Three lines of defence model and the role of internal audit activities as the response to the global economic crisis

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Abstract. The existing framework of corporate governance has shown a number of weaknesses, and the result was a new economic crisis at the global level. The main problems were identified as: increased risk of investors, non-transparency of information, conflict of interest between corporation subjects. European Institute of Internal Auditors in response to the strengthening the trust in information, shareholders activism, better communication, which all will lead to the reduction of risks and restore investors confidence, proposed the Model Three Lines of Defence, where the key role has internal audit.

1. Introduction
The main characteristic of today's market is the financial instability. By looking for the cause of this instability it is recognized that one of the main problems lies in access to information. Access to information is different according to the groups within and outside the company (shareholders, managers, employees, investors, etc.). In such incoherence and conflict of goals and interests there are many problems, such as: relevance, timeliness and transparency of information. In this sense, the more stressed are the necessity of creating functional areas in the company, with basic prefixes on reliability, timeliness and objectivity and with equal access to quantitative and qualitative performances of company.

The introduction of quality as the basic parameter of company performance, it can be concluded that external audit is not a sufficient instrument, especially with reference to its role of unsatisfactory from the perspective of many investors, and in the context of its timeliness (after time conclusions), areas of operation, transparency of activities etc. As the response to the above-set requirements, but also the perceived contradictions in the case of external audit, the European Confederation of the Institute of Internal Auditors (ECIIA), answer finds in internal audit function.

Confederation stresses the importance of truthfulness and relevance of financial statements, from the perspective of market instability, and requires of potential investors, in order to increase confidence in the same [1]. By conducted analysis it was concluded the needs of complex study of the

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It is very frequent case where the external auditors appear as a consultant, which will lead to a conflict of interest, especially as the financial compensation in these cases are many times higher than the audit services.

European Confederation of the Institute of Internal Auditors, an association of the Global Institute of Internal Auditors located in 35 countries and employs 35,000 internal auditors.
risk problems, for which financial statements are not sufficient, as they represent the finished action, not a continuum.

In that case ECIIA define the Model of three lines of defense in the function of efficient corporate governance. On the first line of defense processes are focused on risk management by the owners of capital. On the second line of defense it is the focus on compliance, risk management, financial control, etc. On the third line of defense is internal audit, as the "guarantee" that the previous activities and procedures in correlation with efficiency and effectiveness of all interest groups and company goals.

Based on the role of internal audit and issues facing the modern corporate governance, it is clearly an assumption that may withdraw the necessity of building the internal audit function as the catalyst in the creation of corporate social responsibility. Consequently, additional research in this work is aimed to determining the same assumptions, with special emphasis on the situation in the Republic of Serbia and the country in region. In this regard, we are starting from the consideration of the efficiency of existing mechanisms at the defined lines of defense of this model.

2. Internal audit in function of conversion the trust in the value

Conclusions from the Conference of the European Confederation of Internal Auditors in December 2008, emphasized the role of internal audit in terms of consultant and advisor in proactive risk management and dynamic and ongoing reporting, for all interest groups in the corporation. "Its independence in internal frames (always present at all levels) offers shareholders and investors the certainty. The importance and role of internal audit derives from its:

- recognition (expected due care, objectivity, fair, accurate reports);
- reliability (high degree of ethics and integrity, focus on specific areas, respect the object of the audit, providing practical and relevant recommendations);
- value (objective and well-informed correspondent of business risk control and corporate governance, reliable advisor, creates balance advice - guarantee)" [2].

"The importance of internal audit in corporate governance and risk management is reflected in its analysis of the likelihood and impact of risks, then the impact on the value of risk. This can be achieved by converting the value of trust in the way that is necessary to review all contractual relationships, identify their objectives, assess the risk on the basis of key criteria and their interconnection. In addition, it is necessary to assess the compliance of key control processes as well as their co-ordination, and based on that define appropriate procedures in order to improve efficiency“ [3].

Internal audit can make a vital instrument of corporate control and risk reduction, from the perspective of comprehensiveness and independence in the assessment of risk. Due to its objectivity and independent functions in the company it might be a good generator of business information from the turbulent environment in terms of globalization. The primary role of internal audit is the function of security for the operational management through a written report and an advisory role on the adequacy of the management control and risk management. The secondary role is to improve governance according to the risks. The ultimate goal of internal audit is to ensure efficiency and effectiveness in dealing with the high level of quality. Internal Audit Standards define
the scope of the operation and quality of functioning. It detects potential weaknesses in the internal control system and thereby exclude the possibility of neglecting certain areas. Therefore, the objective of the internal audit can be defined as the instrument by which management and all other employees of the company efficiently and effectively fulfill their obligations. Its mission is reflected in the identification of risk and its avoidance or mitigation.

3. **Difference between internal and external audit**

Although the internal and external audit are different, the performance of different goals (internal audit is an aid to the management, and external audit verify the reality of performance), they are still partially connected because of similar areas of study, techniques and methods.

External audit is connected to internal audit in two aspects: [5]

a. It can be conducted as an auditor of internal audit departments which control the follows:
   - Degree of independence of internal audit;
   - Areas of auditing and objectivity of performing the internal audit;
   - the expertise and professionalism of internal auditors;
   - technical competence;
   - reports of internal auditors;
   - level of available resources.

b. From the aspects of coordination of internal and external audit.

External audit may not always be a relevant indicator of the contribution of internal audit to successful decision-making, due to conflict of interest. Assessment of the independence and objectivity of the internal audit may be conducted in terms of the assessment of effectiveness, the extent to which external audit may rely on the internal auditing department during the annual audits, not only on the basis of application of generally accepted audit standards.

The link between internal and external audit is in the methods and techniques, and not in the objectives and results (for example, an external auditor will determine the reality expressed in inventories, while the internal auditor has to analyze the effectiveness of the applied method of calculation and stockpiling). So, the basic difference between the internal and external audit is presented in Table 1 [6].

| Item                      | External audit                                                                 | Internal audit                                                                 |
|---------------------------|-------------------------------------------------------------------------------|--------------------------------------------------------------------------------|
| Recipient of reports      | Shareholders or Members                                                       | Board members and senior managers                                              |
| Objective(s)              | Add credibility and reliability to reports from the organization to its shareholders by giving an opinion on them | Provide the assurance that members of the board and senior management use to fulfill their duties |
| Coverage                  | Financial reports and related disclosures, financial reporting risks and their management⁶ | All processes and categories of risks, their management (c) including the flow of information throughout the company, and governance |
| Timing and frequency      | Project(s) tied into financial reporting cycle, focused on objective of audit opinion | Ongoing and pervasive                                                          |
| Focus                     | Mainly historical                                                             | Forward-looking on the basis of “as-is” and recommended “to-be” scenarios       |
| Responsibility for identifying | None – duty to report problems                                                | Responsibility to report                                                       |

⁶ Risk management starts with objectives/purpose, then includes identification, evaluation and assessment of the risk; selection and implementation of the appropriate responses; and monitoring to ensure that the responses are working as required.
| Item               | External audit                        | Internal audit                                                                 |
|--------------------|---------------------------------------|--------------------------------------------------------------------------------|
| areas for improvement | noted during engagement | recommendations for improvement and promote related action plans, fundamental to the mission of internal auditing |
| Status and authority | Statutory and regulatory framework and International Auditing Standards (IAS) | International professional standards and Code of Corporate Governance |
| Independence       | Professional ethical standards overseen by audit committee and regulatory framework | Professional ethical standards overseen by audit committee |

To what extent will be achieved coordination of internal and external audit, primarily depends on the degree of independence and objectivity of internal audit. The greater degree of independence and objectivity of internal auditing, the greater is the possibility of relying external on internal audit, and vice versa, because by the end of the external audit, the internal auditor will have a more objective and realistic picture of the situation in the department of internal audit and will take the corrective measures and activities that will later contribute to the better functioning of the internal audit, and thus will contribute to more efficient management.

**4. Internal audit and new governance framework of corporate governance in EU**

The global economic crisis has raised the question of additional insurance in providing a framework of financial stability. External auditors have proved to be insufficient instruments in the creation of this framework. European Confederation of Institutes of Internal Auditors considers that an important role in the creation of this framework should take internal audit, which interacts with other mechanisms of corporate control can provide high-quality frames, which will improve risk management and the framework for future regulatory initiatives, which in the finale results in increased financial stability.

In creating the crisis response, the European Commission in 2010 formed the Reflection Group (Reflection Group), whose task was to draw attention to the current problems in the European legal framework, with a focus on corporate governance domains, i.e. to the quality of the Green Paper (Green Paper), of importance for the efficiency of corporate governance assimilated the necessary changes, which will improve and stabilize the financial markets, ultimately.

Reflection Group pointed to the inadequacy of the Sarbanes Oxley act to prevent financial crisis in the US, and that there is an increased need for risk management. At the European level, internal control and risk management is based on only two directives: Directive 2006/43 / EC86, whose Article 41 requires respect for the public interest of the majority, in terms of the formation of the supervisory board, as well as the obligation to establish audit committees to monitor the effectiveness of internal controls, internal audit (if any) and risk management system [7].

Directive 2006/46 / EC88 Article 7 requires from the listed companies, with the disclosure of financial statements, an annual publication, the report on corporate governance, which needs to contain a description of the main features of the internal control of the company, as well as the risk management system in relation to the financial reporting process [7].

The Group emphasizes the importance of European Commission Recommendation 2005/162 on the role of non-executive or supervisory directors, but also emphasized the need for the Commission Audit Committee as well as the assistance in supervising the internal control and risk management as well as instrument of effectiveness of the external audit. This would contribute to the informing process of shareholders and helped the strategic approach to risk management as well as the reduction or elimination of conflicts of interest.

It is clear that the European Commission in the documents related to the new framework of corporate governance highlights two key instruments:

- To increase the security level of investors,
- To improve internal and external communication.
Increasing the level of security of investors includes a true and fair audit report. From this point of view ECIIA sees a solution in supportive role of external and internal audit. Such a role would enable the management of company more efficient approach to managing risks, because of the efficiency of individual perception of risk. In response to such a position was established three lines of defence model, which is increasingly accepted in European companies.

**Three Lines of Defense Model**

![Diagram of Three Lines of Defense Model](source)

**Figure 2.** Model three line of defense (Source: ECIIA, Response to Green Paper Audit Policy: Lessons from the Crisis, December 2010, [www.eciia.eu](http://www.eciia.eu), Downloaded: April 2012, p.3)

On the first line of defence function key of responsibilities in the assessment, control and reduction of risk has operational management.

On the second line of defence risk management, compliance, implementation and enforcement of risk management system, is reflected in reporting higher levels of management and owners of the binding information for risk management.

The third line of defence is internal audit, which will provide assurances, by his functional approach, to the higher levels of management the effectiveness of risk management, as well as on the effectiveness of the first two levels of defence. Within this line means all activities related to the elements of risk institutions: risk identification, assessment, communication related to the risk.

This risk management model, which emphasizes the importance of the role of internal audit in risk reduction, ie. improve the corporate governance framework, is largely recognized as an efficient and expeditious finds its application in practice.

Better external and internal communication is a need that arises from the perspective of information provided by external audit. The consensus is that the report of the external auditor provides information related to completed operations (so-called. "Historically focused information"), but also that this information must have value for investors, they have to indicate a potential risk. Research shows that inadequate risk management can mean the loss of 80% of the shareholders [8]. Given that such analytical and scope beyond the scope of the external audit, the solution is to be found in communication with the internal audit. The elements of such claim are arising from its independence and professionalism.
Risk management is one of the key parameters of the new corporate governance framework. Shareholder activism and the value of information for potential investors, created the need to create a model that provides accurate and transparent information, which creates confidence in the reported value. Given the complexity of risk (environmental, social, political, financial, etc.) EKIIR proposed the model of risk assessment, which will contribute to its reduction. This model is useful in risk assessment and in the function of the Model the three lines of defence. This includes proper oversight by the management in the process of risk management, where it will be strategic profiled. Within the EU, it is proposed that companies adopt a framework for risk management (COSO ERM, COSO 2, ISO31000). Benefit from the adoption of this framework is underlined and in a recent report of Reflection Group. Successful implementation of this model of risk management can contribute to: the likelihood and consequences of the materialization of risks, better information in terms of strategic decision-making, reduce cost of capital, more accurate financial reporting, creating competitive advantages, market share and corporate social responsibility. Structured approach for the implementation of risk management is possible by the adoption of Enterprise Risk Management framework (ERM – whose main components are: profile of the internal environment, set goals, risk identification, control activities, information, communication and monitoring.) and it is compatible with ISO 31000.

In this regard, enterprise risk management framework aimed at achieving the objectives of the entity, included in four categories:
• Strategic - high goals, aligned with the mission
• Operations - effective and efficient use of existing resources
• Reporting - reliability of reporting
• Compliance - compliance with applicable laws and regulations

From the listed risk management framework it is a clear the functional relationship with internal audit. Precisely internal audit is the only entity within the company who considers the efficiency and effectiveness of risk management at strategic level, and the assessment of conformity submits to the strategic management. Operational objective comes from its methods, rules and procedures of implementation of activities to evaluate the effectiveness of activities. Reporting by internal audit has a proactive component, in the profiling of potential risk areas, and evaluate the degree of that risk. Compliance comes from its connection with the external audit, but also form his own governing framework regulations internal audit.

Thus, the functional area of internal audit is compatible with the framework to improve corporate governance in the global economic crisis. Creates relevant information, reliable and transparent, which will be for shareholders and potential investors represent a conversion of confidence in the value.

5. The necessity of implementing the new framework of corporate governance

5.1. The efficiency of corporate governance before recommendations of implementing the model of three lines of defence

The Model of three lines of defense, is a response to the efficiency of corporate governance in times of crisis and instability of the global market. While there in 2011 ECIIA is indicative of its importance and the necessity of implementation, electronic research shown that in the Republic of Serbia, this model still largely represent as the unknown. Precisely, with the aim of emphasizing the extent of necessary to implement this model, we used the research about the effectiveness of corporate governance in 2009 [9] (period, which initiated the establishment of this model in Europe). The study surveyed 14 companies in the territory of the Republic of Serbia. The survey was conducted by the survey - a questionnaire Efficiency of corporate governance in the global economic crisis in 2009 year. The survey included 65 questions that were diversified spectrum in terms of establishing a model of corporate governance in the Republic of Serbia. Surveyed enterprise in 47% are in service area, 38% are wholesale companies and 15% have the production activity. In 79% of surveyed companies,
number of employees is smaller than 200, 14% have over 500, and 7% have between 200 and 300 employees [9].

Using the results of that research, in order to prove the necessity of the implementation of the Model three lines of defense in the Republic of Serbia, it was made the systematization of certain segments of research, and within defined the lines of defense.

5.1.1. First line of defence – operational management and internal control. The first line of defense in risk management, represents the operational management and internal control system. The task of operational management is based on the identification, assessment, management and control measures to eliminate the risk. Operational management is responsible for taking corrective measures in the functioning of processes and controls [10].

On the basis of the research, it can be concluded that the effectiveness of operational management is based on relevant and timely information in 62% of the respondents (Chart No.1), and that the control procedures in the same percentage assessed as effective. Unfortunately, the percentage is greater than 30% in the negative connotation justified doubt on the effectiveness of implemented first line of defense in the surveyed companies, which indicates the high level of risk at the first line of defense. An additional measure of risk is the fact that 33% of respondents believe that the descriptions of activities only partially regulated, and that 20% of the problems of internal control in just partly or not at all documented.

![Figure 3. First line of defense](image)

5.1.2. The second line of defence - risk management, compliance, financial control. The fact that high risk is present at the first line of defense, further jeopardizing the effectiveness of the second line of defense, which was confirmed afterwards as well. The functions of risk management, compliance and controlling exhibit a high degree of risk. The lowest risk is on the side of formal management responsibility (7% non formalized). A similar degree of risk present in the control contract (8% partially set), but more in the control of execution of contracting that risk increases (8% did not set up controls and 8% only partially).
The highest degree of control operations are related to the formal act (regulations, minutes) as 25% of it, the cooperation with the Supervisory Board is 11% and 19% are the area of operation, rules are 19%, while the conflict of interest is exposed to the greatest risk, because it is regulated by only 6%. The risk of conflict of interest is further substantiated by the fact that the members of the supervisory board in only 10% independent in a given sample. Payment policy management and supervisory boards in 70% are public.

Based on the foregoing, the partial mechanisms justifiably casts doubt on the fact that 92% of respondents implemented risk management mechanisms that are formalized 69%. Even a large degree of deviation from the implementation to the formalization indicates an extremely high degree of risk on the second line of defense, as well as the reasonable doubt to the effectiveness of the implemented mechanisms.

5.1.3. Third line of defence – internal audit. On the third line of defense are the functions that are objective and independent assurance company interest groups that information is timely, relevant, accurate, supportive, precisely those that are arising from internal audit activities.
Figure 5. Third line of defence
Analyzing the data of the research can be seen that within the framework of implemented activities in a high percentage is the audit of finance (85%) and adaptation to changes within the finance (73%).

One of the problems in the third line of defense in effective corporate management is the Audit Committee. It was formed in only 56% of surveyed companies, 67% of it is delivered to the financial statements, and even 78% of the assessment was not carried introduction of internal audit by the said Commission. The Commission assesses the internal control system is in 62% of cases. Even 71% of the committee members are not independent members, representing a high degree of vulnerability in terms of objectivity.

Figure 6. Third line of defence - Audit Committee

When it comes to internal audit, it has been implemented in only 33% of companies, and the objectivity of the external auditor information is further jeopardize because one of the key reasons, and that is that in 30% ownership, interest or through other services, auditor is associated with the company (this cause was one of the principal that has led to the necessity of creating new models of corporate governance, because conflict of interest of auditor is caused the false presentation and biased information which they manipulated shareholders and investors - the case of Enron and Arthur Andersen Company). In addition to previous statements is the fact that the Supervisory Board members have 30% shares of the company.

5.2. Efficiency of corporate governance after recommendations of the model three lines of defence

In order to obtain relevant data, confirm the hypothesis, and given the fact that even after the recommendations of implementation the model of three defence lines in order to reduce the risk of business activities, the model is not implemented, we conducted the short version of the previous survey, and included a small number of companies from the region, because the latest recommendations go in the direction of regional networking. Unfortunately, the results have been devastating. The causes may be founded in contempt of implementing the recommendations of the Model. Risk management is drastically increased.

On the first line of defence (operational management and internal control system) we observed the following results of higher potential risk of defence:

- 62,5% is the efficiency of control procedures (27.5% negative responses)
- 50% activity is only partially defined
- 37,5% problems of internal control are partially or not at all documented.

On the second line of defence (risk management) high potential risk of defence have:

- 37,5% verify the execution of the contracts
- 25% of members of Supervisory Board, only, are independent members

On the third line of defence (internal audit), is present extremely high risk in the following business segments:

- 75% revision applies only to Financial Statements
- Only 50% have an audit committee
- In 50% case assessment was not carried out by the Audit Commission for the implementation of internal audit
- 50% Commission members are not independent members
Reduced research confirms the urgent need for the implementation of the Model the three lines of defence.

6. Conclusion

Causes and consequences of the global economic crisis caused the need to study the new corporate governance framework and seeking mechanisms and instruments to mitigate the risks which are facing the shareholders, investors, managers, creditors and all other subjects of interest of the corporation. A key question in this context arises, which instruments can lead to the establishment the system of efficiency and effectiveness of corporate governance in a climate of high risk of data inaccuracies, lack of confidence, macroeconomic instability. European Confederation of Institutes of Internal Auditing, the response required in the activities and functioning of the internal audit area. Based on the requirement of creating corporate social responsibility as a response to the need of converting confidence in the value ECIIA defined the Model three lines of defence. The first level of defence is against the risk on the operational management level, while the second level of risk is managed through an enhanced level of communication management and owners of the capital, the third level of defence is internal audit, which is a function of the effectiveness of the risk management and efficiency of the first two levels of defence. Therefore, it is necessary to increase the level of security of investors and establish better internal and external communication. As a result, the set requirements and models, it is emphasized the need for synergetic linking of internal and external audit. Internal audit is an instrument that is based on the independence and professionalism and could provide analytical information of risk management, which extend the scope of the external audit, and on the other hand contribute to transparent and comprehensive audit process. All the above would lead to increased safety risk management processes, and ultimately contribute to the construction of corporate social responsibility.

Thus, it is clear proof that the necessity to develop internal audit as a catalyst in the creation of corporate social responsibility. The analysis of the research in the Republic of Serbia, we can conclude that, although the financial and corporate market is still largely undeveloped, the problems facing the global market in these markets even more pronounced and require complex and analytical approach. Also, the data speak in favour of the claim that risk management is largely poor but on the second line of defence, and the fact that the third line of defence is still in the construction phase, which further jeopardizes the market and creates a negative image, which does not attract new investors, or threatens and the interests of the existing ones.

In this sense, the implementation of internal audit, integrated into the company through three lines of defence model, it is necessary and alarming solution in establishing a new framework of corporate governance.

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