appropriately applied. The monitoring process also involves communicating weaknesses found in the system, identifying corrective action to be taken and following up.

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[12] ASA 220/ISA (NZ) 220, paras. 16–17; ASQC 1/PES 3, para. 32.
[13] ASQC 1/PES 3, para. A35.
[14] ASQC 1/PES 3, para. 33.
[15] In New Zealand, this applies to "audits of financial statements of FMC reporting entities considered to have a higher level of public accountability, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required". In Australia, this applies to "audits of financial reports of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required". See para. 19–NZ21.1 of ISA (NZ) 220 and para. 19–Aus 21.1 of ASA 220, respectively.
[16] ASQC 1/PES 3, paras. 39–41.
[17] ASQC 1/PES 3, para. 35.
[18] ASA 220/ISA (NZ) 220, para. 25(b); ASQC 1/PES 3, para. 36.
[19] ASQC 1/PES 3, para. 48.
[20] ASQC 1/PES 3, para. A68.

Appendix 2: The Benefits of Root Cause Analysis

RCA is cost-beneficial for audit firms of all sizes. If done correctly, it is an effective way to maintain and improve audit quality. Implementing remedial action without knowing the real cause of a finding costs more in both the long and short term, because the remedial action will not address the cause, and the finding will reoccur. The cost of the remedial action will therefore be wasted. This is the 'putting out fires' approach.

Larger firms have been performing RCA for many years, both locally and overseas. While larger firms have more resources than smaller ones, RCA does not have to cost a lot of time or money when done on a scale that suits the size of the firm. Smaller firms should not have to perform RCA the same way as larger firms, and RCA should start on a small scale. When some of the larger firms in Australia started performing RCA, they did so on a very small scale. RCA should not take up more time than the 'putting out fires' approach, but it does require some thought and planning.

Firms should consider the points below when contemplating whether to practice this thematic RCA process:

- Improving the firm's audit quality in a cost-effective way will lead to superior services and sustainable profits.
- An audit firm must maintain audit quality – this is not a choice.
- It makes sense from both a time and cost perspective to address multiple symptoms at once using one remedial action, instead of putting out fires all the time. To enable this, it is necessary to find the shared root cause of many symptoms.
- Firms that perform RCA also discover good practices and better ways of doing things.
- If firms do not conduct a proper root cause analysis of inspections findings, audit quality is not improved and the defects discovered just become perpetual irritations.

Although performing RCA may seem like more work, this is not the case. Firms that just put out fires often never truly learn and so do not become more efficient. Performing RCA will allow firms to connect the dots more quickly in the future, freeing up time.

Case study

A review of some of XYZ Incorporated's audit files found that there were no engagement letters on file. A simple root cause analysis suggested that the firm did not adequately plan its work before the busy season hit, which is why there was no time to put engagement letters on file. A 'putting out fires' approach would have been to send engagement letters to the relevant audit clients to be signed and then put on file.

However, the firm decided to follow a more thoughtful approach by asking why there was no engagement letter on file. It asked, "Why is ASA 210/ISA (NZ) 210 important? Why is agreeing to the terms of the engagement a requirement in the standards and how can this benefit us?"

The firm then revised its annual planning, which gave staff members more time to meet with clients in advance to discuss upcoming work. The firm also addressed its fee structure and client expectations. This may initially have seemed to take longer than would have been the case if the firm had used a 'putting out fires' approach, but the final result was more profitable and less risky than just having a signed engagement letter on file for each client. After all, having an engagement letter on file is just part of the requirements of ASA 210/ISA (NZ) 210, and in this case was the symptom of a deficiency in compliance with this standard.

Appendix 3: Illustrative Review of the Results of Inspection Findings

This sheet may be used to input findings into a database that can be used to identify themes and set parameters (**Step 6**) for thematic RCA. This sheet is purely for illustrative purposes, and the level of detail depends on the size and circumstances of each firm. Other information that may be added includes a unique finding number, the name of the audit manager, the review year/cycle, the name of the reviewer, and AQIs such as the qualifications of team members, the time budget and billing. Not all information in the list should be shared firm-wide.

STEP 3						STEP 4		
Information that should be available even when a firm is not performing RCA						Tagged information for RCA		
						Significant?	Systemic?	
Partner	Client	Review/EQCR/ inspection	Description of finding	Comment from partner/manager	Comment from inspector/reviewer	Severity rating	Theme 1/ category	Theme 2/ sub-category
AB	#123	Inspection	Journal entries were not raised as significant risks.	The presumed risk of management override of control linked with journal entries is indicated on working paper X and each individual audit program item Y (significant risk of management override of control).	The risk of management override was documented on X, however the testing for completeness of journal entries was insufficient. With regard to each individual audit program, procedure Y was only raised as a significant risk on the revenue audit program, with specific reference to calculations management performed. On all other audit programs, procedure Y was documented as 'not relevant', indicating that there were no other significant risks.	3/4*	Risk assessment	Journal entries
CD	#456	Inspection	There was insufficient documentation regarding fraud risk considerations.	Sections 2 and 3 of working paper A (in the electronic version) facilitate the consideration of risk factors as per ISA 315, as well as fraud risk factors as per ISA 240 for each of the key elements of our understanding of the business. Relevant (and identified) risk factors are transferred to working paper B (summary of fraud risk factors and consideration of risk of material misstatement due to fraud). Refer in particular to page X of working paper	Paragraph 25 of ISA 240 states: "In accordance with ISA 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures". Working papers A and B refer to fraud risk at the financial statement level. B does not consider fraud risk related to the completeness of revenue.	3/4*	Risk assessment	Fraud

STEP 5

Do not share this information firm-wide

Filter or summarise this information before sharing it firm-wide

Summarise the information in these columns before sharing it firm-wide

STEP 3						STEP 4		
Information that should be available even when a firm is not performing RCA						Tagged information for RCA		
						Significant?	Systemic?	
Partner	Client	Review/EQCR/ inspection	Description of finding	Comment from partner/manager	Comment from inspector/reviewer	Severity rating	Theme 1/ category	Theme 2/ sub-category
				B, where risk factors are linked to individual F/S items.				
EF	#789	Inspection	Not documented that all transactions equal to or greater than performance materiality will be selected for testing	This is a methodology matter. All audit programs commence by drawing the audit team's attention to the planning materiality figure and the related performance materiality figure (whether overall or applicable to the specific item – refer to XYZ for all audit programs). After the risk assessment, a final evaluation is performed where the performance materiality requires adjustment – refer to ABC for all audit programs. Furthermore, in this audit file, the consideration that your finding refers to was taken into account on program X and Y.	The planning materiality and performance materiality are documented on the audit programs; however, there was no evidence on the testing that consideration was given to all individual items above performance materiality.	3/4*	Sampling and selection	Material transactions

*** Not necessarily an appropriate severity rating**

The three right hand fields (columns) above represent the various 'tags' of information that may be added to each finding. The objective of tagging is to make it easier to identify significant findings for specific RCA (hence the 'Severity rating' column), and to analyse correlations or trends for specific RCA (hence columns like 'Theme 1' and 'Theme 2').

Appendix 4: More on Tagging (Taxonomy)

The level of detail and specific uses are unique to each firm. This section provides more examples of tagging with various levels of detail.

Example 1a – simple tagging

Finding

The auditor did not perform substantive procedures for a material journal entry at year end (and therefore did not obtain sufficient appropriate audit evidence).

Theme 1

Sufficient appropriate audit evidence (ISA 330 and/or ISA 500)

Theme 2

Material transactions

Example 1b – complex tagging

Finding

The auditor did not perform substantive procedures for a material journal entry at year end (and therefore did not obtain sufficient appropriate audit evidence).

Auditing standard tag/theme can be linked to a specific paragraph

ISA 330.18

Or a theme name as 'Theme 1'

Material transactions

Example 2a – simple tagging

Finding

The auditor did not document ...

Theme 1

Documentation

Theme 2

N/A

Example 2b – complex tagging

Finding

The auditor did not document ...

Auditing standard tag/theme can be linked to a specific paragraph

ISA 230.08–.09

Or a theme name such as 'Theme 1'

Documentation

Using the quality inspections results, the findings can then be linked to a secondary theme, which can also be one or both of the following:

- A reference or references to auditing standard(s) that were breached
- An 'auditing standard theme' linked to the breach.

Example 3 – more than one theme

Finding

The auditor did not perform substantive procedures for a material journal entry at year end (and therefore did not obtain sufficient appropriate audit evidence).

Theme 1/theme

'ISA 330.18 – Material transactions'

Theme 2/theme

'ISA 240.27, .31 – Management override of internal controls'

Alternative Theme 2/theme or third tag/theme

'ISA 500.A55 – Haphazard selection vs sampling' (It can also have something to do with related parties if it is a journal entry on a shareholder's or director's loan account.)

Tagging does not have to be complicated, and the more tags added to the finding, the better the chances of connecting the dots and finding correlations. When starting out, there is no way to tell how correlated the findings could be, so it's beneficial for tagging to be as structured and as detailed as possible.

For example, all the findings may relate to documentation, being ISA 230, and therefore you cannot simply link a 'theme' to one standard only. For instance, professional judgement is a theme that occurs throughout the standards, but it has sub-level themes. The reviewer's report may guide the person creating the taxonomy, which is part of the reason why the reviewer's work and communication skills are important.

You can also tag accounting standards, which may involve an accounting issue or a recurring area of financial reporting that needs to be addressed. If it is an accounting issue, there is always a related audit issue, because a finding is ultimately connected to compliance with the standards.

Firms that do not have a technical team will find the process of determining appropriate tags and themes to be rewarding and instructive. This can be a team exercise; it does not necessarily need to be done by one person. It is important to be strategic about who should participate in this process, however, as it can be time-consuming for some staff members.

'Why' tags

The above are examples of 'what' tags. While the 'why' question is basically part of RCA, it will often arise when discussing findings with the team as part of the review or inspection process. If a partner or manager offers a 'why' answer to the reviewer, these responses should be documented. It is expected that engagement teams will dispute findings and put forward reasons as to why they occurred. It is important to keep an open mind and not jump to conclusions about root causes; however, you need a hypothesis to be able to ask focused questions during interviews (**Step 7**).

More about tagging

- Tagging applies to each finding. Tag the audit file first (e.g. the client name and year).
- You may need to improve the way your practice performs particular types of audits; e.g. you may have an audit package for self-managed super funds and do these well, but do other types of audits poorly (or vice versa). Another useful relevant tag is therefore the type of engagement.
- Tag people/team members. You can tag findings with the person(s) responsible for the working paper, section and/or entire audit file the finding was on. It's possible that an individual or group of individuals is the problem, which suggests that remedial action does not have to be firm-wide but can instead focus on specific groups or individuals. You will need access to the reviewed audit files; a good time to do this is at the end of the quality control review – while the audit files are still checked out. Do not change your audit methodology or firm policies and procedures if a single person or team needs training, or if it is an isolated case.
- You can also tag the client and/or industry.
- Start with simple tags and do not overcomplicate tags.
- Add a tag for the severity of the finding – this may come in handy later.

Example – severity ratings tags

0 – No issues

1 – Documentation of shortcomings, but risk of inappropriate assurance opinion or conclusion is unlikely

2 – Substantial non-documentation or inadequate documentation, and risk of inappropriate assurance opinion or conclusion is indeterminate

3 – Substantial non-documentation or inadequate documentation, and risk of inappropriate assurance opinion or conclusion is likely

4 – Fundamental non-documentation or inadequate documentation, and risk of inappropriate audit opinion is highly likely.

Appendix 5: The RCA Process

Step 6

Set parameters

- Remedial action must be carried out for significant and repetitive findings (audit quality deficiencies)
- During this step, the firm sets the parameters (the scope of data analysis, i.e. which findings to investigate) for specific RCA (on findings deemed 'significant') and thematic RCA (on findings deemed 'repetitive or systemic')

Step 7

Gather information

- Significant findings and repetitive themes have been identified in Step 6 by setting parameters
- Information is gathered about the facts and circumstances relating to the relevant findings. This is done through inspecting the working papers and interviewing relevant engagement team members using 'what' questions

Step 8

Analyse data

- All relevant information is used to consider various possible root causes
- The most common method is the 'five whys', which involves asking multiple 'why' questions
- Focus groups involving the engagement partners allow RCA teams to see the 'wood from the trees'

Step 9

Remedial action

- Feedback is provided to the firm leaders, along with a remedial action plan that includes milestones and deadlines
- Remedial action can include remedial plans for individuals or teams, training, changes to quality control policies and procedures, and disciplinary action

Appendix 6: Illustrative Remedial Action Plan

Area for improvement			Quality improvement actions			Monitoring of remediation		
Engagement or quality control finding	Significant or recurring finding? (S/R/–)	Potential root causes	Remedial actions	Who is responsible?	When/deadline /target output or measure	Who will monitor quality improvement actions?	How will they be monitored?	Timeline for monitoring

Contacts and request for feedback

This guide was developed by CA ANZ on behalf of the APPC. It is aimed to be a useful tool for firms of any size and as such we welcome feedback from small and medium sized firms on how the guide could be improved or made more relevant to you. It is based on the insights and experiences shared by representatives of the large networked firms while recognising the needs of different sized firms. CA ANZ and CPA Australia will be undertaking targeted consultation with members to incorporate feedback.

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