

December 8, 2010

Secretary  
European Commission  
Brussels, Belgium

**Richard F. Chambers**  
Certified Internal Auditor  
Certified Government Auditing Professional  
Certification in Control Self-Assessment  
*President and Chief Executive Officer*

T: +1-407-937-1200  
E-mail: richard.f.chambers@theiia.org

Response e-mailed to [markt-greenpaper-audit@ec.europa.eu](mailto:markt-greenpaper-audit@ec.europa.eu)

RE: Response to the Green Paper "Audit Policy: Lessons from the Crisis" (the Green Paper)

Dear Sir/Madam:

The Institute of Internal Auditors (IIA) welcomes the opportunity to respond to the European Commission's (EC) Green Paper. Our comments are based on a thorough analysis and discussion, utilizing a core team of audit experts who serve on The IIA's Professional Issues Committee and Standards Board. These individuals consist of Certified Internal Auditors, Chartered Accountants and Certified Public Accountants who have worked in public accounting and in management positions in small, medium, and large multinational companies.

The following are our principal comments and observations. Much of the Green Paper addresses issues which we believe are outside of the scope of the internal audit profession. As such, we have not commented on them in this response. There are other areas which do involve fundamental aspects of audit methodology or interaction with internal auditing and these are the primary areas of our response.

- 1) The Green Paper focuses nearly exclusively on the role of external audit firms in the recent financial crisis. We understand this is the intent of this paper but want to emphasize that the key objectives are best addressed through a robust governance system for an organization. Such a system incorporates multiple "lines of defense" to ensure financial statements are a true and fair representation of an organization's finances. The external auditors are only one of these lines of defense. Organizational management, boards, internal assurance providers (such as internal audit), regulators and others all need to work together to provide assurance regarding the true and fair presentation of financial statements. The recent crisis was due solely to failures in financial reporting and the external audit line of defense cannot be viewed as the mechanism which can compensate for serious weaknesses in the other lines of defense. There are limits of what can be expected from an external audit.

We encourage the Commission to give increased consideration to encouragement of the proper use of internal auditing by organizations, regulators, and external auditors to address the concerns underlying this Green Paper. Internal audit is increasingly recognized as a fundamental component of an organization's governance and risk management structures. A well-performing internal audit function, operating in conformance with the International Standards for the Professional Practice of Internal Auditing and related mandatory and strongly recommended guidance of the

International Professional Practices Framework as issued by the IIA, can meet the expectations of this role.

- 2) The discussion of external auditors providing a very high level of assurance to stakeholders suggests “going back to the basics” of auditing with a stronger focus on substantive testing of the balance sheet. The size and interconnected nature of most large complex organizations make it almost impossible for an audit to gain a comprehensive and full understanding of the organization’s financial statements without significant attention to the organization’s system of internal controls. We agree internal audit has a critical role in providing assurance over the adequacy of an organization’s system of internal control, but this does not negate the importance of internal controls that support financial reporting processes. External auditors, with the right level of coordination and cooperation with internal audit, will continue to need to address the system of internal control.
- 3) An organization can fall prey to many different risks that can challenge its ability to survive as an organization and thrive. Internal auditors in most large organizations have a very broad mandate to address a wide variety of risks. External auditors have historically been focused on the accuracy of reported financial results. Expansion of the external auditor’s focus to include other types of risks would require fundamental changes to the practice of external auditing. Internal audit functions over many decades have worked to develop the skills and competencies to address a wide range of risks and provide assurance to stakeholders that these risks are being properly managed. The level of effort required to be invested in recruiting, training, and audit process modifications by external audit firms to address a broader range of risks should not be underestimated. In addition, the legal implications of expanding the mandate of an external audit would need to be carefully and fully considered. We believe stakeholders are best served by organizations properly engaging internal governance mechanisms, including internal audit, to ensure adequate risk management.
- 4) The Green Paper poses a number of questions regarding the direction that could be taken regarding standardization of audit standards across jurisdictions. The IIA operates as a global organization with globally recognized professional standards and guidance. We have found this approach to work well across multiple jurisdictions and ensure best thinking is incorporated into audit standards used by all internal auditors. We encourage the Commission to consider the advantages of moving towards auditing standards that cross jurisdictions as used by the IIA.
- 5) The effectiveness of external auditors would be improved by ensuring there is full and open communication with the board and other governance parties of the organization, including internal audit. Encouragement of transparent, two-way communications between the external and internal auditors would help ensure an effective audit of an organization’s financial reporting.

Detailed responses to certain of the questions posed in the Green Paper can be found in Attachment A.

The IIA welcomes the opportunity to discuss any and all of these comments with you. We offer our assistance to the EC in its initiatives to support financial stability.

Best Regards,

Richard F. Chambers, CIA, CGAP, CCSA  
President and Chief Executive Officer

**About The Institute of Internal Auditors**

The IIA is the global voice, acknowledged leader, principal educator, and recognized authority of the internal audit profession and maintains the *International Standards for the Professional Practice of Internal Auditing (Standards)*. These principles-based standards are recognized globally and are available in 29 languages. The IIA represents more than 170,000 members across the globe and has 103 affiliates in 165 countries that serve members at the local level.

## Attachment A

### Specific Questions and Responses

- (4) Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose?  
*No. Opining on the financial health of a company would require competencies of the external audit firm that are not consistent with the background, training, or historical practice of the external auditors. Audit, and the related audit standards and guidance, are not suited for this purpose.*
- (6) Should "professional skepticism" be reinforced? How could this be achieved?  
*A key to any effective audit is professional skepticism. Skepticism is supported by an attitude and position of objectivity by the auditor. These are largely the result of the proper attitude of the auditor, supported by the right organizational structure. Internal auditors give special attention to fostering the proper attitude as there are compromises inherent in the organizational structure of internal audit. External auditors currently have the proper organizational structure so substantive improvement in skepticism would be the result of improvement in auditor attitude. This is best accomplished through emphasis from professional guidance and regulatory enforcement action when unprofessional actions occur.*
- (9) Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?  
*Addressed in point five of the cover letter.*
- (10) Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?  
*While external auditors could play an increased role with CSR reporting, the most effective and cost efficient approach to ensuring the adequacy and accuracy of CSR reporting is to rely upon and leverage the other lines of defense internal to an organization.*
- (18) Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?  
*Limitations on continuity of audit engagements results in mandatory audit firm rotation. At any time there is turnover of an audit firm there is increased detection risk from the audit as well as increased cost. The assumption that mandatory rotation of audit firms will improve audit quality is unproven and increases audit risk during the period of transition.*
- (21) Should new rules be introduced regarding the transparency of the financial statements of audit firms?  
*It is unclear how this change would improve audit quality.*
- (29) From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?  
*See response to 18 above.*