THE NEW THREE LINES MODEL FOR STRUCTURING CORPORATE GOVERNANCE – A CRITICAL DISCUSSION OF SIMILARITIES AND DIFFERENCES

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Abstract

The efficient and effective organization and coordination of corporate governance activities is still one of the major challenges of modern corporate management. For many years, it was precisely the so-called three lines of defense model that was used to structure governance functions. However, as more and more open points of discussion regarding practical implementation have emerged over the past years, the three lines model was published in 2020 as a fundamental update by the Institute of Internal Auditors (IIA). This article presents the new model and critically discusses the similarities and differences to the existing model. Thus, this article contributes to the current discussion of best practices regarding corporate governance structure and the fundamental issues of efficient and effective oversight. Both practitioners and researchers should benefit from the critical analysis of this paper.

Keywords: Corporate Governance Structure, Three Lines of Defense, Three Lines Model, Internal Auditing, Risk Management Internal Controls, Compliance

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1. INTRODUCTION

The design of an efficient and effective internal corporate governance and monitoring structure is still a central challenge for modern corporate management. Theory and practice have not yet been able to present a generalizable framework for structuring the different governance functions. Furthermore, past and current scandals in the national and international corporate world also prove that weaknesses in the governance structure can still be exploited to commit fraud or fraudulent acts.

Against this background, corporate management, in the form of the management board or C-level, and corporate monitoring, in the form of the supervisory board or audit committee, are faced with the question of how to align the internal governance structure (e.g., Eulerich, Kremin, & Wood, 2019) and how much to invest into different governance functions (e.g., Anderson, Christ, Johnstone, & Rittenberg, 2012; Barua, Rama, & Sharma, 2010; Carcello, Hermanson, & Raghunandan, 2005). Over time, various governance functions have evolved to perform specific auditing and monitoring functions.
For many years (IIA, 2013). The advantages of the TLoD model have been sufficiently discussed in the practical and scientific literature (e.g., Bantleon et al., 2020) and form the basis for an objective and independent IAF. Both of these characteristics are still the key to a successful and value-creating IAF (e.g., D’Onza, Selim, Melville, & Allegrini, 2015; Fanning & Piercey, 2014; Arena & Azzone, 2009).

The direct assignment to the board supports both the objectivity and independence of the IAF and gives the authorization for a comprehensive internal audit of the first and second line of defense and the associated functions. Nevertheless, the TLoD model also has conceptual and substantive weaknesses which have led to problems during the implementation in many companies (Bantleon et al., 2020). For example, the delineation of the individual functions was just not as clear and “clean” as in the TLoD concept. Even in smaller organizations or companies with grown structures, the TLoD model repeatedly reached its limits. In addition, the “people” component was completely neglected within the framework of the model and is still a challenge for the position of the IAF and internal auditors (Fanning & Piercey, 2014). The cooperation of the governance functions was and is, of course, always based on the actors involved. This applies to both, the cooperation of the individual lines of defense and their use by the board. Particularly, due to the “information overload”, it is becoming increasingly difficult for management boards and supervisory boards to extract the appropriate decision-relevant information. Approaches, such as combined assurance (e.g., d’Arcy & Eulerich, 2020) or the COSO enterprise risk management (COSO, 2017; De Zwaan, Stewart, & Subramaniam, 2011) try to reduce weaknesses of a too static model, such as the TLoD, through an integrated or coordinated governance organization and to realize potential advantages in terms of synergy effects as well as efficiency and effectiveness improvements. However, a unified optimal model has still not been found in the scientific and practical discussion, especially since the combined approaches attack the two basic principles of a successful IAF, namely objectivity and independence (Abbott, Daugherty, Parker, & Peters, 2016), or even make them non-existent.

Especially in our uncertain, complex, and interconnected time, the concept of the original TLoD model has been discussed more intensively in recent years (Bantleon et al., 2020). In addition, changing bottleneck situations and interests of the various stakeholders make the management and monitoring of the company more difficult, which is why the alignment of governance functions is also being discussed more and more intensively and must continuously adapt to the changing conditions. The changing objectives and (digital) processes in companies require new and powerful structures so that the executive board and supervisory board can manage and monitor the company in the best possible way. Against this background, internal audit is the necessary and sensible provider of independent and objective auditing services to ensure the necessary level of assurance. Of course, in addition to internal auditing, all other governance...
functions, such as risk management, compliance, internal control functions, quality management, etc., are also necessary components of successful corporate governance.

The new three lines model of the IIA represents an opportunity to scrutinize one’s own governance structure and to identify potential for improvement and strengths. For this reason, this article presents the new three lines model and discusses similarities and differences to the classic TLoD model.

The remainder of this paper is structured as follows. Section 2 gives an overview of the main challenges of the traditional TLoD, before Section 3 presents the new model. Afterwards, Section 4 discusses the similarities and differences, before Section 5 concludes and presents an outlook.

2. CHALLENGES OF THE TRADITIONAL TL oD

The broad acceptance of the existing model results, in particular, from the simple and visual presentation and the associated ease of understanding and simplicity in communication (Bantleon et al., 2020; Arndorfer & Minto, 2015; Decaux & Sarens, 2015; EY, 2013; IFAC & IIA, 2018; IIA, 2013; KPMG, 2013; PWC, 2017). The structuring into clearly separated lines of defense with neatly separated tasks supports the clear definition of functions and responsibilities. The focus on independent and objective internal auditing is also in line with the global international professional practice framework (BPPF) (IIA, 2017), as well as many legal regulations in different countries and the requirements of the Basel Committee on Banking Supervision. However, even though the advantages seem very obvious, there are numerous starting points for improvements as well as disadvantages in the existing framework.

For example, the TLoD only allows a separation of first-, second-, and third-line functions. However, this is not always practical to implement in all companies or organizational forms. For example, smaller companies may not be able to set up all functions separately due to budgetary constraints, or the possible synergy effects of combining individual functions may make the separation preferred under the TLoD model seem impractical. The original model also does not provide any statements on the cooperation and coordination of individual activities (Bantleon et al., 2020). However, it is precisely this coordination that poses a challenge in many companies (Bantleon et al., 2020), as functions at the same hierarchical level (e.g., compliance, risk management, and internal auditing) may have a de facto hierarchical division into first, second, and third lines as a result of the TLoD.

For the reasons mentioned above, critical discussions about the TLoD have increased in recent years (Bantleon et al., 2020). These discussions have been exacerbated by approaches of integrated governance or combined assurance, in which improvements in the efficiency and effectiveness of overall governance are made possible by integrating individual or all governance functions and thus, creating more value through internal auditing (Roussy & Rodrigue, 2018; Sarens, Decaux, & Lenz, 2012; D’Onza et al., 2015; Luburic, 2017; Udding, 2016).

Against this background, the IIA has announced a comprehensive revision of the existing model and has spent several years redesigning the model, which will be presented in detail in the coming chapter.

3. THE NEW THREE LINES MODEL

By further developing and redesigning the traditional TLoD, the IIA has developed a model that is valid for all organizational forms and sizes and is intended to directly address the weaknesses of the original TLoD (IIA, 2020). For this purpose, a principle-based approach was defined as the basis for action, with each individual principle helping to implement the new TLM (three lines model). Furthermore, the model was adapted to the framework and objectives of today’s organizations, which is why more recent developments, such as an integration of individual governance functions, were also taken into account. The new model focuses, in particular, on the management of risks in order to increase value and protect assets at the same time. So that the coordination and cooperation of the individual actors can be ensured through the definition of roles, responsibilities, and relationships of all actors involved. The new model also aims to ensure that all activities and objectives of the organization are in line with the interests of the different internal and external stakeholder groups of the organization (e.g., shareholders, employees, customers, financial institutions, regulators, suppliers, etc.). Finally, the nomination of “defense” or “defense lines” was removed to minimize a possible negative connotation of the term “defense” or “defense lines” and, in particular, to address possible challenges in interpretation from an internal audit perspective. Figure 1 depicts the new model.

In particular, the newly defined principles and roles are a significant change in the new model, which is why both areas will be presented briefly.
3.1. Principles

The new TLM uses six different principles, which are intended to further concretize the understanding in terms of interpretation and implementation. The first principle, “governance”, aims to create a goal-oriented management and monitoring structure as the basis for successfully securing the company in the long term. To this end, the management and supervisory board or audit committee should be characterized by a high degree of integrity, good governance, and comprehensive transparency, and be perceived by stakeholders (like shareholders, employees, or customers) as a trustworthy partner with a high level of “accountability”. All decisions (“actions”) should be made in such a way that the available resources are used optimally and are always risk-oriented in the interest of the stakeholders. Internal auditing supports the governance actors and the monitoring and oversight activities by providing independent and objective audit and advisory services (“assurance and advice”).

The second principle considers the roles of the governing body or “governance body”. As the model originates from the U.S., this refers to the classic “one-tier board” of the Anglo-American governance system. Regardless of the monistic or dualistic governance system, the management and/or supervisory board/audit committee must implement suitable governance structures and processes and thereby ensure the achievement of the company’s and stakeholders’ objectives. The more complex (e.g., the larger) the organization, the more extensive the delegation of management and supervision must be, so that additional levels of the hierarchy must be drawn into the governance. In addition, the independent and objective IAF should assist this governance body.

The third principle regarding the management and tasks of the first and second lines can be seen as another change in the new model compared to the TLoD. For this purpose, a new definition of the two lines is introduced. In general, this third principle first defines that the management of individual corporate functions must always pursue the achievement of the overriding corporate goals while minimizing corporate risks. Therefore, all business units and activities are assigned to the first line which directly comprise or concern the production, provision, and delivery of products or services. All the necessary support functions (e.g., purchasing department or logistics) are also assigned to this line. The second line supports the management of the first line in controlling and reducing all risks arising in the first line. Interestingly, all functions and areas of the first and second line can be integrated or separated. In general, the second line can be seen more as a specialist function that supports the first line, e.g., through risk management, compliance, or quality management, but it is also conceivable to integrate it into the value creation activities of the first line. These changes also provide links to enterprise risk management (ERM), for example, along the lines of COSO, which enables the implementation of the TLM with existing frameworks (De Zwaan et al., 2011).

The fourth principle of third-line roles is aligned with the definition of internal auditing, according to which the audit provides independent and objective audit and advisory services (assurance and advice) on the adequacy and effectiveness of governance and risk management. A systematic and goal-oriented internal audit process in combination with specific expertise and knowledge then helps to generate unique audit results, thereby supporting first- and second-line management, but also the top-level management and supervisory board/audit committee in particular. This is also very helpful to support the IAF in becoming a management training ground for current internal auditors (Burton,
Starliper, Summers, & Wood, 2015; Carcello, Eulerich, Masli, & Wood, 2018; Christ, Masli, Sharp, & Wood, 2015; Hoos, Messier, Smith, & Tandy, 2018).

The fifth principle is closely related to the previous principle and once again explicitly describes the independence of internal auditing, which is understood as a mandatory prerequisite for an efficient audit, based on the worldwide professional guidelines of the IIA. It is only through an independent IAF that all areas of the company can be examined and considered in detail and all necessary information can be processed.

The sixth principle focuses on the creation and protection of corporate values. According to this principle, all roles involved should work together in a coordinated manner to contribute to value creation and asset protection, thereby safeguarding the company’s goals and the interests of its stakeholders. Coordination and harmonization of all corporate goals and functions can be ensured through communication, cooperation, and other forms of collaboration.

These principles are supported by the respective roles of the stakeholders involved, which are presented in the following sub-section.

3.2. Roles

The various newly defined roles of the main actors represent more far-reaching guidelines and principles of behavior as to how the implementation of the new TLM can look in practice. However, these roles are always to be evaluated in the respective company-specific context and thus always as variable. Nevertheless, the five new roles also represent more and helpful recommendations for action.

As a management and monitoring function, the governing body is intended to link the spheres of the corporate world with the associated stakeholder groups. Whereas in the monistic governance system this refers to the board, in the dualistic governance system the governing body is divided into two separate bodies, the management board (C-level) and the supervisory board with the audit committee. What is important here is the transparent and open communication of corporate risks and opportunities or corporate performance to all internal and external parties. In this context, the supervisory board or audit committee can be seen as a link to the shareholders and transfers the objectives of the shareholders to the management board, which can use the guidelines as a basis for creating a corporate culture and a corresponding corporate ethics. In addition, this role also includes the implementation of a goal-oriented governance structure as described above. Based on the corporate objectives, the risk appetite is also defined and the monitoring of all entrepreneurial activities is ensured.

The role of management in the context of the first line is aimed at the presented performance or value creation in the context of entrepreneurial activities. Management in all value-creating and supporting areas should always implement the allocation of resources in such a way, that the corporate objectives are met and the inherent risks are minimized or mitigated. Continuous exchange with the management body and corresponding reporting structures, in particular, are intended to ensure ongoing monitoring and control of the planned, realized, and possible future results. First-line management acts largely independently in terms of coordinating subordinate decision-making levels. Finally, the responsibility of the first line also includes compliance with legal, regulatory and ethical guidelines and requirements.

The role of the second line describes the support of the first line based on specific expertise related to the management of existing or potential risks. The new model is primarily oriented to a holistic view of risks, but of course also includes the necessary internal controls in addition to the development, implementation, and continuous improvement of risk management practices at the process, system, and entity level (following the wording of COSO). Consequently, this role must be assigned to the achievement of all risk management objectives, such as compliance with laws, regulations and expected ethical behavior, internal control, information and technology security, sustainability and quality assurance, etc. The second line must also ensure the reporting lines, especially with reference to the risk perspective, to higher and lower-level entities, i.e., the governing body and first-line functions, respectively. Depending on the governance system, second-line management may be assigned to the C-level or board of directors or to a lower hierarchical level.

The role of internal auditing is defined as a central body for providing assurance services that support the management body and is not involved in direct management tasks. The focus on the assurance of the internal control system, risk management, and governance structure is in line with the global professional definition of internal auditing.

The role of external assurance providers, such as the external auditor or other consulting firms, is to align with the internal governance structure and provide further assurance. In addition, the governance board may, upon request, engage external assistance to cover special topics or to support or relieve the existing governance functions. This is also in line with prior research, which discusses the positive effects of a collaboration between the internal and external auditors (Abbott, Parker, & Peters, 2012).

3.3. Relationships between the individual roles

The principles and roles described above create a complex network of relationships, which is why the new model also offers further guidance in this area. For example, the cooperation between the management body and the first- and second-line management should be characterized by the fact that the management body defines the overriding goals, strategies, and risk appetite and makes the basic allocation of existing resources. Subsequently, the first- and second-line management, on the one hand, deploys the resources to meet the objectives, and, on the other hand, reports to the corporate management and supervision, in particular, with regard to the risk position and the achievement of objectives.
In this context, the new TLM offers the possibility of institutionalizing any combination of functions and bodies that are to be optimally configured for target achievement against the background of the company-specific circumstances. Thus, this flexibility of the new model also allows the cooperation or direct influence of the governing body and first- and second-line management to be more or less intense. Depending on the governance system, for example, the chairman of the board or the CEO can be considered a member of the management body (one-tier governance system) or, alternatively, the CEO is supervised as a management function by the governing body, i.e., the supervisory board or audit committee (two-tier governance system). Nevertheless, and regardless of the respective design of the governance system and governance structure, transparent, direct, and intensive communication between all stakeholders is of central relevance, with the CEO classically assuming this central coordination task. As mentioned before, the new model allows for any configuration and thus creates maximum flexibility to decide how the governance structure looks like.

The cooperation between first- and second-line management and internal auditing is characterized by the strong positioning of audit as a downstream and independent assurance function that reviews and assesses the performance and risk positioning of the audited entities, i.e., the first and second line, on behalf of the management body. Against the backdrop of the strong risk orientation of the individual players in the new TLM, this cooperation, in particular, can no longer be imagined as an exchange of only two or more separate functions, but also allows for an integration of individual governance areas, i.e., for example, internal auditing and risk management or internal auditing and compliance. Thus, the new TLM is moving closer and closer to integrated governance or a combined assurance approach. The coordination and cooperation are also intended to help to realize synergies and avoid duplication of efforts while reducing “white spots” on the assurance map.

The cooperation of the IAF with the top-level management and the governing body follows the concept that the IAF, as the “eyes and ears” of the board, examines and evaluates all those areas on behalf of the governing body that cannot be examined by the management board and supervisory board/audit committee themselves. Consequently, the governing body acts as the direct “boss” of the IAF and ensures the effectiveness and performance of internal auditing. To this end, a target-oriented reporting structure must be selected.

Finally, the new model also provides recommendations for the cooperation of all roles, whereby the close coordination and cooperation of all actors involved is not to be understood as contradictory to the rules and principles presented previously. Depending on the company-specific circumstances, this coordination can be implemented more narrowly or more widely, whereby the respective circumstances and specifications always determine the optimum.

4. SIMILARITIES AND DIFFERENCES

If we compare the two models, we can first identify various similarities. Both models separate three lines for risk minimization, whereby the first line, as the business frontline, should cover all risks of the value creation process. The second line represents higher-level support functions which, in terms of corporate objectives and risk positioning, support the first line in managing existing and potential risks. The third line is staffed by an IAF, which independently and objectively audits and assesses the first two lines on behalf of the board or audit committee. In addition, the new model is based on the existing requirements of the IIA’s IPPF. The simple visualization and primary focus on internal company guidelines can also be seen as a constant. In addition, the terminology of “lines” remains in the new model, even if this only serves the habit of the reader.

However, it is the innovations and differences that appear to characterize the flexibility of the new TLM. The new model allows any combination of “individual lines”, whereby cooperation, coordination, or integration is conceivable. This freedom in the design of the internal governance structure allows management to implement exactly the structures that best takes into account the company-specific characteristics. In addition, it should be noted that the existing differentiation between the internal control system (first line of defense), risk management and compliance, etc. (second line of defense) and the IAF (third line of defense) no longer exists in this way. Although it seems to make sense to see internal controls as a component of the value creation activities of the first line, this new definition of the lines can also be quite challenging, since it precisely does not provide the desired clarity in the separation of individual responsibilities and potential coordination problems can arise as a result.

The addition of supplementary principles and the definition of differentiated roles should be seen as additional recommendations for action and as a further regulatory framework. These points help companies to choose their own “lines model”, regardless of company size, resources, or existing organization. Furthermore, the omission of the term “defense” is understandable, since, on the one hand, it broadens the perspective of the model and, in addition to “defensive”, i.e., risk-minimizing activities, “offensive”, i.e., opportunity-creating activities, can now also be subsumed in the model. On the other hand, it must also be critically noted to what extent this concept actually has a negative effect. Table 1 summarizes the similarities and differences.
5. CONCLUSION

The organization of corporate governance is still one of the central challenges of good corporate management and oversight. Even if the configuration of the individual governance actors appears almost infinite, it is not always easy to institutionalize a goal-oriented alignment of all activities. For this reason, the internal organization of the central governance functions, internal control system, risk management, compliance, and internal auditing, is still a complex task. Past and current corporate scandals demonstrate the enormous risks that can arise from a poor or non-existent internal governance structure. It is particularly exciting to see that the new TLM allows a high degree of flexibility and freedom in the design of the governance structure. On the positive side, this freedom means that from the many options available, precisely the one that best reflects the company’s specific characteristics and needs can be selected. Negatively formulated, the excessive degree of freedom, unfortunately, leads to an insufficient framework with regard to the configuration of the governance structure. How and where which functions are combined or kept separate is formulated just as vaguely in the new model, just as the allocation of individual functions does not appear clear. For this reason, the new model should initially be seen as an additional aid that can support companies with integrated approaches in particular.

REFERENCES


