Topics for Today

• History of the Three Lines of Defense Model
• Why Update Now?
• Pros/Cons of the Old Model
• The New Three Lines Model
• Principles in the New Model
• How Internal Audit can use the Model
Polling Question #1

How familiar are you with the old Three Lines of Defense Model?

1. Very familiar – Have used it for discussions with management several times in the past
2. Somewhat familiar – Aware of the model, but have had few if any discussions with management
3. Not very familiar – Heard of it, but never used it
4. Never heard of it
History of the Three Lines of Defense

Origins c.1996
Principally Financial Services
2013 IIA Position Paper
Good Advocacy Piece
Old Three Lines of Defense Model

Adapted from ECIIA/FERMA Guidance on the 8th EU Company Law Directive, article 41
Pros of Old 3 LoD Model

- Well-known
- Widely adopted
- Simple graphic
- Easy to explain
- Useful for discussions
Cons of Old 3 LoD Model

- Appears/suggests:
  - Reactive, defensive
  - Prescriptive/silos
  - Structured/unscalable
  - Remote governing body and senior management
  - Risk management not independent
  - Blurring between lines
  - Internal audit “boxed in”
  - One-way communication
  - Doesn’t address public sector or unregulated industries
Polling Question #2

Based on the Pros/Cons of the old Three Lines of Defense Model, how important was it to update the model?

1. Very Important – It was no longer fit for purpose in today’s changing world
2. Somewhat important – It had some issues, but a complete overhaul was not necessary
3. Not important – The old model still works fine
4. Not sure
New Model Considerations

• Organizations
  – Are important
  – Differ widely
  – Don’t exist to manage risk
  – Are more like organisms than machines

• Risk management
  – Is not just about stopping bad things from happening
  – Must be integrated and embedded
Importance of Governance

• Stakeholders expect success
  – Efficiently, effectively, ethically, sustainably

• Stakeholder interests
  – Change
  – Are sometimes opposing
  – Include future generations

• Separation exists between
  – Stakeholders and governing body
  – Governing body and management

• Operations are complex and interconnected

• Humans are unreliable, subjective, self-interested
The Three Lines Model – High Level

- Illustrates a relationship between roles (not structural)
- There can be multiple points of interaction between the governing body and management if required:
  - CEO, CRO, etc.
Three Lines Model

GOVERNING BODY
Accountability to stakeholders for organizational oversight

Governing body roles: integrity, leadership and transparency

MANAGEMENT
Actions (including managing risk) to achieve organizational objectives

First line roles: Provision of products/services to clients; managing risk
Second line roles: Expertise, support, monitoring and challenge on risk-related matters

INTERNAL AUDIT
Independent assurance

Third line roles: Independent and objective assurance and advice on all matters related to the achievement of objectives

KEY:
↑ Accountability, reporting
↓ Delegation, direction, resources, oversight
↔ Alignment, communication coordination, collaboration
Key Changes

• Context
• Six principles
• Changed use of language:
  – First line roles, etc.
• First line roles and second line roles may be separated or blended but remain within the responsibility of management
• Internal audit is more clearly independent from management roles, decisions, interference
Principles of the Model

1. Governance of an organization
2. Governing body roles
3. Management and 1\textsuperscript{st} and 2\textsuperscript{nd} line roles
4. 3\textsuperscript{rd} line roles
5. 3\textsuperscript{rd} line independence
6. Creating and protecting value
Principle 1: Governance

- Governance requires appropriate structures and processes that enable:
  - **Accountability** to stakeholders for organizational oversight through integrity, leadership and transparency
  - **Actions** by management (including managing risk) to achieve the objectives of the organization
  - **Assurance and Advice** by an independent [internal audit] function to provide clarity and confidence
Polling Question #3

What independent and objective assurance functions exist within your organization?

1. Internal Audit is the only one
2. Internal Audit and Risk Management
3. Internal Audit and some other 2\textsuperscript{nd} line functions
4. Not sure
Principle 2: Governing Body Roles

- The governing body ensures:
  - Appropriate structures and processes are in place
  - Organizational objectives and activities are aligned

- The governing body:
  - Delegates responsibility and provides resources to management to achieve objectives while ensuring legal, regulatory and ethical expectations are met
  - Establishes and oversees an independent, objective and competent internal audit function
Principle 3: Management & First Line Roles

- Management comprises both 1st and 2nd line roles
  - First line roles directly align with delivery of products and services
    - Ultimately, the 1st line is responsible for effective risk management
  - Second line roles assist with managing risk
    - May include specialists to specifically support 1st line roles
    - May focus on specific risk management objectives, such as compliance, internal control, IT security, sustainability and quality assurance
    - Alternatively, may span risk management more broadly (responsibility for overall ERM)
Principle 4: Third Line Roles

- Internal audit provides independent and objective assurance and advice on the adequacy and effectiveness of governance and risk management
  - Achieve this through competent application of systematic and disciplined processes, expertise and insight
  - Reports to management and the governing body to promote and facilitate continuous improvement
    - May consider assurance from other internal and external providers
Principle 5: Third Line Independence

• Internal Audit’s independence from management responsibilities is critical to its objectivity, authority and credibility

• Independence is established by:
  – Accountability to the governing board
  – Unfettered access to people, resources and data
  – Freedom from bias or interference
Principle 6: Creating & Protecting Value

- All roles together contribute to the creation and protection of value when they are aligned with each other and with the prioritized interests of stakeholders.
- Alignment is achieved through communication, cooperation and collaboration.
- Ensures reliability, coherence and transparency of information needed for risk-based decision making.
- Consistent with the Mission of Internal audit to “enhance and protect organizational value …”
How Internal Audit Can Use the Model

- Understand how to fit the principles to your organization
- Discuss with 2nd line roles to improve collaboration and coordination
- Leverage effective 1st and 2nd line roles where appropriate (combined assurance)
- Use it to reinforce independence (if needed)
- Ensure internal audit activities and reporting focus on creating and protecting value
Summary

• The old Three Lines of Defense Model served the world well for more than 20 years
• In today’s world, an updated, but not radically different, model was needed
• The new Three Lines Model focuses on roles and accountability more than departments
• Ultimately, it’s about creating and protecting value
Thanks!

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