PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

# SPOTLIGHT

## Root Cause Analysis – An Effective Practice To Drive Audit Quality

April 2024

This document represents the views of PCAOB staff and not necessarily those of the Board. It is not a rule, policy, or statement of the Board.

# CONTENTS

# OVERVIEW

The Board's strategic plan includes a goal to enhance inspections. One objective of this goal is to deliver useful guidance to the audit profession through publishing staff Spotlights and other materials that describe observations from our inspections and our reviews of remediation activities, including areas where staff ("we") find common deficiencies. Our focus is to provide audit committees, auditors of public companies and brokers and dealers, and others with additional context and relevant information on inspections to further their understanding and support their efforts to proactively drive audit quality. The PCAOB's mission is to protect the interests of investors and to further the public interest in the preparation of informative, accurate, and independent audit reports.

Our standard-setting agenda includes a proposal for a new quality control standard (QC 1000) that currently would require a firm to perform root cause analysis (RCA) of all quality control deficiencies. We encourage you to read this proposal. This Spotlight is not intended to prescribe how a firm might perform that analysis or the framework a firm might develop but is meant to help smaller firms right now in their efforts to improve audit quality. As part of this effort, in February 2023 we published a Spotlight – "Additional Insights on the Remediation Process" – to share our insights into how firms remedy criticisms in their quality control systems (QCS), as well as to identify some emerging trends and challenges related to remediation. We also discussed the importance of root cause analysis and how it may be helpful in determining whether a remediation action is relevant and appropriately designed to remediate quality control deficiencies.

We believe that RCA has been shown to be an effective practice for registered public accounting firms ("audit firms" or "firms") to drive audit quality. Rather than simply detecting and remediating audit deficiencies, many firms can consider – and we strongly encourage that they do so – focusing more on assessing the underlying root causes of a deficiency so that the deficiency can be effectively addressed and ultimately eliminated.

RCA is an important procedure that many firms use to evaluate the adequacy of and compliance with their QCS. As this Spotlight will discuss, we have observed that a firm's deeper understanding of the underlying root causes of a deficiency can result in incremental improvements to a firm's QCS and may drive further improvements in audit quality. Like all Spotlights, this publication shares our inspection-based observations to help improve audit quality. We have observed that firms' analysis of the root cause(s) has been helpful in determining the appropriate actions to remedy repeated or persistent criticisms from our inspections. The nature and extent of the root cause process will differ significantly based on a firm's size and structural complexity.

Successfully performed RCA may be helpful to identify points in a complex process that can fail, either at the engagement level or within the QCS. In addition, RCA can highlight positive outcomes. As firms begin to better understand the drivers of positive outcomes, and the underlying drivers of quality, we expect that they will be able to drive their remedial efforts more effectively and proactively, and ultimately improve audit quality.

In addition to audit firms, audit committees and others charged with governance may find the firm's root cause information useful

as they discuss with their audit firm past inspection deficiencies, what corrective actions were taken to address these deficiencies, and what preventive measures a firm has taken to improve their audit quality going forward.

# ROOT CAUSE ANALYSIS: GENERAL CONSIDERATIONS

RCA is predicated on the belief that a problem is best solved by attempting to address, to correct, or to eliminate fundamental cause(s) of the problem. Identifying these causes can lead to remedial actions that drive continual improvement in a firm's QCS.

## A Multifaceted Approach

RCA is not a single, well-defined process or methodology; rather, it is broadly described as any structured approach to identifying causes that contributed to an outcome. These causes then become a key input into the identification of remedial actions that drive continual improvement. There are many different tools, techniques, processes, and philosophies for performing RCA. It is important for firms to consider what makes sense for their particular practice.

Moreover, RCA does not mean that only one factor is the cause of an issue or that there is a single solution. There may be multiple contributing causes that converge to cause

negative quality events. Each deficiency being analyzed would benefit from an appropriate RCA. Selecting from a list of potential causes, opting for prepopulated fields, or even using the five-whys technique,[1] although helpful, appears to be too linear and limiting for complex problems, and these methods will not likely show the many intricate interrelationships between each cause and associated effect. The more thoughtful the analysis, the more likely a firm will identify the major causal factors.

As an illustrative example, consider a situation in which a firm had to address an audit deficiency: insufficient testing of management review controls in a business combination. The firm concluded that one root cause of the deficiency was insufficient supervision and review by the audit partner who appeared to rely heavily on a senior manager who was new to the engagement team and did

## Example Audit Deficiencies Where Application of RCA Could be Helpful

While a thorough RCA is recommended to analyze all audit deficiencies, the following are some examples of generic audit deficiencies where the firm might benefit from application of an RCA process to determine why the deficiency occurred:

- Lack of professional skepticism including overreliance on the prior year's audit approach and procedures.
- Insufficient supervision and review.
- Lack of experience or understanding of the public company's business, processes, and industry.
- Insufficient technical knowledge and/or training.
- Inappropriate communication, implementation, or execution of firm guidance, either through training or application in audits.
- Insufficient audit planning, including scoping and initial risk assessments.
- Insufficient time to complete the audit, including establishing an unrealistic budget, heavy personnel workload, and staff turnover.
- Insufficient consideration of matters that should have resulted in the auditor updating its initial risk assessments and audit responses.
- Overreliance on the work of the public company's specialist's and/or failure to test the accuracy and completeness of company-produced data used by the public company's specialist.
- Uncoordinated efforts among teams with auditor-engaged specialists.

[1] The "five-whys" technique is a term that refers to a strategy of asking "why" five times, drilling down to the root cause.

not have sufficient experience or knowledge of the public company. Additionally, the firm identified other root causes such as lack of technical competence and lack of training of key senior team members as the team had insufficient knowledge on how to test review controls, including appropriate use of firm guidance and templates. Performing a thorough RCA and identifying these root causes helped the firm design and implement appropriate corrective actions into its QCS to address each of the causal factors that contributed to the deficiency.

## Characteristics of a Well-Designed RCA Process

We have observed the following characteristics and effective practices of a well-designed RCA process that may contribute to improving audit quality, for firms of any size and/or structural complexity. We have also included specific ideas for smaller, less complex firms to consider that may accomplish the same objective.

- **Dedicated team:** Some larger firms use independent, dedicated teams with RCA experience to bring more objectivity to the process, including full-time or part-time senior-level professionals with relevant experience and background as well as professionals with expertise in behavioral fields. A diverse RCA team promotes multiple perspectives and drives an in-depth understanding of causal factors.

  Smaller, less complex firms can also benefit by having an individual or team assigned to evaluate audit deficiencies periodically throughout the year, perhaps when methodology and process updates are incorporated into the firm's audit practice.

- **Guidance and training:** Some larger firms — that have internally developed audit methodology and processes — have also developed well-documented RCA guidance and processes for their professionals that provide insights and techniques in executing RCA procedures. This guidance promotes consistency, comparability, and accountability in the firms' RCA processes. Firms also provide specific, targeted internal and external training to those responsible for causal analyses, develop multiple onboarding sessions, and provide on-the-job training by shadowing alongside other staff with more RCA experience.

  Many smaller, less complex firms subscribe to a third-party service for their audit methodology and processes. The outcome of RCA can lead to a firm augmenting or tailoring the subscription methodology and processes for its specific audit firm needs. For example, augmenting or tailoring might include adding an internally developed template for certain financial statement accounts or customization of generic audit programs for an engagement or engagements in a particular industry. These firms can benefit from RCA by assigning an individual or team to specifically be responsible for communication of updates and interpretation of the methodology and processes to the firm's audit practice professionals.

- **Data gathering and tools:** Some firms use a variety of techniques to gather information for the RCA including (1) interviews with the engagement team immediately after the deficiencies are identified and/or after some passage of time to provide the audit team members some degree of perspective and less emotion or personal bias, (2) review of the engagement team's time and training records, (3) review of audit workpapers, (4) review of audit metrics or data (such as milestones, realization rates, or engagement team member's individual years of experience), and (5) use of software and proprietary tools to effectively analyze and evaluate large amounts of data. We saw firms using third-party software tools for qualitative and quantitative research,

analysis and evaluation of interview responses and observations from work paper reviews, and for tracking other related data. We also observed the use of proprietary tools to capture data such as causal factor categorization, severity assessments, and action plans. The use of these technology tools may increase the effectiveness and efficiency of the firms' RCA processes.

Smaller, less complex firms can benefit by having an assigned individual or team track and evaluate identified deficiencies across their audits to understand whether applicable guidance, templates, and/or training may need to be modified or augmented.

- **Scope:** Some firms analyze both negative and positive quality events. We observed firms compare the results of their analysis of positive quality events to those audits with deficiencies, which help inform the firm of potential actions to continuously improve audit quality.
- **Level of analysis:** Some firms are analyzing both individual deficiencies at the engagement performance level and also considering a broader assessment, such as topical trends or deficiencies related to specific guidance or aids, to inform improvements in their QCS.
- **Prioritization:** Firms are prioritizing RCA efforts on areas determined to pose the highest risk to the firm and/or to the financial statements being audited. We observed firms that are focusing their detailed analyses on material restatements and collectively analyzed the remaining restatements for trends. We also observed certain firms prioritizing and categorizing causal factors based on weightings and exception types, or deficiency types. Focusing efforts on higher-risk areas ensures that firms spend their time and resources on areas likely to have the most impact. Notwithstanding higher-risk areas, some firms also prioritize efforts on pervasive or broadly applicable areas that affect more audits.
- **Conclusions:** We observed that some firms' RCA conclusions involved collaboration among various groups within the firm. In addition to the engagement team, the firms' RCA conclusions are generally determined by internal quality monitoring groups, professional practice personnel, regional leaders, and audit methodology personnel.

  In smaller firms, the individual or team responsible for methodology and process updates could perform this role, perhaps in combination with their coordination of new training for updates to the methodology and processes.
- **Monitoring remedial actions and reporting:** At some firms, monitoring involved collaboration among various process owners and groups such as audit leadership, professional practice, and internal inspections to provide oversight of the design, implementation, and monitoring of remedial actions responsive to the identified root cause. We observed certain firms create monitoring groups or task forces comprised of individuals from various groups to monitor specific remedial actions related to frequently occurring findings. Firms are also providing firm leadership with annual reporting of audit deficiencies, causes of systemic or episodic findings, related corrective actions, preventive measures, and monitoring of results. When deficiencies recur, firms reassess the prior RCA to consider new facts or omissions.

  In smaller firms, periodic discussion during leadership meetings or even audit staff meetings might accomplish the same result.

# OTHER OBSERVATIONS ABOUT RCA FROM OUR INSPECTIONS

## Annually Inspected Firms

We observe that annually inspected firms have formal RCA processes at varying stages of design and implementation. These firms take identified audit deficiencies and perform systematic analyses to identify what went wrong, to understand the specific causal factors, to inform improvements in the firms' QCS, and then monitor performance.

## Other Firms

There are triennial firms, both affiliated and not affiliated with global networks (both U.S. and non-U.S. firms), that have an RCA process tailored for their structure and size that is effective; however, we observed that many triennially inspected firms (both U.S. and non-U.S. firms) including auditors of brokers and dealers, either performed limited or no RCA procedures. We strongly encourage all firms to consider the information in this Spotlight and to develop an approach to understanding the causal factors of their audit deficiencies and to assess how the firm's QCS can be improved.

## Metrics

Information obtained from firms' RCA may further enable identification and development of metrics that correlate to what may prevent a deficiency, both at the audit engagement level and at the level of the firm's QCS.

We observed that certain firms have identified and tracked metrics such as milestones (a date by which all planning is complete or all preliminary work is complete, including review and resolution of review comments), distribution of hours during the year, partner workload and utilization, partner industry/client experience, involvement in pre-issuance review programs, and use of specialists, among others. Some of these firms also measure firm-level metrics such as personnel turnover rates, partner to staff ratio, and investment in audit quality.

## Challenges

We observed the following challenges and limitations in certain firms' RCA processes, which could result in a failure to adequately address quality control criticisms, potentially leading to their reoccurrence:

- Persistent criticisms may indicate that the RCA process may not consider all the contributing causal factors that exist in complex audit environments. Therefore, the RCA process may not be identifying all the causal factors and their inter-relationships. Persistent criticisms may also indicate that firms may not be monitoring changes in causal factors driving those criticisms. In a very simple example, a persistent criticism that required communications to the audit committee did not include all required communications might initially be caused because the firm's template for such communications is incomplete with respect to required communications but may persist in subsequent years because the firm's personnel find the updated template difficult to use.
- Many firms have no formal quality control process that identifies risks or "what could go wrong" and related controls within its RCA process. This limits a firm's ability to assess the effectiveness of its QCS.
- Use of a checklist approach to RCA may result in a bias towards assigning pre-identified causal factors, limiting the number of causal factors identified or the specific causal factors.
- Completion of causal analysis was not timely. This limits the firms' ability to implement remedial actions in a timely manner.

# KEY QUESTIONS FOR AUDIT FIRMS TO CONSIDER

We continue to observe a high level of audit deficiencies.[2] We encourage firms to perform objective, narrowly focused, and robust RCA to understand the causes of reoccurring deficiencies to design effective remedial actions.

As firms assess the effectiveness of their RCA and remedial actions, consider these inquiries:

1. Does the firm consider the objectivity and independence of the individuals performing the RCA?
2. Does the firm have enough experienced and skilled professionals trained in causal analysis techniques to perform RCA?
3. Does the firm's RCA process include adequate causal analysis techniques that would yield an in-depth understanding of the wide range of potential contributing causal factors and their inter-relationships?
4. Does the firm consider the QCS itself and other pervasive impacts that may need evaluation?
5. Does the firm have well-defined guidance for specific areas of an audit to allow for more robust and consistent analysis of audit deficiencies in order to determine what went wrong and inform remedial efforts?
6. Does the firm monitor how associated persons executed remedial actions to prevent deficiencies from recurring?
7. Does the firm monitor changes in causal factors for frequently occurring audit deficiencies and consider how remedial actions should adapt to such changes?
8. For smaller, less complex firms using subscription methodology and processes, does the firm map audit deficiencies to the subscription guidance and consider how the guidance can be supplemented or better communicated for the firm's specific audit practice structure and size?
9. Is the root cause identified related to the QCS itself and therefore having a more pervasive impact that needs to be evaluated?

## Tell Us What You Think

Was this Spotlight helpful to you? In fulfilling our mission to serve investors and the public, the PCAOB wants to know how we can improve our communication and provide information that is timely, relevant, and accessible. We welcome comments on this publication or other matters. You can fill out our **short reader survey** or email us at **info@pcaobus.org**.

[2] For more on audit deficiencies observed recently, see, for example, our Spotlight, "Staff Update and Preview of 2022 Inspection Observations."

STAY CONNECTED TO THE PCAOB

Contact Us | Subscribe | PCAOB | @PCAOB_News