



## **An External Auditor's Guide to Performing Root Cause Analysis**

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## Section 1

### Introduction

#### 1.1 Purpose of this guide

- 1.1.1 This guide provides guidance to firms for performing a robust root cause analysis (**RCA**) and formulating a plan of action to remediate audit quality deficiencies and improve the quality of their audits.

#### 1.2 What is RCA

- 1.2.1 RCA is a process for discovering the underlying causes of audit quality deficiencies. Such deficiencies may be identified from internal monitoring activities, external inspections and other relevant sources including complaints and allegations received by the firms. It enables firms to take responsive actions to prevent matters that affect audit quality from recurring in their future audits. It can also be a means of identifying good practices to promote continuous improvement in audit quality.

#### 1.3 Why is RCA important

- 1.3.1 Hong Kong Standard on Quality Management 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements (HKSQM 1)*, which will be effective on 15 December 2022, requires firms to undertake RCA of audit quality deficiencies, and use the outcome for determining appropriate remedial actions to address the deficiencies in the firms' systems of quality management.
- 1.3.2 RCA is a powerful process that enables firms to identify the underlying causes of audit quality deficiencies effectively and systematically and to determine the corrective actions to prevent them from recurrence. The performance of RCA is not a box-ticking exercise but an evaluation process to understand the factors that caused the deficiencies and establish more appropriate and effective actions to remediate them. A robust RCA drives improvements in audit quality.

#### 1.4 Scalability

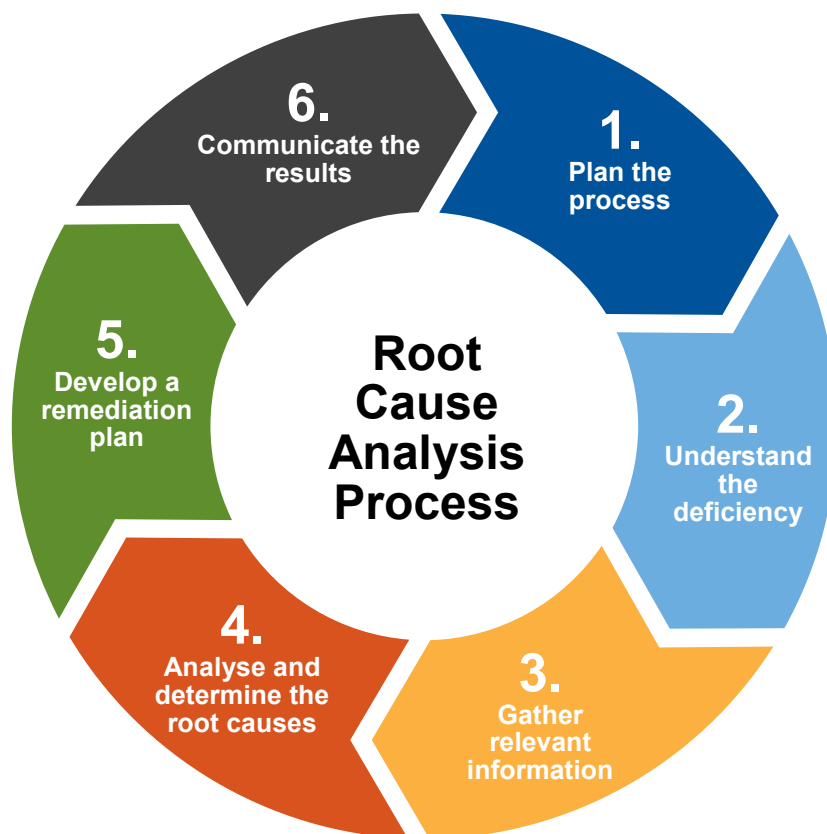
- 1.4.1 There is no one-size-fits-all approach to RCA. It is important that firms tailor their approach to their specific needs and circumstances, and in a manner that is responsive to the nature, extent and severity of identified deficiencies, both individually and in aggregate.

## Section 2

### Overview of the RCA process

#### 2.1 Introduction

2.1.1 The key activities of the RCA process are depicted in the diagram below.



#### 2.2 Plan the process

2.2.1 Proper planning helps firms to achieve their objectives and improve the effectiveness of the RCA process.

2.2.2 A firm should prepare a plan at the start of the process to set out the scope of the RCA, the planned procedures, the timeline of completion of key milestones and the resources needed. It should budget sufficient time and resources to perform an effective RCA.

### *Timing*

- 2.2.3 RCA should be performed as soon as practicable after the completion of internal or external inspections and ideally be completed before the commencement of the next audit cycle so that necessary actions can be taken to prevent the deficiencies from recurrence.
- 2.2.4 It is also important to gather the information as quickly as possible to avoid the possibility of information loss due to the turnover of key team members or loss of memory.
- 2.2.5 Other factors that may affect the timing of performance of the RCA include the scope of the RCA, the number of deficiencies and/or inspections subject to the analysis, availability of resources and past experience.

### *Scope*

- 2.2.6 Firms should determine the scope that is most relevant to their own circumstances and, as a minimum, cover:
- significant deficiencies identified from internal and/or external inspections; and
  - systemic (i.e. repetitive) issues identified from the internal and external inspections that require firm-wide improvements.
- 2.2.7 Firms are also strongly encouraged to perform an analysis with engagement teams who deliver good quality audits. The purpose of the analysis is to learn what worked well in the audits and to promote these good practices to the other teams to continuously improve the audit quality of the firm.

### *Assigning appropriate person*

- 2.2.8 It is crucial that the RCA is performed or closely supervised by a partner (or director) with the appropriate level of authority and experience to perform a thorough and credible analysis.
- 2.2.9 The person or team who conducts the RCA (the **RCA Analysts**) should possess the necessary technical skills to understand the issues, experience to identify possible causes and remedial actions, and authority to challenge different parties within the firm. They should also have strong interpersonal skills, including listening, interviewing and communication to interact with different parties during the information gathering phase.
- 2.2.10 The RCA Analysts should be independent of the engagement teams and where possible, independent from the inspections.

## 2.3 Understand the deficiency

2.3.1 The RCA Analysts should first obtain an understanding of individual audit quality deficiencies. This can be obtained by:

- reviewing the internal and/or external inspection reports;
- reviewing other communications between the inspectors and the engagement teams; and
- discussing with the inspectors or the internal support team for external inspections.

2.3.2 The RCA Analysts should also obtain an understanding of the Firm's existing policies, procedures and controls in its quality control system that are relevant to the deficiency.

2.3.3 The RCA Analysts should consider whether the deficiencies identified in the current year are similar to those identified previously. If so, they should understand the remedial actions undertaken in the prior period and evaluate whether:

- they were ineffective due to inappropriate design and/or implementation; or
- there are new or additional causes that need to be addressed.

2.3.4 The RCA Analysts should also consider whether the deficiencies identified at the engagement level indicated a systemic issue that require prompt action and attention at the firm level.

## 2.4 Gather relevant information

2.4.1 RCA should be evidence-based. Firms should gather detailed information on the facts and circumstances relating to each significant deficiency and systemic issue identified, and analyse the information obtained to determine the underlying cause(s) contributing to those significant deficiencies and systemic issues. Information can be gathered through:

- Review of engagement metrics;
- Review of audit working papers; and
- Interview relevant engagement team members.

### *Review of engagement metrics*

2.4.2 A good understanding of the engagement metrics provides RCA Analysts valuable insight into the environment under which the work was performed and assists them in identifying possible causal relationships with the

deficiency and developing meaningful and responsive questions to be discussed in the interviews.

2.4.3 Examples of engagement metrics include:

- Time spent by staff and partner level
- Percentage of time spent in each audit phase (i.e. planning, interim, final and post-issuance)
- Timeliness of completion of key phases of the audit
- Timing and extent of involvement of engagement partner and engagement quality control (**EQC**) reviewer
- Audit fee and engagement profitability
- Staff utilisation
- Quality and timeliness of information provided by the listed entity

*Review of audit working papers*

2.4.4 It is crucial for the RCA Analysts to understand the background information of the engagement concerned and the basis of the deficiencies by reviewing the relevant audit working papers prior to conducting the interviews. They could also hold a discussion with the individual who identified the deficiencies (or the internal support team for external inspections) to understand the specifics of the deficiencies identified and to obtain their views on whether they are related to guidance, planning, execution or other causes. This provides the RCA Analysts with some ideas on the possible causes of the deficiencies and facilitates them to prepare the interview questions.

2.4.5 The RCA Analysts should also review the gap analysis (i.e. the gap between the actual audit procedures performed and the procedures that would have been expected or required by the standards) and, where applicable, the remediation working papers prepared by the engagement team to understand the details of the deficiencies and how they were addressed.

*Interview relevant engagement team members*

2.4.6 Interview is a critical activity in the RCA process as it provides important insight into what may have caused the deficiency. It also allows the RCA Analysts to obtain different views from the engagement team members on the possible cause(s) which helps them in determining the underlying cause(s).

2.4.7 The interviews should include all key individuals who were involved in the area pertaining to the deficiency identified such as the audit working paper preparer and reviewer, engagement partner, and EQC reviewer. When interviews are performed in person on a one-to-one basis, collective mindsets can be avoided and all points of view can be heard.



- 2.4.8 Sometimes group interviews that focus on a thematic issue rather than an individual deficiency may also be useful and effective. Such interviews may include team members from engagements with and without findings, and persons from the audit technical and methodology teams as they may provide deeper insight as to whether any of the causes are related to the firm's processes.
- 2.4.9 Interviews should be conducted in a structured manner that facilitates the collection of facts and circumstances related to the deficiency identified. Interview questions should be tailored to each interviewee based on the review of audit working papers and other information relevant to that interviewee.
- 2.4.10 It is important to communicate the objective of the interview to the interviewee by emphasizing that the purpose is to identify the underlying causes of the identified deficiency, but not to evaluate his/her performance. Firms should encourage the interviewee to provide his/her perspectives without fear and avoid creating a blame culture.
- 2.4.11 During the interview, the RCA Analysts should obtain an understanding of:
- the interviewee's role and responsibility in the engagement team, and his/her specific responsibility in relation to the subject matter; and
  - the interviewee's understanding of the firm's policy, guidance and expectation.
- 2.4.12 The RCA Analysts may also consider asking the interviewee what he/she thinks the root cause(s) was/were at the end of the interview.
- 2.4.13 The RCA Analysts may consider the following when formulating the interview questions:
- Instead of asking "why" something was not done or was done wrongly, start the questions with "what" and "how". A "what" and "how" answer encourages a factual and honest response, while a "why" answer tends to be an opinion and put the interviewee on the defensive.
  - Ask open-ended questions, instead of closed-ended questions. Such questions allow the interviewee to provide you with his/her perspectives.
  - Keep the questions short and precise and avoid asking more than one question in one go.
  - Avoid leading questions.
  - Avoid negatively worded questions.
  - Ask appropriate follow-up questions to drill down to the core of the issue.
  - A great question to ask is "What would you have done differently?".

## 2.5 Analyse and determine the root causes

- 2.5.1 Identifying the root causes is an iterative process and requires the exercise of professional judgement based on the evidence available. It forms the basis of the actions to be taken by the firm.
- 2.5.2 Once sufficient information has been gathered, the RCA Analysts should analyse the information and determine the root cause(s) for each of the identified deficiencies based on the evidence obtained.
- 2.5.3 Categorising the root causes by themes helps firms to identify systemic issues. Below is a non-exhaustive list of examples of possible themes:

Primary themes	Secondary themes
Lack of required knowledge/skills	<ul style="list-style-type: none"> <li>• Preparer and reviewer skill gap</li> <li>• Insufficient understanding of the client's business</li> <li>• Lack of sufficient industry or technical experience</li> <li>• Inappropriate identification of risks</li> <li>• Audit procedures not responsive to identified risks</li> <li>• Unaware of available firm guidance or tools</li> <li>• Failure to consult or inadequate consultation</li> </ul>
Lack of adequate exercise of professional skepticism	<ul style="list-style-type: none"> <li>• Insufficient challenge to management of the entity</li> <li>• Over reliance on historical practices</li> <li>• Lack of understanding or evaluation of implications of certain evidence</li> <li>• Lack of consideration of contradictory evidence</li> </ul>
Ineffective use of specialists/experts	<ul style="list-style-type: none"> <li>• Specialists/experts' skill gap</li> <li>• Ineffective interactions with specialists/experts</li> <li>• Insufficient evaluation of work performed by the specialists/experts</li> </ul>

Primary themes	Secondary themes
Inadequate resources	<ul style="list-style-type: none"> <li>• Budgetary pressures</li> <li>• Unplanned staff turnover</li> <li>• Inappropriate team mix</li> <li>• Excessive workload</li> <li>• Lack of proper budgeting or planning of required resources</li> <li>• Lack of available resources in the firm</li> </ul>
Inadequate supervision and/or insufficient review	<ul style="list-style-type: none"> <li>• Oversight or inadvertent mistake</li> <li>• Insufficient coaching</li> <li>• Failure to escalate matters up the chain</li> <li>• Insufficient partner's involvement</li> <li>• Inadequate EQC review</li> <li>• Failure to perform a timely review</li> </ul>
Ineffective project management	<ul style="list-style-type: none"> <li>• Reluctant to miss deadlines</li> <li>• Poor planning</li> <li>• Delay in performing audit work and reviews</li> <li>• Weakness in communicating expectations and requirements to management of the entity (including poor quality of information prepared by management of the entity)</li> </ul>

2.5.4 The RCA Analysts should also analyse and determine the root cause(s) for systemic issues and remediate those issues at the firm level. The evaluation of root cause at the firm level facilitates the firm to assess the design and operating effectiveness of its responses to address the quality risks under HKSQM 1. Below is a non-exhaustive list of examples of possible root causes of audit quality deficiencies at the firm level:

- Inappropriate tone at the top
- Ineffective client acceptance and continuance assessment processes
- Lack of accountability
- Expectation gap of roles and responsibilities
- Inadequate training or guidance
- Inadequate staff resources
- Limitations in infrastructure and processes that support consistent quality execution of audits
- Ineffective monitoring activities

## 2.6 Develop a remediation plan

2.6.1 An effective remediation plan addresses audit quality issues and prevents them from recurring.

2.6.2 Firms should consider to follow the **SMART** guideline to formulate the remediation plan:

<b><u>S</u>pecific</b>	The remediation plan should be specific and focus on the identified root causes.
<b><u>M</u>easurable</b>	The remediation plan should be quantifiable and enable the firm to measure the progress towards completion.
<b><u>A</u>ttainable</b>	The remediation plan should be attainable – not unrealistic.
<b><u>R</u>elevant</b>	The remediation plan should be responsive to the identified root causes.
<b><u>T</u>ime-bound</b>	The remediation plan should have a defined and reasonable time frame for completion.

2.6.3 Common types of remedial actions include but are not limited to:

- Provision of additional training and guidance
- Review of the firm’s policies, procedures and audit methodology
- Review of the firm’s client and engagement acceptance and continuance policies and processes to ensure it appropriately evaluates the adequacy of skilled resources within the firm before accepting or continuing a client relationship
- Review of resources assigned to the engagement team
- Evaluation of individual’s workload
- Reassessment of partner or EQC reviewer assignment
- Enhancement of project management
- Ongoing monitoring and support – e.g. partners with unsatisfactory internal and/or external monitoring results to be subject to the firm’s internal monitoring program in the next monitoring cycle and/or pre-issuance review
- Review of the firm’s performance evaluation policies and processes

- 2.6.4 We often see firms tend to propose training as a remedial action. Firms should take note that the provision of additional training may not be a universal solution to all the root causes identified. If training has been provided but the deficiency still recurs, the firm should evaluate whether this indicates that the training is not effective or there are other causes such as unreasonable workload or unrealistic deadlines that have to be remediated by other action.
- 2.6.5 Firms should identify the steps and key milestones for achieving their objectives, and clearly set out the responsibilities and timeframe for completion of individual milestones. Firms should also ensure they have appropriate and sufficient resources to complete the remediation plan in an appropriate and timely manner.

## **2.7 Communicate the results**

- 2.7.1 Firms should communicate the results of the RCA to the firm leaders and the firm leaders should understand the identified root causes and be satisfied that the remedial actions could address these causes. It is also important to keep the firm leaders apprised of the ongoing progress, the status of key milestones, and any slippage in the timeline.
- 2.7.2 Firms should also communicate the results of the RCA to all the audit partners and staff in an open and transparent manner through training, meeting or publication to promote awareness and foster behaviour change.