Public Internal Control Systems in the European Union

The three lines of defense in a Public Sector environment

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The three lines of defence in a Public Sector environment

Public Internal Control (PIC) is becoming seen more and more as a total and integrated concept for improving governance within the public sector. PIC actors have different roles and responsibilities derived from their historical background, together with the specific needs, reform vision and administrative tradition of the member state. As key promoters of efficiency and effectiveness, PIC actors themselves should regularly reflect on how to enhance their own efficiency and effectiveness.

This paper proposes to further sustain the achievement of a balanced, efficient and effective system of internal control by developing different lines of defence and clarifying their specific roles and responsibilities in a public sector context. Optimizing PIC means, on one hand, better collaboration between the different actors to create synergies and to avoid overlap. And on the other hand, PIC actors should evolve continuously, according to the constantly changing environment, conditions and requirements.
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1. INTRODUCTION

Striving for better performance and more efficiency has become a continuous challenge for public entities, in particular in times when budgets are under considerable pressure. As key promoters for more effectiveness and efficiency, Public Internal Control (PIC) actors themselves need to assess how well they are functioning in order to optimize the PIC framework. Internal Control is of course the responsibility of all within an organization. However it is clear that all key actors within and outside a particular public entity need a clear understanding of their precise role and responsibilities in order for PIC to function most effectively and efficiently.

This paper aims to encourage a balanced PIC system by using the concept of the different lines of defence\(^1\) in the public sector. It is however clear that not all public internal control systems are the same. An individual system may have evolved specific roles and responsibilities, for instance in the fields of financial management, anti-fraud and integrity policies. The paper takes a holistic view, looking at the interaction between actors at government level, as well as those within an organization, while respecting differences in the administrative culture and the institutional framework within member states.

The paper emphasizes the importance of a dynamic approach, evolved and adapted according to the maturity level of the PIC system. As all actors strive to reach common objectives, the search for ways to promote cooperation and effective communication, and to obtain synergies from better coordination of the different actors, needs to be highlighted. The paper sets out suggested good practice for the role and responsibility of key PIC actors at the government level and ways to enhance their effectiveness and efficiency.

\(^1\)Adapted from [https://na.theiia.org/standards-guidance/Public%20Documents/PP%20The%20Three%20Lines%20of%20Defense%20in%20Effective%20Risk%20Management%20and%20Control.pdf](https://na.theiia.org/standards-guidance/Public%20Documents/PP%20The%20Three%20Lines%20of%20Defense%20in%20Effective%20Risk%20Management%20and%20Control.pdf)
2. **The Different PIC Actors**

Within an organisation, the division between the different lines of defence is quite clear. Positioning the PIC actors according to the three lines of defence model on the government level is however more challenging. This paper tackles the organisation of the PIC actors on the government level, taking into account their specific features and different historical background within the EU member states. Irrespective of this variety of structures, the three lines of defence model can serve as a solid framework for clarifying the specific roles and responsibilities of the individual PIC actors.

Governing bodies and senior management do not form part of the three lines of defence but are the main stakeholders. Collectively they are responsible and accountable for setting the organization's global objectives, defining its strategies for achieving those objectives and establishing appropriate governing structures to oversee the organization. In a public sector context, governing bodies are those represented by the **political level**. In democratic governments, the executive political branch, traditionally referred to as the Board in the private sector, is responsible for giving strategic direction, whereas the legislative branch is responsible for authorizing the executive's budget and government expenditure. Translating the three lines of defence model within a public sector context can therefore be interpreted as the assignment of the responsibilities of public organizations and PIC actors being accountable to the executive political branch.

The political level traditionally delegates the authority for day-to-day operations of a public entity to the **executive leader** of that entity. The executive leadership or senior
management of public entities is therefore accountable to the executive political branch. Depending on the governance structure, the executive leader, whether or not s/he is linked to the political level, is responsible for the operational functioning of the organization and the execution of the policies set out by the executive political level. This executive leader and senior management are responsible for implementing an organization's governance structures and PIC, as directed by the political level.

A critical precondition for a solid PIC system is that the roles, responsibilities and accountability structures of the different layers (being political level and executive management level) are clear and developed in a balanced way. In a government context, the responsibilities of executive management are often broad and vague and they have often restricted authority in terms of budget spending to take up their responsibilities. Also, external pressure from citizens, press and external regulators increases. The three lines of defence provide information to the executive management to direct the public entities and to support the execution of their responsibilities. In addition, it offers an instrument to render account, to the political level and to external stakeholders such as the general public, on the performance of the organisation.

3.1. The first line of defence

The first line of defence within public entities describes the responsibilities of the risk owners, being the management within the public entity, in supervising the implementation and execution of PIC up and down to the level of individual staff being responsible for executing the internal controls. These internal controls cover the operations within every level of the entity. Public servants have a specific responsibility since they work with public funds. They need to perform and execute operations in the most efficient and effective way possible and internal controls must be designed, implemented and executed to deliver achievement of the organization's objectives. The focus of the first line of defence is to ensure the proper operation of, and monitoring the performance of, the entity. Line management of public entities are responsible for assessing, controlling and mitigating risks and are accountable to the executive leader and senior management.

3.2. The second line of defence

The second line of defence helps management by developing specific parts of the risk management framework, by monitoring and facilitating the implementation and functioning of effective risk management practices led by operational management, and assisting risk owners to report adequate risk-related information up and down the organization. In particular, within the public sector, it remains important to work in compliance with legislation and regulations. There is a trend of increased regulation and some of these areas are becoming more and more complex and require specific expertise.

Management can establish various compliance and controller functions to support them by monitoring specific risk areas to ensure that the first line of defence is properly designed, in place and operating as intended. This line consists of centralized or
decentralized, supporting and coordination functions in the field, as well as quality or other specific areas such as finances and accounting. These functions do not own the risk but focus on supporting internal control and reporting on the functioning of these controls to the risk owners (i.e. the management). They are accountable to the executive leader and senior management by providing them with information regarding risk management and internal controls in these specific domains.

**Financial Management and Control**

Most member states still have separate PIC actors in the domain of Financial Management and Control (FMC), focusing on budget and accounting processes.

The role of financial inspection functions is very diverse varying from strict monitoring responsibilities to broad concepts of supervising, monitoring and advising on the budget. In some member states they have responsibilities in the field of combatting and investigating fraud and corruption. Financial inspection functions are often centralized functions, reporting to the Ministry of Finance and in some instances to the Prime Minister or the Council of Ministers. In most cases the financial inspection also reports detected irregularities for follow-up by a competent authority, which can vary, depending on the procedures in the member state and/or on the type of irregularity. Types of competent authority include the Supreme Audit Institution, the prosecutor, General Inspection, etc.

As an actor in a specific domain of PIC, the financial inspection function is a second line supporting and coordinating function in the field of FMC. The financial framework, clarifying the roles and responsibilities of the different actors in the field of FMC, has to be consistent with the accountability structures of the member states.

Financial inspection should support and report to the actors responsible for FMC. In this regard, it is important to ensure that Financial Inspection does not restrict or interfere with the application of managerial accountability within an organisation. Managers should retain the discretion to make financial decisions on policy matters and to be accountable for such, with any ex ante. Financial Inspection should not be able to block policy decisions by management.

As PIC systems become more mature, centralized Financial Inspection can still be relevant as a tool for the public administration, but their function should be aimed as a second line of defense actor, at the fight against fraud and corruption, mainly performing specialized inspections (ex-post) on the basis of complaints or other indications of wrongdoing.

### 3.3. The third line of defence

The third line of defence, the independent internal audit function plays a double role. First of all, internal audit supports and advises executive management on PIC. Secondly, it possibly serves as a supervising function for the executive political level. Internal audit provides effective ways of improving existing processes, and assists therefore
management on implementing improvements. To maximise internal audit's value added contribution to an organization, there should be a functional reporting line to executive leader of the public entity, making internal audit independent of the management, enabling it to make objective judgments and giving it the authority to conduct its work across the whole entity without constraints. It should also have access to all the management information. The public sector internal auditor's role is to support management and possibly to the political executive level via oversight, insight and foresight. Depending on the administrative set-up, there could also be a reporting line to the executive political level, optionally represented by an audit committee. Oversight provides assurance not only on whether or not public entities are doing what they are supposed to do, but also on the way they do so. Insight provides support to management in the decision making process via independent assessments and advice. Public sector internal audit should also exercise foresight by pro-actively identifying trends and emerging challenges.

4. **TOWARDS A MORE EFFECTIVE AND EFFICIENT PIC**

To ensure effectiveness, PIC actors have to function taking into account stakeholder expectations. Since available resources are limited, PIC actors should focus, within their respective responsibilities, on the main risks, exchanging information and collaborating in order to enhance efficiency.

4.1. **Enhancing effectiveness and adding value by addressing different stakeholder’s needs**

To ensure the effectiveness of PIC, actors should have clear roles and responsivities within the three lines of defence, focusing on and addressing the needs of their specific stakeholders. The first line is the basis, since management and staff are the risk owners responsible for designing, implementing and executing the internal controls. In the second line, some PIC actors focus on specific areas within risk management. Financial management and control is an area that is traditionally well developed. The assurance provided by the financial management and control system is sometimes linked to the obligation of the minister and top management to sign a statement and make a declaration on the functioning of the entity’s internal control systems. The third line has an important oversight function on the global functioning of public entities. As part of internal control, the main stakeholders are management and the executive political level.

Other actors have responsibilities in providing the oversight function towards external stakeholders. Since public entities work with taxpayer’s money, they have a specific responsibility towards citizens to render account on the public spending. External audit, in most cases the **Supreme Audit Institution**, has the specific task of reporting to the legislative level on the performance of public entities and their use of public funds. It is responsible for assessing the reliability and completeness of the financial and non-financial information provided by the government. In some member states, the Supreme
Audit institution has judicial powers. It can open a financial responsibility procedure and request the reimbursement of any undue payments made by managers.

Organisations also have to comply with regulations from external regulators such as European Regulatory bodies. These external regulators, although not part of the 3 lines of defence, are stakeholders since they are also providing assurance on the internal control system related to the specific regulations. For public sector entities, it is important that the PIC systems also take into account these external obligations. Actors within the 3 lines of defence should consider the requirements from external bodies.

There may be an audit committee or several audit committees. They represent the political executive level and serve as a professional partner by informing and providing oversight to this political level on one hand and in safeguarding the proper functioning of internal audit on the other hand. They can be centrally placed or be decentralized (within Ministries or entities of the public sector). They are an advisory function, sometimes directly concerned with the management and operations of an existing internal audit function.

The added value delivered by the various actors depends on the clear assignment of responsibility. In many instances the boundaries between the roles of the different lines of defence are blurred. For instance in less mature systems, the internal audit function is pushed to take up responsibilities within the second line. As the PIC system becomes more mature, the roles of the second and third line of defence may become less substantial since operational and management control becomes more solid.

4.2. Enhancing efficiency by collaboration and coordination

The three line of defence model may seem to be a heavy structure to implement and it may be perceived as additional controls. Therefore it should be emphasized that the three lines each have each their specific role toward their stakeholders. To avoid control burden, it is important that all actors, inside and outside the organisation, cooperate and that there is appropriate coordination between them. This is essential to avoid overlap so that each line of defence adds value with regard to the result of the previous one. This also eliminates possible gaps, where responsibilities have not been clearly assigned and important actions are not being carried out.

Cooperation and coordination between the second and third line creates the right conditions for enhancing the single audit concept, where each level can take assurance from the work of others and can therefore use their results and conclusions for their specific functions and activities. Being able to depend upon information from other PIC actors, necessitates a good understanding of the work of other assurance providers. This may also entail some additional activities in evaluating the reliability of the information delivered by other actors. The first line of defence, being responsible for the risks, remains the basis and should pro-actively inform and support other actors. Working with formalized reporting lines, standardized templates and shared IT platforms can help to create collaboration in practice.
This collaboration should also improve the quality of reporting to the stakeholders and mitigate the risk of overload and duplicated information for stakeholders. Management and political level have to be informed with qualitative information. The quality of the information depends often on the completeness, but without detail overload. PIC actors should strive to create integrated reports for their stakeholders linking all relevant pieces of information together.

Central harmonisation units/functions serve to support the PIC framework and can play an important role in the coordination of the different PIC actors. In response of the increasing control and audit demands from different types of organisations with different reporting demands, a central harmonisation function can detect overlaps or audit gaps. Central harmonisation can also enhance collaboration by promoting information exchange, thus helping to create more trust and a common understanding between the different actors. In this sense, a wider and more common use of the single audit concept, including techniques, procedures and reporting arrangements, allows to create synergies between different PIC actors by taking into account the work of all assurance providers in the execution of proper tasks and activities. The central harmonisation function can also provide support in coordination between federal and local level of administrations, depending on the institutional set-up of the member state.

5. MANAGING RELATIONS AND RESPONSIBILITIES BETWEEN PIC ACTORS

PIC has developed into a widely used, integral and vital part of most governance systems in the EU member states. We can find different PIC systems in EU member states, evolved from their historical background. They integrate varying combinations of differing elements of PIC and consist of different actors which makes it difficult to include them in one single model. This also entails that there is not a unique solution to managing and controlling public resources to ensure their most adequate use. Moreover, the context of managing and controlling public funds has changed considerably over time by strengthening the accountability principles within public entities. It therefore remains a challenge to ensure that the PIC system, and in particular the field of FMC, is continually in line with managerial expectations, and delivering to agreed standards.

Although, the different actors have varying roles and responsibilities, they should work together on enhancing PIC. Since budgets have become even tighter for public entities, it is important that the PIC system, as a promoter of efficiency, incorporates the necessity to work efficiently. Therefore the different PIC actors have to work together to ensure adequate coverage of the audit universe and avoid any gaps. It is also important to use a common language and to ensure homogeneous application, whenever possible, of the internal control principles, procedures and standards, achieving similar approaches and desired levels of quality. This can be done through instructions, checklists, quality controls, coordination of audit plans, etc.

Relations between PIC actors and external stakeholders can be a challenge. For example, the relation between internal and external audit is not always well established.
and formalized. How this relation is defined depends on the mandates and roles of both institutions. It can be useful, in any case, to take initiatives that could allow moving towards a single audit model, for example, cooperating on methodological and training matters, avoiding duplication of work (such as by coordinating annual plans as much as possible).

Another challenge is **disclosure of information** to external stakeholders. As has been said, the actors within the three lines of defence support management and the political level. Disclosure of information can pose a risk to the levels of trust between PIC actors and senior management and the political level. However, public entities work with public funds so the principles of transparency towards the citizen are applicable and appropriate. Therefore disclosure of PIC information should be balanced and take into account the risks inherent of disclosure.

The PIC system and the actors incorporated therein should be **adapted to the size and maturity level** of the public entity. The specificities of each entity require a flexible interpretation of the maturity level, meaning that the model of the most mature entity is not necessary the best one for all entities. Small entities do not have the resources to split risk management between various actors and lines of defence. Working together with other entities or centralizing functions can offer a solution. PIC is not a static system but needs to be dynamic by continuously taking into account new needs and requirements. The roles and responsibilities of the PIC actors should evolve accordingly and changes need to be clear and consistent.

Member states have adopted different solutions for the **coordination or harmonisation of the PIC system**. In some cases there are formal or informal networking arrangements between financial controllers, internal and external auditors, to provide the necessary level of coordination and harmonisation. In other cases, the solution has been to set up ‘central harmonisation units or functions’. Primarily these functions are competent for proposing regulations, harmonising the standards of the various internal control components, monitoring overall quality and performance, and establishing and coordinating training activities. This harmonization function should also evolve according to the needs of the PIC environment and enhance the coherent approach by coordinating the work of different PIC actors. Depending upon the political set-up of the country, this central harmonisation function can equally serve the central government administration, as well as other institutional or territorial levels of the public sector.
6. **TOPICS FOR DISCUSSION**

(1) What are the main challenges to ensure the effective functioning of the three lines of defence model in your country?

(2) Clarification of the roles and responsibilities of PIC actors can positively influence the 'single audit model'. Is the single audit model applied in your country? What factors could restrict the further development of the single audit model in your country?

(3) The paper points out that the "disclosure of PIC information [to external stakeholders] should be balanced. What type of information could or should be disclosed to external stakeholders? What factors could affect decisions for the non-disclosure of information?"