OCC RESPONSES
QUESTIONNAIRE ON AUDIT EFFECTIVENESS

The Business Environment

Are auditors devoting sufficient attention to the areas where management discretion and judgment are required in financial reporting? If not, please explain why you believe this.

Auditors generally exercise more care and a more stringent materiality concern when management has discretion over an accounting treatment. However, this is an area of growing concern to financial regulators. Increasingly, in an effort to reduce audit costs, auditors are relying on client representations to document areas when no supporting evidence is available. While this may at times be appropriate, there have been situations where auditors appear to have relied blindly on management's assertions or audit judgments have been inappropriately influenced.

To what extent do analysts' earnings estimates influence management's judgments in preparing financial statements, and what are the effects on the auditor? If you see any effects, please elaborate on their importance.

Our experience seems to suggest that analysts' earning estimates do in fact exert pressure on management's financial reporting. We believe this can impact financial reporting or require special audit attention if clients improperly value assets, change accounting practices or make other inappropriate adjustments to meet analysts' projections. Unfortunately, the lack of stringent materiality criteria or the existence of alternative accounting principles is a factor that may cause auditors to overlook or tolerate minor adjustments or management choices in selecting accounting principles. Adjustments and the use of less preferable accounting principles in these situations may potentially result in the misinterpretation of earning trends and other analytical data that is based on comparisons.

Do accounting standards issued in recent years help or hinder auditors in meeting the needs of users of financial statements? If they hinder auditors, how do they do so and what should be done?

The OCC fully supports the FASB efforts to improve financial reporting. While we may not always be in complete agreement with all aspects of an accounting standard, we do not believe that recent accounting standards have hindered auditors in meeting the needs of users of financial statements. However, there may be an impact on users if new standards require excessive or overly complex disclosures or present too much latitude in their application.

Responsibilities for Detecting Financial Statement Fraud

Are auditors' responsibilities with respect to the detection of deliberate misstatements of earnings appropriate? Please explain your view.

Yes, auditors should be responsible for the detection of deliberate, material misstatement of earnings as well as other aspects of fraud in financial statements. Auditors should be alert to situations or transactions that could be indicative of fraud, errors or deliberate misstatements. We believe this is consistent with the auditor's ultimate objective to report on the fairness of the financial statements.

What are users' views of those responsibilities and are they realistic? Please feel free to elaborate on differing views of various types of users, such as individual investors and institutional investors.

As users of financial statements and related reports of independent accountants, we believe auditors should be responsible for the detection of errors, deliberate misstatements or fraud when the effect is material. Auditors provide assurance that financial statements are not materially misstated. However, we recognize that auditors use statistical sampling and there are time and cost considerations that limit the extent of audit work performed. Consequently, there is a risk that material errors or irregularities will not be detected.

Investors and other users of audited financial reports have very high expectations concerning the accuracy of audited financial statements. However, it appears that many users may lack a full understanding of the inherent limitations of an audit under generally accepted auditing standards. Often investors and other users may presume that an audit will detect all instances of fraud or other misstatement.

What, if anything, should be done to change these views, or to change auditors' responsibilities for detecting fraud?

As a general matter, we do not believe it is practical or cost effective for auditors to expand their audit coverage to eliminate this expectation gap. However, certain steps should be considered to address this issue. An attempt should be made to inform financial statement users of audit objectives and how they are impacted by time restraints and cost limitations so that this misunderstanding about the auditors' responsibility for the detection of fraud may be eliminated. Additionally, auditors should consider the routine use of transaction testing and verification in areas particularly susceptible to fraud.

The Audit Risk Model

Is this model, where auditors are encouraged to use their judgment in selecting their audit approach based on the individual company's nature and circumstances, appropriate? Please elaborate on your point of view.

A risk-based audit approach can be appropriate and can contribute to the efficiency of audits when properly used. However, risk-based auditing must include periodic testing of low-risk areas and comply with specific procedures required under generally accepted auditing standards. OCC examiners use a risk-focused examining process, but examination activities include appropriate testing and validation.

What are the best safeguards to make sure that auditors exercise this judgment in ways that protect shareholders and other investors?

The best safeguard is for auditors to be knowledgeable about their client's systems, management process and overall business environment. To ensure that an audit approach is appropriate in the circumstance, auditors should document the client's control environment and its risk assessment in the audit workpapers. The assessment should include management's philosophy and operating style and be based on the substance rather than the form of the client's policies and procedures. Moreover, as noted above, an important additional safeguard to an audit risk model is the periodic testing by auditors of low-risk areas of bank operations.

Breadth of Auditors' Involvement

Do you believe auditors should be more involved in and familiar with their clients' business and operational matters and ongoing communications with the investment community? Please explain why you feel the way that you do.

First, there needs to be a common understanding of appropriate auditor involvement in client business and operational matters. We believe the independence of auditors is essential to establishing and maintaining an effective audit process. When auditors are too closely involved in the daily operational activities of the client or in communications with the client’s investors, auditor independence may be impaired. Auditor independence could be impaired also if they become too involved in client press releases or analysts' interviews or other management releases. Also, a danger exists that the appearance of such involvement may potentially cause an auditor's independence to be questioned. Despite those concerns, auditors must be sufficiently familiar with their clients' business and operational activities to effectively audit such activities. These factors influence financial reporting and impact audit risk.

Should auditors be more or less involved with:

- ***internal controls***
- ***interim financial statements***
- ***forecasts***
- ***management's discussion and analysis***
- ***non-financial data***

While auditors have professional responsibilities with supplemental financial information included in annual reports, we believe that becoming more actively involved in internal controls, interim financial statements, forecasts, and non-financial data, may be construed as being part of management and involved in the decision-making process. For instance, an auditor's objectivity may be diminished if they directly participate in making earnings forecasts for the client. Further, this may create the appearance that the auditor is verifying the accuracy or achievability of the forecast. Additional, direct involvement in these functions could interfere with the auditor’s ability to objectively assess client activities.

Should auditors be required to report on such matters? If so, which matters and why?

Currently, auditors may review and report on internal controls. Further, FDICIA requires independent auditors to report on management's assertion on the effectiveness of internal control over financial reporting for banks with $500 million or more in assets. We believe that reporting on the internal control system is very useful. Accordingly, it might be appropriate to expand auditors' responsibilities to cover internal and other operating controls as well as other kinds of information. This can be done separately or as an integral part of the audit. For example, we think it might be beneficial to investors if auditors reported on interim financial statements. Reporting on interim financial statements would better meet the needs of security holders and provide support for the annual financial statements if auditors extended their work to report on quarterly financial results. However, we believe the professional requirements for performing a review engagement need to be significantly expanded.

Management discussion and analysis (MD&A) is another area that should be considered for expanded reporting by auditors. MD&A is included with the financial statements presented to investors and other users. Therefore, it may be appropriate for auditors to review and report on this information if cost effective.

Audit Committees and Auditors' Communications

Do you believe auditors currently communicate effectively with:

- ***management***
- ***audit committees***
- ***boards of directors***
- ***stockholders (feel free to elaborate on institutional versus individual investors)***

We encourage open and candid communications between auditors and the board or audit committee. However, increasing competition among audit firms appears to be impacting audit effectiveness and may at times discourage auditors from complete and straightforward communications with client management, board or audit committees.

Are audit committees effective in promoting quality audits? How can audit committees be more effective in that regard? Do audit committees do enough to seek our auditors' opinions and input?

We believe that audit committees perform an important function in overseeing bank operations and promoting the effectiveness of audits. The OCC encourages the board of each institution to establish an audit committee consisting entirely of outside directors, if practicable. One of the principal oversight duties of the board or audit committee should be to review the scope of audit work performed at least annually and determine whether the external auditor is independent, competent, and knowledgeable about banking. Also, the audit committee should have access to examination reports and other communications between regulators and the institution. Further, they should have the power to conduct any investigation relating to its duties and have independent access to the bank's counsel for advice.

The Auditing Profession

What are your views on audit personnel taking jobs with clients?

We realize that audit personnel may not spend their entire career in public accounting. However, the profession should ensure that no conflict of interest or even the appearance of a conflict of interest exists when it employees leave to work for an audit client. Further, auditors should refrain for participating in any matter relating to a prospective employer when seeking a position or they are contacted about a possible job opportunity and, instead of rejecting it, they express an interest in finding out more.

The Business of Auditing

The effects of competition

What are your views about the effects of competition and pricing on the quality of audits?

We believe that the long-term effects of competition and pricing on audits warrants further study. We are concerned that such factors may weaken the professionalism and independence of auditors and potentially lead to sub-standard audits. This increased competition places greater importance on audit committee oversight and effective peer reviews to ensure audit work is in compliance with professional auditing standards.

How do you see time and budget pressures affecting the quality of audits?

Time and budget restraints may potentially result in an audit staff not performing sufficient work in order to meet deadlines. Further, excessive cost cutting may cause audit work to be inappropriately reduced. It also raises concerns as to whether adequate staff resources will be devoted to audit engagements.

Scope of Services Offered by Audit Firms

What are your impressions of the importance (stature, compensation, advancement, investment, etc.) audit firms place on audit work relative to the other services they offer, and how, if at all, does this affect the quality of audits?

Accounting firms are increasingly offering new services and expanding into other consulting areas to grow and meet client needs. Audit firms must ensure that the availability of these services does not impair their objectivity or otherwise impact the provision of core audit services. To serve the public interest and promote quality audits, auditors must be careful not to become business partners.

Do you believe non-audit services offered to audit clients affect the independence or perceived independence of auditors? If so, how do they do so and what should be done about this?

Whether non-audit services impact an auditor's independence is a complex issue. We believe that the performance of non-audit services for audit clients may cause the independence of auditors to be questioned by users, especially where the fees for such services significantly exceed the client's audit fee. This may be mitigated by mandated peer reviews and the establishment of an audit committee to approve all services provided.