

4 Implementing Corporate Governance with the “Lines of Defense Model”

Introduction

The advanced market economies in the European Union (EU) have been faced with the implementation of corporate governance for more than twenty years by now. But still today it seems that there is some disagreement at least “on how good or bad existing governance mechanisms are”.¹ Corporate governance is widely understood as the system of guidelines, processes and practices by which a company is directed and controlled.² According to the Organisation for Economic Co-operation and Development (OECD) this system “provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined”.³ The governance system implemented by a company has to fulfill obligations by respective national law, which in turn has to transpose requirements forced by the European Union. Therefore, directive 2006/43/EC from 17 May 2006, which is also known as “EuroSox” according to the US-American legislation (SOX, the Sarbanes-Oxley-Act of 2002), can be regarded as

¹ On that point Shleifer/Vichny remark “a great deal of disagreement” as a result of their survey 17 years ago, see A. Shleifer, R.W. Vishny, *A Survey of Corporate Governance*, “The Journal of Finance” 1997, Vol. 52, No. 2, p. 737.

² According to the basic definition given in the Cadbury Report, see *Report of the Committee on the Financial Aspects of Corporate Governance*, The Committee on the Financial Aspects of Corporate Governance 1992, No. 2.5, www.ecgi.org/codes/documents/cadbury.pdf (accessed 27.06.2015).

³ *OECD Principles of Corporate Governance*, Organisation for Economic Co-operation and Development (OECD), Paris 2004, www.oecd.org/daf/ca/corporateregovernanceprinciples/31557724.pdf (accessed 27.06.2015).

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good example. In Poland the harmonization with polish law was achieved with the Act of 7 May 2009 on Statutory Auditors, their Self-Governing Organisation, Entities Authorised to Audit Financial Statements and on Public Oversight. In Germany the directive was transposed with the Bilanzrechtsmodernisierungsgesetz (BilMoG) of 25 May 2009. In addition to legislation many countries are trying to regulate governance systems within companies by so called corporate governance codes.⁴ The aim of these codes is to make capital markets attractive to investors and issuers and to strengthen shareholders' rights,⁵ as well as to enhance the transparency and comprehensibility of corporate governance systems and to increase the confidence of stakeholders in the management and supervision of especially market-listed companies.⁶

In order to meet the company's objectives, the various stakeholders – especially senior management, supervisory board, shareholders and other stakeholders, like internal monitoring functions as well as external bodies – have to collaborate within a structured and controlled environment. This broader stakeholder perspective can be marked as a major shift in the concept of corporate governance. Due to best-known business failures like Worldcom and Enron around the turn of the millennium, an “effective corporate governance system should provide mechanisms for regulating directors' duties in order to restrain them from abusing their powers and to ensure that they act in the best interests of the company

⁴ For an index of corporate governance codes from countries all over the world see *Corporate Governance Codes, Principles & Recommendations*, European Corporate Governance Institute (ECGI), www.ecgi.org/codes/all_codes.php (accessed 27.06.2015).

⁵ See *Code of Best Practice for WSE Listed Companies*, Warsaw Stock Exchange Supervisory Board, Appendix to Resolution No. 19/1307/2012 of the Exchange Supervisory Board dated 21 November 2012, p. 1, www.ecgi.org/codes/documents/best_practice_wse_poland_nov2012_en.pdf (accessed 27.06.2015).

⁶ See *German Corporate Governance Code*, as amended on May 5, 2015 with decisions from the plenary meeting of May 5, 2015, Regierungskommission Deutscher Corporate Governance Kodex, p. 1, www.dcgk.de/files/dcgk/usercontent/en/download/code/2015-05-05_Corporate_Governance_Code_EN.pdf (accessed 27.06.2015).

in its broad sense”⁷ This focus on the directors` position is nowadays replaced by the question on how collaboration between the different stakeholders has to be organized in an effective and efficient manner.

1. Motivation and aim of the study

Professional-run companies today have to tackle major governance challenges, notably related to reliability and accuracy of financial reporting, fraud prevention, compliance with laws and regulations, and monitoring of business processes. For this reason, many big and medium-sized companies implemented several management systems like risk management systems, financial controlling systems, quality assurance systems, internal control systems, and compliance management systems. All these systems are run by respective functions for managing, monitoring, controlling, supervising or auditing purposes. The question is how these functions have to collaborate in order to integrate the various systems for running them effectively and efficiently. As a blueprint for this collaboration a new governance model arose in the last years, which was becoming increasingly widespread in practice and literature, the “lines of defense model” (LOD model).

The aim of this paper is to demonstrate the key role the LOD model can play in implementing a corporate governance system, which addresses legal and regulatory as well as business and professional management requirements. It should be worked out, that today an integrated approach is needed. Whereas a system-approach is found in almost all of the above mentioned management areas, the functional integration still remains an open point. So the following discussion is a contribution to this issue, focusing on the Polish and the German corporate governance environment.

⁷ S. Sheikh, S.K. Chatterjee, *Perspectives on Corporate Governance*, in: *Corporate Governance & Corporate Control*, eds. S. Sheikh, W. Rees, Cavendish Publishing, London 1995, p. 5.

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2. Methodology

With reference to scientific classification this study fits into the stakeholder concept as part of the strategic management of organizations. This concept follows the basic idea, that with the emergence of additional “groups and individuals that can affect, or are affected by, the accomplishment of organizational purpose”⁸ a major strategic shift has occurred in the last years. As each “of these groups plays a vital role in the success of the business enterprise in today’s environment”⁹, a special stakeholder management is needed. As shown in Figure 1, in such a stakeholder view the board of directors is acting as a strong connector between the supervisory board, shareholders and other financial stakeholders on the one hand side and the internal stakeholders, like management and employees, and other external stakeholders, like suppliers, customers, auditors, and regulators, on the other hand side.

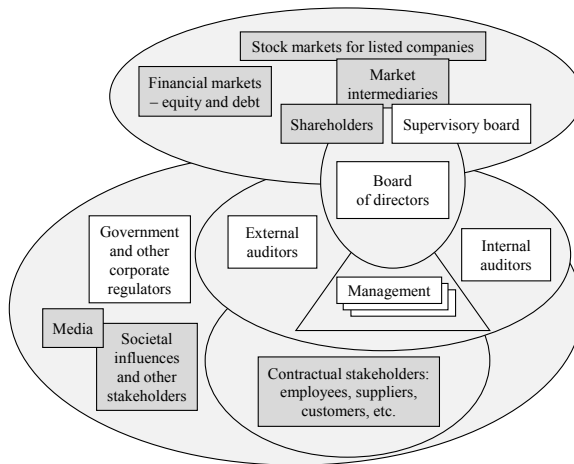


Figure 1. Scope of stakeholders

Source: Adapted from B. Trikker: *Corporate Governance – Principles, Policies, and Practices*, 3rd. ed., University Press, Oxford, 2015, p. 33.

⁸ R.E. Freeman, *Strategic Management: A Stakeholder Approach*, University Press, Cambridge et al. 2010, p. 25.

⁹ *Ibidem*.

The white boxes shown in Figure 1 are subject of this article. The LOD model will be applied for these stakeholders, whereas the management boxes will be differentiated into the various supporting and controlling functions, like risk management, security and compliance. As the aim of the article is to relate the LOD model to the selected stakeholders as main players of the corporate governance system, the following discussion is based on a literature review, empirical data of research institutions and regulations concerning corporate governance. Results from this discussion will affect the current discussion about the corporate governance system in companies as well as the further refinement of the respective management systems. In the end the article should support the development towards a strategy how companies should deal with various interests of main stakeholders as well as with pressure from regulation and public opinion for more effective und efficient governance systems.

3. The Lines of Defense Model

The LOD Model in its current discussed form goes back to a position paper of The Institute of Internal Auditors (IIA) from 2013.¹⁰ The starting point for the IIA is the fact, that in nowadays companies “diverse teams of internal auditors, enterprise risk management specialists, compliance officers, internal control specialists, quality inspectors, fraud investigators, and other risk and control professionals”¹¹ have to collaborate to manage risk and control. But the challenge here is “to assign specific roles and to coordinate effectively and efficiently among these groups

¹⁰ Although the term “Three lines of defense” was used by auditors long years before. The graphic model goes back to the design presented in the paper *Guidance on the 8th EU Company Law Directive – article 41*, FERMA (Federation of European Risk Management Associations) and ECIIA (European Confederation of Institutes of Internal Auditing), Brussels 2010, p. 8f, www.ferma.eu/app/uploads/2011/09/eciia-ferma-guidance-on-the-8th-eu-company-law-directive.pdf (accessed 27.06.2015).

¹¹ *The Three Lines of Defense in Effective Risk Management and Control*, The Institute of Internal Auditors (IIA), position paper, 2013, p. 1, <https://na.theiia.org/standards-guidance/Public%20Documents/PP%20The%20Three%20Lines%20of%20Defense%20in%20Effective%20Risk%20Management%20and%20Control.pdf> (accessed 27.06.2015).

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so that there are neither ‘gaps’ in controls nor unnecessary duplications of coverage”.¹² Especially this challenge of cohesion and coordination is addressed by the LOD model. Figure 2 indicates its basic outline.

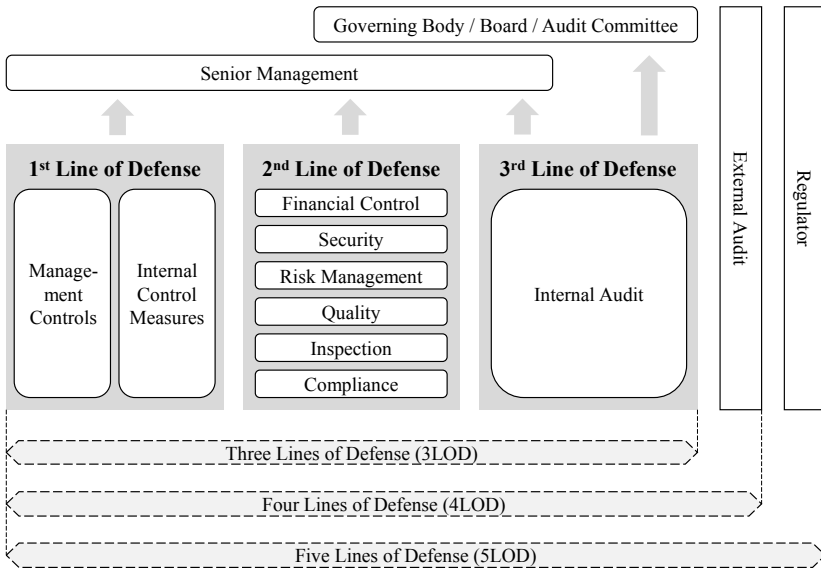


Figure 2. The LOD Model

Source: Adapted from *The Three Lines...*, p. 2.

The core model is formed by three lines of defense (3LOD):

1. The first line of defense is built up by functions that own and manage risks. These are the operational managers and their staff, who manage risks on a day-to-day basis according to guiding policies, procedures, standards, and defined processes.¹³ “Through a cascading responsibility structure, mid-level managers design and implement detailed procedures that serve as controls and supervise execution of those procedures by

¹² *Ibidem*.

¹³ See J.C. Paterson, *Lean Auditing – Driving Added Value and Efficiency in Internal Audit*, John Wiley & Sons, Chichester 2015, p. 60.

their employees.”¹⁴ The importance of the role of management is due to the fact, that today’s internal control systems are based on controls, which are integrated into the operational processes and systems. Especially with reference to information technology (IT) systems the operational management has to take the responsibility “to ensure compliance and to highlight control breakdown, inadequate processes, and unexpected events.”¹⁵

2. The second line of defense consists of specialized functions, like financial control, security, risk management, etc. These functions “should help to create the policies, processes and standards that inform management and staff as to what is expected and should be available to support them”.¹⁶ Although tasks and responsibilities of the various functions are dependent of their basic orientation, like risk, compliance, quality, security etc., they can be summarized as shown in Table 1.

Table 1
Responsibilities of 2nd LOD functions

No.	Responsibility
1	2
1	Supporting management policies, defining roles and responsibilities, and setting goals for implementation
2	Providing risk management frameworks
3	Identifying known and emerging issues
4	Identifying shifts in the organization’s implicit risk appetite
5	Assisting management in developing processes and controls to manage risks and issues
6	Providing guidance and training on risk management processes
7	Facilitating and monitoring implementation of effective risk management practices by operational management
8	Alerting operational management to emerging issues and changing regulatory and risk scenarios
9	Monitoring the adequacy and effectiveness of internal control, accuracy and completeness of reporting, compliance with laws and regulations, and timely remediation of deficiencies

Source: *The Three Lines...*, p. 4f.

¹⁴ *The Three Lines...*, p. 3.

¹⁵ *Ibidem.*

¹⁶ J.C. Paterson, *op.cit.*, p. 60.

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From an organisational point of view, the 2nd LOD functions have only some degree of independence from the first line of defense, as they may have to modify and develop internal control and risk management systems. “Therefore, the second line of defense serves a vital purpose but cannot offer truly independent analyses to governing bodies regarding risk management and internal controls.”¹⁷

3. The internal audit function serves as the third line of defense as it provides “assurance to the organisation’s board and senior management, on how effectively the organisation assesses and manages its risks, including the manner in which the first and second lines of defence operate”.¹⁸ This assurance is reported to senior management as well as to governing bodies, the supervisory board in particular.

If external auditing is also understood as an additional line of defense, it comes to a model with four lines of defense (4LOD). The main responsibility of external audit is to provide an independent assurance over the accuracy of the company’s financial statements. In regulated industries, like banking, insurance, and energy-sector, also corporate regulators play an important role in oversight and monitoring. If these external bodies are also taken into account it comes to a model with five lines of defense (5LOD) in total.

With the LOD model described, corporate governance has a powerful concept at hand, which helps to structure the different managing, monitoring, controlling, supervising, and auditing processes as well as responsibilities of all stakeholders and the necessary collaboration between them.

4. Comparative analysis – The LOD Model as an instrument for corporate governance

For design of the corporate governance system in German companies three basic rules are of fundamental importance, the Aktiengesetz (Stock Corporation Act, abbr. AktG), the Handelsgesetzbuch (Commercial

¹⁷ *The Three Lines...*, p. 3.

¹⁸ *Guidance on...*, p. 10.

Code, abbr. HGB) and the already mentioned German Corporate Governance Code. The latter contains rules, which are also part of laws, especially the Aktiengesetz, but also recommendations and suggestions for good and responsible corporate governance. Through the declaration of conformity pursuant to para. 161 AktG, the code has a legal basis. Deviations from the recommendations have to be explained in the declaration of conformity as part of the annual financial report.¹⁹ The Stock Corporation Act is binding only for joint-stock companies of course, but in practice its legal regulations for management and supervision influence also other types of companies, especially limited liability companies.

The German Stock Corporation Act follows a two-tier board system with a management board and a supervisory board. According to para. 107 sec. 3 sent. 2 AktG the supervisory board has the right to authorise an audit committee. This committee is concerned with issues of financial control, the internal control system, the risk management system, the internal audit system, and the statutory external annual auditor.²⁰ In addition under para. 91 sec. 2 AktG the management board has to take measures for the early identification of developments that endanger the continual existence of the company. As one of such measures the German Stock Corporation Act calls for the establishment of a monitoring system. All these legal requirements can be seen as a governance toolbox, which – from the legislators point of view – has to be applied by the senior management and governing bodies of a company. Especially the intensification of compulsory control by the supervisory board was a result of the national transmission of directive 2006/43/EC.²¹ This legislation gave clearly more power to supervisory boards. But this gain of power also led to a higher extent of responsibility and accountability, resulting in an increase in liability claims against supervisory board members of German joint-stock companies.²²

¹⁹ See *German Corporate...*, p. 2.

²⁰ The year-end audit by an external auditor is stated in para. 316 HGB.

²¹ See introduction.

²² Fissenewert gave an estimation of 500 supervisory board members subject to court proceedings, see P. Fissenewert, *Monitoring obligations and liability risks of*

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The German Corporate Governance Code also “contains material statutory regulations concerning the management and monitoring of listed German companies as well as internationally and nationally accepted standards of good and responsible corporate governance.”²³ As said before, the Code partly recapitulates rules from the Stock Corporation Act.²⁴ What is added by the Code is the compliance issue. As part of its tasks and responsibilities the „management board ensures that all provisions of law and the enterprise’s internal policies are abided by and works to achieve their compliance by group companies”.²⁵

The situation in Poland is basically similar to Germany. This is not really surprising as the present Polish company law is historically influenced by the German law as well as currently by the law of the European Union.²⁶ The Polish counterpart of the German Stock Corporation Act is “The Code of Commercial Partnerships and Companies”. Under this directive the Polish joint-stock companies are also structured according to the two-tier board system with separated management and supervisory boards. The latter has to supervise the company’s operations, especially the management board’s report and its financial statements. The financial statements in turn have to be approved by a statutory auditor according to the Polish Accounting Act. A further important legislation for Corporate Governance in Poland is the “Act on Certified Auditors, their Self-government, and Entities Authorized to Audit Financial Statements and Public Oversight” of 2009. Herein the establishment of an audit committee is formally requested. The mandatory responsibilities of the audit committee extend to monitor the financial reporting process,

supervisory boards during a corporate crisis, “Insolvency and Restructuring International” 2014, No. 1, Vol 8, p. 9.

²³ *Ibidem*.

²⁴ This is true for risk management and the annual audit.

²⁵ *German Corporate...*, No. 4.1.3, p. 6.

²⁶ More on the development of Polish business law in K. Oplustil, A. Radwan: *Comparative View on Company Law in Poland: Between Autonomous Development and Legal Transplants*, Working Paper Instytutu Allerhanda No. 2, Kraków 2010, www.allerhand.pl/images/allerhand/pdf/wp/WP%201A%202_2010%20Oplustil%20Radwan.pdf (accessed 27.06.2015).

the efficiency of internal control systems, internal audit and risk management, and the performance of audit activities.²⁷

For the corporate governance of stock-listed companies also the “Polish Code of Best Practice for WSE Listed Companies” plays a central role. This code was published by the Warsaw Stock Exchange (WSE). The current version is of 2012. It “aims at enhancing transparency of listed companies, improving quality of communication between companies and investors, and strengthening protection of shareholders’ rights”.²⁸ Herein the evaluation of the internal control system as well as the risk management system by the supervisory board is regarded as a best practice.²⁹

From a broader perspective there are many similarities concerning the fulfilment of legal and regulatory requirements for corporate governance, especially of Polish and German stock-listed companies. With reference to the LOD model, Table 2 shows the main elements of a corporate governance system addressed by cited laws and corporate governance codes.

Taken all together, in both countries laws and the respective corporate governance code cover all or nearly all main elements of a corporate governance system. Only compliance as an issue and management system is not addressed by the considered Polish law and code. For the side of the law the assessment for both countries is the same – what is not surprising given the necessity to transpose EU law into national law. So it is interesting to analyse the differences for the both corporate governance codes. The German code covers all the relevant elements, whereas the Polish code lacks many issues, especially the audit committee, auditing stakeholders, and internal audit. A main difference between the Polish and the German situation is tied to the implementation of audit committees. According to empirical studies all German stock-listed companies of the German stock index DAX30 had established an audit

²⁷ See Art 86 sec. 7 Act on Certified Auditors, their Self-government, and Entities Authorized to Audit Financial Statements and Public Oversight of May 7, 2009.

²⁸ *Code of Best Practice...*, p. 2.

²⁹ *Ibidem*, III. 1, p. 8.

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Table 2
Comparison of corporate governance addressed
by German and Polish law/governance code

No.	Element of corporate governance system	Addressed by			
		German		Polish	
		law	code	law	code
1	Supervisory board	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
2	Management board	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
3	Audit committee	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	
4	External auditor	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	
5	Internal control system	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
6	Financial control	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	
7	Risk management	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>
8	Compliance management		<input checked="" type="checkbox"/>		
9	Internal audit	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	<input checked="" type="checkbox"/>	

Source: own illustration.

committee in 2011. For companies listed in the MDAX index the figure is 78%.³⁰ At the same period, less than 50% of Polish WSE listed companies had established audit committees.³¹ This relative lower degree of realisation may result from the historical dominant ownership structure in Polish companies, where the majority owners have “full influence over the composition of the supervisory board control”.³² Regarding the effectiveness of audit committees the European Bank for Reconstruction and Development (EBRD) comes to the conclusion that “many audit

³⁰ See M. Steller, *Der Prüfungsausschuss des Aufsichtsrats – Eine empirische Untersuchung bei deutschen und österreichischen Aktiengesellschaften*, Gabler, Wiesbaden 2011, p. 9. As the MDAX (Mid-Cap-DAX) is the German index for mid-size companies, this index is better suited for a comparison with the WSE listed Polish companies.

³¹ See P. Szczepankowski, *Audit Committee Practice in the Polish Listed Stock Companies. Present Situation and Development Perspectives*, „Business, Management and Education” 2012, Vol. 10 (1), p. 57, www.bme.vgtu.lt/index.php/bme/article/download/bme.2012.05/pdf (accessed 27.06.2015).

³² M. Aluchna, *Corporate Governance: Polish Lessons from the Global Financial Crisis*, in: *Corporate Governance: An International Perspective*, eds. S.O. Ido-wu, K.T. Caliyurt, Springer, Heidelberg et al. 2014, p. 64.

committees do not seem to be independent in practice and do not have the necessary expertise to perform their duties”.³³ Nevertheless the ERBD stated „significant progress in introducing and enhancing its corporate governance framework”³⁴ for Poland.

Conclusion

The objective of this article was to discuss the adequacy of the LOD model for implementing a corporate governance system according to business laws and corporate governance codes. As shown, all corporate governance elements prescribed by German as well as by Polish laws and governance codes are covered by the LOD model. Contrary not all elements of the LOD model are addressed in a single law or code, especially for the Polish regulations, where the governance code lacks some of the important elements of the LOD model. From this perspective, the LOD model has the potential to serve as a mover and an integration mechanism, combining all elements of a corporate governance system in an effective and efficient manner.

Using the LOD model for corporate monitoring and control must not mean the implementation of all management aspects, like risk, compliance etc., as separate organizational functions. An internal control system for example is not run by one single function but is a system, which has to be designed, implemented and monitored in a collaborative way by the various stakeholders of the first, second and third line of defense. In the same way financial control is exercised by different stakeholders, like management, auditors or the accounting department. The main strength of the LOD model is to demonstrate these interrelationships and to offer a basis for structuring tasks and responsibilities. From this perspective the LOD model can be perceived as an approach towards a functional implementation of a corporate governance system. The assignment

³³ *Commercial laws of Poland – An assessment by the EBRD*, European Bank for Reconstruction and Development (EBRD), February 2014, p. 18, www.ebrd.com/downloads/sector/legal/poland.pdf (accessed 27.06.2015).

³⁴ *Ibidem*.

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of roles, tasks, and responsibilities to positions and functions may differ from company to company. But all three lines of defense should exist, regardless of size and complexity, in some kind for every organization to prevent irregularities, frauds, and errors.³⁵

“The functioning of adequate corporate governance (...) contributes to enhanced competitiveness, since a well-managed enterprise guided by the principles of sustainable development is better prepared to pursue a specific strategy and builds public confidence in the marketplace (...) Thus, adequate corporate governance (...) is expected to provide for effective management and actions”.³⁶ So the main motivation for establishing a corporate governance system should not be punishment and fines resulting from non-compliance with laws and regulations, but reputable entrepreneurship and professionalism. The LOD model can play its role to attain this goal.

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³⁵ See *The Three Lines...*, p. 7.

³⁶ M. Lament, *Audit as a Control Mechanism Used by Insurance Companies*, “Insurance Review” 2013, No. 4, p. 105f, www.piu.org.pl/public/upload/ibrowser/WU/WU4_2013/lament.pdf (accessed 27.06.2015).

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