

September 18, 2019

Institute of Internal Auditors
1035 Greenwood Blvd., Suite 401
Lake Mary, FL 32746 USA

For the attention of the Working Group on the Three Lines of Defense

Dear Sir/Madam:

Comments on the IIA Exposure Document on the Three Lines of Defense by the Public Expenditure Management Peer-Assisted Learning Network¹

1. This letter contains comments on the IIA Exposure document on the three lines of defense developed by the **Internal Audit Community of Practice** of the Public Expenditure Management Peer-Assisted Learning (PEMPAL) network².
2. Since 2006, PEMPAL has been facilitating the exchange of professional experience and knowledge transfer among public finance management practitioners across the Europe and Central Asia countries. With multilateral support from the World Bank and other donors, the network aims to contribute to strengthening public finance management practices in member countries through disseminating information on good practices and their application. Three communities of practice, for budgeting, treasury, and internal audit bring together practitioners at the most senior levels in these specific fields of public finance (typically up to the level of deputy minister).
3. The PEMPAL Internal Audit Community of Practice met by videoconference on 9 September 2019 to discuss the IIA exposure document, reflecting the importance PEMPAL attaches to use of the three lines of defense model in the

¹ For more information on PEMPAL see www.pempal.org

² The members of the PEMPAL Internal Audit Community of Practice represent the following 23 countries: *Albania, Armenia, Azerbaijan, Belarus, Bosnia & Herzegovina, Bulgaria, Croatia, Czech Republic, Georgia, Hungary, Kazakhstan, Kosovo, Kyrgyz Republic, North Macedonia, Moldova, Montenegro, Romania, Russian Federation, Serbia, Tajikistan, Turkey, Ukraine, and Uzbekistan*, for more information see www.pempal.org/event/internal-audit

development of public sector internal audit in its member countries. Participants agreed that each member of PEMPAL's internal audit community should be encouraged to complete the on-line survey questionnaire, and that these individual responses should be supplemented by a formal letter to the IIA summarizing the main (broader) issues identified.

4. This letter focuses on five issues:
 - overall views on the new model;
 - the need for more refined public sector context;
 - the impact of the maturity of public sector institutions on the use of the three lines of defense;
 - the need for rigorous safeguards of the independence of internal audit;
 - the impact on small organizations.

(a) PEMPAL has a positive view of the new model

5. There is widespread support in PEMPAL for the three lines of defense model as presented by the IIA in 2013. Members noted that the idea of using the concept of three lines of defense as a way of explaining how organizations identify and manage risk has been in general use since the mid 1990s. Indeed, the model is an example of a clever idea being quickly adopted and used by many risk management and audit practitioners such that the origins of the concept are unknown.
6. The 2013 IIA model has been used in PEMPAL countries by both audit practitioners and those responsible for developing internal audit at a national level (known as Central Harmonization Units or CHUs) to promote the need for, and benefits of, independent internal audit units at the third line as part of the development of more effective systems of public expenditure management. The model has also helped to promote the important message in PEMPAL member countries that public sector managers and staff have a clear role to play at the first and second lines of defense.
7. However, PEMPAL members also recognize that the three lines of defense is a broad presentation of how organizations operate that needs to be interpreted as public sector entities evolve and mature. PEMPAL therefore welcomes the shift outlined in the exposure draft to promote the broader added value role of internal audit: indeed "blurring the lines" represents the reality in many PEMPAL countries where internal audit are asked to support management in many different ways.
8. While the proposed changes to the model are welcomed by PEMPAL, there are also some concerns about how this will be interpreted in less mature public sector entities.

(b) The need for more refined context for the application of the model in the public sector

9. PEMPAL welcomes the inclusion of a public sector dimension in the exposure draft. The concept of the three lines of defense can and should be applied in the public sector. There are though some aspects of this public sector application that need clarification.

(i) Governing bodies

10. PEMPAL notes that the definition in the paper of “*organization*” is broad and includes “*central government bodies*”. The definition of “*governing body*” also promotes various forms of governance arrangements such as “*multi-tier boards, councils, and similar organs*”. However, only in the most advanced public sector entities (for example, the United Kingdom and the Netherlands) is there the equivalent of a board which provides some degree of leadership and also carries out oversight of management actions. Many advanced public sector entities have also established audit committees which provide a pivotal role in promoting and ensuring the independence of internal audit.
11. However, for the majority of public sector entities (i.e. those countries like PEMPAL members which are developing or in transition), the role of leadership and oversight is unlikely to be assigned to a single governing body. Moreover, very few PEMPAL countries have succeeded in establishing audit committees. Leadership (in terms of establishing the strategy and objectives of the organization) is typically a political process led by Government ministers. Oversight (where it exists) is likely to be provided either through Parliament (e.g. by committees to examine the actions of ministers) or through a suitably empowered member of the Government (for example, oversight of budgetary implementation by the Minister of Finance or oversight of policy implementation by the Prime Minister’s Office).
12. To make the three lines of defense relevant to the public sector there is a need for the IIA to recognize the lack of a direct analogy to private sector governing bodies.

(ii) Central harmonization

13. There is no mention in the exposure draft of the role of the central harmonization function that exists for public sector internal audit in both developed and developing countries. Most counties have established some form of central function with a responsibility to develop policies and practices for internal audit or for overseeing in general the effectiveness of internal audit by coordinating its development.
14. These CHUs are important regulators for internal audit in the public sector and they will have a critical role in promoting the more refined implementation of the three lines of defense model. Typically, it is these units that are promoting

the adoption of IIA standards and also encouraging the creation of audit committees in developing and transitional countries to provide support for the role of internal audit. PEMPAL believes that this function should be recognized in the model as an additional “other body” in Section C.1.5.

(iii) The role of supreme audit institutions

15. The exposure draft correctly recognizes the role of Supreme Audit Institutions (SAIs) as the External Audit in the public sector. However, the majority of SAIs are independent of the government bodies that they audit. They either report directly to Parliament or have an independent legal status established in the Constitution. Consequently, it may not be possible for a governing body. “to provide oversight of the work of ... SAIs and receive reports” as stated in the draft.
16. PEMPAL endorses the sentiments of the statement “It is important to ensure that the planning of external audit and SAIs is coordinated with that of internal audit to allow for mutually beneficial sharing and integration.” However, this raises the question who would ensure that this happens. In the private sector the role could be undertaken by the Board. For the public sector this is not possible as this would impinge on the independence of the SAI.
17. A different formulation is needed in the paper that encourages closer working between SAIs and Internal Auditors while also noting and respecting the legal independence of the SAI.
18. In most PEMPAL countries the SAI can have a key role in reinforcing the independence of internal audit, mainly by reporting on the effectiveness of the work of internal audit in promoting strong systems of internal control.

(c) The impact of the maturity of public sector organizations

19. The public sector administrations of PEMPAL member countries have different levels of maturity. Most PEMPAL countries have been transitioning from a financial management and control system based on strong ex-ante controls by the Ministry of Finance to one which relies more heavily on clear lines of responsibility/accountability in Ministries for financial control by first and second line managers and ex-post control/assurance by internal audit.
20. In most PEMPAL countries, internal audit in the public sector is a relatively new function, often developed in response to external (donor and European Union) demands for better financial management and driven forward by newly created CHUs. The basic problem in less mature countries is that the three lines of defense have yet to be clearly established and the concept of a fully independent internal audit has yet to be fully accepted.
21. In this context, the 2013 three lines of defense model has been very useful for CHUs in reinforcing the independence of internal audit and its role of providing third line assurance, rather than undertaking first and second line activities. There is therefore major concern that the evolution towards blurring the lines

will increase the pressure on internal audit units to carry out compliance and risk management activities that should be undertaken predominantly by management. By way of example, many CHUs have declared that internal audit units cannot carry out compliance or risk management functions mainly to protect these units from dilution of independence. Guidance from the IIA that this is now possible and/or encouraged could be problematic in ensuring independence.

22. In PEMPAL countries it is therefore critical that there are adequate safeguards to reinforce and/or protect the independence of internal audit in the public sector (see section (d) below). It is also important that these are made clear and explicit where possible.

(d) The need for rigorous safeguards of the independence of internal audit

23. PEMPAL agrees that “‘blurring’ when it involves the internal audit function demands special attention”. However, the main solution suggested in the draft is that this should be addressed through consultation between the Chief Audit Executive and the Governing Body so that appropriate safeguards can be put in place. For the reasons noted in (b)(i) above, most public sector organizations do not have the type of governance arrangements that make this singular approach feasible.
24. For PEMPAL countries it would be extremely helpful for the IIA to provide more specific guidance and possibly examples of ways to ensure adequate safeguards. One issue worth considering is whether the IIA should provide specific guidance on the proportion of non-assurance activities that would prima facie have a major impact on the independence of internal audit. For example, that an internal audit unit should be seriously concerned about the impact on its independence of spending a material amount of time (i.e. more than 25 per cent) on non-assurance activities.

(e) Small organizations

25. PEMPAL supports IIA comments that smaller organizations may choose to adopt a form of the model with more blending (or integration) of governance roles and activities particularly as regards the first and second lines of defense. However small organizations may also have very small internal audit units, e.g. one person. In this case the impact of blurring the lines on independence could be significantly greater than it would be for a larger internal audit unit. Greater care is therefore needed to ensure that where internal audit exists in a small organization its independence is satisfactorily safeguarded.
26. PEMPAL is grateful for the opportunity to contribute to the debate on the evolution of the three lines of defense model. Please feel free to contact me (edit.nemeth@pm.gov.hu) or Kristina Zaituna of the PEMPAL secretariat

(kzaituna@worldbank.org) should you have any questions about the issues raised in this letter.

Sincerely,

A handwritten signature in blue ink that reads "Nemeth Edit." The signature is written in a cursive, flowing style.

Edit Nemeth

*Chair of the Executive Committee
Internal Audit Community of Practice
Public Expenditure Peer Assisted Learning (pempal.org)*