

Principles or Rules?



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Auditing Standards Principle or rule based?

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Rules and principles – briefly defined

Principles

- A moral rule or a strong belief that influences your actions
- A law, a rule or a theory that something is based on (= the most basic rules)
- A belief that is accepted as a reason for acting or thinking in a particular way

Rules

- A statement of what may, must or must not be done in a particular situation - or when playing a game
- A statement of what you are advised to do in a particular situation

(Source: Oxford Dictionary)



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Principles v Rules in business

- *...in corporate governance, it is the principles that matter, not the rules. "I spent a lifetime working in the accounting business where we had rules coming out of our ears and it didn't get us very far.*

Lord Colin Sharman, chairman of Aegis Corporation



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Principles v Rules in business

- *The better approach lies in instilling fundamental principles, not rules, that focus on the spirit, not just the letter, of good corporate governance.*
- *Actions must be based upon the long term interests rather than the short-term expedient solutions that we find ourselves with.... This requires us to manage our businesses with integrity, cultivating long-term relationships with customers that are based on trust.*

James Schiro, CEO of Zurich Financial Services Group



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Principles v Rules in business

- *I am not appealing against every new, generally applicable form of rule outside or within the formal law, but simply for a sense of proportion.*
- *Do new rules produced in response to one-off events actually help matters and effectively prevent abuses of power?*
- *The question of how a board of directors organizes itself should be resolved pragmatically rather than dogmatically. One thing that recent events in the United States has demonstrated is that an excessively complex, formalistic approach tends to heighten rather than reduce the risk of abuse.*

Peter Brabeck-Letmathe, CEO, Nestle



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Principles v Rules in business

- *In a debate with many trends, but no clear direction, the focus – wrongly - has increasingly been on detailed rules rather than principles, and on control rather than responsibility.*
- *Only sound, rock-solid principles in accounting, corporate and global governance will be able to respond to the major challenges of growing complexity, increasing turbulence and rapid change in the business world. Rules remain necessary for predictability and enforcement, but further details in rules will be counter-productive; excessive reliance on ever more detailed rules instead of principles is even one of the causes of the recent business failures and scandals.*

Peter Brabeck-Letmathe, CEO, Nestle



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Contributing Factors – Developments

- Legal structure
 - Code-law (Roman law) versus Case-law
 - US-Generally Accepted Accounting Principles (GAAP) v
 - International Financial Reporting Standards (IFRS)
 - X standards cover Y% of issues
 - Company acts
 - Development in external audits, audit process, reporting
 - Corporate Governance initiatives
- History
 - The conqueror decides and writes the history – Wars
- Culture
- Incidents
- Societal development
- Cost of regulation – Principles or Rules?
- Desires and needs – Cookbook mentality?



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Institute of Internal Auditors - Code of Ethics

The Code of Ethics contains principles and rules:

- **Principles** that are relevant to the profession and practice of internal auditing.
- **Rules of Conduct** that describe behaviour norms expected of internal auditors. These rules **are an aid** to interpreting the Principles into practical applications and are **intended to guide** the ethical conduct of internal auditors.



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Principles and Rules – IIA Code of Ethics

Integrity

The integrity of internal auditors establishes reliance on their judgment.

Objectivity

Internal auditors exhibit the highest quality of judgment in the process of gathering, evaluating, and communicating information about the process being examined. Internal auditors consider the relevant circumstances and are not influenced by personal interests or by others in forming judgments.

Confidentiality

Internal auditors respect the value of confidential information they receive and do not disclose information unless there is a legal or professional obligation to do so.

Competency

Internal auditors apply the knowledge, skills, and experience necessary for the performance of internal auditing services.

1. Integrity (Rule of conduct)

Internal auditors:

- 1.1. Shall perform their work with honesty, diligence, and responsibility.
- 1.2. Shall observe the law and make disclosures expected by the law and the profession.
- 1.3. Shall not knowingly be a party to any illegal activity, or engage in acts that are discreditable to the profession of internal auditing or to the organization.
- 1.4. Shall respect and contribute to the legitimate and ethical objectives of the organization.



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„Moses tried it, and he failed. Sarbanes and Oxley tried it, and they will fail. We cannot legislate against dishonesty.“

„Lawyers can make rules as much as they like, but good corporate lawyers will get around rules“.

(Mervyn King, in: Barrier, M. (2003). „Principles, Not Rules“, Internal Auditor, 08/03, p. 73)



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The IIA-Standards

The purpose of the *Standards* is to:

1. **Delineate basic principles** that represent the practice of internal auditing as it should be.
2. Provide a **framework** for performing and promoting a broad range of value-added internal audit activities.
3. Establish the basis for the **evaluation** of internal audit performance.
4. Foster improved organizational processes and operations.

- Although mandatory and comprehensive, the Standards are primarily designed as principles, not rules
- The Practice Advisories, which are only recommended for implementation, have more character of rules
- Recent IIA Development: Practice Advisories are flourishing

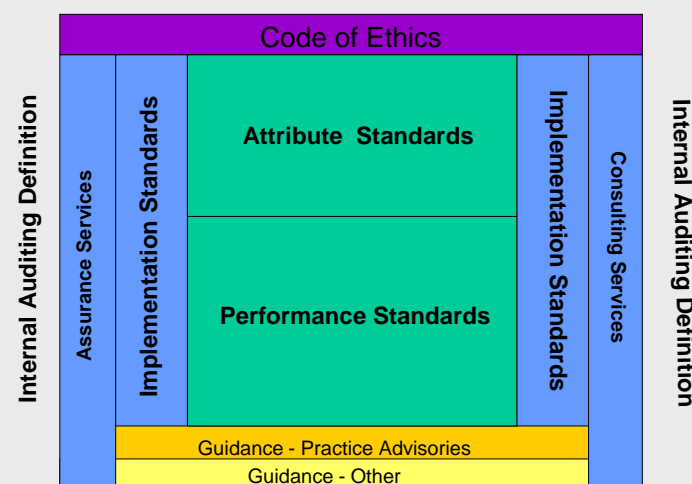


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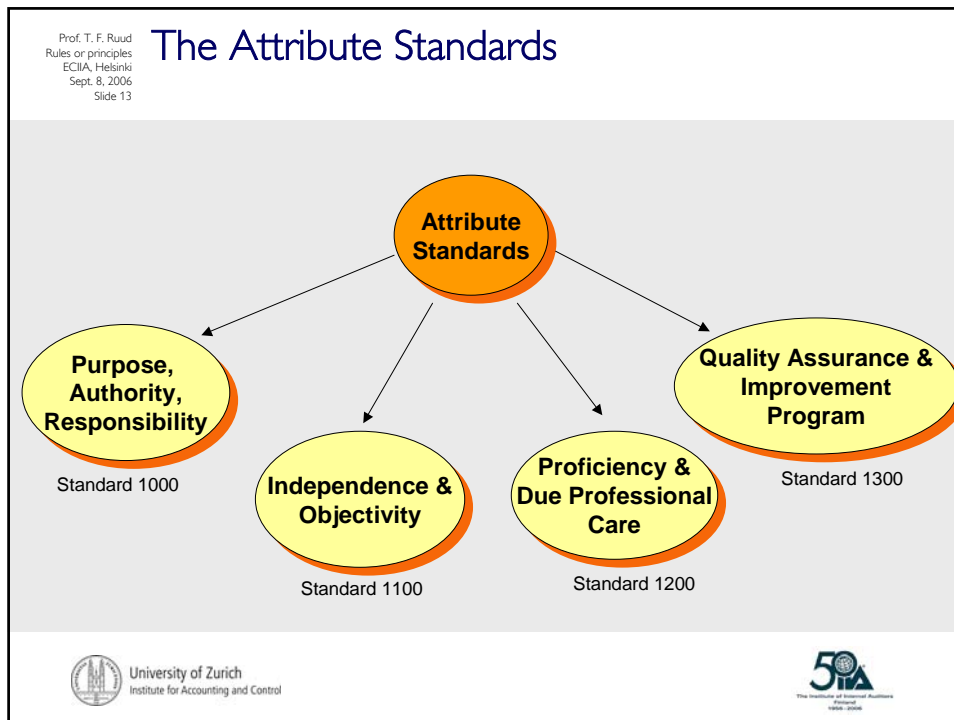
The Professional Practices Framework



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The Performance Standards

2000 – Managing the Internal Audit Activity - The chief audit executive should effectively manage the internal audit activity to ensure it adds value to the organization.

2100 – Nature of Work - The internal audit activity evaluates and contributes to the improvement of risk management, control and governance systems.

2200 – Engagement Planning - Internal auditors should develop and record a plan for each engagement.

2300 – Performing the Engagement - Internal auditors should identify, analyze, evaluate, and record sufficient information to achieve the engagement's objectives.

2400 – Communicating Results - Internal auditors should communicate the engagement results promptly.

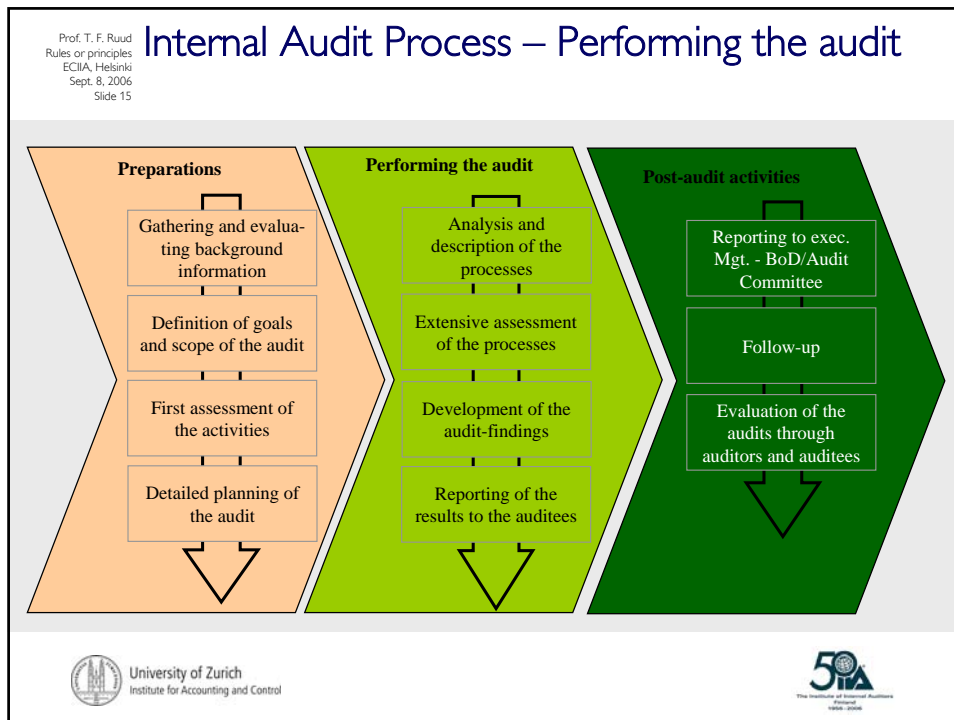
2500 - Monitoring Progress – The chief audit executive should establish and maintain a system to monitor the disposition of results communicated to management.

2600 - Management's Acceptance of Risks – When the chief audit executive believes that senior management has accepted a level of residual risk that is unacceptable to the organization, the chief audit executive should discuss the matter with senior management. If the decision regarding residual risk is not resolved, the chief audit executive and senior management should report the matter to the board for resolution.

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The Institute of Internal Auditors
1944-2004

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Everyday Life - Example German Autobahn

For much of the Autobahn speed is still unlimited, but there is a recommended limit of 130 km/h (80 mph). However, if you exceed the recommended limit and are involved in an accident, you could be responsible for some of the costs even if you are not at fault.



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Everyday Life – Example Ten Commandments

GOD

- 1: Do not worship any other gods
- 2: Do not make any idols
- 3: Do not misuse the name of God
- 4: Keep the Sabbath holy

MAN

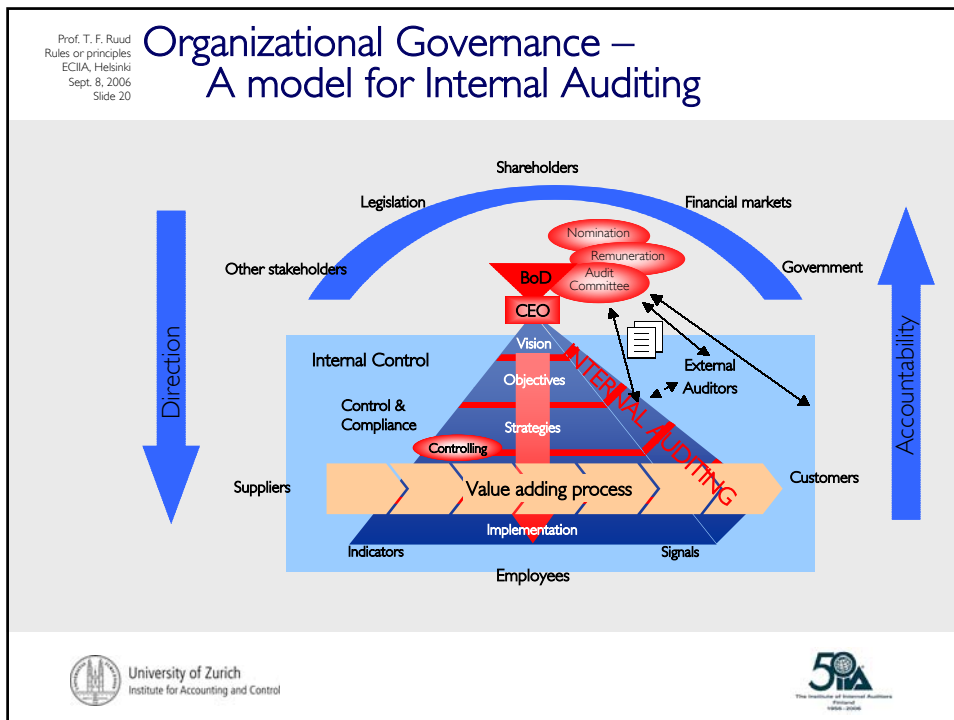
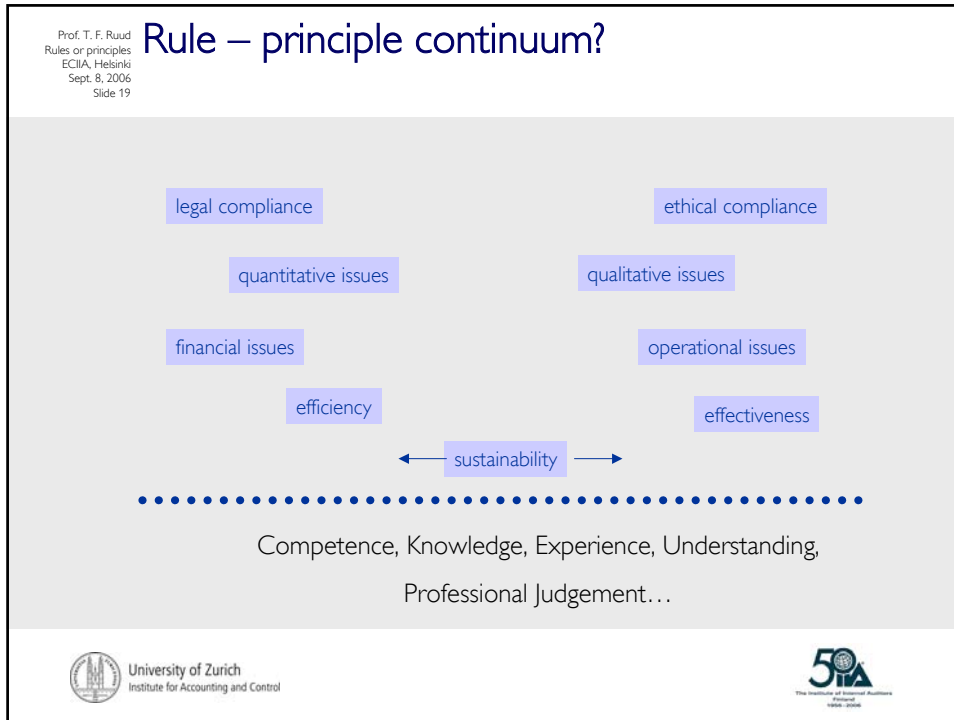
- 5: Honour your father & mother
- 6: Do not murder
- 7: Do not commit adultery
- 8: Do not steal
- 9: Do not lie
- 10: Do not covet



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Does internal auditing
need to be more rule-
based?



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What speaks *in favour* of more rules for the
internal audit profession

- Precision – and complexity – added to internal auditing
- Efficiency potentials due to standardization
- No need to justify the internal audit activity to third parties, provided that it adheres to the defined rules
- More objective third-party evaluation of the performance of internal auditing possible, as it can be compared to defined, pre-defined rules
- Reduction of a potential expectation gap
- Increased credibility of internal auditing in countries that have a ruled-based culture



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What speaks *against* more rules for the internal audit profession

- Principles can be adopted (by means of interpretation) to a dynamic environment and to different basic conditions, whereas rules provide less space for evolution and adoption → *always a principle you can stick to*
- High commitment and incentive to obey principles, whereas people try to get around rules
- Rules are often too complex, non-transparent, detailed and, as a matter of principle, incomplete and vulnerable to loopholes – question of system
- Restrictive rules do not allow a better set-up of a process, structure or system
- Lawyers go after non-compliance – litigation



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What speaks *against* more rules for the internal audit profession (cont'd)

- Too many rules bind internal auditors (= restrictions)
- Other potential assurance or consulting providers are free in delivering their services → competitive disadvantage
- Rules are particularly interesting for issues that have predictable characteristics
- Int. Audit deals far less with predictable “standard” issues
- Poor rules can have a negative impact on the performance, e.g., because they are not challenging enough or because they limit the ‘radius’ of action
- Internal auditors are professionals that are committed to the Code of Ethics and that are trained in critical thinking, they should be allowed a certain degree of autonomy
- Professionalism



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„I think principles are more effective than rules, simply because it's easier to get around a rule than to get around a principle.“

(Mervyn King, in: Barrier, M. (2003). „Principles, Not Rules“, Internal Auditor, 08/03, p. 71)



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Interacting dimensions

Principles guiding the internal auditing activity

Code of Ethics Definition and Standards COSO, CoCo Corporate Governance

Rules
guiding
the
internal
auditing
activity

Corporate guidelines

Legislation

Industry sector regulation

Financial reporting guidelines (e.g. IAS, / IFRS USGAAP)

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