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Combined Assurance vs. Three Lines of Defense – an Empirical Comparison

Extended Abstract

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Abstract

Due to the high governance requirements for the early detection of risks, the organization of the individual functions is gaining in importance. The Three Lines of Defense approach separates the functions into three lines and thus creates the corresponding organizational structure. The newer approach Combined Assurance aims at a smooth flow and interfaces between the functions. In practice, however, the concepts are little known. This empirical survey by the Aalen Management Institute (AAUF) examines the structure of the monitoring units and the implementation status of the two approaches on the basis of 141 companies.

1 Introduction

The entry into force of the German Act on Corporate Control and Transparency (KonTraG) in 1998 already brought about a major step toward an improved governance structure (Fiege, 2006, p. 2). Since then, the amendments have made it mandatory for stock corporations to have a risk management system, which in Section 91 (2) of the German Stock Corporation Act (AktG) provides for the introduction of a monitoring system for the early detection of risks by the management board. Here, there are two significant approaches that show the arrangement of governance functions: Three Lines of Defense and Combined Assurance.

The Three Lines of Defense model is understood as the structural organization of governance. It is used to identify structures and processes to achieve corporate goals and strengthen individual functions (DIIR, 2020, p. 7; IIA, 2020, p. 1). While the first line comprises operational management as a control unit, the second line stands for internal monitoring units such as risk management or compliance management. The third line, on the other hand, includes Internal Audit, which is responsible for external, process-independent monitoring.

In order to avoid duplication of work between the lines, a further development of the approach, the Combined Assurance, was developed. The approach stands for the harmonization of the individual functions, so that the concept offers a suitable process organization to the Three Lines of Defense model (DIIR, 2020, p. 7). In this way, synergies can be generated by reducing the use of resources, which in the long term create performance increases and thus improve the quality of corporate management (Eulerich, 2016, p. 194ff.). Despite the potential of combined assurance, the approach is still rarely implemented in practice (DIIR, 2020, p. 3ff.).

Against the background of the importance of early risk identification and thus a functioning and efficient governance system, the Aalen Management Institute (AAUF) investigates the use and organization of monitoring units, the actual awareness of the two approaches as well as their challenges and opportunities for companies in this study.

2 Three Lines of Defense and Combined Assurance

2.1 Three Lines of Defense

In an effective monitoring system of a company, controlling should be integrated. The organization of a monitoring system could be modeled on the Three Lines of Defense to position and structure the individual governance functions accordingly. According to the Institute of Internal Auditors (IIA) position paper (2013), the TLoD provides a simple and effective way to improve communication about risk management and control by clarifying essential roles and responsibilities (Bantleon et al., 2021, pp. 59-74). The first "line of defense" is formed by the individual departments and operational management, which is responsible for ensuring that risks are identified, assessed, controlled, and reduced accordingly in day-to-day operations. The second "line of defense" can be considered an extension of the first line, as this line serves to monitor the risk management functions of the first "line of defense." This includes risk management, controlling and compliance functions. The third "line of defense" is represented by the internal audit function as an objective and independent auditing and advisory body (Dennery et al., 2010, p. 6 ff.). With the help of the various lines of defense, information symmetries between principles and agents can be reduced across the various hierarchical levels and risks can be minimized through discretionary decisions by the agents (Bantleon et al., 2021, pp. 59-74).

2.2 Combined Assurance

A functioning governance structure requires a high level of coordination and communication in order to manage individual functions in a targeted manner and successfully minimize risks. The implementation of a holistic approach such as combined assurance is suitable for this purpose (Eulerich, 2016; DIIR, 2020, p. 9). In the course of a professional governance structure, it is recommended that the combined assurance executives align their activities with internal and external governance stakeholders (Bantleon et al., 2021, pp. 59-74). Combined assurance

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is understood as a coordinated and integrated cooperation of all governance functions that have a direct or indirect risk reference and contribute to the optimization of the governance structure (Eulerich, 2016; DIIR, 2020, p. 9). This is consistent with coordination theory, which states that overlapping tasks require coordination mechanisms to reach agreements that are acceptable to all concerned (Crowston, 1997, pp. 157 f.). Finally, empirical research has shown that combined assurance in this way allows duplication of effort to be avoided, internal audit to be strengthened, and differences in risk mitigation to be minimized (Azzali & Mazza, 2018, p. 97).

3 Survey

Data collection was carried out with the aid of a standardized online questionnaire containing open and closed questions. To check the questionnaire, a pre-test was first conducted with several subjects. Subsequently, the actual survey was conducted in the period from February 10, 2021 to March 2, 2021. For this purpose, e-mail addresses of German companies were randomly generated in advance using the Nexis database.

A total of 8,688 companies were contacted by e-mail, whereby 1,269 e-mails could not be delivered. Thus, 7,419 companies received the link to the online survey. The online questionnaire was accessed 141 times during the survey period, corresponding to a participation rate of 1.9 percent. 85 abandoned the survey prematurely, with 56 answering all the questions posed. The descriptive data was first analyzed using Microsoft Excel. Subsequent statistical analyses will be carried out using SPSS, Stata, and R.

4 Results

4.1 Sample Description

In terms of the form of the company, 80 percent of the companies are sole proprietorships and 20 percent are subsidiaries or parent companies within a group. 68 percent of the companies have the legal form of a GmbH, with only 2 percent being formed as an AG. The majority of companies (63 percent) were founded between 1990 and 2010. The number of employees is less than 50 for 72 percent and 50-249 for 16 percent. More than one-third of the companies operate in the service sector, 14 percent in healthcare and 9 percent in industry. Finally, in 39 percent of the companies, the management consists solely of the family, while 21 percent are externally organized. In 39 percent, the management is mixed.

4.2 First Empirical Results

First, the respondents were asked to what extent the three corporate bodies - the Executive Board/Management, the Annual General Meeting and the Supervisory Board/Advisory Board - are involved in the work of the monitoring units. The results show that it is primarily the Board of Management and the Executive Board that are involved in decision-making (58 percent decision). More than half of the respondents (61 percent) do not attribute any role to the annual general meeting in the work with monitoring units. For 39 percent, the supervisory board or advisory board plays no role, and for 32 percent it is primarily a listening and informative role.

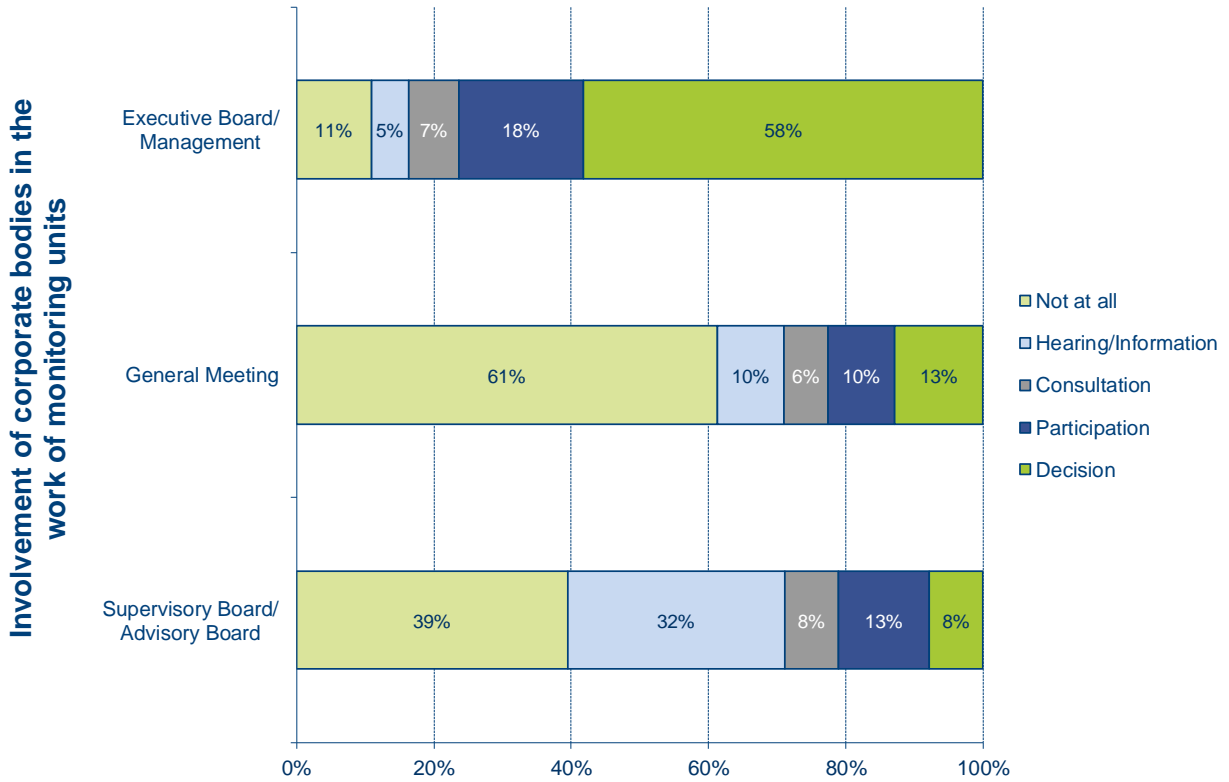


Figure 1: Involvement of corporate bodies in the work of monitoring units

The next two questions were designed to find out whether the Three Lines of Defense and Combined Assurance approaches are known in practice.

The Three Lines of Defense approach is known to 19 percent of the respondents.

Awareness of the Three Lines of Defense Approach [N=141]

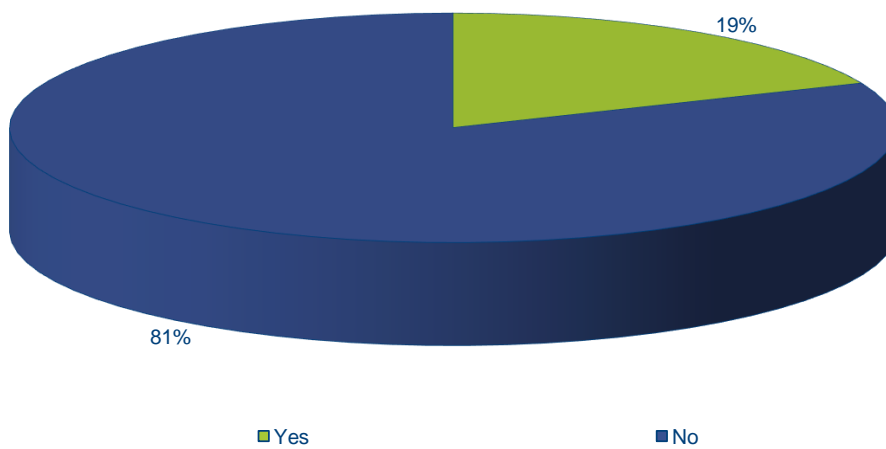


Figure 2: Awareness of the Three Lines of Defense Approach

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10 percent are familiar with the Combined Assurance approach. Consequently, 90 percent are not familiar with the approach.

Awareness of the Combined Assurance Approach [N=141]

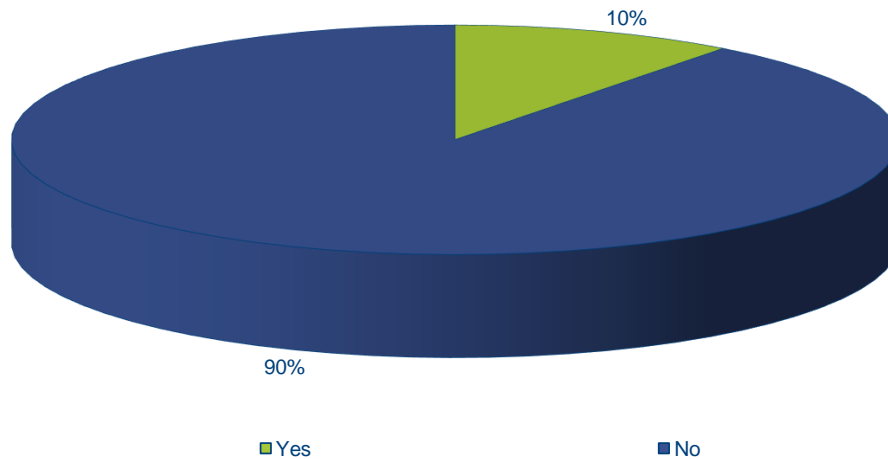


Figure 3: Awareness of the Combined Assurance Approach

5 Discussion

This AAUF study has a sample size of 141, which is very satisfactory and generally indicative of a presence and timeliness of the topic. Nevertheless, both the Three Lines of Defense approach and the Combined Assurance approach are still little known and consequently rarely implemented. However, this should change in the future, especially due to the legal requirements and the personal liability of the shareholders. A functioning governance structure ultimately enables companies to minimize risks. In the course of further evaluations of the results, it should be found out where exactly the hurdles lie for companies to apply the approaches. In this way, recommendations for action and assistance for practice can be derived.

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